Chapter X :Negotiable Instruments

Bank Liability to Honor Checks Endorsement &Defenses

Bank Liability to Honor Checks

- **concept:** A **bank is liable to honor** the checks written by its customers, with the usual stipulation **that sufficient funds must be available.** When the **bank** properly **dishonors** a check for insufficient funds, it has **no liability to the customer.**
- **Exception: “overdraft protection agreement”** If such an agreement is formed, **any failure of the bank to honor** a check <u>because it would create an overdraft</u> **breaches this agreement** and is treated as a wrongful dishonor
- **Postdated Checks: a bank may charge** a postdated check against a customer’s account, **unless the customer notifies the bank,** in a timely manner, **not to pay** the check **until the stated date**.

Bank Liability to Honor Checks

- **stale check:** A bank is **not obligated to pay** an uncertified check **presented more than six months** from its date.
- **Death or Incompetence of a Customer :Neither** the death nor the incompetence of a customer **revokes a bank's authority to pay** a check **unless the bank is notified** and has had **reasonable time to act on the notice**
- A **stop-payment order** is an **order by a customer** to her or his bank **not to pay** a certain check.

➢ A customer has **no right to stop payment** on a check that has already **been certified** (or accepted) by a bank,

Bank Liability to Honor Checks

- **Forged Drawers' Signatures :** When a bank pays a check on which the drawer's signature is forged, generally the **bank suffers the loss.**

➢ When a **customer's negligence** substantially **contributes to a forgery**, the **bank** normally **will not be obligated to recredit the customer's** account for the amount of the check .

Endorsement

Endorsement concept

- negotiation is the transfer of an instrument in such form that the transferee becomes a holder by endorsement for **Order Instruments or by delivery for Bearer Instruments**.
- An **endorsement** is a signature written on the back of the instrument itself.
- **For example**, Luisa Parks receives a graduation check for $100. She can transfer the check to her mother (or to anyone) by signing it on the back. Luisa is an endorser. If Luisa endorses the check by writing "Pay to Avery Parks," Avery Parks is the endorsee.
- **Types of endorsements:**

➢ blank, special, qualified, and restrictive.

Type of Indorsement	Description	Examples	Legal Effect
Blank Indorsements	Indorser does not identify the person to whom the instrument is payable; can consist of a mere signature.	"Elana Guiterrez" "Mark Deitsch"	Creates a bearer instrument, which can be negotiated by delivery alone.
Special Indorsements	Indorser identifies the person to whom the instrument is payable.	"Pay to the order of Russell Clay" "Pay to William Hunter"	Creates an order instrument; negotiation requires indorsement and delivery.

Type of Indorsement	Description	Examples	Legal Effect
Qualified Indorsements	Indorser includes words indicating that he or she is not guaranteeing or assuming liability for payment.	"Without recourse, Elana Guitterez" (blank qualified indorsement) "Pay to Allison Jong without recourse, Sarah Jacobs" (special qualified indorsement, which creates an order instrument)	Relieves indorser of any liability for payment of the instrument; frequently used by agents or others acting on behalf of another.
Restrictive Indorsements	Indorser includes specific instructions regarding the funds involved or states a condition to the right of the indorsee to receive payment.	"For deposit only" "For collection only"	Only a bank can become a holder of instruments that are indorsed for deposit or collection.
		"Pay to Stephanie Contento as agent for Ralph Zimmer" "Pay to Ellen Cook in trust for Roger Callahan"	In a trust indorsement, the third party agent or trustee has the rights of a holder but has fiduciary duties to use the funds consistently with the indorsement.

Signature liability

- **The general rule** is that every party, except a qualified indorser, who signs a negotiable instrument is either primarily or secondarily liable for payment of that instrument when it comes due.
- **Primary Liability:** On Makers (in case of PN) & Drawees accepting an instrument.
- **Secondary Liability:** On *Drawers* and *indorsers* will be liable ***only if*** the party that is **primarily responsible** for paying the instrument **refuses** to do so.

➢ A drawer's secondary liability does not arise until the drawee fails to pay or to accept the instrument , whichever is required.

Defenses to Negotiable instruments payment

Ordinary Holder Vs. Holder In Due Course

- **Ordinary Holder** is a person who legally **obtains the negotiable** instrument, **with his name entitled on it**, to receive the payment from the parties liable.
- **A holder in due course (HDC)** is a person who **acquires the negotiable** instrument **in good faith** for some consideration, whose payment is still due.

Universal (Real) Defenses against all holders

- **FORGERY** of a <u>maker's or drawer's signature</u> **cannot bind the person** whose name is used **unless that person ratifies** (approves or validates) the signature or is precluded from denying it.
- **FRAUD IN THE EXECUTION** If a **person is deceived** into signing a negotiable instrument, **believing that she or he is signing something other than a negotiable instrument.**
- **MATERIAL ALTERATION** Making any change in the amount, the date, or the rate of interest .
- **DISCHARGE IN BANKRUPTCY of** issuer **or indorser.**
- **MINORITY, MENTAL INCAPACITY, EXTREME DURESS of issuer or indorser.**

Personal(Limited) Defenses against ordinary holders ONLY….
NOT holders in due course

- **BREACH OF CONTRACT**
- **FRAUD in the inducement** Drawer will be able to avoid payment on that instrument, unless the holder is an HDC.
- **MENTAL INCAPACITY** If a **maker or drawer** issues a negotiable instrument **while mentally incompetent but before a court** has declared him or her to be so, **the instrument is voidable**.
- **Discharge by previous payment or cancellation** ,

case

- Willy agrees to purchase Carin’s used tractor for $26,500. Carin, knowing her statements to be false, tells Willy that the tractor is in good working order and that it has been used for only one year. In addition, she tells Willy that she owns the tractor free and clear of all claims. Willy pays Carin $4,500 in cash and issues a negotiable promissory note for the balance. Ten days later, Willy’s neighbour , a technician while trying the tractor found out the real facts about the tractor and told willy who refused to pay the issued promissory note.
- **Advise Willy with a justified legal advice.**

Answer

- In this situation, Willy can refuse to pay the note if it is held by an ordinary holder (Carin) because of fraud in the inducement. If, however, Carla has negotiated the note to an HDC, Willy must pay the HDC. Of course, Willy can then sue Carin to recover the funds.