

#### Question 4 – February 2014 – Selected Answer 1

{1} Yes, the promissory note is negotiable. The issue is the requirements for a negotiable instrument. A negotiable instrument is: (1) a written, signed agreement; (2) providing an unconditional promise; (3) to pay a fixed sum; (4) of money; (5) on demand or a specified date; (6) contains language of negotiability; and (7) does not contain any other undertakings. Negotiability is determined at the time of issuance and does not thereafter change.

Here, the promissory note was written and signed by Cathy. The note provided an unconditional promise to pay as it is not conditioned on an event (i.e. it does not say "If you paint my house, I will pay..." which would not be unconditional). The fact that the note required Cathy to pay from her account at First Bank is not a problem, that is not considered an impermissible condition. The note is for a fixed sum of \$20,000. The "fixed sum" requirement requires only that the principal amount be readily identifiable on the face of the instrument. The fact that there is a variable interest rate (or even an interest rate identified that may no longer be published) does not prevent negotiability. The note must be for payment of money--US or foreign currency--rather than services. Here, the \$20,000 meets this requirement.

The note is payable at a specified date. The note is payable on March 15, 2014. The fact that Cathy may at her option extend the date 1 year is not a problem because there is still an identifiable due date if she does so of March 15, 2015. The note contains language of negotiability. A note must contain either bearer or order language. Bearer language is such that it is not made out to a specific person and anyone in possession may enforce. Order language is such that it is made out to specific person and only a person with possession and proper endorsements may enforce. Here, the note made payable "to the order of Gary" contains the requisite order language of negotiability.

Finally, the note does not contain any further undertakings. The fact that the note required Cathy to pay from her account at First Bank is not a problem, that is permitted without harming negotiability.

{2} Either the prime rate or the judgment rate will be applied. The issue is what interest rate will be applied when the one listed in a promissory note is no longer published. Generally, the interest rate applied is the one listed in a promissory note agreed to by the parties. If a note is silent with regard to interest, it is assumed that no interest will apply. If a note specifies that interest will be paid but does not provide a calculation method, the judgment rate will be used.

Here, the interest rate agreed to by the parties was the "prime rate." Although the parties identified the rate as being listed in the "Interest Rate Reporter" because that is no longer published, it may be that the "prime rate" is published elsewhere in a different reporter. If so, the prime rate will be used. If there is no other publication of the prime rate (or if somehow the prime rate itself no longer existed) the judgment rate would apply because the parties did provide for interest on the note.

{3} Yes, the bank was justified in dishonoring the check. The issue is whether a bank may dishonor a check that does not contain all proper endorsements. First, it is important to identify the type of instrument at issue, a note (promise to pay between maker and payee) or a draft (an instruction by a drawer to a drawee to pay a payee). A check is a draft whereby the drawer (Cathy) orders the drawee (First Bank) to make payment on demand to a payee (here Bill and Kay). Second, we should note that the check is negotiable as it meets the requirements listed in part 1 above. Then we must determine if the check was properly negotiated. In order for someone to be a holder of the check (entitled to cash it), it must be properly negotiated. For order paper, such as the check here made out to specific people (Bill and Kay) this requires both possession and proper endorsements. Because the check was made out to Bill **and** Kay, it required both signatures to be properly negotiated. Only Kay endorsed the check. This means that it was not properly negotiated and that Steve was not a holder (and not entitled to enforce).

Because Steve was not a holder, First Bank properly dishonored the check. In order to be properly payable, a check must contain the proper endorsements. Because this check did not contain Bill's endorsement, it was not properly payable. The bank was justified in dishonoring the check (and indeed would have been liable to Cathy had they not done so and paid a check that was not properly payable.)

**{4}** Yes, the bank was justified in debiting Steve's account. The issue is whether a bank may debit a customer's account when a check is deposited and subsequently dishonored. A bank may debit an account if a check is dishonored before final settlement of the check. This means that it may do so before a check is cashed, final settlement is made, or before the midnight rule deadline expires. The midnight rule allows the bank until midnight the next business day after a check is dishonored to debit the account. Here, as explained in Part 3 above, First Bank was justified in dishonoring the check and returning it to Secure Bank. Because Secure Bank "immediately" debited the account and returned the check to Steve (assuming "immediately" means before the midnight deadline), the debit was proper.

It should be noted that Steve is not left without remedy. He may be able to claim a breach of endorser contract or transfer warranty against Kay. Generally, a buyer who gives consideration can demand a missing endorsement. Here, however, Bill was not involved in the transaction between Steve and Kay and, thus, Steve cannot compel his signature. He may, however, recover against Kay because there was presentment of the check and dishonor by the bank if he provides Kay notice of the dishonor within 30 days.

#### **Question 4 – February 2014 – Selected Answer 2**

**1)** The note Cathy delivered to Gary was negotiable when issued. In order for a note to be negotiable it must meet the following requirements 1) signed writing; 2) unconditional promise or order to pay; 3) a fixed amount of money; 4) at a definite time or upon demand; 5) to order or to bear (words of negotiability); 7) the instrument cannot contain any extraneous undertakings; 8) not marked non-negotiable.

- 1) Signed Writing - Cathy signed and delivered the note to Gary. The fact that Gary drafted it is irrelevant.
- 2) Unconditional promise or order to pay - Cathy's promise to pay the note was not conditional upon any other event. The fact that the note stated Cathy would pay from a particular source or fund does not make the note conditional. Therefore, the note was an unconditional promise or order to pay.
- 3) Fixed Amount of Money - Cathy agreed to pay Gary in cash, which constitutes money. The amount was fixed because the principal of the note was clear on its face--\$20,000. The fact the note provided for interest does not affect this requirement--the fixed amount only applies to the principal. In addition, the parties can set an interest rate by reference to an outside source.
- 4) Definite Time - Cathy promised to pay the note in one year from the date of issuance, which makes the time for payment definite. The parties can agree to extend the due date of the instrument by expressly stating the terms of the extension without violating this rule. Here, the parties expressly agreed to an extension and it was provided in the note, so the note is still due at a definite time.
- 5) Words of Negotiability - Cathy issued the note with the words "payable to the order of Gary", which are valid words of negotiability. The note is order paper.
- 6) Extra Undertakings - Cathy only agreed to pay money, and did not take on any additional obligations. This element is satisfied.

7) Finally, the note was not marked non-negotiable, which would make the note non-negotiable regardless of the requirements listed above. Because all of the elements of negotiability were met the note was negotiable

**2)** The judgment interest rate is the applicable interest rate because the referenced source is no longer in existence. Under the TUCC, if an instrument is silent as to interest, it is not an interest bearing instrument. However, the maker and payee can agree to make a negotiable instrument, except for a check, interest bearing. The parties may set an interest rate based upon a flat fee, an interest rate, or with reference to an outside source. If the referenced source is no longer in existence, the code provides that the applicable interest rate is the judgment interest rate.

Here, Cathy and Gary expressly stated that the note would provide interest by referencing an outside source. Even though the outside source is no longer in existence, and thus, cannot supply an interest rate, the code provides that the applicable interest rate is the judgment interest rate. Therefore, the note will still be interest bearing and the rate of interest will be determined by the judgment interest rate.

**3)** First Bank was justified in dishonoring the check because it was not signed by both Bill and Kay. The issue is the effect issuing note to co-payees with the use of the word "and" has on negotiability. A drawer can issue a check to co-payees. Generally, the ability of the co-payees to negotiate or transfer their rights under the check depends on the nature of issuance. If the check was issued to both payees using the word "or", either payee can effectively negotiate by indorsing and transferring possession of the check. However, if the check was issued to both payees with the word "and", both payees must indorse and transfer possession for negotiation to be effective. If only one payee indorses the check, the indorsement is ineffective to transfer the rights under the check to another holder. The subsequent holder is not entitled to enforce the check, and the drawee bank can properly refuse to honor the check.

Here, Cathy issued the check payable to "Bill and Kay"; thus, both Bill and Kay were required to indorse the check to properly negotiate the instrument (transfer their rights to the check). However, only Kay indorsed the check to Steve, which was not effective negotiation. Therefore, Steve was not a holder of the check and was not entitled to enforce the check. First Bank was well within its rights to dishonor the check for the lack of a co-payees signature.

**4)** Secure Bank was justified in debiting Steve's account because it revoked its provisional settlement by midnight of the next banking day. A enters into a provisional settlement with an account holder by immediately crediting his account upon transfer of the check. The bank is entitled to revoke the provisional settlement by midnight of the next banking day if the check is dishonored by the drawee/payor bank. The account holder is not entitled to payment on the instrument. Here, Secure Bank entered into a provisional settlement with Steve by immediately crediting his account when he transferred the check to them--this event started the provisional settlement clock. When First Bank dishonored the check upon presentment by Secure Bank, Secure Bank had the right to revoke its provisional settlement with Steve by debiting his account before midnight of the next banking day. Secure Bank properly revoked the provisional settlement, and thus, they were justified in debiting his account.

Normally, a transferee who gives value for an instrument is entitled to the signature of the transferor. However, in order for this rule to apply, the transferor must have received value from the transferee. In this case, only Kay received consideration for the transfer, not Bill. Therefore, Steve was not entitled to Bill's signature, which would allow him to deposit the check. Steve must receive Bill's signature to have the right to enforce the check.

#### **Question 4 – February 2014 – Selected Answer 3**

1. The note was a negotiable instrument. The issue here is what the requirements for a negotiable instrument are. A negotiable instrument must be in writing, signed by the maker, containing an unconditional promise to pay a fixed amount of money on demand or at a definite time, with no additional undertaking and containing words of negotiability. Here, the note was in writing. It was signed by the maker, Cathy. It contained an unconditional promise to pay. The fact that it was to be paid in Austin does not make it conditional or require some unpermitted undertaking. Further, it is also permissible for a negotiable instrument to specify the source of the funds (here, Cathy's checking account). Thus the note was unconditional per the UCC.

It was also a promise to pay a fixed amount of money (\$20,000). The reference to the interest rate in the Interest Rate Reporter does not make this not fixed, conditional, or requiring some additional undertaking. A negotiable instrument may reference some outside source as to amount of interest. The fixed requirement only pertains to the principal.

Further, the note was payable at a definite time, because it was dated and was due precisely one year from that date. That Cathy was permitted to extend the due date of the note for 1 year does not destroy negotiability. The UCC permits the maker of a note to extend the note to a further definite time stated in the note without destroying negotiability. Here the extension date was also a definite time (one year from the due date). There is also no additional undertaking, and it contains words of negotiability ("to the order of Gary"). Therefore this note was a negotiable instrument.

2. The interest rate applicable to the note in question is either the prime rate or the judgment rate. At issue here is what interest rate to use when the source specified in the note no longer exists. The general rule is that payment under a negotiable instrument does not include payment of interest unless the instrument so provides. Here it is clear that the parties intended that interest would be paid under the note, along with the principal. A case could be made that this was never intended because the source specified did not exist at the time of the note. However this argument is unpersuasive because there are no facts that indicate the parties knew that the Interest Rate Reporter had stopped publication.

Where the source specified in the note cannot be ascertained, the parties should just use the judgment rate. However, because the note specifically used the language "prime rate" it may be more appropriate to use the prime rate but as specified by another source. As such, the interest rate is either the prime rate or the judgment rate.

3. First Bank was justified in dishonoring the check. The issue here is whether it is a wrongful dishonor for a drawee bank to dishonor a check that lacks a necessary indorsement. Generally, an instrument has not been properly negotiated when it lacks a necessary indorsement. If an instrument has not been negotiated, any subsequent holder is not entitled to enforce it. As a result, the drawee bank need not pay the instrument.

An indorsement is necessary if it is needed to negotiate the instrument. Where a check is made payable to two payees using the word "and", the indorsement of both payees is required to properly negotiate the check. In this case, the check was payable to Bill and Kay. As such, the signature of both Bill and Kay were necessary to negotiate the check. Thus, when Steve acquired the check after it had only been indorsed by Kay, he had not yet become a person entitled to enforce the check. Thus his bank (Secured) was not entitled to present the check for payment.

Note that while Steve had a right to get Bill's indorsement, he did not seek to get this signature. Additionally, hile a bank may become a holder when it takes a check of its customer, even without the indorsement of its ustomer, the bank does not also become a customer when there is a lack of a necessary indorsement from a payee further up the chain. Thus the check was not negotiated when Steve got it. He was not a person entitled to enforce it, his bank had no right to demand payment, and First Bank was well within its rights to dishonor the check for lack of a necessary indorsement.

4. Secure Bank was justified in debiting Steve's account for \$200.

The issue is when a presenting bank may debit its customer's account after making funds available to the customer. The general rule is that a bank is only liable to its customer once it has made final payment. Final payment occurs when the bank pays the check in cash, or fails to revoke a provisional settlement (i.e. crediting the customer's account before payment on the check has been made by the drawee bank) by its midnight deadline. The midnight deadline is midnight of the day after the bank accepts the check.

In this case, Secure Bank gave Steve a provisional settlement because the facts indicate that it merely credited his account (as opposed to paying the check in cash). Further, the facts do not indicate that the bank's midnight deadline had passed, so the settlement remained provisional (it appears that this all happened in the span of one day, May 2). The UCC provides that a collecting bank may take back a provisional settlement at any time before final payment. In this case, because there had been no final payment, the bank was entitled to revoke its provisional settlement by debiting the account for the amount it had credited the account (\$200). Therefore bank was justified in debiting the account.