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## Can Demand Notes Really Be Demanded

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information obtained illegally or obtained legally and then illegally misappropriated for personal use. Phillips & Zutz, supra note 93, at 86-93; Barbara Bader Aldave, Misappropriation: A General Theory of Liability for Trading on Nonpublic Information, 13 Hofstra L. Rev. 101, 122 (1984).

Under a constructive insider theory one "who knowingly receives nonpublic material information from an insider has a fiduciary duty to disclose before trading." Dirks, 463 U.S. at 656. See Phillips & Zutz, supra note 93, at 93-95.

The breach of duty under each of these theories, however, is not to the investing public and, therefore, each is a rather roundabout way of protecting the public. Under the misappropriation theory the wrong is to the rightful possessor of the information. Under the constructive insider theory the wrong is to the corporate shareholders.

111. See, e.g., United States v. Carpenter, 484 U.S. 19 (1987); Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980); Santa Fe Industries v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); SEC v. Texas Gulf Sulphur C., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969); In re Cady, Roberts & Co., 40 S.E.C. 907 (1961).

112. An example of "mere good fortune" is inadvertently, while waiting on line at the movies, overhearing a conversation about a particular corporation's business, and then, in reliance on the overheard information, buying shares of the corporation's stock. The corporate information on which Chiarella traded, on the other hand, was not obtained because of Chiarella's "mere good fortune." It was available to him because of his special relationship as an employee of the corporation's printing contractor.

## CAN DEMAND NOTES REALLY BE DEMANDED?

by

Peter M. Edelstein\*

### Introduction

**Facts:** ABC Bank lends \$100,000 to B. Benny. B. Benny executes and delivers to the bank a negotiable promissory note payable "on demand". ABC later demands payment. B. Benny refuses. ABC sues B. Benny for \$100,000. B. Benny defends on the grounds that reasonable notice was required and not given.

**Issue:** Whether a holder of a demand note can demand payment at any time?

**Decision:** Maybe.

A "demand note" is an instrument payable on demand and includes those payable at sight or on presentation and those in which no time for payment is stated.<sup>1</sup> By its nature, and as reflected in long accepted case law and in the U.C.C., a demand note entitles the holder to freely determine the time for payment. In fact, such a note is actually due on the date it is made, and it has been suggested that its name is misleading in that no actual prior demand is necessary to enforce payment.<sup>2</sup>

Questions concerning a holder's ability to require payment of a demand note at any time arise because of two apparently inconsistent rules of law and because the intent of the parties is not always clear. A two step analysis is called for: (1) what is the effect of the applicable provisions of the Code? and, (2) what is the intent of the parties?

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### The Problem

U.C.C. Section 1 - 203, embodies a principle long a part of the common law of contracts,<sup>3</sup> by imposing an obligation of good faith with respect to all transactions covered by the Code: "Every contract or duty within this Act imposes an obligation of good faith in its performance and enforcement." Good faith is defined as "honesty in fact in the conduct or transaction concerned".<sup>4</sup> Since negotiable notes are covered in Article 3 (Commercial Paper) and security agreements in Article 9 (Secured Transactions), one could fairly assume that demand notes are subject to the requirement of good faith.

The Official Comment to Section 1-208, however, proves this assumption to be incorrect. Section 1-208, entitled "Option to Accelerate at Will", imposes the requirement of good faith on a party, who among other things, desires to accelerate payment or performance "at will" or "when he deems himself insecure." The Official Comment states: "Obviously, this section has no application to demand instruments whose very nature permit call at any time with or without reason".<sup>5</sup> (emphasis added).

While the authors of the Code could have been more precise by setting forth the two rules in the body of Article 2, the Official Comment is not unclear. The obligation of good faith simply does not apply to demand instruments. Determining whether a demand instrument exists, based on the intent of the parties may not be so clear.

A "pure" demand note is simple and classic and by its terms is due "on demand". In the absence of any inconsistent language, either within or without the instrument, it may be called at any time with or without reason. By contrast, there is the note which was born as a demand note, but may have been bastardized into something else.

Consider a demand note which contains a provision that it is due on demand, but if no demand is made, the note is payable "at a certain date"; or a demand note which contains a default interest rate which is "due and payable at maturity, on demand or otherwise"; or a demand note given in conjunction with the execution and delivery of a loan agreement which contains covenants, ratios, and other requirements, the default of which constitutes an "event of default".

Since a court will look to the documents as a whole to determine the intent of the parties, it might conclude when reviewing the foregoing examples that the parties did not, in fact, intend the instrument to be payable on demand. The court might wonder why the parties agreed to such additional and unnecessary language if the note was really due on demand? These "demandable" types of notes have been labelled "impure"<sup>6</sup> demand notes and can become a lender's worst nightmare.

Shaughnessy v. Mark Twain State Bank, addressed this issue and concluded that the so-called "demand note" in question was not entitled to be treated as one:

"First, the words "[o]n demand, and if no demand is made, then on the" are printed on the form, but according to the note's language the date February 16, 1980 is typewritten in. Second, the interest rate is prime plus two but after the note becomes "due and payable (whether at maturity, on demand or otherwise)" the interest rises to prime plus three. In addition, paragraph 16 of the deed of trust lists eight events which constitute default. The deed itself recites 26 paragraphs of covenant by Shaughnessy. The deed then states that defaults or failure to perform the covenants shall cause the obligation to become due and payable regardless of maturity. Again, we apply the court's analysis [in an earlier case] to underscore the point that a demand note is, on issue, due. Further, Shaughnessy, in the security ... agreement, agreed that failure to pay at maturity constituted default. Therefore, had the note been a demand note it would be mature and Shaughnessy would have been immediately in default. Likewise, with the deed of trust language, if this were a demand note, the note would not need default for it to be due and payable at the option of the bank. It would already have been due."

Once the conclusion is reached that the instrument alleged by the lender to be a demand instrument is not entitled to be treated as such, the U.C.C. requirements of good faith apply by virtue of U.C.C. Section 1-203. In the context of commercial instruments this means that "neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract".<sup>8</sup> This obligation to protect the legal expectations of a party translates, in the case of demand notes, into an obligation to give fair notice to the borrower before requiring payment.

K.M.C. Co., v. Irving Trust Company,<sup>9</sup> did not directly deal with the right of the lender to demand its note, but did require "the exercise of reasonableness" and "valid business judgment"<sup>10</sup> in electing to terminate a line of credit under an agreement by which the loan was payable on demand.

K.M.C., a wholesale grocer, entered into a financing agreement with Irving Trust Company ("Irving") whereby Irving agreed to provide a line of credit, in its discretion, up to \$3.5 million. The loan was due on demand and was secured by all of K.M.C.'s accounts receivables and inventory. The

proceeds of all of K.M.C.'s receivables were required to be deposited into a "blocked account" to which only Irving had access.

K.M.C. requested an advance of \$800,000, which was available under its line. Irving, which was fully collateralized, refused and eventually K.M.C. was forced to liquidate its business.

K.M.C., in its lawsuit against Irving alleged, among other things, that Irving breached its implied duty of good faith and fair dealing by terminating the line without notice. Irving defended by arguing that since the line was due on demand and that because advances were discretionary, it could terminate the line at any time.

The court found for K.M.C. The jury awarded K.M.C. \$7.5 million in damages on the theory that Irving breached its implied duty of good faith and fair dealing by not giving K.M.C. notice of its intention to terminate the line.

The court noted that even though the obligation of K.M.C. was evidenced by a demand note (to which the obligation of good faith under the U.C.C. did not apply), provisions in the loan agreements indicated that the parties did not actually intend the instrument to be due on demand. The existence of financial covenants and events of default required that Irving exercise discretion, in good faith.

The court held:

"The record clearly established that a medium-sized company ... such as K.M.C. could not operate without outside financing. Thus, the literal interpretation of the financing agreement ... as supplemented by the "blocked account" mechanism, would leave K.M.C.'s continued existence entirely at the whim or mercy of Irving, absent an obligation of good faith performance ... Logically, at such time as Irving might wish to curtail financing K.M.C., as was its right under the agreement, this obligation to act in good faith would require a period of notice to K.M.C. to allow it a reasonable opportunity to seek alternative financing ..."

#### Avoiding the Problem

The problem, once recognized, is subject to avoidance by early and thorough attention to drafting. If a pure demand note is intended, care should be taken not to include any language inconsistent with the right to demand at any time, for any reason, or for no reason.

If the transaction requires a demand instrument together

with other loan documents, use a pure demand instrument together with clear and specific "saving" language in another document stating that the note is due on demand, in all events, and that any other language is to be construed cumulatively for the lender's benefit and not in derogation of its right to demand without notice. Any apparently inconsistent language may be justified as serving to assure the continued credit-worthiness of the borrower or to provide the borrower with notice of circumstances when the note is likely to be called.

The issue will never arise if you use a time instrument together with such due dates, events of default, default interest rates and covenants, and like provisions, as you wish.

#### Related Problems

"Discretionary advances" language is subject to an analysis similar to demand notes. Even where the language of the loan documents makes advances discretionary, the lender may be required, by the rules of good faith and commercial reasonableness (as in K.M.C.), to give the borrower fair notice that future advances will not be made.

If other terms in the loan documents require commitment fees or periodic payments, for example, a court might find these provisions inconsistent with the right to make discretionary advances, and infer an obligation on the part of the lender to make the advances.

To avoid this issue, consider using language in the loan documents which commit the lender to make the advances, instead of making them discretionary, but make the agreement subject, in each instance, to the borrower's satisfaction of a list of conditions (ratios, performance standards, affirmative and/or negative covenants, absence of default, etc.) which will give the lender sufficient comfort.

The right to accelerate the entire indebtedness in the event of default usually causes no problems. The risk lies with the use of language permitting acceleration "at will" or when "insecure". The U.C.C., in Section 1-208, states that the lender may accelerate at will or when it deems itself insecure only if it believes in good faith that the prospect of payment or performance is impaired (emphasis added).

If the lender accelerates pursuant to an "acceleration at will" clause the file should support the belief, in good faith, that the loan is in jeopardy. As noted above, this U.C.C. section does not apply to demand instruments, therefore, to avoid the issue consider, when appropriate, casting the instrument as "demand" and avoiding the use of the "at will" language, or alternatively, using a time instrument

with well-defined events of default tied to performance standards.

Like the "acceleration at will" language, an "insecurity" clause is subject to the provisions of U.C.C. Section 1-208, requiring the lender to believe in good faith that the prospect of repayment or performance is impaired. To cover this situation, include in the loan documents a definition of "insecure" or set forth those acts or events which would render the lender insecure; for example, state that a breach of a covenant requiring certain financial ratios to be maintained renders the lender insecure. Your client's file should then contain information evidencing the breach and supporting the determination of insecurity before the loan is called. Better yet, do not use or rely upon the "insecurity" clause. Whatever would make the lender feel insecure should be included as an event of default, in the case of a time instrument; or use a pure demand instrument to which the U.C.C. section does not apply.

#### Conclusion

The K.M.C. decision and subsequent cases<sup>12</sup> constitute notice to the bar that the courts will not consider the title of the instrument to be determinative of the intent of the parties. If the instrument is a pure demand instrument and there exists no documentary evidence indicating otherwise (ratios, covenants, events of default, etc.), the courts will not impose an obligation of good faith. Where, however, notwithstanding the title of the instrument, the intent of the parties is clear from other related agreements, the instrument may be held not to be a demand instrument, but a "demandable" instrument, and subject to the obligations of good faith.

At least one author has stated that "... it is rarely, if ever appropriate to document a commercial loan transaction with a demand note ...".<sup>13</sup> This suggestion surely deserves more than casual consideration. It is a common feeling by lenders that a demand note gives them more control over their money and its repayment. They feel that by being able to demand repayment at any time they can constantly monitor the credit-worthiness of their borrowers. Well, while this may seem to make sense, consider the following:

1. Case law (K.M.C.) tells us that the demandable instrument may not be subject to demand without reasonable notice.

2. The same control and monitoring can be obtained by the use of time instruments with performance standards (tied to events of default) covenants, and ratios.

3. Most importantly, as a matter of fairness and equity, what business person, dealing at arms length would

ever voluntarily execute and deliver a demand note which could have the effect, if demanded without notice, of causing it substantial economic difficulties?

#### ENDNOTES

1. U.C.C. §3-108.
2. Halt & Willier, "Commercial Paper" in 2 Bender's U.C.C. Serv. §5.02[2] (1988).
3. Restatement (Second) of Contracts, §205. See also: Palisades Properties, Inc. v. Brunetti, 44 NJ 117, 207 A2d 522, 531 (1965).
4. U.C.C. Section 1-201(19).
5. See: Centerre Bank of Kansas City, NA v. Distributors, Inc., 705 SW2d 42 (Mo. Ct. App. 1985).
6. "The Law of Lender Liability", Helen Davis Chaitman, published by Warren, Gorham & Lamont, 1990, §2.01[4][a][ii].
7. Shaughnessy v. Mark Twain State Bank, 715 SW2d 944, 951 (Mo. Ct. App. 1986).
8. Palisades Properties, Inc. v. Brunetti, 44 NJ 117, 207 AD2d 522, 531 (1965).
9. K.M.C. Co., Inc. v. Irving Trust Company, 757 F2d 752 (6th Cir. 1985).
10. Id at 761. See: Centerre Bank of Kansas City, NA v. Distributors, Inc., 705 SW2d 42 (Mo. Ct. App. 1985).
11. Id, at 759 - 760.
12. See: Reid v. Key Bank of Southern Maine, Inc., 821 F2d 9 (1st Cir. 1987); MSV, Inc. v. Bank of Boston, 87 BR 752 (Bankr. D. Mass. 1988); Spencer Cos v. Chase Manhattan Bank, N.A., 81 BR 194 (D. Mass 1987).
13. "The Law of Lender Liability", Helen Davis Chaitman, published by Warren, Gorham & Lamont, 1990, §2.01[4][a].