Understanding Negotiable Instruments and Payment Systems

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Chapter 1

INTRODUCTION TO INSTRUMENTS

§ 1.01 Distinguishing Instruments from Other Personal Property

Although this treatise deals primarily with negotiable instruments, a wider perspective is taken here at the outset. A brief examination of the entire range of personal property for purposes of the Uniform Commercial Code (U.C.C. or Code) demonstrates where instruments fit within the array. Although the law governing negotiable instruments is derived from multiple sources, most of it is codified in the U.C.C. The various subjects governed by the articles of the Code are neither a comprehensive nor a random selection of concepts relevant to commercial transactions; and certain fundamental principles flow through them and serve as unifying themes that bind the articles together.[1] Placing negotiable instruments within the context of the other forms of personal property shows that these instruments are a discrete subject within a broad and integrated code.

Personal property can be divided into three overarching categories: goods, indispensable paper, and intangibles. Goods and intangibles essentially cover opposite ends of the spectrum that runs from tangible to intangible personal property. Goods are moveable, tangible property whose value depends upon its physical characteristics; the definitions of goods exclude any of the property that comprises the intangible and indispensable paper categories.[2] Intangibles are comprised of choses in action, like accounts and other contract rights, and certain miscellaneous rights, such as informational rights and rights protected by patent, trademark, and copyright law.[3] Neither the legal nor the business community recognizes any single physical embodiment as representative of the property rights associated with pure intangibles. Even when there is a writing that shows the existence of the right, its value is purely evidentiary; that is, that paper need not be delivered for a transfer of the right to be effective. Pure intangibles are transferred using the common-law assignment mechanism, and the assignee need not receive any physical totem in order to enforce its rights.

The category of indispensable paper occupies a middle ground between goods and intangibles. The right itself, such as an obligation to pay money,

[1] Concepts like the rule of derivative rights, negotiability, agency, priority, loss allocation, and the hierarchy of buyer, bona fide purchaser, and buyer in the ordinary course of business permeate most of the U.C.C. articles. The general provisions of Article 1, which apply to all transactions under each article, further demonstrate that the U.C.C. is a unified code.

[2] U.C.C. §§ 2-105(1); 9-102(a)(44).

[3] U.C.C. § 9-102(a)(42).

is intangible; but with these types of property the right is reified, meaning that it is embodied in a writing. The writing itself is tangible, of course, but its value does not lie in its physical characteristics. Rather, its value is in the rights embodied in the paper. Because the writing is recognized as the single embodiment of those rights, the mechanism used to transfer the rights is physical delivery to the transferee of the paper itself. Because the transferee needs the paper to enforce the rights, the paper is referred to as "indispensable."

Another characteristic that joins the various types of indispensable paper is that they are the only property on which our legal system will confer full-fledged attributes of negotiability. This concept, which is covered in detail in the next chapter,[4] essentially enables a qualifying transferee to attain greater rights in the transferred property than were possessed by the transferor. This attribute of negotiability operates as a significant exception to the doctrine of derivative rights, a general rule governing property transfers which limits the rights of a transferee to precisely those possessed by the transferor.

Indispensable paper consists of three major categories: negotiable documents of title, negotiable instruments, and chattel paper. The most common forms of negotiable documents of title are bills of lading issued by a carrier upon shipment of goods and warehouse receipts issued by a warehouseman upon storage of goods.[5] All documents of title, whether negotiable or nonnegotiable, represent the right to possession of the covered goods. The issuer of a negotiable document will not release the goods to anyone without surrender of the document, so a person wanting to take delivery of the goods will need to be in possession of the document. Negotiable documents of title are sometimes referred to as "goods paper" because they represent title to the goods that have been shipped or stored. This means that the owner of these goods can sell them and transfer title by transferring the document.

Two basic types of instruments[6] are governed by the Code. The first type, certificated securities, can be called "investment paper." They are an interest in property commonly dealt in as a medium for investment.[7] Paper constituting stock or a bond is valuable because of the investment share that it represents, which can be traded or redeemed. The owner of 100 shares of stock represented by a certificated security can effectuate a sale by delivery of the security to the buyer. Similarly, the owner of a bond can sell the right to enforce the bond by delivery.

The other type of instrument is the primary subject matter of this text. Negotiable instruments, also known as commercial paper, can be readily identified as "money paper," because this form of indispensable paper

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[4] *See* § 2.02 *infra*.

[5] U.C.C. §§ 1-201(15); 7-201(2).

[6] Article 9 also identifies a third type of instrument — one that is nonnegotiable — for certain transactions that are beyond the scope of this work. *See* U.C.C. § 9-102(a)(47).

[7] U.C.C. § 8-102(a)(4).

derives its value from obligations to pay money that are indicated on the paper.[8] The basic forms of negotiable instruments are notes and drafts.[9]

Chattel paper is a form of personal property created when a debtor signs a writing (or writings) that evidences an obligation to pay money coupled with a security interest in or lease of specific goods.[10] The monetary obligation is sometimes represented by a negotiable instrument. Chattel paper functions like indispensable paper in certain respects and like a pure intangible in others. Specialized provisions of Article 9 govern this form of property and a detailed analysis is beyond the scope of this book.

§ 1.02 Scope — § 3-102

Article 3 "applies to negotiable instruments."[11] The term "instrument" is used extensively throughout Article 3 and for purposes of this Article means "negotiable instrument."[12] The requisites for a negotiable instrument under Article 3, discussed in detail in the next chapter,[13] are codified in section 3-104(a). They essentially describe a writing creating the unconditional right to the payment of a fixed amount of money. Writings that meet the requisites for a negotiable instrument, and that are not otherwise excluded, are within the scope of Article 3. Writings for the payment of money that do not fall within its scope generally are governed under ordinary contract law.

Article 3 includes a specific provision that limits its scope. The provision excludes money, payment orders that are part of an Article 4A funds transfer (as opposed to payment orders that are drafts within the scope of Article 3), and investment securities.[14] Even though money[15] may technically meet the requirements of section 3-104(a) on negotiability, it is excluded from Article 3 because of inherent differences. Money is negotiable at common law or under different statutes, but Article 3 does not apply to it. The mutual exclusivity of Articles 3 and 4A is made apparent by Article 3's exclusion of payment orders that are part of an Article 4A funds transfer and Article 4A's definition of "payment order" specifically excluding drafts governed by Article 3.[16]

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[8] U.C.C. § 3-104(a).

[9] U.C.C. § 3-104(e). Notes include certificates of deposit and drafts include checks. *See* § 2.03 *infra*.

[10] U.C.C. § 9-102(a)(11).

[11] U.C.C. § 3-102(a).

[12] U.C.C. § 3-104(b).

[13] *See* § 2.02 *infra*.

[14] U.C.C. § 3-102(a).

[15] " 'Money' means a medium of exchange authorized or adopted by a domestic or foreign government and includes a monetary unit of account established by an intergovernmental organization or by agreement between two or more nations" U.C.C. § 1-201(24).

[16] U.C.C. § 4A-103(a)(1)(iii). For an explanation of payment orders that are part of an Article 4A funds transfer, see § 15.04[B] *infra*.

Investment securities also are excluded from Article 3. The original uniform codification on the law of negotiable instruments, the Negotiable Instruments Law (N.I.L.), did not distinguish between instruments intended for investment and instruments that created money paper. The distinction was unnecessary at the time of the codification because the securities market was not active then. The N.I.L., however, proved to be a burden on the subsequent development of the bond market. Marketability depended upon the bonds being negotiable, but negotiability required that the payment obligation of the corporate issuer not be subject to conditions. Bond obligations had to be subject to conditions in other writings, however, so an impasse was created. The problem was resolved by the Uniform Commercial Code, which separated the treatment of investment securities and commercial paper. Any instrument that qualifies under section 8-102(1)(a) is governed exclusively by that Article, even if it also technically satisfies the section 3-104(a) definition of a negotiable instrument.

Section 3-102(b) provides that the provisions of Article 9 control the provisions of Article 3 in the event of conflict. Negotiable instruments often play an important role in secured transactions, and the two Articles are relatively well coordinated (more so with the 1998 revision of Article 9 than its predecessor). Nevertheless, conflicts do occur, and a mechanism for resolving them is a necessity.

Section 3-102(b) also provides that the provisions of Article 4 control the provisions of Article 3.[17] Article 4 becomes applicable whenever an instrument is introduced into the bank-collection process.[18] Instruments often fulfill their intended purposes without entering bank collection. Many promissory notes and drafts are transferred and paid outside of bank collection, so none of the transactions affecting them ever invoke Article 4. Because checks are by definition orders to pay drawn upon a bank, checks inevitably enter the bank-collection process, and as soon as they do, Article 4 applies. In addition, ordinary drafts that are payable through a bank and notes that are payable at a bank[19] come within the scope of Article 4 once they enter the bank-collection process. Many similar transactions are governed by Articles 3 and 4, making conflict between the two articles likely. If Article 4 is silent on a point covered in Article 3, the latter Article governs.[20] In the event of conflicting provisions, however, Article 4 controls.[21]

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[17] The same hierarchy is recognized in section 4-102(a).

[18] The bank collection process is used for the collection of instruments in addition to negotiable instruments covered by Article 3. Article 4 thus is written in terms of items. " 'Item' means an instrument or a promise or order to pay money handled by a bank for collection or payment." Article 4A payment orders, as well as credit and debit card slips, are excluded. U.C.C. § 4-104(a)(9).

[19] U.C.C. § 4-106(a),(b).

[20] U.C.C. § 4-102(a).

[21] *See*, *e.g.*, Available Iron & Metal Co. v. First Nat'l Bank, 56 Ill. App. 3d 516, 371 N.E.2d 1032, 23 U.C.C. Rep. Serv. 694 (1977) (even though notice of dishonor may be oral under Article 3, it is not sufficient for a bank under Article 4).

As a study on payment systems, many of which center around the use of negotiable instruments, this text focuses extensively on the provisions of Article 3 and on Article 4 to the extent that it governs bank collection of negotiable instruments. Article 3, however, is not a comprehensive codification of the law of negotiable instruments. Consequently, provisions within the Article must be examined for their intended scope, and when a particular problem falls outside that scope, reference must be made to common law.[22] Furthermore, the Code in general is far from comprehensive in its treatment of payment systems. Payments by means of negotiable instruments are governed by Articles 3 and 4. Article 4A on wholesale fund transfers was promulgated in 1989 and has been adopted by most states. Other payment systems, including cash, credit card, and electronic funds transfers, are not governed by the Code at all. An explanation of the law governing these payment methods requires an examination of both common law and other statutory sources.[23]

§ 1.03 Historical Context

Fourteenth-century merchants developed the use of the draft, or bill of exchange, as a means to conduct their transactions while avoiding the risk associated with the transport of large sums of money. A merchant in Italy desiring to place funds into the hands of someone in London could accomplish the objective by means of a draft. Having made prior arrangements with a party in London, the Italian merchant would issue a written order to that party to pay the person designated in the draft to receive payment. The party in London upon whom the order was drawn would make the payment when the designated person presented the paper. The party in London might have agreed to make the payment because doing so discharged a debt that the party owed to the Italian merchant for goods sold or for money lent. Alternatively, the party in London might have agreed because the Italian merchant also agreed to honor the party's drafts drawn on him.

Another mechanism could be used to achieve the same result. Rather than drawing a draft upon someone in London, the Italian merchant might have used a local money changer. The merchant would pay the money changer, who in turn would draw a draft on another money changer in London with whom an account was maintained. The designated payee on the draft would receive payment from the London money changer upon presenting the draft.

The modern banking role in England did not develop until the seventeenth century. Before that time, London merchants typically deposited their valuables for safekeeping with the King's mint in the Tower of London. After Charles I, in 1640, unilaterally borrowed 200,000 pounds from their deposits, merchants increasingly took their business to goldsmiths who

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[22] *See* U.C.C. § 1-103.

[23] For discussion of the alternative payment systems, see Chapters 13-15 *infra*.

offered the service of safekeeping valuables in addition to trading in gold and silver plate. The goldsmiths began to make arrangements with their depositors to make loans with the money on deposit, thereby converting the relationship from bailor-bailee to that of creditor-debtor. That is, rather than holding the bailed property *in specie*, the goldsmith became a debtor of the merchant. The goldsmiths also began to honor orders drawn on them by their depositors ordering them to pay designated persons. Checks, patterned on the form of drafts, evolved as the instrument by which a depositor ordered payment.

In addition to instruments that served as a safe and convenient means to transmit funds, commercial practice in the seventeenth century also developed instruments of credit. The time draft was the initial development. This type of draft allowed a stated period of time before payment was due. A seller of goods could draw such a draft on the buyer, who would then sign it. By signing the draft, the buyer engaged to pay it when it became due.[24] If the seller did not want to finance the sale by holding the draft until the due date, the seller could transfer it to a lender for less than its face value (*i.e.*, at a discount). The lender would then be paid the face amount of the draft by presenting it to the buyer for payment on the maturity date. The time draft thus served both as a credit instrument and an instrument to transmit funds.

When the credit function alone was desired, the promissory note became the instrument of choice. The debtor signed a writing promising to make payment to a lender (or to the bearer of the note) on a specified date in the future. The lender could hold the note and await payment at maturity, or, as with the time draft, the lender could discount the note to someone else. The note provided written evidence of the borrower's obligation to pay money.

The law merchant was the original source of the law of negotiable instruments. It was not law *per se*, but rather a body of commercial custom that evolved as merchants in England entered into more commerce with merchants on the continent. Drafts, checks and notes were governed originally by the custom of merchants that developed concerning the transmission of funds and evidence of credit. Rather than recourse through the courts, special tribunals of merchants were used to enforce these customs.

Eventually, the law merchant was absorbed into the English common law, but the process was quite difficult. The common-law courts understandably were resistant to the acceptance of principles that evolved outside their purview and often from foreign sources. The common-law doctrine on the nonassignability of choses in action also posed a formidable barrier. By the early eighteenth century, however, drafts had come to be seen as freely transferable, but the same attribute was denied to promissory notes.[25]

[24] The signing of a draft by the drawee is called an "acceptance," a concept that is described in detail in § 4.02[B] *infra*.

[25] Buller v. Crips, 6 Mod Rep. 29, 87 Eng. Rep. 793 (1704).

Parliament stepped in at this point, however, and with the passage of the Statute of Anne,[26] made promissory notes freely transferable as well.

Throughout all of the eighteenth century, England did not have any official paper currency, and several denominations of gold and silver coins were in short supply.[27] Increasing mercantile activities forced merchants to adopt money substitutes. Consequently, drafts and notes came to be circulated widely though several hands before ultimately being presented for payment or acceptance. Lord Mansfield decided two major cases that helped assure the acceptability of instruments as money substitutes.[28] His rulings that a holder of a negotiable instrument who acquires it in good faith and for value takes free of the claim of a prior owner of the instrument state the fundamental principle of negotiability.[29]

Since 1882, negotiable-instrument transactions in England have been governed by the Bills of Exchange Act. It served as a model for the National Conference of Commissioners on Uniform State Laws (NCCUSL), which promulgated the Uniform Negotiable Instruments Law (N.I.L.) in 1896. All of the states adopted the law by 1924. The American Bankers Association drafted the Bank Collection Code, which was adopted in about twenty states. The law of negotiable instruments and bank collections was revised and modernized through Articles 3 and 4 of the Uniform Commercial Code. The Code was promulgated in 1952 through the joint efforts of NCCUSL and the American Law Institute.

By the 1980s, changing commercial practices and technological innovations in the handling of negotiable instruments again created an impetus for change in the codification scheme. Draft revisions on Articles 3 and 4 were completed by 1990, and the revisions have now been widely enacted. A new Article 4A on wholesale fund transfers was also promulgated and has been enacted by most states.[30] Congress also passed legislation that preempted certain aspects of Article 4 check collections and empowered the Board of Governors of the Federal Reserve System to enact regulations that preempt substantial portions of Articles 3 and 4.[31] The initial incursion by the Board is Regulation CC, which implements the preemption required by this legislation and also exercises some of the discretion authorized by it.[32] All of this modernized law of negotiable instruments and alternative payment systems is explained in this text.

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[26] 3 & 4 Anne, ch. 9, § 1 (1704).

[27] Bank of England notes did not become legal tender until 1833.

[28] Miller v. Race, 97 Eng. Rep. 398 (K.B. 1758); Peacock v. Rhodes, 99 Eng. Rep. 402 (K.B. 1781).

[29] For discussion of these cases, see § 2.01[C][2] *infra*.

[30] For discussion of Article 4A, see § 15.04 *infra*.

[31] Expedited Funds Availability Act, Pub. L. No. 100-86, 101 Stat. 552, 12 U.S.C. §§ 4001–4010.

[32] 12 C.F.R. Part 229. For discussion of the legislation and Regulation CC, see §§ 11.01[B], 11.04 *infra*.