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Much Ado About Nothing: Achieving "Essential" Negotiability in an Electronic Environment

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MUCH ADO ABOUT NOTHING: ACHIEVING ESSENTIAL NEGOTIABILITY IN AN ELECTRONIC ENVIRONMENT

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I. INTRODUCTION

The history of negotiable instruments law chronicles a strong infatuation with form.¹ While the formal requirements for negotiabil-

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1. Professor Gilmore, in summing up the popular perception of negotiability, states: "Few generalizations have been more often repeated, or by generations of lawyers more devoutly believed, than this: negotiability is a matter rather of form than substance." Grant Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1068 (1954). Gilmore, however, perceives things differently:

Few generalizations, legal or otherwise, have ever been less true; the truth is, in this as in every other field of commercial law, substance has always prevailed over form. "The law," has always been in a constant

ity are not dictated by any one overriding explanatory principle,² they seem to have gathered strength historically in a society plagued by a shortage of currency and increasingly oriented towards the market transactions that made currency important.³ For an instrument to function as a money substitute it was believed that its value must be clearly reflected on its face. This meant, at a minimum, that the amount payable and the time of payment had to be specified with certainty, and the obligation to pay, unconditional.⁴ Negotiable instruments law and a world-wide market economy came of age together.

Today, the formal requirements for negotiable instruments are found in Article 3 of the Uniform Commercial Code.⁵ With only mi-

state of flux as it struggles to adjust itself to changing methods of business practice; what purport to be formal rules of abstract logic are merely *ad hoc* responses to particular situations.

Id. at 1069.

2. See Fred Beutel, *Comparison of the Proposed Commercial Code, Article 3, and the Negotiable Instruments Law*, 30 NEB. L. REV. 531 (1951).

3. This explanation of the forces behind the birth of negotiability has long been recognized. Gilmore summarized it this way:

The radically new problems all stemmed from the industrial revolution and the vastly increased number of commercial transactions which it spawned. When goods were shipped they had to be paid for. The idea that payments could be made in metallic currency, chronically in short supply, was ludicrous. The primitive banking system could not cope with the situation: The bank check which—a hundred years later—became the universal payment device was unknown. In effect the merchants and bankers invented their own currency. The form which they used was an old one: the so-called bill of exchange which was an order issued by one person (the drawer) to a second person (the drawee) directing the drawee to pay a specified sum of money at a specified time to a third person (the holder). . . . These bills moved in a world-wide market, typically ending up in the possession of people who knew nothing about the transaction which had given rise to the bill, had no way of finding out anything about the transaction and, in any case, had not the slightest interest in it.

Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441, 447-448 (1979). See also FRED H. MILLER & ALVIN C. HARRELL, *THE LAW OF MODERN PAYMENT SYSTEMS AND NOTES* 2-3 (2d ed. 1992) ("In the years during which the form requirements were being fashioned, the law wished to promote the free transfer of negotiable instruments because negotiable instruments that passed from hand to hand in payment of debts were used to supplement the otherwise inadequate money supply").

4. Thus, derives the now familiar maxim that an instrument to be negotiable must be "a courier without luggage." *Overton v. Tyler*, 3 Pa. 346, 347 (1846).

5. Unless otherwise indicated, all references and citations to "the Code" or "U.C.C." in this article are to the official text and comments of the UNIFORM COMMERCIAL CODE (1990).

Bear in mind that although we limit our discussion to Article 3, the law of

nor variations these are the same basic requirements that were developed at common law and were later embraced by the Negotiable Instruments Law of 1896.⁶ To put this point another way, "time seems to have been suspended, nothing has changed, the late twentieth century law of negotiable instruments is still a law for clipper ships and their exotic cargo from the Indies."⁷ To be negotiable under Article 3, the instrument must: be written;⁸ be signed by the maker or drawer;⁹ contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation, or power given by the maker or drawer except as authorized by Article 3;¹⁰ be payable on demand or at a definite time;¹¹ and be payable to order or to bearer.¹²

What was evidently overlooked by the drafters in their "anti-quarian zeal"¹³ was the spectacular growth in the use of electronic communication technologies. We have evolved from a paper-based world in which clipper ships roamed the seas to one in which information is organized and structured into electronic messages.¹⁴ The question arises as to whether the traditional formalities of negotiable instruments law can be harmonized with the inexorable march of commercial practice towards electronic commerce. In the course of assessing the ability of existing paper-based legal requirements to accommodate technological change, a number of difficult issues arise. By far the most intractable issues are whether the electronic message can be brought within the definition of a "writing"¹⁵ and whether it

negotiability is not so limited. For example, section 3-102 states: "This Article applies to negotiable instruments. It does not apply to money, to payment orders governed by Article 4A, or to securities governed by Article 8." U.C.C. § 3-102.

6. Unfortunately, much about the history of the Negotiable Instruments Law of 1896 (N.I.L.) remains shrouded in mystery. See Gilmore, *supra* note 3, at 457 ("I do not know whether the banks drafted the N.I.L. The truth is that no one knows anything about the drafting of the N.I.L.: it was carried out almost in secret.").

7. Gilmore, *supra* note 3, at 448.

8. U.C.C. §§ 3-103(a)(6), (9); 3-104(a).

9. *Id.* §§ 3-103(a)(6), (9); 3-304(a).

10. *Id.* § 3-104(a).

11. *Id.*

12. *Id.*

13. Gilmore, *supra* note 3, at 461 n.44. Gilmore refers to Article 3 as "a museum of antiquities—a treasure house crammed full of ancient artifacts whose use and function have long since been forgotten." *Id.* at 461.

14. See generally Amelia H. Boss, *The International Commercial Use of Electronic Data Interchange and Electronic Communications Technologies*, 46 BUS. LAW. 1787 (1991).

15. U.C.C. § 1-201(46) ("Written" or "writing," includes printing, typewriting

can satisfy the definition of a "signature."¹⁶ A number of commentators have addressed these vexing issues, but there seems to be little consensus on the proper disposition.¹⁷ For their part, courts continue to reach ad hoc determinations rather than principled resolutions.¹⁸

It is not inopportune therefore to take stock of Article 3's formalities and the premises upon which they rest. In order to do more than restate the arguments for or against each prerequisite for negotiability, it seems necessary, even at this late date, to take a second look at the first principle of negotiability. This principle is most often referred to as the "merger" principle.¹⁹ This is the idea that an abstract and intangible form of wealth has been transformed into a tangible piece of paper with an obvious physical presence. The upshot of such a transformation is that the rights embodied in the paper can only be transferred by a transfer of the paper itself.

The approach adopted here is both historical and analytical. Part II of this Article describes the historical development of assignment law, and demonstrates that it parallels a more general shift of the law away from physical conceptions of property. It concludes that although a paper-based document may still be a practical requirement, there is no longer a valid theoretical justification for not making the law of negotiable instruments media neutral.

In Part III we survey the features of negotiable instrument law and compare it generally with the law of assignments. This comparison suggests that the most striking substantive difference between the two systems is the doctrine of good faith purchase. In simple terms, this is the idea that a bona fide purchaser of a negotiable

or any other intentional reduction to tangible form.").

16. *Id.* § 1-201(39) (" 'Signed' includes any symbol executed or adopted by a party with present intention to authenticate a writing.").

17. For a collection of views with respect to "writing" and "signature" issues relating to the Statute of Frauds of section 2-201, see Sharon F. DiPaolo, Note, *The Application of the Uniform Commercial Code Section 2-201 Statute of Frauds to Electronic Commerce*, 13 J.L. & COM. 143 (1993). With respect to "writing" and "signature" issues relating to letters of credit, see Task Force on the Study of U.C.C. Article 5, *An Examination of U.C.C. Article 5*, 45 BUS. LAW. 1521 (1990).

18. For example, compare *Armstrong v. Bush*, 721 F. Supp. 343 (D.D.C. 1989), *aff'd sub nom*; *Armstrong v. Executive Office of the President*, 1993 WL 304567 (D.C. Cir. 1993) (holding that a "record" under the Federal Records Act includes electronic data stored on Magnetic tapes) with *Sinclair Oil Corp. v. Sylvan State Bank*, 22 U.C.C. Rep. Serv. 2d (Callaghan) 961 (Kan. 1994) (holding that an electronic fund transfer is not a writing).

19. See Gilmore, *supra* note 3, at 449. Other commentators have given it other names. For example, Robert Clark has referred to it as the "paperization" principle. See Robert Charles Clark, *Abstract Rights versus Paper Rights under Article 9 of the Uniform Commercial Code*, 84 YALE L.J. 445 (1975).

instrument takes it free from all outstanding claims, including contract defenses.

Finally, in Part IV we explore the extent to which the consequences of the good faith purchase doctrine can be replicated outside of the negotiability system. We conclude that even in a paper-based legal environment, this key feature of negotiability is readily attainable by parties employing electronic technologies.

II. THE HISTORICAL DEVELOPMENT OF ASSIGNMENT LAW

Throughout most of the history of the common law, the contractual right to payment of a sum of money was not assignable to a party who was not a party to the original contract.²⁰ In contrast, today contract rights generally are freely assignable. Indeed, the law has gone so far as to restrict the scope of permissible contractual prohibitions on the right to assign.²¹

Three traditional explanations for the rule against assignability have been suggested. First, it has been widely suggested that the restriction on assignment was based on an embedded judicial fear of potential abuse which could occur if legal rights were assigned to persons in a more powerful or influential position and who could use that position unlawfully to enforce the newly acquired right: a fear of maintenance.²² Whether the fear of maintenance was actually the reason for the rule against assignability is questionable: "[T]his could not be so, since it is clear that the rule prohibiting assignments antedates the law relating to maintenance."²³ Yet it appears clear that the fear of maintenance slowed down the development of the law regarding the assignment of contracts.²⁴ This, combined with the technicalities of the common law procedures, the expense of legal

20. The prohibition of assignment of contract rights was not peculiar to the common law: "Ancient German law, like ancient Roman law, sees great difficulty in the way of an assignment of debt or other benefit of a contract. The assignee who sued the debtor would be met by the plea 'I never bound myself to pay money to you.'" 2 POLLOCK AND MATTLAND, *THE HISTORY OF THE COMMON LAW* 226 (2d ed. 1978). The reasons for the prohibition are shrouded in history. See FARNSWORTH, *CONTRACTS* 780 (2d ed. 1990); MURRAY ON *CONTRACTS* 788 (3d ed. 1990).

21. See U.C.C. § 9-318(4) ("A term in any contract between an account debtor and as assignor is ineffective if it prohibits assignment.").

22. W.S. Holdsworth, *The Treatment of Choses in Action by the Common Law*, 33 HARV. L. REV. 997, 1006 (1920); Winfield, *History of Maintenance and Champerty*, 35 LAW Q. REV. 50 (1919).

23. MURRAY, *supra* note 20, at 789.

24. See HOLDSWORTH, *HISTORY OF ENGLISH LAW* 534 (1925); J.B. Ames, *Disseisin of Chattels*, 3 HARV. L. REV. 337 (1890).

proceedings, and the ease with which jurors and other law enforcement personnel could be corrupted or intimidated, directed courts to repeatedly prohibit all practices which favored maintenance.²⁵

It has also been suggested that early common law lawyers had difficulty thinking in abstractions, and therefore could not conceive of the transfer of an intangible contract right.²⁶ However, "the incapacity of early lawyers to corporialize the incorporeal has been greatly over-stressed by modern writers. Medieval lawyers were perfectly capable of visualizing ownership of disembodied interests—ownership of an office, the right to appoint a parson to a particular church, right to labor [or] services in homes or in the fields, rights to be paid annuities, to collect tolls from passersby, or to occupy a front seat at the king's coronation."²⁷

Finally, it has been suggested that contract rights under the ancient writs were personal in nature and could not be transferred. The assignment of a contract right is a species of a chose in action; a chose in action being all personal rights which cannot be claimed or enforced by the taking of physical possession: in other words, an intangible.²⁸ Historically, choses in action were those personal claims based on obligations which arose from the writs of debt, detinue, or trespass.²⁹ These writs were construed narrowly, and the

25. Holdsworth, *supra* note 22, at 1007. See also Garrard Glenn, *The Assignment of Choses in Action: Rights of a Bona Fide Purchaser*, 20 VA. L. REV. 621 (1934).

26. See F.W. Maitland, *The Mystery of Seisin*, 2 LAW. Q. REV. 481 (1886).

27. J. DAWSON, ET AL., *CASES AND COMMENTS ON CONTRACTS* 902 (5th ed. 1987). See also, Percy Bordwell, *The Alienability of Non-Possessory Interests*, 19 N.C. L. REV. 279 (1941).

28. Holdsworth, *supra* note 22. See also *Torkington v. Magee*, 2 K.B. 427, 430 (1902).

29. See Holdsworth, *supra* note 22, at 1001; 2 HOLDSWORTH, *HISTORY OF ENGLISH LAW* 219-20 (5th ed. 1972). The oldest writ, covenant, appeared to promise a form of action applicable to contracts. However, the requirement of a seal and a remedy of only specific performance proved to be unpopular. FIFOOT'S *LAW OF CONTRACTS* 13-14 (9th ed. 1976). As early as the twelfth century, the common law courts recognized the writ of debt. The writ of debt could be used to recover the value of a breached obligation. W.T. BARBOUR, *THE HISTORY OF CONTRACT IN EARLY ENGLISH EQUITY* 26-28 (1914). For example, the writ could be used by a lender to recover money lent or by a seller to recover the purchase price of goods sold. The writ of debt, however, was restricted to recovering specific goods or their value. KESSLER, ET AL., *CONTRACTS: CASES AND MATERIALS* 25 (3d ed. 1990). Thus, out of commercial necessity the writ of detinue soon developed so that a fixed sum could be recovered. *Id.* As with most of the early common law writs, detinue was based on the concept of the transfer of property. Accordingly, detinue allowed for recovery of property losses and debt allowed for recovery of contractual obligations. W.T. BARBOUR, *supra*, at 26-28.

rights which could be claimed under them were deemed personal rights, and, as such, belonged solely to the person who created them. Whether the action arose from what would now be classified as a contractual obligation or a tort was of no concern; at common law, the right of action was a personal matter between two persons which could not be sold or assigned.³⁰

Whatever the reason for it, the general prohibition against assignment persisted generally until the 1800's. However, the common

Debt and detinue covered a very considerable area of contract law including the sale of goods, bailments, and loans of money. Covenant was appropriate for the residue of the promises. However, because of a reluctance to change the rigid requirements of these writs, contractual rights which were not based on the specific transfer of property were not enforceable.

By the end of the fourteenth century, the writ of trespass on the case developed. A.W.B. SIMPSON, *A HISTORY OF THE COMMON LAW OF CONTRACT: THE RISE OF THE ACTION OF ASSUMPSIT* 199, 273-74 (1975) [hereinafter SIMPSON, *COMMON LAW OF CONTRACT*]. This writ allowed the transfer not only of actual property rights but also abstract contractual obligations. A.W.B. SIMPSON, *EMERGENCE OF CONTRACT LAW* 200 (1975) [hereinafter SIMPSON, *EMERGENCE OF CONTRACT LAW*]. The characteristic feature of this action was that a plaintiff was allowed to claim damages by way of compensation for a wrong which had caused him harm, and the liability could be based upon a prior informal transaction which the other party had entered into with the plaintiff. In this respect, trespass on the case actions embodied a legal technique which was quite different from the technique of the ancient contractual action of debt, detinue, and covenant, where the claimant could only demand recovery of tangible property. SIMPSON, *COMMON LAW OF CONTRACT*, *supra*, at 199-205.

From the writ of trespass on the case, a species of case known as assumpsit developed. The assumpsit, or undertaking, played an important role in actions on the case. Soon assumpsit encroached on the domain of all the writs. This radical change in legal doctrine was accomplished with remarkable rapidity. SIMPSON, *COMMON LAW OF CONTRACT*, *supra*, at 249. By the seventeenth century, assumpsit had acquired its own identity and became a regular common law contractual doctrine. Assumpsit became an action for the breach of informal agreements or covenants and it became almost the sole remedy for contracts by parol that did not involve a bailment. SIMPSON, *COMMON LAW OF CONTRACT*, *supra*, at 299. The modern English law of contract has grown up around an action of assumpsit.

Thus, the law of contract in general had moved from a rigid emphasis on actual property rights to a recognition of abstract contractual obligations. *See generally*, MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW 1780-1860*, 160-210 (1977). This evolution of the law of contract had developed along similar lines of the law of negotiable instruments. 2 POLLOCK AND MAITLAND, *supra* note 20, at 184-233.

30. 2 SPENCE, *EQUITABLE JURISDICTION* 850 (1846); J.B. AMES, *THE INALIENABILITY OF CHUSES IN ACTION, LECTURES ON LEGAL HISTORY* 210 (1913). However, a party entitled to such a right could release it to the person against whom it could be brought, and it could have as easily been dissolved as it was created. Holdsworth, *supra* note 22, at 1003 n.23.

law began to succumb to the pressure to permit free assignability of certain limited legal rights much earlier. For example, as early as the fourteenth century, merchants began to circumvent the common law prohibition on the assignment of rights by clever application of the technicalities of the common law writs.³¹ Typically, a merchant would assign a right to receive a sum of money to an assignee who he would appoint as his attorney to sue for the debt. The appointment of the creditor contained a stipulation that the attorney should keep the amount received on the suit.³²

Also, by the fifteenth century certain claims, which were in reality choses in action involving personal rights, were categorized as actions to recover property, and therefore as real (as opposed to personal or intangibles) actions. Unlike actions for personal rights, assignments of real actions were recognized.³³ Accordingly, a husband could release his wife's right to previously bailed property to the bailee, and this contract of sale was viewed as giving a right to receive possession instead of the more obvious and accurate description of the right to transfer ownership of goods already possessed.³⁴ Categorized as a property right, it was freely assignable.³⁵

During the seventeenth century, assignees began to bring their claims in the courts of chancery. The chancery courts, which apparently did not have the same antipathy to assignment as did the common law courts, recognized the assignee as the owner of the claim, and not merely as the assignor's agent.³⁶ The common law courts were not insensitive to the encroachment on their domain, and the acceptance of assignments in the common law courts soon followed.³⁷

Nonetheless, the most powerful legal tool to avoid the prohibi-

31. The writ system was burdened by formalities. In so far as it was possible to bring contractual actions, the possibility depended upon the existence of a suitable form of action. Thus medieval lawyers were required to manipulate the chose in action to accommodate the formulary writ system. SIMPSON, COMMON LAW OF CONTRACT, *supra* note 29, at 4.

32. 2 POLLOCK AND MAITLAND, *supra* note 20, at 226.

33. 2 POLLOCK AND MAITLAND, *supra* note 20, at 1004. In 1431, Justice Paston stated that "if I bailed to you a deed to rebail to me, and then I grant the same deed to B, I shall not have writ of detinue against you after this grant, but the said B will have the writ of detinue." Y.B. 9 Hy. VI Hil. pl.17 (1431). Furthermore, in 1491, the validity of a gift by a bailor seems to be maintained by Vavisor. Y.B. 9 Hy. VII Mich. pl.4 (pp. 8-9) (1491).

34. 3 HOLDSWORTH, *supra* note 24, at 282-84.

35. 3 HOLDSWORTH, *supra* note 24, at 282-84.

36. *Peters v. Soame*, 23 Eng. Rep. 874 (Ch. 1701); *Fashion v. Atwood*, 22 Eng. Rep. 819 (Ch. 1679).

37. *Winch v. Keely*, 99 Eng. Rep. 1284 (K.B. 1787).

tion on the assignment of debts was the development of negotiable instruments. The rise of the importance of negotiable instruments was a rapid and necessary one. The industrial revolution dramatically increased the number of commercial transactions which created a need for a means of paying for huge numbers of goods in an economy where metallic money was chronically in short supply. In response to this, bankers and merchants used bills of exchange and other negotiable instruments.³⁸

38. Gilmore, *supra* note 3, at 441, 447. A bill of exchange is an unconditional order in writing, issued by one person (the drawer) to a second person (the drawee), directing the first person to pay a sum certain at a specified time to a third person (the holder). THOMAS C. SIMONTON, *THE LAW OF CHECKS, NOTES, AND BANKS* 121 (2d ed. 1906). One of the first true negotiable instruments, the bill of exchange was first used by the bankers and merchants of Florence and Venice to facilitate the transfer of credit between distant points. In the fourteenth century, bills of exchange came to England by way of France and the Civil law. JAMES M. OGDEN, *THE LAW OF NEGOTIABLE INSTRUMENTS* 20 (4th ed. 1938). Originally, bills of exchange were used to avoid sending money out of or into the country. The merchant paid a third party by giving an order on one of his foreign debtors. In addition to facilitating international transactions, though, bills of exchange also provided an effective method for eluding the common law rule that a debt is not assignable. Bills of exchange provided the assignee with an assignment binding on the original creditor, capable of being ratified by the debtor, and assignable still further. Moreover, the validity of a debt was proven by its authentication in a bill of exchange. A bill of exchange reduced the debt to a sum certain, affording an indisputable title to the whole debt. JOHN B. BYLES, *TREATISE OF THE LAW OF BILLS OF EXCHANGE, PROMISSORY NOTES, BANK-NOTES, BANKERS' CASH-NOTES AND CHECKS* x-xi (4th ed. 1856).

Although in 1603, the first negotiable instruments case was heard in the common law courts involving the enforceability of a bill of exchange, *Martin v. Boure*, 79 Eng. Rep. 6 (K.B. 1603), it was another 150 years before the courts fully recognized that negotiable instruments should be exempt from defenses in the underlying transaction. In *Miller v. Race*, 97 Eng. Rep. 398 (K.B. 1758), the King's Court recognized that when a bank note came into the possession of a holder, for full and valuable consideration and in the normal course of business, without knowledge that it is stolen, the bank note should be treated as money and not as goods, giving bank notes the credit and currency of money. *Id.* at 452. Later, in *Peacock v. Rhodes*, 2 K.B. 633 (1781), it was held that like a bill of exchange, a stolen promissory note that passes into the possession of a good faith holder is not subject to the underlying transaction. *Id.*

Within the last century, the law of negotiable instruments reached maturity. England codified the law of negotiable instruments in 1882 with the English Bills of Exchange Act. In the United States, the earliest codification of negotiable instruments was in the California Civil Code of 1872. JAMES MATLOCK OGDEN, *THE LAW OF NEGOTIABLE INSTRUMENTS* 23 (4th ed. 1938). In 1896, the National Conference of Commissioners on Uniform State Laws drafted the Uniform Negotiable Instruments Law, broadly based on the English Bills of Exchange Act. These statutes contained the fundamental principles and essential definitions of the law of negotiable instruments and provided a set of standards for formal requisites of

Because of the widespread use and utility of negotiable instruments, the necessity of using basic contract assignment principles to achieve the same commercial results, as we suggest in this article, has not been closely examined. Yet, it is clear that whatever the formalistic reasons were which justified a prohibition against the assignment of contract rights, the law has developed in directions fully contrary to those reasons. Therefore, if the commercial goals sought, such as the protections afforded parties through the negotiable instruments law, can be achieved through the established doctrines of contract assignment, such an approach should be considered as a viable legal alternative to achieving those goals. Furthermore, and more important, if the same protections afforded a party under the law of negotiable instruments can be achieved through the law of contract, the formal requirement of a paper driven transaction, as is now required in the negotiable instruments law, may be dispensed with. In this way, the present law can accommodate electronic transfers without any diminution of protection to the parties.

Moreover, modern contract law has developed into the perfect vehicle for the transfer of the right to the payment of money (as opposed to the actual payment of money). Such a statement is so empirically obvious in the day to day world of contract law, that it hardly would appear worth saying. But since the law of negotiable instruments is nothing more than the legal recognition of the right to the payment of money, there exists a vast overlap in the two legal arenas. This should not be surprising because at the same time the mercantile law of negotiable instruments was developing to provide a commercial medium for the transfer of the right to payment of money, the law of contract in general was moving from a rigid emphasis on physical, tangible property rights to a recognition of abstract contractual obligations.³⁹

negotiability, methods of transfer, rights of the holder, and liabilities of the parties. *Id.* at 23.

At the time of the Uniform Negotiable Instruments Law's enactment, over ninety per cent of the greatly expanding interstate commerce was handled by commercial paper, which created a need for uniformity in commercial paper law. By eliminating conflicting negotiable instrument laws, the Uniform Negotiable Instruments Law facilitated interstate commerce, making business transactions less complicated. *Id.* at 24, 28. Today, Article 3 of the Uniform Commercial Code replaces the NIL. By any standard, for the last century, the negotiable instruments law has achieved the goal of facilitating and encouraging commerce. The law of negotiable instruments is well understood and accepted.

39. Morton J. Horwitz, *Historical Foundations of Modern Contract Law*, 87 HARV. L. REV. 917 (1974); A.W.B. Simpson, *The Horwitz Thesis & the History of Contracts*, 46 U. CHI. L. REV. 533 (1979).

This can be seen in a comparison of modern legal conceptions of property with an eighteenth century view of property. For example, Blackstone's conception of property has two aspects or dimensions: property can exist only in tangible things, and all property is absolute. Clearly, neither aspect is credible today. The idea that property is limited to a collection of physical objects lost whatever force it had as courts looked for ways to extend the protective umbrella of the Due Process Clause of the Fourteenth Amendment and to protect new forms of wealth. The best strategy they found was to designate the interest involved as property.⁴⁰ Thus, we see our legal conception of property is such today that the same rights and protections historically given to tangible property is generally accorded to intangible property. In this respect, to the degree that negotiable instruments allowed the transfer of intangible rights in a way that simple contract law did not, this aspect of negotiable instruments law can easily be achieved through the law of contract assignments.

III. A BRIEF COMPARISON OF THE LAW OF NEGOTIABLE INSTRUMENTS AND THE LAW OF ASSIGNMENTS

Can the law of the assignment of contracts operate as a fully functional replacement to a negotiable instrument? We think so. In this section, we briefly examine these two bodies of law and discuss their basic similarities and differences.

The principle attributes of a negotiable instrument are: the paper must be freely assignable, the debt is "merged" into the paper evidencing the claim, transfer can only be made by physical delivery of the paper with evidence of the transferor's intent to make the transfer, discharge of the debt can only be made by payment to the person holding the instrument, creditors can only assert their claims by getting legal possession of the paper, and the situs of the debt is the physical location of the instrument.⁴¹ The primary legal advantage bestowed by the law of negotiable instruments is the protection afforded the "holder in due course" from defenses which could be raised in the underlying transaction.⁴² It is this protection, which we

40. See Dean G. Acheson, Book Review, 33 HARV. L. REV. 329, 330 (1919) ("Everything was thought of in terms of property, — reputation, privacy, domestic relations, and as new interests called for protection, their success depended upon their ability to take on the protective coloring of property.") (footnote omitted); see also Kenneth J. Vandeveld, *The New Property of the Nineteenth Century: The Development of the Modern Concept of Property*, 29 BUFF. L. REV. 325 (1980) (discussing the extension of property protection to business goodwill, trademarks, trade secrets, and oil and gas).

41. Gilmore, *supra* note 1, at 1064.

42. For a holder of a negotiable instrument to be a holder in due course, the

refer to as "essential negotiability," that is not automatically given the assignee of a contract right, which is the primary and substantial distinction between negotiable instruments law and the law of contract assignments. The holder in due course retains a favored legal position as a bona fide purchaser for value who can take and enforce negotiable instruments free of most claims and defenses.⁴³ Thus, the legal status of holder in due course promotes transactions and encourages the rapid and unimpeded flow of capital.

In contrast, an assigned contract right places the assignee in the same legal position as that of the assignor. Unlike the holder in due course, the obligor can assert any claims or defenses against the assignee which could have been asserted against the assignor regardless of whether the assignee knew of their existence at the time of the assignment or whether the claim existed at the time of the assignment.

There are other distinctions between a negotiable instrument and a contract assignment, but the distinctions are not substantive. The most obvious distinction between a negotiable instrument and a contract assignment are the formalities of creating the legal right. The formalities of a negotiable instrument are rigid and axiomatic.⁴⁴ In contrast, assignments lack these formalities. In the absence of a statute or contract term to the contrary, there are no prescribed methods to make an effective assignment. The assignor must only manifest his intention, either through words, conduct, or both, to make a present transfer of his rights to the assignee.⁴⁵

holder must take the instrument for value, in good faith, and without notice of any defenses to the instrument itself. U.C.C. § 3-302.

However, even a holder in due course is subject to a very limited set of defenses:

[A] defense of the obligor based on (i) infancy of the obligor to the extent that it is a defense to a simple contract, (ii) duress, lack of legal capacity, or illegality of the transaction which, under other law, nullifies the obligation of the obligor, (iii) fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms, or (iv) discharge of the obligor in insolvency proceedings;

U.C.C. § 3-305(a)(1).

43. Thus, for example, in the classic holder in due course situation, if the purchaser of goods pays for the goods with a negotiable instrument, regardless of whether the product proves defective, the product is never received, or the product's sale is achieved fraudulently, a holder in due course of the negotiable instrument is entitled to full payment on the instrument.

44. See *supra* text accompanying notes 5-12.

45. This is not to say that no legal formalities are required to make an effective assignment. There must be an intent to transfer a present, not future,

This distinction, however, is merely one of form. The requirements of negotiable instruments go to the question of definiteness of value, time of payment and the expression of who the parties are to the agreement. There is no reason why a contract assignment could not have the same level of specificity, and, at the same time, not require the sine quo non of a negotiable instrument: a tangible written document. Therefore there is no substantive distinction between a negotiable instrument and a contract assignment that would have the effect of negating the use of the law of contract assignments as a substitute to negotiable instruments.⁴⁶

In addition, certainly at one time, transferability served as an essential characteristic of negotiable instruments, and because simple contract rights were not assignable, this was a distinguishing element between the two. Since the prohibition of the transfer of contract rights has been abolished, this aspect of negotiable instruments has no particular contemporary significance. There is another major distinction between a holder in due course and the assignee of a contract right. The holder of a negotiable instrument automatically receives the benefit of the contracts of endorsers to pay on the instrument upon dishonor⁴⁷ as well as the prior transferor's implied warranties.⁴⁸ A contractual assignee does not normally have these benefits.⁴⁹

interest. An assignment must be a completed transaction between the parties which is intended to vest in the assignee a present right. RESTATEMENT (SECOND) OF CONTRACTS § 321 (1979).

46. In saying this, we do not wish to suggest that the lack of formalities in assignments is not without consequences. As Professor Corbin explains, "It is not always easy to determine whether the owner of a right has made an assignment, or a mere promise to assign later on, or a promise to pay out of a fund to be collected." 4 ARTHUR CORBIN, CORBIN ON CONTRACTS § 879, at 531 (1951). Furthermore, as Professor Gilmore reminds us, "Assignment law harshly requires a contract obligor to determine, at his own risk, the validity of assignments of claims against him." Grant Gilmore, *The Assignee of Contract Rights and his Precarious Security*, 74 YALE L.J. 217, 227 (1964). However, for purposes of the argument we are making here, we do not deem this a problem, as it is assumed that any contract and assignment of the rights of that contract that may be made pursuant to the ideas expressed in this article will be made with sufficient formalities to show the express intent of the parties.

47. U.C.C. § 3-414(1).

48. *Id.* § 3-417(2).

49. See e.g., Northern Trust Co. v. E.T. Clancy Export Co., 612 F. Supp. 712, 715-16 (N.D. Ill. 1985). Depending on the circumstances of the assignment, an assignor may implicitly make warranties which are comparable to those in U.C.C. § 3-417(2) for assignments "without recourse." RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 45, at § 333. These warranties do not run to subsequent assignees. *Id.* § 333(4). In addition, these warranties can be disclaimed. *Id.* § 333

In addition, the simplified procedures of enforcement also distinguish the holder of a negotiable instrument from the assignee of a contract. To enforce a negotiable instrument, a holder establishes a prima facie case simply by producing the instrument.⁵⁰ An assignee has to bring the more complicated traditional contract suit.

Moreover, a holder of a negotiable instrument receives specific benefits simply by having possession of the instrument. Only the person in possession of the instrument can discharge the underlying debt.⁵¹ This benefit is not equally accorded an assignee. Before the notice of the assignment, payment to the assignor discharges the obligor's duties.⁵² In addition, claimants may assert claims by seeking garnishment against the obligor.⁵³ And then there is the reoccurring and never resolved question of whether the assignor and obligor can rearrange the debt after the assignment.⁵⁴

In sum, the advantages accorded a party under a negotiable instrument which are not generally given to an assignee of a contract right are, freedom from defenses in the underlying transaction, simplicity of proof of the right of payment, and certainty of the right of payment on mere possession of the instrument. As we will discuss in the next section, the advantages of essential negotiability can be created for an assignee in a carefully drafted agreement between the obligor and the assignor.

IV. NEGOTIABILITY BY CONTRACT

Thus far we have discussed the attributes of negotiability as if their presence could only be found in a single legal universe—that is, as if there were no parallel universe where one or more of these attributes could exist without the presence of an indispensable writing. In fact, however, a coherent legal framework for negotiability without paper is not only possible, it already exists. The 1977 amendments to Article 8 of the Code were designed to accommodate for the first time the uncertificated security.⁵⁵ In so doing, the drafters had to choose

cmt. b.

50. U.C.C. § 3-307(2). Furthermore, there is a presumption that all of the signatures are valid. *Id.* § 3-307(1).

51. Gilmore, *supra* note 3, at 449-50.

52. RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 45, at § 338(1).

53. Gilmore, *supra* note 1, at 1067.

54. Gilmore, *supra* note 46, at 243-249.

55. The 1977 amendments are now incorporated in the 1990 Official Text of the U.C.C. See generally Martin J. Aronstein, et al., *Article 8 is Ready*, 93 HARV. L. REV. 889, 890-93 (1980) (discussing the history of the 1977 amendments). Interestingly, this new system of securities ownership envisioned by the drafters has

between a system of non-negotiability based on the law's traditional treatment of commercial intangibles, and a system of negotiability based on the certificated security. In an effort to "facilitate the elimination or reduction in use of negotiable stock certificates,"⁵⁶ the drafters chose the latter system.⁵⁷ For the first time the world beheld the "negotiable non-instrument."⁵⁸

What bearing does the legal structure of Article 8 have on the negotiability of intangibles generally? Two conclusions follow from the development of the certificateless system. First, and most importantly, the legal system should be allowed to depart from current commercial law and practice, certainly in the face of changed conditions, but also to reflect new views of policy. Second, new departures should be accorded somewhat more deference than longstanding practices if the departure is for reasons that have to do with technological change and new conceptions of property. But this is not to say that courts are free to do whatever they wish. Because much of commercial law has been codified in the Uniform Commercial Code, it is clear that within a wide range the choice of policy is for the legislature.

For example, on the question of negotiability, the Code makes it clear that the scope of Article 3 is defined by the definition of "negotiable instrument"⁵⁹ and, despite the general ability of parties to

yet to materialize. With the exception of mutual fund shares, "virtually all other forms of publicly traded corporate securities are still issued in certificated form." U.C.C. REVISED ARTICLE 8, Prefatory Note, at 2 (1994). Article 8 has again been revised, this time to accommodate the evolution of the indirect holding system. See *id.*

56. Aronstein, et al, *supra* note 55, at 890.

57. The decision to opt for a system of negotiability was based on the belief that such a security would be more acceptable to the commercial community and on the premise that cost and efficiency should be determinative of which type of security to issue, not which form produces the better result for one of the parties to a particular transaction. Aronstein, et al., *supra* note 55, at 893-94. *But see* Peter F. Coogan, *Security Interests in Investment Securities Under revised Article 8 of the Uniform Commercial Code*, 92 HARV. L. REV. 1013 (1979) (criticizing the 1977 amendments).

58. Aronstein, et al., *supra* note 55, at 896.

59. Section 3-104 acts as the basic section defining the reach of Article 3. It, however, cannot be read in isolation.

An instrument is either a "promise," defined in Section 3-103(a)(9), or "order," defined in Section 3-103(a)(6). A promise is a written undertaking to pay money signed by the person undertaking to pay. An order is a written instruction to pay money signed by the person giving instruction. Thus, the term "negotiable instrument" is limited to a signed writing that orders or promises payment of money.

U.C.C. § 3-104 cmt. 1.

vary by agreement the Code's provisions,⁶⁰ this is one instance where freedom of contract is restrained.⁶¹ Whether or not a narrow formulation of this restriction on the parties' contractual freedom is desirable, it is still possible to find a place for an alternative system of negotiability by exploring the relationship between that principle and other Code provisions. Indeed, comment 2 to section 3-104 not only suggests the application of Article 3 by analogy,⁶² it raises the possibility that the parties can, by appropriate contract, achieve some or all of the attributes of negotiability.⁶³

In this Part, we discuss how the doctrine of good faith purchase interacts with other principles and Code sections. We conclude that the current restrictions on negotiability are overcome by methods that permit the original parties to a transaction to create for them-

60. See *id.* § 1-102(3) ("The effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act. . . .").

61. Comment 2 to section 1-102 so provides by stating that "private parties cannot make an instrument negotiable within the meaning of Article 3 except as provided in Section 3-104. . . ." *Id.* § 1-102 cmt. 2. See also *id.* §§ 3-102(a) ("This Article applies to negotiable instruments."), 3-104 cmt. 2 ("a writing cannot be made a negotiable instrument within Article 3 by contract or conduct of the parties. . . .").

62. There are cases where the former Article 3 has been applied by analogy. See, e.g., *United States v. First National Bank*, 263 F. Supp. 298 (D. Mass. 1967); *Sweeney v. First Nat'l Bank*, 299 S.E.2d 858 (Va. 1983). In contrast, see *European American Bank & Trust Co. v. Starcrete International Industries, Inc.*, 613 F.2d 564 (5th Cir. 1980).

63. Comment 2 reads, in pertinent part, as follows:

Moreover, consistent with the principle stated in Section 1-102(2)(b), the immediate parties to an order or promise that is not an instrument may provide by agreement that one or more of the provisions of Article 3 determine their rights and obligations under the writing. Upholding the parties choice is not inconsistent with Article 3. Such an agreement may bind a transferee of the writing if the transferee has notice of it or the agreement arises from usage of trade and the agreement does not violate other law or public policy. An example of such an agreement is a provision that a transferee of the writing has the rights of a holder in due course stated in Article 3 if the transferee took rights under the writing in good faith, for value, and without notice of a claim or defense.

U.C.C. § 3-104 cmt. 2. It would seem that this expression of the drafters' intent would preclude a rebirth of the negotiability by contract controversy that existed under the Negotiable Instruments Law. See generally, Frederick K. Beutel, *Negotiability by Contract*, 28 ILL. L. REV. 205 (1934). Not all would agree, however, with the drafters' choice. See William E. Britton, *Formal Requisites of Negotiability—The Negotiable Instruments Law Compared with the Proposed Commercial Code*, 26 ROCKY MNT. L. REV. 1, 32 (1953) (stating that the invitation to "courts to confer upon various nonconforming writings, some of the attributes of negotiability, is thoroughly unsound . . . [and] should be struck from the Code.").

selves a universe of essential negotiability. That universe would enable a good faith purchaser of an intangible for the payment of money to cut off defenses of the obligor, ascertain the existence of prior claims and assure against subordination to future claims.⁶⁴

A. Cutting Off Defenses of Obligors

By most accounts the so-called cut-off clause, by which the buyer waived, against all assignees, any defenses which she might have against the seller, was the central concept through which sales finance companies were able to develop into national enterprises.⁶⁵ Their ultimate financial success depended in great measure upon their being able to achieve free-of-defenses status on both the money claim and on the security agreement. The idea of inserting a waiver of defenses provision into the conditional sale contract appealed to the legal imagination, for, if it proved successful, it would at once free finance companies from buyers' defenses even in those jurisdictions where title retention clauses rendered the sales notes nonnegotiable⁶⁶ and despite the refusal of courts to apply the "imparting negotiability" doctrine to conditional sales.⁶⁷

Initially, the courts' response to cut-off clauses was less than favorable. It was inevitable that this attempt to waive defenses would ultimately draw into question the ability of parties to make instruments negotiable by contract. Indeed, the idea that these clauses were an attempt to circumvent the mandatory nature of the

64. To be sure, it may be possible to achieve by contract a number of other attributes of negotiability; some of which may depend upon the existence of a writing. For example, the rules as to alteration and incomplete instruments would seem to make sense only if the contract is embodied in a written document. See U.C.C. § 3-407. For present purposes it will be sufficient if we limit our discussion to only those attributes that we have identified as essential to a universe of negotiability.

65. See Gilmore, *supra* note 1, at 1093-98.

66. See, e.g., *General Motors Acceptance Corp. v. Davis*, 218 P.2d 181 (Kan. 1950) (holding that conditional sales contract destroyed negotiability of note); *Central Nat. Bank v. Hubbel*, 154 N.E. 551 (Mass. 1927); *Polk County State Bank of Cookston v. Walters*, 176 N.W. 496 (Min. 1920). *But see Chicago Ry. Equipment Co. v. Merchant's Bank*, 136 U.S. 268 (1890) (holding that a conditional sales contract does not destroy negotiability of note); *Howard v. Simpkins*, 69 Ga. 773 (1882); *Burnley v. Tufts*, 5 So. 627 (Miss. 1888).

67. The "imparting negotiability" doctrine provided that if a negotiable note and mortgage are given by the debtor, the negotiability of the note will be "imparted" to the mortgage, so that both can be transferred free of outstanding equities and defenses. See 127 A.L.R. 190 (1940). For some unknown reason the doctrine was never applied to conditional sale contracts. See Gilmore, *supra* note 1, at 1094.

Negotiable Instruments Law by creating a new type of negotiable instrument won judicial endorsement in several jurisdictions.⁶⁸ Despite this early resistance, between 1930 and 1940 the tide turned and a majority of courts ultimately honored the effectiveness of waiver of defenses clauses embodied in nonnegotiable instruments.⁶⁹

Nevertheless, in the aftermath of the no negotiability by contract assault on cut-off clauses, courts sometimes said that the defense of fraud could not be waived.⁷⁰ By contrast, a contractual waiver was effective to bar a simple breach of warranty defense. It seems clear that although the finance companies would have preferred a fully negotiable instrument, the protection they received from the cut-off clause was probably all the protection they needed in the vast majority of cases.

All of this being said, perhaps the most persuasive evidence of the capacity of parties to waive defenses by contract today is the most obvious one: U.C.C. section 9-206. Under this section, one is entitled to the status of a holder in due course if the following conditions are met:

[A]n agreement by a buyer or lessee that he will not assert against any assignee any claim or defense which he may have against the seller is enforceable by an assignee who takes his assignment for value, in good faith, and without notice of a claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the article on commercial paper (Article 3 of this title).⁷¹

68. See, e.g., *American Nat'l Bank v. Sommerville, Inc.*, 216 P. 376 (Cal. 1923); *Motor Contract Co. v. Van Der Volgen*, 298 P. 705 (Wash. 1931); *Progressive Finance & Realty Co. v. Stempel*, 95 S.W.2d 834 (Mo. Ct. App. 1933).

69. See Gilmore, *supra* note 1, at 1096-97.

70. Gilmore, *supra* note 1, at 1096.

71. U.C.C. § 9-206. In the context of consumer transactions, there has long been recognition of the need for greater protection against unscrupulous sellers. For this reason many state legislatures have enacted statutes which prohibit waivers by consumers. See Ralph J. Rohner, *Holder in Due Course in Consumer Transactions: Requiem, Revival, or Reformation?*, 60 CORNELL L.Q. 503 (1975); Alan Schwartz, *Optimality and the Cutoff of Defenses Against Financers of Consumer Sales*, 15 B.C. IND. & COM. L. REV. 499 (1974). In 1975, the Federal Trade Commission entered the fray with a rule that made it an unfair trade practice to attempt to deprive consumers of their defenses. See 16 C.F.R. § 433 (1994). See also 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.

To be sure, the waiver of defense clause does not create a negotiable instrument. But if it is used, it will make it possible to achieve one of the most basic attributes of negotiability.⁷² If the assignee would otherwise qualify as a holder in due course,⁷³ she will take free of "personal" defenses, but not "real" defenses.⁷⁴

This approach has a good deal to be said in its favor. Above all, it is a plausible way for an assignee to take free of defenses in situations where there is no writing that embodies the underlying obligation. Although it is common parlance to speak of a waiver of defense or cut off *clause*, there is no requirement that it be in writing.⁷⁵ And if it need not be evidenced by a writing, the "agreement" can be manifested orally or can come from other relevant circumstances including trade usage, course of dealing and, as the Code now reads, maybe course of performance.⁷⁶

There are, however, at least two problems with this approach. First, the need for certainty in this area may call for an easy way to ascertain whether the debtor did, in fact, waive defenses. Absent a written waiver, how can this be accomplished? The resolution of this problem might well call for an understanding of modern communication and storage technologies. These include "magnetic media, optical discs, digital voice messaging systems, electronic mail, audio tapes and photographic media, as well as paper."⁷⁷ Thus, whether or not

72. In the absence of such an agreement "the rights of an assignee are subject to all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom; and any other defense or claim of the account debtor against the assignor which arose before the account debtor receives notification of the assignment." U.C.C. § 9-318(1).

73. Query whether for purposes of section 9-206 the definition of value in section 3-303 controls, rather than the general definition of value appearing in section 1-201(44).

74. See *supra* note 42 and accompanying text.

75. Moreover, if it is in writing it need not be conspicuous. See, e.g., *Chase Manhattan Bank, N.A. v. Coleman*, 496 A.2d 935 (R.I. 1985).

76. Although the definition of "agreement" in section 1-201(3) includes usage of trade, course of dealing and course of performance, the definition of course of performance appears in section 2-208 and the concept is conspicuously absent from the interpretational priority set out in section 1-205(4). See U.C.C. §§ 1-201(3), 2-208, 1-205(4). It is therefore open to question whether course of performance was intended to be part of the definition of agreement when that term appears outside of Article 2. Recently, the A.B.A. Article 1 Task Force recommended to the Permanent Editorial Board for the U.C.C. that the definition of course of performance be relocated to Article 1 and that section 1-205 be amended accordingly. The Permanent Editorial Board has accepted this recommendation.

77. Proposed Comment Language, submitted by Professor Patricia B. Fry to the Reporters for the Limited Liability Company and U.C.C. Article 5 Drafting Committees.

the debtor's agreement is in writing, there may be a "record" of the agreement.⁷⁸

Another strategy for overcoming this problem might be to have the waiver of defenses reflected in a trading partner agreement.⁷⁹ This agreement would structure the relationship between the debtor and its original creditor and would act as a source of information for interested third parties. Of course, the idea of a separately negotiated trading partner agreement only makes sense if the original parties intend to transact business on a somewhat regular basis.

The second problem with the section 9-206 approach is its scope. In some cases the debtor will be neither a buyer or a lessee.⁸⁰ The creditor might, for example, have a claim against the debtor for services rendered. Although this claim would be an Article 9 account,⁸¹ it would not seem to be within the contemplation of section 9-206. Although a broader scope to section 9-206 would have the virtue of simplicity and ease of application it would seem that essential negotiability could still be achieved. Recall that the official comment to section 3-104 makes it explicitly clear that notwithstanding the

78. The term "record" will appear in the Code for the first time when revised Article 5 (Letters of Credit) receives final approval by the American Law Institute and the National Conference of Commissioners on Uniform State Laws. See U.C.C. § 5-102(14) (Proposed Draft 1994). That section will read as follows: "Record means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form." *Id.* We anticipate that the same term will also appear in the other Code Articles under revision and ultimately as one of the general definitions in section 1-201. All of this makes it clear that a writing is but one of many possible forms of record.

79. See generally Amelia H. Boss, *Electronic Data Interchange Agreements: Private Contracting Toward a Global Environment*, 13 NW. J. INT'L L. & BUS. 31 (1992). Boss writes:

The terms *trading partner agreement* and *interchange agreement* are generally used interchangeably, the former being the preferred American usage and the latter the international formulation. Arguably, however, the terms may reflect a difference in approach: the trading partner agreement referring to any agreement structuring the relationship between the trading partners, whether arising from the exchange of electronic information or not, and the interchange agreement being restricted to the exchange of information electronically.

Id. at 37-38 n.27.

80. Originally, section 9-206 only referred to buyers. Lessees were included in 1962 because of the "substantial growth in lease financing and the quite parallel application of problems dealt with by this section to both conditional sale contracts and leases." 4 ANDERSON, UNIFORM COMMERCIAL CODE § 9-206, at 197-99 (2d ed. 1971). In the case of a finance lease under Article 2A, a "hell or high water clause," is made a part of every agreement. See U.C.C. § 2A-407(1).

81. See *id.* § 9-106.

parties' ability to contract into Article 3 they are nevertheless free to contract for the various attributes of negotiability.⁸² To accord such power to the parties would suggest that with the passage of new Article 3, section 9-206 has become redundant.⁸³ But the statement about negotiability has been relegated to a comment, and there is as yet no clear answer to this question.

Because the ability to recover the full amount of the underlying claim is what is crucial here, the assignee's position is enhanced considerably by the warranties that it receives from its assignor. An assignor impliedly warrants that the assigned right is subject to no defenses or claims good against the assignor.⁸⁴ Moreover, the assignee may require warranties in addition to those implied by law.⁸⁵ For example the assignee can demand an express warranty that the obligor is solvent and that she will perform her obligation.⁸⁶

In sum, an assignee of a claim can minimize the risk of nonpayment by capitalizing on the warranties—express and implied—given by the assignor. Even if the obligor can successfully resist payment, the assignor stands as an alternative source of recovery. An approach of this sort appears to be a reasonable substitute for negotiability.

B. Competing Claims of Ownership

The competing claims problem has two dimensions: one who acquires an obligation by assignment (a) has to be protected against claims of ownership predicated on events which occurred prior to the

82. See *supra* note 10 and accompanying text.

83. Comment 1 to section 9-206 explains that the section was intended to settle the negotiability by contract debate. It states: "These clauses have led to litigation and their present status under the case law is in confusion. In some jurisdictions they have been held void as attempts to create negotiable instruments outside the framework of Article 3 or on the grounds of public policy. In others they have been allowed to operate. . . ." U.C.C. § 9-206 cmt. 1.

84. See RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 45, at § 333(1). Compare this warranty with that given by the transferor of an negotiable instrument without an indorsement. Such a person warrants, among other things, that "the instrument is not subject to a defense or claim in recoupment of any party which can be asserted against the warrantor. . . ." U.C.C. § 3-416(a)(4).

85. See RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 45, at § 333 cmt. b. ("The rules stated in this Section can be varied by agreement. Express warranties are created in the same ways as express warranties in the transfer of goods. . . .").

86. Cf. U.C.C. § 3-415(a) ("[I]f an instrument is dishonored, an indorser is obliged to pay the amount due on the instrument . . . according to the terms of the instrument at the time it was indorsed. . . ."). The words "with recourse" ordinarily constitute such a guarantee of payment. See *e.g.*, *Ranchers Bank v. Pressman*, 97 Cal. Rptr. 78 (Ct. App. 1971).

assignment, and (b) has to be protected against claims of ownership predicated on events which occur subsequent to the assignment. It is commonly believed that the transformation of an intangible claim into a negotiable instrument is the principle means of coping with both aspects of the problem. As we explain, however, modern concepts of property and contract together with the existence of the Article 9 filing system protect the expectations of current assignees at least as well as the negotiability system, permitting them to acquire and retain most rights to payment free from the interference of others.

1. Existing Claims of Ownership

According to the traditional conception of the good faith purchase doctrine, only the transfer of a negotiable instrument ensures that the purchaser will take free of existing claims of ownership.⁸⁷ Yet, despite its undeniable advantages, the negotiability system is generally unsuited to handle this problem. No one has placed greater stress on this particular point than James S. Rogers.⁸⁸

Rogers points to the rather obvious fact that the advantages of holder in due course status are unobtainable unless the transferee of the instrument first becomes a holder.⁸⁹ That is, unless the instrument is properly negotiated, the significant benefits that accrue to a holder in due course are lost.⁹⁰ Problems can arise because an instrument in order form can only be negotiated if properly indorsed.⁹¹ Thus, if an order instrument is stolen or if the true owner's agent indorses in excess of authority, no subsequent transferee can become a holder.⁹² This means that in a vast array of disputes involving

87. See e.g., William F. Willier, *Nonnegotiable Instruments*, 11 SYRACUSE L. REV. 13, 24 (1959) ("Negotiable" in its most important sense means the ability of a transferee to acquire greater contract and property rights than his transferor had."). See also *supra* notes 59-64 and accompanying text.

88. See generally James Steven Rogers, *Negotiability as a System of Title Recognition*, 48 OHIO ST. L.J. 197 (1987).

89. *Id.* at 211. See U.C.C. § 3-302(a) ("[H]older in due course' means the holder of an instrument. . . .").

90. How an instrument is negotiated will depend on whether it is in bearer or order form. If in order form "negotiation requires transfer of possession of the instrument and its endorsement by the holder. If an instrument is payable to bearer, it may be negotiated by transfer of possession alone." U.C.C. § 3-201(b). See also *id.* § 1-201(20) (stating the definition of the term "holder").

91. *Id.* § 1-201(20).

92. See *id.* §§ 1-201(43) ("Unauthorized' signature means one made without actual, implied, or apparent authority and includes a forgery."); 3-403(a) (1990) ("Unless otherwise provided in this Article or Article 4, an unauthorized signature

conflicting ownership claims "the effect of the rules of transfer of negotiable instruments is precisely the opposite of that assumed by the usual assertions: the negotiability rules ensure that any subsequent parties, even bona fide purchasers, will take subject to the prior ownership claim."⁹³

Suppose, however, that the obligation is not embodied in a negotiable instrument. The risk to the transferee is not that the obligation was previously stolen, which concededly would be impossible since there is nothing tangible to steal,⁹⁴ but rather there still may be the risk that the assignment is being made by one without appropriate authority. But this risk is independent of the form that the obligation takes.⁹⁵ Ironically, as it turns out, if the obligation has been transformed into a negotiable instrument courts may actually be less willing to find authority to transfer than they would in other circumstances.⁹⁶ In the end, this may mean that the transferee who relies on the negotiability system for protection may actually find herself at a disadvantage.

Consider next, by contrast, prior equitable claims of ownership.⁹⁷ Certainly a holder in due course will take free of these claims.⁹⁸ But to understand and evaluate the need for negotiability

is ineffective. . . .").

93. Rogers, *supra* note 88, at 213.

94. To say this is not to deny that a situation similar to theft might not occur. Suppose, for example, that prior to the assignment to X the assignor had previously assigned the same claim to Y. In such a case, could it not be said that the assignor is attempting to steal the interest already granted to Y? Because discussion of this issue will inevitably involve the Article 9 filing system we reserve it for later in the article. See *infra* Part IV.B.2.

95. This is a matter of agency law, not negotiable instruments law or the law governing any other type of transfer. "Thus, the position of a transferee of a negotiable instrument in order form that was transferred by an agent in excess of the agent's actual authority is at best the same as that of a transferee of any other form of property in such circumstances." Rogers, *supra* note 88, at 212.

96. Rogers notes that "the field of negotiable instruments law has provided what may be the most extreme instance of narrow construction of an agent's authority known to American law." Rogers, *supra* note 88, at n.62.

97. Rogers refers to these claims as "secret equities," and makes the point that this category of claims "is as broad as the inclination of the courts of equity to lend their assistance to parties who have lost property, by some misfortune or equity." Rogers, *supra* note 88, at 202.

98. See U.C.C. § 3-306. Section 3-306 states:

A person taking an instrument, other than a person having rights of a holder in due course, is subject to a claim of a property or possessory right in the instrument or its proceeds, including a claim to rescind a negotiation and to recover the instrument or its proceeds. A person having rights of a holder in due course takes free of the claim to the instrument.

in this context, attention must focus on whether the assignee would take subject to these claims if no negotiable instrument were involved. To be sure, there was a time when the interest of a bona fide purchaser would be subordinate to latent equities, but that is no longer true.⁹⁹ One of the more explicit articulations of the current state of the law is found in the Restatement (Second) Contracts:

If an assignor's right against the obligor is held in trust or constructive trust for or subject to a right of avoidance or equitable lien of another than the obligor, an assignee does not so hold it if he gives value and becomes an assignee in good faith and without notice of the right of the other.¹⁰⁰

Two quite general conclusions emerge from the discussion so far. First, even the transferee of a negotiable instrument may be vulnerable to competing claims of ownership. To that extent, the form that the underlying obligation takes is irrelevant. Second, holder in due course status is not the only shield that protects transferees against latent equities. The bona fide purchase doctrine will provide the transferee with the same degree of protection.

2. Future Claims of Ownership

It seems clear that once a monetary obligation has been transformed into a negotiable instrument the only effective way to deal with the underlying claim will be to deal with the instrument. In other words, the only way to transfer the claim is to transfer the instrument.¹⁰¹ This explains why, with some exceptions, the holder of the instrument will be the only one with any rights on it and the only one who can enforce payment of the obligation.¹⁰² It also means that to be a holder one must have possession of the instrument.¹⁰³

Id.

99. Originally, it was thought that the assignee received merely an equitable interest. See *supra* text accompanying notes 28-36. This meant that it was subject to all prior equities. 1 J. POMEROY, EQUITY JURISPRUDENCE § 413-415 (1st ed. 1881) ("where there are equal equities, the first in order of time shall prevail."). Today, the interest is considered to be legal and, as such, is not subject to prior equities of the assignee. See *supra* notes 37-46 and accompanying text; *infra* notes 105-12 and accompanying text.

100. RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 45, at § 343.

101. This is true whether or not the transfer is voluntary. If a creditor wishes to get at the value of the underlying claim, she must first gain possession of the instrument. S. RIESENFELD, CASES AND MATERIALS ON CREDITORS' AND DEBTORS' PROTECTION 173 n.2 (3d ed. 1979).

102. See U.C.C. § 3-301 ("Person Entitled to Enforce Instrument").

103. The holder of a negotiable instrument "means the person in possession if

The central point is this: rightful possession of the paper guarantees priority over prior and subsequent assignees of the same claim. By taking and keeping possession of the instrument, the holder can effectively ensure that no competing claimant can achieve have priority.¹⁰⁴

The priority of competing assignees of a nonnegotiable chose has always been considerably more complex. The problem here is that there are at least three common law approaches that a court can take to decide this type of case. A court can apply the "New York" rule,¹⁰⁵ the "English" rule,¹⁰⁶ or what is alternatively referred to as the "Massachusetts" or "four horsemen" rule.¹⁰⁷ In this legal environment an assignee faces two difficulties. First, there is no effective way for him to learn whether the same claim had been assigned previously. Second, even in the absence of a prior assignment, the assignee may find its interest subordinated to a subsequent assignee. Given such a regime, we may wonder whether the negotiability system provides the only effective mechanism of title assurance.

There is a ready answer to this question. Clearly, with the promulgation of Article 9 of the Code we now have a system of title assurance which will provide the assignee with the information and protection she needs. Although the most obvious application of Article 9 is to consensual liens on personal property, its scope is not so limit-

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." *Id.* § 1-201(20).

104. As Rogers explains: "[T]he rule that interests in negotiable instruments can be effectuated only by possession of the instrument provides a simple mechanism of title assurance." Rogers, *supra* note 88, at 205.

105. The "New York" rule is a first-in-time rule. It is premised on the idea that after the first assignment, there would be nothing left for the assignor to assign. See, e.g., *Superior Brassiere Co. v. Zimetbaum*, 214 A.D. 525 (N.Y. Sup. Ct. 1925).

106. The "English" rule too favors the first-in-time assignee. The difference between it and the New York rule is that under the former, the second assignee can achieve priority by being the first to notify the obligor of the assignment. See *Dearle v. Hall*, 38 Eng. Rep. 475 (Ch. 1828).

107. See *Rabinowitz v. People's Nat'l Bank*, 126 N.E. 289 (Mass. 1920). This is the rule that we find in the Restatement. The first assignee prevails, unless:

- [T]he subsequent assignee in good faith and without reason to know of the prior assignment gives value and obtains
- (i) payment or satisfaction of the obligation,
 - (ii) judgment against the obligor,
 - (iii) a new contract with the obligor by novation, or
 - (iv) possession of a writing of a type customarily accepted as a symbol or as evidence of the right assigned.

RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 45, at § 342.

ed. It also covers sales of accounts.¹⁰⁸ Thus, if the assigned right to payment is an account the first assignee who files a financing statement wins.¹⁰⁹ In light of this, a potential assignee can determine from the appropriate filing office exactly where it will stand following the assignment. If there are no financing statements on file, the assignee can ensure its priority by filing immediately.¹¹⁰ What we have, therefore, is a system which, if not superior to the negotiability system,¹¹¹ will reduce the cost of uncertainty just as well.¹¹²

V. CONCLUSION

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

108. Article 9 applies:

[T]o any transaction (regardless of its form) which is intended to create a security interest in personal property . . . and also to any sale of chattel paper.

U.C.C. § 9-102. An "[a]ccount means any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance." *Id.* § 9-106.

109. *See id.* § 9-312(5). There is no need to file, however, if the assignment "does not alone or in conjunction with other assignments to the same assignee transfer a significant part of the outstanding accounts of the assignor." *Id.* § 9-302(i)(c).

110. The assignee can even file before the assignment is made. *See id.* § 9-402(1).

111. Indeed, there are those who argue that the benefits of the Article 9 filing system outweigh those of the negotiability system. *See Clark, supra* note 19, at 473-479; Rogers, *supra* note 88, at 202-209.

112. One might object that this conclusion ignores the fact that not all monetary claims are accounts. If a non-account is assigned, the priority of successive assignees would be determined according to whichever common law rule is followed by the particular jurisdiction. *See supra* notes 88-111 and accompanying text. While this is presently true, it should be noted that the Article 9 Drafting Committee has tentatively decided to include within the scope of Article 9 the outright sale of all rights to the payment of money.

can be made roughly and at the cost of a great deal of litigation. The more readily we can accept as a basic proposition, that the corpus of the law is a floating mass and not a solid body, the more easily will the necessary changes be made, and, paradoxically, the greater will be the real, as distinguished from the apparent certainty.¹¹³

Grant Gilmore wrote those words forty years ago. Then, he worried about whether, with the adoption of the new Uniform Commercial Code, the law would be able to keep pace with evolving commercial practices. This symposium proves that his concern is not any less valid today. As commercial practice becomes more electronic, the challenge will be to adjust our traditional paper-based rules to keep pace with this new way of transacting business.

It is beyond question that the formal requirement that a negotiable instrument must be written cannot accommodate electronic messaging technologies. But it must be recognized that the question is not an all-or-nothing one between traditional negotiability and no negotiability. The barriers to "essential" negotiability outside of the traditional negotiability system have shrunk considerably since the system was first developed. Excessive focus on what constitutes a writing has, therefore, obscured the field. This Article has argued that it may be time to abandon our efforts to somehow make paper-based rules fit electronic commerce, while accepting other common law and statutory concepts for what they can accomplish. If the response to electronic commerce is new legislation, we hope that our analysis will provide a foundation on which appropriate legislation can be based.

113. Gilmore, *supra* note 1, at 1107.

