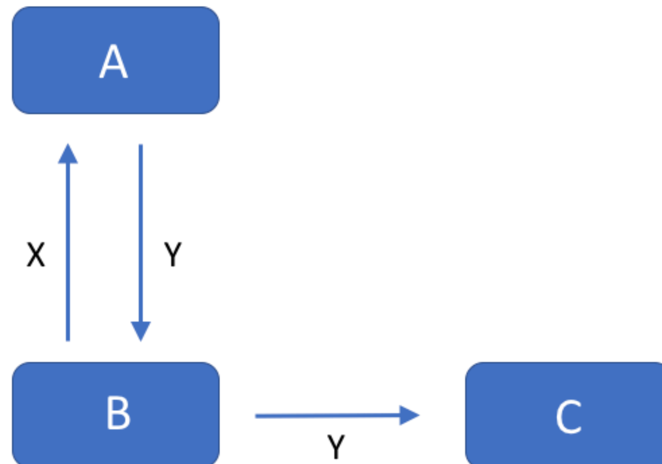
THE VALUE OF NEGOTIABILITY

LAURA WOLFE*

I. INTRODUCTION

In this paper I seek to explain how negotiable instruments facilitate commercial transactions.[1] I do so by drawing out a simple fact pattern and describing how rights of recourse differ depending on the nature of payment. In the process I briefly contrast the law of negotiable instruments with the law of assignment. Suppose that party A transacts with party B to purchase *x*, and agrees to pay for *x* in the form of *y*. Further suppose that B assigns *y* to C. If B fails to deliver *x* to A, can C nonetheless collect payment from A in the form of *y*? I explore this question in two slightly different contexts in order to demonstrate the value of negotiability.



* © Laura Wolfe, 2019.

[1] This paper was written in 2018 for Prof. Bangsund's class "Banking, Payment & Transfer Systems" at the University of Saskatchewan, College of Law. Thank you to Prof. Bangsund for his support, thoughtful feedback and encouragement in the writing process.

II. NEGOTIABLE INSTRUMENTS

A. BILLS OF EXCHANGE

The bills of exchange system is premised on principles of negotiability, certainty, and finality, all of which are integral to the operation of the *Bills of Exchange Act*[2] ("BEA"). Subsection 16(1) of the BEA is reproduced below:

> 16(1) 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 or to the order of a specified person, or to bearer.

At its most basic, a bill of exchange is an order to pay. Negotiable instruments have historical roots and developed as part of the law merchant that existed in Western Europe during the Middle Ages. As a payment device, they were used as mechanisms to transfer value between merchants, eliminating the need to transfer gold or coins across vast distances. Underlying this system was a quest for efficiency and the reduction of risk that inevitably characterized the payment process.

Instruments that qualify as bills of exchange are unconditional, meaning that they are not payable on contingency. A bill expressed to be payable on contingency is not a negotiable instrument covered by the BEA, and the happening of the contingent event does not cure this defect.[3] Put another way, to give effect to the principles of negotiability, certainty, and finality, the negotiability of a bill must be determinable on its face. Otherwise, the efficiency

[2] *Bills of Exchange Act*, RSC 1985, B-4.
[3] Anthony Guest, *Chalmers and Guest on Bills of Exchange and Cheques*, 7th ed (London: Thomson Reuters, 2009) at 702.

created by the bills of exchange system would be undermined as a holder would be required to conduct an investigation into subjective factors to determine the validity of every bill acquired in the course of business. Negotiability in this context means that the law recognizes that "under prescribed circumstances, the person identified as being entitled to payment of the amount set out in the bill (the payee) can 'negotiate the bill'"[4]: meaning that B (the payee) can give to C (the transferee) his or her right to payment on the instrument.

As it relates to bills of exchange, negotiability, as per its characteristic of being unconditional, evolved to include the ability to pass on a better right to payment to C then B initially possessed him or herself. Looking to the above diagram, this would mean that before B delivered *x* to A, B could negotiate *y* to C, and C would have the right to collect the full value of *y* against A even if B did not deliver *x* to A. Put another way, this aspect of negotiability means that B can transmit title to *y* despite flaws in B's underlying property right. C, then, who is a transferee of the instrument, acquires from B (the payee) a similar right which may be further transferred.[5] In each case there is an understanding that the ultimate holder of the instrument may present it to A for payment and receive the amount owed on the bill. Negotiability in this context therefore rejects the common law principle *nemo dat quod non habet.*[6] The person transferring a bill of exchange has the power to pass title to the transferee free from any defects.

[4] Ronald C.C. Cuming and Clayton Bangsund, *Banking, Payment and Transfer Systems, Part 2: Bills of Exchange Act* (Saskatoon: University of Saskatchewan, 2018) at 8.
[5] *Ibid.*
[6] Literally meaning, "no one gives what they don't have."

B. PROMISSORY NOTES

A promissory note is an unconditional promise, from a maker to a payee, to pay a specified amount.[7] The maker is "the party who, by his signature on a promissory note, promises to pay it."[8] In Canada, promissory notes are governed by the BEA. Section 176 is reproduced below:

> 176(1) A promissory note is an unconditional promise in writing made by one person to another person, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person or to bearer.
>
> (2) An instrument in the form of a note payable to the maker's order is not a note within the meaning of this section, unless it is endorsed by the maker.
>
> (3) A note is not invalid by reason only that it contains also a pledge of collateral security with authority to sell or dispose thereof.

A promissory note, like a bill of exchange, must be unconditional. It cannot have on its face conditions that restrict this characterization. In fact, as noted by Crawford, "marking a note 'to be held as collateral security' renders it not unconditional and, therefore, not negotiable."[9] With reference to subsection 176(3), Crawford further notes that "a notation that the maker has deposited collateral security for his note with the payee, or that collateral security which had been deposited is to be returned upon due payment, does not impose a condition upon payment."

---

[7] Maurice Coombs, "Commercial Law II (Bills of Exchange)," Reissue, (Toronto: Halsbury's Laws of Canada, 2015). Online: https://advance.lexis.com/api/permalink/301261a8-df35-453e-ae6f-d6dcaba39177/?context=1505209.
[8] *Ibid* at 1305.
[9] Bradley Crawford, *Payment, Clearing and Settlement in Canada*: Bills, Cheques and Notes, 2nd ed (Toronto: Canada Law Book, 2002) at 1259.

As in the case with all bills of exchange, “no particular form of words is essential to the validity of the note provided the requirements of [section 176] are fulfilled.”[10] This is to say, the words “promissory note” do not need to be present anywhere on the instrument. Similarly, if the parties do not intend to create a negotiable instrument, the words “promissory note” presented on the instrument are not sufficient to make a document a note. Another distinguishing feature, found at common law, and now embodied in the BEA, is that there is a presumption in favour of the transferee that “he has taken the instrument for value,” and also “in good faith and without notice.”[11]

III. The Law of Assignment

The *Personal Property Security Act*[12] ("PPSA") provides a comprehensive set of rules for governance of the rights of creditors and debtors when personal property is used as collateral to secure payment of debt or the performance of other obligations.[13] The PPSA applies to every transaction that in substance creates a security interest in personal property. Under the PPSA, "personal property" is defined as “chattel paper, investment property, a document of title, an instrument, money or an intangible.”[14] In this varied context, *y* is an account, and its assignment creates a security interest.[15]

In order to create a security interest that is valid and enforceable against a third party under the PPSA, there must be attachment. Attachment connotes that an interest was created

[10] *Supra* note 3 at 700.
[11] *Ibid* at 637.
[12] *The Personal Property Security Act*, SS 1993, P-6.2.
[13] In this paper I refer to the Saskatchewan PPSA, but it should be noted that all of the Canadian common law provinces have enacted similar, if not identical, legislation.
[14] PPSA, s 2(1)(ff).
[15] PPSA, ss 2(1)(qq)(ii)(A), 3(2).

voluntarily by a debtor with rights in the collateral in favour of a secured party. The exercise of deciding whether and when such an interest has been created lies at the very heart of secured transactions law.[16] While the interests of other parties will be of great significance in valuing and using a security interest, attachment is very much the domain of the two parties — debtor and secured party — themselves.[17]

There are no particular legislated rules about offer, acceptance, certainty of terms, undue influence, unconscionability, misrepresentation and so on that can affect the creation or enforceability of a security interest. To a large extent these matters are left to the general law of contract. It is noteworthy that past consideration is accepted as valid consideration in the context of attachment.

IV. SCENARIOS

A. SCENARIO A: OUTCOME WHERE A NEGOTIABLE INSTRUMENT IS NOT INVOLVED

In this first scenario, I will explore this problem under the law of assignment, in the absence of a negotiable instrument. In this case, *y* represents an account – a mere right to payment under contract. C (the assignee) must contend with A's rights as account debtor, embodied in subsection 41(2) of the PPSA, which states:

> 41(2) Unless the account debtor on an intangible or chattel paper has made an enforceable agreement not to assert defences to claims arising out of a contract, the rights of an assignee of the intangible or chattel paper are subject to:

---

[16] Bruce MacDougall, "Personal Property and Secured Transactions," Reissue, (Toronto: Halsbury's Laws of Canada, 2017). Online: <https://advance.lexis.com/api/permalink/f72d7038-d7f8-4b6f-aead-2137ab2f4c84/?context=1505209>.

[17] *Ibid.*

> (a) the terms of the contract between the account debtor and the assignor and any defence or claim arising from the contract or a closely connected contract; and
>
> (b) any other defence or claim of the account debtor against the assignor that accrues before the account debtor acquires knowledge of the assignment.

In the scenario at hand, and for the purposes of section 41 of the PPSA, A is an "account debtor;" and C is a "secured party", and thus an "assignee." As noted above, in order to create a security interest that is valid and enforceable against a third party under the PPSA, there must be attachment. Here there is attachment in favour of C since all the statutory requisites are satisfied. This generally means that C has the right to enforce *y* against A. However, subsection 41(2) provides that C's interest in *y* is subject to any contractual agreement that exists between A and B in relation to *x.*

In this example, C has taken his or her interest subject to "any other defence or claim" that A has against the assignor. And so, if A has a defence that would excuse him or her from paying the amount of the debt to B, A may assert that defence against C. A's defences and claims against C include, for example, a contractual term stipulating that A will only pay to B *y* upon the delivery of *x*. Accordingly, A is excused of his or her obligation to pay C the debt of *y* where there is a contract stipulating that the payment on *y* is conditional upon performance, namely, the delivery of *x.* The *nemo dat* principle prevails under assignment law. B can only transfer as good of a property right as she has; if B's right to *y* is contingent on the delivery of *x*, then C's title is subject to A's defences respecting *y*.

B. SCENARIO B: OUTCOME WHERE A NEGOTIABLE INSTRUMENT IS INVOLVED

In contrast with assignment law, the law of negotiable instruments rejects the *nemo dat* principle.

1. *MODIFIED SCENARIO*

In this second scenario *y* is represented by a negotiable instrument. This means that through the transfer of *y* from B to C, C acquires an unconditional promise to pay from A. Now, whether or not B delivers *x* to A is beside the point.

The process of determining whether a term has imposed conditions which negate negotiability requires legal interpretation, sensitive to both fact and law. That said, subsection 176(3) of the BEA, as a general principle, does not permit text "either as a matter of grammatical construction or of law" to "introduce a condition upon the enforceability of the promise of payment."[18] The distinguishing feature of a promissory note was emphasized by Bowen L.J. in 1888 when he said that promissory notes "are meant to include documents the contents of which consist substantially of a promise to pay a definite sum of money, and of nothing else."[19] That said, there are a number of reported cases where a party signs a negotiable instrument and then claims an absence of intent to create a promissory note. The case of *BMO v. Abrahams*[20] illustrates this point.

---

[18] *Supra* note 4.
[19] *Mortgage Insurance Corp v IRC* (1888) 21 QBD 352.
[20] *Bank of Montreal v Abrahams*, (2002) 59 OR (3d) 180 (Sup Ct).

2. BMO v. Abrahams

In 1989, a group of investors, the appellants, contracted with Reemark, a property developer, for the purchase of residential condo units. At the time that closing documents were signed, each investor was given a document booklet containing a series of agreements relating to their condominium purchase. The promissory note was appended to the booklet with a perforated edge for ease of removal. Each of the investors signed and gave to Reemark a promissory note contained in this booklet as partial payment of the condominium units being purchased. Reemark later sold, or "negotiated," the investors' promissory notes to BMO, and assigned to the Bank Reemark's rights under the purchase agreements.

After receiving notice of the negotiation of the notes, each of the investors made payments to BMO on the promissory notes. They stopped payment, however, when they discovered that Reemark had not transferred title to the condo units into their respective names. BMO sued on the notes and obtained judgment. At trial, Lissaman J. proceeded in part on an agreed statement of facts, which included the following:

> When each Investor purchased a Unit from Reemark, the possibility of Reemark assigning the Promissory Notes to a third party was not discussed between Reemark and the Investors. Each Investor understood that their obligation under the Promissory Note was to pay Reemark by December 31, 2000 that portion of the purchase price of the Unit reflected by the principal amount of the Promissory Note along with interest on the outstanding balance from time to time. The Investors were not aware of the legal concepts of "negotiable instruments" or "holder in due course" or the provisions of the Bills of Exchange Act in that regard. Reemark did not demand payment of any of the Promissory Notes prior to the to the sale of the Promissory Notes to the Bank.[21]

[21] *Ibid* at para 20.

The investors appealed. The issue before the Ontario Court of Appeal was whether the promissory notes were unconditional within the meaning of subsection 176(1) of the BEA?[22] Simmons J.A. held that the notes were unconditional on their face. Based on the facts, it was held that each note stood independently from the conditional sales contract. The appeal was dismissed and it was found that the promissory notes were unconditional within the meaning of subsection 176(1). In his judgement, Simmons J.A. stated: “it would frustrate the purposes of the *BEA* to hold that an apparently unconditional promissory note must be interpreted in conjunction with a related contract on the sole ground that it is appended to that contract by a perforated edge.”[23] As such, the investors could not rely on Reemark’s breach of contract as reason to refuse payment to BMO on the notes. In other words, BMO was not subject to the investors’ defences against Reemark.

In determining whether a particular instrument is “unconditional” and is thus governed by the BEA, the court will examine the document as a whole. Outside of “real defences” (i.e. theft, fraud, incapacity, impersonation, delivery, etc.), the key issue likely to come before a court is whether the promissory note is independent of another agreement, as was the case in *BMO v Abrahams*, *Killoran v Monticello State Bank,*[24] and *Range v Belvedere Finance Corp.*[25] The issue before the courts in these cases was whether a promissory note could be construed independently of the conditions of another agreement, or alternatively, read as conditional on the execution of that agreement.

[22] *Bank of Montreal v Abrahams et al*, [2003] 68 OR (3d) 34 (CA).
[23] *Ibid* at para 34.
[24] *Monticello State Bank v Killoran*, [1921] 61 SCR 528.
[25] *Range v Corp. de Finance Belvédère*, [1969] SCR 492.

3. *KILLORAN V MONTICELLO STATE BANK*

In *Killoran v Monticello State Bank*, the appellant Killoran bought a horse from Dygert for $1,700, paying $300 in cash and signing two notes for $700 each. On each note was a written agreement providing that the property in the horse would not pass until the balance of the purchase price was paid. Dygert endorsed the notes to Monticello State Bank for value. The horse, however, died before it was delivered to Killoran and before the notes were paid.

Monticello State Bank sued Killoran for full payment on the notes. The Bank lost at trial. The decision was successfully appealed to the Alberta Supreme Court, Appellate Division. Ives J., writing for the Court, stated:

> In my opinion the issue is as to defendant's liability as the maker of the promissory notes. The only connection between these notes and the conditional sale agreement is that they are found on the same sheet of paper. But they are distinctly and separately signed and by the expressed intention of the parties intended to be separate from the agreement… In my opinion the notes are bills of exchange within The Bills of Exchange Act and this plaintiff is the holder for value.[26]

The decision was further upheld by the Supreme Court of Canada. In a unanimous decision Duff, J. (as he then was), gave the following reasons:

> I have no difficulty in concurring with the view of the Appellate Division that the instruments sued upon are promissory notes. In each case there is, it is true, on the same piece of paper one of these instruments and a collateral agreement, but the collateral agreement is no part of the instrument sued upon. By its express terms, indeed, it is not to qualify the absolute obligation of the promissor or to affect the contractual rights of the parties in such a way as to impair the negotiability of the note.[27]

---

[26] *Monticello State Bank v Killoran*, [1920] 16 Alta LR 341, 3 WWR 542 (CA) at 543.
[27] *Supra* note 24 at 531.

This same issue of whether the note was severable from the agreement to which it was attached was explored in *BMO v Abrahams*, and there it was determined that the promissory note could not be read as being conditional upon transfer of the real estate assets which Abrahams had invested in. Applying this authority to our scenario, *y* is not conditional upon the delivery of *x.* A is liable to pay to C any outstanding balance on the note.

C can therefore claim to be a holder in due course whose rights are delimited in BEA subsections 53(1), 55, 57(2), and 73. C is able to enforce his claim against primary and secondary parties who in other contexts may have available valid legal defences.

> 73 The rights and powers of the holder of a bill are as follows:
> (a) he may sue on the bill in his own name;
> (b) where he is a holder in due course, he holds the bill free from any defect of title of prior parties, as well as from mere personal defences available to prior parties among themselves, and may enforce payment against all parties liable on the bill;
> (c) where his title is defective, if he negotiates the bill to a holder in due course, that holder obtains a good and complete title to the bill;

Returning to scenario 2, where *y* is represented by a promissory note, we can see that A would not be able to claim a defence of breach of contract for non-delivery of *x.* A is the maker of the note, and is the principal obligor. A is primarily and absolutely liable to the holder, which in this case is C. C has acquired title to *y* from B, and is able to claim status as a holder in due course, which entitles C to claim payment on *y* against A. C holds title free from any defects or equities (e.g. if B fails to deliver *x* to A) and may sue on the bill in his own name.

V. Conclusion

As the cases *Killoran v Monticello State Bank* and *BMO v Abrahams* clearly demonstrate, unless a party has a real defence available, a purchaser cannot raise a defence of non-performance to avoid payment on a negotiable instrument. By signing a promissory note, a maker undertakes an unconditional obligation. Even if it appears that there is an accompanying agreement that reads like a conditional sales contract, it is very unlikely that the courts will overturn the above cases and excuse the payment obligation in respect of any outstanding amount due on the note.

Signing a negotiable instrument has very real legal significance and should not be done without fulsome consideration of the risks at hand. One must fully appreciate the consequences of signing a negotiable instrument as it is, in most instances, an iron-clad legal engagement, speaking to its fundamental purpose of facilitating business transactions. In this paper it has been my intention to impress upon the reader the core nature of negotiable instruments. When a promissory note, cheque or bill is negotiated to a holder in due course, the transfer is certain and final. A holder in due course may therefore enforce the instrument free of any defences or equities that may exist between the account debtor and assignor.