

Lesson 17

Negotiable Instruments

Exchange of goods and services is the basis of every business activity. Goods are bought and sold for cash as well as on credit. All these transactions require flow of cash either immediately or after a certain time. In modern business, large number of transactions involving huge sums of money take place everyday. It is quite inconvenient as well as risky for either party to make and receive payments in cash. Therefore, it is a common practice for businessmen to make use of certain documents as means of making payment. Some of these documents are called negotiable instruments. In this lesson let us learn about these documents.

17.1 Objectives

After studying this lesson, you will be able to:

- explain the meaning of negotiable instruments;
- identify the various features of negotiable instruments;
- describe the various types of negotiable instruments; and
- differentiate between bills of exchange, promissory notes, and cheques.

17.2 Meaning of Negotiable Instruments

To understand the meaning of negotiable instruments let us take a few examples of day-to-day business transactions.

Suppose Pitamber, a book publisher has sold books to Prashant for Rs 10,000/- on three months

credit. To be sure that Prashant will pay the money after three months, Pitamber may write an order addressed to Prashant that he is to pay after three months, for value of goods received by him, Rs. 10,000/- to Pitamber or anyone holding the order and presenting it before him (Prashant) for payment. This written document has to be signed by Prashant to show his acceptance of the order. Now, Pitamber can hold the document with him for three months and on the due date can collect the money from Prashant. He can also use it for meeting different business transactions. For instance, after a month, if required, he can borrow money from Sunil for a period of two months and pass on this document to Sunil. He has to write on the back of the document an instruction to Prashant to pay money to Sunil, and sign it. Now Sunil becomes the owner of this document and he can claim money from Prashant on the due date. Sunil, if required, can further pass on the document to Amit after instructing and signing on the back of the document. This passing on process may continue further till the final payment is made.

In the above example, Prashant who has bought books worth Rs. 10,000/- can also give an undertaking stating that after three month he will pay the amount to Pitamber. Now Pitamber can retain that document with himself till the end of three months or pass it on to others for meeting certain business obligation (like with sunil, as discussed above) before the expiry of that three months time period.

You must have heard about a cheque. What is it? It is a document issued to a bank that entitles the person whose name it bears to claim the amount mentioned in the cheque. If he wants, he can transfer it in favour of another person. For example, if Akash issues a cheque worth Rs. 5,000/- in favour of Bidhan, then Bidhan can claim Rs. 5,000/- from the bank, or he can transfer it to Chander to meet any business obligation, like paying back a loan that he might have taken from Chander. Once he does it, Chander gets a right to Rs. 5,000/- and he can transfer it to Dayanand, if required. Such transfers may continue till the payment is finally made to somebody.

In the above examples, we find that there are certain documents used for payment in business transactions and are transferred freely from one person to another. Such documents are called Negotiable Instruments. Thus, we can say negotiable instrument is a transferable document, where negotiable means transferable and instrument means document. To elaborate it further, an instrument, as mentioned here, is a document used as a means for making some payment and it is negotiable i.e., its ownership can be easily transferred.

Thus, negotiable instruments are documents meant for making payments, the ownership of which can be transferred from one person to another many times before the final payment is made.

Definition of Negotiable Instrument

According to section 13 of the Negotiable Instruments Act, 1881, a negotiable instrument means “promissory note, bill of exchange, or cheque, payable either to order or to bearer”.

17.3 Types of Negotiable Instruments

According to the Negotiable Instruments Act, 1881 there are just three types of negotiable instruments i.e., promissory note, bill of exchange and cheque. However many other documents are also recognized as negotiable instruments on the basis of custom and usage, like hundis,

treasury bills, share warrants, etc., provided they possess the features of negotiability. In the following sections, we shall study about Promissory Notes (popularly called pronotes), Bills of Exchange (popularly called bills), Cheques and Hundis (a popular indigenous document prevalent in India), in detail.

i. Promissory Note

Suppose you take a loan of Rupees Five Thousand from your friend Ramesh. You can make a document stating that you will pay the money to Ramesh or the bearer on demand. Or you can mention in the document that you would like to pay the amount after three months. This document, once signed by you, duly stamped and handed over to Ramesh, becomes a negotiable instrument. Now Ramesh can personally present it before you for payment or give this document to some other person to collect money on his behalf. He can endorse it in somebody else's name who in turn can endorse it further till the final payment is made by you to whosoever presents it before you. This type of a document is called a Promissory Note.

Section 4 of the Negotiable Instruments Act, 1881 defines a promissory note as 'an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument'.

Specimen of a Promissory Note

Rs. 10,000/-	New Delhi
	September 25, 2002
On demand, I promise to pay Ramesh, s/o RamLal of Meerut or order a sum of Rs 10,000/- (Rupees Ten Thousand only), for value received.	
To, Ramesh	Sd/ Sanjeev
Address.....	Stamp

Endorsement means transfer of any document or instrument to another person by signing on its back or face or on a slip of paper attached to it.

Parties to a Promissory Note

There are primarily two parties involved in a promissory note. They are-

- i. **The Maker or Drawer** – the person who makes the note and promises to pay the amount stated therein. In the above specimen, Sanjeev is the maker or drawer.
- ii. **The Payee** – the person to whom the amount is payable. In the above specimen it is Ramesh.

In course of transfer of a promissory note by payee and others, the parties involved may be -

- a. **The Endorser** – the person who endorses the note in favour of another person. In the above specimen if Ramesh endorses it in favour of Ranjan and Ranjan also endorses it in favour of Puneet, then Ramesh and Ranjan both are endorsers.
- b. **The Endorsee** – the person in whose favour the note is negotiated by endorsement. In the above, it is Ranjan and then Puneet.

Features of a promissory note

Let us know the features of a promissory note.

- i. A promissory note must be in writing, duly signed by its maker and properly stamped as per Indian Stamp Act.
- ii. It must contain an undertaking or promise to pay. Mere acknowledgement of indebtedness is not enough. For example, if some one writes 'I owe Rs. 5000/- to Satya Prakash', it is not a promissory note.
- iii. The promise to pay must not be conditional. For example, if it is written 'I promise to pay Suresh Rs 5,000/- after my sister's marriage', is not a promissory note.
- iv. It must contain a promise to pay money only. For example, if some one writes 'I promise to give Suresh a Maruti car' it is not a promissory note.
- v. The parties to a promissory note, i.e. the maker and the payee must be certain.
- vi. A promissory note may be payable on demand or after a certain date. For example, if it is written 'three months after date I promise to pay Satinder or order a sum of rupees Five Thousand only' it is a promissory note.
- vii. The sum payable mentioned must be certain or capable of being made certain. It means that the sum payable may be in figures or may be such that it can be calculated. (See specimen below).

Rs. 10,000/-	New Delhi
	November 14, 2002
I, Ramesh , s/o Sadanand of Surat, Gujarat promise to pay Sashikant, s/o Sunil Kumar of Ahmedabad, Gujarat or order, on demand, the sum of Rs 10,000/- (Rupees Ten Thousand only) with interest at the rate of 10 percent per annum, for value received.	
	Sd/- Ramesh
	Stamp
To Sashikant Ahmedabad, Gujarat	

Intext Questions 17.1

(A) Fill in the blanks with suitable word(s)

- (i) The person to whom the amount mentioned in the promissory note is payable is known as _____.
- (ii) Transfer of a negotiable instrument to another person by signing on it, is known as _____.

- (iii) In a promissory note, the person who makes the promise to pay is called _____.
- (iv) The person who endorses the promissory note in favour of another is known as _____.
- (v) A promissory note must be signed as per _____ Act.
- (B) Which of the following are negotiable instruments?
- (i) Currency notes
- (ii) Coins
- (iii) Postal orders
- (iv) Money orders
- (v) Cheques
- (vi) Hundis

ii. Bill of Exchange

Suppose Rajiv has given a loan of Rupees Ten Thousand to Sameer, which Sameer has to return. Now, Rajiv also has to give some money to Tarun. In this case, Rajiv can make a document directing Sameer to make payment up to Rupees Ten Thousand to Tarun on demand or after expiry of a specified period. This document is called a Bill of Exchange, which can be transferred to some other person's name by Tarun.

Section 5 of the Negotiable Instruments Act, 1881 defines a bill of exchange as 'an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to or to the order of a certain person, or to the bearer of the instrument'.

Specimen of a Bill of Exchange

Rs. 10,000/-		New Delhi
		May 2, 2001
Five months after date pay Tarun or (to his) order the sum of Rupees Ten Thousand only for value received.		
To	Accepted	Stamp
Sameer	Sameer	S/d
Address		Rajiv

Parties to a Bill of Exchange

There are three parties involved in a bill of exchange. They are-

- i. **The Drawer** – The person who makes the order for making payment. In the above specimen, Rajiv is the drawer.

- ii. **The Drawee** – The person to whom the order to pay is made. He is generally a debtor of the drawer. It is Sameer in this case.
- iii. **The Payee** – The person to whom the payment is to be made. In this case it is Tarun.

The drawer can also draw a bill in his own name thereby he himself becomes the payee. Here the words in the bill would be *Pay to us or order*. In a bill where a time period is mentioned, just like the above specimen, is called a *Time Bill*. But a bill may be made payable on demand also. This is called a *Demand Bill*.

Features of a bill of exchange

Let us know the various features of a bill of exchange.

- i. A bill must be in writing, duly signed by its drawer, accepted by its drawee and properly stamped as per Indian Stamp Act.
- ii. It must contain an order to pay. Words like ‘please pay Rs 5,000/- on demand and oblige’ are not used.
- iii. The order must be unconditional.
- iv. The order must be to pay money and money alone.
- v. The sum payable mentioned must be certain or capable of being made certain.
- vi. The parties to a bill must be certain.

Intext Questions 17.2

Write ‘True’ or ‘False’ against each statement regarding a bill of exchange.

- (i) A bill of exchange must be accepted by the payee.
- (ii) A bill of exchange is drawn by the creditor
- (iii) A bill of exchange is drawn for all cash transaction
- (iv) A bill payable on demand is called Time bill.
- (v) The person to whom payment is to be made in a bill or exchange is called payee.

(B) On December 31 Rajesh draws a bill at two months for Rs. 500/- on Kavita. The sum is payable to Mukesh. Kavita accepts the bill. Identify the parties to the bill.

iii. Cheques

Cheque is a very common form of negotiable instrument. If you have a savings bank account or current account in a bank, you can issue a cheque in your own name or in favour of others, thereby directing the bank to pay the specified amount to the person named in the cheque.

Therefore, a cheque may be regarded as a bill of exchange; the only difference is that the bank is always the drawee in case of a cheque.

The Negotiable Instruments Act, 1881 defines a cheque as a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand. Actually, a cheque is an order by the account holder of the bank directing his banker to pay on demand, the specified amount, to or to the order of the person named therein or to the bearer.

Specimen of a Cheque

	20.....
Pay.....		
	 or Bearer
Rupees.....	<i>Rs.</i> _____	
STATE BANK OF INDIA		
Jawaharlal Nehru University, New Delhi – 110067		
MSBL/97		
6 5 3 0 0 3	1 1 0 0 0 2 0 5 6	1 0

Features of a cheque

Let us look into some important features of a cheque.

- i. A cheque must be in writing and duly signed by the drawer.
- ii. It contains an unconditional order.
- iii. It is issued on a specified banker only.
- iv. The amount specified is always certain and must be clearly mentioned both in figures and words.
- v. The payee is always certain.
- vi. It is always payable on demand.
- vii. The cheque must bear a date otherwise it is invalid and shall not be honoured by the bank.

Types of Cheque

Broadly speaking, cheques are of four types.

- a) Open cheque, and
- b) Crossed cheque.
- c) Bearer cheque
- d) Order cheque

Let us know details about these cheques.

- a) **Open cheque:** A cheque is called ‘Open’ when it is possible to get cash over the counter at the bank. The holder of an open cheque can do the following:
- i. Receive its payment over the counter at the bank,
 - ii. Deposit the cheque in his own account
 - iii. Pass it to some one else by signing on the back of a cheque.
- b) **Crossed cheque:** Since open cheque is subject to risk of theft, it is dangerous to issue such cheques. This risk can be avoided by issuing another types of cheque called ‘Crossed cheque’. The payment of such cheque is not made over the counter at the bank. It is only credited to the bank account of the payee. A cheque can be crossed by drawing two transverse parallel lines across the cheque, with or without the writing ‘Account payee’ or ‘Not Negotiable’.
- c) **Bearer cheque:** A cheque which is payable to any person who presents it for payment at the bank counter is called ‘Bearer cheque’. A bearer cheque can be transferred by mere delivery and requires no endorsement.
- d) **Order cheque:** An order cheque is one which is payable to a particular person. In such a cheque the word ‘bearer’ may be cut out or cancelled and the word ‘order’ may be written. The payee can transfer an order cheque to someone else by signing his or her name on the back of it.

There is another categorization of cheques which is discussed below:

Ante-dated cheques:- Cheque in which the drawer mentions the date earlier to the date of presenting if for payment. For example, a cheque issued on 20th May 2003 may bear a date 5th May 2003.

Stale Cheque:- A cheque which is issued today must be presented before at bank for payment within a stipulated period. After expiry of that period, no payment will be made and it is then called ‘stale cheque’. Find out from your nearest bank about the validity period of a cheque.

Mutilated Cheque:- In case a cheque is torn into two or more pieces and presented for payment, such a cheque is called a mutilated cheque. The bank will not make payment against such a cheque without getting confirmation of the drawer. But if a cheque is torn at the corners and no material fact is erased or cancelled, the bank may make payment against such a cheque.

Post-dated Cheque:- Cheque on which drawer mentions a date which is subsequent to the date on which it is presented, is called post-dated cheque. For example, if a cheque presented on 8th May 2003 bears a date of 25th May 2003, it is a post-dated cheque. The bank will make payment only on or after 25th May 2003.

Intext Questions 17.3

Match the terms given under column ‘A’ correctly with the statement given under column ‘B’.

Column A	Column B
(i) Stale cheque	a) Cheque which can be encashed at the counter of the bank
(ii) Ante-dated cheque	b) Risk of theft is less.

- | | |
|------------------------|---|
| (iii) Crossed cheque | c) Cheque issued on 15th March on which the drawer puts the date of 10th March. |
| (iv) Post-dated cheque | d) Cheque presented for payment after 6 months from the date of issue |
| (v) Open cheque | e) Cheque presented on 20th April on which date mentioned is 25th April. |
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iv. Hundis

A Hundi is a negotiable instrument by usage. It is often in the form of a bill of exchange drawn in any local language in accordance with the custom of the place. Some times it can also be in the form of a promissory note. A hundi is the oldest known instrument used for the purpose of transfer of money without its actual physical movement. The provisions of the Negotiable Instruments Act shall apply to hundis only when there is no customary rule known to the people.

Types of Hundis

There are a variety of hundis used in our country. Let us discuss some of the most common ones.

Shah-jog Hundi: This is drawn by one merchant on another, asking the latter to pay the amount to a Shah. Shah is a respectable and responsible person, a man of worth and known in the bazaar. A shah-jog hundi passes from one hand to another till it reaches a Shah, who, after reasonable enquiries, presents it to the drawee for acceptance of the payment.

Darshani Hundi: This is a hundi payable at sight. It must be presented for payment within a reasonable time after its receipt by the holder. Thus, it is similar to a demand bill.

Muddati Hundi: A muddati or miadi hundi is payable after a specified period of time. This is similar to a time bill.

There are few other varieties like Nam-jog hundi, Dhani-jog hundi, Jawabee hundi, Jokhami hundi, Firman-jog hundi, etc.

17.4 Features of Negotiable Instruments

After discussing the various types of negotiable instruments let us sum up their features as under-

- i. A negotiable instrument is freely transferable. Usually, when we transfer any property to somebody, we are required to make a transfer deed, get it registered, pay stamp duty, etc. But, such formalities are not required while transferring a negotiable instrument. The ownership is changed by mere delivery (when payable to the bearer) or by valid endorsement and delivery (when payable to order). Further, while transferring it is also not required to give a notice to the previous holder.
- ii. Negotiability confers absolute and good title on the transferee. It means that a person who receives a negotiable instrument has a clear and undisputable title to the instrument. However, the title of the receiver will be absolute, only if he has got the instrument in good faith and for a consideration. Also the receiver should have no knowledge of the previous holder having any defect in his title. Such a person is known as holder in due course. For example,

suppose Rajiv issued a bearer cheque payable to Sanjay. It was stolen from Sanjay by a person, who passed it on to Girish. If Girish received it in good faith and for value and without knowledge of cheque having been stolen, he will be entitled to receive the amount of the cheque. Here Girish will be regarded as ‘holder in due course’.

- iii. A negotiable instrument must be in writing. This includes handwriting, typing, computer print out and engraving, etc.
- iv. In every negotiable instrument there must be an unconditional order or promise for payment.
- v. The instrument must involve payment of a certain sum of money only and nothing else. For example, one cannot make a promissory note on assets, securities, or goods.
- vi. The time of payment must be certain. It means that the instrument must be payable at a time which is certain to arrive. If the time is mentioned as ‘when convenient’ it is not a negotiable instrument. However, if the time of payment is linked to the death of a person, it is nevertheless a negotiable instrument as death is certain, though the time thereof is not.
- vii. The payee must be a certain person. It means that the person in whose favour the instrument is made must be named or described with reasonable certainty. The term ‘person’ includes individual, body corporate, trade unions, even secretary, director or chairman of an institution. The payee can also be more than one person.
- viii. A negotiable instrument must bear the signature of its maker. Without the signature of the drawer or the maker, the instrument shall not be a valid one.
- ix. Delivery of the instrument is essential. Any negotiable instrument like a cheque or a promissory note is not complete till it is delivered to its payee. For example, you may issue a cheque in your brother’s name but it is not a negotiable instrument till it is given to your brother.
- x. Stamping of Bills of Exchange and Promissory Notes is mandatory. This is required as per the Indian Stamp Act, 1899. The value of stamp depends upon the value of the pronote or bill and the time of their payment.

Intext Questions 17.4

Which of the following statements are ‘True’ and which are ‘False’ ?

- a) A negotiable instrument does not require the signature of its maker.
- b) The hundi which is payable after a specified period of time is called ‘Darshani Hundi’.
- c) A negotiable instrument is not freely transferable.
- d) Stamping of promissory note is not mandatory.
- e) The time of payment of a negotiable instrument need not be certain.

17.5 Differences between bill of exchange, promissory notes and cheques

You have already studied about a bill of exchange, a promissory note and a cheque. Try to find out differences between them and compare your answer with the points given at the end of this lesson.

17.6 What You Have Learnt

- Negotiable instruments are particular type of documents used for making payment in business transactions, the ownership of which can be freely transferred from one person to another.
- Types of Negotiable Instruments
 - Promissory note
 - Bill of exchange
 - Cheque
 - Hundi
- Promissory note - An instrument in writing containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument.
- Bill of exchange - An instrument in writing containing an unconditional order, signed by the maker, directing a certian person to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument.
- Cheque - It is an order by the account holder of the bank directing his banker to pay on demand the specified amount, to or to the order of the person named therein or to the bearer.
- Hundi - It is form a of bill of exchange drawn in any local language in accordance with the custom of the place.
- Features of negotiable instruments are-free transferability, good title, always in written form, unconditional order or promise, certainty of payment, payee, time, etc.

17.7 Terminal Exercise

- (1) Name any two types of commonly used negotiable instruments.
- (2) Write two points of distinction between a promissory note and a cheque.
- (3) “The drawer can only draw a Time Bill”. Do you agree with this statement? Give reason.
- (4) “A cheque need not bear a date.” Do you agree? Give reason.
- (5) Explain ‘Darshani Hundi’ in about 20 words.
- (6) State any four essential features of a bill of exchange.
- (7) Write any four points of distinction between a promissory note and a bill of exchange.
- (8) Explain briefly “certainty of person” and “time of payment” as features of negotiable instruments.
- (9) “A bill of exchange must contain an unconditional promise to pay.” Do you agree with this statement? Justify your answer.
- (10) State the three parties involved in a bill of exchange.
- (11) Define Promissory note and state its any four important features.
- (12) State the important features of a bill of exchange.
- (13) Give the definition of a ‘cheque’. How does it differ from a bill of exchange?

- (14) “There are different types of Hundis used in our country”. Do you agree? State any two important varieties of Hundis.
- (15) “Negotiable means transferable and instrument means documents. Thus, negotiable instrument means a transferable document.” But apart from these, there are other essential features of a negotiable instrument. State any six.
- (16) What are the different types of cheques? Distinguish between open cheque and crossed cheque.

17.8 Key to Intext Questions

- 17.1 (A) i) Payee, ii) Endorsement, iii) Drawer / Maker, iv) Endorser, v) Indian Stamp.
 B) v) Cheques, vi) Hundis
- 17.2 (A) i) False, ii) True, iii) False, iv) False, v) True
 (B) Drawer - Rajesh, Drawee - Kavita, Payee - Mukesh
- 17.3 i) d, ii) c, iii) b, iv) e, v) a
- 17.4 (i) False, (ii) False, (iii) False, (iv) False, (v) False

Distinction between a Promissory Note and a Bill of Exchange

Promissory Note	Bill of Exchange
1. It contains an unconditional promise.	1. It contains an unconditional order.
2. There are two parties – the maker and the payee.	2. There are three parties – the drawer, the drawee and the payee.
3. It is made by the debtor.	3. It is made by the creditor.
4. Acceptance is not required.	4. Acceptance by the drawee is a must.
5. The liability of the maker/drawer is primary and absolute.	5. The liability of the maker/drawer is secondary and conditional upon non-payment by the drawee.

Distinction between a Cheque and a Bill of Exchange

Cheque	Bill of Exchange
1. It is drawn only on a banker.	1. It can be drawn on any body including a banker.
2. The amount is always payable on demand.	2. The amount is payable on demand or after a specified period.
3. It can be crossed to end its negotiability.	3. It can not be crossed.
4. Acceptance is not required.	4. Acceptance is a must.

Activity For You

- Draw specimens of different types of cheque that you have learnt from this lesson.