

Chapter 12
Negotiable Instruments and Secured Transactions

1 Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Negotiable Instruments

- Negotiable instruments serve two functions
 - Substitute for money
 - Credit device

2 Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

What is negotiable?
Negotiable means transferable. The negotiation that goes on refers to the transfer of the instrument between two people, or from one bank to another, or even from one country to another.

What is an instrument?
In the broadest sense, almost any agreed-upon medium of exchange could be considered a negotiable instrument. In day-to-day banking, a negotiable instrument usually refers to checks, drafts, bills of exchange, and some types of promissory notes.

3 Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Four Requirements for Negotiable Instruments

- Written and signed by maker or drawer
- Are unconditional promises or orders to pay a fixed amount of money
- Are payable to bearer
- Are payable on demand or at a definite time

4 Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Types of Negotiable Instruments

- Two party
 - Promises to pay
 - Notes
 - CDs
- Three party
 - Order to pay
 - Drafts
 - Checks

5 Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

CHECKS

- Most common form of negotiable instrument
- Preferred method of payment for many debts
- Offer convenience, safety, and a record of transactions

6 Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

STANDARD FEATURES OF PERSONAL CHECKS

Maria Mills 12 River Street Pettisville, OH 43553-0177	Check Number 801
Date <u>Date</u>	55-25 412
Pay to the order of <u>Payee</u>	\$ <u>Amount</u>
Amount Pettisville Bank Pettisville, Ohio	Dollars
<i>For simulation use only</i>	
For <u>Memo</u>	<u>Signature</u>
⑆000601⑆ ⑆041200257⑆ ⑆103⑆ 7943⑆	

Identification Numbers Account Number



Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

DRAFTS

- A draft is a three-party instrument similar to a check.
- A draft is an order signed by one party (the *drawer*, or *draftee*) that is addressed to another party (the *drawee*) directing the drawee to pay to someone (the *payee*) the amount indicated on the draft.
- The payment may be at sight or at some defined time.
- Most drafts are used for the purchase of goods and services when the transaction goes beyond the bounds of U.S. banking law.



Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

BILLS OF EXCHANGE

- A bill of exchange is a negotiable and unconditional written order, such as a check, draft, or trade agreement, addressed by one party to another.
- The receiver of the bill must pay the specified sum or deliver specified goods on demand or at a specified time.
- Bills of exchange are a common form of internationally negotiable instruments.



Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

PROMISSORY NOTES

- A promissory note is a written promise to pay at a fixed or determinable future time a sum of money to a specified individual.
- These two-party instruments are legally binding documents with many specified terms that vary widely.
- *Commercial paper*, a short-term (270 days or fewer) note or draft issued by a corporation or government, is a common investment instrument.



Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

ELEMENTS OF NEGOTIABILITY

- Written
- Signature
- Unconditional promise or order
- Sum certain
- Payable on demand or at a defined time
- Words of negotiation



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Signature Liability

- This relates to signatures on the instrument
- Signers of negotiable instruments are potentially liable for the amount of the instrument
- Primary liability
 - Acceptors or makers
- Secondary liability
 - Drawers or indorsers



Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Four Categories of Indorsements

- Unqualified
 - Blank
 - Secondary liability
 - Special
 - Secondary liability
 - Restrictive
 - Conditional indorsements
 - Prohibiting indorsements
 - Trust indorsements
- Qualified

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Holder in Due Course

- The holder (possessor of order or bearer paper)
 - Gives value
 - Takes in good faith
 - Has no notice that the instrument is overdue
 - Has no notice of defects
 - Has no notice of unauthorized signatures
 - Has no notice of a claim to the instrument
 - Has no notice of any party's real defense

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Shelter Principle

- Person is not a holder in due course, but derives his/her title through a holder in due course

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Assignment

- An assignee of a negotiable instrument obtains the assignor's contract rights
- A holder in due course generally has greater rights than the assignor

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Defenses

- Real
 - Forgery
 - Fraud in the execution
 - Instrument discharged in bankruptcy
 - Illegal conduct
 - Material alteration
- Personal
 - Breach of contract
 - Breach of warranty
 - Misrepresentation
 - Mistake
 - Undue influence
 - Economic duress

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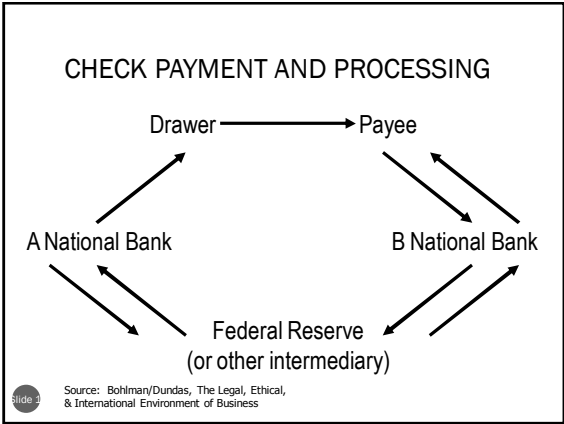
Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Checks and the Banking System—Duties

- Customer's duties
 - Examine monthly bank statements
- Bank's duties
 - Honor customer's checks
 - Accept deposits in currency and collect checks
 - Honor stop-payment orders
 - Authenticating signatures on checks

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business



- ### BANK PAYMENTS
- Electronic funds transfer (EFT)
 - Direct deposit
 - Automatic payments
 - Automated clearing houses (ACHs)
 - Online transfers
 - Fedwire
 - Clearing House Interbank Payment System (CHIPS)
- Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

- ### Maker/Drawer Is Liable
- Imposter rule
 - Fictitious payee rule
 - Dishonest employee rule
- Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Electronic Funds Transfer Systems

- Components
 - Automatic teller machines
 - Point-of-sale systems
 - Automatic payments and direct deposits
 - Telecommunications systems
 - Automatic clearinghouses
- Federal statutes
 - Electronic Funds Transfer Act
 - Debt Collection Improvement Act

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Secured Transactions—Definition

- Creditor must have a written security agreement
- Creditor must have given something of value to the debtor
- Debtor must have ownership rights in the collateral
- If the above are present, creditor's rights are said to "attach" to the collateral, i.e., the creditor has an enforceable security interest against the debtor

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Secured Transactions—Perfection

- Occurs automatically upon attachment if there is a purchase-money security interest agreement in consumer goods
- Occurs if the creditor is in possession of the collateral
- Occurs upon the proper filing of a financial statement
- First party to perfect its security agreement has the first priority over the collateral

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Secured Transactions—Default

- Secured party's remedies
 - Forgo its security interest and proceed directly to a court judgment on the debt
 - Take peaceful, legal possession of the collateral, or repossess it
 - Retain the collateral or resell the collateral to satisfy the debt
- Termination statement
 - Shows that the debt has been paid and that the creditor must file it in the same office where she/he filed the financing statement

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

International Considerations

- Convention on International Bills of Exchange and Promissory Notes
- Uniform Customs and Practices for Documentary Credits

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Summary

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