Marquette Law Review

Volume 78
Issue 4 *Summer 1995*

Article 4

A Spectrum Theory of Negotiability

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A SPECTRUM THEORY OF NEGOTIABILITY

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> The first law course I had a chance to teach was Bills and Notes. Yale was very gentle with the unbroken colt: Bills and Notes three times a week at 8 A.M.—and nothing else. And I had John Edgerton's copy of Smith & Moore's Cases: "'My face is my fortune, Sir,' it said," was his observation on *Miller v. Race*. "Notes make music, once you learn to play." That was inside the cover. . . . "Why 'Equities'? It is the bfp who has the equities." There was time and occasion to fall really in love with the subject, and I have never fallen out.
>
> Karl Llewellyn[1]

Negotiable instruments scholarship rests on four interconnected and largely untested propositions. Llewellyn, with an instinct for the jugular, touches on three of them in his brief reminiscence. The other premise has evolved in a handful of theoretical commercial paper articles published over the past twenty-five years, and all four assumptions underlie virtually the entire contemporary discourse on negotiable instruments.

"My face is my fortune." Negotiable instruments are seen to inhabit a separate and exclusive enclave where basic principles of contract and property law do not apply. Entrance to this domain is entirely a matter of form. Documents satisfying the requirements of Article 3 of the Uniform Commercial Code[2] gain admission. Documents failing the formal tests are deemed "simple" contracts and relegated to rules of contract assignment and property transfer that reduce their value to purchasers. A corollary of the separate enclave premise is that negotiable instrument principles are viewed as having limited applicability outside Article 3.

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1. Karl N. Llewellyn, *Meet Negotiable Instruments*, 44 COLUM. L. REV. 299, 299 (1944).

2. American Law Institute & National Conference of Commissioners on Uniform State Laws, Uniform Commercial Code: 1990 Official Text with Comments [hereinafter U.C.C.]. The negotiability requirements are spelled out in U.C.C. §§ 3-104, 3-106, 3-108, 3-109, 3-112, 3-113.

"Notes make music, once you learn to play." Negotiable instruments statutes have invariably preferred rigid rules over flexible standards.[3] For the past one hundred years American negotiable instruments law has been embodied in two successive rules-based uniform statutes; the now antiquated Uniform Negotiable Instruments Law and Article 3 of the Uniform Commercial Code.[4] Pursuing Llewellyn's music analogy, the drafters of Article 3 deployed an intricate twelve-tone scale, and "learning to play" can be a daunting task.[5] Moreover, the structure of Article 3 contributes to rigid either/or thinking about negotiable instruments. In Article 3 an instrument is either negotiable or it is not. Negotiable instruments are either promises or orders,[6] payable on demand or at a definite time,[7] and payable to order or bearer.[8] A holder of a negotiable instrument is either a holder in due course or she is not.[9] Disputes involve either defenses[10] or claims[11] or both.[12] Disappointed purchasers

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3. For a discussion of the rules/standards dichotomy, *see* Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1685-701, 1710-13 (1976).

4. The Uniform Negotiable Instruments Law was the first uniform act produced by the National Conference of Commissioners on Uniform State Laws. The N.I.L. was promulgated in 1896 and adopted in all 48 states. *See* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 2-3 (3d ed. 1988). The Uniform Commercial Code was drafted during the 1940s, substantially revised during the mid-1950s, and by 1968 had been enacted in 49 states. The final state, Louisiana, enacted U.C.C. Articles 3 & 4 in 1974. *See id.* at 4-5. For discussions of the drafting of the Uniform Commercial Code, see *id.* at 1-6; WILLIAM TWINING, KARL LLEWELLYN AND THE REALIST MOVEMENT 270-301 (1973). For a succinct analysis of U.C.C. Articles 3 & 4 see ELLEN A. PETERS, A NEGOTIABLE INSTRUMENTS PRIMER (2d ed. 1974).

5. The intractability of commercial paper has found its way into popular literature:

> 'I went to Cairo, Illinois . . . bought an eating place called *The Green Frog* and married a grass widow. It had one billiard table. We served ladies and men both, but mostly men.'
>
> 'I didn't know you had a wife.'
>
> 'Well, I don't now. She taken a notion she wanted me to be a lawyer. Running a eating place was too low-down for her. She bought a heavy book called *Daniels on Negotiable Instruments* and set me to reading it. I never could get a grip on it. Old Daniels pinned me every time. My drinking picked up and I commenced staying away two and three days at a time with my friends.'

CHARLES PORTIS, TRUE GRIT 98 (Penguin Books 1969)(1968).

6. U.C.C. §§ 3-103(a)(6), (a)(9), 3-104(a). In section 3-104(e) promises are linked to notes and orders to drafts.

7. U.C.C. §§ 3-104(a)(2), 3-108.

8. U.C.C. § 3-104(a)(1).

9. U.C.C. § 3-302(a).

10. In U.C.C. Article 3 the term "defense" implies a cause of action in contract with the defendant raising a defense based either on the underlying transaction (*e.g.*, duress, lack of consideration, fraud, failure of consideration) or on a statutory discharge provision (*e.g.*, alteration, § 3-407(b); payment, § 3-602(a); tender of payment, § 3-603(b); cancellation, § 3-604). A "claim in recoupment" is similar to a failure of consideration defense, but is restricted to

may have a cause of action either in contract[13] or warranty[14] or both. Defenses to contract liability are either personal or real.[15]

The inflexible dualism of negotiable instruments logic contributes to the view that most issues are resolvable by the application of predictable rules: "[T]here is little room for the chancellor's foot to rotate in the law of bills and notes."[16] Furthermore, commercial paper literature seldom investigates or even sees connections to other subjects. Negotiable instruments law is viewed as self-contained and self-sufficient. Similarly, non-commercial paper legal scholarship shows little interest in negotiability principles.

"It is the bfp who has the equities." It is conventional wisdom that a transfer[17] of property vests in the transferee only the right, title, and interest of the transferor. As a consequence, a transferee takes a position no better than her transferor. An assignee of rights under a simple contract takes subject to all defenses and claims that would be effective against the assignor. This "same as" position is seen as a fundamental and almost inviolable principle—as natural as water seeking its own level. A holder in due course, on the other hand, *can* take a position that is better than his transferor. A holder in due course takes free of all claims to the instrument and most defenses.[18] Holder in due course

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cases in which the defective performance is accepted by the obligor, who then has an obligation to pay but also has a cause of action for breach of warranty. *See* U.C.C. § 3-305(a)(3), cmt. 3.

11. In Article 3 the term claim refers to a property or possessory right and includes a right arising out of recision to recover an instrument issued or transferred. *See* U.C.C. § 3-202(b), 3-306.

12. For example, a theft of a negotiable instrument gives rise both to a conversion claim and a defense to contract liability. U.C.C. §§ 3-305(c), 3-420.

13. The nature of U.C.C. Article 3 contract liability depends on the capacity in which the obligor signs the instrument: issuer of a note, cashier's check, or other draft drawn on the drawer, § 3-412; acceptor, § 3-413; drawer, § 3-414; or indorser, § 3-415.

14. U.C.C. § 3-416.

15. Although the terms "real defense" and "personal defense" do not appear in Article 3, they are in general use in the literature and court opinions. The real defenses implement important policies that outweigh negotiability policies and are available even against a holder in due course. U.C.C. § 3-305(a)(1), (b). Personal defenses and claims in recoupment are ineffective against a holder in due course. U.C.C. § 3-305(a)(2), (a)(3), 3-305(b).

16. Stream v. CBK Agronomics, Inc., 361 N.Y.S.2d 110, 112 (Sup. Ct. 1974) (modifying 368 N.Y.S.2d 20 (App. Div. 1975)), *quoted in* Robert S. Summers, *General Equitable Principles Under Section 1-103 of the Uniform Commercial Code*, 72 NW. U. L. REV. 906, 927 n.76 (1978).

17. This article uses the term "transfer" as it is defined in the Bankruptcy Code: "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property." 11 U.S.C. § 101(54) (1990).

18. Even a holder in due course takes subject to real defenses. *See supra* note 15.

rights are considered an unnatural and extraordinary violation of the basic principle. In U.C.C. Article 3, water flows upstream.

The final premise of negotiable instrument scholarship has become apparent in a succession of articles whose very titles leave little doubt about the authors' opinions: *Negotiability—Who Needs It?*,[19] *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*,[20] *Formalism and the Law of Negotiable Instruments*,[21] *The Holder in Due Course and Other Anachronisms in Consumer Credit*,[22] *The Last Nail in the Coffin of the Holder in Due Course Doctrine*,[23] and *Codification of Negotiable Instruments Law: A Tale of Reiterated Anachronism*.[24]

This scholarship is based on the proposition that negotiability serves a single policy. It argues that the "better than" position evolved in the nineteenth century to encourage commercial transactions in negotiable instruments and similar documents.[25] A better than position enhances the price purchasers will be willing to pay by eliminating the need to discount for the possibility of claims and defenses. A holder in due course is subject only to the problems arising from her particular transaction of purchase, a transaction over which she has control and whose details she knows. Problems arising out of prior transactions, whether the initial issuance of the instrument or transfers subsequent to issuance, are of no concern except to the extent they give rise to real defenses.

It is further argued that the negotiability principle would have been abandoned in the late nineteenth century except for the "apparent accident of codification."[26] The Negotiable Instruments Law and Uniform Commercial Code perpetuated an archaic and exhausted concept that, although wounded, is still dangerous when applied to modern transactions. Negotiability operates to cut off legitimate consumer defenses,[27]

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19. Albert J. Rosenthal, *Negotiability—Who Needs It*, 71 COLUM. L. REV. 375 (1971).

20. Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605 (1981).

21. Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441 (1979).

22. Vern Countryman, *The Holder in Due Course and Other Anachronisms in Consumer Credit*, 52 TEX. L. REV. 1 (1973).

23. Leroy Randolph, Jr. & Douglas Whitman, *The Last Nail in the Coffin of the Holder in Due Course Doctrine*, 14 AM. BUS. LAW. J. 311 (1977).

24. M.B.W. Sinclair, *Codification of Negotiable Instruments Law: A Tale of Reiterated Anachronism*, 21 U. TOL. L. REV. 625 (1990).

25. *See, e.g.*, Gilmore, *supra* note 20, at 610.

26. Gilmore, *supra* note 21, at 456.

27. *See generally* Countryman, *supra* note 22; Gilmore, *supra* note 20; Sinclair, *supra* note 24.

confers on banks undeserved rights against third parties,[28] and is generally seen to place the weak at the mercy of the strong.

This Article examines all four assumptions: that the negotiability principle inhabits a special enclave, is rigidly dualistic, is self-contained, and promotes a single antiquated policy. Part I argues that the negotiability concept[29] is one of the fundamental ways of thinking about transfers of property and a "better than" position is an option generally available to courts and legislatures. While a "better than" position may not be chosen in a particular case or statutory section, it is more widely used than the literature recognizes. Moreover, negotiability is not rigidly dualistic with alternatives limited to a "same as" position or full holder in due course rights. Instead, the negotiability principle offers an entire spectrum of possibilities—from positions only marginally better than "same as," through numerous intermediate positions, to a full Article 3 holder in due course position, and then beyond, to negotiability positions even more radical than those found in U.C.C. Article 3. The negotiability principle displays flexibility, diversity, and subtlety, and is so firmly imbedded in the idea of transfer it often goes unnoticed.

Part II explores one of the major symptoms of commercial paper scholarship's inflexible dualism. While the literature has devoted tremendous energy explicating holder in due course rights and contrasting those rights with a "same as" position, it has entirely failed to explore a third alternative: the transferee might take a position that is worse than her transferor. A "worse than" position displays a range of possibilities similar to the negotiability spectrum, from outright prohibitions of transfer to positions only marginally less than a "same as" position. The

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28. Rosenthal argues that since depositary banks rely almost exclusively on their customers in establishing accounts and taking items for deposit, granting holder in due course status to banks gives them windfall rights against drawers. Rosenthal, *supra* note 19, at 385, 392-94.

29. This article uses the term negotiability to refer to the principle that a transferee can receive a right, title, or interest that is better than the transferor's right, title, or interest. In U.C.C. Article 3 the principal application of the negotiability concept is found in holder in due course rights. These rights are generally contrasted with rights received when a simple contract is assigned. Article 3 has, however, other advantages *versus* the assignment of contract rights: strategic advantages in litigation, § 3-308; the merger doctrine, which clarifies issues related to assignment, claims, and payment, § 3-310; contract rights against prior assignors based on indorsement, § 3-415; warranty rights against prior transferors, § 3-416; a generous statute of limitations, § 3-118; rights to compel an indorsement creating contract liability even in the absence of agreement, § 3-203(c); and generally, a statutory rather than a common law scheme for analyzing disputes. For a discussion of some of these points under the N.I.L., see Grant Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1063-68 (1954).

"worse than" alternative is in many ways as important as negotiability and demonstrates a comparable richness and variety.

Part III demonstrates that negotiability, far from being self-contained, developed in an atmosphere of borrowing and reverse-borrowing across property lines. Analogies to goods, bank notes, and coin were particularly important. Furthermore, negotiable instruments law still exists as part of a complex network with numerous connections to other types of property. The negotiability principle is not, nor has it ever been, restricted to negotiable instruments. A general failure to recognize this network of connections has produced peculiar anomalies such as negotiable instruments being treated as less negotiable than other kinds of property[30] and documents being first banished from Article 3 and then readmitted with little thought to the consequences.[31]

The "same as" position is neither natural nor fundamental—it is constructed like any other legal principle. It is no more nor less important than the "better than" and "worse than" alternatives. It is often either ignored or unseen and in many instances it appears as mere argument joined to a "better than" or "worse than" counterargument.

Throughout, this Article claims that negotiability serves not one policy but many policies. While negotiability clearly can have disastrous consequences for consumers, it can also protect consumers,[32] guard against secret liens,[33] defend the integrity of a filing system,[34] encourage ordinary course transactions in goods,[35] speed bank collections and payments,[36] and even insulate Samuel Williston from tax liability for the interest coupons he gave as gifts to his daughter during the Christmases of 1934 and 1935.[37] Negotiability cannot be identified with a single inter-

30. *See infra* notes 110-13, 116-17, 126, 156-58, 248, 260 and accompanying text.

31. *See infra* notes 283-88 and accompanying text.

32. U.C.C. §§ 9-103(2)(d), 9-307(2). In his consumer credit article, Vern Countryman observes, "But all human beings who obtain credit, other than for the purposes of a business in which they are engaged, are consumers. In short, we are all consumers at least part of the time." Countryman, *supra* note 22, at 17. For a discussion of section 9-103(2)(d) see *infra* notes 108-09 and accompanying text.

33. See *infra* text accompanying notes 90-98.

34. See *infra* text accompanying notes 90-98.

35. See *infra* text accompanying notes 161-64.

36. See *infra* text accompanying notes 257-60.

37. Commissioner of Corporation & Taxation v. Williston, 54 N.E.2d 43 (Mass. 1944). Williston detached bearer interest coupons from corporate bonds he owned and gave them to his daughter, who was a New York resident. The coupons matured in the years following the gifts, 1935 and 1936 respectively, and the Massachusetts Commissioner assessed an income tax for the amount of the interest. The court held that since the coupons were negotiable, title passed to the daughter upon delivery and the tax should be abated. In dictum the court im-

est: it has been an ally and a foe of many interests. Negotiability is not a closed system but rather a fundamental principle at work in many systems.

Roland Barthes refers to the work of novelist Jean Cayrol as "literature at floor level"[38] and proposes for its totem, the mouse which "deals with things; it omits little on its way, concerned with everything its oblique gaze, proceeding from the ground up, can encounter . . . a terrestrial sliding, a sliding across of the floor."[39] This description is equally apt when applied to negotiable instruments scholarship—weaving its way through Article 3 at floor level, turning left or right as it encounters issues, but seldom elevating itself to gaze at the surrounding landscape and the horizon. My hope is to gain some perspective on the negotiability principle by moving off floor level.

I. A SPECTRUM THEORY OF NEGOTIABILITY

> The whole "holder in due course" concept could usefully have been abolished when negotiable instruments law was codified at the end of the nineteenth century. In fact it was preserved like a fly in amber both in the N.I.L. and in its successor, Article 3 of the Uniform Commercial Code.[40]
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> On the video monitor, they watched as he inserted a long needle through the amber, into the thorax of the prehistoric fly. "If this insect has any foreign blood cells, we may be able to extract them and obtain paleo-DNA, the DNA of the extinct creature. We won't know for sure, of course, until we extract whatever is in there, replicate it, and test it. That is what we have been doing for five years now. It has been a long, slow process—but it has paid off."[41]

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plied the result would be different if a mere chose in action was being assigned. *Id.* at 45. For a description of Williston's domestic life see SAMUEL WILLISTON, LIFE AND LAW; AN AUTOBIOGRAPHY 167-82, 326-38 (1941).

38. ROLAND BARTHES, THE RUSTLE OF LANGUAGE 183 (1986).

39. *Id.* at 183-84.

40. GRANT GILMORE, THE DEATH OF CONTRACT 108 n.18 (1974). Gilmore was so pleased with the fly in amber metaphor that he used it again in *Formalism and the Law of Negotiable Instruments*. Gilmore, *supra* note 21, at 461.

41. MICHAEL CRICHTON, JURASSIC PARK 102 (1990). In *Jurassic Park* scientists build an island theme park stocked with live dinosaurs. Things go wrong. If my characterization of the negotiability principle is correct (*i.e.*, it is a fundamental way of thinking about transfers of property rather than an arcane, antiquated concept), then negotiability not only survives but flourishes. Attempting to eradicate negotiability would be, as Wittgenstein almost said, like trying to put the fly back in the amber.

There are three alternatives when property is transferred or contract rights assigned: the transferee can take a better position, a same position, or a worse position than her transferor. A "better than" position means that the transferee takes free of one or more defenses or claims that would be effective against the transferor. A "same as" position results from a transfer in which the transferee takes a position identical to the transferor or "stands in the shoes" of the transferor. A "worse than" position means that the transferee takes subject to a defense or claim that would not have been effective against the transferor.

The archetypal "better than" position is a U.C.C. Article 3 holder in due course. For example, *A* signs a promissory note as maker and issues the note to *B*. When *B* sues *A*, any defense or claim arising out of the transaction underlying the issuance of the note would be effective against *B*.[42] However, if *B* negotiates the note to *C* and *C* qualifies as a holder in due course, when *C* sues *A* all claims and personal defenses arising out of the transaction between *A* and *B* would be ineffective against *C*. Therefore, in the transfer of the note from *B* to *C*, *C* takes a position that is better than the position of *B*.

A "same as" position, sometimes referred to as the shelter rule, gives the transferee a right, title, and interest that is identical to the transferor. In U.C.C. Article 3, "[t]ransfer of an instrument . . . vests in the transferee any right of the transferor to enforce the instrument . . . ."[43] In the previous hypothetical, if *C* does not qualify as a holder in due course she is relegated to the shelter rule, takes a position identical to *B*, and is subject to all defenses and claims effective against *B*. The shelter rule also means that a party who *does* qualify as a holder in due course can pass those rights by transfer.

A "worse than" position is illustrated in U.C.C. section 3-203(b), which creates an exception to Article 3's shelter rule. If the transferee "engaged in fraud or illegality affecting the instrument,"[44] he is disqualified from taking holder in due course rights from the transferor. Such a transferee obviously could not qualify as a holder in due course on his own.[45] But if his transferor has holder in due course rights, a transferee engaging in fraud or illegality affecting the instrument is also disqualified from taking his transferor's rights under the shelter rule. The comment

42. *B*'s cause of action against *A* would be on a contract theory under U.C.C. § 3-412.
43. U.C.C. § 3-203(b).
44. *Id.*
45. A transferee who "engaged in fraud or illegality affecting the instrument" would not take in good faith and also would take with notice of a defense and with notice of a claim. U.C.C. § 3-302(a)(2).

to section 3-203 explains that the exception is created so that such a party cannot "wash the instrument clean by passing it into the hands of a holder in due course and then repurchasing it."[46] In the hypothetical, if *B* had engaged in fraud or illegality affecting the instrument and then transferred the note to *C*, who qualified as a holder in due course, and *B* subsequently reacquired the note from *C*, *B* would take subject to all of *A*'s claims and defenses. In the transfer from *C* to *B*, *B* takes a position worse than *C*.

This article will not discuss transfers that lead to a better or worse position in a purely pragmatic sense. For example, an old negotiable instruments adage holds that "the more indorsements, the better the bill."[47] When *A* signs a note as maker and issues it to *B*, *B* has a cause of action against only one party, *A*, and the cause of action is contract.[48] If *B* negotiates the note to *C* by unqualified indorsement[49] and receives consideration, *C* will have rights both against *A* as maker and against *B* on theories of indorsement contract[50] and transfer warranty.[51] If *C* negotiates the note to *D* by unqualified indorsement and receives consideration, *D* would have rights against three parties and so on. Pragmatically, the more defendants the better the position. This improvement in position occurs, however, whether or not any of the transferees is a holder in due course and is distinct from the question of claims and defenses. Other purely pragmatic differences arising from transfer, such as the differing levels of involvement in and knowledge of the original transaction by the transferee and, in litigation, the parties' differing resources and levels of risk aversion, also will not be addressed.

In addition, this Article will not consider changes that occur to a party's position without a transfer. A party holding property of any type, including a negotiable instrument, will find herself in different positions over time. Even a holder in due course[52] suffers adverse conse-

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46. U.C.C. § 3-203 cmt. 2. Although the comment seems to limit the exception to reacquisition cases, the statutory language is not so limited.

47. James Steven Rogers, *The Myth of Negotiability*, 31 B.C. L. REV. 265, 303 (1990). *See also* MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1780-1860, at 223 (1977).

48. U.C.C. § 3-412.

49. An indorsement is unqualified if it does not disclaim contract liability by adding "without recourse" or similar language. U.C.C. § 3-415(b). It is also possible to disclaim transfer and presentment warranties on any instrument except a check. *See* U.C.C. §§ 3-416(c), cmt. 5, 3-417(e), cmt. 7.

50. U.C.C. § 3-415.

51. U.C.C. § 3-416.

52. Holder in due course status is determined when a party becomes a holder and gives value. *See* U.C.C. §§ 3-203(c), 3-302(a), (d), 3-303(a). While that status is not lost with the

quences from holding an instrument too long or failing to give timely notice. For example, holding an instrument beyond the due date discharges indorsers from contract liability[53] and failing to give notice of dishonor may discharge liabilities both in indorsement contract and warranty.[54] And ultimately, all rights are lost with the running of the statute of limitations.[55] There are numerous ways, quite apart from transfer, of waking up on Tuesday morning with a right, title, or interest in property that is worse than it was the night before.

A party's position can also improve with the passage of time. The "forgotten notice" doctrine, for instance, allows a party to receive notice of a claim or defense and later with the passage of time "forget" the notice was received.[56] A person who could not have qualified as a holder in due course in February might be eligible if he purchases the instrument in August.[57] In U.C.C. Article 9, several sections operate to improve the priority position of a purchaser[58] if a competing secured party with priority fails to act in a timely fashion. For instance, if a debtor moves collateral[59] from one state to another and the collateral is kept in the destination state for four months, security interests perfected in the state of origin become unperfected unless action is taken to per-

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passage of time, it does not protect a holder in due course from the consequences of holding the instrument past its due date or failing to give a timely notice.

53. U.C.C. §§ 3-415(a), (e).

54. U.C.C. §§ 3-415(c), 3-416(c), 3-417(e).

55. U.C.C. § 3-118.

56. The U.C.C. defers to the common law of each state on the issue of the validity of the forgotten notice doctrine: "The time and circumstances under which a notice or notification may cease to be effective are not determined by this Act." U.C.C. § 1-201(25).

57. In Lord v. A. & J.F. Wilkinson, 56 N.Y. Sup. Ct. 593 (Barb. 1870), one of the defendants was informed on February 9 of the theft of U.S. government notes and given a handbill describing the notes. The defendants purchased one of the stolen notes on February 14 and another on August 14. A jury instruction stating "the defendants once having notice, are bound by it" was held improper since it did not allow for the possibility the notice might have been forgotten. *Id.* at 596-97.

58. Although in ordinary usage the terms "purchase" and "buy" are interchangeable, the U.C.C. gives "purchase" a very broad definition: "'Purchase' includes taking by sale, discount, negotiation, mortgage, pledge, lien, issue or re-issue, gift or any other voluntary transaction creating an interest in property." U.C.C. § 1-201(32).

59. The multistate rule discussed here applies to documents, instruments, and ordinary goods. U.C.C. § 9-103(1). Although "document" and "instrument" are terms defined in the U.C.C., "ordinary goods" is not. Ordinary goods, by a process of elimination, are goods which are neither mobile goods (U.C.C. § 9-103(3)(b)) nor goods covered by a certificate of title issued by a state "under the law of which indication of a security interest on the certificate is required as a condition of perfection." U.C.C. § 9-103(2)(a). Rules that function in a way similar to § 9-103(1)(d)(i) are found in §§ 9-103(3)(e) and 9-403(2).

fect the interest in the destination state.[60] Furthermore, the interest is "deemed to have been unperfected as against a person who became a purchaser after removal."[61] A secured party taking an interest in collateral or a party buying collateral within the four month grace period can improve from a junior to a senior priority position with the mere passage of time.[62]

If this Article were expanded to include purely pragmatic changes arising from transfer and changes that occur without transfer, the entire concept of a transferee taking a position that was identical to the position of her transferor would fade like mist on a summer's morn. The discussion will focus exclusively on changes in right, title, or interest resulting from transfer.

This Article argues that there is an entire spectrum of "better than" positions; a spectrum that reaches from positions only marginally better than "same as" to points beyond holder in due course. "Worse than" positions are also arrayed along a spectrum. The possibilities arising from transfer are analogous to a number line displaying negative and positive integers from –10 to +10. A "same as" position would be located at 0. Holder in due course rights would not be found at +10 but rather at some intermediate position; perhaps at +8. Options on the "better than" or negotiability scale would not be limited to either +8 or 0, but instead would occupy numerous points between 0 and +10. Outright prohibitions on transfer would be located at -10 and other "worse than" positions would be found between -10 and 0. While it would be a delusion to attempt mathematical precision on the question of the transferee's right, title, and interest, a number line is a useful analogy for thinking about the spectrum of possible positions.

There is, however, one kind of precision about transfers of property that is absolutely essential but generally unrecognized in the literature. It is important to be issue specific in analyzing the transferee's position. It is entirely possible for a transferee to be in a better position on one issue, in the same position on another issue, and in a worse position on a third.[63]

Negotiability, or the possibility of a transferee taking a position better than the transferor, is a fundamental and indispensable way of think-

60. U.C.C. § 9-103(1)(d)(i).

61. *Id.*

62. Of course U.C.C. § 9-103 merely states whether the security interest is perfected or unperfected. After the status of the interest is determined, a priority rule must be applied to resolve the dispute. *See, e.g.*, U.C.C. §§ 9-301(1), 9-308, 9-312.

63. *See infra* text accompanying notes 353-58.

ing about transfers of property. The literature occasionally recognizes that negotiability plays a role outside U.C.C. Article 3, but it is usually a narrow and limited recognition; as if negotiability had escaped from its special enclave, inflicted some damage, but would soon be recaptured. Negotiability is never seen as central to transfers except in Article 3. Outside of Article 3, negotiability is viewed as an anomaly that implements some parochial policy in a specific area of law such as secured transactions or sale of goods. And yet, a simple list of the different topics and types of property discussed in the literature as having at least some negotiability consequences begins, by its breadth, to undermine orthodox opinion: municipal bonds,[64] corporate bonds,[65] chattel paper,[66] credit card agreements,[67] documents of title,[68] principles of equity,[69] interest coupons,[70] letters of credit,[71] sale of goods,[72] secured transactions,[73] securities,[74] real property,[75] and trusts.[76] The secured

64. George W. Peak, *Negotiable Non-Negotiables*, 30 KY. L.J. 174 (1941).

65. Gilmore, *supra* note 29, at 1088-93; Roscoe Turner Steffen & Henry E. Russell, *The Negotiability of Corporate Bonds*, 41 YALE L.J. 799 (1932).

66. Homer Kripke, *Chattel Paper as a Negotiable Specialty Under the Uniform Commercial Code*, 59 YALE L.J. 1209 (1950).

67. Ralph J. Rohner, *Holder in Due Course in Consumer Transactions: Requiem, Revival or Reformation?*, 60 CORNELL L. REV. 503, 508-509 (1975); Rosenthal, *supra* note 19, at 400.

68. John F. Dolan, *Good Faith Purchase and Warehouse Receipts: Thoughts on the Interplay of Articles 2, 7, and 9 of the UCC*, 30 HASTINGS L.J. 1 (1978); Grant Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1076-79 (1954); Robert A. Riegert, *The Rights of a Transferee of a Document of Title Who is Not a Holder By Due Negotiation*, 9 CUMB. L. REV. 27 (1978); Rosenthal, *supra* note 19, at 397-98; William D. Warren, *Cutting Off Claims of Ownership Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 469, 482-87 (1963).

69. Henry W. Ballantine, *Purchase For Value and Estoppel*, 6 MINN. L. REV. 87 (1922); George P. Costigan, Jr., *The Theory of Chancery in Protecting Against the Cestui Que Trust One Who Purchases From a Trustee for Value and Without Notice*, 12 CAL. L. REV. 356 (1924); John S. Ewart, *Negotiability and Estoppel*, 16 L. Q. REV. 135 (1900); Rohner, *supra* note 67, at 509-11; Warren, *supra* note 68, at 481.

70. Note, *Negotiability of Interest Coupons*, 33 VA. L. REV. 80 (1947).

71. Gilmore, *supra* note 29, 1108-18.

72. Gilmore, *supra* note 20, at 616-19; Gilmore, *supra* note 29, at 1057-62; Rosenthal, *supra* note 19, at 398; Warren, *supra* note 68, at 469-78.

73. Grant Gilmore, *The Secured Transactions Article of the Commercial Code*, 16 LAW & CONTEMP. PROBS. 27, 46-47 (1951); Gilmore, *supra* note 20; Gilmore, *supra* note 29, at 1081-88, 1102-07; Kripke, *supra* note 66; Randolph & Whitman, *supra* note 23, at 316; James S. Rogers, *Negotiability as a System of Title Recognition*, 48 OHIO ST. L.J. 197, 205-06 (1987); Rosenthal, *supra* note 19, at 399.

74. Gilmore, *supra* note 29, at 1072-76; Rogers, *supra* note 73, at 207-08, 213-16; Rosenthal, *supra* note 19, at 398; Warren, *supra* note 68, at 487-92.

75. John S. Ewart, *Priorities in Relation to Estoppel* (pts. 1 & 2), 13 L. Q. REV. 46 (1897), 13 L. Q. REV. 144 (1897).

transactions and sale of goods literatures, two samples from this list, illustrate conventional wisdom about the negotiability principle.

A. Negotiability in U.C.C. Article 9

The secured transactions scholarship mentioning negotiability is particularly interesting since it includes the work of Grant Gilmore, one of the principal drafters of Article 9.[77] The scholarship creates the general impression that negotiability has a very minor role to play in Article 9. Most of the discussion arises from specific references to Article 3 in sections 9-206 and 9-309. Section 9-206 authorizes contract terms whereby buyers or lessees agree not to assert "against an assignee any claim or defense which he may have against the seller or lessor . . . ."[78] The assignee must satisfy requirements similar to the prerequisites for holder in due course status, Article 3 real defenses are preserved, and section 9-206 is made subject to consumer protection statutes and case law. Predictably this section, which Gilmore describes as following "a well-blazed trail,"[79] is commonly included in consumer protection discussions of the holder in due course doctrine.[80] Section 9-309 clarifies that nothing in Article 9 limits the rights of an Article 3 holder in due course (*i.e.*, since a security interest is a "claim" in Article 3 and a holder in due course takes free of all claims, a holder in due course prevails over a security interest, even a perfected interest).[81]

Other negotiability questions arise in the secured transactions literature because Article 9 creates a unified scheme for creating and perfecting security interests in personal property, and negotiable instruments are a type of personal property.[82] How is the free transferability philosophy of Article 3 to be reconciled with the creation of security interests

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76. J.B. Ames, *Purchase For Value Without Notice*, 1 HARV. L. REV. 1 (1887); Costigan, *supra* note 69; Thaddeus D. Kenneson, *Purchase For Value Without Notice*, 23 YALE L.J. 193 (1914); W.A. Searey, *Purchase For Value Without Notice*, 23 YALE L.J. 447 (1914).

77. For comments of Gilmore's role in drafting Article 9, see TWINING, *supra* note 4, at 284, 292, 316, 318, and 460; Symposium, *Origins and Evolution: Drafters Reflect Upon the Uniform Commercial Code*, 43 OHIO ST. L.J. 535, 544, 551-55, 569, 578 (1982).

78. U.C.C. § 9-206(1).

79. Gilmore, *supra* note 73, at 46.

80. *See, e.g., id.* at 46-47; Gilmore, *supra* note 73, at 1093-1102; Kripke, *supra* note 66, at 1209-22; Randolph & Whitman, *supra* note 23, at 316.

81. Section 9-309 also duplicates a provision in 3-302(b) stating that filing does not constitute notice of the security interest. For a discussion of negotiability and § 9-309, see Dolan, *supra* note 68, at 18-19.

82. Article 9 applies "to any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures . . . ." U.C.C. § 9-102(1)(a). Article 9 also applies to a *sale* of accounts or chattel paper. U.C.C. § 9-102(1)(b).

in commercial paper?[83] If possession is to be the exclusive means of perfecting a security interest in instruments, should exceptions be created and what should the scope of those exceptions be?[84] Should chattel paper[85] be treated as fully negotiable or only partially negotiable?[86]

Finally, in several articles Grant Gilmore confessed error in the drafting of Article 9:

> One of the ideas I took from Llewellyn's bounteous store was that the good faith purchaser is always right and that the story of his triumph was not only one of the most fascinating episodes in our nineteenth-century legal history (which it was), but was also one of continuing relevance for our own time (which, I have belatedly come to believe, it is not).[87]

Surprisingly, however, Gilmore's list of good faith purchase topics in Article 9 is no broader than the rest of the literature except for an extended discussion of accounts receivable financing[88] in which he concludes that Article 9 is too generous to the secured party.[89] The secured transactions literature completely fails to discuss or even recognize that the entire Article 9 edifice is built on the negotiability principle.

Assume a debtor owns personal property in fee simple absolute. The debtor applies for and receives a loan from a secured party (*SP1*) who enters into a security agreement with the debtor, whereby an Article 9 security interest attaches.[90] The debtor now holds the property subject to an Article 9 security interest. If the debtor were only able to transfer her right, title, and interest in the property, all transferees would take subject to *SP1*'s security interest. If she used the property as collateral for a second secured loan, the secured party (*SP2*) would take subject to *SP1*'s interest. If she sold the property, the buyer would take subject to *SP1*'s interest. If a judgment were entered against the debtor and the judgment creditor levied against the property, the levying creditor would take subject to the interest. If the debtor filed for bankruptcy, *SP1*

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83. *See, e.g.*, Rogers, *supra* note 73, at 205-06.

84. U.C.C. § 9-304(1).

85. Chattel paper is a hybrid document that evidences "both a monetary obligation and a security interest in or lease of specific goods . . . ." U.C.C. § 9-105(1)(b). Chattel paper is similar in concept to a negotiable instrument but does not qualify under Article 3 since it contains more than a mere promise or order to pay money. *See* U.C.C. § 3-104(a).

86. Gilmore, *supra* note 29, at 1102-07; Kripke, *supra* note 66, at 1222-27.

87. Gilmore, *supra* note 20, at 605.

88. *Id.* at 620-28.

89. *Id. at 627.*

90. The requirements for a security agreement to become effective (*i.e.*, attach) between the parties and against the collateral are enumerated in U.C.C. § 9-203.

would prevail over the interest of the bankruptcy trustee. If a "same as" position prevailed in Article 9, *SP1* would take priority over any and all transferees.

Of course Article 9 has a priority scheme that is nothing like the simple scheme just described. Article 9 implements a mixed bag of policies and generally ignores the "same as" principle. Secured parties compete under a first to file or perfect rule[91] with a purchase money exception,[92] or if neither of the interests is perfected, the first interest to attach prevails.[93] Priority disputes between a secured party and a buyer are addressed in seven different sections and subsections.[94] Article 9 "lien creditors,"[95] a term including both a levying judgment creditor and a bankruptcy trustee, take priority over unperfected interests,[96] but purchase money interests are awarded a ten-day grace period to file a financing statement.[97] All of the Article 9 priority rules are built on the possibility that a debtor can transfer a position better than his own. They assume that it is possible for a second secured party to have the first bite of the apple, that a buyer can take free of an interest effective against the seller, and that a lien creditor, although last, can be first. The drafters of Article 9 were apparently so focused on the twin policies of disclosing secret interests and protecting the integrity of the filing system[98] that they failed to notice that these policies are based on the possibility that a debtor can transfer an interest in collateral better than his own.

A recent case, *Aircraft Trading and Services, Inc. v. Braniff, Inc.*,[99] which triggered an official reaction by the Permanent Editorial Board of the Uniform Commercial Code, is symptomatic of this negotiability myopia. The facts of the case are summarized in the Permanent Editorial Board Commentary:

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91. U.C.C. § 9-312(5)(a).

92. U.C.C. § 9-312(3), (4). A purchase money security interest is:

(a) taken or retained by the seller of the collateral to secure all or part of its price; or
(b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

U.C.C. § 9-107.

93. U.C.C. § 9-312(5)(b).

94. U.C.C. §§ 9-103(2)(d); 9-301(1)(c); (d); 9-301(2); 9-307; 9-308; 9-309.

95. U.C.C. § 9-301(3).

96. U.C.C. § 9-301(1)(b).

97. U.C.C. § 9-301(2).

98. For discussion of the policies underlying the priority rules see §§ 9-101 cmt. 1, 9-301 cmt. 9, 9-302 cmt. 1, 9-312 cmt. 5.

99. 819 F.2d 1227 (2d Cir.), *cert. denied*, 484 U.S. 856 (1987).

> *A* sold an aircraft engine to *B* and took back a purchase-money mortgage (security interest), which for a time *A* failed to record as required by federal law. *B* sold the engine to *C*, who searched the record and ascertained that there was no recorded mortgage. Thus *A*'s mortgage was subordinate to *C*'s interest, under § 9-301(1)(c), which provides that an unperfected security interest is subordinate to a buyer like *C* to the extent that he gives value and receives delivery of the collateral without knowledge of the security interest and before it is perfected. Thereafter the mortgage was recorded, thus perfecting the security interest, and still later *C* sold the engine to *D*.[100]

The court held that although *C* was protected from *A*'s unperfected security interest,[101] *D* was not protected because *A* perfected its interest by filing prior to the sale from *C* to *D*. Arguments that since *C* held the property free of *A*'s interest *D* should also be protected under the shelter principle were unavailing. The court pointed out that section 9-301 has no shelter principle. In response to an argument that the shelter principle in U.C.C. section 2-403 should be applied by analogy, the court remarked, "It is a novel theory that we believe must fail."[102]

The Uniform Commercial Code often attaches a shelter rule to sections or articles that clearly provide for negotiability. In Article 3 the shelter rule is stated in section 3-203(b). In Article 2, section 2-403 applies the negotiability principle to certain kinds of sale of goods and also furnishes a shelter provision: "[a] purchaser of goods acquires all title which his transferor had or had power to transfer . . . ."[103] Similar shelter rules are found in sections 7-504(1), 8-301(1), and 9-313(4)(b).[104] There are numerous other U.C.C. sections, however, that use the negotiability principle and no shelter rule is to be found. The Article 9 priority scheme is but one instance of negotiability in the U.C.C. without an explicit shelter rule. The Permanent Editorial Board (P.E.B.) correctly disagreed with the result in *Aircraft Trading v. Braniff* and amended

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100. Permanent Editorial Board Commentary on the Uniform Commercial Code, Commentary No. 6, § 9-301(1) (1990) [hereinafter PEB Commentary].

101. The court held that *C* was not a buyer in the ordinary course since the seller *B* was selling its equipment, not inventory. Therefore, *C* was not protected by U.C.C. § 9-307(1). *Aircraft Trading*, 819 F.2d at 1232-33. *C* was, however, a buyer protected by U.C.C. § 9-301(1)(c) against *A*'s unperfected interest. *Id.* at 1233-34, 1236. Although perfection of an interest in aircraft requires compliance with the Federal Aviation Act, 49 U.S.C. 1403 (1992), the court applied Article 9's priority scheme. *Aircraft Trading* 819 F.2d at 1230-32. For a discussion of security interests in aircraft, see WHITE & SUMMERS, *supra* note 4, at § 26-17.

102. *Aircraft Trading*, 819 F.2d at 1234.

103. U.C.C. § 2-403(1).

104. *See* PEB Commentary, *supra* note 100.

comment 9 to section 9-301 by adding, "There is no conflict between the principle of s. 9-301(1) and the 'shelter principle,' which is applied at several points in the statute, but is most explicitly stated in s. 2-403(1): 'A purchaser of goods acquires all title which his transferor had. . . .'"[105]

This incident has interesting negotiability implications from two different perspectives. Although a "same as" position is generally touted as the norm, the court did not reach that result in either of the transfers at issue. Indeed, it seemed scarcely conscious of the better/same/worse alternatives. *A*'s security interest had attached to the collateral and was effective against *B*. When the collateral was sold by *B* to *C*, *C* took free of *A*'s security interest and therefore took a position better than *B*. When the collateral was subsequently sold by *C* to *D*, however, *D* took subject to *A*'s security interest. In the transfer from *C* to *D* the court imposed a position on *D* that was worse than the status of *D*'s transferor, *C*. It reached the "worse than" result through a narrow, one might say maniacal, reading of section 9-301(1) and apparently gave no thought to the deeper implications of the case.

The reaction by the P.E.B. is equally intriguing. It expressed concern about the policy implications of the court's refusal to apply the shelter rule[106] and argued that "[u]nderlying principles of fairness require a broad reading and a broad application of the shelter concept, even when not expressly stated."[107] However, the P.E.B. failed to acknowledge that the negotiability principle was at work in Article 9 at an even deeper level. If the shelter principle requires a "broad application" in Article 9 and elsewhere, it must be as a result of an equally broad application of the negotiability principle.

The priority rules in Article 9 are arrayed along the negotiability spectrum with rules being more or less generous to the purchaser than the Article 3 holder in due course archetype. The priority rule in 9-103(2)(d),[108] for example, is less generous than Article 3 in that it does

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105. *Id.*

106. The primary policy mentioned by the P.E.B. is protecting the value of the property to the transferor: "The shelter principle should be applied to protect *D*. Otherwise the value of *C*'s status, as one taking free of the security interest, is unjustifiably impaired if he cannot confer that status on his transferee." *Id.*

107. *Id.*

108. U.C.C. § 9-103(2) is a multistate provision that applies to goods covered by a certificate of title issued by a jurisdiction requiring notation on the certificate for perfection. If goods are brought into a state and the state issues a certificate that neither shows the goods are subject to a security interest nor indicates the goods *may* be subject to security interests, then "the security interest is subordinate to the rights of a buyer of the goods who is not in the business of selling goods of that kind to the extent he gives value and receives delivery of the

not protect a buyer who is "in the business of selling goods" of the kind sold. Article 3 does not automatically disqualify a group of buyers from holder in due course status.[109]

On the other hand, Article 9 is more generous than Article 3 in its definition of value. Article 3 has a restricted definition of value that excludes a mere promise of performance.[110] Only "to the extent the promise has been performed"[111] has value been given for the purpose of establishing holder in due course status. Article 9, however, uses the expansive Article 1 definition of value, which includes "any consideration sufficient to support a simple contract."[112] Under the priority rule in section 9-301(1)(c), for instance, a buyer who merely promised to pay for goods would have given value under Article 9 and could be protected against a competing security interest. A buyer of a negotiable instrument, however, who had merely promised to pay would not have given value under Article 3 and could not be a holder in due course.[113]

Section 9-307(1) is both more and less generous than the holder in due course rule. It is less generous in that a buyer in the ordinary course of business takes free only of security interests created by his seller. Interests created by predecessors in title to the seller are effective against the buyer.[114] In Article 3, on the other hand, a holder in due course takes free of all claims including claims of predecessors in title to her

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goods after issuance of the certificate and without knowledge of the security interest." U.C.C. § 9-103(2)(d).

109. However, § 3-302(c) does disqualify certain types of *transactions* from creating holder in due course rights:

> [A] person does not acquire rights of a holder in due course of an instrument taken (i) by legal process or by purchase in an execution, bankruptcy, or creditor's sale or similar proceeding, (ii) by purchase as part of a bulk transaction not in ordinary course of business of the transferor, or (iii) as the successor in interest to an estate or other organization.

110. U.C.C. § 3-303(a)(1).

111. *Id.*

112. U.C.C. § 1-201(44)(d).

113. *See* U.C.C. §§ 3-302 cmt. 6, 3-303 cmt. 2.

114. Massachusetts has a nonuniform 9-307(1) that gives expanded protection to consumer buyers:

> A buyer in ordinary course of business (subsection (9) of section 1-201) other than a person buying farm products from a person engaged in farming operations (a) takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence; and (b) *takes free of a security interest created by a predecessor in interest of his seller if the buyer buys without knowledge of the security interest and for his own personal, family or household purposes.*

MASS. GEN. LAWS ANN. ch. 106, § 9-307(1) (West 1992) (emphasis added).

transferor.[115] But section 9-307(1) is more generous in the sense that a buyer is protected even though he knows of the existence of the security interest.[116] A purchaser of a negotiable instrument who takes with notice of a claim cannot be a holder in due course.[117]

Negotiability plays a role in Article 9 beyond the priority rules. Three sections authorize or contemplate transfer of a better interest by contract.[118] Section 9-206 is already part of the negotiability literature.[119] Section 9-316 allows a party with priority to relinquish her position in a subordination agreement.[120] And section 9-306(2), after stating the general rule that a security interest continues in collateral upon disposition, creates an exception, "unless the disposition was authorized by the secured party in the security agreement or otherwise . . . ."[121] Security agreements taking an interest in the debtor's inventory, for example, invariably authorize ordinary course sales. By contract, then, the debtor is empowered to transfer an interest in collateral better than his own.

The default rules in Article 9 allow a secured party to take possession of collateral and either dispose of it, applying the proceeds to the debt,[122] or alternatively, propose to keep the collateral in satisfaction of the debt.[123] If the collateral is sold, a negotiability rule delivers to a pur-

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115. U.C.C. § 3-306.

116. U.C.C. § 9-307(1). A buyer in the ordinary course is protected against both unperfected and perfected interests created by her seller even though she knows of the interest. The policy behind this rule is that normally ordinary course sales from inventory are authorized by the secured party and the buyer takes free of the interest under § 9-306(2). Section 9-307(1) is implicated only if the sale is not authorized. In the typical transaction, then, a buyer with knowledge of the security interest is entitled to assume the transaction is authorized. It is only when the buyer takes with knowledge that the sale *violates* the security interest that she is not entitled to ordinary course status. *See* § 1-201(9). For other Article 9 rules that establish priority over a competing interest despite knowledge of the interest, see §§ 9-308(2), 9-312(2)-(5), 9-312 cmt. 3, cmt. 5.

117. U.C.C. § 3-302(a)(2)(v).

118. U.C.C. §§ 9-206, 9-306(2), 9-316.

119. *See supra* note 73.

120. For example, in Woco v. Benjamin Franklin Corp., 20 U.C.C. Rep. Serv. (Callaghan) 1015 (D.N.H. 1976), the defendant held a mortgage and perfected Article 9 security interest in debtor's real estate, fixtures, and equipment. The plaintiff held a competing perfected security interest in some of the debtor's equipment but would have lost in a priority dispute with the defendant, except for a letter sent by the defendant to the debtor. The court construed the letter as a statement of subordination and granted judgment for the plaintiff. *Id.* at 1026. In other words, the subordination letter granted the debtor the right to transfer an interest in the equipment superior to its own.

121. U.C.C. § 9-306(2).

122. U.C.C. § 9-504.

123. The requirements for the secured party keeping the collateral in satisfaction of the obligation (commonly called "strict foreclosure") are specified in U.C.C. § 9-505.

chaser for value the debtor's rights in the collateral and discharges the seller's security interest and subordinate security interests and liens.[124] Furthermore, since section 9-504 contemplates not only sales of collateral, but also leases and "other dispositions," buyers, lessees, and other transferees are protected by the negotiability rule.[125] Even if the secured party has failed to comply with the default requirements of Article 9, the purchaser is protected as long as he satisfies standards that are substantially less rigorous than the requirements for holder in due course status.[126]

If the secured party opts to keep the collateral in satisfaction of the obligation, other secured parties claiming an interest lose their rights against the collateral if they fail to object.[127] At the end of the process, a secured party complying with Article 9's strict foreclosure requirements acquires an interest in collateral better than her transferor, the debtor.

Ironically, because of its importance to Article 9's priority scheme, the negotiability principle plays a more significant role in Article 9 than in Article 3. In Article 3, holder in due course status is only material when claims or defenses are at issue, and that is in relatively few cases. The vast majority of negotiable instruments are transferred, presented, and paid without difficulty.[128] In *every* Article 9 transaction, on the other hand, the secured party must consider the possibility that the debtor might become insolvent or that collateral might be sold, used as collateral for a second loan, or become subject to statutory or judicial liens.[129] A secured party must be constantly aware of the negotiability

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124. U.C.C. § 9-504(4).

125. *See* 9 WILLIAM D. HAWKLAND, UNIFORM COMMERCIAL CODE SERIES § 9-504:11 (1990).

126. *Id.* In a private sale the purchaser need only satisfy the requirements of purchasing for value and in good faith. It is also worth noting that Article 9 uses the U.C.C. § 1-201(19) definition of good faith as "honesty in fact in the conduct or transaction concerned," while the Article 3 definition of good faith adds an objective component: "'Good faith' means honesty in fact and the observance of reasonable commercial standards of fair dealing." U.C.C. § 3-103(a)(4). *But see* Neil O. Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 S. CAL. L. REV. 48 (1966), for skepticism about the difference between subjective and objective good faith standards.

127. U.C.C. § 9-505(2).

128. A comment to U.C.C. Article 4 gives some indication of the scale of use of negotiable instruments: "By the time of the 1990 revision of Article 4 annual volume was estimated by the American Bankers Association to be about 50 billion checks." U.C.C. § 4-101 cmt. 2. Most of these Article 4 checks would also be Article 3 negotiable instruments.

129. A secured party with a perfected interest takes priority over a U.C.C. § 9-301(3) "lien creditor" but may be subordinate to the type of lien creditor discussed in § 9-310:

> When a person in the ordinary course of his business furnishes services or materials with respect to goods subject to a security interest, a lien upon goods in the possession

risk and do whatever she can to insure the debtor will be unable to transfer an interest better than his own.

B. Negotiability and Sale of Goods

In sale of goods under U.C.C. Article 2, the negotiability principle, although not foundational as in Article 9, is still important and generally unrecognized in the literature.[130] For obvious reasons, U.C.C. section 2-403 has elicited negotiability discussion.[131] There are two different rules at work in the section. The "voidable title" rule empowers a buyer who has taken a title voidable by the seller due to some defect in the transaction to "transfer a good title to a good faith purchaser for value."[132] Since one of the enumerated voidable title cases involves delivering goods in exchange for a check that is later dishonored,[133] the rule has potential application in an enormous number of cases. In addition, the rule protects "purchasers,"[134] not just buyers, and as a consequence secured parties are protected by the rule.[135]

In *First-Citizens Bank & Trust Co. v. Academic Archives, Inc.*,[136] four academic institutions delivered bound volumes of periodicals to the defendant Archives in exchange for the defendant's promise to deliver microfilm copies of the volumes delivered and of other periodicals. The volumes were delivered to Archives between March and July 1970 but only some of the microfilm copies were received by the institutions before the defendant was placed in receivership. The court characterized the agreements as a sale of the bound volumes under U.C.C. Article 2.[137] Plaintiff First-Citizens held a security interest against Archives's "equipment, fixtures and furniture, all present and future inventory,

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of such person given by statute or rule of law for such materials or services takes priority over a perfected security interest unless the lien is statutory and the statute expressly provides otherwise.

130. The historical importance of sale of goods in the development of negotiability is discussed *infra* note 370 and notes 377-80 and accompanying text.

131. *See supra* note 72.

132. U.C.C. § 2-403(1). Transactions in which goods are not sold but rather leased are covered by U.C.C. Article 2A, which is largely parallel to Article 2 on negotiability issues. For the rule applicable to a "lessor with voidable title" see U.C.C. § 2A-304(1). Although Article 2 is currently being rewritten, it does not appear the amendments will have any substantial impact on sale of goods negotiability issues.

133. U.C.C. § 2-403(1)(b).

134. *See supra* note 58.

135. *See, e.g., In re* Samuels & Co. Inc., 526 F.2d 1238, 1242 (5th Cir.), *cert. denied*, 429 U.S. 834 (1976).

136. 179 S.E.2d 850 (N.C. Ct. App.), *cert. denied*, 181 S.E.2d 601 (N.C. 1971).

137. *Id.* at 852-53.

products of debtor, present accounts receivable and all future accounts receivable."[138] The court held that First-Citizens' security interest attached to the bound volumes as after acquired inventory,[139] the interest was perfected by a filing on June 11, 1968,[140] and the institutions had no right to recover the volumes. Arguments that Archives held voidable title due to its misrepresentation of solvency were brushed aside because, in the court's view, First-Citizens was a section 2-403 good faith purchaser for value[141] and "one with voidable title can transfer better title than he had."[142]

The court in *First-Citizens v. Archives* used the negotiability principle at two different junctures. When the bound volumes were delivered to Archives the security agreement between First-Citizens and Archives operated to simultaneously transfer an interest in the volumes to First-Citizens that was better than Archives' interest. And as microfilm copies were produced, they would also be subject to the security agreement while in Archives' possession.[143] The educational institutions attempted unsuccessfully to reclaim the microfilm copies held by the receiver.[144] But with respect to the microfilm copies that had been delivered to the educational institutions prior to the appointment of the receiver, the result would be different. As to those microfilm copies, the negotiability principle was at work and they were no longer subject to First-Citizens' security interest.[145]

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138. *Id.* at 851.

139. *Id.* at 853-54.

140. *Id.* at 851, 853.

141. U.C.C. § 2-403(1). The case illustrates how Article 2 grants extremely limited reclamation rights. The educational institutions attempted to recover the bound volumes by using a seller's right under § 2-702(2) to reclaim goods upon discovery of the buyer's insolvency. The court ruled against the institutions, citing § 2-702(3): "The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser under this Article (Section 2-403)." *First Citizens*, 179 S.E.2d at 853. Alternatively, the institutions argued that they were Article 2 buyers of the microfilm copies and entitled to recover the microfilms still held by Archives under § 2-502(1). The court held § 2-502(1) inapplicable since the section requires that the seller become insolvent "within ten days after receipt of the first installment on their price" and Archives was already insolvent at the time the bound volumes were delivered. *Id.* at 854.

142. *First-Citizens*, 179 S.E.2d at 853.

143. The microfilm copies would be part of the debtor's inventory.

144. *See supra* note 141.

145. There is no indication in the opinion that First-Citizens attempted to recover the microfilm copies delivered to the educational institutions. Had it raised the issue, however, the court almost certainly would have applied the buyer in the ordinary course priority rule found in U.C.C. § 9-307(1) to protect the institutions.

In contract law generally, a duress rule similar to the U.C.C. section 2-403 "voidable title" rule applies the negotiability principle to sales of all types of property, including goods. If the seller of property is subjected to duress in the bargaining process, the buyer's title to the property is defective. The blueprint for analyzing this issue under the *Restatement (Second) of Contracts*[146] replicates Article 3. Does the duress make the contract voidable[147] or is it of such severity that the contract is entirely void?[148] If the buyer holds a voidable title, the seller can recover the property from the buyer but not from a subsequent good faith purchaser. However, if the buyer's title is void, a subsequent purchaser takes a title that is also void.[149] This scheme is identical to the Article 3 distinction between duress that creates a mere personal defense and duress that creates a real defense.[150] Even a holder in due course takes subject to a defense that the instrument was "signed at the point of a gun . . . ."[151] In duress cases, then, the distinction between negotiable instruments and other types of property is relatively unimportant.

Negotiability appears again in U.C.C. section 2-403 in the entrustment rule.[152] A person entrusting goods to a "merchant who deals in goods of that kind"[153] gives him the power to transfer her title to a buyer in the ordinary course of business. For example, in *Heiselman v. Marcus*[154] the defendant agreed to purchase a new boat from a boat dealer and traded in his old boat in partial payment. The plaintiff agreed to buy the trade-in from the dealer. When the dealer was unable to deliver the new boat to the defendant, the defendant took possession of the trade-in despite the sale to the plaintiff. The court held that the defendant had entrusted the trade-in to the dealer and that the buyer was protected because he qualified as a section 2-403(2) buyer in the ordinary course.[155]

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146. RESTATEMENT (SECOND) OF CONTRACTS §§ 174-176 (1981). The misrepresentation rule in *Restatement (Second)* makes a similar distinction between void and voidable obligations. *See id.* § 163 cmt. c.

147. *Id.* § 175.

148. *Id.* § 174.

149. *Id.* cmt. b.

150. U.C.C. § 3-305(a)(1)(ii).

151. U.C.C. § 3-305 cmt. 1.

152. U.C.C. § 2-403(2), (3). A "lessee in the ordinary course of business" is given similar protection in U.C.C. § 2A-304(2).

153. U.C.C. § 2-403(2).

154. 41 U.C.C. Rep. Serv. (Callaghan) 395 (N.Y. Sup. Ct. 1985).

155. *Id.* at 397.

The section 2-403 entrustment rule is narrower than the voidable title rule since it protects only buyers and not other purchasers. In comparison with the Article 3 holder in due course rule, however, the entrustment rule is both more and less generous. It is less generous in that the seller must be a merchant who deals in goods of the kind sold.[156] Furthermore a buyer in ordinary course does not necessarily receive a clear title under the entrustment rule. The buyer merely receives the entruster's rights to the goods with any and all defects.[157] If the entruster is a thief, for example, the buyer in ordinary course receives no title at all. A holder in due course, on the other hand, takes free of all claims to the instrument. But both the voidable title and entrustment negotiability rules in section 2-403 are more generous than the holder in due course rule in that they use a broader definition of value.[158]

An application of the negotiability concept in U.C.C. section 7-205[159] parallels the entrustment rule in section 2-403, although section 7-205 is much narrower in its scope, applying only to sales of fungible goods by a

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156. The "merchant" definition in general use in Article 2 provides:

> "Merchant" means a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill.

U.C.C. § 2-104(1).

The use of the term "merchant" in the entrustment rule is narrower. The entrustment rule applies only when the merchant "deals in goods of that kind." U.C.C. § 2-403(2). It does not apply to a "knowledge or skill peculiar to the practices or goods" case.

157. This limitation on the entrustment rule is comparable to the limitation in U.C.C. § 9-307(1), which protects a buyer in ordinary course against security interests created by the seller but not against security interests created by predecessors in title.

158. The voidable title rule merely requires the good faith purchaser to purchase "for value" as defined in U.C.C. § 1-201(44). *See supra* text accompanying notes 110-13. The entrustment rule protects buyers in the ordinary course of business. The definition of buyer in ordinary course of business explains:

> "Buying" may be for cash or by exchange of other property or on secured or unsecured credit and includes receiving goods or documents of title under a preexisting contract for sale but does not include a transfer in bulk or as security for or in total or partial satisfaction of a money debt.

U.C.C. § 1-201(9).

"Buying" is both broader and narrower than the U.C.C. § 3-303 definition of value. While taking an instrument in payment for an antecedent claim is value, taking goods in satisfaction of a money debt is not "buying." On the other hand, taking an instrument for a mere promise to perform is not value, but taking goods on credit, secured or unsecured, is "buying."

159. U.C.C. § 7-205 provides that "[a] buyer in the ordinary course of business of fungible goods sold and delivered by a warehouseman who is also in the business of buying and selling such goods takes free of any claim under a warehouse receipt even though it has been duly negotiated."

warehouseman who is also in the business of buying and selling goods of the type sold. Despite its limited range, section 7-205 demonstrates that the negotiability principle is a flexible tool adaptable to many kinds of problems. In addition to the general policy of encouraging ordinary course sales, in the case of fungible goods, difficult issues of tracing and recovery make any attempt to match claims to specific goods a mere "theoretical right."[160] Section 7-205 wisely abandons any such attempt, at least as to buyers in the ordinary course, by adopting the negotiability principle.

All four U.C.C. rules[161] protecting buyers or lessees in the ordinary course of business employ the negotiability principle to encourage ordinary course transactions in goods. Not only are all retail sales and retail leases covered by these rules, but also sales and leases by manufacturers and wholesalers.[162] Whenever the seller or lessor is in the business of selling or leasing goods of the kind, a buyer, even a wholesale buyer, can qualify for ordinary course status.[163] These rules are of more than mere theoretical interest—in 1992 the goods component of the Gross Domestic Product equaled $2,264.7 billion.[164]

While U.C.C. section 2-403 has generated significant discussion in the negotiability literature, the preceding section 2-402, which also employs the negotiability principle, has been ignored. Unsecured creditors, unlike Article 9 secured creditors, have no contractual claim against any particular property of the debtor. There are mechanisms, however, by which an unsecured creditor can stake a claim to particular assets. An unsecured creditor who obtains judgment against the debtor and levies against her property will at some point acquire lien creditor rights. Alternatively, if the debtor becomes bankrupt, the bankruptcy trustee representing unsecured creditors gathers assets that become "property of the estate."[165] All of these potential lien creditor or bankruptcy rights against particular goods in the debtor's hands vanish once the goods have been transferred to a good faith buyer for value.

U.C.C. section 2-402 addresses cases in which there is a contract to sell but the goods remain in the seller's possession. Other provisions in

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160. *Id.* cmt.

161. U.C.C. §§ 2-403(2), 2A-304(2), 7-205, 9-307(1).

162. *See, e.g., In re* Bearhouse, Inc., 84 B.R. 552 (Bankr. W.D. Ark. 1988); Locke v. Arabi Grain & Elevator Co., Inc., 399 S.E.2d 705 (Ga. Ct. App. 1990) *cert. denied* (Ga. 1991); Cessna Fin. Corp. v. Skyways Enter., Inc., 580 S.W.2d 491 (Ky. 1979).

163. *See* U.C.C. §§ 1-201(9), 2A-103(1)(a)-(o).

164. U.S. DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE U.S. 443 (1993).

165. *See* 11 U.S.C. § 541 (1992).

Article 2 allow a buyer to claim possession of goods held by the seller "if the seller becomes insolvent within ten days after receipt of the first installment on their price"[166] or in circumstances where specific performance or replevin are appropriate remedies.[167] Section 2-402 resolves any potential priority dispute between unsecured creditors and a buyer claiming section 2-502 or 2-716 rights by adopting the negotiability principle. A buyer fulfilling the requirements of section 2-502 or section 2-716 takes the goods free of any rights of the seller's unsecured creditors. To promote a buyer's "special property"[168] and a buyer's rights to specific performance or replevin, the seller is able to transfer an interest better than her own.

In U.C.C. section 2-702, negotiability is neither a violation of some fundamental principle nor an exception to a general rule; in fact, in any choice between a seller of goods and a good faith purchaser from the buyer, the negotiability principle is inescapable. U.C.C. section 2-702 grants a seller of goods a right of reclamation if the seller "discovers that the buyer has received goods on credit while insolvent . . . ."[169] These rights, however, are "subject to the rights of a buyer in ordinary course or other good faith purchaser under this Article (Section 2-403)."[170] If reclamation is denied, as in *First-Citizens v. Archives*,[171] the negotiability principle transfers an interest to the good faith purchaser that is better than the interest of the buyer. But if reclamation is granted, negotiability is also at work. The reclamation order transfers the goods from the buyer to the seller and the seller takes free of any claims effective against the goods in the buyer's hands.[172] Negotiability is vital, not only in section 2-702, but whenever a transferor is granted rights to recover property free and clear of claims against that property in the hands of the transferee. Indeed, because those rights can be defeated by a third party

166. U.C.C. § 2-502.

167. U.C.C. § 2-716.

168. U.C.C. § 2-502 requires that the buyer have an interest that qualifies as a § 2-501 "special property" and that the buyer tender any unpaid portion of the purchase price.

169. U.C.C. § 2-702(2).

170. U.C.C. § 2-702(3).

171. *See supra* note 141.

172. For example, in *In re* Daylin, Inc., 596 F.2d 853 (9th Cir. 1979), the court permitted Ray-O-Vac to reclaim goods delivered on credit to Daylin, Inc. Daylin filed for Bankruptcy on February 26, 1975, and on February 27, 1975 Ray-O-Vac made a U.C.C. § 2-702 written demand. *Id.* at 854. The court held that since a bankruptcy trustee does not qualify as a § 2-702(3) "buyer in the ordinary course or other good faith purchaser under this Article," Ray-O-Vac could reclaim the goods free and clear of the trustee's interest. *Id.* at 856.

with rights derived from or a claim against the transferee, negotiability is a logical necessity.

The Article 2 provisions on money damages allow an aggrieved seller to resell the goods and recover from the buyer the difference between the resale price and the contract price,[173] and a comparable rule allows a buyer in possession of nonconforming goods who rejects or revokes acceptance to sell goods in her possession.[174] In either case, the "purchaser who buys in good faith at a resale" is protected from claims by the original seller or buyer, even when the resale fails to comply with Article 2's requirements.[175] This double layer of protection implements a policy of encouraging resale at the highest possible price and, in theory, benefits both buyer and seller.[176] The negotiability principle of Article 2's resale provision is a counterpart of the section 9-504(4) rule facilitating disposition of collateral by the secured party.[177] This type of application of the negotiability principle appears throughout the U.C.C. in a menagerie of transactions: a merchant lessee's disposition of rightfully rejected goods,[178] a lessor's disposition of goods after breach by the lessee,[179] a bulk sale by auction,[180] a bulk sale conducted by a liquidator on the seller's behalf,[181] a sale to enforce a warehouseman's lien,[182] and a sale to enforce a carrier's lien.[183] Beyond the Uniform Commercial Code, the negotiability principle is in widespread use whenever property subject to a dispute or claim is transferred to a third party.[184]

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173. U.C.C. § 2-706(1).

174. U.C.C. § 2-711(3).

175. U.C.C. § 2-706(5). Although this subsection only explicitly addresses the case of an aggrieved seller ("A purchaser who buys in good faith at a resale takes the goods free of any rights of the original buyer even though the seller fails to comply . . ."), the issues in the case of an aggrieved buyer are similar and the subsection should be applied *mutatis mutandis*.

176. Section 2-706(5) protects both against claims by the original seller or buyer and against defects in the resale.

177. *See supra* notes 122-26 and accompanying text.

178. U.C.C. § 2A-511(4).

179. U.C.C. § 2A-527(4).

180. U.C.C. § 6-108(4).

181. *Id.*

182. U.C.C. § 7-210(5).

183. U.C.C. § 7-308(4).

184. For instance, a Massachusetts statute provides that unclaimed property is deemed abandoned after a period of time. If the rental for a safe deposit box is unpaid for one year, for example, the contents are to be removed by the bank, held for seven years, and, if unclaimed, turned over to the state. Title to the property vests in the state and if it is sold the purchaser obtains absolute title. The original owner may have a claim against the proceeds, which are placed in an abandoned property fund, but has no claim against the property itself. The Massachusetts statute also applies to unclaimed bequests; unclaimed property on deposit; unclaimed property deposited as security; unclaimed dividends, stocks, bonds, drafts, insur-

In addition to U.C.C. Article 2, both Article 6 and Article 7 employ the negotiability principle in sale of goods transactions. The entire history of bulk sale legislation has been a response by state legislatures to courts applying the negotiability principle to the sale of a business and its inventory.[185] A prefatory note to the recent Repealer and Revision of U.C.C. Article 6 explains how such sales have the potential to lead to fraud: "a merchant would acquire his stock in trade on credit, then sell his entire inventory ('in bulk') and abscond with the proceeds, leaving creditors unpaid. The creditors had a right to sue the merchant on unpaid debts, but that right often was of little personal value."[186] The inventory itself was no longer subject to the claims of the seller's creditors since the claims were unsecured and the buyer, unless he had acted fraudulently, was protected as a bona fide purchaser.[187] In the sale of the business, then, the buyer received an interest in the inventory that was better than the seller's interest because the inventory was no longer subject to claims by the seller's creditors.

U.C.C. Article 6 imposes an obligation on a buyer in a bulk sale[188] to obtain a list of the seller's creditors and notify listed creditors of the impending sale.[189] In some states the buyer must also insure that the proceeds of the sale are paid to creditors.[190] Compliance with Article 6

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ance proceeds, money paid into court, and property distributable upon dissolution or liquidation; and unused traveler's checks, gift certificates, and other claims for money and credits. *See* MASS. GEN. L. ch. 158, § 17; ch. 200A §§ 1-17 (1992).

185. The National Conference of Commissioners on Uniform State Laws and the American Law Institute have withdrawn their support of U.C.C. Article 6. For states choosing not to repeal, an amended version of Article 6 is recommended. *See* U.C.C. Repealer of Article 6 Bulk Transfers and [Revised] Article 6 Bulk Sales, Prefatory Note (1990). For discussions of the history of bulk sales legislation, see Don L. Baker, *Bulk Transfers Act—Patch, Bury, or Renovate?*, 38 BUS. LAW. 1771, 1772-76 (1983); Thomas Clifford Billig, *Bulk Sales Laws: A Study in Economic Adjustment*, 77 U. PA. L. REV. 72 (1928); Benjamin Weintraub & Harris Levin, *Bulk Sales Law and Adequate Protection of Creditors*, 65 HARV. L. REV. 418, 419 (1952).

186. UNIFORM COMMERCIAL CODE, Repealer of Article 6 Bulk Transfers and [Revised] Article 6 Bulk Sales, Prefatory Note (1990).

187. *See* Billig, *supra* note 185, at 78-80.

188. A bulk sale is defined in U.C.C. § 6-102(1)(c). In essence a bulk sale is a "sale or series of sales not in the ordinary course of the seller's business of more than half of the seller's inventory . . . ." *Id.* If the sale *were* in the ordinary course of the seller's business, Article 6 would not apply and the buyer would be protected by negotiability rules in U.C.C. §§ 2-403(2), 7-205, 9-307(1).

189. *See* U.C.C. §§ 6-104(1)(b), (d), 6-105.

190. U.C.C. § 6-106 (1987). Revised Article 6 merely requires the buyer to "distribute the net contract price in accordance with the undertakings of the buyer in the schedule of distribution." U.C.C. § 6-104(1)(e) (1990). As of January 1, 1995 five states had adopted the 1988 Revisions to U.C.C. Article 6 and twenty-seven states had repealed Article 6.

allows the buyer to take the inventory free of the claims of the seller's creditors. In other words, Article 6 creates a complex system of negotiability by verified list, filing, distribution schedule, and notice to creditors.

The sanctions for noncompliance have changed substantially in revised Article 6. Under the previous version, noncompliance resulted in the buyer taking the business subject to all claims effective against the seller; or to use the description in the official rationale for revision of Article 6, "[f]ailure to comply with the provisions of the Article renders the transfer ineffective."[191] The expression "renders the transfer ineffective" is an odd description for a result that actually is a mere application of the "same as" principle. If a bulk transfer buyer failed to comply, under the prior Article 6 he succeeded to the right, title, and interest of the seller. Subsequent purchasers from the noncomplying buyer, however, who purchased for value, in good faith, and without notice of the noncompliance were protected by the negotiability principle.[192]

Under revised Article 6, noncompliance "neither renders the sale ineffective nor otherwise affects the buyer's rights in or title to the assets,"[193] but instead makes the buyer liable in damages to the seller's creditors.[194] The total elimination of *in rem* rights is additional evidence that Article 6 was more trouble than it was worth. Furthermore, under the revisions, a buyer who made a good faith and reasonable effort to comply or exclude the sale from Article 6 or held a good faith and reasonable belief the Article did not apply is not liable for noncompliance.[195]

U.C.C. Article 7 creates a distinction between negotiable and nonnegotiable documents of title[196] that is related to the negotiable/non-negotiable dichotomy in Article 3. Unlike Article 3, however, the formal requirements in Article 7 are minimal: "A warehouse receipt, bill of lading or other document of title is negotiable (a) if by its terms the goods are to be delivered to bearer or to the order of a named person

191. U.C.C. § 6-101 cmt. 1 (1990).

192. U.C.C. § 6-110 (1987). This rule is similar to rules in Articles 3 and 4 that impose an obligation on the first transferee but protect subsequent transferees. *See infra* notes 242-60 and accompanying text.

193. U.C.C. § 6-107 cmt. 2 (1990).

194. U.C.C. § 6-107(1) (1990).

195. U.C.C. § 6-107(3). The comment explains: "When a buyer makes a good faith effort to comply with this Article or to exclude the transaction from its coverage, the injury caused by noncompliance is likely to be *de minimis*. . . . The good-faith-belief defense is an acknowledgement that reasonable people may disagree over whether a given transaction is or is not a bulk sale . . . ." U.C.C. § 6-107 cmt. 7 (emphasis added).

196. U.C.C. § 7-104.

. . . ."[197] "Documents of title" are produced when goods are either shipped[198] or stored[199] and a document is "issued by or addressed to a bailee and purport[s] to cover goods in the bailee's possession . . . ."[200] Transactions in documents ultimately are transactions in goods and to the extent Article 7 implements the negotiability principle, goods also become negotiable. For instance, in *R.E. Huntley Cotton Co. v. Fields*,[201] the plaintiffs stored 1640 bales of cotton with Panhandle Warehouse. The plaintiffs sold the warehouse receipts to Nowlin, who paid with checks later dishonored. In the meantime, Nowlin had sold the warehouse receipts to the defendants. The plaintiffs sought the return of the warehouse receipts and the trial court enjoined the defendants from removing the cotton from the warehouse. The appellate court in dissolving the injunction held that the warehouse receipts were negotiable under U.C.C. section 7-104[202] and had been duly negotiated to the defendants.

Many of the issues associated with documents of title are akin to commercial paper questions. A negotiable document may be "duly negotiated."[203] A holder by due negotiation enjoys rights similar to holder in due course rights.[204] Article 7 provides a shelter rule.[205] Certain claims against goods covered by a negotiable document of title are effective even against a holder by due negotiation—an echo of the real defenses in Article 3.[206] Article 7 grants transferees a right to compel indorsement,[207] creates warranties upon transfer,[208] and furnishes a mechanism for bringing suit on a lost or missing document.[209] It is al-

197. *Id. See also* Hodges v. Anderson, 35 U.C.C. Rep. Serv. (Callaghan) 1280 (Bankr. D.S.C. 1981), *aff'd sub nom.*, Hodges v. First National Bank of S.C., 35 U.C.C. Rep. Serv. (Callaghan) 1289 (4th Cir. 1982).

198. Examples of shipment documents include bills of lading, airway bills, air consignment notes, and destination bills.

199. Examples of storage documents include warehouse receipts, dock receipts, and dock warrants. Delivery orders may be either storage or shipment documents. *See generally* RAY D. HENSON, DOCUMENTS OF TITLE UNDER THE UNIFORM COMMERCIAL CODE 9-20 (2d ed. 1990); ROBERT A. RIEGERT & ROBERT BRAUCHER, DOCUMENTS OF TITLE 19-29 (3d ed. 1978).

200. U.C.C. § 1-201(15).

201. 21 U.C.C. Rep. Serv (Callaghan) 1157 (Tex. Civ. App. 1977).

202. *Id.* at 1160.

203. U.C.C. § 7-501(4).

204. U.C.C. § 7-502.

205. U.C.C. § 7-504(1).

206. *See* U.C.C. §§ 7-209(1), 7-307(1), 7-503(1).

207. U.C.C. § 7-506.

208. U.C.C. § 7-507.

209. U.C.C. § 7-601.

most as if the Article 7 drafting committee used Article 3 as a template in drawing these sections.

Furthermore, U.C.C. Article 7 is drafted in a cursory manner and seems to rely on Article 3 to fill in the gaps. Article 7, for example, uses the terms "indorsement in blank," "to bearer," and "special indorsee" but provides no definitions and minimal illustrations of how these principles work in practice.[210] One commercial law treatise remarks that "everyone seems to understand that an order document is comparable to an order instrument."[211] Article 3, on the other hand, devotes an entire part to negotiation, transfer, and indorsement.[212] Article 7 provides no explicit litigation entitlements to a holder of a document of title: Article 3 presumes the validity of signatures, imposes the burden of producing evidence on the party attacking a signature, and assumes a holder is entitled to payment unless the defendant establishes a defense.[213] A holder of a document of title hoping for a litigation advantage is relegated to arguing section 3-308 by analogy and citing a feeble section in Article 1.[214]

Article 7 also piggybacks on Article 3 with respect to a due negotiation issue. In Article 3 a purchaser of a negotiable instrument who takes with notice of overdueness is disqualified from holder in due course status.[215] Article 7 does not address the issue of overdueness, but presumably transfer of a stale document would raise a serious question whether the transferee had taken by due negotiation. Article 3 and its overdueness cases would provide a persuasive analogy.

C. Negotiability in U.C.C. Articles 3 & 4

Negotiable instruments jurisprudence is dominated by dichotomous thinking[216] which undoubtedly stems, in part, from the phenomenology of the classroom. Typically, the "same as" principle of property transfers and contract assignments is sketched as a backdrop to Article 3 and then the negotiability concept is introduced:

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210. U.C.C. §§ 7-501(1)-(3).

211. HENSON, *supra* note 199, at 128-29. For discussions of Article 7's incompleteness on the indorsement issue, see *id.* at 127-33; RIEGERT & BRAUCHER, *supra* note 199, at 76-78.

212. U.C.C. §§ 3-201, 3-202, 3-203, 3-204, 3-205, 3-206, 3-207.

213. U.C.C. § 3-308.

214. U.C.C. § 1-202. *See* HENSON, *supra* note 199, at 130-31; RIEGERT & BRAUCHER, *supra* note 199, at 74-76.

215. U.C.C. §§ 3-302(a)(2)(iii), 3-304.

216. *See supra* notes 3-15 and accompanying text.

> Whenever the word *negotiable* is applied to any kind of paper, the concept always means this: if the paper is technically *negotiable* (which refers to its form), it is technically *negotiated* (which refers to the transfer process) and reaches the hands of a purchaser for value who has no knowledge of problems with the transaction giving rise to the paper's creation (such a person is called a *holder in due course*); then the later purchaser becomes *Super-Plaintiff* and can sue the parties to the instrument who are not (with certain exceptions) permitted to defend the lawsuit; the defendants simply lose and pay up.[217]

This caricature[218] is based on the assumption that commercial paper disputes are resolvable by asking two straightforward either/or questions. Is the instrument negotiable or non-negotiable? If the instrument is negotiable, is the holder a holder in due course? If the answer to both questions is yes, the holder prevails. If either answer is no, the holder takes subject to all claims and all defenses. Although some cases are as straightforward as this simple calculus would suggest, many are not, and negotiable instruments issues can be enormously complex, subtle, and uncertain. Quite apart from the great variety of negotiability principles found in Article 3,[219] holder in due course status itself is more enigmatic, flexible, and subject to qualification than the conventional explanation suggests.

First, the real defenses put a dent in the "super plaintiff" myth. Defenses of infancy, "essential" fraud, discharge in insolvency proceedings, and defenses based on obligations void through duress, incapacity, or illegality prevail over holder in due course status.[220] The defense of forgery is also effective against a holder in due course, implementing a principle even more fundamental than the distinction between real and personal defenses: no person can be contractually liable on an instrument unless the instrument bears their signature.[221] A defendant whose

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217. DOUGLAS J. WHALEY, PROBLEMS AND MATERIALS ON COMMERCIAL LAW 290-91 (3d ed. 1993).

218. I suspect everyone who teaches commercial paper is more or less guilty of summarizing holder in due course rights in this manner.

219. *See infra* notes 242-48, 261-88, and accompanying text.

220. U.C.C. § 3-305(a)(1).

221. U.C.C. § 3-401. *See also* U.C.C. § 3-403(a), cmt. 1. It is possible to be liable on a warranty theory without signing the instrument. Under § 3-416, for example, a person who transfers an instrument for consideration makes transfer warranties to his immediate transferee and "if the transfer is by indorsement, to any subsequent transferee." U.C.C. § 3-416(a). Transfer warranty liability between immediate parties is based on transfer rather than indorsement.

name has been signed without authority is not liable, even to a holder in due course.

Discharge by material alteration also operates like a real defense, although only in part. If *A* issues a $100 promissory note to *B* and *B* fraudulently alters the amount to $500, *A* is discharged.[222] However, if *B* negotiates the note to *C* and *C* qualifies as a holder in due course, *A*'s discharge defense is ineffective against *C*, but *A* is liable only for the original amount $100.[223] *C* has no rights versus *A* to recover the $400 difference between the original amount and the altered amount. *C*'s sole remedy for the difference is against *B* on theories of indorsement contract and transfer warranty.

It is in part due to the real defenses, forgery and material alteration limitations on holder in due course rights, and the comparatively strict requirements for holder in due course status, that holder in due course does not occupy the extreme polar position on the negotiability spectrum but instead has been compromised. Other types of property such as cash and in some cases goods, securities, documents of title, and chattel paper can be more negotiable than negotiable instruments.[224]

Furthermore, although Article 3 relies principally on rules, standards add flexibility, elasticity, and uncertainty at several key junctures. A finding of negligence allows a court to overturn the entire Article 3 rule apparatus,[225] and the 1990 revisions of Articles 3 and 4 introduce comparative negligence in four sections.[226] An obligation of good faith applies throughout Article 3 by way of a general provision in Article 1.[227] Further, Section 1-103 provides that unless displaced, the principles of

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222. U.C.C. § 3-407 (a), (b).

223. U.C.C. § 3-407(c). A defendant who has been negligent may be liable for the altered amount. *See* U.C.C. § 3-406.

224. *See supra* notes 110-13, 116-17, 126, 156-58 and accompanying text and *infra* notes 248, 260, 451-58, 461-64 and accompanying text.

225. U.C.C. § 3-406(a). For similar sections see U.C.C. §§ 3-404(a), (c), 3-405(b), 4-406. The Article 3 definition of "ordinary care" illustrates a common statutory drafting technique of covering an area of law with a blanket standard ("'[o]rdinary care' in the case of a person engaged in business means observance of reasonable commercial standards") supplemented by rules applicable to particular practices ("[i]n the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument . . ."). U.C.C. § 3-103(a)(7). *See* Kennedy, *supra* note 3, at 1690.

226. U.C.C. §§ 3-404(d), 3-405(b), 3-406(b), 4-406. "Due care" and "reasonableness" are paradigm standards. *See* Kennedy, *supra* note 3, at 1688.

227. U.C.C. § 1-203 provides that "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement" and § 1-201(19) gives "good faith" a subjective definition: "honesty in fact in the conduct or transaction concerned."

law and equity shall supplement the Uniform Commercial Code.[228] Within Article 3, explicit statements of a good faith requirement[229] create maneuverability in thirteen sections.[230] And perhaps most significantly, a holder in due course, in addition to satisfying a list of relatively rigid requirements such as holder status and value, must also take in good faith.[231] As a result, the central Article 3 negotiability provision is no more certain in its application in any particular case than the good faith standard.

Additionally, it is possible to be a holder in due course of a limited interest. For example, a party taking an Article 9 security interest in an instrument can also be an Article 3 holder in due course. Such a party takes free of defenses, claims, and claims in recoupment but only to the extent of her interest, which is not necessarily the amount of the instrument.[232] Upon default by the debtor, a secured party, whether a holder in due course or not, must proceed under Part 5 of Article 9. This process is no less complicated than any other Article 9 default case.

On the question of remedies, the Article 3 contract rights of a disappointed purchaser, whether a holder in due course or not, display the same expectancy/reliance/restitution alternatives that fill the contract literature.[233] Although recovery of the amount stipulated in the instru-

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228. For an expansive reading of § 1-103, see Robert S. Summers, *General Equitable Principles Under Section 1-103 of the Uniform Commercial Code*, 72 Nw. U. L. REV. 906 (1978).

229. The Article 3 definition of good faith adds an objective component to the Article 1 definition. In Article 3 "'good faith' means honesty in fact and the observance of reasonable commercial standards of fair dealing." U.C.C. § 3-103(a)(4).

230. *See* U.C.C. §§ 3-202(b), 3-302(a), 3-403(a), 3-404(a), 3-404(b), 3-405(b), 3-406(b), 3-407(c), 3-409(c), 3-416(b), 3-417(a), 3-418(c), 3-420(c).

231. U.C.C. § 3-302(a).

232. U.C.C. § 3-302(e), cmt. 6. *See, e.g.*, Hollemon v. Murray, 666 P.2d 1107 (Colo. Ct. App. 1982).

233. The *Restatement (Second) of Contracts* provides:

> Judicial remedies under the rules stated in this Restatement serve to protect one or more of the following interests of a promisee:
>
> (a) his "expectation interest," which is his interest in having the benefit of his bargain by being put in as good a position as he would have been in had the contract been performed,
>
> (b) his "reliance interest," which is his interest in being reimbursed for loss caused by reliance on the contract by being put in as good a position as he would have been in had the contract not been made, or
>
> (c) his "restitution interest" which is his interest in having restored to him any benefit that he has conferred on the other party.

RESTATEMENT (SECOND) OF CONTRACTS § 344.

For discussions of contract remedies see P.S. ATIYAH, THE RISE AND FALL OF FREEDOM OF CONTRACT 1-7, 455-501, 764-79 (1979); PETER LINZER, A CONTRACTS ANTHOLOGY 210-60, 419-452 (1989); Lon L. Fuller & William R. Perdue, Jr., *The Reliance Interest In Contract*

ment is the norm, reliance and restitution operate at the edges and work to undermine an all or nothing view of Article 3 negotiability. In *Universal Acceptance Corp. v. Burks*,[234] for instance, the defendant purchased goods from District T.V. Corporation and paid by issuing a promissory note. At the time of the transaction, the corporate charter of District T.V. had been revoked for failure to file an annual report and pay annual fees.[235] District T.V. negotiated the note to the plaintiff and the defendant defaulted after making some of the payments on the note. The plaintiff sued the defendant on the note, and the defendant raised as a defense the revocation of District T.V.'s corporate charter. The court held that the revocation created a defense to liability on the note and also that the defense qualified as a real defense. The plaintiff, however, did not walk away empty handed. The court held that although the defendant was not liable on the instrument, she was liable in restitution for the value of the goods retained by her. The court held that the goods were worth at least the total of her payments on the note and denied her counterclaim for return of the amount she had paid.[236]

At a key juncture, Article 3 seems concerned primarily with protecting the reliance interest, not the full expectancy. An executory promise is not "value" for the purpose of establishing holder in due course status: an instrument is taken for value only "to the extent the promise has been performed."[237] If a purchaser of a negotiable instrument receives notice of a claim or defense prior to performance on her promise, she cannot be a holder in due course even though she subsequently performs. The purchaser's expectation, measured at the time of contracting, is disappointed. The comments to U.C.C. section 3-303 point out that a purchaser receiving notice of a claim or defense is entitled to suspend her own performance and raise a failure of consideration defense against her transferor.[238] A purchaser is protected by holder in due course status only to the extent that she has relied by actual performance prior to receiving notice of a claim or defense.

Damages (pts. 1 & 2), 46 YALE L.J. 52 (1936), 46 YALE L.J. 373 (1937); Stanley D. Henderson, *Promissory Estoppel and Traditional Contract Doctrine*, 78 YALE L.J. 343 (1969); Edward Yorio & Steve Thel, *The Promissory Basis of Section 90*, 101 YALE L.J. 111 (1991); Steve Thel & Edward Yorio, *The Promissory Basis of Past Consideration*, 78 VA. L. REV. 1045 (1992).

234. 7 U.C.C. Rep. Serv. (Callaghan) 39 (D.C. Ct. Gen. Sess. 1969).

235. *Id.* at 40.

236. *Id.* at 43.

237. U.C.C. § 3-303(a)(1). *See also* U.C.C. § 3-302(d).

238. U.C.C. § 3-303 cmt. 2.

Cases of partial performance raise a particularly intriguing remedy issue. The recent revisions to Article 3 adopt a pro rata solution.[239] A comment to section 3-302 illustrates the mathematics of partial performance:

> Case #5. Payee negotiates a $1,000 note to Holder who agrees to pay $900 for it. After paying $500, Holder learns that Payee defrauded Maker in the transaction giving rise to the note. Under subsection (d) Holder may assert rights as a holder in due course to the extent of $555.55 ($500 ÷ $900 = .555 × $1,000 = $555.55). This formula *rewards* Holder with a ratable portion of the bargained for profit.[240]

At the time Holder purchased the note he expected holder in due course status in the full amount of the note ($1,000). When he learned of the defense, however, he had paid only five-ninths of the agreed consideration. A full expectancy position would award Holder full rights upon payment of the $400 balance. If, as in the hypothetical, he is taking from the wrongdoer and further payment should be discouraged, his full expectancy interest could be protected by granting him holder in due course status as to $600—$1,000 minus $400 of costs saved. The reliance interest would be $500. Subsection 3-302(d) creates a result that is a compromise between full expectancy and mere reliance. In calling the pro rata formula a "reward," the comment implies it is somewhat beyond Holder's entitlement and only granted out of a spirit of generosity.

The pro rata approach follows logically on the heels of the exclusion of a purely executory promise from qualifying as value under Article 3. If Holder had not paid any of the $900 agreed consideration, he would not be a holder in due course in any amount ($0). If he had paid the full $900 agreed consideration he would be a holder for value in the full amount of the note ($1000). Only a full payment case places Holder in a full expectation position. Partial payment cases position the purchaser on a pro rata scale between $1000 and $0. This pro rata scale is a compromise between the expectation and the reliance interests.

The negotiability principle clearly plays a central role in Article 3 in the rights of a holder in due course to take free of claims to the instrument, claims in recoupment,[241] and most defenses. Numerous other Article 3 provisions, however, use the negotiability principle and are

239. U.C.C. § 3-302(d).

240. U.C.C. § 3-302 cmt. 6 (emphasis added).

241. U.C.C. §§ 3-305, 3-306.

displayed along the spectrum from positions only marginally better than "same as" to positions more generous than holder in due course.

A typical use of the negotiability principle imposes an obligation on the first transferee of an instrument but allows subsequent transferees to take free of the obligation. Negotiability is a useful mechanism for balancing the conflict between a compelling obligation on the one hand and the free transferability of commercial paper on the other. For example, section 3-307 creates an elaborate and detailed rule for determining whether a person who takes from a fiduciary has notice of a breach of fiduciary duty. The rule, however, applies exclusively to the first taker[242] from the fiduciary. Subsequent transferees, whether holders in due course or not, are not affected by the rule and are liable only if they have actual knowledge of the breach of fiduciary duty.

A parallel rule applies to restrictive indorsements using language "to the effect that payment is to be made to the indorsee as agent, trustee, or other fiduciary for the benefit of the indorser or other person."[243] The comments to section 3-206 illustrate the rule:

> Suppose Payee indorses a check "Pay to *T* in trust for *B*." *T* indorses in blank and delivers it to (a) Holder for value; (b) Depositary Bank for collection; or (c) Payor Bank for payment. In each case these takers can safely pay *T* so long as they have no notice under Section 3-307 of any breach of fiduciary duty that *T* may be committing. For example, under subsection (a) of Section 3-307 these takers have notice of a breach of trust if the check was taken in any transaction known by the taker to be for *T*'s personal benefit. Subsequent transferees of the check from Holder or Depositary Bank are not affected by the restriction unless they have knowledge that *T* dealt with the check in breach of trust.[244]

If Holder took with notice of the breach of fiduciary duty under section 3-307(a), she would be subject to the fiduciary's claim. A transferee from the Holder, however, would not be subject to the claim absent knowledge of *T*'s breach of trust. Sections 3-206(d) and 3-307 allow Holder to transfer an interest better than her own and impose only minimum requirements on the transferee. The negotiability principle strikes

242. The rule applies to the first party who takes the instrument from the fiduciary, whether "for payment or collection or for value." U.C.C. § 3-307(b)(1).

243. U.C.C. § 3-206(d).

244. U.C.C. § 3-206 cmt. 4.

a compromise between protecting the represented person[245] and encouraging the transfer of commercial paper.

A similar rule applies to restrictive indorsements imposing a condition on the indorsee's right to payment (*i.e.* "Pay *D* if he loses 10 pounds"). Such conditions may be binding on the indorsee under contract principles,[246] but "[a] person paying the instrument or taking it for value or collection may disregard the condition, and the rights and liabilities of that person are not affected by whether the condition has been fulfilled."[247] If *D*, then, transfers the instrument to *E* for value, *E* can ignore any agreement between *D* and a prior party that payment to *D* would be conditioned on *D* losing ten pounds.

These two restrictive indorsement rules are both more and less generous to the purchaser than the holder in due course prototype. They are less generous in that they protect the transferee from only one claim, failure to comply with the terms of the indorsement, not all claims. They are more generous in that they impose fewer prerequisites than holder in due course status. Since the only transferees not protected are transferees with knowledge "that the fiduciary dealt with the instrument or its proceeds in breach of fiduciary duty,"[248] the rules are more generous to the purchaser than the holder in due course rule. Admittedly, the rules speak to a narrow issue, but in cases of breach of fiduciary duty, purchasers are protected by rules that fall between +8 (the holder in due course position) and +10 on the metaphorical number line.

An analogous application of the negotiability principle protects intermediary banks[249] from claims in conversion. A representative, other than a depositary bank, acting in good faith is not liable in conversion unless it still has proceeds in its hands.[250] Depositary banks must seek refuge in the more exacting holder in due course rule or, in a case of a fraudulent indorsement by an employee, U.C.C. section 3-405.[251] A

245. A "represented person" is a person to whom a fiduciary duty is owed. *See* U.C.C. § 3-307(a)(2).

246. U.C.C. § 3-206 cmt. 2.

247. U.C.C. § 3-206(b).

248. U.C.C. § 3-206(d)(2).

249. An intermediary bank is "a bank to which an item is transferred in course of collection except the depositary or payor bank." U.C.C. § 4-105(4).

250. U.C.C. § 3-420(c).

251. U.C.C. § 3-405 imposes liability on the employer in cases where the employer entrusts an employee with responsibility regarding an instrument, the employee or accomplice applies a fraudulent indorsement, and the depositary bank in good faith takes the item for collection. If the depositary bank fails to exercise ordinary care, the loss is shared between the employer and the bank.

transfer of an instrument from a depositary bank to an intermediary bank is, therefore, a transfer of a "better than" position. An intermediary bank need only act in good faith to take free of a conversion claim that is effective against its transferor, the depositary bank.

In the typical case of conversion of corporate checks, an employee steals checks payable to his employer, forges the employer's indorsement, and deposits the checks in an account especially established for the receipt of the stolen checks. It is sensible to impose conversion liability on one of the banks handling the checks for collection, but it is not necessary to hold all collecting banks liable. The depositary bank is in the best position to guard against this type of fraud since it is the first bank handling the item, and subsection 3-420(c) imposes liability on that bank. The rule has the additional virtue of being symmetrical with warranty liability.[252] The conflict between the policy of protecting the true owner's property interest in a negotiable instrument and the policy of encouraging free transfer of instruments through the bank collection process is mediated by the negotiability principle.

Most discussions of U.C.C. Article 3 sooner or later implicate Article 4. An examination of the negotiability principle is no exception. Article 4 applies to items[253] that are either deposited into or paid by the bank deposits and collections network.[254] The term "item" includes all negotiable instruments paid or collected by a bank, but also includes non-negotiable promises and orders.[255] To the extent Article 4 uses the negotiability principle, then, it undermines a rigid distinction between negotiable instruments and nonnegotiable choses in action.[256]

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252. A payor bank paying on a forged indorsement is liable to the true owner in conversion since it "makes . . . payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment." U.C.C. § 3-420(a). The payor bank has presentment warranty rights against the presenting bank and previous transferors. U.C.C. § 4-208. The intermediary banks have transfer warranty rights against the depositary bank. U.C.C. § 4-207. Ultimately, the depositary bank would end up pursuing its customer.

253. U.C.C. § 4-104(a)(9).

254. *Id. See also* U.C.C. § 4-101, cmts.

255. U.C.C. § 4-104(a)(9), cmt. 8. Although typically collecting banks merely act as agents for the owner of the item, Article 4 applies "even though action of the parties clearly establishes that a particular bank has purchased the item and is the owner of it." U.C.C. § 4-201(a).

256. In addition to its use of the negotiability principle, Article 4 applies other Article 3 concepts to items both negotiable and nonnegotiable. For example, § 4-207(a) creates transfer warranties rights against all prior customers and collecting banks. Furthermore, section 4-207(b) imposes an obligation to pay the amount of the item that is analogous to Article 3 indorsement contract liability.

Section 4-203 provides that "only a collecting bank's transferor can give instructions that affect the bank or constitute notice to it."[257] This "chain of command" principle not only allows a collecting bank to ignore instructions given by a party that is not the bank's transferor, but also protects the bank from liability for actions in compliance with instructions from or agreements with its transferor.[258] In the interests of accelerating the bank collection process,[259] a transferor to a collecting bank transfers an item free of instructions and liabilities imposed on it by its transferor. A treatise on Article 4 provides the following illustration:

> Customer instructs Depositary Bank that a draft must be presented within three days. Depositary Bank forwards the draft to Presenting Bank for presentment to Buyer, the drawee. Depositary Bank neglects to instruct Presenting Bank that presentment must be made within three days. As a result, Presenting Bank is not bound by the instruction. If Presenting Bank takes four days to present the draft, the question arises as to whether Presenting Bank has exercised ordinary care under section 4-202(b). If it did not, Presenting Bank is liable to Customer for any losses caused thereby. If taking four days to present the draft constituted the exercise of ordinary care, Customer would have no action against Presenting Bank. However, Customer would still have an action against Depositary Bank for its failure to include the time limit in its instruction to Presenting Bank.[260]

In this example, Presenting Bank takes a position that is better than the position of Depositary Bank since it is not bound by the instruction given to Depositary Bank by its Customer. The rule in section 4-203 applies whether the instrument is negotiable or not; all "items" collected by collecting banks benefit from the rule. The rule is more generous than the holder in due course archetype in that the transferee is only bound by the instruction if it takes with actual knowledge of the instruction. In fact, this rule seems to be located at the +10 polar position on the negotiability number line.

There are other negotiability sections in U.C.C. Articles 3 and 4 that implement an assortment of policies. The transfer[261] and presentment[262] warranties generally operate under a "same as" approach unless a party

257. U.C.C. § 4-203.
258. *Id.*
259. *Id.* cmt.
260. 6B WILLIAM D. HAWKLAND & LARY LAWRENCE, U.C.C. SERIES § 4-203:01 (Rev. Art. 4) (1993).
261. U.C.C. §§ 3-416, 4-207.
262. U.C.C. §§ 3-417, 4-208.

establishes holder in due course status. For example, the transfer warranty that "the instrument is not subject to a defense or claim in recoupment of any party which can be asserted against the warrantor"[263] is predicated on transferees receiving an interest no better than their transferors. If *A* issues a note to *B* and the note provides for a usurious interest rate, *A* has a defense good against *B*.[264] If *B* transfers the note to *C* for consideration, *B* is liable to *C* for breach of transfer warranty. If *C* is not a holder in due course, when *C* transfers the note to *D* for consideration *C* also breaches the transfer warranty since *A*'s defense is effective against *C*. The warranty is breached whether *C* knows of the defense or not. The "no defense or claim in recoupment" warranty is a warranty about the state of the transferor's right, title, and interest in the property.

Most of the other warranties also operate under this "same as" regime, but one transfer warranty and one presentment warranty are disconnected from orthodox transfer rules.[265] The presentment warranty concerning an unauthorized signature of a drawer of a draft is not an absolute warranty that the signature is authentic and authorized, but instead a limited warranty that "the warrantor has *no knowledge* that the signature of the drawer is unauthorized."[266] Because this particular warranty is not based on right, title, or interest in the instrument but rather on the transferor's knowledge, it is possible for a transferee to take a position better than her transferor.[267] If *Z* steals *A*'s checkbook, forges *A*'s signature on a check as drawer, inserts his own name as payee, and negotiates the check to *B*, when the check is ultimately paid by the payor bank, *Z* is liable to the bank for breach of presentment warranty. *B*, however, is not locked into a position identical to *Z*. When *B* transfers or presents the check she would not be liable to the payor bank unless she knew the drawer's signature was unauthorized. This "no knowledge" warranty preserves the rule of *Price v. Neal*,[268] which places the risk of an unauthorized drawer's signatures on the drawee but creates a good faith exception that imposes liability on a party who presents or

263. U.C.C. § 3-416(a)(4).

264. The hypothetical assumes that the defense of usury is not a real defense.

265. U.C.C. §§ 3-416(a)(5), 3-417(a)(3), 4-207(a)(5), 4-208(a)(3).

266. U.C.C. § 3-417(a)(3) (emphasis added). *See also* U.C.C. § 4-208(a)(3).

267. Although this discussion concerns presentment warranties, not transfer warranties, the presentment warranties are made not only by the party presenting the instrument but also by all prior transferors. *See* U.C.C. §§ 3-417(a), 4-208(a).

268. 97 Eng. Rep. 871 (K.B. 1762).

transfers with knowledge of the unauthorized signature.[269] A warrantor without knowledge does not breach the warranty. A warrantor who knows that the drawer's signature is unauthorized is liable.

The negotiability principle is also implicated when transfer warranties are disclaimed.[270] As between immediate parties, warranties can be disclaimed either by adding specific language to the indorsement or by separate agreement. A disclaimer on the instrument will be effective against subsequent transferees. But in a separate agreement case, the disclaimer is effective only against the immediate party. As a result, a subsequent transferee will take free of the disclaimer and therefore has rights in the instrument not available to the transferor.

The 1990 revisions of Article 3 have eliminated a negotiability provision that dealt with the issue of signatures on negotiable instruments by authorized representatives. A classic commercial paper problem is the agent who signs her own name to an instrument and either names the person represented or discloses her representative capacity, but not both. Prior to the recent amendments, negotiability was deployed to answer the question whether in such a case the agent should be personally liable.[271]

Between the immediate parties (in most cases the issuer and the payee) parol evidence was admissible to prove the parties did not intend

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269. If the unauthorized signature is an indorsement, rather than the drawer's signature, the result is different since one of the presentment warranties is that the warrantor was a person entitled to enforce. In a forged indorsement case, the loss should fall on the first person to take from the forger, rather than on the drawee, since the drawee has no reason to be familiar with the indorser's signature. *See* U.C.C. §§ 3-417(a)(1), 4-208(a)(1).

270. Subsection 3-416(c) prohibits warranty disclaimers with respect to checks, but as to other instruments transfer warranties may be disclaimed. Hawkland and Lawrence comment:

> The transferor's warranties cannot be disclaimed with respect to checks. Persons receiving checks, especially depositary banks, seldom look carefully at the back of the check. It would be very easy for a transferee to overlook a disclaimer of the transferor's warranties. Since the check collection system relies upon the transferor's warranties, a transferor of a check is not allowed to disclaim any of the transferor's warranties. Transferor's warranties on other instruments may be disclaimed either by an agreement between the immediate parties or by including in the indorsement words like "without warranties" or a similar phrase.

6A HAWKLAND & LAWRENCE, *supra* note 260, § 3-416:02.

271. Prior to the 1990 revision, U.C.C. Article 3 provided:

> (2) An authorized representative who signs his own name to an instrument . . .(b) except as otherwise established between the immediate parties, is personally obligated if the instrument names the person represented but does not show that the representative signed in a representative capacity, or if the instrument does not name the person represented but does show that the representative signed in a representative capacity.

U.C.C. § 3-403(2)(b) (1987).

It is worth noting that as of January 1, 1995 this provision was still in force in 15 states.

personal liability.[272] If the instrument had been transferred by the payee and was held by a nonimmediate party, however, the agent was personally liable and parol evidence was not admissible to prove otherwise. In *American Exchange Bank, Collinsville, Okla. v. Cessna*,[273] for example, the defendant signed a check with the corporate name printed in the lower left hand corner, but the signature did not disclose his representative capacity. When the check was transferred from the payee to the plaintiff bank, the bank received an interest superior to the payee since it had rights not only against the corporation but also against the representative.[274] If the check were still held by the payee, parol evidence would be admissible and the agent could escape personal liability.[275] This rule was exceptionally generous to the transferee: holder in due course status was not required, and apparently any good faith transferee could use the rule.[276] On the negotiability number line, this rule would be found at the +10 polar position.

The 1990 revisions to Article 3 introduce a new concept, "claims in recoupment,"[277] which previously had been encompassed within the generic term "defenses" but now has been separated out for special treatment. The negotiability principle is an indispensable part of this new concept. The comments to section 3-305 provide an illustration of a claim in recoupment:

> Buyer issues a note to the order of Seller in exchange for a promise of Seller to deliver specified equipment. . . . [S]uppose Seller delivered the promised equipment and it was accepted by Buyer. The equipment, however, was defective. Buyer retained the equipment and incurred expenses with respect to its repair. In this case, Buyer does not have a defense under Section 3-303(b). Seller delivered the equipment and the equipment was accepted. Under Article 2, Buyer is obliged to pay the price of the equipment which is represented by the note. But Buyer may have a claim against Seller for breach of warranty. If Buyer has a warranty claim, the claim may be asserted against Seller as a counter-

272. U.C.C. § 3-403 cmt. 3 (1987).

273. 386 F. Supp. 494 (N.D. Okla. 1974).

274. *Id.* at 496.

275. The 1990 Revisions comment on the abandonment of this particular negotiability rule states: "If the original parties to the note did not intend that [the agent] also be liable, imposing liability on [the agent] is a windfall to the person enforcing the note." U.C.C. § 3-402 cmt. 2 (1990).

276. Uniform Commercial Code section 1-203 imposes a general obligation of good faith in transactions under the Code.

277. U.C.C. § 3-305(a)(3).

> claim or as a claim in recoupment to reduce the amount owing on the note.[278]

As between Buyer and Seller, Buyer may use her U.C.C. Article 2 breach of warranty claim to reduce her liability on the note. Buyer could also recover damages beyond the sum due on the note by way of a counterclaim against Seller. Additionally, claims and obligations arising out of separate transactions between Seller and Buyer could be used by Buyer as set-offs against her liability on the note.

If Seller transfers the note, however, the transferee takes a position that is better in two respects. First, as against a transferee from the original payee, the claim in recoupment may be used "only to reduce the amount owing on the instrument at the time the action is brought."[279] If the claim in recoupment is more than the sum due on the instrument, Buyer has no rights to recover the excess from the transferee even if payments have been made to the transferee. A worst case scenario would have the Seller immediately transferring the note, Buyer making payment in full to the transferee, and the Buyer then discovering a defect in the goods. Buyer would have no Article 3 rights *vis-a-vis* the transferee and would be forced to pursue Seller on an Article 2 breach of warranty claim. Second, the transferee takes an interest in the instrument that is not subject to set-off by unrelated claims against the Seller. As against a transferee, the Buyer can only use claims that "arose from the transaction that gave rise to the instrument."[280] This double negotiability rule protects all transferees; holder in due course status is not required.[281]

The most significant negotiability development in the 1990 Revisions may prove to be the abandonment in three sections of a full holder in due course requirement.[282] These sections now impose a mere "person who, in good faith . . . takes [the instrument] for value or for collection"

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278. U.C.C. § 3-305 cmt. 3.

279. U.C.C. § 3-305(a)(3).

280. U.C.C. § 3-305 cmt. 3.

281. A transferee who did not satisfy the U.C.C. § 1-203 requirement of good faith, however, should not be protected by these rules.

282. U.C.C. §§ 3-406, 3-407, 3-418. Other Article 3 sections that benefit purchasers and require less than full holder in due course status are §§ 3-403, 3-404, 3-405. The requirements in § 3-403, which make an unauthorized signer liable to "a person who in good faith pays the instrument or takes it for value," are unchanged by the 1990 revisions. Sections 3-404 and 3-405, although not requiring holder in due course status, are less generous to purchasers than prerevision U.C.C. § 3-405 (1987), which imposed no requirements at all. Courts generally applied § 3-405 (1987) if they found that the purchaser satisfied a general good faith standard. *See* Robert G. Ballen et. al., *Commercial Paper, Bank Deposits and Collections, and Other Payment Systems*, 43 BUS. LAW. 1305, 1345 (1988); Robert G. Ballen et. al., *Commercial Paper,*

standard and, as a consequence, are substantially more generous to purchasers. They now occupy a more extreme position on the negotiability spectrum, a position between holder in due course and +10. Furthermore, when these sections are combined with Revised Section 3-106(d), they may have unexpected and adverse consequences for consumers in goods or services transactions.

In 1976, a generation of U.C.C. Article 3 consumer litigation came to a close when the Federal Trade Commission promulgated a regulation requiring credit contracts issued in consumer goods or services transactions to contain a "Notice" providing that a holder of the contract is subject to all claims and defenses the consumer could assert against the seller of the goods or services.[283] Courts and commentators generally interpreted the "Notice" language as destroying the negotiability of the instrument because payment was conditional.[284] Revised Section 3-106(d) brings these instruments back into Article 3 but provides that there cannot be a holder in due course of such instruments.[285] The drafters of this section were obviously locked into an either/or view of negotiability: either the transferee is a holder in due course and takes a position better than her transferor, or she is not a holder in due course

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Bank Deposits and Collections, and Other Payment Systems, 44 BUS. LAW. 1515, 1555-56 (1989).

283. FTC Holder-In-Due-Course Regulations, 16 C.F.R. 433 (1993). The full text of the "Notice" reads as follows:

> Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained pursuant hereto or with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder.

16 C.F.R. 433.2(a) (1993).

284. A negotiable instrument must be an unconditional promise or order. *See* U.C.C. § 3-104(a). For commentary on the F.T.C. rule see JAMES J. WHITE & ROBERT S. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE app. (2d ed. 1980). *See also* Daniel E. Murray, *Revised Articles 3 & 4 of the Uniform Commercial Code: A Friendly Critique*, 47 U. MIAMI L. REV. 337, 341 (1992). *But see* Michael F. Sturley, *The Legal Impact of the Federal Trade Commission's Holder in Due Course Notice on a Negotiable Instrument: How Clever are the Rascals at the FTC?*, 68 N.C. L. REV. 953, 956-58 (1990). For cases holding that the F.T.C. notice made the instrument conditional, see Capital Bank & Trust Co. v. Lacey, 393 So. 2d 668, 669 (La. 1980); Thomas v. Ford Motor Credit Co. 429 A.2d 277, 281-82 (Md. App. 1981); Ford Motor Credit v. Morgan, 536 N.E.2d 587, 589 (Mass. 1989).

285. U.C.C. § 3-106(d) provides:

> If a promise or order at the time it is issued or first comes into possession of a holder contains a statement, required by applicable statutory or administrative law, to the effect that the rights of a holder or transferee are subject to claims or defenses that the issuer could assert against the original payee, the promise or order is not thereby made conditional for the purposes of Section 3-104(a); but if the promise or order is an instrument, there cannot be a holder in due course of the instrument.

and takes a position that is the same as her transferor. The negotiability issue is not, however, an either/or question. Instead a full spectrum of positions are possible. Holder in due course is but one stopping point on the line between 0 and +10.

For example, assume a consumer (*C*) signs a contract for the installation of aluminum siding on his home. The contractor refers him to a finance company, which makes a purchase money loan to *C*, who pays $500 down and signs a note for the $2,000 balance. The note contains the required F.T.C. notice. *C* is negligent, however, in signing the note by leaving blank spaces in the segments of the note stating the amount. The finance company fraudulently alters the amount from $2,000 to $22,000 by filling in the blank spaces. The note is then sold to a good faith purchaser (*P*) who pays the finance company market price for a $22,000 consumer note. The siding is never installed on *C*'s home, and both the finance company and contractor file for bankruptcy.

When *P* brings suit against *C* for the amount of the note ($22,000), *C* will have two defenses: failure of consideration[286] and alteration.[287] As to the $2,000 failure of consideration defense, *C* would prevail both before and after the Revisions. The F.T.C. notice provides that *P* takes subject to all claims and defenses available against the seller of the goods or services; the failure of consideration defense is effective against the seller. The defense therefore is also effective against *P*.

With respect to the alteration defense, however, the result appears to have been changed by the Revisions. Prior to new section 3-106(d), Article 3 would not have applied to the note because it is conditional and *P* could take no better rights in the note than the finance company. Since *C*'s alteration defense would have been good against the finance company, it would also have been good against *P*. Under the Revisions, however, it appears that *C* would be liable to *P* for $20,000. The note is subject to U.C.C. Article 3, *C* has been negligent and the negligence substantially contributed to the material alteration, and *P* is a person who in good faith took the instrument for value.[288] Although section 3-106(d) disqualifies *P* from holder in due course status, that status is no longer required in a section 3-406 preclusion case. It is hard to imagine that the drafting committee intended this outcome, but when reading revised section 3-106(d) together with 3-406, it is a result difficult to escape. Under

286. U.C.C. § 3-305(a)(2).

287. U.C.C. § 3-407.

288. U.C.C. § 3-406(a).

a dichotomous approach to the negotiability principle, it is remarkably easy for the right hand not to know what the left hand is doing.

II. THE "WORSE THAN" ALTERNATIVE

> "What! And not sell out the rest o' the property? March off like a passel o' fools and leave eight or nine thous'n' dollars' worth o' property layin' around jest sufferin' to be scooped in?—and all good salable stuff too."
>
> The duke he grumbled; said the bag of gold was enough, and he didn't want to go no deeper—didn't want to rob a lot of orphans of *everything* they had.
>
> "Why, how you talk!" says the king. "We shan't rob 'em of nothing at all but jest this money. The people that *buys* the property is the suff'rers; because as soon's it's found out 'at we didn't own it—which won't be long after we've slid—the sale won't be valid, and it'll all go back to the estate."[289]

The king's oration demonstrates a keen awareness of the "same as" principle with its negotiability alternative and a finely tuned sensitivity to differences in property. The gold coin could be spent "down river" and good faith purchasers would take free of the true owner's claim.[290] The other property, however, would be subject to the "same as" principle. Purchasers, even good faith purchasers, would take a "rapscallion's" title, and that is no title at all. But when property is transferred or contract rights assigned, there is a third alternative, not mentioned by the king, and also ignored in the negotiable instruments literature: the transferee might take a right, title, or interest that is worse than the interest of her transferor. When property is transferred or contract rights assigned, there are numerous instances in which the transferee takes subject to a defense or claim that would be ineffective against the transferor or receives an interest in property that is in some way inferior to the interest of the transferor. There is no more profound symptom of either/or thinking in commercial paper scholarship than this total failure to investigate or even see this third alternative.

A "worse than" position can arise by agreement of the parties or be imposed by a legislature or court. It is an important alternative to the "same as" and "better than" positions and further undermines the assumption that the shelter rule is dominant, natural, and fundamental. A

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289. MARK TWAIN, THE ADVENTURES OF HUCKLEBERRY FINN 241-42 (Peter Coveney ed., Penguin Books 1985)(1884).

290. *See infra* note 370.

transferor is not locked into transferring an interest that is either identical to or better than her own. An entire spectrum of "worse than" positions is available by contract and is also displayed in statutes and court opinions. Like negotiability, the "worse than" alternative is a handy tool for implementing a variety of policies and a myriad of positions between -10 and 0 are available.

The polar -10 position on the "worse than" spectrum is an outright prohibition of transfer. Historically the common law was reluctant to recognize transfer of intangible and quasi-tangible property. Assignment of contract rights was particularly slow to develop and was not fully recognized until the twentieth century.[291] Merchants originally were attracted to negotiable instruments not because they granted "better than" rights, but because they could be transferred.[292] As one commentator has observed, the term negotiability has both an "original" and an "acquired" meaning: "Originally it meant transferable; but afterwards it was used to indicate the *effects* of transfer, namely that the transferee (1) took free from equities, and (2) could sue in his own name."[293] In the seventeenth and eighteenth centuries, while simple contracts were stuck at -10 on the metaphorical number line, negotiable instruments were struggling to stake out a position at 0.

Common law courts were reluctant to recognize the merchant practice of transferring bills of exchange and promissory notes. In a 1703

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291. *See, e.g.*, 4 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS 403-09 (1952); Walter Wheeler Cook, *The Alienability of Choses in Action: A Reply to Professor Williston*, 30 HARV. L. REV. 449 (1917).

292. *See, e.g.*, Rogers, *supra* note 47, at 275-77.

293. Ewart, *supra* note 69, at 140-41. *See also* Rogers, *supra* note 47, at 277. For discussions of the history of negotiable instruments see PATRICK ATIYAH, THE RISE AND FALL OF FREEDOM OF CONTRACT 104-05, 135-37, 154 (1979); LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 69, 235-36 (1973); J. MILNES HOLDEN, THE HISTORY OF NEGOTIABLE INSTRUMENTS IN ENGLISH LAW (1955) [hereinafter HOLDEN, HISTORY OF NEGOTIABLE INSTRUMENTS]; 8 WILLIAM HOLDSWORTH, A HISTORY OF ENGLISH LAW 113-76 (2d ed. 1937); MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1780-1860, 177-79, 212-26 (1977); WILLIAM E. NELSON, AMERICANIZATION OF THE COMMON LAW 43, 81-82 (1975); Frederick K. Beutel, *The Development of Negotiable Instruments in Early English Law*, 51 HARV. L. REV. 813 (1938) [hereinafter Beutel, *Development of Negotiable Instruments*]; Frederick K. Beutel, *Colonial Sources of the Negotiable Instruments Law of the United States*, 34 ILL. L. REV. 137 (1939) [hereinafter Beutel, *Colonial Sources*]; Frederick K. Beutel, *The Development on State Statutes of Negotiable Paper Prior to the Negotiable Instruments Law*, 40 COLUM. L. REV. 836 (1940) [hereinafter Beutel, *Development of State Statutes*]; J. Milnes Holden, *Bills of Exchange During the Seventeenth Century*, 67 LAW Q. REV. 230 (1951) [hereinafter Holden, *Bills of Exchange*]; Rogers, *supra* note 73; Harold R. Weinberg, *Commercial Paper in Economic Theory and Legal History*, 70 KY. L.J. 567 (1981-82).

case, *Buller v. Crips*,[294] the defendant had signed a note in the following form: "I promise to pay John Smith, or order, the sum of one hundred pounds, on account of wine had from him."[295] The payee indorsed the note to the plaintiff who brought suit directly against the maker. The case raised no negotiability issue in the sense of the holder attempting to assert rights that were better than the payee. The plaintiff was simply attempting to establish that the payee had transferred his right of payment and that transfers of notes were a merchant custom as firmly established as transfers of bills of exchange which, by 1703, had been recognized in common law courts. The court, however, ruled against the plaintiff, and Chief Justice Holt remarked:

> I remember when actions upon inland bills of exchange did first begin; and there they laid a particular custom between London and Bristol; and it was an action against the acceptor; the defendant's counsel would put them to prove the custom; at which Hale, Chief Justice, who tried it, laughed, and said they had a hopeful case of it.[296]

Parliament, not seeing the humor in restricting the transferability of bills and notes, responded by passing the Statute of Anne, which made promissory notes as assignable as inland bills of exchange.[297]

Although generally the common law and statutory law have adopted a philosophy of free alienability of most types of property,[298] certain

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294. 87 Eng. Rep. 793 (K.B. 1703).

295. *Id.* at 793.

296. *Id.* An "inland" bill of exchange was a bill arising from trade internal to England. An "outland" bill arose from foreign trade. *See* HOLDEN, HISTORY OF NEGOTIABLE INSTRUMENTS, *supra* note 293, at 47-54; HOLDSWORTH, *supra* note 293, at 158.

297. The statute provided in pertinent part:

> All notes in writing made and signed by any person or persons, whereby such person or persons shall promise to pay any other person, his, her, or their order, or to bearer, any sum of money mentioned in such note . . . every such note shall be assignable or indorsable over in the same manner as inland bills of exchange . . . and any person or persons to whom such note is indorsed or assigned . . . may maintain an action for such sum of money, either against the person or persons who signed such note, or against any of the persons who indorsed the same, in like manner as in cases of inland bills of exchange.

3 & 4 Anne, ch. 9 (1705).

298. In his treatise Corbin offered a tentative summary of this transition in the common law's treatment of assignments of contract rights:

> A shift, from the doctrine that a "chose in action" is of such a nature that it cannot be assigned and that an attempt to assign it as a subject of sale is illegal because involving maintenance, to the doctrine that a provision in a contract forbidding the assignment of rights is invalid because it involves an improper restraint on the alienation of property, marks a great change in the climate of judicial opinion. Such a shift, however, has to some extent occurred. It cannot be said that the new doctrine is yet established; nor should it be predicted as yet that it will be established.

kinds of transfers are still prohibited. For example, a federal statute not only prohibits the transfer of rights and delegation of duties under public contracts and orders, but in addition "any such transfer shall cause the annulment of the contract or order transferred."[299] Federal and state licenses and permits are typically nontransferable or transferable only if the transferee submits to an application process virtually identical to an original application.[300] Although contract *rights* are for the most part freely assignable, an assignment is ineffective if it materially changes the duty, burden, or risk of the obligor, or reduces the value of the return performance, or violates public policy.[301] Normally contract *duties* can be delegated, but not if the delegation is contrary to public policy or if the "obligee has a substantial interest in having [the obligor] perform or control the act promised."[302] Although contract rights and duties are generally transferable, an offer may not be assigned by the offeree.[303]

Attempts to prohibit by agreement the transfer of rights and interests otherwise fully alienable have met with mixed success and have become increasingly suspect.[304] Contract terms prohibiting an assignment of "the contract" are interpreted to exclude only delegation of duties, not

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CORBIN, *supra* note 291, at 487.

299. 41 U.S.C. § 15 (1951).

300. *See, e.g.*, 47 U.S.C. § 310(d) (1990).

301. RESTATEMENT (SECOND) OF CONTRACTS § 317 (1981); U.C.C. § 2-210(1). Rights under a letter of credit can be transferred "only when the credit is expressly designated as transferable or assignable." U.C.C. § 5-116(1).

302. RESTATEMENT (SECOND) OF CONTRACTS § 318(2)(1981). Under the U.C.C., a delegation of duties gives the other party to the contract a right to demand assurances from the delegatee under § 2-609. Since the mere fact of delegation creates reasonable grounds for insecurity under § 2-609, the delegatee is in a worse position than the delegator. *See* U.C.C. §§ 2-210(1), (5).

303. *Id.* § 52. Corbin comments on this apparent anomaly:

> An offer may be made by *A* to one specific person *B*; in such case *B* is the sole person who can accept *A*'s offer. The power of acceptance is not assignable by *B* to any third person.... [The rule] persists ... in spite of the fact that in nearly all cases *B* can accept *A*'s offer and at once assign his contract rights and delegate the performance of his own duties without *A*'s assent.... In no case has *B* the power to rid himself of his duties by assigning them to *C*, even though their performance is not personal and can be delegated. This leads to the observation that when *B* attempts to assign his power of acceptance ... their action is usually to be interpreted as an attempt to substitute *C* for *B* in all respects as party to the contract with *A*.

1 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS 235-38 (1963).

Rights of an offeree arising under an option contract, however, are assignable. *See* RESTATEMENT (SECOND) OF CONTRACTS § 320 (1981).

304. A contract term prohibiting transfer may assist the court in resolving borderline cases involving rights arguably nonassignable for other reasons. *See* RESTATEMENT (SECOND) OF CONTRACTS § 317(2), cmts. d & f (1981).

assignment of rights.[305] Several provisions of the U.C.C. invalidate nonassignability clauses.[306] Despite this trend, terms prohibiting the transfer of rights under insurance policies,[307] agreements for the future transfer of land,[308] and certain kinds of personal property[309] have been upheld.

In addition to contract provisions prohibiting transfer, many contracts contain terms that allow transfer but place the transferee in a position inferior to the transferor. There are myriad reasons why a transferor might prefer to transfer an interest inferior to her own. Absent a serious conflict with free alienability principles or some other countervailing policy, the concept of freedom of contract supports restrictions and limitations created by agreement. An owner of property might convey a limited interest such as a security interest, leasehold, mortgage, easement, mineral right, freehold estate, future interest, lien, bailment, concurrent interest, license, or benefit of a covenant running with land. An assignment of a contract right may be made for a limited purpose as, for instance, an assignment for collection. Assignments may be subject to conditions imposed by agreement (*e.g.*, a "building contractor may assign his right to payment to a bank as security for a loan, conditional upon the non-payment of the loan by a certain day").[310] It is also open to the transferor to assign only a part of her contract rights against the obligor. In *Restatement (Second) of Contracts*, partial assignments have been separated from their equitable roots and "a partial assignment and a total assignment are equally effective, subject to the protection of the obligor . . . ."[311] In all of these cases the shelter principle is easily overturned by agreement. These transfers would be positioned somewhere between -10 and 0 on the "worse than" scale.

Numerous statutory provisions impose a "worse than" position on the transferee and clearly conflict with the shelter principle. The con-

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305. RESTATEMENT (SECOND) OF CONTRACTS § 322(1) (1981); U.C.C. § 2-210(3). *See* CORBIN, *supra* note 291, at 482-87.

306. U.C.C. §§ 2-210(2), 2A-303(3), 2A-303(4), 3-206(a), 9-311, 9-318(4).

307. *See* CORBIN, *supra* note 291, at 495-96.

308. *Id.* at 491-92.

309. For example, in TransWorld Airlines, Inc. v. American Coupon Exchange, Inc., 913 F.2d 676 (9th Cir. 1990), the nonassignability of frequent flier coupons was upheld.

310. CORBIN, *supra* note 291, at 509. If the transferor's own rights are conditional, the transferee receives conditional rights by application of the shelter rule. The building contractor example, however, is different. In the example the condition is created by the assignment agreement and the bank's rights are inferior to the building contractor's rights.

311. RESTATEMENT (SECOND) OF CONTRACTS § 326 cmt. b. The obligor is entitled to joinder of all persons entitled to the performance unless he has agreed to perform the part separately. *Id.* § 326(2). *See also* CORBIN, *supra* note 291, at 568-76 for a discussion of partial assignments.

flict, however, is seldom resolved or even mentioned in the statute. Occasionally, statutory shelter rules create explicit exceptions relegating certain types of transferees to a "worse than" position.[312] U.C.C. section 8-301, for example, states a shelter rule as applied to transfers of securities: "the purchaser acquires the rights in the security which his transferor had or had actual authority to convey unless the purchaser's rights are limited by Section 8-302(4)."[313] Subsection 8-302(4) stipulates that a transferee who participated in fraud or illegality related to the security or who as a prior holder had notice of a claim is prohibited from "improv[ing] his position by taking from a bona fide purchaser."[314] These provisions recognize and address the clash between the shelter principle and policies against fraud, illegality, and status laundering.

Other U.C.C. sections, however, clash just as discordantly with the shelter principle, and neither the section nor the shelter rule mention the conflict. In Article 3, for example, transfer warranties run in favor of the immediate transferee and "if the transfer is by indorsement, to any subsequent transferee . . . ."[315] Assume *A* signs a promissory note in bearer form and issues the note to *B*. *B* transfers the note for consideration and without indorsement to *C*, who subsequently transfers the note for consideration to *D*. Under section 3-416, *C* has transfer warranty rights against *B* but apparently *D* does not. *D*'s warranty rights are solely against *C*. In the transfer from *C* to *D*, then, *D* took a position inferior to *C* in that one of *C*'s rights were not transferred to her. Could *D* bring an action directly against *B* for breach of transfer warranty, arguing that since C had warranty rights against *B*, those rights were transferred to her under the Article 3 shelter rule?[316] The argument is not wholly implausible because Article 3 does not explicitly resolve the conflict between transfer warranties and the shelter rule.

A court *could* justify a decision denying *D* the right to sue *B* for breach of transfer warranty by merely citing a rule of statutory construction, such as "expression of one thing excludes another"[317] or perhaps the "plain meaning"[318] rule. But, as Llewellyn taught us, every rule of

312. *See supra* notes 44-293 and accompanying text.

313. U.C.C. § 8-301(1).

314. U.C.C. § 8-302(4).

315. U.C.C. § 3-416(a).

316. U.C.C. § 3-203(b).

317. *See generally* 2A SUTHERLAND STATUTORY CONSTRUCTION §§ 47.23 -.25 (Norman J. Singer ed., 5th ed. 1992).

318. *Id.* § 46.01.

statutory construction has a counter rule.[319] If the purposes and policies of the shelter rule were sufficiently compelling, a court could overcome the "plain meaning" of section 3-416(a) by merely citing the counter rule: "language may fairly comprehend . . . different cases where some only are mentioned by way of example"[320] or "[plain meaning may be avoided] when literal interpretation would . . . thwart manifest purpose."[321]

A court taking a deeper look at the issue would find that the shelter principle is completely foreign to the concept of warranty liability. Warranties attaching to the transfer of property typically benefit only the immediate transferee. Warranties arose out of contract, and, contract privity requirements inhibited development of third party rights. In U.C.C. Article 2, the implied warranties of merchantability,[322] fitness for particular purpose,[323] and implied warranties created by course of dealing or usage of trade[324] traditionally have conferred rights on the immediate buyer and not on subsequent buyers in the distribution chain. Only recent case law and statutory liberalization of privity restrictions have started to erode this position. The entire question, sometimes known as the "vertical privity" issue, is generated because the shelter principle, far from being a fundamental concept, is unknown to warranty liability. If the shelter principle did apply, a subsequent buyer would receive the right, title, and interest of his seller, which would include rights against the prior seller for breach of warranty. In fact, historically these rights were not transferred. Courts and legislatures have been agonizingly slow in extending liability.[325]

When a document of title is negotiated or transferred, warranty issues are raised both about the document (*i.e.*, its genuineness, knowledge of facts impairing its validity or worth, and the rightfulness and effectiveness of the transfer) and about the goods represented by the

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319. *See* KARL N. LLEWELLYN, THE COMMON LAW TRADITION: DECIDING APPEALS app. C (1960).

320. *Id.* at 526.

321. *Id.* at 524. For general discussions of statutory interpretation, see GUIDO CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES 31-43 (1982); JAMES WILLARD HURST, DEALING WITH STATUTES 31-65 (1982); Elizabeth Warren, *Formal and Operative Rules under Common Law and Code*, 30 UCLA L. REV. 898 (1983).

322. U.C.C. § 2-314(1).

323. U.C.C. § 2-315.

324. U.C.C. § 2-314(3).

325. For discussion of vertical privity, see Harry G. Prince, *Overprotecting the Consumer? Section 2-607(3)(a) Notice of Breach in Nonprivity Contexts*, 66 N.C. L. REV. 107, 132-36, 152-53 (1987); Richard E. Speidel, *Warranty Theory, Economic Loss, and the Privity Requirement: Once More into the Void*, 67 B.U. L. REV. 9, 42-44, (1987).

document. On the question of warranties about the goods, U.C.C. Article 7 defers to other law.[326] But warranties about the document are addressed in section 7-507, and those warranties expressly benefit only the immediate purchaser and not subsequent transferees.[327] When documents of title are transferred, the transferee takes a position worse than her transferor since the right to sue a prior party in warranty is not transferred.

In comparison, then, with warranties applied to other types of property, warranties arising from the transfer of negotiable instruments are relatively generous. An Article 3 purchaser has warranty rights not only against his transferor but also against prior transferors who indorse. This largess arises not from the negotiability concept but simply from an application of the "same as" principle to an area of the law, warranty liability, where it is otherwise unknown.

Statutory applications of the "worse than" concept are not limited to warranty sections. Uniform Commercial Code sections imposing a position on transferees that is in some sense inferior to the transferor demonstrate the scope and variety of "worse than" provisions.

When a promissory note or uncertified check is taken for an obligation, the merger principle suspends the obligation until the instrument is dishonored.[328] Upon dishonor, the rights of the person entitled to enforce[329] depend, however, upon his status as the original obligee or a transferee. If, after dishonor, the person entitled to enforce is the original obligee, he may sue the obligor either on the instrument or on the underlying obligation.[330] On the other hand, if the person entitled to enforce is not the original obligee, "the only right that survives is the right to enforce the instrument."[331] In other words, when the payee of a promissory note or uncertified check transfers the instrument, the transferee takes fewer rights than were available to the transferor. The right to sue on the underlying obligation is not transferable and it does not

326. While previous versions of Article 7 addressed warranties as to goods, the comments to current § 7-507 indicate: "This section omits provisions of the prior acts on warranties as to the goods as unnecessary and incomplete. It is unnecessary because such warranties derive from the contract of sale and not from the transfer of the documents." U.C.C. § 7-507 cmt. 1.

327. U.C.C. § 7-507.

328. U.C.C. § 3-310(b).

329. The expression "person entitled to enforce" was introduced by the 1990 revisions and is defined as "(i) the holder of the instrument, (ii) a nonholder in possession of the instrument who has the rights of a holder, or (iii) a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 3-309 or 3-418(d)." U.C.C. § 3-301.

330. U.C.C. § 3-310(b)(3).

331. U.C.C. § 3-310 cmt. 3.

remain with the obligee: it simply evaporates upon transfer of the instrument.[332] If the instrument is reacquired by the original obligee, however, the right to sue on the obligation reappears and the obligee can sue either on the instrument or on the underlying obligation.[333]

Even the most rudimentary check or note transaction, then, utilizes both the "worse than" and "better than" principles. *A* signs a check as drawer and issues it to *B*. *B* transfers the check to *C*, who presents it to the payor bank and the check is dishonored. *B* reacquires the check from *C* and demands payment from *A*. In this scenario, *B* transferred a position to *C* that was worse than her own. *B* could have sued *A* either on the instrument or on the underlying obligation, while *C* is restricted to suing *A* on the instrument. When *C* retransferred the check to *B*, however, *B* took an interest better than *C* since *B* has rights to sue either on the instrument or on the obligation. It could be argued, of course, that *B*'s rights are not derived from transfer but are based on her original rights, which are simply reacquired upon transfer. The transfer from *C* to *B* is, however, at least a necessary, if not a sufficient, condition of *B*'s "better than" status. The point here is that section 3-310 violates the allegedly fundamental shelter rule at least once and perhaps twice without so much as a nod in its direction.

The 1990 Revisions create a new rule in section 3-312 that uses the "worse than" option to address a particularly knotty commercial paper problem; "cases in which a cashier's check, teller's check, or certified check is lost, destroyed, or stolen."[334] The conflict between protecting the bank against the risk of double liability and providing some relief to the owner of the check had not been addressed by statute prior to the Revisions.

To illustrate the issue, consider the tale of Jesus Santos.[335] In June 1978 Santos withdrew $15,514.46 from a savings account and purchased a cashier's check in that amount payable to his order. He sent the check to his father, and it was apparently lost in the mail. The bank refused to issue a substitute check unless Santos provided an indemnification bond or posted other security. Santos found this impossible because he was

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332. U.C.C. § 3-310(b)(4), cmt. 3.

333. The discussion of the merger rule in comment 3 to U.C.C. § 3-310 includes the following remark: "Thus, if the seller sold the note or the check to a holder and *has not reacquired it after dishonor*, the only right that survives is the right to enforce the instrument." (emphasis added).

334. U.C.C. § 3-312 cmt. 1.

335. Santos v. First Nat'l State Bank of N.J., 451 A.2d 401 (N.J. Super. Ct. App. Div. 1982).

unemployed and the cashier's check represented all of his assets.[336] He brought suit under prior U.C.C. section 3-804 requesting that the bank be ordered to issue a substitute without security.[337] The trial court adopted the bank's position and held that the bank was required to issue a substitute only upon Santos obtaining a security bond effective until June 17, 1985 (seven years after issuance of the check).[338] On appeal Santos fared somewhat better—the bank was ordered to issue a certificate of deposit in Santos' name, pay the interest from the certificate quarterly, and pay the principal to Santos on July 1, 1984, if the check had not surfaced by that date.[339] The result hardly encourages the purchase of cashier's, teller's, or certified checks.

Revised section 3-312 uses the "worse than" option to strike a balance between the bank and its customer. When a cashier's, teller's, or certified check is lost, destroyed or stolen, the customer has a right to simply file a written "declaration of loss"[340] with the bank and if the check is not presented to the bank for payment within 90 days of its date, the bank must pay the amount of the check to the customer.[341] If the customer has transferred the check to a third party, however, that person does not have a right to file a section 3-312 "declaration of loss" and usually will be required to provide security to the bank.[342] The Official Comment to section 3-312 discusses the refusal to grant rights under the section to transferees:

> Limitation to an original party or remitter gives the obligated bank the ability to determine, at the time it becomes obligated on the check, the identity of the person or persons who can assert a claim with respect to the check. The bank is not faced with having to determine the rights of some person who was not a party to the check at that time or with whom the bank had not dealt.[343]

When the check is transferred from the customer to the third party, the transferee takes a position inferior to the transferor.[344] Apparently the

336. *Id.* at 403.

337. In the alternative, Santos requested an account be established that would periodically pay interest to him and pay the principal after the six year limitations period. *See id.* at 404.

338. *Id.* at 403. This date was seven years after issuance of the check. The New Jersey limitations period is only six years and it is unclear why the trial court tacked on an extra year.

339. *Id.* at 414.

340. U.C.C. § 3-312(a)(3).

341. U.C.C. § 3-312(b)(2).

342. See U.C.C. §§ 3-312 cmt. 1, 3-309.

343. U.C.C. § 3-312 cmt. 2.

344. On the negotiability number line, the transferee takes a position that is somewhere between -10 and 0.

drafting committee did not feel constrained by any sense that whenever property is transferred the transferee must inevitably receive all of the rights of the transferor or by any feeling that a "same as" position is fundamental and natural. Section 3-312 betrays no hint that it is departing from the shelter concept.

The U.C.C. Article 3 requirements for "holder" status are among the most rigid rules of negotiable instruments law. A "holder" must have possession of the instrument and the instrument must either be in bearer form or payable to the person in possession.[345] Transferring an order instrument without indorsement, even though the transfer is completed by delivery and otherwise fully effective, means that the transferee is not a holder[346] and further, that the delivery does not qualify as an Article 3 negotiation.[347] This failure to comply with the formalities for negotiation results in the transferee taking a position that is worse than the position of her transferor in two different senses.

First, in litigation a transferee who does not qualify as a holder is not entitled to the section 3-308(b) presumption that she is a person entitled to enforce the instrument.[348] Instead, she must plead and prove a transfer to her from the holder and then claim the protection of the shelter rule.[349] Ironically, the shelter rule is put to work in a circumstance where realistically the transferee is not in the same position as her transferor.

Second, if the transfer is a transfer for value, "the transferee has a specifically enforceable right to the unqualified indorsement of the transferor,"[350] and when the indorsement is applied, the transferee becomes a holder. But since a negotiation of the instrument does not occur until indorsement,[351] if, in the interim, the transferee receives notice of a claim, defense, dishonor, overdueness, unauthorized signature, or alteration, he cannot be a holder in due course.[352]

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345. U.C.C. § 1-201(20) provides: "'Holder,' with respect to a negotiable instrument, means the person in possession if the instrument is payable to bearer or, in the case of an instrument payable to an identified person, if the identified person is in possession."

346. Although the transferee would have possession, she would not be the person "identified" in the instrument as required by U.C.C. § 1-201(20).

347. In order for a transfer to be a negotiation, Article 3 requires that the transferee qualify as a holder. *See* U.C.C. § 3-201(a).

348. *See* U.C.C. § 3-308 cmt. 1.

349. *See id.*; U.C.C. § 3-203(b), cmt. 2.

350. U.C.C. § 3-203(c).

351. *Id.*

352. U.C.C. § 3-203 cmt. 3. *See, e.g.*, Security Pac. Nat'l Bank v. Chess, 129 Cal. Rptr. 852 (Cal. Ct. App. 1976).

Both rules undoubtedly encourage transferees to insure the transferor indorses at the time of delivery, but the rigidity of the rule also means that a failure to observe the requirements places the transferee in a position substantially worse than her transferor. Furthermore, the formalities of negotiation place negotiable instruments at a relative disadvantage *vis-a-vis* other types of property (*e.g.*, goods, cash, contract rights) that can be transferred by mere delivery.

The final point is that the "worse than" and "better than" spectra are issue specific. It is entirely possible for a transferee to be in a better position on one issue, in the same position on a second issue, and in a worse position on a third.

For example, assume *A* owes a $10,000 annual rent to *B* for office space. The local economy has been poor, *A* is unable to make the rental payment, and *B* decides she will take a $9,000 one year note from *A* rather than lose a tenant. *B* fails to make certain repairs to the premises as required by the lease, giving *A* a $1,500 claim in recoupment. *B* indorses and transfers the note to *C* who subsequently indorses and transfers the note to *D*. Both *C* and *D* take the note with notice of the claim in recoupment. As the due date approaches, it is apparent *A* will have difficulty paying, and *B* repurchases the note from *D*.

When *D* transfers the note to *B*, does *B* take a position that is better than, the same as, or worse than *D*? The correct answer is all of the above. If the issue is *A*'s liability on the underlying obligation to pay the $10,000 rent, *B* is in a better position than *D*. *D* had no right to sue *A* on the obligation because his rights would have been limited to rights on the instrument.[353] *B*, the original obligee, could opt to sue *A* either on the instrument for his $9,000 obligation as maker[354] or on the underlying $10,000 rental obligation.[355] If the issue is *A*'s ability to raise his $1,500 claim in recoupment as a set off to his liability as maker of the note, *B* takes a position that is the same as *D*'s. *A*'s claim in recoupment is effective both against *B* and *D* since neither of them qualifies as a holder in due course.[356] However, if the issue is *C*'s liability in contract as an indorser of the note, *B* takes a position that is worse than *D*'s. *D* could have sued *C* on her indorsement,[357] but *B*, as a holder prior to *C* who

353. *See supra* notes 328-33 and accompanying text.
354. U.C.C. § 3-412.
355. U.C.C. § 3-310(b)(4).
356. U.C.C. § 3-305(a)(3).
357. U.C.C. § 3-415.

reacquires the note, is unable to sue *C*.[358] In the transfer from *D* to *B*, *B* takes a position that is better than, the same as, and worse than *D*'s depending on the issue.

III. THE NEGOTIABILITY NETWORK

> [I]n the notes to *Miller v. Race* (1 Smith Lead. Cas. at 259), where all the authorities are collected, the very learned author says: "It may therefore be laid down as a safe rule that where an instrument is by the custom of trade transferable, like cash, by delivery, and is also capable of being sued upon by the person holding it *pro tempore*, then it is entitled to the name of a negotiable instrument, and the property in it passes to a *bona fide* transferee for value, *though the transfer may not have taken place in market overt.*"[359]

Both the standard histories of negotiable instruments and the brief synopses typically included in general histories of the common law emphasize two different aspects of the story. Some stress the commercial and economic forces (*e.g.*, debt collection, settlement of foreign accounts, lender protection, transmission of funds, demands for liquidity) that created and nurtured promissory notes and drafts.[360] Others focus on the rise and fall of competing court systems in England.[361] My goal is to concentrate on a third relatively neglected aspect of the story: the extent to which courts in negotiable instrument cases borrowed concepts from other property areas to fashion the "better than" principle. Furthermore, when the negotiability principle became established for notes and drafts, connections to other types of property tended to be ignored and then forgotten, surfacing only in cases falling at the borders between properties. Once amnesia had set in, the situation was ripe for "reverse borrowing" in which the negotiability principle was borrowed back by the originating property area. The principles of borrowing and then ig-

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358. U.C.C. § 3-207. The revised section is less clear on this point than U.C.C. § 3-208 (1987), but the rule that intervening parties (C) are discharged as against prior reacquiring parties (B) almost certainly survives the revisions. The policy of the rule is to escape an otherwise unavoidable circularity problem (*i.e.*, if *C* were not discharged, *B* would sue *C* on *C*'s indorsement, then *C* would sue *B* on *B*'s indorsement, etc.).

359. Crouch v. The Credit Foncier of England, Ltd., 8 L.R. 374, 381 (Q.B. 1873), *quoted in* HOLDEN, HISTORY OF NEGOTIABLE INSTRUMENTS, *supra* note 293, at 4 (emphasis added).

360. *See, e.g.*, ATIYAH, *supra* note 293, at 104-05, 154; FRIEDMAN, *supra* note 293, at 235-38; HORWITZ, *supra* note 293, at 212-26; NELSON, *supra* note 293, at 43; Beutel, *Colonial Sources*, *supra* note 293, at 139-40; Holden, *Bills of Exchange*, *supra* note 293, at 234-36; Weinberg, *supra* note 293.

361. *See, e.g.*, HOLDEN, HISTORY OF NEGOTIABLE INSTRUMENTS, *supra* note 293, at 14-20; Beutel, *Development of Negotiable Instruments*, *supra* note 293.

noring or forgetting are displayed in two pivotal negotiability cases: *Miller v. Race*[362] and *Peacock v. Rhodes*.[363]

The item of property at issue in *Miller v. Race* was a bank note issued by the Bank of England. At the time, bank notes were not legal tender but mere promises to pay.[364] A modern equivalent would be a certificate of deposit. Finney owned the bank note and on December 11, 1756, mailed it to Odenharty. The note was stolen in transit and on December 12 the plaintiff Miller, an inn keeper, purchased the note in good faith.[365] Finney requested and the Bank of England agreed to stop payment on the note.[366] When Miller presented the note, the defendant Race, a bank clerk, refused to pay and kept the note. Miller brought suit against Race for payment. At the time, bank notes were fully transferable, but the "better than" principle had yet to be applied to them. The facts of *Miller* forced the court to confront the issue. If Miller could not take a better right, title, and interest than his transferor, he would lose because his transferor was either a thief or held title through a thief. In order for Miller to prevail, the court would have to decide that a transferee of a bank note could take a right, title, or interest better than the transferor.

The arguments of counsel and the opinion of the court invoke a dazzling array of analogies to other types of property: goods, money,[367] lottery tickets, bills of exchange,[368] non-bank notes,[369] Exchequer notes, and land. In two of these areas, goods and money, the "better than" principle had been firmly established, so they became fruitful sources of analogy for the plaintiff.[370]

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362. 97 Eng. Rep. 398 (K.B. 1758).

363. 99 Eng. Rep. 402 (K.B. 1781). Both *Miller v. Race* and *Peacock v. Rhodes* are opinions by the legendary commercial law judge William Murray (Lord Mansfield). For discussions of Mansfield's judicial style, see LLEWELLYN, *supra* note 319, at 36-38; Daniel R. Coquillette, *Legal Ideology and Incorporation IV: The Nature of Civilian Influence on Modern Anglo-American Commercial Law*, 67 B.U. L. REV. 877, 948-70 (1987).

364. Notes of the Bank of England became legal tender in 1833. *See, e.g.*, J.S. Waterman, *The Promissory Note as a Substitute for Money*, 14 MINN. L. REV. 313, 321 (1930).

365. Apparently Miller gave cash (*i.e.*, coins) in exchange for the bank note. *Miller*, 97 Eng. Rep. at 402. At the trial it was found "that he took it for a full and valuable consideration in the usual course of business." *Id.*

366. *Id.* at 399. The bank required Finney to post security.

367. The report of the case uses "money" and "cash" interchangeably to refer to coins.

368. Bills of exchange are also referred to as "securities" in the report.

369. Non-bank notes are also referred to as "documents for debts" in the report.

370. The negotiability principle had been applied to coin at least as early as 1599. In Higgs v. Holiday, 78 Eng. Rep. 978 (K.B. 1599), the court denied a cause of action in trover for recovery of coin "because it cannot be known" and "when he had lost the possession thereof he lost the property also." *See also* Waterman, *supra* note 364, at 315.

The goods question was raised initially by defendant's counsel Lloyd. The plaintiff had sued in trover, a form of action used to test title to goods.[371] Lloyd contended that the action here was brought "not for the money due upon the note; but for the note itself, the paper . . . ."[372] He argued that although bank notes were accepted in the course of trade as cash,[373] the question before the court was title to the note itself, not the bank's obligation to pay, and "[n]ow this note, or these goods (as I may call it) was the property of Mr. Finney who paid in the money: he is the true owner."[374] Lloyd cited *Armory v. Delamirie*[375] in support of the proposition that a finder of property may keep it "against all but the rightful owner."[376] The thrust of his argument was that the true owner recovers goods when they are lost or stolen and the same rule should apply to bank notes.

Williams, counsel for the plaintiff, argued in reply that the case "falls within the reason of a sale in market-overt; and ought to be determined upon the same principle."[377] For at least one hundred-fifty years it had been established that a buyer of goods in market-overt received good

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A sale of goods in market overt delivered good title to the purchaser. English law flirted with the principle for a few hundred years before it became "settled law by 1596." Holdsworth, *supra* note 293, at 111. Blackstone provides the following description:

> Market overt in this country is only held on the special days provided in particular towns by charter or prescription; but in London every day, except Sunday is market day. The market place, or spot of ground set apart by custom for the sale of particular goods, is also in the country the only market overt; but in London every shop in which goods are exposed publicly to sale is market overt for such things only as the owner professes to trade in.

2 WILLIAM BLACKSTONE, COMMENTARIES *449, *quoted in* RAY ANDREWS BROWN, THE LAW OF PERSONAL PROPERTY 232-33 (2d ed. 1955).

371. *See* F.W. MAITLAND, THE FORMS OF ACTION AT COMMON LAW 57-58 (A.H. Chaytor & W.J. Whittaker eds. 1968) (1909).

372. *Miller*, 97 Eng. Rep. at 399.

373. The report of the case states:

> It was admitted and agreed, that, in the common and known course of trade, bank notes are paid by and received of the holder or possessor of them, as cash; and that in the usual way of negotiating bank notes, they pass from one person to another as cash, by delivery only and without any further inquiry or evidence of title, than what arises from the possession.

Id. at 398-99.

374. *Id.* at 399.

375. 93 Eng. Rep. 664 (K.B. 1722). *Armory v. Delamirie* is a chestnut property case. A chimney sweep's boy found jewels set in a jewelry setting. The boy took the jewelry to a goldsmith. An apprentice removed the stones, weighed them, and offered the boy three halfpence, which the boy declined, whereupon the apprentice returned the setting without the stones. The court gave recovery against the goldsmith in trover.

376. *Miller*, 97 Eng. Rep. at 400.

377. *Id.*

title even if the goods had been stolen.[378] Williams agreed with Lloyd that a finder or a thief of a note does not have a right against the true owner, but "after circulation, the holder upon a valuable consideration has a right"[379] and that the case should be "considered upon the same foot as a sale in market overt."[380] The report of *Miller v. Race* does not specify the reason or "foot" of the market-overt rule, but Williams was undoubtedly referring to the policy of encouraging ordinary course transactions in goods[381] and was attempting to establish that there was an equally important policy in encouraging ordinary course transactions in bank notes.

Lloyd, in reply, emphasized the general rule that when a "thing" is stolen it may be recovered and the bank note was "a mere piece of paper."[382] As to the market-overt exception, he argued that "there is no market overt for bank notes"[383] and that the reason behind the market-overt rule did not apply here.

Before considering further arguments by analogy, it is worth noting Mansfield's posture in the case. The arguments were delivered on a Friday.[384] At the conclusion, Mansfield deferred his decision until the following Tuesday. When court reconvened, the reporter recorded the following preliminary remark:

> Upon this argument on Friday last, Ld. Mansfield then said Sir Richard Lloyd had argued it so ingeniously, that (though he had no doubt about the matter,) it might be proper to look into the cases he had cited, in order to give a proper answer to them; and therefore the Court deferred giving their opinion, to this day. But at the same time, Ld. Mansfield said, he would not wish to have it understood in the city, that the court had any doubt about the point.[385]

In his opinion, Mansfield, speaking for a unanimous court, ruled in favor of the purchaser of the bank note. He opted not to employ the analogy

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378. *See supra* note 370.

379. *Miller*, 97 Eng Rep. at 400.

380. *Id.*

381. Arguably, a further policy justification for the market overt rule is that the true owner should be estopped since she did not track down the goods. In Baynes Case, 79 Eng. Rep. 1196, a silver basin and ewer were stolen from the Bishop of Worcester and sold in a London scrivener's shop. The court held that the sale was not in market overt, "for a scrivener's and cutler's shop, or the like, is not proper for the sale of plate, nor a place to which men will go to seek for such a thing lost or stole." *Id.*

382. *Miller*, 97 Eng. Rep. at 400.

383. *Id.* at 401.

384. The report indicates the date was January 27, 1758.

385. *Id.*

to market-overt and its underlying policy. A simpler analogy was available to him. Money provided a more direct corollary to bank notes and was unburdened by the time and place restrictions of market-overt.

On the previous Friday, Lloyd argued that there were two distinctions between the question before the court and a case involving money. First, the plaintiff had sued in trover, which was always linked to goods, here the paper itself, and that was a different form of action "from what must be brought against the bank for the money."[386] Second, bank notes are different from money in that notes are unique.[387] Money, unlike bank notes, "is not to be distinguished, but these notes or bills are distinguishable . . . . They have distinct marks and numbers on them."[388]

Williams replied that as to the first point "the right to the money will attract to it a right to the paper."[389] On the second point he reaffirmed the admitted and agreed course of trade that bank notes were in fact treated as money. Lloyd responded: "Supposing this note to be a sort of mercantile cash; yet it has an earmark by which it may be distinguished."[390]

Mansfield began his opinion by asserting that bank notes are not like goods or securities or documents for debts but are treated as money: "they are as much money, as guineas . . . ."[391] He then surveyed instances in the law in which bank notes were treated as money: bank

386. *Miller*, 97 Eng. Rep. at 399.

387. The bank note in *Miller* was in the amount of 21 pounds and 10 shillings. *Id.* at 398.

388. *Id.* at 399.

389. *Id.* at 400.

390. *Id.* The expression that something has an "ear-mark" has a peculiar history. The words chattel and cattle have a similar root. The term "ear-mark" referred to a brand that allowed the owner to reclaim cattle if lost or stolen:

> My cattle have been driven off; I must follow the trail; it is the duty of my neighbors to assist me, to ride with me. If we catch the marauder still driving the beasts before him, we take him as a "hand-having" thief and he is dealt with in a summary fashion; "he can not deny" the theft. The practice of ear-marking or branding cattle, and the legal duty that I am under of publicly exposing to the view of my neighbors whatever cattle I have, make it a matter of notoriety that these beasts, which this man is driving before him, have been taken from me. Even if we can not catch a thief in the act, the trail is treated as of great importance. It leads into a man's land, he must show that it leads out again; otherwise it will "stand instead of a foreoath"; it is an accusing fact. If the possessor has no unbroken trail in his favour, then, when he discovers the thing, he lays his hand upon it and claims it. He declares the ox to be his and calls upon the possessor to say how he came by it. . . . Then the pursuer with his left hand grasping one of the beast's ears, and his right hand upon a relic or a sword, swears that the beast is his.

2 FREDERICK POLLOCK & FREDERICK WILLIAM MAITLAND, THE HISTORY OF ENGLISH LAW 157-58 (1911).

391. *Miller*, 97 Eng. Rep. at 401. A guinea was an English gold coin worth 21 shillings.

notes pass by a will bequesting "money or cash"; receipts for payment of bank notes "are always given as for money"; and in bankruptcy proceedings bank notes are treated as money.[392] He commented that the real reason money cannot be recovered is because of its currency; "in case of money stolen, the true owner can not recover it, after it had been paid away fairly and honestly upon a valuable and bona fide consideration."[393] He quibbled with the rationalization that money cannot be recovered because it is indistinguishable and has no earmark: "It is a pity that reporters sometimes catch at quaint expressions that may happen to be dropped at the Bar or Bench; and mistake their meaning."[394]

Mansfield's goal here is clear. Defining the "true" reason for money's currency as commercial practice, rather than the lack of distinguishing features, allowed him to group bank notes with money, rather than with goods. Once bank notes had been linked to money, the result followed inevitably: "Apply this to the case of a bank-note. An action may lie against the finder, it is true; (and it is not at all denied:) but not after it has been paid away in currency."[395]

Lottery tickets are a third type of property explored as an analogy in *Miller*. Lloyd cited *Ford v. Hopkins*,[396] an opinion by Sir John Holt in which Holt had reportedly stated bank notes, Exchequer notes, and lottery tickets were similar in that they had distinctive numbers and marks unlike money, which cannot be distinguished. The plaintiff's reply in *Miller* is not spelled out in the report of the case, which merely comments "he answered Sir Richard Lloyd's cases."[397]

Mansfield responded to *Ford v. Hopkins* by attacking the report of the case:

> But this must be a very incorrect report of that case: it is impossible that it can be a true representation of what Ld. Ch. J. Holt said. It represents him as speaking of bank-notes, Exchequer-notes, and million lottery tickets, as like to each other. Now no two things can be more unlike to each other, than a lottery-ticket, and a bank-note. Lottery tickets are identical and specific: specific actions lie for them. They may prove extremely unequal in value: one may be a prize; another a blank. Land is not more specific, than lottery-tickets are.[398]

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392. *Id.*
393. *Id.*
394. *Id.*
395. *Id.*
396. 91 Eng. Rep. 250 (K.B. 1700).
397. *Miller*, 97 Eng. Rep. at 400.
398. *Id.* at 402.

Mansfield employed the lottery ticket analogy to construct a distinguishability scale from property with no "ear-mark" to property that was extremely particular. By extending the scale (*i.e.*, from money to bank notes to goods to lottery tickets to land) it became easier for him to group bank notes with money. A shorter scale (*i.e.*, money to bank notes to goods) would have made the question of linking bank notes to money appear problematic.

Miller has several references to other types of property both in argument and in the opinion. "[A bank note] is like a medal which might entitle a man to payment of money, or to any other advantage."[399] "[T]his note is a mere piece of paper; it may be as well stopped, as any other sort of mercantile cash (as, for instance, a policy which has been stolen)."[400] "Now [bank notes] are not goods, not securities, nor documents for debts . . . ."[401] The array of analogies provided the court with a wealth of options, and the analogy to money allowed Mansfield to reach a result that implemented the commercial policies he viewed as critical.

In addition to Mansfield's introductory remark ("he would not wish to have it understood in the city, that the Court had any doubt about the point"), he indicated that even at the trial he had no doubt the plaintiff would win "upon the general course of business, and from the consequences to trade and commerce which would be much incommoded by a contrary determination."[402] As Mansfield sorted through analogies to eight different types of property, it is clear he was guided by the commercial consequences of his decision. *Miller* clusters money, bank notes, and goods sold in market overt as types of property where a "better than" position was possible, but bills of exchange and non-bank notes were still relegated to the "same as" rule.

Twenty-three years later Mansfield faced an identical issue concerning a stolen bill of exchange.[403] In *Peacock v. Rhodes*,[404] the bill that had

399. *Id.* at 399.

400. *Id.* at 400.

401. *Id.* at 401.

402. *Id.* In an article published during World War I, it was argued that bona fide purchasers for value of overdue paper should nonetheless take free of equities of ownership (but not defenses). Z. Chafee, Jr., *Rights in Overdue Paper*. 31 HARV. L. REV. 1104, 1108 (1918). In a Mansfield-like manner, Chafee sorts through analogies: ordinary choses in action, *id.* at 1105, chattels, *id.* at 1106; instruments not overdue, *id.* at 1106. And like Mansfield, he bases his ultimate position on policy (encouraging negotiable paper to further the war effort). *Id.* at 1148.

403. A bill of exchange was an order to pay and would be comparable to a "draft" in U.C.C. Article 3.

been issued by Rhodes and indorsed in blank by the payee was stolen from Fischer. The plaintiff Peacock was a mercer who subsequently took the bill in exchange for cloth, other articles, cash, and "small bills."[405] Peacock presented the note to the drawee, who refused to pay or accept, and Peacock sued Rhodes as drawer of the bill. At trial it was determined that the plaintiff had taken the bill "in the course of trade."[406] The facts gave Mansfield an opportunity, which he did not miss, to establish the "better than" principle for bills and notes.

Miller and *Peacock* have one striking difference both in the way they were argued and in the opinion of the court. In *Peacock* only money and bank notes were mentioned by way of analogy. There were no references to goods, lottery tickets, or any of the other types of property argued in *Miller*. It was as if *Miller* had taken a half-step toward establishing the "better than" principle for bills and notes, and that the analogy to bank notes was now sufficient to cover the remaining distance. Possible connections to other types of property were ignored.

In *Peacock* the plaintiff argued that bills of exchange indorsed in blank by the payee were considered cash and "the very object in view, in making negotiable securities, is, that they serve the purposes of cash."[407] He cited *Miller* in support of the "principle" of bills being treated as cash, although he admitted "the question there arose upon a banknote."[408] His argument illustrates reverse borrowing in that a concept borrowed from one field of law by another field is used to establish or support the concept in the originating field of law. In *Miller*, an analogy to money was used to establish the "better than" principle with respect to bank notes. In *Peacock*, oddly, the plaintiff argued *Miller* to establish the "better than" principle with respect to money. Typically reverse borrowing occurs when the original borrowing has been forgotten. In *Peacock*, the plaintiff used reverse borrowing in his argument despite the conspicuous nature of the initial borrowing.

The defendant's reply stressed a distinction in commercial practice between bank notes or banker's cash notes and bills of exchange; "the

404. 99 Eng. Rep. 402 (K.B. 1781).

405. The fact that the plaintiff gave smaller bills in change indicates extensive use of bills of exchange at the time. Other facts of *Peacock v. Rhodes* also reflect common use. The bill had been issued August 9, 1780, at Halifax and was payable in 31 days. It was transferred twice and was in Fisher's possession at York when it was stolen "along with other bills in his pocket-book." *Id.* at 402.

406. *Id.* at 403.

407. *Id.* at 402.

408. *Id.*

two first sorts only are considered as cash."[409] He also pointed out, quite correctly, that in *Miller* bills of exchange were seen "as only being a security or document for debt"[410] and had not been grouped with money or bank notes but rather with goods and other property that is transferable but may be recovered if lost or stolen. Finally, the defendant urged the court to consider the policy consequences of finding for the plaintiff; "if the law were as contended for on the part of the plaintiff, the temptations to theft would be increased."[411]

Mansfield told the plaintiff a rejoinder was unnecessary and launched into his opinion: "I am glad this question was saved, not for any difficulty there is in the case, but because it is important that general commercial points should be publicly decided."[412] He stressed the point that holders of bills of exchange and promissory notes should not be considered as mere assignees who take "subject to all the equity to which the original party was subject."[413] Instead, bills and notes should be considered "within the *principle* of all [the cases plaintiff] has cited, from that of *Miller v. Race*, downwards."[414] In Mansfield's relatively brief opinion there was no analogy to other types of property, and in particular, no justification for the result based on analogies of cash or goods or bank notes. He merely cited cases and focused on policy.

Miller and *Peacock* demonstrate both the importance of other types of property in establishing the "better than" principle for negotiable instruments and the tendency for connections between negotiable instruments and other properties to be overlooked. Perhaps at first the connections were merely ignored, but later they would be forgotten. The connections surface only when a case arises at the borders between types of property.

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409. *Id.* at 403.

410. *Id.*

411. *Id.*

412. *Id.*

413. *Id.*

414. *Id.* (emphasis added). In *Peacock v. Rhodes*, Mansfield extends the "better than" principle both to bills of exchange and non-bank promissory notes although the case involved only a bill of exchange. Undoubtedly the primary reason for including both types of documents was commercial policy, but perhaps an additional reason is hinted at in one of his observations from an earlier case about reporters:

> Upon looking into the reports of the cases on this head, in the times of King William the Third and Queen Anne, it is difficult to discover by them, when the question arises upon a bill and when upon a note: for the reporters do not express themselves, with sufficient precision, but use the words "note" and "bill" promiscuously.

Grant v. Vaughan, 97 Eng. Rep. 957, 961 (K.B. 1764).

Two areas of property that are different but also connected are goods and money. In *Moss v. Handcock*,[415] the respondent, Handcock's butler, stole a five pound gold piece that had been given to his employer twelve years before in conjunction with the 1887 Jubilee. The butler changed the gold coin at the appellant's shop for five sovereigns.[416] The appellant Moss was "a dealer in new and second-hand clothes, jewellery, and other articles."[417] The respondent argued that the gold coin was his property, it had been stolen, and he was entitled to restitution of the coin under the Larceny Act.[418] The appellant replied that the gold piece was "a current coin having been made so by proclamation, and cannot be ordered to be restored having once got into circulation"[419] citing *Miller* in support of his argument.

The court had a choice of characterizing the transaction either as a sale of goods or as a transfer of the coin as currency. As a sale of goods, the respondent would win since the sale was not in market-overt and the appellant could take no better right, title, or interest than his transferor, the thief. If the coin had passed as currency, however, the appellant would prevail. Judge Darling ruminated, "I ask myself was this gold piece passed in its character as coin of currency or was it rather the subject of a sale as an article of *vertu*?"[420] Although the coin had been exchanged for coins of an equal face value, both judges were of the opinion it was a sale of goods and affirmed the lower court's order of restitution. Several factors apparently influenced the court: the gold coin had a market value greater than the face amount, the purchaser was a dealer in new and secondhand jewelry and other articles, and, in the words of Judge Channell, "it was offered to appellant's son because he dealt in curiosities and was taken by him as such."[421]

A more recent case, *United States v. Barnard*,[422] raised a similar issue about characterizing a coin as cash or goods. In 1933, the Philadelphia mint produced twenty-dollar gold pieces that were never placed in circulation. Later in the same year, an executive order prohibited any further

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415. 80 L.T.R. 693 (Q.B. 1899).

416. Five sovereigns equaled the face amount of the five pound gold coin.

417. *Moss*, 80 L.T.R. at 693.

418. Larceny Act, 1861, 24 & 25 Vict., ch. 96, § 100.

419. *Moss*, 80 L.T.R. at 693.

420. *Id.* at 694.

421. *Id.* Judge Channell expressed skepticism about the magistrate's finding that the transaction was bona fide. *Id.* at 695. The butler had been employed by Handcock for only a month, the appellant's son knew he was an "indoor servant," and apparently it would be unusual for a butler to own a coin of this type.

422. 72 F. Supp. 531 (W.D. Tenn. 1947).

issuance of gold coins.[423] Two of the coins were delivered to the Smithsonian and the rest were to be melted into bullion. In 1944 Barnard, a numismatist, purchased a 1933 twenty-dollar gold piece from another collector. The United States sued Bernard in replevin, alleging he was a purchaser of stolen property. The court was persuaded the coin must have been stolen by an employee of the mint.[424]

The defendant argued the coin was lawfully minted currency and that he had purchased it as currency and not as goods. The court, undoubtedly echoing arguments by the plaintiff, pointed out that the 1934 Gold Reserve Act provided that "gold coin may only be acquired and held when such gold coin is of special recognized value to collectors of rare and unusual coins."[425] Further, the defendant had paid nine hundred dollars for a coin with a face value of twenty dollars. The court held that Bernard had purchased the coin as a chattel and granted the government's replevin demand.

The court could have reached the same result without characterizing the coin as a good. It could have found that the coin was currency but that Bernard was not a bona fide purchaser since he took with notice of the government's claim.[426] A purchaser of money who takes with notice of a claim takes subject to the claim. In cases involving property at the borders between types of property, characterization is but one method of justifying a result. Typically, within each of the property areas there are alternatives that will allow a court to impose a "same as" position or a "better than" position. The court in *Barnard* could have found for the plaintiff either by characterizing the transaction as a sale of goods or as a transfer of money to a purchaser who took with notice of the claim.

On the other hand, although there are connections between areas of property and the negotiability principle is generally available across property areas, each area will have its own peculiarities. In *Barnard*, for example, an argument that the coin was currency but Bernard took with notice of the claim would be bolstered by the fact that he paid nine hundred dollars for a twenty-dollar coin. The higher the price, the more probable it would be that he knew the coin had been issued illegally. In a negotiable instruments case, however, price works in exactly the oppo-

423. *Id.* at 532.

424. The coins had been weighed after minting and later as bullion and the results were identical. Apparently the employee had substituted a similar coin with another date. *Id.* at 531.

425. *Id.*

426. *See* Case Note, *Negotiable Instruments—Innocent Purchaser Receiving Stolen Coin As Curio-Application of the Law Merchant*, 1 VAND. L. REV. 314 (1948).

site way. In a transfer of a negotiable instrument, the higher the price relative to the face amount of the instrument, the more likely it is the purchaser is taking in good faith and without notice of defects.

In goods transactions, although the "same as" principle is the general rule, there are numerous exceptions. In addition to the concepts discussed previously,[427] the estoppel principle implements a negotiability result in many instances.[428] Generally the common law has been more protective of the true owner of goods than the civil law.[429] For example, in civil law if the true owner allows another person to use goods and the goods are sold without authority, the purchaser takes free of the true owner's claim.[430] Under the common law, however, merely entrusting goods to another does not give the entrustee the power to deliver the entruster's title.[431] But in the common law, entrusting, plus something else, may estop the true owner from recovering against a purchaser. Entrusting goods and delivering a document indicating the entrustee owns the goods, for example, is usually sufficient for a good faith purchaser to establish estoppel.[432]

In *O'Connor's v. Clark*,[433] the property transferred was indisputably goods, but within the rules applied to goods the facts were located at the border between estoppel and nonestoppel cases. O'Connor owned a wagon and allowed Tracy to use it in his business—a fact insufficient on its own to create an estoppel. But O'Connor also allowed Tracy to paint "George Tracy, Piano Mover" on the wagon.[434] Tracy sold the wagon to the defendant without authority from O'Connor, who sued in replevin. Had O'Connor merely entrusted the wagon, Tracy could have told a potential buyer he was the owner, and O'Connor would not have been estopped. However, allowing the wagon to speak was a different matter. The court held that because the buyer had bought the wagon in good faith and had been misled by the circumstances into believing Tracy was the owner, O'Connor was estopped. The result makes this particular wagon as negotiable as a negotiable instrument.

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427. *See supra* notes 130-215 and accompanying text.

428. *See* Ewart, *supra* note 69, for an attempt to create an estoppel theory of negotiability.

429. *See* POLLOCK & MAITLAND, *supra* note 390, at 154-55.

430. *Id.*

431. The entrustment rule in U.C.C. § 2-403(2) is a notable exception.

432. In Nixon v. Brown, 57 N.H. 34 (1876), the plaintiff authorized his agent to purchase a horse and keep possession of the horse and bill of sale, which was in the agent's name. When the agent sold the horse to the defendant without authority, the plaintiff was estopped.

433. 32 A. 1029 (Pa. 1895).

434. *Id.* at 1030.

Since the negotiability principle evolved in an atmosphere of borrowing across property areas and is an option generally available in each area, it is of fundamental importance to recognize the connections between these areas. Cultivating these connections exposes anomalies and may assist a court or legislature in resolving questions about a transferee's right, title, or interest. For instance, in 1990 the Permanent Editorial Board of the Uniform Commercial Code faced a thorny Article 9 priority question concerning cash proceeds.[435] The issue arises when a cash payment from an account debtor[436] is paid to a secured party with a junior priority position.[437] The question is whether the secured party is required to turn over the payment to the secured party with a senior position. In its discussion, the P.E.B. first asked what the outcome would be if the payment had been made by check and then took the position that the same result should apply to cash.[438] The result turns on "whether *B* received the payment in good faith and without knowledge or reason to know of [the competing] security interest."[439] In other words, a court faced with the issue should apply the holder in due course principle by analogy; "[o]therwise, cash would be rendered less negotiable than a check."[440]

Another instance of clear-eyed borrowing across property lines is the treatment of "symbolic writings" under the *Restatement (Second) of Contracts*, which borrows the merger principle[441] from negotiable instruments and donor/donee concepts from goods. As a general rule, gratuitous assignment of contract rights are revocable by the assignor and the death or incapacity of the assignor revokes the assignee's rights.[442] An exception makes the assignment irrevocable if "the assignment is accom-

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435. Proceeds are defined in U.C.C. § 9-306(1) as "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds. . . . Money, checks, deposit accounts, and the like are 'cash proceeds.'"

436. An "account debtor" in Article 9 is a "person who is obligated on an account, chattel paper or general intangible." U.C.C. § 9-105(1)(a).

437. The payment could be made directly from the account debtor to the secured party or the account debtor could make the payment to the debtor who then remits the payment to the secured party.

438. Permanent Editorial Board Commentary on the Uniform Commercial Code, Commentary No. 7, The Relative Priorities of Security Interests in the Cash Proceeds of Accounts, Chattel Paper, and General Intangibles (1990).

439. *Id.*

440. *Id.*

441. The merger rule provides that when a negotiable instrument is taken for an obligation, the obligation is merged in the instrument. The rule is a mechanism for giving tangible form to an otherwise incorporeal obligation. *See* U.C.C. § 3-310.

442. RESTATEMENT (SECOND) OF CONTRACTS § 332(2) (1981).

panied by delivery of a writing of the type customarily accepted as a symbol or as evidence of the right assigned."[443] Symbolic writings include negotiable instruments and non-negotiable writings such as documents of title, securities, and chattel paper as well as other symbols such as savings account bank books.[444] The *Restatement* comments on the symbolic writing exception: "A gift of a right embodied in such a writing may be made by delivery in accordance with rules governing gifts of chattels by delivery."[445]

Historically, the merger rule developed in an atmosphere of borrowing among five different areas of property: coin, bank notes, goods, negotiable instruments, and contract rights. In English law goods were the bedrock of transferability and merger, because goods have always been transferable. Coin also could be transferred since it was considered goods,[446] but incorporeal rights could not be assigned.[447] The merger rule of negotiable instruments originated as a fiction—incorporeal rights were embodied in a document and the document, being a good, could be transferred.[448] The merger rule became the mechanism for transferring incorporeal rights by giving them tangible form.[449] At about the same time, the Bank of England began issuing fully transferable bank notes.[450]

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443. *Id.* at § 332 (1)(b). *See also* CORBIN, *supra* note 291, at 645.

444. RESTATEMENT (SECOND) OF CONTRACTS, § 332 cmt. c (1981).

445. *Id.* The *Restatement (Second) of Contracts* provision about discharge of an obligor after an assignment of rights also uses symbolic writings to create an exception to the general rule. *See id.* § 338(4).

446. *See* Waterman, *supra* note 364, at 315.

447. *See, e.g.*, CORBIN, *supra* note 291, at 423. Holdsworth provides the following explanation of the impediments to assigning contract rights:

> In ancient law anything approaching a negotiable instrument was legally impossible, for three reasons. Firstly, ancient systems of law do not allow one man to represent another in litigation before a tribunal. . . . Secondly, ancient systems of law do not allow a creditor to assign his right to another. That the relation of debtor and creditor was a strictly personal relation is obvious from the strictly personal character of the creditor's remedy—he could even imprison the debtor. Therefore it was only just that the creditor and the creditor alone should be able to enforce his claim. Thirdly, such a transfer, even if otherwise permissible, was impossible, because there could be no transfer of anything without a physical delivery of possession; and how can the right to enforce the payment of a debt be physically transferred?

Holdsworth, *supra* note 293, at 115.

448. *See, supra* notes 292-97 and accompanying text.

449. Negotiable instruments law is capable of remembering that the merger rule is a fiction. If your bicycle is stolen you cannot ride it anymore, but if a negotiable instrument is stolen (or lost or destroyed) the owner can still bring an action on the instrument. *See* U.C.C. § 3-312.

450. The Bank of England first issued bank notes in 1694. Waterman, *supra* note 364, at 321.

When courts and legislatures ignore or forget connections between areas of property, peculiar anomalies can result. For example, from 1956 to 1972 the Official Text of the Uniform Commercial Code made chattel paper (which is non-negotiable) more negotiable on a particular issue than negotiable instruments. In 1956 U.C.C. section 9-308 was amended to provide as follows:

> A purchaser of chattel paper or a non-negotiable instrument who gives new value and takes possession of it in the ordinary course of his business and without knowledge that the specific paper or instrument is subject to a security interest has priority over a security interest which is perfected under Section 9-304 (permissive filing and temporary perfection). A purchaser of chattel paper who gives new value and takes possession of it in the ordinary course of his business has priority over a security interest in chattel paper which is claimed merely as proceeds of inventory subject to a security interest (Section 9-306), even though he knows that the specific paper is subject to the security interest.[451]

The amended version protected purchasers of chattel paper against competing proceeds of inventory claims even though the purchaser took with knowledge of the competing interest. A purchaser of a negotiable instrument, however, who took under similar circumstances would take subject to the interest.[452]

The anomaly was not repaired until 1972 when the protection of section 9-308 was extended to purchasers of negotiable instruments.[453] The official comment on the 1972 amendment stated that section 9-308 had been "rewritten for clarity" and acknowledged that in the prior version "the holder of a negotiable instrument was in some circumstances in a less protected position against competing claims than the holder of chattel paper."[454]

The 1956 version of section 9-308 contained another anomaly, apparently unnoticed by the drafters of the 1972 revision, that was corrected inadvertently.[455] This second anomaly made nonnegotiable Article 9 in-

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451. U.C.C. § 9-308 (1956). *See* 18 UNIFORM COMMERCIAL CODE DRAFTS 284-85 (Elizabeth Slusser Kelly compiler, 1984) [hereinafter Kelly].

452. A U.C.C. Article 9 security interest is a "claim" in Article 3. A purchaser of a negotiable instrument who takes with notice of a claim is not a holder in due course and a nonholder in due course takes subject to all claims to the instrument. *See* U.C.C. §§ 3-302, 3-306, 9-309.

453. The 1972 revision is currently the recommended section. *See* U.C.C. § 9-308.

454. U.C.C. 1972 Official Text Showing Changes Made in Former text of Article 9, Secured Transactions, and of Related Sections and Reasons for Changes § 9-308 (1972).

455. The second anomaly is not mentioned in the comments to the 1972 revision.

struments[456] more negotiable in certain instances than negotiable instruments. A purchaser of a nonnegotiable instrument who "gives new value and takes possession of it in the ordinary course of his business and without knowledge that the specific . . . instrument is subject to a security interest"[457] was protected by the 1956 version against competing Article 9 interests perfected by filing or perfected automatically under subsections 9-304(4) or (5). In a comparable situation, a purchaser of a negotiable instrument who took without notice of the competing interest might be disqualified from holder in due course status for other reasons (*e.g.*, she took with notice of overdueness). In Article 3 a nonholder in due course takes subject to all claims.[458]

To illustrate, assume a secured party has an interest perfected by possession in two items of collateral: a negotiable instrument and a nonnegotiable Article 9 instrument. Both are payable on demand and somewhat stale. Both are returned to the debtor to be presented for payment to the account debtor. Instead, the debtor immediately sells both to a purchaser who gives new value, takes possession in the ordinary course of her business, and without knowledge of the security interest. It appears that under the prior 9-308, the purchaser would take the non-negotiable instrument free of the competing interest but would take the negotiable instrument subject to the interest. A court faced with this question could have used the "ordinary course of his business" requirement to make the results consistent, but it could have just as easily protected the purchaser as to the non-negotiable instrument but not as to the negotiable instrument. The statutory anomaly could have easily been avoided if the drafters of the 1956 version had looked at the connections between chattel paper, non-negotiable Article 9 instruments, and negotiable instruments and been aware of the broad use of the negotiability principle.

Anomalies can be found throughout the Uniform Commercial Code and in other statutory and common law systems governing the transfer of interests in property. Usually they result from a failure to see connections between types of property, but sometimes they are intentional. A check or other negotiable draft is not an assignment and gives the holder

456. The U.C.C. Article 9 definition of instruments includes all Article 3 negotiable instruments and also extends to certified securities and "any other writing which evidences a right to the payment of money and is not itself a security interest or lease and is of a type which is in ordinary course of business transferred by delivery . . . ." U.C.C. § 9-105(1)(i).

457. Kelly, *supra* note 451, at 285.

458. U.C.C. § 3-306.

no rights against the drawee,[459] but an assignment of rights under a simple contract does give the assignee rights against the obligor.[460]

U.C.C. Article 4 applies to all items, whether negotiable or not, and provides several rules more generous than their Article 3 counterparts. A collecting bank can give value by merely promising to allow its customer to withdraw a provisional settlement, whether or not the customer in fact withdraws the funds.[461] In Article 3 a mere promise to perform is not value.[462] In Article 4 a depositary bank becomes a holder of an item when its customer, who was a holder, transfers the item to the bank, even without the customer's indorsement.[463] In Article 3 a transferee of an order instrument without indorsement is not entitled to holder status.[464] These anomalies were created intentionally in response to arguments by the banking industry that both rules are necessary to a large volume check collection and payment system. The interesting point is how easily the wall around negotiable instruments can be breached when another area of property is attracted to the negotiability principle.[465]

CONCLUSION

A spectrum theory of negotiability allows an escape from the dualism that has dominated commercial paper scholarship and pedagogy. It exposes connections between negotiable instruments and other types of property and exhibits the full spectrum of "better than" and "worse than" positions utilized by courts and legislatures. Further, a spectrum theory shows that whenever property is transferred, the transferee does not automatically receive the right, title, and interest of the transferor. Negotiability should in fact be of interest to anyone investigating the transfer of property interests.

In the past, commercial paper scholarship has asked the negotiability question in a way that seeks a definite answer and attempts closure on the issue. A spectrum theory offers an alternative way of asking the negotiability question; a method of inquiry that reveals the issue of negotiability can be an open and an interesting question.

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459. U.C.C. § 3-408.
460. *See* CORBIN, *supra* note 291, at 536.
461. U.C.C. § 4-210(a)(2).
462. U.C.C. § 3-303(a)(1).
463. U.C.C. § 4-205.
464. U.C.C. §§ 3-201(a), 3-203(c).
465. *See* Dwight A. Olds, *Should Negotiable Instruments Suffer Disadvantages Not Shared by Non-Negotiable Choses in Action*, 2 HOUS. L. REV. 43 (1964), for a rare discussion of negotiability anomalies.