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Regulation

Negotiable Instruments Sample

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Editorial Notes

Throughout these materials, we have chosen particular language, spellings, structures and grammar in order to be consistent and comprehensible for all readers. HOCK study materials are used by candidates from countries throughout the world, and for many, English is a second language. We are aware that our choices may not always adhere to “formal” standards, but our efforts are focused on making the study process easy for all of our candidates. Nonetheless, we continue to welcome your meaningful corrections and ideas for creating better materials.

This material is designed exclusively to assist people in their exam preparation. No information in the material should be construed as authoritative business, accounting or consulting advice. Appropriate professionals should be consulted for such advice and consulting.

Introduction to Negotiable Instruments

A transfer of compensation from one party to another in exchange for goods or services is the basis for most business transactions. In its most basic sense, this transfer is accomplished when Party B sells goods to Party A, and Party A pays cash to Party B in satisfaction of the purchase price of the goods. This type of transaction is easy to effect, assuming that: 1) Party A has sufficient cash available to pay immediately, and 2) Parties A and B (or agents for the parties) are in close geographic proximity to each other and are therefore able to meet to make the exchange.

However, since the above two conditions are often impossible to meet, commercial paper (governed by Article 3 of the UCC) is often used as a substitute for cash money. Through the use of negotiable instruments, a buyer with insufficient cash to pay for goods may obtain the goods on credit and issue a **promissory note** (see definition below) to the seller. This note acts as a legally enforceable promise to pay. Similarly, a buyer who resides in an area other than the seller's geographic region and considers it unsafe or impractical to send cash to the seller, may purchase goods from the seller by issuing a **draft** (usually in the form of a **check**) ordering a third party (usually a bank) to pay funds on behalf of the buyer. In short, a **negotiable instrument is an unconditional promise or order to pay the holder of the instrument a fixed amount of money.**

It should be noted that although negotiable instruments are often used to carry out business transactions, they may also be given as a gift (in a gift no consideration is received in return for the note). Because of this, an exchange of consideration is not required for an instrument to be negotiable.

Example: Ann writes a \$500 check to her nephew and transfers the check to him at his birthday party. Can Ann's check be a negotiable instrument?

Assuming that Ann's check meets all the requirements for negotiability (covered later), then the check is valid and is a negotiable instrument.

Negotiability is the ability of the instrument to be transferred from one party to another – for value or as a gift. This negotiability lies at the heart of the concept of commercial paper. Through negotiability, commercial paper retains its value even though it may pass through the hands of many intermediaries. There are specific requirements that must be met for an instrument to be negotiable. If the instrument does not meet these requirements, the instrument is simply an instrument, and not negotiable.

If the instrument is non-negotiable, then its transfer is simply the assignment of a contract right, and regular contract law governs. Thus, a negotiable instrument is more valuable than non-negotiable instrument to the recipient because they have more rights and a greater degree of certainty regarding collection than under a contract (non-negotiable instrument). That is, non-negotiable instruments are not the equivalents of cash, and the recipients of non-negotiable instruments often are subject to many contractual terms.

Note: A contract is different from a negotiable instrument in the respect that a contract must be given for consideration while a negotiable instrument is assumed to have consideration as part of the transaction.

This means that in order to enforce a contract you must prove that consideration was given, and with a negotiable instrument there is no need to prove the payment of consideration.

Types of Negotiable Instruments

The types of negotiable instruments listed below on this page and the following page are subject to the requirements of Article 3 of the UCC.

Promissory Notes (A “Note”)

A note is a written **promise to pay** money. Notes are different from drafts in that notes are a *promise* to pay. Drafts (covered below) are an *order* to pay.

There are **two parties** involved in a note.

- 1) The **Issuer** (Maker) is the *promisor*. This is the party who is obligated to pay the note.
- 2) The **Payee** is the person to whom the note is owed. The Payee will receive the money paid by the Issuer.

The following are the main types of notes.

- 1) A **Certificate of Deposit** is a bank promissory note. That is, a bank signs a note acknowledging the receipt of money (principal) and promising to repay principal and interest. The bank is not able to accept or decline a CD since it is directly liable for the note itself.
- 2) A **Time Note** is payable at a specific time in the future.
- 3) A **Demand Note** is payable when the Payee presents the note to the Issuer for payment.
- 4) An **Installment Note** is a note for which the principal is payable over time.

Note: All promissory notes include language such as, “I promise to pay . . .” or “the undersigned promises to pay . . .”

Drafts

A draft is a written **order to pay** money. In a draft, one party orders another party to pay money to yet a third party.

There are **three parties** involved in a note:

- 1) The **Drawer** – The drawer writes and signs the note,
- 2) The **Drawee** (usually a bank) – The drawee is ordered by the drawer to pay the Payee, and
- 3) The **Payee** – The payee will receive the money from the drawee.

Note: If the drawer and drawee on the document are the same person, then the holder treats the document as a note. If there is any doubt whether a document is a note or a draft, then the holder of the document can decide what it is.

The main types of drafts are

- Checks,
- Cashier’s checks,
- Trade acceptances,
- Sight drafts, and
- Time drafts.

Types of Drafts

- 1) **Check.** A check is a special form of a draft that is written on a bank and **payable on demand**. The technical definition of “check” requires that the Drawee be a bank.

Example: John wants to purchase a guitar from Bill. John writes a check payable to Bill for the purchase price. In this situation John is the Drawer, John’s bank is the Drawee, and Bill is the Payee.

A check that is made payable to “bearer” is called a **bearer check**. In order to be the holder of a bearer check and able to cash it, a person simply needs to have possession of the check itself.



- 2) **Cashier’s Check.** This is a check that is drawn by a bank on itself. Thus, the bank is both the drawer and the drawee. A **remitter** is a person who purchases a cashier’s check. Cashier’s checks are often required by businesses when they do not have any previous experience with a customer. This is because a cashier’s check is less likely to be defaulted on. Even though the bank has already “accepted” and has primary liability on a cashier’s check, the individual still has a secondary liability on the cashier’s check.

A **certified check** is essentially the same as a cashier’s check.

Example: Ann wants to purchase a guitar from Bill. Bill lives in Los Angeles, and Ann lives in New York City. Bill agrees to accept payment by check, but he has never done business with Ann before, and he requires that Ann send a cashier’s check. Ann goes to her bank, pays the bank a sum of money, and the bank issues a cashier’s check for the purchase price of the guitar and names Bill as the payee.

- 3) **Trade Acceptances.** This occurs when a seller of goods writes a draft ordering the buyer of the goods to pay the seller or some third party at a future time. Thus, the seller generally is both the drawer and payee, and the buyer is the drawee. The drawee/buyer will be obligated (primarily liable) to pay the draft once he has “accepted” it. Acceptance is achieved once the buyer signs in the lower left-hand corner of the instrument.

Trade acceptances are easily distinguished from other types of drafts because words such as “**accepted by**” or “**accepted**” appear in the lower left-hand corner of the instrument.

A **Bank Acceptance** is similar to a trade acceptance, except that the check is drawn on the buyer’s bank, rather than the buyer personally.

- 4) **Sight Drafts and Time Drafts.** A sight draft is payable when it is delivered and a time draft is payable at certain point of time in the future.

Note: Investment Securities (stocks and bonds) and Documents of Title (warehouse receipts and bills of lading) are not negotiable instruments, but they follow many of the same rules used for negotiable instruments. There is an easy way to distinguish between negotiable instruments and documents of title: 1) negotiable instruments give the holder rights to **money** only; 2) documents of title give the holder rights to **goods**.

Question 40: Under the Negotiable Instruments Article of the UCC, which of the following documents would be considered an order to pay?

- I. Draft
- II. Certificate of deposit
- a) I only.
- b) II only.
- c) Both I and II.
- d) Neither I nor II.

(CPA Adapted)

Question 41: A bank issues a negotiable instrument that acknowledges receipt of \$50,000. The instrument also provides that the bank will repay the \$50,000 plus 8% interest per annum to the bearer 90 days from the date of the instrument. The instrument is a:

- a) Certificate of deposit.
- b) Time draft.
- c) Trade or banker's acceptance.
- d) Cashier's check.

(CPA Adapted)

Negotiability versus Negotiation

Negotiability focuses on the form of the instrument. An instrument is either negotiable or it is not negotiable. An instrument is negotiable only if it is in the form prescribed by UCC Article 3. These requirements for negotiability are looked at below in the section "Elements of Negotiability."

Negotiation refers to the transfer of the instrument from one party to another. This is the verb – the transfer from one person to another. A successful negotiation transfers the rights of the instrument and creates a new **holder of the instrument**.

Note: A nonnegotiable instrument (for example, a contract right and a letter of credit) is covered by contract law and is not negotiable. Because it is covered by contract law, a nonnegotiable instrument is **assignable**. The benefits of assignment are fewer than for negotiation.

Elements of Negotiability

In order for an instrument to be negotiable, it must have the following five elements, which are first listed and then discussed in greater detail below:

- 1) It must be **in writing** and **signed by the issuer**,
- 2) It must be for a **sum certain** (a specific or calculable amount of money),
- 3) There must be an **unconditional promise or order to pay**,
- 4) It must be **payable upon demand or at a specific time**, and
- 5) It must be payable either **to order or to bearer**.

1. In Writing and Signed

A negotiable instrument cannot be an oral communication – it must be written. However, there is no requirement that the writing be on a piece of paper (the writing may be on other items).

This requirement for written documentation can be fulfilled in many ways. Documentation can be handwritten, maintained on preprinted forms, or prepared individually. There is a hierarchy of validity regarding these various types of written documentation if there is a mixture and the terms conflict:

- Handwritten documentation is valid over preprinted forms or specifically written documents.
- A specifically written document is valid versus a preprinted document.
- A written word is more valid than a written number.

Additionally, the instrument must be **signed by the maker (in the case of a note), or drawer (in the case of a draft)**, to be considered negotiable. The use of any symbol executed or adopted by a party with a present intention to authenticate a writing is sufficient to meet the definition of “signed.” Thus, a signature can be made manually or by means of a device or a machine, and it can use any name (including a trade or business name) so long as the signatory intends to authenticate the writing. The signature can also be a sign or symbol different from the person’s name.

Note: If two people are signing the documentation for one transaction as the maker, acceptor, drawer or indorser, then both parties are jointly and severally liable for the document unless expressly agreed otherwise in the document.

Example: Fred Locksteed, the owner of a cattle farm, wants to use a fancy stamp in the shape of an “X” to sign his checks. Is this acceptable under the UCC?

Yes, Fred has an intention to authenticate the writing; therefore, his signature (the “X”) would be acceptable.

Note: Signatures can be printed, stamped, or typed. Additionally, there is no requirement that an instrument be signed in ink. Thus, even signatures made in pencil are acceptable.

2. A Sum Certain of Money

The negotiable instrument must promise a payment of a **fixed amount of money**. This often is referred to as a sum certain. Money is defined as the “medium of exchange authorized or adopted by a domestic or foreign government as part of its currency.”

In most cases a person must be able to look at the instrument and readily calculate the amount the maker or drawer has promised to pay without reference to any other documents. This means that the sum certain can include an interest rate, as long as the interest rate that should be used is determinable from the instrument.

Exceptions to Sum Certain: Though these items appear to contradict the sum certain requirement, the following items do not destroy the negotiability of a note:

- A disparity between the words and numbers on an instrument (in this case the written words are used, not the numbers),
- A provision for collection costs (including attorneys’ fees in the event of the debtor’s default),
- A reference to an exchange rate, and
- Variable interest rate provisions.

Additionally, the instrument must be **payable only and completely in money**. Thus, a note fails the negotiability test if the note specifies that it is payable in money **and/or** personal services or goods.

Example: *Variable Interest.* Ann issues a promissory note to Cam. The note states that the interest rate is 1% above prime at the date of the note's maturity. Is this note negotiable?

The note is negotiable because interest may be stated as fixed or variable; thus, negotiability is not destroyed by the fact that the holder must consult an outside source for interest due.

Example: Ann writes a check payable to Bill. In the amount box, she writes \$100, and on the line below she writes "Ten dollars and no/100." Is the check negotiable? If so, for what amount?

The check is negotiable for \$10. When there is a disparity between written words and written numbers, the written words control.

Note: A "sum certain" can in essence be summarized as follows: a person must be able to calculate the amount of money that they will receive from the instrument itself without reference to any other documents. If the amount to be received is not able to be calculated from the instrument on the note, then it is only an instrument and not a negotiable instrument.

3. Unconditional Promise or Order to Pay

The instrument must be a simple unconditional *promise* (in the case of **notes**) or a simple unconditional *order* (in the case of **drafts**). Thus, an instrument must be a "courier without luggage." This means that the promise or order must not be contingent on some other event happening.

If, for example, an instrument says, "I promise to pay, **contingent upon** satisfactory completion of the terms of the contract signed today . . ." then the note is not negotiable because it is conditional. That is, the terms of the contract must be met before the obligor's legal liability would attach.

However, if instead the instrument says, "**As per** the contract signed today, I promise to pay . . ." then this instrument is negotiable because it only makes reference to an underlying contract; the instrument does not set any conditions on the payment.

There are, however, certain conditions that may exist in the instrument without destroying the negotiability of the instrument:

- 1) A promise or order is not made conditional if it makes **reference to another writing** for the statement of rights with respect to **collateral**, a **prepayment** clause, or an **acceleration** clause or because payment is limited to a particular source.

Example: Ann issues a note that gives Bill, the holder, the right to demand additional collateral from Ann in the event that Ann's business falls into financial distress. Is this note negotiable?

Ann's note is a negotiable instrument; references to collateral are permitted. This reference to collateral does not change the amount that is owed or the fact that a certain amount is owed.

Note: **Acceleration clauses** enable the creditor to collect more quickly should the debtor not make timely payment. These are permitted because they minimize the burden on creditors and courts. In the below example, the creditor may commence an action for collection after Allan's first default and will be able to collect the entire amount due in the future. This is much easier for the courts than if the creditor were required to commence separate actions each time Allan missed a payment.

Example: Allan signs an installment note that requires him to pay monthly payments of \$500 for 60 months. One provision of the note reads as follows: "In the event of the debtor's default, the creditor has the right to demand payment in full." Is this note negotiable?

Allan's note is a negotiable instrument. Acceleration clauses are permitted in negotiable instruments. Again, the amount or certainty of payment is not changed by this clause.

- 2) If a promise or order requires **countersignature** by persons whose signature appears on the promise or order, as condition of payment, this condition does not make the promise or order conditional. This instrument would continue to be negotiable.

4. Payable on Demand or at a Specific Time

Since the holder of the instrument must be able to determine when it comes due, the instrument must be **payable on demand or at a definite time**. The time does not need to be a specific date in the future as long as there is reference in the instrument that enables the time to be determined (see examples below) at the time the instrument is issued.

Despite the fact that there needs to be a date of payment, there is no requirement that an instrument be dated. **Undated** instruments are negotiable and are treated as **payable on demand** by the holder.

Instruments may also be antedated (backdated) or postdated. An instrument payable on demand is not payable before the date that is written on its face.

Note: It is also possible for the time period for payment to be extended without destroying the negotiability of the instrument. However, when the payment term is extended, it must be extended to a specific date – it cannot be extended indefinitely.

There will be situations where the place of payment is not defined in the documentation. This lack of definition does not make the document nonnegotiable.

Example: "Payable 30 days after sight."

The instrument meets the test of being payable at a definite time because both parties will know when they see each other; therefore, the instrument is negotiable.

Example: "Payable when the sun comes up tomorrow."

As long as the instrument is dated, the instrument is payable at a definite time and therefore is negotiable.

Example: A post-obituary note: "Payable six months after the death of my rich wife."

This instrument is not negotiable because there is no definite time period involved. Though the death of the rich wife is certain to occur, there is no certainty as to when it will occur. Because of this, post-obituary notes such as this one cannot be negotiable instruments. They are instruments, but just not negotiable.

Example: "Payable on my next birthday."

This instrument is negotiable – so long as the instrument is dated. (The note is payable on the anniversary of a person's birth; it does not depend on the continued life of the person.)

Example: "Payable 10 days after I sell my car."

This instrument is not negotiable. Because other parties will not know when the maker sells their car, they will not know when the instrument becomes payable.

Note: Remember that **checks must be payable on demand** – not at a definite time specified on the instrument.

5. Payable to Bearer or to Order

General Rule: The instrument must contain the “magic words” of negotiability: “payable to bearer” or “payable to order.”

- 1) **Payable to Bearer.** An instrument is payable to bearer if it
 - a. Is payable to bearer or to the order of the bearer,
 - b. Does not state a payee (may be negotiated simply by possession), or
 - c. Is payable to cash or to the order of cash, or
 - d. is otherwise not payable to an identified person.

An instrument **payable to bearer** (or any of the other listed above) allows whoever **holds the instrument** to exercise the instrument’s rights without indorsement (endorsement) by the maker of the instrument. That is, the bearer may just deliver the instrument for payment. Additionally, the bearer can transfer the instrument to another holder simply by delivering the instrument to the new holder.

- 2) **Payable to Order.** An instrument payable to order specifies the person to whom payment should be made. Because of the fact that there is a named payee, until the named person makes a transfer of his rights by indorsing the instrument, the instrument cannot be redeemed for value and cannot be readily transferred to a new holder.

Note: Sometimes an instrument payable to order will be payable to multiple payees. In this case the payment will depend upon the specific wording of the instrument. If it is payable to multiple people **as an alternative** (person A or person B or person C), then any of the named individuals may indorse the document for payment as long as they possess the instrument. If an instrument is payable to multiple people together (person A **and** person B for example), then all people named on the instrument must exercise and indorse the instrument together at the same time.

Exception to the General Rule: The “payable to bearer or to order” requirement **no longer applies to checks**. Thus, checks are negotiable even if they lack the magic words of negotiability. However, the words used on the check must convey the same idea.

Note: An instrument may be made payable to **both the order of someone and to the bearer**. In this case the note is still negotiable, and it may be negotiated either by endorsement by the person to whom it is payable or simply by delivery.

Summary Note: It is important to remember that if an instrument does not meet the requirements of negotiability, it does not mean that the note is not an instrument. This simply means that it is not a negotiable instrument. It may still be a valid instrument enforceable by the recipient. However, they would not be able to negotiate it to someone else.

Question 42: Which of the following prevents an instrument from being negotiable?

- a) An endorsement on the back of the instrument reads: "Pay Smith only."
- b) An instrument is payable after completion of a contractual obligation that is certain to happen but uncertain as to the time of occurrence.
- c) Whether the instrument is intended to be a note or a draft is unclear.
- d) The capacity in which the party signed was unclear.

(CPA Adapted)

Question 43: The following instrument is in the possession of Bill North:

On May 30, 2010, I promise to pay Bill North, the bearer of this document, \$3,800.

Joseph Peppers (signed)

Joseph Peppers

Re: Auto Purchase Contract

This instrument is:

- a) Nonnegotiable because it is undated.
- b) Nonnegotiable because it is not payable to order or bearer.
- c) Negotiable even though it refers to the contract out of which it arose.
- d) Negotiable because it is payable at a definite time.

(CPA Adapted)

Question 44: Anderson agreed to purchase Parker's real property. Anderson's purchase was dependent upon her being able to sell certain real property that she owned. Anderson gave Parker an instrument for the purchase price. Assuming the instrument is otherwise negotiable, which of the statements below, written on the face of the instrument, will render it nonnegotiable?

- a) A statement that Parker's cashing or endorsing the instrument is full satisfaction of Anderson's obligation.
- b) A statement that payment of the instrument is contingent upon Anderson's sale of her real property.
- c) A statement that the instrument is secured by a first mortgage on Parker's property and that, upon default, the entire amount of the instrument is due.
- d) A statement that the instrument is subject to the usual implied and constructive conditions applicable to such transactions.

(Source Unknown)

Negotiation (or Transfer) of a Negotiable Instrument

There are three stages in a negotiable instrument's life:

- 1) **Issuance** when the instrument is created and transferred to the first holder,
- 2) **Transfer** when the instrument is transferred from one holder to another, and
- 3) **Presentment** when the instrument is presented for payment and after payment is made ceases to exist as an instrument.

The issuance of the instrument is not a negotiation. Transfer and presentment of an instrument may constitute a negotiation. Physical transfer of the instrument gives to the transferee (recipient) whatever right the transferor (giver) had in instrument. If the transferee becomes a "holder" of the instrument, then the transfer is called "negotiation."

The way that an instrument is transferred depends on whether the instrument is payable to bearer or to order.

Negotiation of Bearer Paper

If an instrument is made out to bearer, the person who physically possesses the instrument is the holder. Since the holder is determined by physical possession alone, a bearer instrument may be **transferred simply by giving the instrument to another person**. The indorsement (signature) of the previous holder is not required to negotiate bearer paper.

Because bearer paper is transferred only by possession, it behaves like cash.

Negotiation of Order Paper

If the instrument is payable to the order of someone, there are two steps to the negotiation of the instrument:

- 1) The **transfer of the instrument itself**, and
- 2) The **indorsement (signature) of the party to whose order the paper is written**. Until the proper indorsement has been received, the recipient is simply an assignee and has only the contract rights of an assignee.

The negotiation of negotiable instruments can be cancelled in certain situations. These situations usually relate to a circumstance whereby the negotiation process should never have taken place. Examples include a lack of capacity by one of the parties, duress, fraud, or the negotiation was part of an illegal transaction. In these cases the right to cancel exists but is not effective until the right is exercised.

Note: Normally, if a transfer is made without value being given (it is transferred as a gift) the courts view this not as a negotiation, but as an assignment.

Exam Tip: When given a problem that deals with the front of a negotiable instrument, the problem will ask about what type of instrument it is (a draft or a promissory note) or if the instrument meets the requirements for **negotiability**. By contrast, when given a problem that deals with the back of a negotiable instrument, the question most likely will ask about **negotiation**.

Types of Indorsements

An indorsement is a signature placed on an instrument by the payee or any later transferees. **Indorsement and delivery** are necessary in order to negotiate an "order" instrument.

If the instrument is payable to a holder under a name that is not his or hers (either an incorrect name that arises from an error or a fictitious name), then the indorser may indorse with the incorrect name, his/her correct name – or both.

Unless an indorsement is qualified, the act of indorsement will establish the indorser's secondary liability. This means that if the maker or drawer fails to pay, the indorser will need to pay.

There are two major types of indorsements and every indorsement is either blank or special:

- 1) **Blank**, and
- 2) **Special**.

All indorsements are either blank or special, regardless of whether the indorsement restricts the manner of the instrument's payment or whether the indorsement is qualified (restrictive and qualified indorsements are covered on the next page).

1. Blank Indorsement

A blank indorsement is when the payee **simply signs his or her name** to the back of the instrument. This indorsement automatically **converts an order instrument to a bearer instrument**. The holder of an instrument with a blank indorsement can convert the instrument to order paper by writing a new payee above the blank indorsement (done by adding the words: "Pay to the order of John Johnson" above the bearer's signature).

A paper with a blank indorsement is bearer paper and is able to be transferred by possession alone.

Example: Anita Smith is the named payee of a check. She presents the check to her bank for payment and signs "Anita Smith" on the back of the check. What type of indorsement has Anita executed?

Anita's indorsement is blank; she merely signed her name on the back and did not name another payee or restrict payment in any way.

2. Special Indorsement

If the payee wishes to preserve the order character of the instrument, then the payee may **specify a new payee**. After this first special indorsement, the signature of the new payee is required for further negotiation of the instrument. If a special indorsement is placed on bearer paper, the **special indorsement makes it order paper**. This is the case even if the words "pay to the order of" are not used in the special indorsement.

Example: Ann Saunders is the named payee of a check. She signs "Ann Saunders" on the back of the check, and above her signature, she writes, "Pay to John Fredricks." What type of indorsement has Ann executed?

Ann's indorsement is special and the new payee is John. John can take the check, properly indorse it and redeem it for value. Or, he can indorse it and transfer it to a new payee.

In addition to being either blank or special, an indorsement can also be (but does not need to be)

- 1) **Restrictive** and/or
- 2) **Qualified**.

a. Restrictive Indorsement

A restrictive indorsement is when the payee adds a condition to the payment of the instrument. Negotiation and further transfer of the instrument are not impaired by this action.

There are two types of restrictive indorsements that are valid:

1) **Indorsements for Deposit or Collection**

These indorsements include the words "for collection", "for deposit", and "pay any bank." This indorsement limits most subsequent indorsers to perform as required. Not all parties must follow this indorsement, but that list is outside the scope of the exam.

2) **Indorsements in Trust**

In this indorsement the indorser creates a trust for the benefit of himself or others. The details of this type of indorsement are not needed.

Note: An indorsement that attempts to limit further negotiation is not valid.

Example: Classify the following indorsement: "Ann Jones, for deposit only."

*This indorsement is both **blank** (because there is no new named payee) and **restrictive**. Note: Most restrictive indorsements use the word "only."*

b. Qualified Indorsement

With a qualified indorsement the payee signs his name and adds "**without recourse.**" If this is not added to an indorsement, the signatory is guaranteeing the payment of the amount in that if the original parties do not pay, the signatory will pay. Therefore, the only way to avoid liability is by indorsing the check with the words "without recourse."

A qualified indorsement does not destroy the negotiability of the instrument and does not prevent its further transfer. Rather, the qualified indorsement on the instrument makes it order paper. It must therefore be indorsed before it can be further negotiated.

Example: Jack, the payee on an instrument, wrote the following indorsement on the back of the instrument: "Pay to the order of Joe without recourse."

Joe must therefore indorse the instrument in order to negotiate it further. If Jack had indorsed the instrument without the wording "without recourse", then the instrument remains payable to bearer and negotiation only upon delivery is possible.

A qualified indorsement **eliminates the indorser's contract liability** (guarantee of payment), but it **does not eliminate the indorser's warranty liability** (see discussions below).

Example: *Indorsement Combinations.* Ann Smith, the payee of a check, wrote the following indorsement on the back of the check: "Ann Smith, without recourse, for deposit only." What type of indorsement has Ann executed?

*This indorsement is **blank** (because no new payee is named), **qualified** (because she has not guaranteed payment), and **restrictive** (the check may be used for deposit only).*

Note: If a signee of an instrument is **crossed off by a later signee**, the person who has been crossed off is no longer secondarily liable for the amount because he or she is no longer considered to be an endorser.

Unindorsed Instrument

If a transfer of a note is made and the transferor does not indorse the note, the recipient has the **right to receive an unqualified indorsement from the transferor.**

Question 45: Jen Day received a check originally made payable to the order of one of his customers, Al Pine. The following endorsement was written on the back of the check:

"Al Pine, without recourse, for collection only."

The endorsement on this check would be classified as:

- a) Blank, unqualified and nonrestrictive.
- b) Blank, qualified and restrictive.
- c) Special, unqualified and restrictive.
- d) Special, qualified and nonrestrictive.

(CPA Adapted)

Question 46: Jane Lane, a sole proprietor, has in her possession several checks that she received from her customers. Lane is concerned about the safety of the checks since she believes that many of them are bearer paper, which may be cashed without endorsement. The checks in Lane's possession will be considered order paper rather than bearer paper if they were made payable (in the drawer's handwriting) to the order of:

- a) Cash.
- b) Ted Tint, and endorsed by Ted Tint in blank.
- c) Bearer, and endorsed by Ken Kent making them payable to Jane Lane.
- d) Bearer, and endorsed by Sam Sole in blank.

(CPA Adapted)

Presentment and Dishonoring of an Instrument

Presentment is the process of submitting an instrument **for payment** or **for acceptance**. Presentation for payment means that the payor is obligated to make payment immediately. Presentation for acceptance means that the payor is not liable to make payment until they accept the document. This acceptance process usually relates to the timing of the payment.

Note: Checks are always presented for payment – never for acceptance.

Example: Laura goes to her bank and presents two documents for deposit. Instrument A includes the following payment terms: “pay 60 days after sight.” Instrument B is a regular check from her sister. What type of presentment did Laura perform with these documents and when will the funds be available for Laura to spend?

Laura submitted instrument A for acceptance and the funds will be available to her upon completion of the 60 day notice period as defined in the document. This instrument is a time draft since it makes reference to a 60 day holding period before the document will be honored. Instrument B is a demand draft (another word for a check). Laura submitted this document for payment. The cash from this document is available immediately.

If a payor does not agree to make payment, or to accept an instrument, that has been presented to them, then the payor has **dishonored** the instrument. This refusal to make payment gives the instrument holder the right of recourse against the parties with secondary liability. In some cases this process of dishonoring an instrument can be done orally. In other cases written documentation, including a **notice of dishonor**, is necessary in order to legally establish the secondary liability against other parties to the instrument such as the indorser.

Contract Liability on An Instrument

Contract liability attaches when someone **signs an instrument** (unless they disclaim that responsibility) as maker, drawer, acceptor or indorser. There are two types of contract liability:

- 1) Primary liability, and
- 2) Secondary liability.

Note: Individuals who do not sign the instrument do not incur contract liability on the instrument. If the individual does not sign the instrument, there is no proof that they ever had possession of the instrument (other than to the party that they transferred the instrument to). This is why they do not have liability for payment – nobody is aware that they existed, and they can deny their ever having had possession of the note.

1. Primary Contract Liability

This is the liability of makers and acceptors (and sometimes accommodation parties, too). Primary liability means that the maker or acceptor is obligated to pay the instrument before any other party.

- 1) **Maker.** This is the party who is obligated to pay a **promissory note** (not a check – the person who writes a check is called the drawer, below) according to the terms that existed at the time of issuance.

Note: If an accommodation party signs on behalf of a maker, then the accommodation party is primarily liable (see the discussion on accommodation parties below).

- 2) **Acceptor.** The drawee (the bank) has no liability for payment until he accepts the draft. Once the drawee accepts the draft (by signing it), he becomes an **acceptor** and agrees to pay the draft as presented. Thus, if the acceptor signs an incomplete draft (for example, the amount is blank), he is liable for any unauthorized amount later filled in.

Note: "Certification" is a bank's acceptance of a check.

2. Secondary Contract Liability

This is the liability that drawers and indorsers have for the instrument. Drawers and indorsers are required to pay for the instrument only if the party with primary liability fails to pay.

- 1) **A Drawer's Liability.** A drawer orders another party (the drawee, usually a bank) to make payment. The drawer (this is a draft) does not expressly promise to pay the instrument himself or herself; however, the drawer implicitly guarantees payment by virtue of using the drawee as a payment agent.

In the event that the drawee refuses to pay a draft (this is called "dishonor"), the drawer is obligated to pay so long as the **drawer is notified** of the drawee's dishonor of the draft.

- 2) **An Indorser's Liability.** An indorser is someone other than the maker, drawer or acceptor who signs the instrument to negotiate it, restrict it or just to incur liability. The indorser's signature is called an "indorsement."

An indorser's liability is created once an instrument has been dishonored and the indorser has been notified of the dishonor. There may be several indorsers to an instrument, and generally indorsers are liable to one another in the order in which they indorse. However, the person entitled to enforce the instrument may proceed against any one of the previous indorsers (there is no requirement to proceed against any particular indorser first).

Disclaimer of Liability (Qualified Indorsement). An indorser may avoid **contract liability** by adding "without recourse" after his or her signature.

Special Note Regarding Agency Law: If an agent signs an instrument and indicates that he is acting on his principal's behalf, then only the principal incurs contract liability – not the agent. However, if an agent signs an instrument and fails to indicate that he is an agent, then he incurs contract liability, and the principal has no contract liability. This is covered again in Agency.

Warranty Liability in Respect to Negotiable Instruments

Warranty liability relates to the warranties (promises, or guarantees) that are made by a transferor in respect to the instrument that is being transferred. The transferring party warrants that:

- 1) Good title to the instrument exists and the instrument is enforceable (it is their instrument to transfer).
- 2) All signatures are authorized and genuine (meaning that there are no forgeries).
- 3) There are no material alterations (for example, the dollar amount has not been increased).
- 4) The transferor has no knowledge of any insolvency proceedings associated with the instrument.
- 5) There are no defenses that can be asserted against the transferor that would prevent payment of the instrument.

Exam Tip: Warranties 2, 3, and 4 above are the most commonly tested areas.

To whom the warranties are granted depends on how the instrument is transferred:

- If the transfer is made **with indorsement**, the transferor incurs warranty liability with respect to the immediate transferee and **all subsequent (following) transferees**.
- If the transfer is made **without indorsement**, the transferor incurs warranty liability only with respect to the **immediate transferee** (recipient). Therefore, it is better for the transferor to transfer without indorsement if that is possible.

The presenter of an instrument also provides some warranties. The presenter warrants that:

- 1) They have good title to the instrument that they are presenting for payment or acceptance,
- 2) They have no knowledge that any signatures on the instrument are unauthorized, and
- 3) They confirm that the instrument has not been materially altered.

Note: A Holder in Due Course (covered later in the material) does not warrant that they have no knowledge of unauthorized signatures on the instrument.

Accommodation Parties (Anomalous Indorsers)

An accommodation party is a party who signs an instrument as maker, drawer, acceptor or indorser with the deliberate purpose of backing the obligation of another party (the **accommodated party**). Thus, the accommodation party incurs liability without being a direct beneficiary of the instrument (this is true even if the accommodation party acts as a paid surety; the key is that someone else gets a direct benefit of value given for an instrument).

Secondary Liability of Anomalous Indorsers

Accommodation parties incur **no warranty liability**, but they do incur **secondary contract liability** just like drawers and indorsers. Additionally, an accommodation party has primary contract liability if he signs on behalf of a **note's** maker.

Example: *Secondary Liability*. Alice, a resident of Ohio, is visiting her friend Mike in Chicago. Alice has a check drawn on an Ohio bank that she needs to cash. Alice indorses the check, and Mike lends his name to the check so that Alice can cash it at Mike's bank. Who would be liable if Mike's bank cashes the check and later is unable to collect from the Ohio bank?

Mike is an accommodation party. If Mike's bank cashes the check and later is unable to collect from the Ohio bank, Alice and Mike will be liable for payment. Mike's bank may seek collection from either Alice or Mike; the bank is not required to proceed against Alice first.

Thus, generally the holder is not required to exhaust remedies against the accommodated party (Alice in the example) first before proceeding against the accommodation party (Mike in the above example).

Exception for Accommodation Parties: If the accommodation party adds the words "collection guaranteed," the holder must attempt to collect from the accommodated party first, and if the accommodated party cannot pay, only then may the holder collect from the accommodation party.

Question 47: Robb, a minor, executed a promissory note payable to bearer and delivered it to Dodsens in payment for a stereo system. Dodsens negotiated the note for value to Mellon by delivery alone and without endorsement. Mellon endorsed the note in blank and negotiated it to Bloom for value. Robb refused Bloom's demand for payment because the note was executed when Robb was a minor. Bloom gave prompt notice of Robb's default to Dodsens and Mellon. None of the holders of the note were aware of Robb's minority. Which of the following parties will be liable to Bloom?

- a) Dodsens and Mellon.
- b) Dodsens only.
- c) Neither Dodsens nor Mellon
- d) Mellon only.

(CPA Adapted)

Question 48: Vince Price has in his possession an otherwise negotiable instrument that reads:

"I, Waldo, hereby promise to pay to the order of Mark or bearer . . ."

Which of the following is true with respect to the above Instrument?

- a) Mark's signature is required to negotiate the instrument.
- b) The instrument is nonnegotiable.
- c) If Mark endorses the instrument, he assumes potentially greater liability to subsequent transferees than if he transfers it by mere transfer of possession.
- d) Because the instrument is payable to Mark's order, it is a draft.

(CPA Adapted)

Termination of Liability on an Instrument

A person who is liable for an instrument will continue to be liable for that instrument until they are discharged. They can be discharged of the entire liability or some of the liability through any of the following actions or events.

- 1) **Discharge by Performance.** Payment to the holder of the instrument results in discharge.

Exception: If the party making payment has knowledge that the holder stole the instrument, then there is no discharge in respect to the amount that is due to the proper holder of the instrument.

- 2) **Discharge by Mere Tender of Payment.** A party who tenders payment to the holder is discharged from any subsequent liability for collection costs, interest and attorneys' fees that arise in connection with the instrument.
- 3) **Discharge by Cancellation or Renunciation.** If the instrument is canceled, or the parties renounce the instrument, then discharge occurs. A renunciation must be in writing. Destruction of the instrument would produce the same result.
- 4) **Discharge by Material Alteration.** If the amount of an instrument is changed fraudulently, then this results in discharge for all previous signatories.
- 5) **Certification of a Check by a Bank.** Such certification discharges all prior parties to the instrument as the bank now becomes primarily liable for the check.
- 6) **Unexcused Delay in Payment.** If there is an unreasonable delay in the presentation of the instrument, previous signatories **may** be discharged.
- 7) **Discharge Through the Release of the Collateral.** When the collateral is released, the original promisor of the collateral is also released. Other indorsers are still help liable, but the individual who promised the collateral is released.

Holders in Due Course

Before we look at holders in due course, we first must first make certain that we define a holder. The term holder has been used earlier. A **holder** is simply the party who **possesses** a properly indorsed negotiable instrument. A person who is in physical possession of the properly indorsed instrument is a holder.

A holder has certain rights that will enable them to collect the money that is due to them under the instrument.

There is also a specific type of holder called a **holder in due course** (HDC). A HDC is in essence a super holder who has more rights available to them. This means that in a court of law a HDC has a better chance of getting payment under the instrument than someone who is just a holder.

The HDC classification is applicable only to cases in which there are more than two parties connected to an instrument. The HDC status is designed to protect an innocent third party from losing his or her investment in a negotiable instrument due to some underlying problem with the instrument. Accordingly, an HDC often is referred to as a "super plaintiff" because he or she will win (prevail) in most conflicts regarding commercial paper.

Becoming a Holder in Due Course

There are four requirements that must be met in order for a holder to be an HDC. All of them must be met:

- 1) **Holder.** The individual must be a holder (must have possession of an instrument with all the necessary indorsements) and the note must be negotiable.
- 2) **Value must have been given.** To be an HDC, the holder must have given **present or past value** for the instrument. Thus, an executory promise (a promise to do something in the future) is insufficient to meet the value criterion. Additionally, receiving the instrument as a gift does not give the recipient of the gift HDC status.
- 3) **The holder must take it in good faith.** The holder must have acted in good faith in the acquisition of the instrument. "Good faith" means honesty in fact and the observance of reasonable commercial standards of fair dealing.
- 4) **It was taken with no notice of defect.** The holder must take the instrument without notice that the instrument is overdue, has been dishonored, or has been forged. A holder is considered to have had notice if he or she knows about a claim, has received notice of a claim, or has reason to know about a claim. An instrument is overdue starting the day after the due date. A payable-upon-demand instrument becomes overdue after a reasonable amount of time.

Note: A check is considered to be overdue if it is **90 days past the date** written on the check. In reality, a bank may still honor the check, but it is legally considered to be overdue for the purpose of determining notice of defect.

Further note on Notice of Defect: If a person takes an instrument without notice of defect, and then finds out about a defect before the entire amount is paid or received, the individual will be an HDC for only some part of the instrument. The amount for which the person will be considered as an HDC is calculated using the following formula:

$$\frac{\text{Amount of Partial Performance}}{\text{Amount of Total Purchase Price}} * \text{Face Amount of the Instrument} = \text{Amount for which the Individual is an HDC}$$

This is shown in a later question.

Shelter Rule: Holder Under Holder in Due Course (HUHDC)

The transfer of a negotiable instrument gives to the recipient (the transferee) any rights the transferor had to enforce the instrument. This includes the rights as an HDC. This means that when an HDC transfers the instrument to someone else, that recipient automatically has all of the same rights as an HDC. If the recipient meets the requirements as an HDC, they will be an HDC themselves. If, however, the recipient does not meet the HDC requirements themselves (perhaps they received the instrument as a gift), they will be an HUHDC if the transferor was an HDC.

This means that it is possible for a person who would not be an HDC (perhaps because he or she knew about some defect or the instrument was overdue) to have all of the same rights as an HDC because the person from whom they obtained the instrument was an HDC.

Note: An HUHDC is a different class of individual from an HDC, but the HUHDC has the same rights as an HDC.

Exceptions to this rule: A person who is not an HDC cannot negotiate the instrument to someone who becomes an HDC and then reacquire the instrument from that person, becoming an HUHDC. Also, a person that is party to a fraud or illegality in regards to the instrument may not become an HDC through this HUHDC method. This means that once a person holds an instrument and is not an HDC or an HUHDC they cannot later become an HDC or HUHDC in respect to that instrument.

Example: Bill entered into a contract with Ann. At the time the contract was signed, Bill misrepresented several key contract provisions (this is *fraud in the inducement*) and induced Ann to execute a promissory note payable to Bill. Later, Bill transferred the note to Cam, an HDC. Ann refused to pay, and Cam gave the note to Dan, a party who had notice of the fraud associated with the note. Does Dan qualify as an HDC?

No, because Dan was aware of the fraud associated with the note.

Question 49: A purchaser of a negotiable instrument would least likely be a holder in due course if, at the time of purchase, the instrument were:

- a) Purchased at a discount.
- b) Collateral for a loan.
- c) Payable to bearer on demand.
- d) Overdue by three weeks.

(CPA Adapted)

Question 50: The value requirement in determining whether a person is a holder in due course with respect to a check will not be satisfied by the taking of the check:

- a) As security for an obligation to the extent of the obligation.
- b) As payment for an antecedent debt.
- c) In exchange for another negotiable instrument.
- d) In exchange for a promise to perform services in the future.

(CPA Adapted)

Question 51: A \$5,000 promissory note payable to the order of Neptune is discounted to Bane by blank endorsement for \$4,000. King steals the note from Bane and sells it to Ott who promises to pay King \$4,500. After paying King \$3,000, Ott learns that King stole the note. Ott makes no further payment to King. Ott is:

- a) A holder in due course to the extent of \$5,000.
- b) An ordinary holder to the extent of \$4,500.
- c) A holder in due course to the extent of \$3,333.
- d) An ordinary holder to the extent of \$3,000.

(CPA Adapted)

Question 52: Under the Negotiable Instruments Article of the UCC, which of the following parties will be a holder but not be entitled to the rights of a holder in due course?

- a) A party who, knowing of a real defense to payment, received an instrument from a holder in due course.
- b) A party who found an instrument payable to bearer.
- c) A party who received an instrument as a gift from a holder in due course.
- d) A party who, in good faith and without notice of any defect, gave value for a negotiable instrument.

(CPA Adapted)

Question 53: Hunt has in his possession a negotiable instrument which was originally payable to the order of Carr. It was transferred to Hunt by a mere delivery by Drake, who took it from Carr in good faith in satisfaction of an antecedent debt. The back of the instrument reads as follows, "*Pay to the order of Drake in satisfaction of my prior purchase of a new video calculator, signed Carr.*" Which of the following is correct?

- a) Drake's taking the instrument for an antecedent debt prevents him from qualifying as a holder in due course.
- b) Carr's endorsement was a special endorsement; thus Drake's signature is not required in order to negotiate it.
- c) Hunt has the right to assert Drake's rights, including his standing as a holder in due course and also has the right to obtain Drake's signature.
- d) Hunt is a holder in due course.

(CPA Adapted)

Defenses From Having to Pay on an Instrument

If the instrument is not honored when it is presented, an HDC will have a better chance of winning a case in court to force payment of the instrument. This is because there are fewer defenses available to the other party that they can use to prove that they do not need to pay the HDC than are available to prevent payment to a holder. Therefore, the main benefit of being an HDC – you have a better chance of getting your money if there turns out to be a problem with the instrument.

When an HDC makes a claim to force payment, the only defenses that the person can use to prevent having to make payment to the HDC are **real defenses**. Real defenses have to do with the validity of the instrument itself and by using a real defense, the defendant (who is trying not to pay) is claiming that the instrument was never actually an instrument and that they never had a liability to that person. **Personal defenses** (listed later) will not work against an HDC, though they would work against someone who is not an HDC.

Real Defenses – Discharge Obligation to Pay a HDC and a Holder

The real defenses are the **only defenses that will prevent a defendant from having to pay the HDC**. In the absence of having one of these defenses, the person will have to pay the HDC.

- 1) **Infancy**. Contracts entered into with infants (minors) are **voidable**. An infant can disaffirm or rescind his contract even though he may have received and enjoyed contract benefits.
- 2) **Duress**. In order for duress to be a good defense against an HDC, this duress must have been very extreme – so extreme as to render the instrument void (for example, being forced to sign a contract at gun point), and not just voidable. Minor duress would be a personal defense.
- 3) **Incapacity**. This defense works against an HDC only when the governing state law declares such incapacity a factor that nullifies (that is, renders void) a contract. For example, adjudicated insanity of the debtor is a real defense against an HDC.
- 4) **Illegality**. This is a good defense against an HDC only if the transaction itself is rendered **void**. In many cases, illegal transactions are just **voidable**; therefore, an illegality defense usually will not prevail against an HDC.
- 5) **Discharge in Bankruptcy**. This type of discharge stops creditors’ actions to collect affected debts (although it does not actually extinguish the debt itself). Therefore, while HDC cannot enforce an instrument against a debtor so discharged, an HDC can enforce an instrument against another party on the instrument, such as an indorser, even though this other party will not be able to get reimbursement from the principal debtor.
- 6) **Fraud in the Execution**. This occurs when the defrauded party is induced to sign an instrument by deception with respect to character or terms of the instrument itself. **This is a defense against an HDC** when the defrauded party can prove that he lacked a reasonable opportunity to learn the true character or terms of the instrument.

Note: There are two types of fraud, fraud in the **inducement** (a.k.a. “fraud in the procurement”) and fraud in the **execution**. Fraud in the inducement occurs when the defrauded party is aware of the character and essential terms of the instrument but is induced to sign by a deception with respect to some other matter. **Fraud in the inducement is not a successful defense against an HDC**, meaning that this will not work against an HDC.

- 7) **Forgery**. If a party never actually signs an instrument, he cannot be liable to an HDC
- 8) **Alteration**. An HDC may not enforce an altered instrument beyond its original terms. However, if the drawer was negligent (for example, writing the amount of a check in pencil), then this will not be considered a real defense against an HDC.
- 9) **Subsequent Claims and Defenses**. An HDC takes the instrument free of all prior claims, but is still subject to claims that may arise **after** he or she takes possession of the instrument.

Personal Defenses – Discharge Obligation to Pay ONLY a Holder

All other defenses, other than real defenses, are personal defenses. **Personal defenses are ineffective against HDCs.** This means that these defenses will not prevent someone from having to pay the HDC. Examples of personal defenses are:

- Fraud in the inducement,
- Lack, or failure, of consideration,
- An illegality that does not make the instrument automatically void,
- Ordinary contract defenses – nonperformance by the other party, failure to pay,
- Acquisition of lost or stolen bearer instruments,
- Unauthorized completion of the instrument (except for signing the instrument, which is forgery),
- Breach of contract, and
- Mistakes.

Note: Non-HDCs (regular holders) are subject to both real and personal defenses. Lack of consideration is by far the most commonly asserted personal defense.

Question 54: A maker of a note will have a real defense against a holder in due course as a result of any of the following conditions except:

- a) Discharge in bankruptcy.
- b) Forgery.
- c) Fraud in the execution.
- d) Lack of consideration.

(CPA Adapted)

Question 55: Bond fraudulently induced Teal to make a note payable to Wilk, to whom Bond was indebted. Bond delivered the note to Wilk. Wilk negotiated the instrument to Monk, who purchased it with knowledge of the fraud and after it was overdue. If Wilk qualifies as a holder in due course, which of the following statements is correct?

- a) Teal can successfully assert the defense of fraud in the inducement against Monk.
- b) Monk personally qualifies as a holder in due course.
- c) Teal can successfully assert the defense of fraud in the inducement against Wilk.
- d) Monk has the standing of a holder in due course through Wilk.

(CPA Adapted)

40 a – A CD is not an order to pay, while a draft is.

41 a – This is what a CD is by definition.

42 b – In order for an instrument to be negotiable, the instrument needs to be payable at a specific time or on demand. If it is uncertain when the event in the item will occur, then it fails the time test.

43 b – This is not negotiable because it is an order to pay only Bill North, not to the order of Bill North or on demand.

44 b – By including this on the note, the note will not be negotiable because it is not unconditional. There is a condition that must be met before it will become payable.

45 b – By definition. The indorsement is blank because no new payee is named; it is restrictive because it is for collection only and it is qualified because it is without recourse.

46 c – If the indorsement makes the check payable to Jane Lane, the check has become order paper under the order of Jane Lane.

47 d – Because Dodsen negotiated the note by delivery alone, his liability is only to Mellon, the person to whom he gave the note. However, because Mellon indorsed the note, he is liable to all subsequent holders.

48 c – If Mark were not to sign the note, he would have no liability to subsequent transferees. By placing his name on the note, he assumes additional liability.

49 d – Of the choices given, the fact that the instrument is three weeks past due is the best indication that there is a defect in the instrument.

50 d – Only present or past value can be given in order for a person to become an HDC.

51 c – To solve this question, we simply need to put the relevant information into the equation: $(\$3,000 / \$4,500) * \$5,000 = \$3,333$.

52 b – In order to be a holder in due course, the holder must give value for the instrument. In the case of the instrument being found, the finder did not give value and therefore, cannot become a holder in due course. But they are a holder.

53 c – Because Drake was a holder in due course and Hunt received the note from Drake, Hunt becomes a holder under a holder in due course. Hunt also is able to collect an unqualified indorsement from Drake.

54 d – By definition.

55 d – Because Wilk was an HDC and Monk received the note from Wilk, Monk is an HUHDC and has the standing of an HDC even though he was aware of the defects in the note.