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THE COMMERCIAL DOCTRINE OF GOOD FAITH PURCHASE

GRANT GILMORE†

The triumph of the good faith purchaser has been one of the most dramatic episodes in our legal history. In his several guises, he serves a commercial function: he is protected not because of his praiseworthy character, but to the end that commercial transactions may be engaged in without elaborate investigation of property rights and in reliance on the possession of property by one who offers it for sale or to secure a loan. As the doctrine strikes roots in one or another field, the "good faith" component tends to atrophy and the commercial purchaser is protected with little more than lip service paid to his "bona fides."

**Good Faith Purchase in the Law of Sales**

The commerciality of the good faith purchase doctrine can be demonstrated by a brief history of its growth in the law of sale of goods. The intangible evidences of property, with which the balance of this article will be concerned, are by their nature almost exclusively commercial. Goods, however, lead a double life: as inventory, they are the subject matter of commercial transactions; as possessions, the things we live by, they have passed out of the stream of commerce and come to rest. Although Anglo-American law does not purport to distinguish between commercial and non-commercial transactions, good faith purchase in the law of sales has, in fact, a very different operation in the two cases.

The initial common law position was that equities of ownership are to be protected at all costs: an owner may never be deprived of his property rights without his consent. That worked well enough against a background of local distribution where seller and buyer met face to face and exchanged goods for cash. But as the marketplace became first regional and then national, a recurrent situation came to be the misappropriation of goods by a faithless agent in fraud of his principal. Classical theory required that the principal be protected and that the risks of agency distribution be cast on the purchaser. The market demanded otherwise.

The first significant breach in common law property theory was the protection of purchasers from such commercial agents. The reform was carried out through so-called Factor's Acts, which were widely enacted in the early part

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of the 19th century. Under these Acts any person who entrusted goods to a factor—or agent—for sale took the risk of the factor’s selling them beyond his authority; anyone buying from a factor in good faith, relying on his possession of the goods, and without notice of limitations on his authority, took good title against the true owner. In time the Acts were expanded to protect people, i.e., banks, who took goods from a factor as security for loans made to the factor to be used in operating the factor’s own business. The Factor’s Acts, as much in derogation of the common law as it is possible for a statute to be, were restrictively construed and consequently turned out to be considerably less than the full grant of mercantile liberty which they had first appeared to be. Other developments in the law gradually took the pressure off the Factor’s Acts, which came to be confined to the narrow area of sales through commission merchants, mostly in agricultural produce markets.

1. The first English Act (4 George IV, c. 83) was passed in 1824 and thereafter several times amended to overrule restrictive judicial constructions. See 2 Williston, Sales §§ 318, 319 (rev. ed. 1948). A group of Eastern and Mid-Western States then enacted similar, although by no means uniform statutes: Maine, Maryland, Massachusetts, New York, Ohio, Pennsylvania, Rhode Island, and Tennessee. A comparable provision was included in the California Civil Code and copied in Montana and North Dakota. See 2 id. § 320, collecting the statutory citations.

2. Thus the Massachusetts Act, passed in 1845 (Mass. Stat. 1845, c. 193) covered only buyers. An amendment in 1849 was added to protect pledgees. Mass. Stat. 1849, c. 216, § 3. In Michigan State Bank v. Gardner, 15 Gray 362 (Mass. 1860), the court refused to protect a pledgee who took goods in 1847, commenting: “[The 1849 amendment] was passed after this transaction, and cannot affect it. But it shows that the former statute was insufficient . . . and by expressly giving the authority to pledge implies that the authority did not exist before, even where the pledge was made in good faith and with probable cause to believe that the agent had authority, and was not acting fraudulently therein against the owner of the property.” Id. at 374.

3. The New York Commission of Appeals (the highest court in the state) expressed the prevalent attitude in First Nat. Bank of Toledo v. Shaw, 61 N.Y. 283, 304 (1874) : “Considerable stress was laid at the argument, by counsel on either side of the case, on the great consequences to commerce of a decision in this cause adverse to their respective views. Finding the principles of law clearly settled, we are bound to administer them as they have come down to us from our predecessors . . . While commercial convenience must be respected, the rights of property must not be sacrificed . . . The true interests of commerce demand that the claims under bills of lading and other such instruments should be scrupulously protected, since commerce will not flourish where the rights of property are not respected.” The case involved grain shipped to New York City. The New York factor, to whom the bill of lading was delivered by plaintiff’s agent, warehoused the goods on delivery and pledged the resulting warehouse receipt to defendant. Plaintiff was allowed to replevy the goods on the theory that there had been no “entrusting” of the bill of lading and that the warehouse receipt was “mere waste paper.” Ibid. No distinction is taken in the opinion between negotiable and nonnegotiable documents. For a relatively modern reiteration of the same restrictive construction of the Factor’s Acts, see Gazzola v. Lacy Bros. & Kimball, 156 Tenn. 229, 299 S.W. 1039 (1927) (also involving a substitution of warehouse receipt for the original bill of lading). The Gazzola case is criticized in an excellent note in 12 Minn. L. Rev. 633 (1928) which collects much of the early material.

4. The practice in the jewelry trade of delivering diamonds on memorandum or consignment to peripatetic sales agents led to a flurry of litigation in New York.
GOOD FAITH PURCHASE

Even while they were cutting the heart out of the Factor's Acts, the courts were finding new ways to shift distribution risks. Their happiest discovery was the concept of "voidable title"—a vague idea, never defined and perhaps incapable of definition, whose greatest virtue, as a principle of growth, may well have been its shapeless imprecision of outline. The polar extremes of theory were these: if B buys goods from A, he gets A's title and can transfer it to any subsequent purchaser; if B steals goods from A, he gets no title and can transfer none to any subsequent purchaser, no matter how clear the purchaser's good faith.5 "Voidable title" in B came in as an intermediate term between the two extremes: if B gets possession of A's goods by fraud, even though he has no right to retain them against A, he does have the power to transfer title to a good faith purchaser.6

Nelkin v. Provident Loan Society, 265 N.Y. 393, 193 N.E. 245 (1934); Sweet & Co. v. Provident Loan Society, 279 N.Y. 540, 18 N.E.2d 847 (1939); Mann v. R. Simpson & Co., 286 N.Y. 450, 36 N.E.2d 658 (1941); Mendelsohn v. R. Simpson & Co., 267 App. Div. 564, 47 N.Y.S.2d 489 (1st Dep't 1944); Landau v. Cramer, 32 N.Y.S.2d 658 (Sup. Ct. 1941); Lindner v. Winston, 151 Misc. 499, 270 N.Y.Supp. 829 (N.Y. City Ct. 1933). Before the passage of the Uniform Trust Receipts Act, and perhaps as a contributing factor to its passage, there were suggestions in two New York cases that the Factor's Act might be applicable to purchasers of collateral entrusted under trust receipts. See In re James, Inc., 30 F.2d 555 (2d Cir. 1929) and Commercial Credit Corp. v. Northern Westchester Bank, 256 N.Y. 482, 177 N.E. 12 (1931). To the same effect in Massachusetts: Associates Discount Corp. v. C. E. Fay Co., 207 Mass. 577, 30 N.E.2d 870 (1940) (involving a transaction which occurred after the passage of the Trust Receipts Act but which, because there was no signed writing, fell outside that Act). It is a nice question whether, in States adopting the Uniform Commercial Code (hereinafter cited as UCC), § 2-404 will operate to repeal the old Factor's Acts.

5. "It is a fundamental doctrine of the law of property that no one can give what he has not ... [O]ne who has no title at all can transfer none, and that a buyer from him pays value in good faith without notice makes no difference." 2 WILLISTON, SALES § 311 (rev. ed. 1948). Cf. UNIFORM SALES ACT § 23: "Subject to the provisions of this act, where goods are sold by a person who is not the owner thereof, and who does not sell them under the authority or with the consent of the owner, the buyer acquires no better title to the goods than the seller had, unless the owner of the goods is by his conduct precluded from denying the seller's authority to sell."

6. The Uniform Sales Act has several provisions on the point. Under § 24 "Where the seller of goods has a voidable title thereto, but his title has not been avoided at the time of the sale, the buyer acquires a good title to the goods, provided he buys them in good faith, for value, and without notice of the seller's defect of title." Under § 25 the case of the seller who remains in possession of the goods after a sale is treated in much the same way with the exceptions that § 25 introduces a requirement that the goods be physically delivered to the second buyer, which is apparently not present in § 24 and that the transactions protected under § 25 are "any sale, pledge or other disposition" of the goods while § 24, read literally, protects only "buyer" and not pledgees and other transferees for security). Furthermore § 20(4), dealing with the case where a seller has drawn a draft on buyer and "transmitted" both the draft and a bill of lading to him, provides that, even though the buyer fails to honor the draft, a "purchaser" (as defined in the Act the term includes mortgagees and pledgees) from him in good faith and for value who "receives delivery" of either the bill of lading or the goods takes free of the original owner's interest. WILLISTON, SALES (rev. ed. 1948), casts no light on the reason for the discrepancies among the several sections.
The ingenious distinction between “no title” in B (therefore true owner prevails over good faith purchaser) and “voidable title” in B (therefore true owner loses to good faith purchaser) made it possible to throw the risk on the true owner in the typical commercial situation while protecting him in the noncommercial one. Since the law purported to be a deduction from basic premises, logic prevailed in some details to the detriment of mercantile need, but on the whole voidable title proved a useful touchstone.

The contrasting treatment given to sales on credit and sales for cash shows the inarticulate development of the commercial principle. When goods are delivered on credit, the seller becomes merely a creditor for the price: on default he has no right against the goods. But when the delivery is induced by buyer’s fraud—buyer being unable to pay or having no intention of paying—the seller, if he acts promptly after discovering the facts, may replevy from the buyer or reclaim from buyer’s trustee in bankruptcy. The seller may not, however, move against purchasers from the buyer, and the term “purchaser” includes lenders who have made advances on the security of the goods. By his fraudulent acquisition the buyer has obtained voidable title and purchasers from him are protected.

Cash sale theory developed quite differently. A reasonable man might suppose that if taking goods on credit without the intention or ability to pay for them is fraud, then the same practice where the buyer is supposed to pay cash would be the same kind of fraud. The courts have held, however, in the cash sale situation that something more serious than “mere” fraud is involved, something approaching theft—“larceny by trick or device” as the time-honored phrase runs—and that consequently the defaulting cash sale buyer gets no title, and can transfer none to a good faith purchaser.

1. The underlying theory of the cash sale is that no title passes on delivery—contrary to the usual sales doctrine under which title passes, as to specific goods in a deliverable state, when the contract is made, even though neither payment nor delivery has occurred. Uniform Sales Act § 19, rule 1. Since no title has passed, where delivery is for cash, seller may replevy against buyer, unless as in Frech v. Lewis, 218 Pa. 141, 67 Atl. 45 (1907), he is held to have waived his right by delay. The rights of third parties, therefore, are governed by § 23 of the Sales Act (sale by a person not the owner) rather than § 24 (sale by one having a voidable title). Curiously, the Sales Act has no express provision on cash sales; the common law doctrine presumably survives as a casus omnis under § 73 ("In any case not provided for in this act, the rules of law and equity, including the law merchant ... shall continue to apply. . . ")
The cash sale theory is stated in the cases as a general rule. But in fact it is almost never applied against good faith purchasers in a commercial setting.11 Most of the cash sale cases involve recoveries from purchasers, whose good faith is doubtful in the first instance, by sellers who are either retail merchants or consumers disposing of their own second-hand possessions.12 So confined, as in fact it has been,13 the cash sale theory is a useful weapon for striking


11. One of the few cases which has applied—or misapplied—the cash sale theory against a good faith purchaser in an ordinary course of business commercial situation is itself a striking demonstration of how carefully the operation of the theory has been confined. Weyerhaeuser Timber Co. v. First Nat. Bank of Portland, 150 Ore. 172, 38 P.2d 48, rehearing, 150 Ore. 203, 43 P.2d 1078 (1935), involved a cash sale of lumber to an insolvent who, having received delivery, resold to various purchasers and assigned the resulting accounts receivable to the defendant bank which made present advances against the accounts. In its first opinion the court gave judgment to the plaintiff seller against the bank for the proceeds of the resales on a theory as to which, in a second opinion, the court confessed itself to have been in error. Nevertheless on rehearing the court adhered to its original decision, assigning as its principal reason a cash sale theory. Under the circumstances it is reasonable to assume that the court searched diligently for all available supporting authority. The best it could do was Johnson v. Iankovetz, 57 Ore. 24, 102 Pac. 799 (1910), see note 12 infra, one of its own prior cases, and a series of cases from other jurisdictions which, although involving commercial transaction, went no further than to support seller's recovery against defaulting buyer's lien creditors. Between the lien creditor seeking to collect a preexisting claim and the subsequent purchaser in good faith there is a polar distance. Apart from the Weyerhaeuser case itself, and a subsequent case in the same jurisdiction (Keegan et al. v. Lenzie, 171 Ore. 194, 135 P.2d 717 (1943)), there is no case authority supporting a cash sale recovery against a subsequent good faith purchaser in a commercial context, whether the purchaser be a buyer or a lender against security. See cases discussed note 13 infra.

12. The typical case is Johnson v. Iankovetz, 57 Ore. 24, 102 Pac. 799 (1910), relied on by the court in the Weyerhaeuser case, supra note 11. Johnson sold two guns to Adams, who gave a bad check in payment of the price of $45.05. On the day Adams got the guns from Johnson he resold them to Iankovetz for $22. Johnson, who took action as soon as he learned of the dishonor of Adams' check, was allowed to replevy from Iankovetz. Although defendant's status as a good faith purchaser is not questioned in the opinion, the fact remains that he bought the guns from Adams for less than half of what they were presumably worth.

13. De Vries v. Sig Ellingson & Co., 100 F. Supp. 781 (D. Minn. 1951), does allow a recovery against a purchaser of commercial property but goes off on the special ground that, because of his status, a livestock commission merchant is not entitled to the protection that ordinarily goes to good faith purchaser. The YALE Note referred to note 10 supra cites a number of cases as if they involved such recoveries, but on investigation the cases stack up as follows: Publicker Commercial Alcohol Co. v. Harger, 139 Conn. 655, 31 A.2d 27 (1943) (defendant was sheriff who had attached goods because of unpaid state taxes; seller recovers on cash sale theory); Tyler v. Kelley Timber Products Co., 192 Ore. 368, 233 P.2d 774 (1951) (plaintiff was a logger; defendant had taken a mortgage on all the assets of the timber company largely for antecedent debt, and it does not appear that the mortgage had been recorded); Parker v. First-Citizens Bank & Trust Co., 229 N.C. 527, 50 S.E.2d 304 (1948) (automobile; action was not against good faith
down fraudulent, often quasi-criminal, transactions which, lying far outside the mainstream of commerce, need no protection on mercantile grounds.14

Sales law offers a guide to the basic line of division. We shall henceforward be concerned with commercial intangibles: negotiable instruments, stocks and bonds, documents of title, "chattel paper" (to borrow a term from the Uniform Commercial Code), accounts receivable, and the like. It will be the aim of this discussion to demonstrate that as these intangibles come into use, the regular course of business transferee is, on one or another theory, granted the privileged status of the good faith purchaser—holding free of latent defenses and equities.

GOOD FAITH PURCHASE OF INTANGIBLES: NEGOTIABILITY

The good faith purchase idea takes on an extra dimension of complexity when intangibles and not goods are concerned. Goods have an ascertainable purchaser, but against agent of deceased buyer for proceeds of resale); Barksdale v. Banks, 206 Ala. 569, 90 So. 913 (1921) (sale of two mules to livery stable; seller recovers from good faith purchaser); Gustafson v. Equitable Loan Ass'n, 186 Minn. 236, 243 N.W. 106 (1932) (retail jeweler recovers diamond from pawnbroker).

Lewis v. McMahon & Co., 307 Mo. 552, 271 S.W. 779 (1925) is a commercial case: S sold 25 carloads of oil to B who paid with a check on defendant bank; B then pledged the bills of lading with the same bank; the bank dishonored the check but retained the bills of lading and sold the oil. The court refers to cash sale theory but the result (S recovers value of oil from bank in conversion) is obviously predicated on defendant's lack of good faith. For a case reaching the same result on remarkably similar facts but without reference to cash sale theory, see Commercial Sav. Bank of Grand Rapids v. Mann, 206 App. Div. 297, 200 N.Y. Supp. 587 (4th Dep't 1923).

Quality Shingle Co. v. Old Oregon Lumber & Shingle Co., 110 Wash. 60, 187 Pac. 705 (1920) is also a case in a commercial setting in which S recovered the value of a carload of shingles from a good faith purchaser. Here S asserted his rights while the goods were still in transit, moving under a nonnegotiable bill of lading. The court bases its decision on provisions of the Federal Bills of Lading Act. See text at note 68 infra.

14. The typical method of denying a seller recovery against a good faith purchaser is to find that by delay seller has waived his rights. Most of the cases involve payment by worthless check. Professor Williston has long argued against the cash sale result in the check cases on the theory that the seller who delivers goods against a check is in fact selling on credit and not for cash. Although the theory had no case law support when propounded in the first edition of Williston's treatise on Sales, recent cases suggest that the courts are beginning to make use of it. See, e.g., Pingleton v. Shepherd, 219 Ark. 473, 242 S.W.2d 971 (1951); Gerber v. Pike, 249 S.W.2d 90 (Tex. Civ. App. 1952).

2 WILLOSTON, SALES, § 341 et seq. (Supp. 1953) has a collection of the recent cases, which involve, almost without exception, automobiles bought by the fraudulent actor from Dealer A and promptly resold to Dealer B, who typically buys with his eyes tightly shut and without requiring production of title certificate or other indicia of ownership.

The UCC purports to abolish cash sale theory. Cf. § 2-401 (1) (b): "[N]o agreement that a contract for sale is a 'cash sale' alters the effects of identification or impairs the rights of good faith purchasers from the buyer." Furthermore § 2-403 (2) provides: "Any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in ordinary course of business." The term "buyer in ordinary course of business" is defined in § 1-201 (9) to exclude pawnbrokers and persons buying from farmers.
location in space and time. If they are in Connecticut it is obvious, even to 
the legal mind, that they are not in New York. If $A$, the owner, sells goods 
to $B$, then $A$, except for claims based on breach of warranty, has nothing 
further to do with them. Nor has anyone ever doubted that goods can be 
sold. Even if, theoretically, goods can be made the subject of the sort of 
future interests which make up so much of our real property law, they have 
ever in fact been so burdened.

None of these truisms is safe when we come to intangibles. Intangibles 
are not in themselves property, in the sense that goods are; they are claims 
to property. Thus when $A$ gives his promissory note to $B$ who negotiates to 
$C$ who in turn negotiates it to $D$, what is being bought and sold is not the 
piece of paper which physically changes hands but the right to collect a 
certain amount of money from $A$ which is represented by the piece of paper. 
Furthermore two distinct types of dispute can arise on the transfer of intang-
ibles, only one of which is possible when goods are sold. When $C$, having 
acquired $A$'s note from $B$, sells it to $D$, $D$ has to worry not only whether he 
has acquired good title to the note against $B$, the original owner, but also 
whether the claim against $A$ was valid in the first place. When he buys goods 
from $C$ and takes delivery, he may or may not get title (depending on whether 
or not $C$ is a thief) but at least he can be sure that the goods exist. When 
he buys $A$'s note and takes delivery of that, it is far from certain that there 
ever was a claim against $A$, whose signature may have been forged or extorted 
or who may be free of liability because of usury. Moreover if $A$, a resident 
of Connecticut, mails the note to $B$ in New York, and if $C$ and $D$ are residents 
of Florida and California, it may be far from clear, even to the lay mind, 
exactly where the claim against $A$ “is.”

Finally in contrast to the idea that public policy favors the free alienability 
of chattels, the law relating to the transfer of intangibles starts from the propo-
sition that claims—chooses in action—are not assignable. It is hard for us to 
understand why this should ever have been the law. The rule may have 
come in at a time when intangible property was little known, insignificant as 
a form of wealth, and therefore could be summarily disposed of in a short-
hand phrase. We like to say that it is no longer the law today.

The development of the law of good faith purchase in this field has thus 
had to take account of burdensome complexities which were not met with in 
the relatively simple case of goods. It has been necessary to work out a 
number of subordinate propositions in addition to, the basic one that the 
purchaser in good faith and for value gets “title” or “good title” or even 
“perfect title.” It is this network of good faith purchase rules that we mean 
when we describe paper as “negotiable.”

*Negotiable Instruments and Nonnegotiable Choses*

“Negotiable” and “negotiability” are words rarely, if ever, defined. They 
mean not one but many things. The principal attributes of negotiability are 
these:
(1) The paper must be freely assignable; no restraints on alienation will be tolerated.\textsuperscript{15}

(2) The debt claim is "merged" into the paper evidencing the claim; thus the paper must be treated in many situations as if it were the claim itself:

   a) Transfer of the claim can only be made by physical delivery of the paper, completed by evidence of the transferor's intent to transfer which is customarily given by his indorsement on the paper itself;\textsuperscript{16}

   b) Discharge of the debt evidenced by the paper can be made only by payment to (or cancellation by) the holder—the person physically in possession;\textsuperscript{17}

   c) Creditors of a holder can assert their claims against the paper (as part of the debtor's assets) only by getting possession of it through appropriate legal process, and not by serving a garnishment order on the obligor;\textsuperscript{18}

   d) The situs of the debt is where the paper is.\textsuperscript{19}

(3) In pursuing his claim against the obligor, the holder receives the benefit of a series of presumptions which cast on the defendant the greater

\textsuperscript{15} An instrument to be negotiable must contain the magic words of negotiability: payable to "order" or to "bearer." NIL § 1. Any attempt to prohibit transfer would make the paper nonnegotiable, since the promise to pay would no longer be "unconditional." \textit{Ibid.}

\textsuperscript{16} "Every contract on a negotiable instrument is incomplete and revocable until delivery of the instrument for the purpose of giving effect thereto." NIL § 16. "If payable to bearer [an instrument] is negotiated by delivery, if payable to order it is negotiated by the indorsement of the holder completed by delivery." NIL § 30.

\textsuperscript{17} See NIL §§ 119 and 88. § 119(4) provides that a negotiable instrument is discharged "[b]y any other act which will discharge a simple contract for the payment of money." A debtor on a simple contract discharges his debt by paying his original creditor, even though the claim may have been assigned, provided the debtor has not received notice of the assignment. \textit{Restatement, Contracts} § 170 (1932). Payment by the obligor of a negotiable instrument to a prior holder, without notice that the instrument has been further negotiated, does not discharge a negotiable instrument, even though § 119(4) seems to say that it does: \textit{Britton, Handbook of the Law of Bills and Notes} § 270 (1943). For the cases see \textit{Brannan, Negotiable Instruments Law} 1114 et seq. (7th ed., Beutel, 1948).

\textsuperscript{18} This proposition is apparently considered to be so self-evident that it goes without saying. Neither the NIL nor Article 3 of the UCC bothers to codify it and the point is not even mentioned in \textit{Britton, op. cit. supra} note 17. \textit{Brannan, op. cit. supra} note 17, at 826-8 collects a few cases, mostly of relatively ancient vintage, which are consistent with the statement in the text. The point seemed less obvious with regard to share certificates and documents of title and appropriate provisions were included in the relevant codifying statutes. See notes 62 and 73 \textit{infra}.

\textsuperscript{19} \textit{Restatement, Conflict of Laws} § 349 (1934): "The validity and effect of a transfer of a negotiable instrument are determined by the law of the place where the instrument is at the time of its transfer."
part of the burden of proof normally carried by plaintiffs in contract actions.20

(4) On default by the obligor, the holder has an automatic right of recourse against prior indorsers.21

(5) As to "purchase in good faith, without notice and for value":
   a) a purchaser is "in good faith" as long as he is "subjectively" honest at the time he takes the paper; he is under no duty of inquiry; he may even have "forgotten" relevant information; he is merely required not to be actively in bad faith;22

20. The most important of these presumptions are that: consideration was given for the instrument (NIL § 24); the instrument was delivered by the obligor to the first holder (NIL § 16); any person in possession of an instrument has prima facie authority to fill any blanks in it (NIL § 14); all negotiations were made before maturity (NIL § 45); every holder is a holder in due course (NIL § 59). Curiously the NIL does not contain a provision under which signatures are presumed to be valid. The cases consequently hold that, where a signature is denied, the burden of proof to establish its genuineness is on the plaintiff. See Britton, op. cit. supra note 17, § 129. The UCC, in § 3-307, adds to all the NIL presumptions a presumption of genuineness of controverted signatures in favor of a holder.

21. NIL § 66. By qualifying his indorsement (i.e., adding the words "without recourse" to his signature), the indorser may disclaim such liability.

22. See generally Britton, op. cit. supra note 17, §§ 100, 101. The NIL formulation is that "[t]o constitute notice of an infirmity in the instrument or defect in the title of the person negotiating the same, the person to whom it is negotiated must have had actual knowledge of the infirmity or defect, or knowledge of such facts that his action in taking the instrument amounted to bad faith" (§ 56). The UCC in addition to an elaborate provision on notice (§ 3-304) provides that a holder in due course is one who takes the instrument "in good faith including observance of the reasonable commercial standards of any business in which the holder may be engaged" (§ 3-302(7)(b)). The "reasonable commercial standards" language has come into controversy. In hearings on the UCC before the New York Law Revision Commission it was attacked by representatives of New York City banks as a reversion to the "objective" standard of good faith announced by the Court of King's Bench in 1824 in Gill v. Cubitt, 3 B. & C. 466 (1824), later abandoned both in England (Goodman v. Harvey, 4 A. & E. 870 (1836)) and the United States (Murray v. Lardner, 2 Wall. 110 (U.S. 1894)). Proponents of the UCC have denied any intention of going back to the rule of Gill v. Cubitt and have insisted that, whether the NIL concept of good faith be described as "subjective" or something else, the ordinary course of business idea has in fact played a major role in the decisions, so that no change in the law is intended or effected. When plaintiff's good faith is controverted, the issue is one for the jury and presumably will continue to be under the UCC. The principal effect of the "reasonable commercial standards" language may be to make evidence of business practice more easily admissible. Although the Code provision is attacked as an attempt to raise the standards of good faith requisite to due course holding, it could, paradoxically, have the opposite effect: plaintiff's chances for a directed verdict, on a showing that he did observe the "reasonable commercial standards of [the] business in which [he was] engaged," might well be better than they are under the present law. Graham v. White-Phillips Co., 296 U.S. 27 (1935), is regularly cited as the finest flower of the "subjective" theory—broker purchased stolen bonds after having received notice, allegedly forgotten, that they had been stolen—but it merely held that plaintiff had made enough of a case to go to the jury. Under UCC § 3-302 plaintiff, on a proper showing, might be held entitled to a directed verdict.
b) a purchaser is not put on notice by anything not contained in the paper itself; he is not subject to constructive notice from public recordation or to limitations contained in collateral agreements unless the limitations are actually known to him; 23

c) a purchaser has “given value” if he has given any consideration sufficient to support a simple contract; moreover a pre-existing debt constitutes value. 24

(6) Any holder, even though he took the instrument in bad faith, with notice of defenses, after maturity and without giving value, has all the rights of any prior holder in due course from whom his title derives (provided only that he himself is not a party to any fraud or illegality affecting the instrument). 25

(7) A holder in due course, or a holder whose title is derived from such a holder, holds the instrument free both of equities of prior owners of the instrument, and of defenses of the obligor except the so-called “real” defenses. The real defenses, which are nowhere defined in the Negotiable Instruments Law, cover essentially the cases where there never was a claim against the obligor on the instrument: forgery, insanity or other lack of capacity to contract, and duress. 26

23. See Britton, op. cit. supra note 17, § 112. There is a lurking ambiguity here. When a negotiable instrument is itself collateral security for a loan (as when A’s note to B is used to secure B’s debt to X), no one has ever thought that filing by X under the chattel mortgage statute was either necessary or relevant to the perfection of X’s security interest in A’s note. But cf. Sammet v. Mayer, 108 F.2d 337 (2d Cir. 1939), which misread an obscure provision of N.Y. LIEN LAW § 230 to mean that filing was a permissible alternative to pledge in the case of stocks and bonds. The filing provisions of Uniform Trust Receipts Act § 13 do not apply to “instruments” which are the subject matter of a trust receipt transaction. The Secured Transactions Article of the UCC specifically provides that a security interest in “instruments” or “documents” may not be perfected by filing (§ 9-303(3)). Suppose, however, that X purchases a note that is secured by mortgage. Under the theory of “imparting negotiability,” see text at note 88 infra, he will hold both note and mortgage free of defenses and equities and no prior interest in the mortgage although recorded would be good against him. On the other hand X would be subject to any prior interest in the land shown by the recording system. To that extent then purchasers of negotiable instruments secured by chattel or real property are on constructive notice of interests in the security shown by the appropriate filing or recording system.

24. NIL § 25.

25. NIL § 58. The second sentence is the so-called “shelter” clause, which always comes as a shock to beginning students of negotiable instruments law. The underlying theory is presumably to preserve the marketability of the paper once it has come into the hands of a holder in due course. That knowledge of defenses does not make a purchaser a “party to the fraud,” see Britton, op. cit. supra note 17, §§ 123, 124.

26. NIL § 57, read literally, seems to suggest no distinction between real and personal defenses. “A holder in due course holds the instrument free from any defect of title of prior parties, and free from defenses available to prior parties among themselves. . . .” On the real defenses see Britton, op. cit. supra note 17, § 125 et seq.
Of the blessings which flow so bounteously for the holder in due course of negotiable paper, the assignee of the "ordinary," "simple" or nonnegotiable chose in action receives only a thin trickle. The doctrine of good faith purchase which made inroads even in the law of sale of goods seems here to be ignored. And the constellation of supporting rules here casts a light so dim that it is almost invisible. The original common law rule against assignability has been grudgingly reversed, but there is still virtually unanimous agreement on the proposition that the obligor can forbid the assignment of any claim against him. The reification of the written evidence of the debt through the operation of the doctrine of merger has made no headway. Consequently the assignee is deprived of the vital protection which the holder gets from possession of the paper: until the obligor receives proper notification of assignment, he may discharge the obligation by paying the assignor; creditors are not required to go after the paper; the locus of the claim is shrouded in mystical confusion. Since the paper itself is not looked on as being, symbolically, the claim itself, physical delivery is not the one effective means of transfer and possession of the paper is not an effective guaranty that the claim has not been transferred to someone else. Consequently a large part of the law of assignment of choses in action has to do with priorities among successive assignees. The useful series of presumptions which run in favor of the holder of negotiable paper do not come in to lighten the assignee's burden. Also reversed is the rule that on default by the obligor there is an automatic right of recourse against the transferor. Nor has there taken place

28. See Restatement, Contracts § 170 (1932). The statement in the text ceases to be true as a particular type of commercial paper moves toward negotiability. In the process there comes a point where a written evidence of the obligation is felt to be essential. Thus the Restatement Section cited states an exception to the general rule: "If there is a tangible token or writing, the surrender of which is required by an obligor's contract for its enforcement," then the obligor, to be discharged, must obtain a surrender of the token or writing. Restatement, Security, § 1, Comment (e) (1941) introduces the concept of an "indispensable instrument" which "means the formal written evidence of an interest in intangibles, so representing the intangible that the enjoyment, transfer or enforcement of the intangible depends upon possession of the instrument." As examples of the "indispensable instrument" in addition to negotiable instruments the Restatement suggests share certificates, bonds, interim certificates, savings bank books, and insurance policies. For a current example of paper which has probably reached this degree of negotiability, see the discussion of "chattel paper" in text at note 138 et seq.
29. See Goodrich, Conflict of Laws 179 et seq. (1949); Stumberg, Principles of Conflict of Laws 107 et seq. (1951).
30. See Goodrich, op cit. supra note 29, at 496: "The validity of an assignment of an intangible chose in action should therefore be determined by the rule of law prevailing at the place where the assignment is made. Though language inconsistent with this view is not uncommon [citing cases referring to the law of the debtor's domicile and the law of the place where the obligation arose] it is believed that the rule expressed is supported by authority." See also Stumberg, op. cit. supra note 29, 245 et seq.
31. See the discussion in 4 Corbin, Contracts § 902 (1951).
32. See Restatement, Contracts § 175 (1932). The warranties of an assignor of a nonnegotiable chose are approximately the same as those of one who transfers a
in favor of the assignee the attenuation of the concept of good faith that marks negotiable instruments law. The assignee may not limit his inquiry to what appears "on the instrument"; he will be affected by constructive notice from public recordation as well as by limitations on the assignor's rights, whether or not known to the assignee.33

The purchaser of nonnegotiable paper not only receives almost none of the protection accorded to the purchaser of negotiable paper, he receives less protection than does the purchaser of chattels. Here the original rules of property law have stood almost unchanged: equities of ownership are effectively maintained, defenses are sedulously preserved. We have a development in three stages: the purchaser of negotiable paper receives an extraordinary degree of protection; the purchaser of chattels gets less, without by any means being left naked to the elements; the purchaser of a nonnegotiable chose gets almost nothing. Why should not the development of the law of assignment have at least run even with the law of sales? The explanation lies in this inarticulate major premise: Negotiable paper is commercial property; nonnegotiable paper is noncommercial; goods can be either.

In sales law the expansion of the good faith purchase idea in commercial situations and its restriction in noncommercial situations was achieved by the manipulation of a set of concepts which did not purport to take "commerciality" into account. There was thus no need in sales law to develop nice distinctions between commercial goods and noncommercial possessions: the subtle accommodation to commercial needs and pressures was worked out at a deeper level. In the field of intangibles, however, we find a sharp distinction drawn between commercial and noncommercial property, between paper that is negotiable and paper that is not. In the growth of the law there came in as a matter of first importance the necessity of distinguishing between the two. Which brings us to that branch of the law of negotiable instruments called "formal requisites."

The Formal Requisites

Few generalizations have been more often repeated, or by generations of lawyers more devoutly believed, than this: negotiability is a matter rather of form than substance. It is bred in the bone of every lawyer that an instrument to be negotiable must be "a courier without luggage."34 It must conform to a negotiable instrument by delivery alone or by a "qualified indorsement" (i.e., "without recourse") under NIL § 65.

33. See RESTATEMENT, CONTRACTS § 167 (1932).
34. Chief Justice Gibson in Overton v. Tyler, 3 Pa. 346, 347 (1846). In every recorded case but one where the question of negotiability has been raised it is the holder who argues that the paper he holds is negotiable and the adverse party (maker, acceptor or prior holder) who argues that the paper is nonnegotiable, so that his defenses or equities may be allowed. Overton v. Tyler is the one exception; on a peculiar set of facts, it was to the holder's advantage to argue, as he did successfully, that the note involved in the case was nonnegotiable. Thus Gibson's famous epigram was delivered in a context exactly opposite from that in which it has been thousands of times repeated.
set of admirably abstract specifications which, for our generation, have been codified in Section 1 of the Negotiable Instruments Law and spelled out in the nine following sections. These rules are fixed, eternal and immutable. No other branch of law is so clear, so logical, so inherently satisfying as the law of formal requisites of negotiability. To determine the negotiability of any instrument, all that need be done is to lay it against the yardstick of NIL sections 1-10: if it is an exact fit it is negotiable; a hair's breadth over or under and it is not.

Few generalizations, legal or otherwise, have ever been less true; the truth is, in this as in every other field of commercial law, substance has always prevailed over form. "The law" has always been in a constant state of flux as it struggles to adjust itself to changing methods of business practice; what purport to be formal rules of abstract logic are merely ad hoc responses to particular situations.

Nevertheless, the cherished belief in the sacrosanct nature of formal requisites serves, as do most legal principles, a useful function. The problem is what types of paper shall be declared negotiable so that purchasers may put on the nearly invincible armor of the holder in due course. The policy in favor of protecting the good faith purchaser does not run beyond the frontiers of commercial usage. Beyond those confines every reason of policy dictates the opposite approach. The formal requisites are the professional rules with which professionals are or ought to be familiar. As to instruments which are amateur productions outside any concept of the ordinary course of business, or new types which are just coming into professional use, it is wiser to err by being unduly restrictive than by being over liberal. The formal requisites serve as a useful exclusionary device and as a brake on a too rapid acceptance of emerging trends.

Under NIL Section 1 an instrument to be negotiable must be: (1) a signed writing which is (2) an unconditional promise or order (3) to pay a sum certain in money (4) on demand or at a fixed or determinable future time (5) to bearer or to the order of a named payee. Furthermore, "[a]n instrument which contains an order or promise to do any act in addition to the payment of money is not negotiable." And finally the order or promise must be one to pay out of the general assets of the obligor; "an order or promise to pay out of a particular fund is not unconditional"—hence such an instrument cannot be negotiable.

35. NIL § 5.

36. NIL § 3. The NIL statement of the "particular fund" rule has led to some case law trouble with instruments signed by trustees, executors, and various types of limited liability business enterprises. Also obligations issued by counties and municipalities which by statutory authorization are payable only out of designated funds have been regularly held nonnegotiable. See Britton, HANDBOOK OF THE LAW OF BILLS AND NOTES § 12 (1943) for the cases. UCC § 3-105 clears up the doubts about the first mentioned type of paper and makes instruments payable "out of a particular fund" negotiable when "issued by a government or governmental agency or unit." Another type of paper which fell afoul of the NIL rule was equipment trust certificates, which are often expressed
The above statement was an apt description of the types of commercial paper which were actually in use during the 17th and 18th centuries when the law of negotiability was taking shape. It is still valid for the mercantile bill of exchange and the check. But even at the time the NIL was drafted, it had ceased to be an adequate description of what the promissory note had become.

Historically, the promissory note was a much later invention than the bill of exchange. The common law courts, which had worked out the elements of negotiability in connection with the bill as early as the beginning of the 17th century, were still denying them to notes a hundred years later.\textsuperscript{37} The denial was based on the essentially sound reason (if true) that notes were "not within the custom of merchants," and it took an act of Parliament to put notes on the same footing with bills.\textsuperscript{38} In this country, until well after the Revolution, notes seem to have been regarded as distinctly less "commercial" than bills. In a group of commercially important jurisdictions the indorser of a note was held to have assumed a lesser degree of liability toward subsequent transferees than did the indorser of a bill.\textsuperscript{39} Despite, or because of, the fact that the rules relating to the note were relatively fluid, it became the vehicle for the 19th century transformation of the American economy both from a cash to a credit basis and from an unsecured to a secured basis. In the process the skeletonic note of 1800 put on a great deal of weight.

The NIL furnishes an authoritative statement of how far the law of promissory notes had departed from the courier without luggage theory by the end of the 19th century. Despite the apparently restrictive approach of Sections 1 and 5 the statute affirmatively authorizes the presence on the face of the note of

to be payable "out of the rentals" received by the trustee from the railroad. \textit{Bartlett, op cit. supra, § 12.} Such obligations have been made negotiable by statutes like the Hofstadter Act in New York, see note 101 \textit{infra}, and are negotiable under the Investment Securities Article of the UCC. See § 8-102.

37. Buller v. Crips, 6 Mod. 29, 1 Salk 130 (K.B. 1704). For a discussion of some of the other early cases, see 8 HOLDSWORTH, A HISTORY OF ENGLISH LAW 170-6 (2d ed. 1936).

38. 3 & 4 Anne, c. 9 (1704). The most pertinent part of the statute reads: "... and also every such note payable to any person or persons, body politic and corporate, his, her or their order, shall be assignable or indorsable over, in the same manner as inland bills of exchange are or may be, according to the custom of merchants. ..."

39. See such cases as Clark v. Young & Co., 1 Cranch 181 (U.S. 1803); Mandeville v. Riddle, 1 Cranch 290 (U.S. 1803); Harris v. Johnston 3 Cranch 311 (U.S. 1805); Yeaton v. Bank of Alexandria, 5 Cranch 49 (U.S. 1809); Violett v. Patton, 5 Cranch 142 (U.S. 1809); Stewart v. Anderson, 6 Cranch 203 (U.S. 1810); Bank of United States v. Weissger, 2 Pet. 331 (U.S. 1829) (with notes to the Kentucky cases); Bank of United States v. Tyler, 4 Pet. 366 (U.S. 1830). Most of these cases came up from Virginia and this type of distinction between bill and note seems to have been limited to Virginia and the states which patterned their law after hers. Conceivably the perennial riddles of the law of suretyship as to the difference between a guaranty of collection and a guaranty of payment and whether an indorser who adds to his signature such words as "I guaranty" is an indorser or a "mere" guarantor may have their roots in this all but forgotten distinction.
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many clauses which might seem fatal to negotiability. The note may be made payable in installments, and may further provide that on default in payment of any installment or of interest the whole shall become due. The note may bind the obligor to pay costs of collection or an attorney's fee in case payment is not made at maturity. It may contain a waiver of the benefit of any law intended for the advantage or protection of the obligor, and may authorize a confession of judgment if the instrument is not paid at maturity. Since it may authorize the sale of collateral security on default, impliedly the note may call for the deposit of collateral in the first place. And since the note may give the holder an election to require something to be done in lieu of payment of money, he apparently may, among other things, call for the posting of additional collateral.

The NIL's generous listing of what notes may "give," "authorize" or "provide for" reflects two key developments in patterns of short-term lending. One is the emergence of the consumer loan, where the borrower is looked on as sub-marginal and more likely than not to default. What sort of a person the new borrower was is revealed by the provisions for amortization of the loan by installment payments, for the borrower's promise to pay collection costs and an attorney's fee, for his waiver of rights under debtor-protective legislation, and for his agreement in advance to confess judgment. The second development is the omnipresence of security. Under the NIL any lender may—and most banks do—write a comprehensive collateral pledge agreement into the note.

Grant that it is the function of a codifying statute to reflect going patterns of business behavior and the conclusion follows that the NIL achieved a remarkably skillful adjustment of rigid theory to flexible fact. Aside from the special problem of the negotiable note or bond tied to a separate security agreement, there has been under the NIL relatively little formal-requisites litigation of a type which a better drafting of the statute could have avoided.

40. NIL § 2(2).
41. NIL § 2(3).
42. NIL § 2(5).
43. NIL § 5(3).
44. NIL § 5(2). Whether or not such confession of judgment or cognovit notes are valid in a given jurisdiction is left to local law by the last sentence of § 5: "nothing in this section shall validate any provision or stipulation otherwise illegal."
45. NIL § 5(1).
46. NIL § 5(4).
47. See discussion under headings "Secured Paper" and "Bonds" infra.
48. The NIL treatment of acceleration clauses has been the only point that has led to a sizeable amount of what might be considered avoidable litigation. The only type of acceleration clause which the NIL specifically validates is a provision in an installment note that "upon default in payment of any installment or of interest, the whole shall become due" NIL § 2(3). Arguably any other type of acceleration clause makes the instrument nonnegotiable, and the argument has been made. The cases have gone considerably beyond the statutory warrant. Generally, clauses conditioned upon some external event (e.g., bankruptcy) do not impair negotiability. On the other hand, the
As long as the law distinguishes between commercial and noncommercial property on the basis of form, there will have to be borderline or fringe litigation. On the whole a continuing trickle of such litigation is not obnoxious; it produces a clearer state of the law than does the law of sales where the doctrines say one thing and mean another, a situation not productive of certainty and predictability.

Theoretically it would have been possible to draft the NIL without reference to formal requisites. The courts could have determined what instruments were entitled to the benefits of the NIL on a case by case basis. That approach commended itself neither to the draftsmen of the NIL nor to those of the Commercial Paper Article of the Uniform Commercial Code. In both codifications an apparently rigid statement of formal requisites is followed by a series of sections authorizing all the clauses generally in use. The only difference between the NIL and the Code is that the Code, being fifty years later, carries a longer list of permissible clauses. There may well be merit in an approach which has now been twice adopted by successive generations of draftsmen. There is little virtue in revolutionizing the law merely to achieve jurisprudential elegance or an impeccably logical form of statement. If traditional vocabulary and categories work well enough, it is the part of wisdom to leave them undisturbed.

Corporate Securities

Between 1850 and 1900 several new types of commercial paper made their appearance in the market and were almost without dissent granted the major attributes of negotiability. The introduction of the corporation and its rapid displacement of competing forms of business organization brought the problem of the negotiability of corporate securities before the courts. Almost from the beginning the courts, both English and American, were disposed to concede frequently found clause accelerating payment whenever the holder may "deem himself insecure" is almost invariably fatal to negotiability. See Notes, 35 L.R.A. (N.S.) 390 (1912); 1915B L.R.A. 472; 34 A.L.R. 872 (1925); 72 A.L.R. 268 (1931). Two of the rare cases allowing the insecurity clause are Dart Nat. Bank v. Burton, 258 Mich. 283, 241 N.W. 858 (1932), and Heard v. Dubuque County Bank, 8 Neb. 10 (1878). For the UCC provision on acceleration see note 50 infra.

49. A recurrent nuisance is the homemade note, e.g., "I.O.U., E. A. Gay, the sum of seventeen dolls. 5-100. . . .", Gay v. Rooke, 151 Mass. 115, 23 N.E. 835 (1890); "I borrowed money from Petros Shemonia, the sum of five hundred dollars with 4 percent interest. The borrowed money ought to be paid within four months from above date," Shemonia v. Verda, 24 Ohio App. 246, 157 N.E. 717 (1927). They should all be held nonnegotiable, but not all of them are. See BRITTON, HANDBOOK OF THE LAW OF USES AND NOTES § 10 (1943). NIL § 10 ("The instrument need not follow the language of this act, but any terms are sufficient which clearly indicate an intention to conform to the requirements hereof") was a tempting invitation to hold all sorts of irregular instruments negotiable, but the courts, commendably, have in general withstood temptation.

50. Compare UCC §§ 3-105, 3-106, 3-109, 3-110, 3-112 with NIL §§ 1-8. The Code's most important change is no doubt its validation, so far as negotiability is concerned, of all possible types of acceleration clauses. UCC § 3-109(1)(c). See however UCC § 1-208 on the effect of the so-called "insecurity" clause.
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their negotiability with little if any inquiry into matters of form. Nor, initially, was any distinction made between bonds, which, in a pinch, might pass as notes, and share certificates, which could not conceivably be fitted into the conventional framework, since they were not promises to pay anyone anything at anytime but were merely evidences of ownership in a business enterprise. As it happened, the bond cases came first, where the analogy to the negotiable note, then in the full course of its own development, was not hard to draw. Perhaps the early practice of making bonds payable to bearer made it even easier. When the share certificate cases arrived on the scene, no one questioned that what was true for bonds was equally so for stock, and the formal requisites argument was never raised.

The easy and early common law recognition of the negotiability of securities did not immediately endow them with all the attributes of negotiability. On the principal issue—the right of the good faith purchaser to hold free of defenses and equities—the common law position was a half-way house which in result, although not in doctrinal statement, approximated what was being done in sales law under the developing idea of voidable title. The key concept in the "quasi-negotiable" status of securities was that of "entrusting," the term having been borrowed possibly from the Factor’s Acts. Under the entrusting rule, the true owner would prevail against any good faith purchaser from an intervening fraudulent actor unless the owner had himself voluntarily "entrusted" the security to the faithless intermediary. In this context, as under the Factor’s Acts, the case law defining "entrusting" grew involved and obscure: leaving securities in pledge with a broker in a sealed envelope might not be entrusting; giving them to a messenger for delivery to a broker might be.54

51. Two early cases showing the willingness of courts to concede the negotiability of securities, are Junction Ry. v. Clenay, 13 Ind. 161 (1859); Carr v. Le Fevre, 27 Pa. 413 (1856). In Mercer Co. v. Hacket, 1 Wall. 83, 95 (U.S. 1853), Justice Grier wrote: "That these securities are treated as negotiable by the commercial usages of the whole civilized world, and have received the sanctions of judicial recognition, not only in this court, but in nearly every State in the Union, is well known and admitted. But we have been referred to the case of Diamond v. Lawrence County [37 Pa. 353 (1841)] for a single decision to the contrary. The learned judge who delivered the opinion of the court in that case says 'We will not treat these bonds as negotiable securities. On this ground we stand alone. All the courts, American and English, are against us.'" See also Bank v. Lanier, 11 Wall. 369, 377 (U.S. 1870). Steffen, Cases on Commercial and Investment Paper 277 (1939) writes: "And from the very first courts were usually able to reach results characteristic of negotiable paper, without much concern as to the exact wording of the bond, though they were slow to say outright that bonds were negotiable." For a good collection of the bond cases, see Steffen and Russell, The Negotiability of Corporate Bonds, 41 Yale L.J. 799 (1932). As a caveat it should be added that Steffen and Russell cite at p. 894 n.27 ten common law cases holding bonds non-negotiable on one or another premise drawn from the law of formal requisites of negotiable paper.

52. For a good statement of the doctrine see Scollans v. Rollins, 179 Mass. 346, 60 N.E. 983 (1901) (Holmes, J.).

53. This was the situation in Scollans v. Rollins, supra note 52. Holmes, although expressly disagreeing with the result, nevertheless wrote the opinion for the court.

54. Or of course might not. See United States Fid. & Guar. Co. v. Newburger, 263
The entrusting limitation came up only in actions between true owner and good faith purchaser where latent equities of ownership were involved. On the other main aspect of good faith purchase of intangibles—the cutting off of the issuing corporation's defenses against the original holder of the security—no distinction was drawn between purchasers of conventional bills and notes and purchasers of corporate securities. In the early days of widespread and light-hearted stock-watering, the question of issuer's defenses was vastly more important than it has since become and was resolved squarely in favor of the good faith purchaser. Somewhat more difficulty was found in the case of the municipal bond issued under a defective statutory authorization or for an improper purpose; yet the municipals tended to follow the path of the corporate bonds.55

The good faith purchase idea, in its two main aspects of protection against prior equities and defenses, thus took hold early and established itself without serious opposition. The common law development was, however, less successful in working out some of the subsidiary rules. The most important of these is unquestionably the doctrine of merger—the reification of the paper evidencing the obligation. At common law in the securities field the merger idea was only imperfectly realized. It is true that possession of the paper—share certificate or bond—was assumed to be indispensable to support a claim of ownership. Furthermore the one effective means of transferring the security has

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N.Y. 16, 188 N.E. 141 (1933) (a common law case), where delivery to a messenger boy was held not entrusting. Another messenger boy case is Turnbull v. Longacre Bank, 249 N.Y. 159, 163 N.E. 135 (1928), in which the court, in some doubt whether the Stock Transfer Act or the common law applied, protected the purchaser. Steffen, op. cit. supra note 51, at 311 suggests that the result is entirely consistent with the "entrusting" theory.

55 The defense of "unauthorized" or "improper" has by no means disappeared from municipal bond litigation; nor are results predictable, although on the whole the defense seems to be disallowed more often than it is upheld. Recent cases holding the municipality liable, by estoppel or some other theory, are: Board of Public Instruction v. State ex rel. Tanger Inv. Co., 121 Fla. 703, 164 So. 697 (1935); Royal Oak Drain. Dist. v. Keefe, 87 F.2d 786 (6th Cir. 1937); City of Florence v. Anderson, 95 F.2d 777 (4th Cir. 1938); Pulasky County v. Eichstaedt, 110 F.2d 79 (6th Cir. 1940); Curb & Gutter Dist. v. Parrish, 110 F.2d 902 (8th Cir. 1940); Women's Catholic Order of Foresters v. Trigg County, 38 F. Supp. 398 (W.D. Ky. 1941); Knott County v. Aid Ass'n for Lutherans, 140 F.2d 630 (6th Cir. 1944); Driscoll v. Burlington-Bristol Bridge Co., 8 N.J. 433, 86 A.2d 201 (1952); City of Erlanger v. Berkemeyer, 207 F.2d 832 (6th Cir. 1953). Cases denying recovery against the municipality are: State v. Belleair, 125 Fla. 669, 170 So. 434 (1936); Bloomfield Village Drain Dist. v. Keefe, 119 F.2d 157 (6th Cir. 1941); Pulasky County v. Ben Hur Life Ass'n, 286 Ky. 119, 149 S.W.2d 738 (1941); Holderman v. Hidalgo County Water Control & Improvement Dist., 142 F.2d 792 (5th Cir. 1944); Newberry Library v. Board of Education, 390 Ill. 48, 60 N.E.2d 552 (1945).

UCC § 8-202 attempts a compromise solution: even though there is a "defect going to the validity" of a security, an issuer who is a government, governmental subdivision or agency will be liable to a purchaser for value and without notice "if either there has been substantial compliance with the legal requirements governing the issue or the issuer has received substantial consideration for the issue as a whole or for the particular security and a stated purpose of the issue is one for which the issuer has power to borrow money."
always been physical delivery of the paper plus the indorsement by the transferor. Unfortunately the desirable negotiable instruments rule that the indorsement must be written on the instrument itself was not adopted; instead the practice of using a separate "power" of transfer developed. Eventually when the "power" came to be printed on the back of the certificate, its form remained unnecessarily cumbersome. Both the separate "power" and the elaborate form of assignment which has remained customary have generated, albeit to a minor degree, a confusion which could have been easily avoided.

A more serious shortcoming of "quasi-negotiable" securities lay in the common law treatment of the rights of creditors. For the purchaser to be fully protected, he must be able to take free of all claims except those of which he has actual knowledge. In the case of fully negotiable instruments this is a truism of so fundamental a sort—on a par with "dog is man's best friend"—that it is hardly discussed in the literature. No lawyer, however ill-advised, has ever thought that he could affect the rights of subsequent holders of a promissory note by garnishee process served on the maker in an action against the payee. That manifestly desirable rule was not at common law carried over to investment securities. The reason for this failure may have been the appearance on securities of the legend "transferable only on the books of the corporation." In a wide range of situations it is necessary that the issuer be permitted to treat as owner the person in whose name the security is registered. Initially the reference to transfer on the books of the corporation raised doubts whether such instruments could be negotiable to any degree. These doubts were resolved in favor of negotiability. More persistent and damaging was the inference that, since the books of the corporation were so important, they were the appropriate place for service of process against the registered holder. Even worse was the idea that liens in favor of the issuing corporation would be enforceable against subsequent purchasers when noted on the books even though they did not appear on the security itself.

We shall never know whether investment securities, if left to a common law development, would have attained all the attributes of negotiability. That development was terminated by the codification movement. First, bonds were held to be within the coverage of the NIL, with the unfortunate results which will be described later. Next, share certificates were promoted to full negotiability by the Uniform Stock Transfer Act.

56. See note 18 supra.
57. See 11 FLETCHER, CYCLOPEDIA OF PRIVATE CORPORATIONS § 5109 (1932) stating the rule and citing cases.
58. See 11 FLETCHER, op cit. supra note 57, § 5262.
59. The Uniform Stock Transfer Act (hereinafter cited as USTA) was promulgated by the Commissioners on Uniform State Laws in 1909 and has since been adopted by all American jurisdictions. See 6 UNIFORM LAWS ANN. 6 (Supp. 1953) for table of adoptions. Section 22 of the Act defines "certificate" as "a certificate of stock in a corporation organized under the laws of this state or of another state whose laws are consistent with this Act." The result was that states adopting the Act continued to have a common law of share certificates running side by side with the statutory law. (See
There have been few statutes which have so admirably done the job they were designed to do as the Stock Transfer Act. It is a statutory courier without luggage—short, simple and uncluttered. Its principal accomplishments were to remove the several common law limitations on full negotiability: the entrusting rule was abolished;60 liens in favor of the issuer were invalidated unless stated on the certificate;61 attachment or levy was permitted only by taking possession of the certificate.62 Although the practice of transferring a certificate by a separate power was recognized, the Act provided that title derived through the certificate prevails over title derived from a separate document.63 Also worthy of note is the draftsman's decision to avoid the terminology of the NIL. For example, the NIL states the rights of the holder in due course; the Stock Transfer Act reverses the approach and, with equal effectiveness, states the limitations on the rights of the owner of the certificate who has been deprived of possession by fraud, duress or mistake.64 By this independent drafting technique, the draftsman preserved his statute from the danger of having a host of NIL technicalities imported by analogy. Finally the draftsman resisted the temptation to define in terms of formal requisites the type of paper his Act was to cover. The Act covers "share certificates," but the task of determining what is a "share certificate" is left entirely to the courts, permitting a free case law development. The refusal to define "certificate" is exactly right, although the correctness of the decision is easier to see now than it was when the Act was drafted.

Documents of Title

The 1850-1900 period saw two other kinds of paper come to market: the documentary twins, bills of lading and warehouse receipts. Since the common law development of this "quasi-negotiable" paper ran parallel to that of corporate securities, it need not long detain us.65 Although documents of title

the two New York cases cited note 54 supra for an example of opposite results on nearly identical facts in the same jurisdiction.) Since Delaware did not adopt the Act until 1945, and apparently did not have a law of stock transfer "consistent with" the USTA, the common law continued to flourish for a long time.

60. USTA § 7.
61. USTA § 15.
63. USTA § 4.
64. USTA § 7.
65. The documentary development was not exclusively a common law affair and statutes covering bills of lading or warehouse receipts or both appeared relatively early. Thus New York Laws 1858, c. 326, § 6, an obvious echo of the Factor's Act, provides: "Warehouse receipts . . . may be transferred by endorsement thereof; and any person to whom the same may be so transferred, shall be deemed and taken to be the owner of the goods. . . . All warehouse receipts, however, which shall have the words "not negotiable" plainly written or stamped on the face thereof, shall be exempt from the provisions of this section." Connecticut copied the New York act in 1878. CONN. GEN. STATS. § 3971 (rev. 1887). A Pennsylvania statute of 1866 is to the same effect except that it covers bills of lading as well as warehouse receipts and adds the flat statement
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had long been known, the law did not attribute to them (except for the ocean bill of lading) any of the attributes of negotiability until late in the nineteenth century.\textsuperscript{66} Irregularities in the issue of documents have been rare, so that the matter of issuer's defenses has been little litigated. More important has been the cutting off of equities in favor of a good faith purchaser when documents are pledged to secure loans or sold on the commodity markets. Most important, however, has been the documentary function of controlling the goods. So long as the issuer is entitled to deliver to the person who appears on its records as depositor or consignee, the goods in storage or in transit cannot be effectively used as security. The crucial step in the development of negotiable documents of title was the application of merger doctrine: just as the only payment that will discharge the obligor on a negotiable instrument is payment to the holder, so, in the documentary adaptation of the rule, the only delivery that will discharge the issuer is delivery to the holder of the document. Once that premise had been accepted, with the necessary corollary that title derived from the document prevails over title derived from the goods, an immense new source of commercial collateral was opened up.

Negotiable documents have not superseded the earlier nonnegotiable ones. The seller who ships on open credit terms neither needs nor wants the protection afforded by a negotiable bill.\textsuperscript{67} Furthermore the negotiable bill of lading has that such documents "shall be negotiable." Purdon's Digest 165 (1895) (under "Bailees"). Massachusetts in 1878 provided that "The title to goods and chattels stored in a public warehouse shall pass to a purchaser or pledgee by the indorsement and delivery to him of the warehouseman's receipt therefore..." Mass. Pub. State 419 (1886). Another variant is found in a Louisiana statute of 1876, La. Acts 1876, No. 72, § 8, which provided that such documents were to be negotiable to the same extent as bills of exchange and promissory notes.

The courts did not look on such statutes as conferring full negotiability on the documents they covered. In the leading case of Shaw v. Railroad Co., 101 U.S. 557 (1879) the Supreme Court had occasion to pass on the rights of a purchaser of a stolen bill of lading. The court found it was not necessary to decide whether the Pennsylvania statute, supra or a Missouri statute, under which bills of lading were made "negotiable by written indorsement thereon and delivery, in the same manner as bills of exchange and promissory notes," governed the case, since both statutes meant the same thing. The court held in substance that the statutes were meant to prescribe merely the manner of negotiation and not to define the effects of a transfer. Id. at 562. "No statute," wrote Mr. Justice Strong, "is to be construed... as making any innovation upon the common law which it does not fairly express. Especially is so great an innovation as would be placing bills of lading on the same footing in all respects with bills of exchange not to be inferred from words that can be fully satisfied without it. The law has most carefully protected the ownership of personal property, other than money, against misappropriation by others than the owner, even when it is out of his possession." Id at 562-6. The "true owner" of the bill of lading, absent any evidence of entrusting, was protected. Thus despite the early statutes, the common law development may be said to have continued substantially undisturbed.

\textsuperscript{66} See Llewellyn, Cases and Materials on the Law of Sales 77 et seq. (1931).

\textsuperscript{67} If goods are shipped under a negotiable bill, the carrier is not entitled to deliver until the original copy of the bill is surrendered. A seller who is willing to trust his buyer's credit ships on a nonnegotiable bill under which the carrier delivers to whoever
not yet been successfully adapted to use in shipments by truck and air, partly because of lack of terminal facilities, and partly because of the extremely short periods of transit. The owner of warehoused goods may want to sell them in small lots to several buyers. This can be done conveniently by delivery orders issued under a nonnegotiable receipt but cannot be done at all where the original receipt for the full quantity of goods is negotiable.

Thus we find in the documentary field a forked development: although commercial pressures have had the predictable result of introducing the good faith purchase concept through the invention of negotiable documents, other considerations of convenience and flexibility, not easily achieved under the ordinary concepts of negotiability, have dictated the perpetuation of nonnegotiable documents. An odd result of the split-off is that although goods covered by a negotiable document become for all intents themselves negotiable, the same goods, covered by a nonnegotiable document, revert to the status of a common law chose, less susceptible to the operation of the good faith purchase concept than before they were covered by the document.\textsuperscript{68}

There were several stages in the codification of documents of title. First, they were covered by the Uniform Sales Act. The Sales Act sections on documents go exclusively to questions of negotiability and do not deal with the rights, duties, and liabilities of the issuer. The same skill at defining by avoiding definition which marked the Stock Transfer Act is notable in Professor Williston's handling of the necessary distinction between negotiable and nonnegotiable documents: "A document of title in which it is stated that the goods referred to therein will be delivered to the bearer or to the order of any person named in such document is a negotiable document of title."\textsuperscript{69} Everything else, by implication, is nonnegotiable. On the central issue of the degree of protection to be accorded good faith purchasers, the Act codified the common-law entrusting rule, and did not promote documents to full negotiability.\textsuperscript{70} For the rest, the Act covered the familiar issues: transfer by indorsement plus delivery,\textsuperscript{71} absolute title to both document and goods in the holder of the document,\textsuperscript{72} requirement that creditors proceed against the document and not against the goods.\textsuperscript{73}

Two sections were devoted to the liabilities of indorsers. Here, as in the corporate securities field, no one has ever assumed that indorsement implies a guaranty by the indorser of performance by the issuer: the Sales Act makes that point with clarity and precision.\textsuperscript{74} A less successful effort was made to

\textsuperscript{68} See, e.g., Quality Shingle Co. v. Old Oregon Lumber & Shingle Co., 110 Wash. 60, 187 Pac. 705 (1920), discussed note 13 \textit{supra}.
\textsuperscript{69} Uniform Sales Act (hereinafter cited as \textit{USA}) \S 27.
\textsuperscript{70} \textit{USA} \S 32 "A negotiable document of title may be negotiated (a) By the owner thereof, or (b) By any person to whom the possession or custody of the document has been entrusted by the owner. . . ."
\textsuperscript{71} \textit{USA} \S\S 28, 29.
\textsuperscript{72} \textit{USA} \S 33.
\textsuperscript{73} \textit{USA} \S 39.
\textsuperscript{74} \textit{USA} \S 37.
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state the degree of liability which an indorser does assume—a complicated issue because a transfer of the document is a transfer not of a money claim but of the underlying goods. Hence the question arises, not met with elsewhere, whether the transferor should be held to make to the transferee the warranties of fitness and merchantability which a seller of goods makes to a buyer. Presumably an owner of goods who is selling or pledging them and carries out the transaction by transfer of a document should be held to warrant the quality of the goods (wherever such warranties would normally be implied). On the other hand a bank acting as seller's collecting agent in a documentary sales transaction, with or without a discount, should not be held to any warranties on the goods or for that matter on the genuineness of the documents. Williston with his penchant for simplified drafting oversimplified at this point and attempted to cover the very different problems of seller's indorsement and bank's indorsement in a single section.\footnote{Except for the happy accident that he soon received a second chance as draftsman, his too tightly compressed treatment of a complicated problem would undoubtedly have led to serious trouble.}

The fragmentary treatment of documents of title in the Sales Act proved to be inadequate. For one thing, the Sales Act sections focused on the rights of holders, leaving the status of the issuer in many respects uncovered, doubtful and confused. For another, the Sales Act treated all types of "documents of title" alike. With respect to negotiability and transfer, bills of lading and warehouse receipts may be regarded as identical and subjected to a single set of rules.\footnote{On the other hand there are obvious differences between running a warehouse and running a railroad, and it would be unlikely that documents issued by such dissimilar enterprises would at all points fit the same bed.}

Such considerations explain why, with the ink of the Sales Act hardly dry, the Commissioners on Uniform State Laws were already at work on a full scale codification of documents, designed to supersede the pertinent sections of the Sales Act.

The Warehouse Receipts Act,\footnote{This was done in some of the 19th century statutes referred to in note 65 supra, and is proposed to be done again in UCC Art. 7, Part 5.} which described in elaborate detail the status of the warehouseman, substantially repeated the Sales Act provisions on the negotiability of receipts. The one important change was the addition of a new section designed to make clear that a pledgee bank did not, by demanding or receiving payment of the debt for which the receipt was security, warrant either the genuineness of the receipt or the quantity or quality of the goods covered.\footnote{The Uniform Warehouse Receipts Act (hereinafter cited as UWARA) was promulgated by the Commissioners on Uniform State Laws in 1906 and has been adopted in all American jurisdictions. For table of adoptions see 3 Uniform Laws Ann. 6 (Supp. 1953).}

\footnote{USA § 36.}

\footnote{This was done in some of the 19th century statutes referred to in note 65 supra, and is proposed to be done again in UCC Art. 7, Part 5.}

\footnote{The Uniform Warehouse Receipts Act (hereinafter cited as UWARA) was promulgated by the Commissioners on Uniform State Laws in 1906 and has been adopted in all American jurisdictions. For table of adoptions see 3 Uniform Laws Ann. 6 (Supp. 1953).}

\footnote{UWARA § 46. The language of this section and its analogue § 37 of the Uniform Bills of Lading Act (hereinafter cited as UBILA) was not immediately successful in convincing the courts of what was meant. There had been a pre-codification Texas case}
The Bills of Lading Act,\textsuperscript{79} which followed the Warehouse Receipts Act, did make a fundamental change. Both the Sales Act and the Warehouse Receipts Act had stopped short of conferring full negotiability on documents. The Bills of Lading Act, hardly ten years later, went all the way.\textsuperscript{80} There was no public explanation of the reason for the shift, but the obvious inference is that, even in so short a time, general commercial understanding had outgrown common law quasi-negotiability.

No one has ever suggested a reason why warehouse receipts should be quasi-negotiable while bills of lading are fully negotiable. The Commissioners themselves, some years after the promulgation of the Bills of Lading Act, sought to remedy the discrepancy by amendments to the Sales Act and Warehouse Receipts Act which would bring both types of documents into fully negotiable harmony. The amendments met with indifferent success and have been adopted in only a handful of states.\textsuperscript{81} The present situation is anomalous and indefensible: bills of lading are throughout the country fully negotiable; ware-

imposing seller's warranties on a holder of a bill of lading taken for security. Landa v. Lattin Bros., 19 Tex. Civ. App. 246, 46 S.W. 48 (1898). After the passage of the documentary Acts, the Texas doctrine was abandoned in Texas but followed in some other jurisdictions. These aberrant cases were mildly criticized in a note in 26 Col. L. Rev. 63 (1926). Professor Williston in a subsequent communication to the editors of the Review, speaking as draftsman, insisted that the provisions of the Acts were entirely clear (which the COLUMBIA note had doubted) and that there could be no question that the cases following the old Texas doctrine were overruled. \textit{Id.} at 330. A "Commissioners' Note" to UBLA § 37, collecting the cases, refers to the Texas doctrine as "opposed to both authority and reason." 4 \textit{Uniform Laws Ann.} 61 (1922). Since the 1920's the truth seems to have prevailed.

\textsuperscript{79} The Uniform Bills of Lading Act was promulgated in 1909. For table of adoptions see 4 \textit{Uniform Laws Ann.} 6 (Supp. 1953). In 1916 Congress enacted the Federal Bills of Lading Act, 39 Stat. 538 (1916), as amended, 49 U.S.C. c. 4 (1946), which applies to bills of lading issued in interstate and foreign commerce. There are a few minor discrepancies between the Uniform and Federal Acts, but the sections dealing with negotiability are identical. The passage of the Federal Act no doubt explains why the Uniform Act was not adopted in all jurisdictions as was the Warehouse Receipts Act.

\textsuperscript{80} UBLA § 31. "A negotiable bill may be negotiated by any person in possession of the same, however such possession may have been acquired. . . ." \textit{Cf.} the language of USA § 32 quoted in note 70 \textit{supra.} UWRA § 40 is identical with USA § 32 except for the substitution of the word "receipt" for "document."

\textsuperscript{81} For the amendments to UWRA §§ 40 and 47, see 3 \textit{Uniform Laws Ann.} 104, 114 (Supp. 1953) with tables of adoption. The amendments have been passed in 16 states; in addition Idaho, for no known reason, has passed the amendment to § 47 without passing the matching amendment to § 40. For the amendments to USA §§ 32 and 38, see 1 \textit{Uniform Laws Ann.} 400, 405 (1950), with tables of adoption. The amendments have been passed in 13 states, the District of Columbia, and Hawaii. Maryland and North Dakota passed the amendment to § 32 without passing the matching amendment to § 38. The jurisdictions which have amended one of the Acts have not always amended the other Act. Query as to what the law is in Arizona, Colorado, Nevada, and New Hampshire, which amended UWRA but not USA; and Delaware, Kentucky, Maryland, North Dakota, Tennessee, Washington, and Wyoming, which amended USA but not UWRA.
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house receipts are fully negotiable in a minority of jurisdictions and quasi-negotiable in the rest.

Secured Paper

Thus far our story has been one of pleasant sailing on sunny seas. The reefs and shoals have been by skillful navigation avoided. At common law and by codification we have ended up where we wanted to go, with only minor miscalculations to complain about. But now the happy idyll becomes a Gothic tale of moan and misadventure. Legal theory broke down spectacularly at what we might consider to be, if we came from Mars, a point of minor difficulty: a money obligation tied to a separate but fellow-traveling security agreement, e.g., note and mortgage, note and conditional sales contract, bond and trust indenture, equipment trust certificate and underlying lease or conditional sale.

A feature of nineteenth century jurisprudence was a generalized hostility to security transactions, particularly when the collateral was chattel property. In the long run the hostility proved unavailing and the cause—whatever the cause may have been—was lost. But the courts did all they could to throw roadblocks in the way of the lender who sought to secure his loan on his debtor's chattel property. This is not the place to trace the tortuous development of security law. The general outlines are reasonably well known; the details await the investigations of the legal historians who, so far, have shown no great enthusiasm for the job. For some reason—and the writer has not even a glimmer of an explanation—the device of pledge escaped the common fate and rode free. Everywhere else the rule was restriction, if not prohibition.

Against this background it is not hard to understand why the courts seized upon what may have been inadvertencies in the drafting of the NIL as an occasion for waging still another rear-guard action in the struggle against security rights. The security transaction is merely peripheral to a loan: one advantage which any lender seeks is to have his loan in negotiable form. Thus one weapon in the courts' long campaign against the secured lender was to deprive him of the advantages of negotiability.

When a loan is secured by pledge, the regular practice has always been to evidence the entire agreement in one instrument. When a loan is secured by mortgage, practice has always been to split the agreement up into two instruments—a note and the mortgage which secures it. As new types of non-possessory security devices have come into use and become institutionalized the mortgage and not the pledge practice has been followed.

When two instruments are used, it is vital that they refer to each other. The note and mortgage, although formally separate instruments, are never meant to be separated in fact: the money claim and the security claim are intended to be in the same hands. Unless each instrument recites the existence of the other, the way is open for any holder to carry out what was at one time a not uncom-

82. For an attempt to sketch the background, see Gilmore & Axelrod, Chattel Security, 57 YALE L.J. 517, 761 (1948).
mon fraud by negotiating the note to X and assigning the mortgage to Y. When that occurred the common law rule was that "the security followed the note," which meant that the noteholder alone was entitled to the benefits of the mortgage and that his fellow-victim was left to his recourse against the vanished or insolvent assignor. It is surprising that the practice of using two instruments has persisted: it would have been no more difficult for a court to hold negotiable a note which contained the traditional mortgage covenants than it was to hold negotiable a note which contained a pledge agreement. Possibly the fact that mortgages, both of real and chattel property, were subject to recording statutes, while pledges were not, hints at an explanation.

At common law the negotiability of notes accompanied by mortgages had been assumed seemingly without question. There was little formal-requisites litigation concerning them, and the treatises of the time devote almost no space to

83. See 1 HILLIARD, THE LAW OF MORTGAGES 236 (1872), quoting Chancellor Kent: "The mortgage interest, as distinct from the debt, is not a fit subject of assignment. It has no determinate value. If it should be assigned, the assignee must hold the interest at the will and disposal of the creditor who holds the bond. 'Accessorium non ducit, sed sequitur principale.' " See also 2 JONES, CHATTEL MORTGAGES AND CONDITIONAL SALES § 505 (6th ed. 1933).

84. There were, of course, some aberrational decisions. In Strong v. Jackson, 123 Mass. 60, 63 (1877), the court commented that a note bearing a memorandum that it is secured by a mortgage on real estate "is not what by men of business is usually denominated commercial or business paper; and . . . may be subject to equities, when strictly mercantile paper would not be. . . ." Consequently such a note was nonnegotiable, or at any rate a purchaser was put on notice of all equities arising from the mortgage. It may be that notes secured by mortgage are still nonnegotiable in Massachusetts. See Stevens v. Mulcahy, 261 Mass. 116, 158 N.E. 344 (1927), sensible. California held mortgage notes nonnegotiable on the special ground that in that state a mortgage was required to have recourse against the mortgaged property before proceeding on the note. Meyer v. Weber, 133 Cal. 681, 65 Pac. 1110 (1901); Central Sav. Bank v. Coulter, 72 Cal. App. 78, 236 Pac. 956 (1925) (holding that the passage of the NIL had not affected the Meyer case). The California rule was eventually changed by amendment of NIL § 184. CAL. CIVIL CODE § 3265 (Deering 1949). Montana, which had the same mortgage rule as California on exhausting the mortgage security before turning to the note, followed the lead of the Meyer case. Cornish v. Woolverton, 32 Mont. 456, 81 Pac. 4 (1905). See also Prudential Ins. Co. v. Folsom, 48 Idaho 538, 283 Pac. 609 (1929). Otherwise, except for the types of cases discussed in note 85 infra, negotiability seems to have been assumed. A note in 32 L.R.A. (n.s.) 858 (1911) collects the early cases.

85. There have been a number of cases where unusual provisions in the mortgage have been held to destroy the negotiability of the note. Mortgage stipulation for payment in produce was sometimes held to render sum or time uncertain. Roblee v. Union Stock Yards Nat. Bank, 69 Neb. 180, 95 N.W. 61 (1903); Commercial Bank v. Crenshaw, 103 Ala. 497, 15 So. 741 (1894). And where the mortgage expressly limited liability to the property mortgaged, negotiability was also denied. Allison v. Hollembeak, 138 Iowa 479, 114 N.W. 1059 (1908); Kennion v. Kelsey, 10 Iowa 443 (1860); Seieroe v. First Nat. Bank of Kearney, 50 Neb. 612, 70 N.W. 220 (1897). Where the mortgage gave the maker the option to declare the note void, or to delay its payment, the note was nonnegotiable. Hull v. Angus, 60 Ore. 95, 118 Pac. 284 (1911); Bank of Evansville v. Kurth, 167 Wis. 43, 166 N.W. 658 (1918). And negotiability was also denied where the
Discussion of the problem. Not only could note and mortgage be used together but, judging by the absence of cases raising the point, it made no difference in what terms the two instruments referred to each other. The lack of resistance to the development of a negotiable note secured by mortgage is illustrated by a common law doctrine which, although it is accepted in the hornbooks as “good law” today, has come to be regarded as an anomalous and altogether queer sort of rule. This is the doctrine that a negotiable note “imparts” its negotiability to the mortgage which secures it, so that both note and mortgage pass free of equities and defenses; the holder in due course of the note can foreclose his mortgage without being subject to the mortgagor’s defenses in the same way that he can collect his money claim by suing on the note.

Strange mortgage provided that the note should be payable only out of funds held at a certain bank. Shushan v. Trepagnier, 187 La. 1012, 175 So. 651 (1937).

There was also a good deal of litigation involving acceleration clauses, which caused trouble in the simple note situation, see note 43 supra. In the mortgage cases the acceleration clause might be found in either the note or the mortgage. In the former case, the principal question was whether a note providing for acceleration on any default in the mortgage was negotiable. In the latter case, two questions were raised: did acceleration of the mortgage accelerate the note? did the note remain negotiable? In general an acceleration clause in the note conditioned on default in the mortgage is no barrier to negotiability. Where the clause is in the mortgage, a few jurisdictions hold that it does not accelerate the note; in such jurisdictions the notes are regularly held negotiable. The majority holding is that acceleration of the mortgage also accelerates the note; in such jurisdictions the note becomes nonnegotiable if the clause would have made it so when printed on the face of the note. There are collections of cases in 34 A.L.R. 843 (1925) and 56 A.L.R. 185 (1928). Two recent cases involving acceleration clauses in the mortgage situation are Nat. City Bank of Cleveland v. Erskine & Sons, 158 Ohio St. 450, 110 N.E.2d 598 (1953) (note to be accelerated on any default in mortgage, mortgage contained insecurity clause; held, note negotiable); and Barnwell v. Hanson, 80 Ga. App. 73, 57 S.E.2d 348 (1950).

86. Thus 1 DANIEL, NEGOTIABLE INSTRUMENTS 170 et seq. (4th ed. 1891) has a short discussion of “Memoranda upon bills and notes, and collateral agreements,” but nothing on the question of notes tied to mortgages. Nor do the many editions of Story, PROMISSORY NOTES deal with the note and mortgage problem.

87. After the passage of the NIL and the development discussed infra the idea attained some currency that where a note and a security agreement are executed simultaneously, all the clauses in the security agreement must be read into the note to test its negotiability. Except in Massachusetts, California, Montana, and Idaho, see note 84 supra, there was little pre-NIL support for such a theory, although Michigan, Brodie v. Struthers, 110 Mich. 562, 63 N.W. 272 (1896), Nebraska, in a series of cases beginning with Garnett v. Meyers, 65 Neb. 280, 91 N.W. 400, 94 N.W. 893 (1902), and Utah, Donaldson v. Grant, 15 Utah 231, 49 Pac. 779 (1897), had so held. The Michigan court was apparently divided in its own mind, since Wilson v. Campbell, 110 Mich. 559, 63 N.W. 278 (1896) goes the other way. The incorporation idea seems to have died out, apart from a revival in cases involving consumer installment notes. See discussion in text at note 125 infra. Nat. City Bank of Cleveland v. Erskine & Sons, 158 Ohio St. 450, 110 N.E.2d 598 (1953), is a good example of recent case law outside the consumer field.

88. See annotation in 127 A.L.R. 190 (1940). Most of the early cases seem to have involved the mortgagor’s defense of failure of consideration. Elliott v. Deason, 64 Ga. 63 (1879); Gabbert v. Schwartz, 69 Ind. 450 (1880); Preston, Kean & Co. v. Morris Case
as the "imparting negotiability" rule may seem to modern eyes, the courts were in effect merely repeating their holdings that a note which spelled out a pledge agreement was fully negotiable despite the security clauses.

This common law development was thrown into utter confusion by the NIL. After fifty years of litigation not only has the confusion not been dispelled, but there has been a net gain in useless, unwanted, and occasionally grotesque formalism. This needless litigation was precipitated by a section of the statute which was almost certainly drafted with an entirely different situation in mind and can hardly have been meant to reverse a settled and unquestioned trend of case law.

The statement of formal requisites in NIL Section 1 includes the rule that the promise or order must be "unconditional." Without more, that is merely a codification of a common law principle: obligations hedged around with con-

& Co., 42 Iowa 549 (1876); Reeves v. Scully, Walk. Ch. 248 (Mich. 1843); Dearman v. Trimmier, 26 S. C. 506, 2 S.E. 501 (1886); Fisher v. Otis, 3 Chand. 83 (Wis. 1850). Other defenses that were unsuccessfully raised included illegal consideration, Hawley v. Bibb, 69 Ala. 52 (1881); Taylor v. Page, 6 Allen 86 (Mass. 1863); incapacity, Hagerman v. Sutton, 91 Mo. 519, 4 S.W. 73 (1887); and set-off, Duncan v. Louisville, 13 Bush (76 Ky.) 378 (1877).

The equities involved in the early cases were mainly priority of liens. The issue was not so much fraudulent conveyance of rights to one mortgage by one person, but rather rights to actual possession of the land under various mortgages, often with an intervening fraudulent release of one mortgage by the original mortgagee. Here, of course, recording statutes were a complicating factor. Thus, in Lewis v. Kirk, 28 Kan. 497 (1882), it was held that the bona fide purchaser of note and mortgage would lose to a bona fide purchaser of the property whenever the mortgage was not recorded or, having been recorded, had been released by the mortgagee. On the other hand, in Bamberger v. Gelser, 24 Ore. 203, 33 Pac. 609 (1893), the court held that, since the recording statute did not require the recordation of assignment of mortgages, the purchaser in good faith of the note and mortgage would be protected as against a subsequent mortgagee relying on the release wrongfully entered on the record by the payee. And in Wynne v. Admire, 4 Tex. Civ. App. 45, 23 S.W. 418 (1893), it was held that the due course holder of note and mortgage would not be affected by any prior liens of which he did not have notice. The New York court in Gould v. Marsh, 1 Hun. 566 (N.Y. Sup. Ct. 1874), likewise protected the due course holder where through the fraud of his assignor his mortgage was recorded prior to a mortgage given earlier. In Pierce v. Faunce, 47 Me. 507 (1859), an innocent purchaser successfully resisted reformation of the deed upon which his mortgage was based, where it was shown that the deed had erroneously been drawn to cover land held under a prior lien.

But some states came to opposite conclusions and refused to impart negotiability to the mortgage. Olds v. Cummings, 31 Ill. 188 (1863); Johnson v. Carpenter, 7 Minn. 176 (1862); Baily v. Smith, 14 Ohio St. 396 (1863). The Illinois doctrine allowed only defenses of the maker, not collateral equities. Baily v. Smith was overruled in Dennis v. Rotter, 43 Ohio App. 330, 183 N.E. 188 (1932).

The case law resistance to the rule in Illinois was later fortified by a provision of the Illinois Chattel Mortgage Act, providing that all notes secured by chattel mortgage shall state on their face that they are so secured, and when assigned shall be subject to all defenses and that where the note does not so state the mortgage shall be absolutely void. Ill. Laws 1895, p. 260, § 1; Ill. Rev. Stats. c. 95, § 26 (1951).
ditions have always been outside the commercial ambit. NIL Section 3 then elaborates on the meaning of "unconditional":

"An unqualified order or promise to pay is unconditional within the meaning of this act, though coupled with—

(2) a statement of the transaction which gives rise to the instrument."

The meaning which has been given to NIL Section 3(2) by the case law is this: any promise or order coupled with anything more than a statement of the transaction which gives rise to the instrument is conditional and makes the instrument nonnegotiable. In particular a note which states that it is "subject to" an accompanying mortgage or conditional sale contract or otherwise attempts to incorporate the provisions of the security agreement is nonnegotiable because the promise is conditional within Section 3(2). The "subject to" rule has been frozen doctrine for so long that its shaky foundations have been lost from sight.

If we can force ourselves to read Section 3(2) without doctrinal preconception—as through the eyes, darkly, of a second year law student—it is clear that the subsection does not say what it is assumed to mean. It is permissive and not restrictive: it confers negotiability on certain instruments even though they refer to collateral transactions. Furthermore it is by no means evident that the section has anything to do with notes and mortgages, or notes and conditional sale contracts, or bonds and indentures of trust. If a reversal of prior law on a point of such major importance had been intended, more explicit language might have been expected.

The source of NIL Section 3(2) was the English Bills of Exchange Act of 1882, from which the NIL was largely copied. Section 3(3) of that Act provides in part that

"... an unqualified order to pay coupled with ... (b) a statement of the transaction which gives rise to the bill, is unconditional."

This language was used with reference to bills of exchange. What the draftsman was thinking of was the mercantile bill which a seller draws on his buyer for the price of goods. In that context the "transaction which gives rise to the bill" is the underlying contract of sale. It is useful, for bookkeeping purposes, to refer on the face of the bill to the particular contract in aid of which the bill is drawn. The contract is not otherwise integrated with the bill; it does not travel with it; holders of or parties to the bill, other than buyer and seller, will have no access to the contract and will have no knowledge of its terms. The "statement of the transaction" language, in its original context,

89. See, e.g., Story, Promissory Notes § 22 (1859). "[T]o make a written Note for the payment of money a valid Promissory Note, the money must be payable absolutely, and at all events, and not be subject to any condition or contingency."
91. 45 & 46 Vict., c. 61.
was an apt description, in permissive terms, of the customary type of notation on mercantile bills. There is no suggestion whatever that the language was intended to deny negotiability to any form of paper currently in use. Under BEA Section 3(3) a bill conditioned on performance of the sales contract ("Pay £10,000, provided that conforming goods are delivered before June 1") would be nonnegotiable because conditional, but that would have been true even without the "statement of the transaction" language. No one has ever drawn bills "subject to" the terms of a sales contract, so that, if we assume what has come to be the American construction of the phrase, we have the odd spectacle of a statutory prohibition of a nonexistent practice.

In the NIL the "statement of the transaction" language becomes a general rule applicable to all types of instruments. Despite the broadening of the rule, there seems to have been no thought on the part of the draftsman, or of his early critics, that a major reversal of prior law would result.

NIL Section 3(2) was attacked by Dean Ames on two counts, neither of which seems to have even a remote cousinship with what Section 3(2) was later construed to mean. In the first place, said Ames, NIL Section 3(2) read literally, might, deplorably, authorize any condition to be expressed on the face of the instrument. Alternatively the subsection might have the beneficial effect of making "chattel notes"—conditional sales notes—negotiable in a few jurisdictions where their negotiability had been denied at common law. But Ames doubted that the language was strong enough to bring the dissident jurisdictions into line. Judge Brewster, in his reply to Ames, did not suggest any more than bad Ames that Section 3(2) was designed to tighten up the rules of negotiability. He accepted Ames' alternative interpretation of the subsection, as designed to confer negotiability on "chattel notes," and disagreed with Ames only in feeling that the language was strong enough to accomplish the result.

Neither the opponents nor the supporters of the NIL, including the draftsman, ever imagined that Section 3(2) had the meaning that was shortly attributed to it. It is clear enough that the "statement of the transaction" phrase had suffered a sea-change on its way across the Atlantic, but all the early testimony is consistent that the principal purpose of Section 3(2) was to reverse the minority holdings that chattel notes were nonnegotiable. And for a time after the NIL went into effect the courts apparently did not consider Section 3(2) to be relevant to note-and-mortgage cases.

93. Brewster, A Defense of the Negotiable Instruments Law, 10 Yale L.J. 84, 87: (1900) "The provision [§ 3(2)] was intended to cover such transactions as a 'chattel note,' in order to unify the law, which has been held differently, as Dean Ames shows in the cases which he cites." The draftsman of the Act, Crawford, The Negotiable Instruments Law, 12 (1897) and McKeelhan, The Negotiable Instruments Law (A Review of the Ames-Brewster Controversy), 41 Am. L. Reg. (n.s.) 437 (1902) agreed with Brewster.
94. The round-up of cases in the first edition of Brannan, Negotiable Instruments Law (1908) is instructive. The Iowa court had held in Allison v. Hollembeak, 138 Iowa
Within a few years the early trend of the case law was reversed for reasons which are, and no doubt will remain, obscure. Sooner or later the possibility of construing Section 3(2) restrictively was bound to occur to someone. The accidents of litigation brought up a few cases involving notes bearing odd references to a variety of companion instruments, most of which would have been nonnegotiable at common law without any help from the "statement of the transaction" concept. Since the statute set one rule for all types of instruments, it would have been difficult for a court, which had, quite reasonably, held nonnegotiable a bill of exchange expressed to be "subject to" a contract of sale, to hold differently in the case of a note "subject to" a mortgage. The end result was that "subject to" came to be fatal to the negotiability of any instrument, without regard to what the companion agreement contained or to the relation between the instrument and the agreement to which it was subject—all this as a necessary implication from Section 3(2).

The settled construction of Section 3(2) at which the courts generally had arrived by approximately 1920 might seem to have made for a state of the law not altogether satisfactory but at least stable and predictable. But the development of the law from 1920 to date has been quite as troubled and obscure as it was during the first two decades following the promulgation of the NIL.

At this point we must distinguish note and mortgage, note and conditional sale contract, bond and trust indenture. Although it has been customary to lump all three together, both in the cases and in the legal literature, each followed its own course. The note and mortgage we may leave without further discussion. The restrictive NIL rule on the permissible limits of the cross-reference clause, although a trap for the unskilled draftsman, was at least workable. A lawyer who knew his business could so draw his note and mortgage that the note remained negotiable and, since the "impacting negotia-
bility" doctrine was thought to survive under the NIL, the mortgage too would pass free of defenses and equities. Furthermore the whole question of the negotiability of note and mortgage lost its early importance as changes in business and banking practice made it much less common than it had been for mortgages to move from the hands of the original mortgagee into those of a purchaser for value. The note and conditional sale as well as the bond and trust indenture require separate discussion.

Bonds

There is no reason to believe that the NIL was intended to apply to long-term investment securities and no excuse for the judicial decision that it does. Nothing in the statute is even remotely helpful in solving the problems peculiar to securities. The only effect of holding it applicable has been that corporate and municipal bonds, equipment trust certificates and the like have been denied, because of their failure to measure up to the formal requisites, the negotiability which everyone assumes they should have.

In fitting the corporate bond secured by an indenture of trust into the formal requisites, a problem, not existing in the simple note and mortgage situation, is found. In a public issue of bonds each secured pro rata by corporate assets, it is obviously impracticable for any specific asset to be allocated to each bond. The bonds as a whole must be secured by the dedicated assets as a whole. It early became standard practice to convey the security for the bonds to a trustee. Equally obvious was the necessity of restraining the action of the individual bondholder on default. This was done by providing that no action to foreclose the security could be taken by the bondholders except through the trustee, and that the trustee should act only on demand of a specified number of the holders of outstanding bonds. The fact that many abuses were perpetrated in the name of these "no action clauses"—which were often so drafted as to make action by the bondholders under any circumstances impossible—does not mean that they were not necessary and proper: without some restriction on the rugged individualism character-

95. See Britton, op. cit. supra note 90, at 66.
96. The New York case of Hibbs v. Brown, cited supra note 94, seems to have been the first judicial discussion of the NIL in connection with investment securities. The Court of Appeals held the bonds negotiable, so that the applicability or nonapplicability of the statute may have seemed of little importance. Typical of the later cases applying the NIL to hold bonds nonnegotiable is King Cattle Co. v. Joseph, 138 Minn. 481, 198 N.W. 798, 199 N.W. 437 (1924). The arguments for the application of the NIL to securities were: 1) while the preamble to the English Bills of Exchange Act describes that statute as an "Act to codify the law relating to Bills of Exchange, Cheques and Promissory Notes," the preamble to the NIL states that it is "A General Act relating to Negotiable Instruments." 2) NIL § 1 is cast in mandatory terms: "An instrument to be negotiable must conform to the following requirements"; 3) NIL § 65 contains a reference to "persons negotiating public or corporation securities." None of the arguments has seemed persuasive to the commentators. For an excellent discussion and collection of cases, see Steffen and Russell, The Negotiability of Corporate Bonds, 41 Yale L.J. 799 (1932).
istic of the widows and orphans who hold bonds, the result would have been corporate chaos.

At least during the NIL period, no draftsman was hardy enough to write the no action clause on the face of the bond. Since the formal requisites had to be met, it would have been asking for trouble to proffer a bond which conditioned remedies on default on the willingness of a trustee, protected by the most elaborate of exculpatory clauses, to take action when prodded by perhaps 90 percent of the holders of outstanding bonds. The no action clause was therefore put in the trust indenture with a cross-reference clause in the bond which, it was hoped, would preclude the individual bondholder's right of action and yet leave the bonds negotiable.

Early results were discouraging. If the reference clause was not specific, the bondholder was allowed to sue the corporation without going through the trustee. If the reference clause was specific, the bond was nonnegotiable.7 The desirability of hobbling the individual initiative of bondholders must have been more important to the corporate issuers than the advantage of offering negotiable securities to the investing public: most of the later cases involve reference clauses whose sufficiency to put the holder on notice could not possibly be denied and whose language would obviously be fatal to negotiability under the current NIL interpretation. As of 1920 an astute commentator might justifiably have pronounced that most corporate bonds were not, and could not be made, negotiable.

The astute commentator would have been reckoning without the intuitive commercial good sense of the New York Court of Appeals, which was shortly to manifest itself in an obscure sequence of cases. In 1926 the New York court was called upon to pass on the negotiability of interim certificates which had been issued by J. P. Morgan & Co. The certificates provided that the holders were entitled to exchange them for definitive bonds “when, as and if” the bonds were delivered to Morgan by the Kingdom of Belgium, the obligor, and further provided that

“Every taker and holder . . . hereby agrees that [J. P. Morgan & Co.] may treat the bearer . . . as the absolute owner . . . for all purposes, and . . . shall not be affected by any notice to the contrary.”8

Three of the certificates were stolen and came into the possession of The Bank of the Manhattan Co., which purchased them in good faith and for value. J.P. Morgan & Co. nevertheless refused to exchange them for bonds, because it had received notice of the theft. The Bank of the Manhattan Co. then sued to recover the value of the bonds.

The issue in the case, said the court, was whether the certificates were “negotiable instruments.” The holding was that they were not, and that the

97. Steffen, Cases on Commercial and Investment Paper 251-75 (1939) contains an admirable selection of material illustrating these twin pitfalls.
98. President and Directors of Manhattan Co. v. Morgan, 242 N.Y. 38, 43, 150 N.E. 594, 595 (1926).
Bank of the Manhattan Co. could not recover. The opinion, by Judge Cardozo, was an extraordinary affair: few of the productions of the great jurist's pen were ever more charged with ambiguity. It may be that, disagreeing with the majority of the court, he deliberately wrote the opinion in such a way as to narrow and confuse the holding.

Cardozo first set out the standard doctrine: the NIL applies to all types of investment securities; its provisions are mandatory and not subject to alteration by agreement. The certificates in suit are clearly nonnegotiable: not only are they conditional promises on a "when, as and if" basis, they are not even promises to pay money. There remains the problem whether the provisions that Morgan & Co. "may treat the bearer . . . as the absolute owner" renders them negotiable despite—or outside—the statute. At this point Cardozo's language became careful and guarded:

"We do not mean to cast doubt through anything here written upon the capacity of merchants to create new forms of negotiability by contract or by estoppel. We do not pass upon the effect of provisions, however phrased, that aim at that result. A right conferred by statute will not be lost to the holder of an instrument at the conflicting behest of a rival, but inferior, body of law, e.g., the law merchant. . . . The conclusion does not follow that it may not be qualified or extinguished by the provisions of a contract. See, however, American National Bank of San Francisco v. A. G. Sommerville Inc., 216 P. 376, 191 Cal. 364."  

The Morgan opinion also notes that the trial judge had refused to find the existence of a general custom whereby instruments like the certificates in suit were treated as negotiable. Thus, as Cardozo stated the case, the court did not pass on the question of negotiability by custom or by contract. All that was involved was permissive language in the certificate whose object was "obviously the protection of the bankers, rather than the change or enlargement of the title of the holder."  

The Morgan case was promptly followed by the enactment of the Hofstadter Act  which overruled the actual holding in the case, while adopting the suggestions in Cardozo's opinion on the possibilities of growth by custom, contract or estoppel. The Act, which gives every sign of hasty drafting, first defines in unnecessarily elaborate terms the types of instruments to which it is to apply. It confers on such instruments the principal attribute of negotiability—that of passing free of equities and defenses when transferred for value before maturity to a purchaser without notice. The final section provides that:

99. Id. at 50, 150 N.E. at 598.

The Sommerville case, which Cardozo cites disapprovingly, was not a bond case. It held that a provision in a conditional sale contract, whereby the buyer of an automobile waived defenses against any assignee of the contract, was void as an attempt to create a negotiable instrument outside the framework of the NIL. Sommerville is discussed infra in text at notes 115-16.

100. Id. at 50, 150 N.E. at 598.

"This article shall not be construed to limit or impair the negotiability or quasi negotiability by agreement or otherwise of any instrument whether or not defined herein."\(^{102}\)

The language seems a clear enough adoption of Cardozo's remarks in the *Morgan* opinion.

The way seemed clear to hold all types of investment securities negotiable, whether or not named in the Hofstadter Act, by building on the "negotiability by agreement or otherwise" language in the statute and on Cardozo's opinion in *Morgan*. The Court of Appeals seems to have been in agreement on the result, but not on the method. In any event they did things the hard way.

*Enoch v. Brandon*\(^ {103}\) was decided only two years after the *Morgan* case and the Hofstadter Act, and while Cardozo was still on the court. The action was by the "true owner" of bearer bonds against a good faith purchaser from a thief. The bonds contained a statement that "they are to be treated as negotiable, and all persons are invited by the company to act accordingly." The court speaking through Judge Andrews, prefaced its opinion by a brief passage denying the possibility of negotiability by custom or contract.

"No such statement will make negotiable a bond not in the form provided by our statute [i.e., the NIL]. Whether the result was or was not fortunate, it is too late to argue that the Legislature did not refer to bonds in its all-inclusive definition of negotiable paper. True, to become negotiable an instrument need not follow any precise language [Citing NIL Section 10]. But it 'must conform' to the definition specified in [Section 1]. In the face of a command so explicit, we must adhere to the design of the Legislature. American National Bank of San Francisco v. A. G. Sommerville, Inc., 191 Cal. 364, 216 P. 376. At times contract rights may be enforced or some theory of estoppel adopted, but no intention, no agreement may make negotiable an instrument which the statute declares to be non-negotiable."\(^ {104}\)

There are several extraordinary aspects to this paragraph. Neither Cardozo's *Morgan* opinion nor the Hofstadter Act is referred to. The *Sommerville* case, expressly disapproved in *Morgan*, is here expressly approved. But strangest of all is the fact that the entire passage is irrelevant and unnecessary dictum, since the court had unanimously agreed to hold the bonds negotiable. Cardozo, it may be assumed, was more than willing to trade the elaborate ambiguities of *Morgan* for the flat holding of negotiability in *Enoch v. Brandon*.

The balance of Judge Andrews' opinion is a never-surpassed example of judicial double-talk. The bonds stated that they were "secured by and entitled to the benefits and subject to the provisions" of a trust indenture "to which reference is hereby made for a description of the property mortgaged and pledged, the nature and extent of the security, the rights of the holders

102. N.Y. PERS. PROP. LAW § 262.
103. 249 N.Y. 263, 164 N.E. 45 (1928).
of the bonds with respect thereto, the manner in which notice may be given to such holders, and the terms and conditions under which said bonds are issued and secured.” “We hold,” wrote Judge Andrews, “that here there is no modification of the promise to pay, made in explicit terms.” It was as easy as that.

Enoch v. Brandon was the turning point in bond litigation. The courts in all jurisdictions were eager to follow the lead of New York. Prior holdings denying negotiability to bonds were quietly buried or forgotten. The cases since 1930 show no desire on the part of the courts to examine the formal requisites problem too nicely or at all.106

105. *Id.* at 268, 164 N.E. at 47.

The Hofstadter Act had originally applied only to “security receipts” (the type of interim certificate involved in the Morgan case) and “equipment trust certificates.” After *Enoch v. Brandon*, the legislature, making assurance doubly sure, added corporate bonds to the Act’s coverage. N.Y. Laws 1930, c. 630, § 2.


But when the bonds were interpreted on the issue of the enforceability of no-action clauses, there were occasional dicta as to nonnegotiability. The cases split about evenly on the enforceability of these clauses. No-action clause held to bar suit by bondholder (or mortgage held incorporated into bond): Gillmor v. Indianapolis Gas Co., 136 F.2d 925 (7th Cir. 1943); Dunham v. Omaha & C. B. St. Ry., 106 F.2d 1 (2d Cir. 1939); McAdoo v. Oregon City Mfg. Co., 71 F.2d 879 (9th Cir. 1934); Lidgerwood v. Halle & Kilburn Corp., 47 F.2d 318 (S.D.N.Y. 1930); Commercial Credit Co. v. Seymour Nat. Bank, 105 Ind. App. 524, 15 N.E.2d 118 (1938); Fidelity & Columbia Trust Co. v. Schmidt, 245 Ky. 432, 53 S.W.2d 713 (1932) (bondholders suing corporation which had paid trustee, now insolvent; mortgage held incorporated, bondholders held not to have negotiable bonds, hence defense of payment good); Detroit Trust Co. v. Detroit City Ser. Co., 262 Mich. 14, 247 N.W. 76 (1933) (dictum that nonnegotiable); Mitchell v. Madison Ave. Offices Inc., 147 Misc. 149, 263 N.Y. Supp. 442 (City Ct. 1933) (not unqualified promise to pay); Colsky v. Eyres Storage & Distributing Co., 178 Wash. 404, 34 P.2d 1114 (1934); Moody v. Pacific S.S. Co., 174 Wash. 256, 24 P.2d 609 (1933) (dictum that non-negotiable); Oster v. Bldgs. Development Co., 213 Wis. 481, 252 N.W. 168 (1934). In the following cases the bondholder was allowed to sue at law despite a no-action clause in the trust indenture: Halle v. Van Sweringen Corp., 7 Harr. 491, 185 Atl. 236 (Del. 1936); Oswianza v. Wengler & Mandell, 358 Ill. 302, 193 N.E. 123 (1934); Continental Nat. Bank v. Chicago Corp., 283 Ill. App. 64 (1935); Cummings v. Michigan-Lake Bldg. Corp., 277 Ill. App. 470 (1934); Betts v. Mass. Cities Realty Co., 304 Mass.
The bond story is an instructive one. It demonstrates the resourcefulness with which a good court can retrieve a position apparently hopelessly lost. It is a melancholy reminder of the dangers of bad drafting: the root of the trouble was an attempt in the NIL, as it came to be construed, to state one rule to cover a variety of unlike situations. It took a generation of vexatious litigation to determine that twenty-year bonds could not be governed by the same rule as thirty-day notes. And the solution reached was complex and obscure, depending on judicial willingness to resort in a good cause to pretense (that bonds must comply with the NIL formal requisites), fiction (that they do comply) and general disingenuousness. Other maxims which the bond story demonstrates are that commercial needs write commercial law, that substance sooner or later prevails over form, and that law, like love, will find a way.

Consumer Paper

The conditional sale first became a commercially important security device with the fantastically rapid growth of the consumer installment purchase industry between 1900 and the end of the first World War. For a variety of reasons the sales finance companies which pioneered the field early abandoned the chattel mortgage in favor of the conditional sale. The principal reason may have been that the conditional sale seemed safe from control under the usury laws. Another was the advantageous position of the conditional vendor on default. A third was the freedom of the conditional sale from filing statutes—an advantage which has now been lost in most jurisdictions.


107. UCC Art. 8 gives full negotiability to "investment securities." Security" is defined in § 8-102 as "an instrument issued in bearer or registered form of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment if (i) it is either one of a class or series or by its term is divisible into a class or series of instruments; and (ii) it evidences a share, participation or other interest in property or in an enterprise or evidences an obligation of the issuer."

108. The reason why the usury laws do not apply is that, at least in contemplation of law, no loan is involved but merely a sale on credit at a higher price than would be charged if the sale were for cash. For some recent questioning of this basic principle, see note 120 infra.

109. At common law a conditional vendor who repossessed on default took the property as his own and was under no duty to account to the buyer for payments made or for the value of the repossessed property in excess of the unpaid balance. A corresponding disadvantage was that the conditional vendor who repossessed had no right to a deficiency judgment. He was forced to an election between retaking the goods and suing for the price.
Like any other lender the sales finance company wanted to stand free of contract defenses between seller and buyer. In this respect the conditional sale presented certain difficulties which the mortgage did not. A purchase-money mortgage and its underlying note can be made to run directly from buyer to lender: in that situation no one has ever thought that defenses good against the seller could be asserted against the mortgagee, who does not appear to be a party to the sales transaction. Or the note and mortgage can run from buyer to seller and be assigned to the lender: if the note is negotiable in form the lender will once again, by virtue of the doctrine of "imparting negotiability," hold both note and mortgage free of the sale's defenses. Where a conditional sale is used it cannot be made to run from buyer to lender. A technical limitation in conditional sales law is that the original vendor must be, as the cases say, a seller in the economic sense; whatever that may mean, he may not be a lender of money. The lender can come in only as assignee. But even if the conditional sale contract travels with a negotiable note, the "imparting negotiability" doctrine, universally accepted in the mortgage cases, does not apply. Why it does not has never been explained, but it does not. Thus by the use of a note tied to a conditional sale contract, the lender-assignee at best holds free of defenses on the money claim; his rights against the security remain subject to any defect in the original transaction.

Furthermore, looking at the situation as of 1910, it was far from clear that a note used with a conditional sale contract would itself be negotiable. Only a minority of pre-NIL cases had held "chattel notes" nonnegotiable. And there was impressive authority to cite to the proposition that the NIL was intended to codify the majority rule. On the other side, there was not only

110. See, e.g., Hughbanks, Inc. v. Gourley, 12 Wash.2d 44, 120 P.2d 523 (1941). Neither the Uniform Conditional Sales Act nor non-uniform conditional sales legislation relaxes this requirement.

111. The leading case was Sloan v. McCarty, 134 Mass. 245 (1883). In the 1870's and 1880's there was a flurry of litigation on the effect of such title retention clauses. Most courts that considered the issue came out for negotiability. Chic. Ry. Equipment Co. v. Merchants' Bank, 136 U.S. 268 (1890); Howard v. Simpkins, 69 Ga. 773 (1882); Collins v. Bradbury, 64 Me. 37 (1874); Burnley v. Tufts, 66 Miss. 48, 5 So. 627 (1888); Heard v. Dubuque County Bank, 8 Neb. 10 (1878); Mott v. Havana Nat. Bank, 22 Hun 354 (N.Y. Sup. Ct. 1880); Mansfield Sav. Bank v. Flowers, 9 Ohio Dec. 169 (1881). But other courts, both before and after the Sloan case, held such paper nonnegotiable. Killam v. Schoeps, 26 Kan. 310 (1881); Wright v. Traver, 73 Mich. 493, 41 N.W. 517 (1889); Third Nat. Bank v. Armstrong, 25 Minn. 530 (1897). And the minority was persistent. Aside from Michigan, where the law was in a state of vacillation for 20 years, see Choate v. Stevens, 116 Mich. 28, 74 N.W. 289 (1898) (negotiable); Worden Grocer Co. v. Blanding, 161 Mich. 254, 126 N.W. 212 (1910) (not negotiable); Schmidt v. Pegg, 172 Mich. 159, 137 N.W. 524 (1912) (negotiable), the minority consistently stuck to its position. See General Motors Acceptance Corp. v. Davis, 169 Kan. 220, 218 P.2d 181 (1950); Central Nat. Bank v. Hubbel, 258 Mass. 124, 154 N.E. 551 (1927); Polk County State Bank of Crookston v. Walters, 145 Minn. 149, 176 N.W. 496 (1920) (explicitly rejecting the suggestion that the enactment of the NIL should alter the existing state of the law).

112. See notes 93 and 94 supra.
Ames' pessimistic view of the effectiveness of the assumed NIL rule but the disquieting fact that the early decisions under the NIL showed that the gloomy Dean was apparently correct.\textsuperscript{113} The NIL had already been enacted in enough jurisdictions to make it a good guess that it would shortly be law throughout the country. The chances of success in achieving the lender's traditional free-of-defenses status under any manipulation of the note and contract combination were slim indeed.

Since the largest of the sales finance companies were or soon became national enterprises, it was of importance to them to devise a scheme of operation that could be carried out nationally, with as few local variations as possible. In the stately world of high finance, counsel had attempted to solve the problem of making bonds negotiable despite the NIL by contractual stipulations in which the issuer "invited all persons to treat the bond as negotiable." In the underworld of consumer finance, no less astute counsel hit on a similar idea: by abandoning the note entirely, the desired result might be obtained under the contract itself. If the trick could be worked, the finance company would have a defense-free position both on the money claim even in the minority jurisdictions and on the security agreement despite the courts' refusal to extend the "imparting negotiability" theory to conditional sales.

In pursuit of these objectives counsel inserted in the contract what came to be known as a "cut-off clause," by which the buyer waived, against any assignee of the contract, all defenses which he might have against the seller. No attempt was made, except in an occasional freak case,\textsuperscript{114} to draft the contract in the form of a negotiable note or to stipulate that the contract might be treated as negotiable. Presumably for all purposes except that of the non-availability of contract defenses the contract remained nonnegotiable: if without notice of assignment the buyer paid the assignor, he would be discharged; if the seller assigned the same contract successively to $A$ and to $B$, their priorities would be determined by the common law of assignment and not by the law of negotiable instruments.

Despite the fact that there was no effort to turn the conditional sale contract into a negotiable instrument, the initial judicial reaction was that in substance this was an attempt to make a nonnegotiable chose negotiable by contract. An early California case, \textit{American National Bank v. Sommerville},\textsuperscript{115} presented a common type of fraud: the buyer of a car was induced before delivery to sign a contract containing a waiver of defenses. The contract was immediately assigned to a finance company, which then pledged it with a bank. The car was never delivered to the buyer, who sought to plead failure of consideration as a defense to suit by the bank. The plea was allowed on

\textsuperscript{115} 191 Cal. 364, 216 Pac. 376 (1923). For the changing attitudes of the New York courts toward the \textit{Sommerville} case, see text at notes 99-104 \textit{supra}. 
the theory that an attempt to deprive an obligor of his contract defenses was in essence an attempt to create a negotiable instrument outside the framework of the NIL, and that the NIL was mandatory and all-inclusive and could not be circumvented by agreement. The waiver clause was void as against public policy.\footnote{116. The Sommerville opinion did leave open the possibility that the buyer might be subject to an "estoppel in pais," by which the court apparently meant that if the buyer had stated directly to the assignee, in response to inquiry, that he had no defenses, he would be bound to his statement. On this ground it has been suggested that Sommerville "far from refusing to accept negotiability by contract, actually sanctioned its use." Beutel, \textit{Negotiability by Contract}, 28 ILL. L. REV. 205, 222 (1933). The suggestion appears not to have commended itself to the finance companies, both because it would be expensive and cumbersome in a volume operation and because, like other lenders, the finance companies wanted to take free of defenses without inquiry.}

In a case almost contemporaneous with Sommerville, the Utah court drew what proved to be a useful distinction.\footnote{117. Anglo-California Trust Co. v. Hall, 61 Utah 223, 211 Pac. 991 (1922). \footnote{118. Between 1920 and 1930 the Utah \textit{Hall} case, \textit{supra} note 117, stood alone in giving effectiveness to the cut-off clause, while on the other side Sommerville, \textit{supra} note 115, was joined by four other holdings: San Francisco Sec. Corp. v. Phoenix Motor Co., 25 Ariz. 531, 220 Pac. 229 (1923); Hall v. Hall, 133 Wash. 400, 234 Pac. 2 (1925); Pacific Acceptance Corp. v. Whalen, 43 Idaho 15, 248 Pac. 444 (1926); San Joaquin Finance Corp. v. Allen, 102 Cal. App. 400, 283 Pac. 117 (1929). Between 1930 and 1940 the balance shifted. Following Sommerville were three more cases: Motor Contract Co. v. Van Der Volgen, 162 Wash. 449, 298 Pac. 705 (1931); Progressive Finance & Realty Co. v. Stempel, 231 Mo. App. 721, 95 S.W.2d 834 (1936); Industrial Loan Co. of Cape Girardeau v. Grisham, 115 S.W.2d 214 (Mo. App. 1938). Five cases during this period upheld the clause: Colson & Sons v. Ellis, 40 Ga. App. 768, 151 S.E. 634 (1930); Elzey v. Ajax Heating Co., 10 N.J. Misc. 281, 158 Atl. 851 (Sup. Ct. 1932); Refrigeration Discount Corp. v. Haskew, 194 Ark. 549, 108 S.W.2d 908 (1937); Nat. City Bank of N.Y. v. Prospect Syndicate, 170 Misc. 611, 10 N.Y. S.2d 759 (1939); U.S. ex rel. F.H.A. v. Troy-Parisian, Inc., 115 F.2d 224 (9th Cir. 1940).} The buyer of a tractor claimed a breach of warranty and the right, by returning it, to rescind the contract and recover payments made. The conditional sale contract, which had been assigned, contained a cut-off clause. Without discussing the metaphysics of negotiability, the court held that the waiver was effective where the asserted defense was merely a breach of warranty and no fraud was alleged.

The Utah decision, so long as a defense could be characterized as a "mere" breach of warranty, gave the financing assignee protection in the ordinary run of cases. He was not quite as well off as a holder of a fully negotiable instrument, whose transfer would cut off even defenses based on fraud, but, from a business point of view, nine cases out of ten were covered. In any event, the "breach of warranty in the absence of fraud" rule was, after the Utah decision, successfully argued to the courts of several jurisdictions, and the barrier of "no negotiability by contract" quietly passed over. It would be fair to say that, by 1940 the Utah rule had become majority doctrine.\footnote{118. Between 1920 and 1930 the Utah \textit{Hall} case, \textit{supra} note 117, stood alone in giving effectiveness to the cut-off clause, while on the other side Sommerville, \textit{supra} note 115, was joined by four other holdings: San Francisco Sec. Corp. v. Phoenix Motor Co., 25 Ariz. 531, 220 Pac. 229 (1923); Hall v. Hall, 133 Wash. 400, 234 Pac. 2 (1925); Pacific Acceptance Corp. v. Whalen, 43 Idaho 15, 248 Pac. 444 (1926); San Joaquin Finance Corp. v. Allen, 102 Cal. App. 400, 283 Pac. 117 (1929). Between 1930 and 1940 the balance shifted. Following Sommerville were three more cases: Motor Contract Co. v. Van Der Volgen, 162 Wash. 449, 298 Pac. 705 (1931); Progressive Finance & Realty Co. v. Stempel, 231 Mo. App. 721, 95 S.W.2d 834 (1936); Industrial Loan Co. of Cape Girardeau v. Grisham, 115 S.W.2d 214 (Mo. App. 1938). Five cases during this period upheld the clause: Colson & Sons v. Ellis, 40 Ga. App. 768, 151 S.E. 634 (1930); Elzey v. Ajax Heating Co., 10 N.J. Misc. 281, 158 Atl. 851 (Sup. Ct. 1932); Refrigeration Discount Corp. v. Haskew, 194 Ark. 549, 108 S.W.2d 908 (1937); Nat. City Bank of N.Y. v. Prospect Syndicate, 170 Misc. 611, 10 N.Y. S.2d 759 (1939); U.S. ex rel. F.H.A. v. Troy-Parisian, Inc., 115 F.2d 224 (9th Cir. 1940).}
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struggle against consumer defenses. Moreover, the cut-off clause was not the only weapon on which the finance companies relied. Initially the clause was used without a note. It was not long, however, before the note began to be used along with a contract which also contained the clause. In jurisdictions which admitted the negotiability of the note, the finance company then had two strings to its bow.¹¹⁹

Until approximately 1940 the courts decided the consumer cases on general principles and abstract doctrine. The finance company which had bought a conditional sale contract from a dealer would be granted or denied its protection on the same conceptual grounds that would apply in any other type of transaction. Is the note negotiable? Is it legal for an obligor on a non-negotiable chose to waive his defenses? Did plaintiff take the note before maturity, for value, in good faith (i.e., subjectively in good faith) and without notice of defenses (being under no duty of inquiry)? The fact that financing charges might amount to 20 or 30 or 40 percent of the purchase price was irrelevant since in contemplation of law there was no loan and therefore no usury.¹²⁰

Since 1940 the solid ground on which finance companies and banks might with reason have fancied themselves to stand has been engulfed. In jurisdic-

¹¹⁹. Despite the early cases under the NIL and the stubbornness of two or three of the minority jurisdictions on the point, see note 111 supra, fears that conditional sales notes would generally be held nonnegotiable were not borne out. Apart from the recent developments discussed infra, conditional sales notes and mortgage notes have come to be treated alike, and the mere statement that a note is given in connection with a conditional sales contract does not in most jurisdictions destroy negotiability. See Britton, HANDBOOK OF THE LAW OF BILLS AND NOTES § 14 (1943).

¹²⁰. Before 1940 the only modern cases, so far as the writer knows, holding the usury laws applicable to consumer sales finance were two decisions of Judge Tompkins of the City Court of Rochester: Universal Credit Co. v. Lowell, 166 Misc. 15, 2 N.Y.S.2d 743 (City Ct. 1938); Failing v. Nat. Bond & Inv. Corp., 168 Misc. 617, 6 N.Y.S.2d 67 (City Ct. 1938), Note, 48 YALE L.J. 1102 (1939). The Failing case was reversed on appeal 12 N.Y.S.2d 260 (County Ct. 1938), aff'd, 258 App. Div. 778, 14 N.Y.S.2d 1011 (4th Dept 1939). Berger, Usury in Installment Sales, 2 LAW & CONTEMP. PROBS. 143 (1935), had argued that the usury laws should apply, but he and Tompkins, J. were the only voices crying in the wilderness.

The Supreme Court of Arkansas has now announced that in the future it will consider financing charges within the purview of the usury laws. Hare v. Gen. Contract Purchase Corp., 220 Ark. 601, 249 S.W.2d 973 (1952) and Schuck v. Murdock Acceptance Corp., 220 Ark. 56, 247 S.W.2d 1 (1952). The Supreme Court of Idaho, although adhering to the majority rule ("a sale of property on contract is in no sense a loan and usury statutes have no application to such sales"), divided 3 to 2 on the issue in Bell v. Idaho Finance Co., 73 Idaho 560, 255 P.2d 715 (1953). See Notes, 36 MINN. L. REV. 744 (1952); 31 TEX. L. REV. 55 (1952).

It is the writer's belief that, although financing charges should be regulated, the application of outdated, poorly drafted, exception-riddled usury laws is no way to accomplish the result. The one direct attempt to regulate rates under a statute creating an administrative agency to do the job has been held unconstitutional by the Indiana Supreme Court in Dept of Financial Institutions v. Holt, 231 Ind. 293, 108 N.E.2d 629 (1952), an outrageous decision.
tion after jurisdiction hard won positions have been swallowed up without trace. It takes no special discernment to see what has happened: consumer finance, at first an interesting novelty, has come to be recognized as a grave social problem. The finance companies have served an important function in making possible—at a handsome profit—the mass distribution of consumer goods. That does not, to the popular imagination, justify what are felt to be prevalent abuses. It is hard, and it becomes each year harder, for counsel to explain convincingly why "the law" requires that a hard-pressed wage-earner who has been bilked by a now-insolvent seller into buying junk masquerading as a television set or a washing machine must pay the full price to a bank or finance company whose own relationship with the fraudulent seller has been intimate, long-continued and profitable. The finance company must win "on the law" if it is to win at all. Uncertainty in the law is a recurrent complaint, but here at least is a situation in which jury verdicts are completely predictable.

The financing institution is in the strongest position procedurally when it sues on a note, either for a money judgment without resort to the security or for a deficiency judgment following repossession and resale. Under the NIL, plaintiff, as holder, makes a prima facie case by introducing the note; defendant then has a chance to show that "the title of any person who has negotiated the instrument was defective" and it is generally agreed that "defective title" includes maker's defenses against the payee, such as failure of consideration, breach of warranty, and fraud; if defendant "shows" defective title, plaintiff must prove that he, or some predecessor in title, acquired the instrument as a holder in due course.\footnote{In the usual case the financing institution has no difficulty in proving that the instrument was "complete and regular," that it gave value and that it took before maturity. It must further prove a taking "in good faith" and "without notice." Good faith is said to be "subjective," not objective; it is enough if there is an absence of bad faith. The purchaser is under no duty of inquiry and has "notice" only if he has "actual knowledge" or "knowledge of such facts that his action in taking the instrument amounted to bad faith." If plaintiff testifies that he did not know of the claimed defense and took the instrument in (subjective) good faith, and his testimony is not impeached, then, by the weight of much authority, he is entitled to a directed verdict.}{121} In the usual case the financing institution has no difficulty in proving that the instrument was "complete and regular," that it gave value and that it took before maturity. It must further prove a taking "in good faith" and "without notice." Good faith is said to be "subjective," not objective; it is enough if there is an absence of bad faith. The purchaser is under no duty of inquiry and has "notice" only if he has "actual knowledge" or "knowledge of such facts that his action in taking the instrument amounted to bad faith." If plaintiff testifies that he did not know of the claimed defense and took the instrument in (subjective) good faith, and his testimony is not impeached, then, by the weight of much authority, he is entitled to a directed verdict.\footnote{See Britton, op. cit. supra note 119, § 102-104.}{122}

The crucial question is, then, what evidence is sufficient to send the case to the jury, over plaintiff's motion for a directed verdict. If we anthologize the cases, the standard approach by defense counsel has come to be to show a course of business between the seller-dealer and the financing institution, a "regular financing" of the dealer's paper. The more contracts assigned by dealer to financer, the stronger defendant's case will be. Proof that the bank or finance company either knew or ought to have known that the dealer, habitually or in the particular case, sold defective merchandise is frosting on

\begin{footnotesize}
\footnote{NIL § 59. See Britton, op. cit. supra note 119, §§ 102-104.}{121}
\footnote{See Britton, op. cit. supra note 119, § 105, collecting cases pro and con on the directed verdict question.}{122}
\end{footnotesize}
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the cake. The trend of the cases seems to be that the minimum showing of a regular course of business is enough to send the case to the jury.123

Not content with allowing the jury to wield the axe, some courts join in the fun themselves and find for the defendant as a matter of law.124 One way to do this is to resurrect the abandoned theory that the two instruments—note and contract—must be read together and to hold that plaintiff would be subject, on the note, to all defenses that would be good against him on the contract.125

A more sophisticated expedient, which avoids the problems presented by a contract containing a cut-off clause, is to have recourse to the doctrines, or at least the terminology, of the law of agency: the dealer was “clearly” or “obviously” a “mere agent” of the bank; as “principal” the bank cannot stand free of defenses on the sale.126 The “agency” approach takes care of all possible

123. See Equipment Acceptance Corp. v. Arwood Can Mfg. Co., 117 F.2d 442 (6th Cir. 1941); Schuck v. Murdock Acceptance Corp., 220 Ark. 56, 247 S.W.2d 1 (1952); Commercial Credit Corp. v. Childs, 199 Ark. 1073, 137 S.W.2d 290 (1940); Commercial Credit Corp. v. Orange County Machine Works, 34 Cal.2d 766, 214 P.2d 819 (1950); Mutual Finance Co. v. Martin, 63 So.2d 649 (Fla. 1953); Walter E. Heller & Co. v. Martin, 319 Ill. App. 209, 48 N.E.2d 771 (1943); Industrial Loan & Trust Co. v. Bell, 300 Ill. App. 502, 21 N.E.2d 638 (1939); State Nat. Bank of El Paso v. Cantrell, 47 N.M. 389, 143 P.2d 592, 152 A.L.R. 1216 (1943). See also the New York cases cited note 127 infra. In White System of New Orleans, Inc. v. Hall, 219 La. 440, 53 So.2d 227 (1951), the court, refusing to follow cases like those just cited, commented that “steps to . . . regulate installment credit sales should be taken by the Legislature, and not by this court in view of the clear provisions of the Negotiable Instruments Law.” Id. at 449, 53 So.2d at 230. The anonymous author of the A.L.R. note to the Cantrell case makes a “suggestion” which shows a touching belief in the sovereignty of concepts: let the finance company take the note by negotiation first and then take a later assignment of the conditional sale contract. “It would seem,” the learned commentator concludes, “that the rights of the holder in due course, once acquired by the indorsement alone of the notes, would not be impaired by the subsequent assignment of the conditional sale contract.” 152 A.L.R. 1222, 1225 n.1 (1944).

124. See the Orange County, Martin and Cantrell cases, supra note 123.

125. This was the approach adopted by the New Mexico court in the Cantrell case, supra note 123. “Unfortunately for plaintiff’s position, however, it not only was a holder in due course of the note sued on but the assignee as well of the conditional sale contract executed at the same time and as a part of the same transaction. While no rights are asserted under this contract in the present action, nevertheless, as assignee thereof, the plaintiff was possessed not alone of the rights it conferred, but burdened as well with the obligations it imposed. [Citations omitted.] Under these authorities, the plaintiff as assignee of the conditional sale contract was subject to all defenses existing against the assignor.” State Nat. Bank of El Paso v. Cantrell, 47 N.M. 389, 392, 143 P.2d 592, 594 (1943). It appears from the foregoing quotation that plaintiff was suing on the note for a money judgment and not asserting any security rights under the contract.

126. Thus in Titone v. General Electric Credit Corp., 201 Misc. 1044, 103 N.Y.S.2d 909 (Sup. Ct. 1951), in denying plaintiff’s motion for summary judgment, the court commented that a question of fact for trial was whether “dealer was really the agent of the credit corporation, rather than an independent dealer . . . .” Id. at 1044, 103 N.Y.S.2d at 911-12. The same idea is suggested in Pub. Nat. Bank & Trust Co. v. Fernandez, 121 N.Y.S.2d 721 (N.Y. Mun. Ct. 1952). Several of the cases cited in note 123 supra seem to be moving toward an agency rationale without having explicitly adopted agency terminology.
combinations: the note by itself, the note plus the contract, and the contract without a note.

If a court is not willing to stretch agency doctrine so far, the case of the contract without a note but with a cut-off clause requires the flexing of a different set of judicial muscles. There are no indications that "no negotiability by contract" is about to be revived and in most jurisdictions the cut-off clause is effective against defenses based on breach of warranty "in the absence of fraud." The "absence of fraud" rider suggests the solution. Where is the dividing line between "mere" breach of warranty and fraud? Is it not fraud for a seller to unload on an unsuspecting public merchandise which he knows to be defective? And, if that be conceded, why not the same conclusion as to defects which he "ought" to know about, whether he does or not? The dealer is surely in a better position than the consumer to find out whether he is selling junk. Let the defendant's answer, then, plead fraud. Can it be doubted that courts which let note cases go to the jury on the proof of a course of business will let contract cases go over on the fraud issue? Or that the appellate courts will refuse to disturb the judgments entered on the predictable verdicts? On the results to date the answer is that it cannot be doubted.127

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127. In Equipment Acceptance Corp. v. Arwood Can Mfg. Co., 117 F.2d 442 (6th Cir. 1941), which involved both a note and a contract with a cut-off clause, the court, in addition to holding that plaintiff had not borne his burden of proof on the due course issue, commented, with reference to the cut-off clause: "A note acquired either in bad faith, or without a showing of good faith . . . should not by the execution of a waiver agreement, contemporaneously with the signing of the note, be relieved of essential impedimenta on its courier course." Id. at 446.

In Thorp Finance Corp. v. Le Mire, 264 Wis. 220, 58 N.W.2d 641 (1953), where the buyer who had signed a contract acknowledging "delivery and acceptance" sought to defend on the ground that the furniture involved had never been delivered, the court reversed a judgment entered for plaintiff on a directed verdict and remanded the case for a new trial. In First Acceptance Corp. v. Kennedy, 95 F. Supp. 861 (N.D. Iowa 1951), defendant pleaded fraudulent inducement of contract and won a jury verdict in the trial court, which was, however, reversed on appeal. 194 F.2d 819 (8th Cir. 1952) (see further discussion of this case note 129 infra). One of the few recent cases which holds the cut-off clause good without discussion or dissent is Jones v. Universal C.I.T. Credit Corp., 88 Ga. App. 24, 75 S.E.2d 822 (1953).

The New York situation is presently confused; there has been a good deal of lower court activity, but no clear line has yet been authoritatively taken. It is now customary in the New York cases for defendant (frequently represented by the Legal Aid) to plead fraud; plaintiff then moves for summary judgment. There have been three cases in the Appellate Division: in Pres. and Directors of the Manhattan Co. v. Monogram Associates, 276 App. Div. 766, 92 N.Y.S.2d 579 (2d Dep't 1949), the court vacated a judgment entered on plaintiff's motion, stating that summary judgment could not be granted because a question of fact was raised by the defense of fraud; President and Directors of Manhattan Co. v. Wax, 276 App. Div. 766, 92 N.Y.S.2d 581 (2d Dep't 1949), was heard simultaneously with the Monogram case and decided in the same way; on the other hand in Pennsylvania Exchange Bank v. Kenmore Furniture Co., 279 App. Div. 899, 111 N.Y.S.2d 194 (1st Dep't 1952), an order granting plaintiff's motion for summary judgment was affirmed without opinion, Van Voorhis, J., dissenting on the ground that the case could not be rationally distinguished from the Monogram case. In the Supreme Court,
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It must be apparent that the writer is heartily in sympathy with this case law trend. "Policy" and "prejudice," taken as descriptive terms, are often functional equivalents. But the development of consumer finance does square with the underlying thesis here set forth. The privilege which commercial law confers upon the purchaser in good faith or his alter ego, the holder in due course, is, always and everywhere, a commercial privilege. It attaches to commercial property and to transactions between merchants. Consumer installment purchase is a commercial phenomenon of considerable magnitude. But from the consumer's point of view the transaction is not mercantile for the goods are no longer in commerce; they have come to rest and become mere possessions. The inequality of bargaining power and technological knowledge between consumer and dealer justifies the conclusion, towards which the cases are moving, that claims against the consumer will not, like ordinary commercial claims, be allowed to pass free of defenses.

The policy of consumer protection defines or ought to define its own limits. In large-scale commercial or industrial financing there is not the least reason why the financing institution should be subject to defenses and every reason why it should not. However, so long as governing law is the common law of assignment for contracts and the NII with its supporting case law for notes, there is danger that the distinction between "commercial" and "noncommercial" will not be observed and that a technique devised to accomplish one sound end will be carried over to a field where it could do a great deal of harm. The plaintiff's motion for summary judgment was denied in Titone v. General Electric Credit Corp., 201 Misc. 1041, 108 N.Y.S.2d 909 (Sup. Ct. 1951), and granted in Nat. City Bank v. La Porta, 109 N.Y.S.2d 143 (Sup. Ct. 1951). In the Municipal Court, the motion was denied in Pub. Nat. Bank & Trust Co. v. Fernandez, 121 N.Y.S.2d 721 (N.Y. Mun. Ct. 1952).

It is not, however, exclusively a case-law trend. See, e.g., the Pennsylvania Motor Vehicle Sales Finance Act, PA. STAT. ANN.: tit. 69, § 615G (Purdon, Cum. Supp. 1953) (forbidding the use of negotiable notes in connection with an installment sale contract) and the Maryland Retail Installment Sales Act, MD. CODE ANN.: Art. 83, § 134 (1951) (note taken as part of an installment transaction shall refer to the underlying transaction and be subject to defenses). See also the provision of the Illinois Chattel Mortgage Act referred to note 83 supra. UCC § 9-205(1) provides that "[a]n agreement by a buyer of consumer goods as part of the contract for sale that he will not assert against an assignee any claim or defense arising out of the sale is not enforceable by any person." The section goes on to make clear that "agreement" covers both the note and the cut-off clause, but its effectiveness is somewhat diluted by the fact that the noteholder appears not to be barred unless he seeks to enforce the security agreement or attaches or levies upon the particular goods in an action on the instrument. Of course, there is no reason why the recent case-law holding consumer financing agencies not to be holders in due course should not continue under Article 3 of the Code.

An example of what, in the writer's view, is an improper use of the technique is Commercial Credit Corp. v. Orange County Machine Works, 34 Cal.2d 769, 214 P.2d 819 (1950), where the property sold was a Ferracute press at a price of $5500 and the form on which the agreement was drawn up was headed "Industrial Conditional Sales Contract." On the other hand the reversal by the Court of Appeals of a judgment for defendant below in First Acceptance Corp. v. Kennedy, 194 F.2d 819 (8th Cir. 1952),
owner of a small grocery store or tavern buying refrigeration equipment is not substantially better able to protect himself than is the ordinary consumer, and might reasonably be afforded consumer protection. Beyond that limit the cases should not go, and on the whole it may be more difficult to draw a line between small and middle-sized business than between consumer and small businessman.

Trust Receipts and Consumer Paper

There is another, and quite different, way in which the question of good faith purchase arises in connection with consumer paper. Before the automobile or the refrigerator has been sold to a consumer, it has typically already been financed as dealer inventory. A finance company or bank has advanced up to 90 percent of the wholesale price, taking back a security interest in the chattel under a trust receipt executed by the dealer. This wholesale or dealer finance is carried out at low rates at little or no profit to the financing agency. But it should not be assumed that customarily tightfisted lenders are engaging in a large scale operation in which they will scarcely break even because of a charitable attitude toward dealers in durable consumer goods. There is a pot of gold at the end of the distribution rainbow: the consumer paper, on which the profits, even after they have been split between dealer and financer, are enormous.

Ordinarily the agency that takes care of a dealer's wholesale finance also buys his consumer paper when, as is usually the case, the dealer does not have sufficient capital to hold it himself. If a dealer does not regularly offer his consumer paper to his wholesale financer for purchase or discount, the dealer will shortly have to make other financing arrangements. Indeed, it might happen that the non-cooperating dealer would not long continue to be a dealer: the manufacturer, for one or another reason, might reluctantly find it necessary to revoke his highly revocable franchise. There are thus reasons of a high order which lead the dealer in most cases to see eye to eye with his financer. The wholesale financer understands, however, that some consumers do pay cash and will be content, occasionally, with nothing more than repayment of the wholesale loan. The dealer may receive from a competing or pirate financing agency an offer of a kickback on the consumer paper so attractive that he would have to be more than human, and many dealers are not, to close his ears. In any case it does happen that Finance Co. B sometimes shows up as owner, holder, and good faith purchaser of paper which Finance Co. A, the wholesale financer, also claims as its own—the dealer being now bankrupt and the true situation having come to light.

was entirely proper: involved in that case was the sale of air conditioning equipment at a price of over $8,000 to a large-scale grower of onions.

UCC § 9-206(2) validates the waiver of defenses by a buyer, by cut-off clause or by the execution of a negotiable note, in all cases outside the consumer field.

130. See Note, Protection of Borrowers in Distribution Finance, 60 Yale L.J. 1218, 1223 n.17 (1951).

131. It has always been a peculiarity of trust receipt law that the entruster's security interest shifts automatically from the original collateral to the proceeds arising from sale. This is codified in Uniform Trust Receipts Act § 10 (hereinafter cited as UTRA).
The legal situation under the Uniform Trust Receipts Act is far from simple. That Act provides for filing of the security interest of the lender-entruster; in wholesale finance that filing is regularly made. But the Act does not protect the filing entruster against all subsequent purchasers of the collateral or its proceeds. Despite the filing the "buyer in ordinary course of trade"—i.e., the consumer himself—takes free of the entruster's interest.\textsuperscript{132} Furthermore, Section 9(1)(a) of the Act provides:

"Nothing in this act shall limit the rights of purchasers in good faith and for value from the trustee [i.e., the borrower] of negotiable instruments or negotiable documents, and purchasers taking from the trustee for value, in good faith, and by transfer in the customary manner instruments in such form as are by common practice purchased and sold as if negotiable, shall hold such instruments free of the entruster's interest; and filing under this act shall not be deemed to constitute notice of the entruster's interest to purchasers in good faith and for value of such documents or instruments, other than transferees in bulk."

The term "instrument" carries a statutory definition much wider than might be expected: it covers not only negotiable instruments as defined in the NIL but also certificates of stock, bonds, and debentures, and finally "any interim, deposit or participation certificate or receipt, or other credit or investment instrument of a sort marketed in the ordinary course of business or finance, of which the trustee, after the trust receipt transaction appears by virtue of possession and the face of the instrument to be the owner.\textsuperscript{133}

The foregoing provisions of the Trust Receipts Act are less than crystal clear. Section 9(1)(a) is of extraordinary interest: it makes filing under the Act ineffective as notice against good faith purchasers of (a) negotiable instruments; (b) negotiable documents (i.e., bills of lading and warehouse receipts); and (c) instruments in such form as are "by common practice" purchased and sold "as if" negotiable, provided the instrument is taken "by transfer, in the customary manner"—presumably by indorsement and delivery. The Act contemplates that there can be types of instruments in addition to those strictly negotiable which will pass free of the entruster's security interest in the case of good faith purchase. The statutory insistence on the "manner" of transfer (assuming that to mean by indorsement and delivery) suggests that an instrument which by practice is so transferred is an instrument, which is being treated "as if" it were negotiable.

Does the "as if" negotiable category include a conditional sale contract taken by a dealer on sale of a car subject to a trust receipt? A "customary" manner of transferring such paper is by indorsement and delivery, so that, if the interpretation suggested in the preceding paragraph is sound, the answer is Yes. On the other hand, the statutory definition of "instrument," fairly read, fits long term investment paper better than short-term consumer paper, and

\textsuperscript{132} UTRA § 9(2)(a).
\textsuperscript{133} UTRA § 1.
may have been designed to make clear that bonds, interim certificates and the like which might not in a given jurisdiction be technically negotiable, would, as the subject matter of a trust receipt transaction, pass free of the entruster's interest. Nevertheless, it is possible to fit the conditional sale contract under the instrument definition as a "credit . . . instrument of a sort marketed in the ordinary course of business or finance of which the trustee, after the trust receipt transaction, appears by virtue of possession and the face of the instrument to be the owner." A reasonably prudent lawyer, if such there be, might not be too far off if he concluded that the arguments are almost evenly balanced.

Although the Trust Receipts Act has been in force in many commercially-important jurisdictions for nearly twenty years and although a vast volume of financing is carried out under it, there has been almost no authoritative judicial construction of its obscure terminology. It is interesting that the question of the relative rights of the entruster and a good faith purchaser of a conditional sale contract resulting from the sale of the entrusted collateral has already been several times before the courts. These cases have come up during the period when, in the consumer defense cases, the clear trend has been to deny the cutting off of defenses. "Defenses" and "equities" have traditionally been treated alike. It might be reasonable to expect that the courts, which have been industriously denying that conditional sale contracts were negotiable or could be made so by contractual stipulation where defenses were involved, would do the same thing for equities of ownership. Some courts have done exactly that. On the whole, however, the results to date

134. The absence of litigation is explained by two factors: 1) since the late 1930's when the Act went into effect in most jurisdictions, business has been generally good; 2) after 1943 there was reason to believe that all trust receipts were vulnerable to attack as voidable preferences under § 60 of the Bankruptcy Act as construed in Corn Exchange Nat. Bank & Trust Co. v. Klauder, 318 U.S. 434 (1943), and consequently those engaged in trust receipt financing deliberately refrained from litigation until § 60 was amended in 1950 in their favor. Since the amendment to § 60 the log-jam seems to have broken; there have been almost as many trust receipt cases during the past two or three years as there had been in the previous fifteen.


136. The lower court so held in General Motors Acceptance Corp. v. Associates Discount Corp., 38 N.Y.S.2d 972, 978 (Mun. Ct. 1942), although on another theory the court protected the purchaser; on appeal the case was reversed on other grounds, 267 App. Div. 1032, 48 N.Y.S.2d 242 (4th Dep't 1944). Two other recent cases involving
have been inconclusive. In the trust receipt cases, there has been no square holding that the resulting conditional sale contracts pass free of equities under the “as if negotiable” language of the Act. On the other hand the purchaser of the contract has been protected against the wholesale financer quite as often as he has lost to him.\(^{137}\) On the cases alone, it would take a more than eagle-eyed observer to declare a trend. The courts are hesitating here, as they are not in the consumer cases, inarticulately feeling, it may be, that the reason which leads them to preserve the consumer defense does not justify the same result in the equity cases.

Article 9 of the Uniform Commercial Code resolves the presently confused state of the law squarely in favor of the negotiability of such “chattel paper.”\(^{138}\) Under Article 9, as under the Trust Receipts Act, a lender who finances a dealer’s inventory has a continuing security interest in the chattel paper or “proceeds” which result from sale of the original collateral. Section 9-306(4) provides that, where a secured party has a claim to chattel paper as proceeds

\[\ldots\text{nothing in this section prevents a transfer thereof for new value in the ordinary course of business, and the security interest or any other right of any such transferee shall have priority over the security interest based on a claim to proceeds.}\ldots\]

The quoted provision goes much further than the Trust Receipts Act, even if chattel paper is assumed to fall under the “as if negotiable” category in the earlier Act. The Trust Receipts Act provided that purchasers “in good faith” should take free of the entruster’s interest and that filing under the Act should not constitute “notice.” The references to “good faith” and “notice” make it clear that a purchaser with actual knowledge of the entruster’s security interest would not be protected. Under the Code the criteria for protection are “new value” and purchase “in the ordinary course of business.” Thus where the chattel paper is proceeds of inventory originally subject to a security interest, even a purchaser who knew of the claim to the paper as proceeds would be protected, provided he gave new value in the ordinary course of business.

The Code also recognizes the “negotiability” of chattel paper where a secured party\(^{139}\) has not merely a claim to it as proceeds but has taken a specific assignment of the paper. One widely practiced form of financing is

\(^{137}\) In the cases cited note 135 supra the entruster won in the Conner case, and the North American Acceptance Corp. case; the purchaser won in the Amsterdam Bank case, the Associates Discount case (in the trial court, reversed on appeal on other grounds), and the Bowman case. In the Petersburg Bank case, the entruster won on some of the contracts involved and lost on others.

\(^{138}\) The term is defined in UCC § 9-105.

\(^{139}\) “Secured party” means a lender, seller or other person in whose favor there is a security interest. . . .” UCC § 9-105.
for the paper, after assignment, to be left in the dealer's possession for him to continue making collections from the buyer, who is not notified that there has been an assignment. This is known as "non-notification" financing, or "indirect collection," in contrast to the practice usually followed, for example, in automobile financing where the paper is physically transferred to the assignee who notifies the obligor of the assignment and proceeds to make collections "directly" from him. The indirect collection method is widely used in the household appliance field—even though, in the present state of the law, counsel would have to be very brave or very foolish to give an unqualified opinion on the rights of the assignee who leaves such paper in the assignor's possession for collection. Since the practice itself is of relatively recent origin, there is no case law that is helpful as authority or precedent. It is entirely possible that, as to the hundreds of millions of dollars of paper handled each year on an "indirect collection" method, the assignees have no security interest that would be effective either against the assignor's trustee in bankruptcy or against subsequent purchasers of the paper from the assignor.

The Code recognizes the "indirect collection" practice and permits the assignee who is not in possession to file a statement which will protect him against the dealer's trustee in bankruptcy.\textsuperscript{140} Despite the filing a purchaser for new value and in the ordinary course of business who takes possession of the paper and who does not have "actual knowledge" of the prior interest takes free of the earlier assignee's equity.

A summary will point up the moral. Before the NIL, some jurisdictions had denied negotiability to "chattel notes." A provision of the NIL, apparently intended to overrule such holdings, did not immediately have that effect. The consumer finance industry, which had turned to the conditional sale as its chosen security device, sought to achieve the substance of negotiability by waiver of defense clauses. In time such clauses came to be recognized as valid "in the absence of fraud"; the negotiability of the conditional sales note also came to be generally admitted. A reverse trend has manifested itself during the past fifteen or twenty years. By case law and under regulatory statutes, the consumer's defenses against a financing assignee are now being preserved, despite the use of notes admitted to be fully negotiable and in jurisdictions recognizing the validity of waiver of defense clauses. But where equities of ownership in consumer paper are involved—as on transfer from dealer to successive assignees—there is a contrasting movement towards a state of limited negotiability.

The story is one of complex, shifting cross-currents. Stability in any field of commercial law depends on a stable business practice. In earlier parts of this discussion we traced the smooth and uncomplicated growth toward negotiability of various types of commercial paper in areas where practice, once fixed, has not thereafter varied. Here the business background has been in a continuing state of dynamic flux. From nothing, in less than fifty years, has grown an enterprise which accounts for an annual business of billions of dollars.
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The legal zig-zags which have accompanied the growth show the law, not at its worst, but at its best in adapting to novel problems despite the necessity of maintaining the pretense of an unchanging continuity.

**Future Developments**

According to a well-worn epigram we learn nothing from history except that we learn nothing from history. If, however, such learning were possible, future developments might take place with less grinding of gears. The law will continue to make, regardless of precedents and statutes, the necessary accommodation to changing practice. There must be a time lag in adjusting to a new way of doing business; just as it took a few years or more for the law to recognize that an automobile (although it has four wheels) is not in all respects like a horse (which has four legs). But, admitting the time lag, the adjustment can be made with relative ease and at little cost; or it can be made roughly and at the cost of a great deal of litigation. The more readily we can accept, as a basic proposition, that the corpus of the law is a floating mass and not a solid body, the more easily will the necessary changes be made, and, paradoxically, the greater will be the real, as distinguished from the apparent, certainty.

The Commercial Code has been enacted in Pennsylvania and is presently under legislative consideration in many other states. Over the next ten years it may well supersede our present commercial statutes in enough important jurisdictions to insure its general adoption. Assuming that outcome, which is not unlikely, we are again in the situation which confronted the legal profession fifty years ago at the time of the first general codification. Our review of that experience may be helpful in determining a state of mind which will make it easier to avoid the same types of mistakes a second time.

Common law extensions of the good faith purchase idea were accomplished with extraordinary ease. When the statutes came, they were successful with respect to those types of property which had reached a mature stage of development. The documentary Acts, the Stock Transfer Act and the NIL, with respect to mercantile bills and checks and even the expanding collateral pledge note, served a useful function well. Trouble came when the NIL was sought to be used as a strait-jacket to confine young members of the family who refused to conform to accepted ideas of proper behavior. The attempt to confine left behind it, as its most undesirable consequence, the idea that under a codified law there can be no further growth.

It is devoutly to be hoped that the negotiability by contract controversy will not be repeated under the Code. Under the NIL the formal basis for the argument that there could be no "negotiability" outside the statute was the all-inclusive coverage suggested by the preamble and the mandatory language of the first sentence of Section 1. On both counts the Code makes the argument more difficult to support. Article 3 of the Code, designed to replace the NIL, is entitled "Commercial Paper," which seems considerably
to narrow the field. The statement of formal requisites contained in Section 3-104 provides that:

"Any writing to be a negotiable instrument within this Article must . . . ."

This repeats the language of NIL Section 1 with the significant addition of the phrase "within this Article." The clear implication is that there may be instruments having some or all of the attributes of negotiability—the term is not defined in the Code any more than it was in the NIL—outside the Article.

Within its own limits Article 3 is a tight statute. Section 3-104 provides in part that a writing to be a negotiable instrument "within this Article" must "contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this Article." The statutory text is reinforced by a comment which states that "a writing cannot be made a negotiable instrument within this Article by contract or conduct,"141 although common law principles of estoppel may justify a finding that a defense is cut off in a particular case. Furthermore, NIL Section 10, which provided that an instrument need not follow the language of the Act if it "clearly indicates an intention to conform," has been deleted from the Code, with the comment that "the provision has served no useful purpose and . . . has been an encouragement to bad drafting and to liberality in holding questionable paper to be negotiable."142

Since Article 3 is a statute of limited coverage and governs only types of paper which have reached a tranquil old age in which further growth appears to be impossible, the "tightness" of the approach seems reasonable. Care must be taken, however, that the strict approach is confined to the limits of Article 3. As to emerging types of paper, it is to be hoped that the freewheeling approach of the nineteenth century courts will, under the stimulus of such open-ended definitions as those of "security"143 and "chattel paper,"144 replace the cramped and technical attitude into which too many of the early NIL courts fell.145

Letters of Credit

Signs of change are already manifest in some areas of commercial financing. One such area is the commercial letter of credit. Simply stated, a letter of

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141. UCC § 3-104, Comment 2.
142. UCC § 3-104, Comment 5.
143. UCC § 8-102.
144. UCC § 9-105.
145. The writer must respectfully disagree on this point with Professor Britton, who concludes that the "within this Article" language of UCC § 3-104 "invite[s] courts to confer upon various nonconforming writings, some of many attributes of negotiability, is thoroughly unsound . . . [and] should be struck from the Code." Britton, Formal Requisites of Negotiability—The Negotiable Instruments Law Compared with the Proposed Commercial Code, 26 Rocky Mt. L. Rev. 1, 32 (1953).
credit is a promise given by a financing agency, on behalf of a buyer of goods, to the seller providing that the financing agency will pay the purchase price by honoring drafts drawn on it when accompanied by specified shipping documents. There are great advantages to both seller and buyer in letter of credit financing. The seller receives a bank's promise to pay and therefore need not rely on, or investigate, a distant buyer's credit standing; the bank has done that before issuing the credit. He is assured of getting his money as soon as he has assembled the required documents evidencing the shipment. The bank will not be excused from honor of the drafts by allegation—or proof—that the goods shipped are nonconforming; thus litigation on breach of warranty will be localized in the seller's forum and a fraudulently inclined buyer will not be able to whipsaw a seller into letting goods go at half their price on false allegations of defective quality. The buyer who can establish a letter of credit in his seller's favor needs no further proof of his own credit standing; and since the issuing bank, on honoring the seller's drafts, automatically gets a security interest in the goods through possession of the bill of lading, the transaction is, in the absence of fraud or sudden market breaks, self-liquidating.

From a seller's point of view, a letter of credit would be even more valuable than it is if he could use it in financing his own procurement of the goods or raw materials with which he will perform his contract of sale. That could be done if, as beneficiary of the letter, he could make an effective assignment of proceeds in the same way that a contractor assigns moneys to become due under a construction or production contract. Since the idea of free assignability is the lifeblood of the banking business, one might expect to find the bankers in a receptive, even a cooperative attitude. The expectation would be disappointed. It is the nearly unanimous opinion of banking groups that

146. The leading case is Maurice O'Meara Co. v. Nat. Park Bank of N.Y., 239 N.Y. 389, 146 N.E. 636 (1925) (bank required to honor drafts, in the hands of a holder not in due course, even though goods nonconforming). Cf., however, Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941) (where "cowhair, other worthless material and rubbish" were shipped instead of bristles, and drafts were not in hands of holder in due course, buyer's action to restrain issuing bank from honoring drafts will not be dismissed). The distinction between O'Meara and Sztejn is the "distinction between a breach of warranty and active fraud on the part of the seller." Id. at 722, 31 N.Y.S.2d at 635. UCC § 5-111 codifies both the O'Meara rule and the Sztejn limitation on it.

147. Of course, if the seller fails to assemble a proper set of shipping documents (and a rule of perfect tender is strictly enforced) the bank, acting presumably in accordance with the wishes of its customer the buyer, is entitled to reject. For an interesting case in which the seller shipped conforming goods but failed to get the documents right and consequently had to dispose of the goods to the original buyer at a heavy loss, see Bank of Nova Scotia v. San Miguel, 196 F.2d 950 (1st Cir. 1952).

148. The point should be made that the banks have worked out procedures under which the seller-beneficiary can get "secondary financing," as it is called, by paying a second bank fee and having a second credit issued "back to back" with the first (the same shipping documents being required under both credits). Kingdom of Sweden v. New York Trust Co., 197 Misc. 431, 96 N.Y.S.2d 779 (Sup. Ct. 1949), contains an excellent
no assignment of proceeds of a letter of credit in favor of a third person should be valid against a bank without the bank's consent.\footnote{149} The distinction between an assignment \textit{to} a bank (\textit{e.g.}, of money to become due under a production contract) and an assignment \textit{against} a bank (\textit{e.g.}, of money to become due under a letter of credit) is easier for a banker than for a merchant to understand.

If we speak loosely of the "assignment of a credit" any one of several types of transfer may be meant:

1. The assignment of the right to draw under the credit: after such assignment, the bank would be required to honor drafts drawn by and documents presented by the assignee of the original beneficiary (seller) of the letter.

2. The assignment of the proceeds of the letter: the drafts would still have to be drawn and the documents presented by the original beneficiary, but, after having received notice of the assignment, the bank would be required to pay the assignee.

3. The negotiation of drafts drawn under the letter to one claiming as a holder in due course with the right to stand free of defenses which might be available to the bank (or its customer the buyer) against the seller-beneficiary.

Banking opinion is that neither an assignment of the right to draw under a letter nor an assignment of the proceeds of a letter is effective without the issuing bank's consent and that only other banks (known as negotiating banks) can ever qualify as holders in due course of drafts—and then only under certain types of credits. It is suggested that the bankers are correct as to the right to draw (although the power to give or withhold consent should be in the bank's customer and not in the bank),\footnote{150} wrong on policy (at least as to assignments made within the United States) as to the assignment and detailed description of the mechanics of the back-to-back credit. On this and other bank-approved methods of secondary financing, see \textit{Ward and Harfield, Bank Credits and Acceptances} c. 9 (3rd ed. 1948) and Harfield, \textit{Secondary Uses of Commercial Credits}, 44 \textit{Col. L. Rev.} 899 (1944).

149. Statements about group opinion made without (or even with) a scientific study of the group are of course hazardous. As a member of the drafting staff for the UCC, the writer participated in numerous conferences in which banking representatives set forth their opinions on the various drafts of Article 5 of the Code (Documentary Letters of Credit). The statement in the text is based in part on his experience at those conferences. Current American banking opinion, the writer believes, is faithfully reflected in the assignment provisions of the \textit{Uniform Customs and Practice for Commercial Documentary Credits} (Brochure No. 151, Int'l Chamber of Commerce 1951) and those of the final draft of UCC Art. 5, both discussed \textit{infra}. The leading American text on letters of credit, \textit{Ward & Harfield, op. cit. supra} note 148, written by eminent bank counsel, takes a position on assignment questions somewhat at variance with what this writer believes to be majority banking opinion. Their position in some respects is not far removed from that adopted in the following discussion. See generally \textit{Ward & Harfield, op. cit. supra}, c. 9 for an excellent presentation of assignment problems.

of proceeds,\textsuperscript{151} and wrong on the law as to negotiation of drafts to holders other than banks.\textsuperscript{152}

The banker's case rests principally on custom, since there is, to date, almost no "law" available. The authoritative statement of banking custom is the \textit{Uniform Customs and Practice for Commercial Documentary Credits}.\textsuperscript{153} As revised in 1951 these Customs have been adhered to by American banks and by the banks in most European countries, except England; they are incorporated by reference in most foreign credits issued by American banks. Before the 1951 revision the Customs contained a fairly simple provision on transfer.\textsuperscript{154} The revision, which the American banks were instrumental in effecting, came up with a more complicated formulation, which gives the issuing bank a much tighter control over the transfer of its credits in several respects.\textsuperscript{155}

\textsuperscript{151} The statement in the text is apparently supported by \textit{Ward & Harfield}, \textit{op. cit. supra} note 148, at 139. Under the heading "Assignment of proceeds" the authors write: "From the bank's point of view there should be no objection to such an assignment. If the assignee properly notifies the bank of the assignment, the bank is required to recognize it and to pay according to the tenor of the assignment whatever would otherwise have been payable to the original beneficiary."

\textsuperscript{152} This statement also is supported by \textit{Ward & Harfield}, \textit{op. cit. supra} note 148, at 137. Under the heading "Drafts drawn to Lender or Supplier—Agency" the authors state a hypothetical case in which the beneficiary of a credit draws drafts to his own order and negotiates them to his supplier, and then comment: "If the credit is a negotiation credit with an undertaking running to holders and endorsers, and if those drafts are presented to the bank accompanied by proper documents, the bank may not only pay them in safety, but is under a duty to do so." The term "negotiation credit" is explained in text at note 158 \textit{infra}.

\textsuperscript{153} See note 149 \textit{infra}.

\textsuperscript{154} The earlier text of the Customs is found in \textit{Brochure No. 82 of the International Chamber of Commerce} (1933). Article 49 on Transfer reads as follows:

"A credit can only be transferred on the express authority of the principal. In this case the credit can be transferred once only, and on the terms and conditions specified in the original credit, with the exception of the amount of the credit and of the time of validity, which both may be reduced."

"If a Commercial Documentary Credit is transferred by fractions, such fractional transfers shall be considered as constituting one single transfer only."

"Authority to transfer a credit covers authority to transfer it to another place. Bank charges entailed by such transfers are payable by the original beneficiary unless otherwise specified. During the validity of the original credit, payment may be made at the place to which the credit has been transferred."

\textsuperscript{155} In the 1951 revision Article 49 on Transfer reads as follows:

"A transferable or assignable credit is a credit in which the paying or negotiating Bank is entitled to pay in whole or in part to a third party or parties on instructions given by the first beneficiary."

"A credit can be transferred only on the express authority of the opening Bank and provided that it is expressly designated as 'transferable' or 'assignable.' In such case the credit can be transferred once only (that is to say that the third party or parties designated by the first beneficiary are
1933 formulation it was the "principal" on whose authority the transfer could be made: the term was not defined but presumably referred to the bank's customer, the buyer. In the revision this authority is lodged in the "opening Bank," which, so far as the language goes, can now authorize transfer without the consent, and even against the will, of its customer. Furthermore, no transfer, even so authorized, is to be binding upon the "bank which is to act thereunder" except as "such Bank" expressly consents and until its charges are paid. The shift in terminology from "opening Bank" to "Bank which is to act thereunder" suggests that even when the opening bank has authorized transfer, another bank which has confirmed the credit need not recognize the transfer until it has consented and been paid a fee. Finally, only a credit expressly designated as "transferable" or "assignable" can be transferred at all.

not entitled to retransfer it), and on the terms and conditions specified in the original credit, with the exception of the amount of the credit, of any unit price stated therein, and of the time of validity or of shipping, any or all of which may be reduced or curtailed. In the event of any reduction in amount or unit price, a transferer may be permitted to substitute his own invoices for those of the transferee, for amounts or unit prices greater than those set forth in the transferee's invoices, but not in excess of the original sum stipulated in the credit, and upon such substitution of invoices, the transferer may draw under the credit for the difference between his invoices and the transferee's invoices.

"Fractions of a transferable or assignable credit (not exceeding in the aggregate the amount of the entire credit) may be transferred separately provided partial shipments are not excluded, and the aggregate of such transfers will be considered as constituting only one transfer of the entire credit.

"Authority to transfer a credit includes authority to transfer it to a beneficiary in another place whether in the same country or not, unless otherwise specified. During the validity of the credit as transferred, payment or negotiation may be made at the place to which the credit has been transferred. "Bank charges entailed by transfers are payable by the first beneficiary unless otherwise specified.

"No transfer shall be binding upon the Bank which is to act thereunder except to the extent and in the manner expressly consented to by such Bank, and until such Bank's charges for transfer are paid."

156. A bank which "confirms" a credit issued by another bank is in effect issuing its own credit on which it is primarily liable (subject of course to reimbursement by the issuer). A bank which merely "advises" the beneficiary of the opening of a credit in his favor without "confirming" it does not become liable. See WARD AND HARFIELD, op. cit. supra note 148, at 23-5; UCC § 5-103(1) (e) and (f). See the form of confirmation used in Dixon, Irmaos & Cia. v. Chase Nat. Bank, 144 F.2d 759, 761 n.1 (2d Cir. 1944): "[W]e confirm the credit and thereby undertake that all drafts drawn and presented as above specified will be duly honored by us."

157. In Bank of Nova Scotia v. San Miguel, 196 F.2d 950, 955 n.1 (1st Cir. 1952) the letter of credit issued by the Chase National Bank provided: "Should this credit be assigned by you to . . . another party all drafts presented to us must be accompanied by your letter of assignment, and our commission charge of ½ of 1% is to be paid by you at the time of such actual assignment." This was presumably a "transferable" or "assignable" credit.
Bankers distinguish between "straight" credits and "negotiation" credits. In the straight credit the bank's obligation is expressed in a clause like the following: "We hereby engage with you [the seller-beneficiary] that all drafts drawn under and in compliance with the terms of this credit will be honored..." In a negotiation credit the bank's obligation is stated to run, not to "you," but to "the drawers, endorsers and bona fide holders of drafts drawn and negotiated in compliance with the terms of this credit..." Presumably neither a straight credit nor a negotiation credit would qualify as a credit "expressly designated as 'transferable' or 'assignable'"—although either could be made so by the addition of appropriate language.

The Transfer Article of the Customs does not clearly differentiate between the assignment of the right to draw under the credit and the assignment of proceeds or the negotiation of drafts. The reference to the transferor's right, after transfer, to "draw under the credit for the difference between his invoices and the transferee's invoices" suggests that an assignment of the right to draw was meant and the Article could reasonably be construed as applying only to that type of assignment. It is believed to be the general banking understanding, however, that the Article applies to assignments of proceeds as well.159

158. See the forms set out in WARD & HARFIELD, op. cit. supra note 148, at 167 et seq.
159. This understanding is borne out by Ericksson v. Refiners Export Co., 264 App. Div. 525, 35 N.Y.S.2d 829 (1st Dep't 1942), which has, in the absence of competition, become a leading case. A statement of the facts of the Ericksson case will illustrate the type of problem here under discussion. The New York Trust Co., acting for its customer the Swedish Marine Board, issued a special (i.e., straight) letter of credit to Refiners Export Co. covering the sale of gasoline by refiners to Sweden at a price of about $240,000. Refiners purchased the gasoline from Cities Service Oil Co. The bank, under instructions from the Marine Board, refused to amend the credit so that it could be assigned to Cities Service. Refiners nevertheless "assigned the letter of credit" to Cities Service and then notified the Trust Co. that "the letter... and its proceeds" had been assigned. Refiners drew a draft under the credit which it endorsed to the order of Cities Service. Cities Service notified the Trust Co. to credit its account with the proceeds of the draft on performance of the letter by Refiners. After all these events, the draft and shipping documents were presented to the Trust Co. (apparently by Refiners). Meanwhile the Marine Board had brought an action in New York against Refiners for alleged breach of another contract involving the sale of toluol. (The facts on which the breach of contract suit were predicated are set out in Kingdom of Sweden v. N. Y. Trust Co., 197 Misc. 431, 95 N.Y.S.2d 779 (Sup. Ct. 1949).) After presentment of the draft and documents to the bank, but before payment, the sheriff levied on the proceeds of the gasoline credit in aid of the action on the toluol credit. The gasoline credit incorporated the Uniform Customs (1933) by reference. Held, that the attempted assignment to Cities Service was ineffective, the funds remained the property of Refiners and were properly subject to a non-resident attachment in the action by the Marine Board against Refiners. Although the opinion refers to an assignment "of the credit," it will be noted that the draft was drawn and presented by Refiners, the original beneficiary, and apparently an assignment of proceeds only was involved. The court gave weight to the provisions of Article 49 of the Customs, as that Article read before the 1951 revision. With respect to the value of Ericksson as a precedent, it should be remembered that Article 49 in the 1933 version did not contain the language about the "transferer's invoices" which, as suggested in the text, supports the construction that the Article as revised applies only to assignments of the right to draw under a credit and not to assignments of proceeds.
If the negotiation clause in credits is to have any meaning at all, the Article can hardly apply directly to negotiation of drafts under such credits.\textsuperscript{160} Article 5 of the Uniform Commercial Code on Documentary Letters of Credit improves somewhat on the Customs in distinguishing between assignment of the right to draw and assignment of proceeds.\textsuperscript{161} As to the first the Code repeats the provisions of the Customs: such a transfer can be made “only on the express authority of the issuer and provided that the credit is expressly designated as transferable or assignable.”\textsuperscript{162} As to assignment of proceeds the Code provides:

“The proceeds of a credit may be assigned and the issuer or any paying, confirming or accepting bank may give effect to the assignment, but unless otherwise agreed, the issuer or any negotiating, paying, confirming or accepting bank may notwithstanding filing or notice of any assignment honor or negotiate a draft drawn by the beneficiary.”\textsuperscript{163}

Earlier drafts of the Code had contained provisions going a good deal further in the direction of free assignability of proceeds.\textsuperscript{164} To these provisions counsel for some of the New York banks—whose influence in the field is preponderant—violently objected. The original draft was progressively watered down until the final draft emerged, which gives with one hand and takes back with the other. The proceeds “may be assigned” \textit{and} the bank “may give effect to the assignment” (is this saying the same thing twice over, or two different things?) \textbf{but} the bank may disregard the assignment despite notice “unless otherwise agreed” (with whom? when? how?). If the Code is widely enacted and Section 5-115(2) stands in its present form, effective assignment of the proceeds of a letter may be blocked.

There remains the possibility of assignment of proceeds by negotiation of drafts drawn under a letter. On this point the banker’s position is that there can be no holder in due course of a draft drawn under a straight credit\textsuperscript{165} and that only a negotiating bank (and not, for example, a merchant who has supplied goods to the beneficiary) can be a holder in due course of a draft drawn under a negotiation credit. As to the straight credit, the conclusion rests on the idea that anyone taking a draft in reliance on such a credit is on notice of its terms, that the credit runs only to seller-beneficiary, and that by banking custom there can be no holder in due course. The argument may seem circular, but circularity is not unknown in the law. As to the negotiation

\textsuperscript{160} Since in the negotiation credit the bank agrees with “drawers, endorsers and bona fide holders” that drafts properly drawn will be honored, any suggestion that the bank’s consent must be obtained before a negotiation of the draft will be effective would make the negotiation clause meaningless.

\textsuperscript{161} UCC § 5-115.

\textsuperscript{162} UCC § 5-115(1).

\textsuperscript{163} UCC § 5-115(2).

\textsuperscript{164} See the 1950 and 1949 drafts of UCC.

\textsuperscript{165} This was the holding in Erickson v. Refiners Export Co., 264 App. Div. 525, 35 N.Y.S.2d 829 (1st Dep’t 1942).
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credit, the argument is the same, doubled and redoubled: the promise to pay "drawers, endorsers and bona fide holders" includes, by banking custom, only negotiating banks which are bona fide holders. Since there is no case law on the point, it cannot be said that the opinion of bank counsel is manifestly wrong. 166

It may be asked why the bankers have set their faces so stubbornly against the principle of free assignability which, elsewhere in their business, they find so attractive. The letter of credit, in its modern form, until quite recently has been used exclusively in financing international shipments. With respect to letters issued to finance imports into the United States, it is easy to sympathize with the banker's reluctance to be put in a position where he must at his risk pass upon the validity of an assignment under the law of Egypt or Indonesia. It is also unquestionably true that the incidence of fraud on the part of sellers shipping from remote parts of the world is higher than in domestic transactions, so that the preservation of defenses has much to recommend it.

Such arguments lose much of their weight as to assignments made within the United States under credits issued to finance exports or domestic transactions. On accepted principles of contract law, it may be agreed that an assignment of the right to draw and to assemble documents (i.e., of the right to perform both the credit and the underlying contract of sale) should not be effective without the consent of the bank, acting in accord with instructions from its customer, the buyer. On the other hand, it is hard to see any sound policy to justify the position that assignments of proceeds alone, made in this country under laws familiar to the issuing bank, should not be effective, without the bank's consent, like the assignment of any other chose in action against any other obligor.

A relatively small group of large banks in such cities as New York, Boston, Philadelphia, and San Francisco has had a virtual monopoly on the issue of letters of credit—for the good reason that those are the banks known to sellers abroad, whose letters alone are acceptable. One result of this concentration of the letter of credit business has been that only a few jurisdictions have any modern letter of credit law at all, and only New York has had enough litigation to have anything like an adequate coverage of even the major points. One reason why the banks outside the major financial centers have hesitated to engage in letter of credit financing has been the blank uncertainty as to the state of the law in most American jurisdictions.

Just as twenty or thirty years ago the trust receipt was successfully adapted for use in financing domestic transactions, so, according to present indications,

166. But see the quotation from Ward & Harfield in note 153 supra.
167. There were some examples of letter of credit financing by American banks in domestic transactions as early as 1800 and recurrently through the 19th century. See the paper by Karl Llewellyn in Ward & Harfield, Bank Credits and Acceptances 63-72 (3rd ed. 1948). These early uses died natural deaths and seem to have no direct filiation with modern letter of credit practice.
is the international letter of credit about to undergo the same mutation. As with the trust receipt, the first type of domestic transaction in which the letter of credit is being used is the sale of automobiles from manufacturer to dealer. Naturally enough, the international banks which were already familiar with its use in the overseas transaction have taken the first conscious steps toward domesticating the letter of credit—“conscious” steps because it is likely that many “country banks” have been issuing documents in domestic financing which are technically letters of credit without calling them that and, of course, without any clear understanding of their rights and liabilities. In this connection the enactment of Article 5 of the Code may become of crucial importance, since it will provide in most American jurisdictions a body of letter of credit law which will be more comprehensive than the scattered case law of the few jurisdictions which now have any. Article 5 may prove to be of enormous help in stimulating the use of letters of credit in all types of domestic finance. The danger is that the Article was tailored to the specifications of the international transaction, and, as the trust receipt experience shows, there can be unexpected changes in practice when a familiar and apparently well-understood device is put to work in a new setting.

If we assume the successful adaptation of the letter of credit to the domestic scene, it is reasonable to expect that the pressure on banks to recognize the free assignability of proceeds as well as the unrestricted negotiability of drafts will increase. Both procedures enhance the usefulness of letters of credit to the mercantile community, both are in line with the development of our commercial law, and the objections of the banks to either lose much of their validity when translated from international to domestic trade. It is to be hoped that banking practice—which is frequently more reasonable than banking forms would suggest—will go along.

The Code’s treatment of the assignment of proceeds is unfortunate. It would have been far better to leave the problem uncodified and to await the development of case law or at least of practice within the domestic field. Indeed, if the letter of credit is about to undergo the same type of mutation

168. See the forms developed by the First National Bank of Boston reproduced in Bracher, Sutherland & Willcox, Commercial Transactions 204-207 (1953).

169. The adaptation of the trust receipt to domestic finance was made during the 1920’s. See In re James, Inc., 30 F.2d 555 (2d Cir. 1929). The Uniform Trust Receipts Act, drafted during the 1930’s, had nearly fifteen years of domestic experience to build on. The Act did a brilliant job of straddling two types of essentially unlike transactions which had both adopted the name “trust receipt”: the import trust receipt is typically a one-shot or non-recurrent transaction, while the domestic trust receipt is a continuing long-term relationship between entruster and trustee. Much of the Act’s obscurity is attributable to this necessary straddle. Article 5 of the UCC was drafted when the domestic use of the letter of credit, in its contemporary rebirth, was in its infancy and before practice had become fixed or generally understood. Under the circumstances it will be a remarkable, but unlikely, achievement if the Code draftsmen (the final draft was largely the work of New York bank counsel who were thoroughly familiar with, but only with, the international letter of credit) have correctly anticipated the changes in practice which will result from the new setting.
that the trust receipt went through, it would perhaps have been wiser to defer
the entire project of codifying letter of credit law. Since the banks have
shown no great enthusiasm for the Letter of Credit Article, it might be de-
leted from the Code as enacted. Or, if the Article is included, the section on
transfer and assignment could be dropped. In states which enact the Code and
include that section, we must hope for an enlightened judicial construc-
170. UCC § 1-201(3): "'Agreed' or 'Agreement' means the bargain in fact as found in
language of the parties or in course of dealing or usage of trade or course of
performance or by implication from other circumstances."
171. Dixon, Irmaos & Cia. v. Chase Nat. Bank, 144 F.2d 759 (2d Cir. 1944), cert.
denied, 324 U.S. 850 (1945). For a criticism of the Dixon case from a banking point of
view, see Backus and Harfield, Custom and Letters of Credit; The Dixon, Irmaos Case;
52 Col. L. Rev. 589 (1952); for a defense of the case, Honnold, Letters of Credit, Custom,
Missing Documents and the Dixon Case: A Reply to Backus and Harfield, 53 Col. L.
Rev. 504 (1953).
869 (1920). There are a few minority cases denying the bank's claim, e.g., Nat. Bank
of Commerce v. Morgan, 207 Ala. 65, 92 So. 10 (1921); see the trenchant criticism of
the Morgan case in Steffen, Cases on Commercial and Investment Paper 550-551
(1939).
counsel to explain why a purchaser of a draft which a bank has promised to honor should be treated differently from a purchaser of a draft which a mercantile buyer who is not a bank has promised to honor.

**Accounts Receivable Financing**

The predicted mutation in the use of the letter of credit is nothing more than a prediction. In another area of commercial financing—the taking of accounts receivable as collateral security—there has already been over the past ten or fifteen years a dramatic increase in volume of transactions. On theory alone we should expect to see signs that lenders against this relatively new type of commercial collateral are demanding their traditional good-faith-purchase position free of equities and defenses. Nor are the signs lacking.

Nothing less like a negotiable instrument can be imagined than an open account receivable. Here we have not even an "indispensable writing" susceptible of transfer "in the customary manner" which has hitherto underlain all developments toward negotiability. And even though we have long since abandoned the common law proposition that choses in action are non-assignable, the law still seems clear enough on the necessity of the assignee standing in the assignor's shoes and the right of the account debtor not only to assert his defenses but even to prohibit the assignment of claims against him.

It is black letter law that the obligor of a chose in action, an account debtor, has the power to prohibit assignment of the claim by an appropriate term in the underlying contract. The proposition is canonized in the *Restatement of Contracts* with no suggestion that the question is in any way doubtful. On the other hand, if we look to what the courts have been doing to "no assignment" clauses for the past thirty years a different story begins to unfold.

In case after case where a commercial debtor has sought to prohibit assignment, the courts have regularly managed to construe the heart out of the clause before them and, while reciting by dictum that a no assignment clause is good, hold that in this case no intent to forbid the assignment appears. The no assignment right is one of those peculiar legal rules which are honored almost exclusively in the breach.

A recent case deserves comment, if only because it finds the New York Court of Appeals uncharacteristically swimming against the current. In *Allhusen v. Caristo Construction Corp.* there had been an assignment to a bank (followed by a further assignment to plaintiff) of moneys due and to become due under a contract which contained the term: "The assignment . . . of any money due or to become due [hereunder] . . . without the written consent of the first party [the obligor] shall be void." The Court of Appeals unanimously upheld an order of the trial court dismissing the complaint on

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174. See the excellent discussion in 4 *Corbin, Contracts* §§ 872-3 (1951).
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defendant's motion made "on the sole ground" that the prohibitory clause was a complete defense to the action by the assignee. A dissent in the Appellate Division suggested that the "account receivable was assignable by nature, and could not be rendered otherwise without imposing an unlawful restraint upon the power of alienation of property." Counsel for the appellant put the same idea in different language, stating that "a prohibition against the assignment of money due under a private contract is per se invalid." It is not without interest that a judge in the intermediate court of appeal as well as counsel on appeal to the highest court were willing to support so novel a proposition. It is of greater interest that the Court of Appeals, in repelling these suggestions, was unable to cite a single New York precedent which had held that a no assignment clause was a defense to an action by an assignee. It was forced to fall back uncomfortably on the dicta in cases which had held the reverse, noting that none of the earlier cases had involved "a contractual provision against assignments framed in the language of the clause now before us." Furthermore nothing in the court's opinion betrays awareness that the conditions of accounts receivable financing had changed in any way since the late 19th or early 20th century, when the cases principally relied on had been decided. The case stands as a monument to the purest type of conceptuality, untainted by a breath of the workaday world.

The draftsmen of the Commercial Code took the plunge from which the Court of Appeals had shrunk in the Allhusen case. Under Section 9-318(4) "[a] term prohibiting assignment of an account or contract right is ineffective." The Code rule gives to commercial accounts the free assignability which is a basic element of negotiability. It has, for that reason, been widely applauded by

178. Id. at 447.
179. Id. at 450, 103 N.E.2d at 892.
180. It may be that the Allhusen case will be quietly buried and forgotten by means of the familiar judicial technique of restricting a case to its own peculiar facts. In Schnitzer v. Freuhauf Trailer Co., 128 N.Y.S.2d 242, 247-S (App. Div., 1st Dep't 1954), the vendee had mortgaged property to plaintiff in spite of a conditional sale contract which required the vendee to keep the property "free from liens and encumbrances." The court said: "Defendant, however, asserts the invalidity of plaintiff's assignment from the buyer on the grounds (1) that the conditional sales contract prohibits assignment. . . . Both grounds are devoid of merit. In the first place the conditional sales contract before us has no provision against assignment by the vendee, and such restriction will not be implied. See: Allhusen v. Caristo Const. Corp. . . . [A]n assignment in violation of a clause requiring vendor's consent constitutes at most a default entitling the seller to resort to available remedies as in the case of non-payment [citing N.Y. PERS. PROP. LAW § 73]."
181. The Comment to § 9-318(4) closely parallels the foregoing discussion in the text. While it would be attractive to shore up these suggestions by citation to such distinguished authority, a more likely explanation of the parallelism is that both discussions were written by the same person.
the same financial circles which have been stoutly maintaining the nonassignability of proceeds of, and the nonnegotiability of drafts drawn under, bank letters of credit.

On the problem of the assignee's freedom from contract defenses, the Code's draftsmen adopted an approach notably more conventional than the one suggested by Section 9-318(4). Outside the consumer field the Code broadly validates an agreement by an account debtor not to assert defenses against an assignee. In the absence of such an agreement the rights of the assignee are subject to "all the terms" of the underlying contract and all defenses and claims arising therefrom as well as to all claims and defenses arising from any source which accrue before notification of the assignment. The validation of the waiver of defense clause in a commercial setting is good as far as it goes and is a useful reminder that the restrictive holdings in the consumer field should not be allowed to slop over into the commercial field. A more radical solution, in harmony with Section 9-318(4), would have been to allow commercial accounts automatically to pass free of defenses in the same way that negotiable instruments do, without requiring the insertion of the cut-off clause. Since accounts receivable financing is clearly here to stay, we may anticipate that the next general codification will as a matter of course adopt the solution that now appears to be too "radical." In the meantime we may hope for a liberal construction of the Code's waiver of defense provisions and a comparable case-law development in non-Code states.

Accounts receivable financing has been immeasurably facilitated by statutes governing the assignment of accounts, which have been enacted by more than thirty states since 1943. Before the passage of these statutes a major roadblock in the way of a large scale development of receivables financing had been the unutterable confusion of the common law on the important question of the rights of successive assignees of the same accounts. At common law an assignee who failed to notify the debtor of the assignment stood to lose to later assignees in a variety of circumstances. Despite the chilly common law attitude, the finance companies who first began to experiment with commercial loans on the security of accounts during the 1930's found that the business advantages of nonnotification financing outweighed the imponderable legal risks which they assumed. Sooner or later the courts would have bowed to the necessity of protecting lenders engaged in legitimate and useful business operations. But by one of the delightful vagaries of the legal process, relief came much sooner than it might have been expected and from a totally unexpected quarter. In the celebrated Klauder case the Supreme Court had apparently made

182. UCC § 9-206(2).
183. UCC § 9-318(1).
184. Conwill & Ellis, Much Ado About Nothing: The Real Effect of Amended 60(a) on Accounts Receivable Financing, 64 HARV. L. REV. 62 (1950) collects the statutory citations.
185. See 4 CORBIN, CONTRACTS § 902 (1951).
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nonnotification financing of accounts receivable in most American jurisdictions vulnerable to attack as a voidable preference under Section 60 of the Bankruptcy Act as it then read. There was no need for those engaged in that type of financing to ask for whom the bell tolled. But, instead of meekly giving up the ghost, they resolutely stormed the state legislatures which, because federal bankruptcy law largely rests upon rights conferred by state law, held the keys of salvation. To get rid of Klauder, it was necessary to provide by statute that no assignee could be subordinated to any later assignee, regardless of notification to the debtor. The common law was abrogated root, stock and branch.

Many of the statutes were weirdly drafted and were whooped through the legislatures like a declaration of war. The early ones were mostly so-called "validation" statutes, protecting the assignee against all comers without any requirement of public notice. Later, good sense broke out, and the subsequent statutes impose a duty of filing as a condition of protection, although the filing provisions are by no means uniform and occasionally read as if they had been drafted at the local institution for the feeble minded. The one detail on which all the statutes are consistent is that no assignee who has achieved "protection" need worry about being displaced by a later laborer in the vineyard. Some of them go so far as to suggest that such an assignee, who has allowed the assignor to collect accounts and use the proceeds in carrying on his business, may follow the proceeds into the hands of a creditor who has received payment from the assignor in the ordinary course of business—a result hardly to be countenanced by anyone pretending to sanity.

The accounts receivable developments show that there can be something new under the sun. For the first time in the long history of the good faith purchase idea it is being applied to a species of intangible property where there is no "indispensable writing" which can be taken as a symbolic representation of the claim. The several important attributes of negotiability which have in the past flowed from the merging of the obligations into the paper are hardly conceivable in the accounts receivable context: there is no written evidence executed by the obligor which can be pointed to as being itself "the debt." And yet, despite the absence of anything resembling an "instrument," good faith purchase is once more running its normal course under the stimulus of the same commercial pressures which have so many times in the past led to the creation of negotiable instruments, quasi-negotiable instruments and just-a-little-bit-negotiable instruments.

The only legal certainty is the certainty of legal change. But if we keep our categories broad and flexible, we can, as lawyers, do a good deal to see that the change which will come in any case is helped into being, is integrated into the body of the law as part of an ordered pattern and not left to come

187. See, e.g., Conn. Gen. Stats. § 6721 (Rev. 1949); N.C. Gen. Stats §§ 44-80 (1950). It is not suggested that the statutes were meant to be construed should be construed or will be construed in the manner indicated in the text. But the statutory language overshot its mark by the distance of a light year.
lurching and banging destructively into the vulnerable framework of a too rigidly conceived structure of doctrine, principles and rules. In a recent paper on jurisprudence Professor Fuller of Harvard has neatly expressed what can be done. Writing of the conflict between the skeptic who sees only formless, chaotic and unpatterned change in the law and the traditionalist who sees only absolutes, Professor Fuller suggests by analogy a middle ground:

“A book on gardening contains the following sentence: ‘In pruning the fundamental rule is to respect the natural growing habits of the plant being pruned.’ If our skeptic is consistent he will reject this statement as being utterly absurd. He will say that if you truly respect the growing habits of a plant you will not prune it at all. Pruning is an interference with nature; it cannot therefore be guided by nature. I doubt that our skeptic would in fact take this view. I think he would keep his epistemology out of the garden. He would hold his ‘logic’ on a sufficiently short leash so that he could absorb whatever wisdom is contained in the innocent sentence quoted. If he were a serious gardener he would set about observing trees under various growing conditions so that he would learn how to help a tree be what it is.”

188. Fuller, American Legal Philosophy at Mid-Century, 6 J. LEG. Ed. 457, 472-3 (1954).