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MEMO: STANDARD MEMO TO CLIENTS *RE:* NEGOTIABLE INSTRUMENT(S)

DATE: 01/17/1998 (last rev.)

The universality of photocopying has led to a de-emphasizing of, or at least confusion about, the significance of original documents. Most people realize that, if the authenticity of a purported signature is questioned, the original document will give the "examiner of questioned documents" much more to go on than a photocopy. As a practical matter, though, the document which is, or is claimed to be, an outright forgery is not often encountered.

There is another factor, distinct from the question of authenticity, that gives the original of certain types of documents unique importance, and experience indicates that there are many people, sometimes even people with substantial business backgrounds, who do not appreciate the significance of this other factor, the legal name for which is "negotiability."

A "negotiable instrument" is one which can pass from hand to hand, readily transferring to the new holder[*] the same rights it evidenced in the hands of the previous holder. The most common form of negotiable instrument, and the one everybody is familiar with, is the "check." Legally, a check is one form of "draft," and a draft is a document in which a creditor (in the case of the normal, everyday check, a bank's checking account customer) instructs a debtor who owes him a liquidated debt (the bank) to satisfy all or a specific part of that debt by paying *his* creditor (the payee). During the centuries before paper money was widely used and accepted, it was a great boon to commerce for such written instructions to be treated like the underlying liquidated debt itself – and thus, assuming the solvency of the underlying debtor, like money. The custom among merchants and bankers to do so was gradually adopted and systematized by the courts into a well defined body of law known as the law of "negotiable instruments."

The (original) check is generally cashed or deposited (either way, legally, "negotiated") immediately, and so questions of retaining or distinguishing the original do not arise. A *promissory note*, however, often simply referred to as a "note," is also a negotiable instrument (if properly drawn up). If this law office assisted you with a transaction which has resulted in your receiving such a document evidencing your right to receive some future payment, you should be aware that the original document represents more than just evidence or proof of the promise made to you and its terms. Generally, and unless specific restrictions are agreed to and reflected by the terms of the note, you have the right to "discount" the note, i.e., sell it to a third party. Under normal circumstances, the buyer then becomes a "holder in due course" and can collect the note even if the maker (the person promising to pay, by the terms of the note) would have some defense or counterclaim against your attempts to collect. Also, if that party should owe money to the maker, he can make the note "good" simply by applying it to

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* More than physical possession of the instrument is required to make one its legal "holder," and especially its "holder in due course," but that is a matter beyond the scope of this memorandum.

reduce or eliminate that debt. Notes made in connection with business transactions are called "commercial paper," and for certain kinds of commercial paper the "secondary market" is quite active (i.e., buying and selling of such notes, in the manner described, goes on quite a lot). As to notes created in connection with consumer transactions, the secondary market is *generally* limited to notes secured by real property.†

On the whole, the "negotiability" which the law attaches to a promissory note is a benefit for the payee (person to whom payment is promised). But the fact that the instrument itself can pass from hand to hand and carry the payee's rights with it also places a burden on the payee or other holder. When it comes time for a payment (or the payment) on the note, the person who is to make payment has a right to know that he is paying the proper person – and that is the current *holder* of the note, not necessarily the person named as the payee by the original terms of the note. This can make for real complications, if you're the person expecting to receive the payment called for by the note and you do not have the original note to hand back to the maker upon payment in full (or, at least theoretically, to exhibit to him before receiving each installment, in the case of a note payable in multiple installments over time).

Also, anyone getting hold of the original instrument, if he is able to claim or fake the payee's (and any other prior holder's) "endorsement," can deal with the person who owes payment under the note and can accept reduced or accelerated payment at any time, in satisfaction of all indebtedness under the note. The law provides some protection for the rightful payee or holder in the event of such "payment on a forged endorsement," but such protection has some significant limitations (And if the original instrument gets back into the hands of the original maker, the law *presumes*, though "rebuttably," that the debt was paid and the note thereupon returned to the maker.)

It is important that you recognize the promissory note (or any other negotiable instrument) you have received as a paper that needs to be treated as both "important" and "sensitive" – that is to say, you want to protect your possession of and control over the original instrument itself, and you should remember that: (a.) a good photocopy, even a good color copy, is *not* as good as the original in all respects; and (b.) any copies made should be clearly identified as such, as by a conspicuous "COPY" stamp. The sorts of physical measures appropriate to protect the original instrument will, of course, vary with the amount involved and other general security considerations applicable to each client. If you have further questions, please feel free to consult with this office, or ask your banker.

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† One commonly hears of trading in, or the buying or selling of, "mortgages" or "deeds of trust" (="trust deeds"). What is always meant is, legally, "notes secured by mortgages" or "notes secured by deeds of trust."