SECTION A – NEGOTIABLE INTSTUMENTS

UNIT 1 - INTRODUCTION TO THE LAW OF NEGOTIABLE INSTRUMENTS

Historical Overview

Bills of exchange probably originated in Italy during the 15th century. This era saw an amazing increase in commercial transactions and the giving of credit among the Lombards in the famous Italian commercial cities of Venice, Genoa and Florence. The merchants and moneychangers found it expedient not to transport the money itself and then to exchange it for foreign money, but to make use of an oral promise to pay. For instance, a moneychanger would make an oral promise to pay in a foreign country in that country's currency, by means of his representative. At that stage, this was still a contract of exchange. This also explains where the term bill of exchange comes from.

Later on, the promise to pay was made in writing, and the moneychanger, for example, would undertake to pay a sum of money in a foreign country in the currency of that country. The merchant who received the promise in writing from the moneychanger would really be buying from the moneychanger the right to claim a particular sum of money in the foreign country. By virtue of this promise of payment, the merchant would obtain the right to claim payment of the amount mentioned in the document from the moneychanger's representative in the foreign country. Because the merchant had bought the promise of payment from the moneychanger with the money of his own country, it became customary to write the words ``for value received'' on the document. The custom of adding these words to bills and promissory notes has survived to this day.

We find a further step in the development of bills of exchange in the so-called "order to pay'', which was later added to the promise to pay. Together with the written promise to pay, the moneychanger would also give his agent in the foreign country an order in writing to pay the merchant a certain sum of money in that country's currency. The promise to pay later disappeared, and the moneychanger gave only an order to pay. This order to pay was the predecessor of the modern bill of exchange.

Suppose merchant C from France wished to have a sum of money available in Italy in order to buy certain merchandise at an annual market. C would then pay a sum of money in French currency to a moneychanger, A, in France. A would give B, his agent in Italy, a written order to pay a corresponding sum of money in Italian currency to D, C's trade associate in Italy, and A would hand the document over to C. C would send the document to his trade associate, D, in Italy, and D would receive payment in foreign currency from B on behalf of C. In this way the danger of transporting money and the inconvenience of exchanging money was avoided. It subsequently became customary not even to mention D in the document. Then C himself could appoint the person (D) to whom B had to pay. This appointment by C was reflected on the document, first on the Front, but later on the back of the document; this is how the concept and use of endorsement originated. At this stage of the development of the bill, three names appeared on it. The three persons mentioned in the document are known as the drawer (A), the drawee (B) and the payee (C). If C appoints another person who is to be paid, C endorses the document and delivers it to the endorsee (D).

These fixed usages of the merchants caught on elsewhere in Europe, and a new, uniform ``law of bills'' originated in countries such as Italy, France, the Netherlands and Germany, and later on in England as well. The law of negotiable instruments

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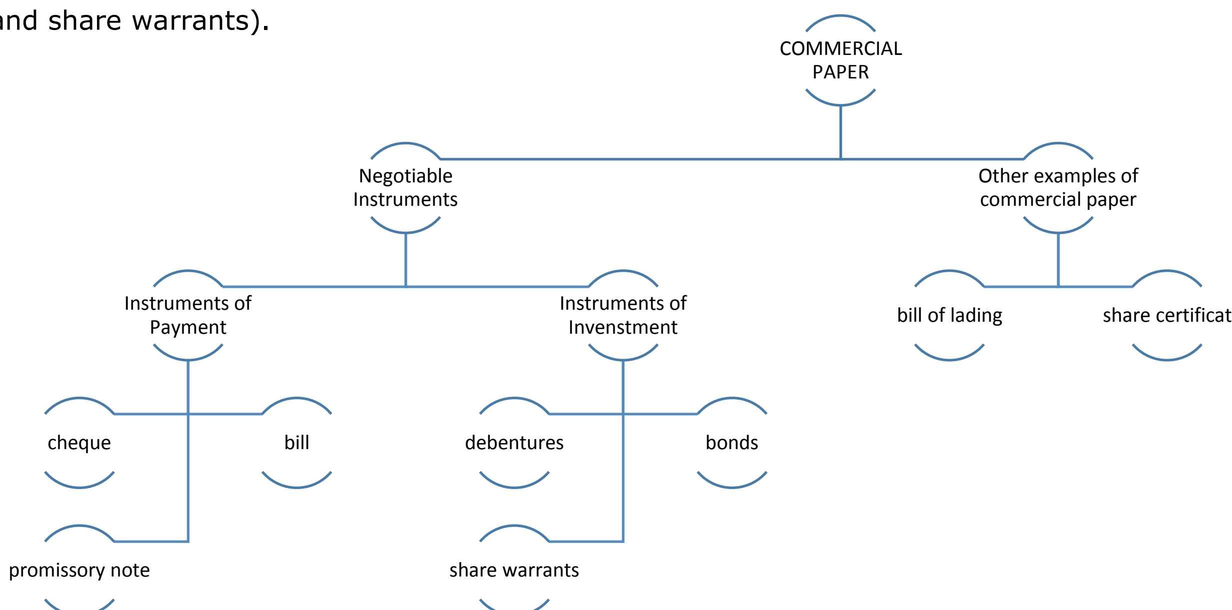
retained its international basis, but national differences developed in the course of time.
Various attempts have been made to bring about an international uniform law of negotiable instruments. An example of this was the International Conference for the Unification of the Bills of Exchange, Cheques and Promissory Notes, held in Geneva in 1930. Despite these attempts, there are still differences between the Commonwealth group of countries (which includes South Africa) and the Continental group of countries (which includes France, Germany, the Netherlands, Italy, Russia and Japan).

Before the creation of the Union of South Africa, the law relating to bills, cheques and promissory notes was governed by the following separate statutes of the four provinces that formed the Union:
. Act 8 of 1887 (Natal)
. Act 19 of 1893 (Cape)
. Proclamation 11 of 1902 (Transvaal)
. Ordinance 28 of 1902 (Orange Free State)

These provincial statutes, and their later amendments, were repealed and replaced by the Bills of Exchange Act 34 of 1964, which consolidates and amends the laws relating to bills of exchange, cheques and promissory notes. Since its promulgation, this Act has been amended four times. The most recent amendments were made in 2000 by the Bills of Exchange Amendment Act 56 of 2000, which came into effect on 1 March 2001.

Examples of Negotiable Instruments

A **commercial paper** is an instrument which embodies contractual rights, and the possession of the instrument is required to enforce those rights that are contained in it.
Although negotiable instruments (bills, cheques, promissory notes, certain bearer debentures, bonds and share warrants) are categorised as commercial paper, not all commercial papers are negotiable instruments.
Examples of commercial papers which are not negotiable instruments include bills of lading and share certificates.
Some negotiable instruments can be characterised as instruments of payment (bills, cheques and promissory notes) whereas others can be seen as instruments of investment (debentures, bonds and share warrants).



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Characteristics of Negotiable Instruments

Basis characteristics:

- Simplicity of transfer
- The possibility of transfer free from equities

Main reason for the development of this type of instrument:

- Beginning and subsequent increase of commercial trade in Europe.
- It became economically practical to use a bill to effect payment because it was safer than money, and
- It made the process of effecting payment less time-consuming

Simplicity of Transfer

The first common characteristic of bills, cheques and promissory notes is that they and the rights embodied in them can be transferred from one person to another without the need to comply with difficult and cumbersome formalities.

Can generally be transferred from one to another either by delivering them to the recipient, or by signing them first before delivery. Whether or not it needs to be signed before it is delivered depends on whether it is an order or a bearer instrument.

Example :

A buys a fridge from B for R2 000 and pays the amount by cheque. A hands the cheque to B. B can do one of two things

(1) B can take the cheque to the bank and receive R2 000; or

(2) B can use the cheque to pay a third party for goods or services received.

Assume that B decides to use the cheque to pay for food that he has purchased at C's shop. If the cheque is payable to bearer, it means that B can simply hand over the cheque to C and C will become its holder. However, if the cheque is payable to order, B first has to sign the cheque and then deliver it to C. C then has the same two choices that B has.

Transfer free from equities

It is a basic principle in our law that one cannot transfer a better title to another person than the title one has oneself.

Law of negotiable instruments creates exception to this rule, which is based on commercial reality. Negotiable instruments will only be used as a method of payment if the person who takes the instrument as payment for a debt obtains ownership and full title to the instrument in the same way he would have if payment was made with cash.

Example :

Suppose a thief steals a R10 note from your purse. The thief uses the R10 note to buy a loaf of bread from the corner café. The shopkeeper (owner) will become owner of the R10 note if he is unaware of the theft. His title as "owner'' is not dependent on him having received the R10 note from someone who has a valid title to it (compare this with the example above where a car had been stolen). It would not make sense if similar consequences did not flow from the use of a negotiable instrument. In other words, people would be very reluctant to make use of negotiable instruments because it would be more difficult to become owner of a negotiable instrument than it would be to become the owner of money.

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In applying this to negotiable instruments, it means that the person who takes the negotiable instrument in good faith acquires ownership of the instrument, even though the person from whom he received the instrument has no title or a defective title to it. In other words, such a person derives his title from the instrument itself and is not subject to defences that could be raised against his predecessor's title.

However, negotiable instruments display characteristics which are different to cash as well. It would defeat the very purpose of using negotiable instruments if negotiable instruments had similar consequences to cash in all circumstances. From the historical overview of negotiable instruments highlighted above, you can see that these instruments were introduced partly as a response to the hazards and inconvenience of physically transporting money across vast distances. Thus, negotiable instruments had to display characteristics that made them "safer" than cash.

Suppose a person loses his own R10 note; he is out of pocket by R10 - he cannot demand that someone gives him a R10 note to replace the one that he has lost. However, the loss of a cheque (a negotiable instrument) does not produce the same results. Where a cheque is lost, the holder of a cheque may, in certain circumstances, ask the drawer to give him a duplicate of the cheque.

Bill of exchange

Section 2(1) of the BEA: "a bill of exchange is an **unconditional order** in **writing, addressed by one person to another, signed by the person giving it**, requiring the **person to whom it is addressed to pay on demand, or at a fixed or determinable future time**, a **sum certain in money** to a **specified person or his order, or to bearer**."

Eight essential elements that a bill has to comply with are:

1. an order;
2. in writing,
3. which is unconditional;
4. addressed by one person to another;
5. signed by the person giving it;
6. requiring someone to pay a sum certain in money;
7. on demand or at a fixed or determinable future time;
8. to a specified person or his order or to bearer.

Cheque

Section 1 defines a cheque as "a bill drawn on a bank payable on demand". If the definition of a bill is combined with that of a cheque in section 1, the definition of a cheque could then be the following: "A cheque is an **unconditional order** in **writing, addressed by one person to a bank, signed by the person giving it**, requiring the **bank to whom it is addressed to pay on demand a sum certain in money** to a **specified person or his order, or to bearer**."

Promissory Note

Section 87(1) of the BEA: "an **unconditional promise** in **writing made by one person to another, signed by the maker**, and **engaging to pay on demand or at a fixed or determinable future time, a sum certain in money**, to a **specified person or his order, or to bearer**."

The similarities and differences between a bill of exchange and a cheque

A cheque is a special kind of a bill of exchange, and with a few important exceptions, the general provisions relating to bills apply. It is clear fromsection1of the BEA that, in order for a bill to qualify as a cheque, two important qualifications must be met:

- The order to pay must always be addressed to a bank.
- It must be payable on demand.

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The similarities and differences between a bill of exchange and a promissory note

This definition corresponds, in several respects, with the definition of a bill. The important differences are that

- a bill is an unconditional order given by one person to another while a promissory note is an unconditional promise made by one person to another.
- in a bill the order to pay is addressed to a third person, whereas in a promissory note the maker of the note promises to make payment.

BILLOF EXCHANGE	CHEQUE	PROMISSORY NOTE
order	order	**promise**
unconditional	unconditional	unconditional
in writing	in writing	in writing
addressed by one person to another	addressed by one person **to a bank**	addressed by one person **to himself**
signed by the person giving it	signed by the person giving it	signed by the person giving it
sum certain in money	sum certain in money	sum certain in money
to pay on demand or at a fixed or determinable future time	to pay **on demand**	to pay on demand or at a fixed or determinable future time
to a specified person or his order or to bearer	to a specified person or his order or to bearer	to a specified person or his order or to bearer

Payment to order or bearer

A negotiable instrument may be payable to order or to bearer, depending on its content.

An instrument payable to order is referred to as an order instrument (an order bill, order note or order cheque).

Similarly, an instrument payable to bearer is referred to as a bearer instrument (a bearer bill, bearer note or bearer cheque).

For an instrument to be negotiable, it must always be payable either to order or to bearer.

Remember that the drawer "orders" (gives an instruction or command) that someone (the payee) is to be paid. If the drawer wants the bill to be payable to a specified person (the payee) or his order, the drawer is "ordering" that either the specified person must receive payment, or the specified person can once again give an "order" as to who must receive payment. If the drawer indicates that payment must be made to bearer, the drawer wants anyone who bears (that is, carries or possesses) the bill to receive payment.

However, a negotiable instrument may be payable neither to order nor to bearer. Such an instrument is called a "non-transferable" instrument. A "non-transferable" instrument is payable to a specified person (the payee) only.

Instrument payable to order

An instrument is payable to order if it is payable to

- a specified person or his order (Pay John Smith or order)
- to the order of a specified person (Pay the order of John Smith)
- to a particular person (Pay John Smith)

The person to whom payment must be made (the payee) must be either named or otherwise indicated with reasonable certainty (s 5(1)).

Instrument payable to bearer

An instrument is payable to bearer in the following instances:

- If it is made payable to bearer (s 6(2)). This will be the case when the instrument originally is made payable to "Bearer" or to "John Smith or bearer".
- If the instrument is payable to "cash or order" or the order of "cash" (s 6(2)).
- If the only or the last endorsement appearing on it is an endorsement in blank (s 6(2)).
- If the payee or endorsee is a fictitious or non-existent person or someone who does not have the capacity to contract. Section 5(3) of the BEA states that in these three cases, the instrument may be treated as if it were payable to bearer. A person "who does not have capacity to contract" probably means someone without capacity to act.

An instrument payable to bearer is payable to anyone who is in possession of it (s 1).

Parties necessary to a bill, cheque and promissory note

Bill of exchange

The definition of a bill of exchange reveals that there are three necessary parties to a bill:

- the person who gives the order (the drawer)
- the person to whom the order is addressed (the drawee)
- the person to whom payment must be made (the payee or bearer)

There need not be three different persons, since the drawer and the payee (A draws a bill on B in favour of A) or the drawee and the payee (A draws a bill on B in favour of B) may be one and the same person (s 3(1)). But at least two different persons must be parties to the bill, since section 2(1) of the BEA requires a bill to be an order addressed by one person to another.

Note further that where the drawer and the drawee (A draws a bill on A in favour of B) are the same person, the holder may elect to treat the instrument either as a bill of exchange or as a promissory note (s 3(2)).

While there is a limit as to the min number of persons who may be parties to a bill, there is no limitation on the max number of persons who may be parties to a bill. There may be various drawers and/or drawees and/or payees.

The drawer

The drawer is the person who gives the written order that a sum of money be paid. He draws the bill and must sign the bill as drawer.

The drawee

The drawee is the person to whom the order to pay is addressed. There are number of reasons why the drawer may choose to draw the bill on the drawee. Ex: the drawer and drawee have entered into an agreement in which the drawer was entitled to draw a bill on the drawee.

The drawee must be named or otherwise indicated on the bill with reasonable certainty (s 4(1)), and until he signs the bill, he incurs no liability on the bill. As soon as the drawee signs the bill, or as soon as he accepts the drawer's order by placing his signature on the instrument, he is called the acceptor.

The payee

The payee is the person to whom payment must be made - he is the person whom the drawer names on the bill as the person in whose favour the bill is drawn. The drawer draws the bill on the drawee in favour of the payee and the drawer then usually issues the bill to the payee.

If the payee of an order document wishes to negotiate the bill, he must sign and deliver the bill, in which case he then becomes the endorser.

The bearer

A bearer is any person in possession of a bill payable to bearer.

Cheque

The fundamental parties to a cheque correspond to the fundamental parties to a bill, since a cheque is, in essence, a bill. Thus in the case of cheques we also have the drawer, the drawee and the payee or bearer. The drawee of a cheque must, however, always be a bank.

When you open a current account with a bank, the bank agrees, among other things, to pay the cheques that you draw on the bank, provided that you have sufficient funds in your account. So, the bank is contractually obliged to pay the cheques that you, its customer, draw on it, provided that there are sufficient funds in your cheque account.

Rudolph Nengome draws a cheque on B Bank in favour of "Cash or Order". The drawer, drawee and payee or bearer are identified as follows:

B BANK – the drawee bank

Registered bank

Pay : Cash or order – payable to bearer 13 December 2009

the sum of Ten thousand rand only **R 10 000.00**

Signed: Rudolph Negome

Rudolph Negome – the drawer

Promissory note

A promissory note differs from a bill or cheque in that there are only two fundamental parties to it (s 87(1)). The parties are:

- the person who promises to pay (the maker)
- the person to whom this promise to pay is made (the payee or bearer).

The maker

The maker is the person who makes the promise to pay. He makes the promissory note and must sign it as maker. At first glance one might think that the maker of a promissory note corresponds to the drawer of a bill, but this is in fact not so. The maker of a note corresponds to the acceptor of a bill because the maker undertakes to make payment personally.

The payee

The payee of a promissory note is the person to whom the promise is made, that is, the person in whose favour the note is made. The maker mentions the payee by name in the promissory note and issues the promissory note to the payee. When the payee negotiates the note (endorses and delivers it), he becomes the endorser.

The bearer

What has been said about the bearer of a bill applies to the bearer of a promissory note as well.

Alvereen Leonard made a promissory note in favour of Michelle Kelly. The parties are identified as follows:

R 10 000.00	Cape Town
The payee	31 December 2009

I promise to pay Michelle Kelly the sum of two thousand rand on 31 January 2010 for value received

Signed: Alvereen Leonard

Alvereen Leonard – the maker

Relationships between parties to Bills, Cheques and Promissory Notes

These relationships will be explained with reference to a bill. What follows also applies to the parties to cheques and promissory notes.

A draws a bill on B in favour of C or order. C negotiates the bill to D.

From this example, we can identify three sets of relationships between the parties A, B, C and D, namely:

(1) the underlying relationships

(2) the relationships which arise from the agreement to make use of the bill

(3) the relationships on the bill

Using the example above, we can expand the explanation of the various set of relationships as follows.

Underlying relationships

There must be some reason why A draws a bill on B; why A draws the bill in favour of C and issues it to C; and why C negotiates the bill to D. There could be various reasons why the parties act as they do. For example: B has given A credit and for that reason allows A to draw bills on him; A has bought a car from C and now A pays C by means of a bill; C has borrowed money from D and for that reason C negotiates the bill to D. These relationships between the parties which lead to the drawing and issuing and later negotiation of the bill may be described as the underlying relationships.

Relationships that arise from the agreement to make use of the bill

Normally the parties to the abovementioned underlying relationships will pay each other in cash. A bill is not legal tender like cash and the parties can always refuse to accept payment by bill. Thus, before C agrees to allow A to pay by means of a bill, and before D, in turn, accepts the bill

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from C in payment, the parties concerned must agree expressly or by implication that a bill will be used to effect payment.

Relationships on the bill

The bill owes its origin, issue and further negotiation to the abovementioned relationships, but as soon as the bill has been issued, a new set of relationships arises on the bill itself. The bill still reflects the monetary aspects of the prior underlying relationships, but the parties no longer rely on those relationships to enforce their rights on the bill. They rely on the bill and derive their rights and liabilities from the various contracts on the instrument; and the right to enforce these rights under the underlying obligations is suspended until the instrument matures.

This means that the underlying relationships are not replaced by the contracts on the bill; the two sets of relationships coexist. The parties may, for example, still raise defences based on the underlying relationships in order to oppose claims on the bill, except against the holder in due course who acquires an independent right based on the instrument. The performance of either set of obligations discharges the other.

The study of negotiable instruments relates to these various relationships which are based on the bill or note. Except for the transferor by delivery, only those parties who have signed the bill in one capacity or another are liable on the bill. At the outset it is only the drawer who signs the instrument. Both the drawee and the payee may, later sign the bill (accept it or endorse it), and doing changes their capacities and becomes liable on the bill as acceptor & endorser respectively.

The first part of section 21 of the BEA reads as follows: “No person is liable as drawer, acceptor or endorser of a bill if he has not signed it as such...”

A bearer who negotiates a bearer instrument without endorsing it (without signing it), is nevertheless liable to his immediate transferee as a “transferor by delivery” (s 56).

Further Parties to and Capacities Under Bills, Cheques and Promissory Notes

Acceptor

As soon as the drawee accepts the bill, the drawee's capacity changes to that of acceptor. The drawee and acceptor are thus one and the same person.

Acceptance is defined in section 1 of the BEA as follows: “Acceptance [means] an acceptance completed by delivery or notification”. A clearer definition is given in section 15(1) of the BEA which provides that: “The acceptance of a bill is the signification by the drawee of his assent to the order of the drawer”.

Although nothing in the BEA prohibits its acceptance, a cheque is usually not accepted.

Section 93(1) of the BEA provides that the provisions relating to bills of exchange apply, with necessary modifications, to promissory notes. In applying the provisions relating to bills, a maker is deemed to correspond to the acceptor of a bill (s 93(2)).

Endorser

Section 1 of the BEA defines endorsement as "an endorsement completed by delivery". If the payee wishes to negotiate an instrument payable to order, he must endorse the instrument and deliver it. As soon as the payee endorses the instrument, his capacity changes and he becomes an endorser. In this particular case, the payee and endorser are the same person. As endorser, the payee becomes a debtor on the bill and incurs liability on the bill.

It is not only the payee who may become an endorser. Any subsequent holder who endorses the instrument is also known as the endorser of the instrument.

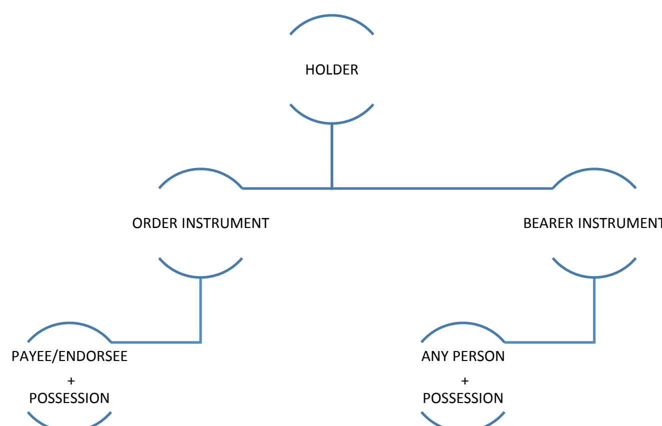
A promissory note, like a bill, is often endorsed, and there may therefore be various endorsers of promissory notes. Cheques, on the other hand, are not endorsed as often as bills.

Endorsee

An endorser may endorse a negotiable instrument specially, that is, he may, above his signature, indicate a specific person to whom payment must be made. The payee may, for example, make the following endorsement: "Pay D or order, (signed) C". The person who is specified by name, namely D, is known as the endorsee. As soon as D negotiates the instrument further, he in turn becomes an endorser.

Holder

One of the most important concepts of the law relating to negotiable instruments is that of holder. Section 1 of the BEA defines a holder as follows: "A holder [means] the payee or endorsee of a bill or note, who is in possession of it, or the bearer thereof". Below is a schematic diagram of the definition of holder:



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A holder is thus either the payee in possession, or the endorsee in possession, or the bearer, who will naturally be in possession. During the life of a negotiable instrument, various persons may qualify as holders, but at any given moment only one person may be a holder (except in the case of joint or alternative holders) since it is essential that the holder be in possession of the instrument.

Holder in due course

The concept of holder in due course is of fundamental importance in the study of negotiable instruments.

The definition of a holder in due course in section 27(1) is as follows:

A holder in due course is a holder who has taken a bill, complete and regular on the face of it, under the following circumstances, namely:

(a) he must have become the holder of it before it was overdue, and if it had previously been dishonoured, without notice thereof; and
(b) he must have taken the bill in good faith and for value, and at the time the bill was negotiated to him, he must have had no notice of any defect in the title of the person who negotiated it.

The various requirements a person must comply with in order to be a holder in due course will be discussed fully later on. Note that a person may only be holder in due course if he is also holder.

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