

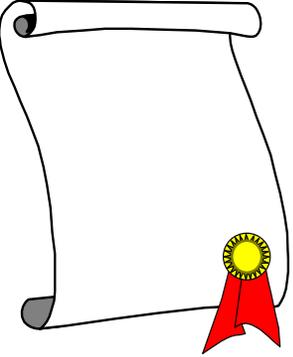
# Negotiable Instruments, Credit and Bankruptcy

## Chapter 12

### Chapter Issues

- **Negotiable Instruments**
- **Credit**
- **Bankruptcy**





# Negotiable Instruments

## Functions of Negotiable Instruments

- substitute for cash (checks for example)
- provides way to extend credit (promissory note)

## • Types of Negotiable Instruments

- 3 party instruments used instead of cash and as credit device
  - Orders to Pay: Drafts
  - Orders to Pay: Checks
- 2 party instruments used as credit device
  - Promises to Pay: Notes
  - Promises to Pay: Certificates of Deposit

# Orders to Pay



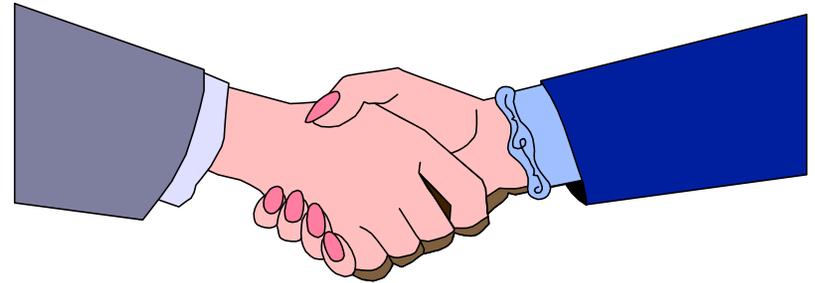
- Drafts

- unconditional written promise to pay
  - *drawer* orders *drawee* to pay \$\$ to *payee*
  - time draft says at a specified time
  - sight draft gets paid upon presentation
- sales draft—for the sale of goods

- Checks

- draft drawn on a bank and payable on demand
- on a cashier's check the bank is both *drawer* and *drawee*

# Promises to Pay



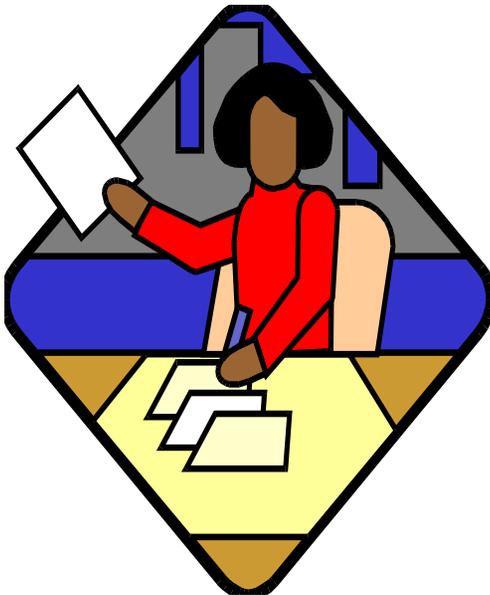
- Notes

- promise by the *maker* to pay certain \$ to *payee*
- usually called *promissory notes*
- but also have
  - *collateral note*
  - *real estate mortgage note*
  - *installment note*
  - *balloon note*

- Certificates of Deposit

- bank is *maker* of certificate & promises to repay customer *payee*
- most large certificates are negotiable which allows them to be sold, used to pay debts or used as collateral

# Negotiable Instruments



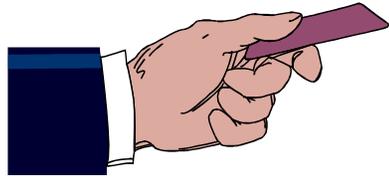
- **Can be transferred to another party**
  - assigned - assignee has same rights and responsibilities as assignor
  - negotiation - transferee takes instruments free of transferor's responsibilities
- **transfer order instrument by:**
  - payee endorses and
  - delivers instrument to third party
- **transfer bearer instrument by:**
  - delivery

# UCC Requirements for Negotiable Instruments

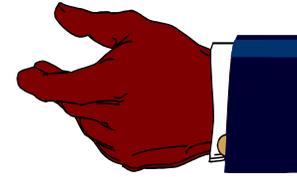


- To be negotiable it must:
  - be written
  - be an unconditional order or promise to pay
  - be signed by the maker or drawer
  - be payable on demand or at a specified time
  - be made out “to order” or “to bearer”
  - state a certain sum of money

# Requirements for Holders in



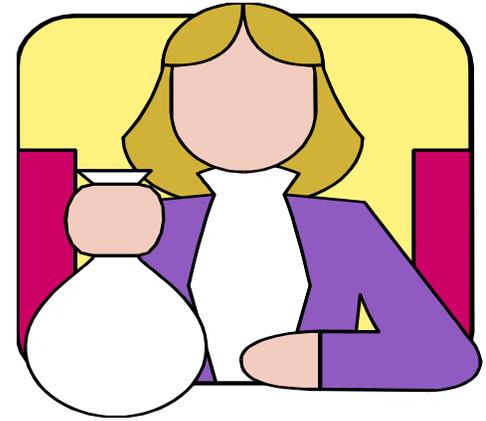
## Due Course



- Person in possession of negotiable instrument may be *ordinary holder* or *holder in due course*
- *ordinary holder* has same contract responsibilities as assignee--*holder in due course* does not
- to be holder in due course, transferee must:
  - **give value for instrument**
  - **take instrument without knowledge it is overdue or defective**
  - **take instrument in good faith**



# Credit



- Credit Policy focuses on characteristics such as:
  - capacity (the debtor's ability to pay)
  - capital (the debtor's financial condition)
  - character (the debtor's reputation)
  - collateral (the debtor's assets to secure the debt)
  - conditions (the economic situation affecting the debtor's business)

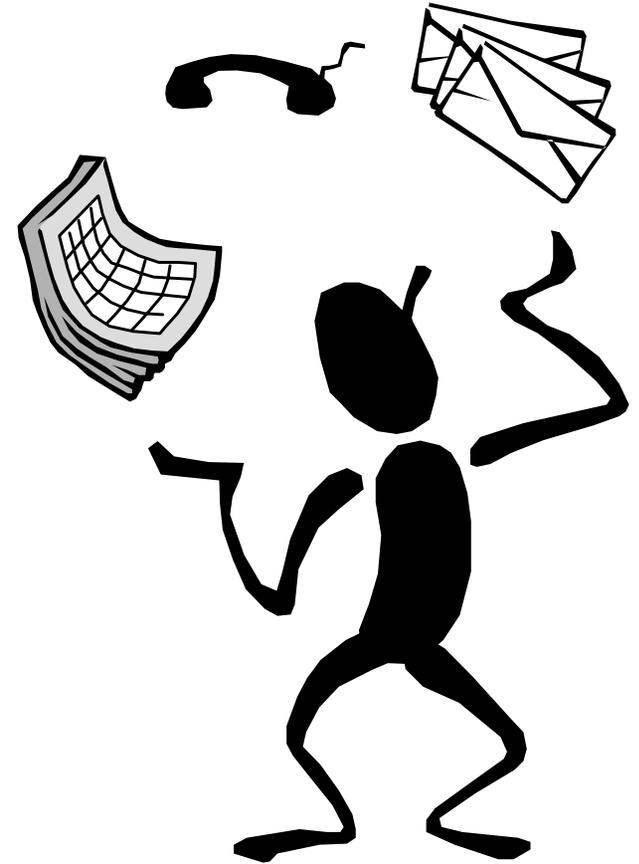
# *Dun & Bradstreet v. Greenmoss Builders*

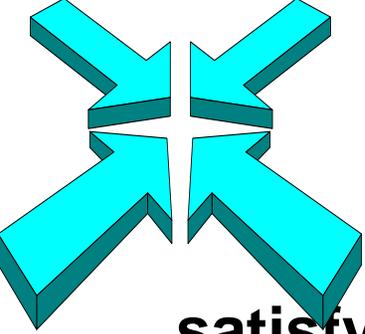


- **Greenmoss sued D&B, a credit reporting agency, for defamation for falsely stating that Greenmoss filed for bankruptcy.**
- **The jury awarded a total of \$350,000 in damages.**
- **The trial judge overturned the verdict; holding D&B protected by the First Amendment.**
- **Vermont Supreme Court reinstated jury verdict.**
- **ISSUE: The U.S. Supreme Court stated the issue is whether the credit report involved a matter of public concern.**
- **HELD: No, it was speech only in the interest of the speaker and a specific business audience. It did not involve any “strong interest in the free flow of commercial information.”**
- **Vermont Supreme Court judgment affirmed**

# Common Types of Credit Accounts

- **Open Account**
  - must pay within fixed time period
- **Installment Account**
  - repay through regular (usually monthly) payments
- **Revolving Account**
  - make minimum payment, can add new debt- i.e. credit card





# Credit with Security

When a creditor can take property of debtor to satisfy debt - by agreement or by operation of law

- **By Agreement** - depends if property is real or personal
- **Suretyship** - promise by a third party to pay debt if debtor doesn't
- **Defenses of Sureties** - since under contract law, there are the same defenses that the principal (debtor) has - including, impossibility, illegality, duress, fraud

# *Travis Pruitt & Associates v. Smith*



- Pruitt and Smith (President of Roswell Properties) executed a 90-day unconditional promissory note. After 90 days note went into default.
- Pruitt sued on the note. Smith counterclaimed alleging negligent performance and breach of contract.
- The trial court granted Pruitt's motion for summary judgment. Smith appealed.
- The appeals court stated that Smith's counterclaims provided no defense since all defenses were extinguished by the execution of the unconditional promissory note.

# Credit with Security



## Secured Transactions

- product may secure debt
- commercial sale of goods
  - UCC Article 9 (not real estate)
- must create security interest and be sure it is:
  - 1. attached
    - signed by customer
    - seller provided value
    - customer has legal, transferable rights in collateral
  - 2. perfected
    - filing w/proper official

## • Default by Debtor

- when the buyer doesn't repay
- creditor can take back property and keep or may resell it (in a “commercially reasonable manner”)
- any excess from sale of repossessed property over debt owed must be returned to debtor



## *HCC Credit v. Spring Valley Bank & Trust*

- HCC had security interest in equipment bought by Lindsey Tractor.
- Soon before bankruptcy Lindsey sold equipment for \$199,122 and deposited the money in an account used to pay debts owed to Spring Valley Bank & Trust. Spring Valley did not know that the funds were subject to HCC's security interest.
- HCC sued Spring Valley to recover the funds. Trial court found for Spring Valley. HCC appealed.
- **HELD**: Appeals court affirmed, stating that Spring Valley did not know that Lindsey was not fulfilling its obligation to HCC. Spring Valley did not accept the payment in reckless disregard of HCC's security interest.

# Liens

- Obtained by operation of law
- No need for debtor's consent

- **Mechanic's Lien**

- party that furnished material, labor, or services for construction or repair of building or other real property places the lien



- **Possessory or Artisan's Lien**

- party that added value to or cared for personal property places the lien





# Real Estate Financing

- ***Mortgage:*** Real estate is used to secure a debt obligation evidenced by a *mortgage*
- Debtor is the *mortgagor*
- Creditor is the *mortgagee*
- Mortgage is a lien in most states
- In case of default, the mortgagee has the right to foreclose on the property



## *Holly Lake Association v. Federal National Mortgage Association*

- **Holly Lake, a homeowners' association, recorded a declaration of covenants in 1974.**
- **The covenants allowed the association to place a lien on the property of a homeowner who did not pay the monthly maintenance assessment.**
- **The McKessons bought a Holly Lake mobile home site, and executed a mortgage to FNMA in 1983.**
- **In 1992 FNMA foreclosed on the property. The association claimed that it had priority over FNMA. The trial court ruled for the association.**
- **HELD: The Supreme Court of Florida held for FNMA stating that the covenants must state that the lien takes priority over intervening mortgages.**

# Bankruptcy



- **Bankruptcies are referred to by chapters of the Federal Bankruptcy Code they are filed under**
- **Key feature of bankruptcy emphasizes fair treatment to creditors**
- **Chapter 7**
  - **most are voluntary, but creditors may force an involuntary proceeding**
  - **upon filing, there is a freeze on actions against the debtor and the debtor's property**
  - **trustee is appointed to administer the debtor's estate**
- **Assets are liquidated and proceeds distributed to creditors**

# Bankruptcy Chapter 7

- **Priority of creditors**
  - secured creditors
  - costs of preserving and administering debtor's estate
  - unpaid wage claims
  - certain claims of farmers and fishermen
  - refund of security deposits
  - alimony and child support
  - taxes
  - unsecured creditors
- **All creditors of a particular class must be paid before going to next class**



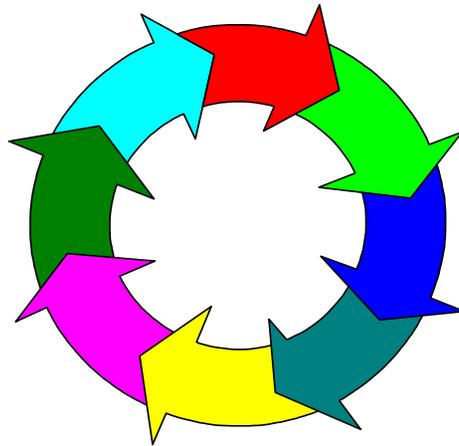


# Bankruptcy Chapter 7

- **Discharge in Bankruptcy**
  - nonexempt assets are liquidated and distributed to creditors and debts are extinguished
  - get clean slate, but bankruptcy remains on credit report for 10 years
  - some debts are not discharged:
    - alimony and child support
    - back taxes
    - some student loans
    - some debts incurred immediately before bankruptcy
    - debts incurred by fraud against the creditors
    - fines owed to the government

# Bankruptcy Chapter 11

- Allows businesses to keep operating, without liquidation of assets
- Reorganization
  - stays further action by creditors
  - debtor acts as trustee, called *debtor in possession*, to run business for benefit of all parties
  - creditors are satisfied by class in order of priority of claims

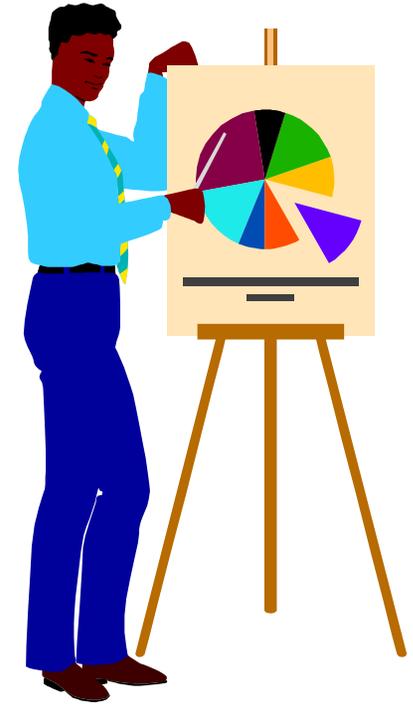


# *In the Matter of Gaslight Club*

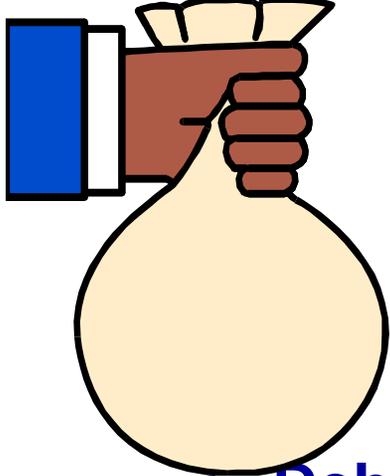


- Gaslight operated dining clubs. It filed for Chapter 11; Fredricks, president, was appointed debtor in possession.
- In the next 8 months the company lost \$1.6 million.
- The court appointed Brandt the debtor in possession. Brandt fired Fredricks.
- The board of directors attempted to have Brandt removed as debtor in possession.
- Bankruptcy & District Courts said no. Fredricks appealed.
- Fredricks argued that the appointment of Brandt improperly avoids the statutory requirements for appointment of a trustee.
- **HELD**: The appointment of Brandt was appropriate to the circumstances and authorized by law.
- The Bankruptcy Code provides that a debtor in possession shall have all the rights and powers and shall perform all duties of a trustee. Brandt stays.

# Bankruptcy Chapter 13

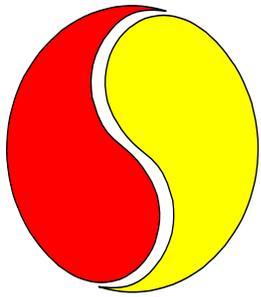


- **Only applies to individuals**
- **Only voluntary**
- **Debtor files plan for payment of creditors over time**
- **Debts are not discharged, just re-scheduled!**

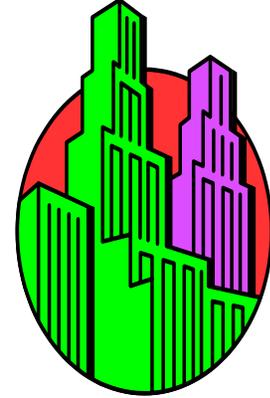


# Nonbankruptcy Alternatives

- **Debt composition or extension**
  - for businesses only
  - a contract where creditors agree to accept some percentage of the total amount due (composition) or to grant more time for repayment (extension)
- **Bank workout**
  - Major creditor agrees to a new debt payment schedule with the bank
- **Assignment**
  - Debtor assigns all nonexempt assets to an assignee, who is a fiduciary for the benefit of the creditors



# Perspectives



- ***“Japanese Business Reorganization Methods”***
  - Reorganization proceedings in Japan to handle bankruptcies
  - Although different from U.S. Chapter 11 bankruptcies, many of the key features are similar in practice
- ***“Will Creditors Work with Minorities?”***
  - Critics complain that women and minorities are discriminated against in getting credit making start-up of businesses difficult. Bank in Houston doing well specializing in that market.