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## THE NEGOTIABILITY OF CORPORATE BONDS

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THERE has smouldered for many years a question whether the Negotiable Instruments Law should apply to long term commercial paper—the bonds, debentures, equipment trust certificates and other instruments invented by an ingenious financial community. Not that any one doubts that such paper should be negotiable, for there has been no criticism of the decisions so holding, nor has there been much concern whether negotiability was reached under the Act or by common law recognition of custom. But when, as has happened several times in recent years, an instrument of this class has run afoul the statute and been held non-negotiable, a considerable flare-up has resulted.<sup>1</sup> Heated statements have been made decrying the “stereotyping,” “strait-jacketing” effect of the Act; it is said that the courts must be given room within which newly devised instruments may be recognized, and that bonds, being long term paper, are functionally different from notes, bills and checks—in fact, are traded in by different people.<sup>2</sup> From this it has been somewhat hastily concluded that the Act should have no application to such paper. This, it is fair to say, has become the general opinion among writers on the subject.<sup>3</sup>

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<sup>1</sup> One of the first cases to provoke general discussion, although not decided under the N. I. L., was *Crocker National Bank v. Byrne & McDonnell*, 178 Cal. 329, 173 Pac. 752 (1918). Bonds which recited that they were secured by a trust deed or mortgage were held non-negotiable. See adverse criticism in Comment (1918) 6 CAL. L. REV. 444.

<sup>2</sup> See BRANNAN, *NEGOTIABLE INSTRUMENTS LAW* (4th ed. 1926) 7, for a summary of the argument.

<sup>3</sup> Aigler, *Recognition of New Types of Negotiable Instruments* (1924) 24 COL. L. REV. 563, 593; Beutel, *The N. I. L. Should Not Be Amended* (1932) 80 U. of PA. L. REV. 368, 384; BRANNAN *op. cit. supra* note 2, Preface VI; Douglas, *The Applicability of the N. I. L. to Bonds* (1925) 25 COL. L. REV. 71; Kent, *Some Further Necessary Amendments to the*

From the technical side it is sought to bolster up this position by the assertion that the Commissioners on Uniform State Laws, in framing the Act, had in mind only three types of paper: notes, bills and checks.<sup>4</sup> The Act was drafted to conform in the main to the English Bills of Exchange Act, which is specifically limited to such instruments. In the opinion of the English draftsman the law with regard to bonds and similar paper had not sufficiently crystallized to warrant codification.<sup>5</sup> But while scant, if any, mention was made of bonds by the Commissioners—the available reports of the proceedings are very inadequate<sup>6</sup>—they deliberately departed from the English precedent to make their Act, verbally at least, much broader in scope. The Act was called the Negotiable Instruments Law, not one concerning specified instruments only, and began with the proposition that, “An instrument to be negotiable must conform to the following requirements.”<sup>7</sup> The language was obviously too inclusive, taken literally, since all the discussion of the Commissioners discloses that there was no intention to cover bills of lading, stock certificates and similar instruments. No doubt a modern realist of easy virtue would have few scruples in restricting the Act to

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*Uniform Negotiable Instruments Law* (1928) 22 ILL. L. REV. 833, 839; Kidd, *The Negotiability of Bonds in California and the N. I. L.* (1918) 6 CAL. L. REV. 444; SMITH AND MOORE, *CASES ON BILLS AND NOTES* (3d ed. 1931) 1, n. 1; Vernier, *Amendments to the Negotiable Instruments Law* (1929) 24 ILL. L. REV. 150, 153.

<sup>4</sup> See BRANNAN, *loc. cit. supra* note 2. But this argument is seriously weakened by the fact that Section 6 (4) refers to seals as not affecting negotiability and Section 65 (4) exempts the transferor of “public or corporation securities other than bills and notes” from the usual warranty as to the capacity of prior parties to contract. BIGELOW, *BILLS, NOTES AND CHECKS* (3d ed. 1928) 35, n. 1. The point is now conceded: BRANNAN, *NEGOTIABLE INSTRUMENTS LAW* (5th ed. 1932) § 8.

<sup>5</sup> “The law relating to negotiable securities for money other than bills, notes, and cheques, is as yet very imperfectly developed, and is, therefore, unsuited for presentation in a codified form.” CHALMERS, *BILLS OF EXCHANGE* (6th ed. 1903) 316.

<sup>6</sup> At the 1893 meeting of the Commissioners in Milwaukee, Commissioner Stimson of Massachusetts read a short act which he had prepared “relating to bills of exchange and promissory notes.” *PROCEEDINGS OF THE COMMISSIONERS ON UNIFORM STATE LAWS* (1893) 203. At the previous session in New York an act relating to days of grace on promissory notes and bills of exchange had been introduced. *PROCEEDINGS OF THE COMMISSIONERS ON UNIFORM STATE LAWS* (1892) 115. At this meeting the point was raised as to whether the title should not be broadened to include all negotiable instruments but it met with the objection that the term might be understood in some states to include warehouse receipts and bills of lading, which obviously was not intended. No definite action was taken at these meetings since both acts were referred to the committee designated to study the whole subject and which later reported the present N. I. L. The detailed discussion of this act in committee and before the general council is not available.

<sup>7</sup> N. I. L. § 1.

instruments for the payment of money, or even to only such paper of that class as he might think proper—but for many, it would still be difficult to see how bonds could decently be excluded in view of the generality of the term “negotiable instrument.”

The matter came before the New York Court of Appeals in 1926 in the now famous *Manhattan* case,<sup>8</sup> which involved interim certificates certifying that the bearer was entitled to receive a bond of the Kingdom of Belgium “when, as and if delivered to them [the signer] in definitive form by the obligor, and upon surrender of and in exchange for the certificate.” Such paper was clearly not within the contemplation of the Commissioners when the Negotiable Instruments Law was drafted. The court nevertheless decided, Judge Cardozo writing the opinion, that the Act applied, and that the paper was not negotiable, since the promise was conditional and the instrument was not payable in money. With this decision it obviously became futile to insist longer that the Act did not apply to bonds and similar paper; it was held to apply even to paper not payable in money. It is interesting to conjecture why such a result was reached by the court, but apparently at least one factor was reluctance to embark on a project of passing upon the negotiability of each of the many types of such instruments then in current use. The court was not prepared to legislate by wholesale; the work, it felt, could be handled more expeditiously by the legislature.<sup>9</sup>

Hard upon the heels of the *Manhattan* case, legislation, consisting of three short paragraphs, was introduced in the New York legislature,<sup>10</sup> by which it was sought to give some aspects of negotiability, not only to security receipts, already held non-negotiable by the court, but also to equipment trust certificates, which it was apparent would be found non-negotiable when similarly tested by litigation.<sup>11</sup> The statute, known as the Hofstadter Act, did not purport to be an amendment to the Negoti-

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<sup>8</sup> *President and Directors of Manhattan Co. v. Morgan*, 242 N. Y. 38, 150 N. E. 594 (1926). The case was criticized in Note (1926) 35 *YALE L. J.* 877, on the ground that the court should have excluded non-money instruments from the purview of the Act.

<sup>9</sup> The court said: “So far as the Negotiable Instruments Law is concerned, the remedy for the evil, if it be one, is an amendment of the statute that will add to the negotiable instruments there enumerated or described such other classes as the law merchant or the custom of the market may from time to time establish. Until such an amendment shall be adopted, the courts in their decisions must take for granted that the Legislature is content with the law as it is written.” *Manhattan Co. v. Morgan*, *supra* note 8, at 52, 150 N. E. at 599.

<sup>10</sup> N. Y. PERSONAL PROPERTY LAW (1926) art. 8 §§ 260-262. For a critical analysis of this statute see Comment (1926) 26 *COL. L. REV.* 884-891.

<sup>11</sup> See case cited *infra* note 69.

able Instruments Law, notwithstanding the decision of the court in the *Manhattan* case that the Act controlled, but was adopted and printed as part of the Personal Property Law. Formal requisites were made extremely liberal; any receipt entitling a person named therein or the bearer to specified securities of any sort, whether upon a contingency or not, was a security receipt within the statute. The definition of equipment trust certificates, on the other hand, was so carefully circumscribed and limited—for no apparent reason—as to admit of no possibility that newly developed instruments could come within its terms.<sup>12</sup> The full purport of the statute then follows in the simple provision<sup>13</sup> that a person to whom such an instrument has been transferred by any other person “for present or antecedent value<sup>14</sup> and without notice of prior defenses or equities or claims of ownership enforceable against such other person,<sup>15</sup> shall have absolute title thereto free of any defenses enforceable against the claims of ownership<sup>16</sup> of the signer or any prior holder.” Obviously this was but a hasty grab for what was conceived to be the essence of negotiability and is excusable only as emergency legislation. The status of corporate bonds, however, was not affected.

Shortly after this, the Commissioners on Uniform State Laws undertook the project, long under consideration,<sup>17</sup> of preparing a draft of amendments to the Negotiable Instruments Law for

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<sup>12</sup> “The term ‘equipment trust certificate’ means any writing in and by which the signer sets forth that the person named therein or the bearer is entitled to an interest or a share of a specified principal amount or par value in money in a trust under an identified trust indenture pursuant to the terms of which the title to rolling stock or equipment for use by or on the lines or routes of common carriers or to vessels or other marine equipment, is held by the trustees for the benefit of all the holders of the interests or shares.” § 260 (2).

<sup>13</sup> Section 261, (3).

<sup>14</sup> The term “antecedent value” is new and the question whether or not it includes a pledge for an old debt will probably precipitate unnecessary and expensive litigation.

<sup>15</sup> This provision omits the requirement of good faith found in all the uniform acts and usually insisted upon in the decisions.

<sup>16</sup> “Defenses enforceable against the claims of ownership” is almost unintelligible. Moreover, if the provision excludes *all* defenses, such as defenses of forgery, alteration, *ultra vires*, illegality and so on it will go much further than the draftsmen probably intended or than would be justified by the decisions.

<sup>17</sup> Agitation for amendment began shortly after promulgation of the statute. See HANDBOOK, NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS (1900) 9; *ibid.* (1912) 81, 123; *ibid.* (1913) 36-38; *ibid.* (1919) 84, 144; *ibid.* (1923) 63, 243. The task was definitely undertaken in 1926; see *ibid.* (1926) 412. Citations to the large literature on the subject are collected in SMITH AND MOORE, *op. cit. supra* note 3, at 920; see generally Britton, *Amendments to the Negotiable Instruments Law* (1928) 22 ILL. L. REV. 815, and Turner, *Revision of the Negotiable Instruments Law* (1928) 38 YALE L. J. 25.

general adoption. The first amendment proposed by Mr. Williston, the draftsman, was to add the word "money" to the title of the Act<sup>18</sup> so that it should thereafter be restricted to instruments for the payment of money—thus, with one word excluding interim certificates and the many other similar instruments, but apparently including bonds, debentures and equipment trust certificates, since they are payable in money. This was done to controvert the broad interpretation of the Act adopted by the court in the *Manhattan* case. In the following year the opening provision was inverted so as to provide merely that an instrument for the payment of money should be negotiable *if* it conformed to certain requirements.<sup>19</sup> This to meet the view that the statute should not be permitted to stifle future recognition of all instruments not conforming to express provisions of the Act.

These suggested amendments, which have now been before the Commissioners at several readings, have met with general approval. Clearly the exclusion from the Act of instruments not payable in money is desirable. But whether the loophole provided by the proposed amendment to Section 1, while desirable as a general proposition, is a satisfactory way of treating bonds, debentures and such instruments, is extremely debatable. At best it is a purely negative solution and relies upon the courts to legislate as cases are presented—a process which clearly should be possible, but which makes it very difficult to advise in advance on a particular security issue, unless, indeed, it conforms to the Act.

Brief consideration of the cases, both prior and subsequent to the enactment of the Negotiable Instruments Law, throws considerable light on the question. State and corporate bonds, of the type so widely known today, made their appearance more than a century ago in the financing of canals and railroads.<sup>20</sup> By 1840, corporate bonds similar to the modern instrument were being issued in considerable numbers,<sup>21</sup> and by 1850, were daily listed on the Stock Exchanges. Such bonds, payable to bearer and under seal, were uniformly held negotiable.<sup>22</sup> Citations and quota-

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<sup>18</sup> Thus the title, as proposed by Mr. Williston, would read: "A General Act Relating to Negotiable Instruments for the *Payment of Money*," the underlined wording being new. HANDBOOK (1927) 623.

<sup>19</sup> See HANDBOOK (1931) 221. The original provision read: "An instrument to be negotiable must conform to the following requirements." N. I. L. § 1.

<sup>20</sup> Douglas, *op. cit. supra* note 3, at 74.

<sup>21</sup> POOR, HISTORY OF RAILROADS AND CANALS (1860) 1 ff.; STETSON, SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION, AND REGULATION (1917) 1-13.

<sup>22</sup> *Ohio v. Van Horne*, 7 Ohio St. 327 (1837); *DeLafield v. Illinois*, 2 Hill 159 (N. Y. 1841); *Morris Canal and Banking Co. v. Fisher*, 9 N. J. Eq. 667 (1855); *Clark v. Janesville*, 10 Wis. 136 (1859); *Commonwealth ex rel. Hamilton v. Select and Common Councils*, 34 Pa. 496 (1859); *Sturtevants v. Alton*, Fed. Cas. No. 13,580, at 338 (C. C. Ill. 1844);

tions, demonstrating the existence of a custom to deal in bonds as negotiable instruments, could be multiplied.<sup>23</sup> Later, in the re-financing which took place following the panic of 1893, the trust mortgage, trust indenture, equipment trust agreement and similar security devices came into prominence and the accompanying money instruments took substantially their present forms.<sup>24</sup>

It has been asserted that bonds were originally held negotiable entirely without regard to the analogy to promissory notes.<sup>25</sup> Whether this was true or not to begin with, it is certain that, at least insofar as the draftsmen were concerned, the corporate bond and mortgage were regarded as merely an adaptation of the realty note and mortgage precedent.<sup>26</sup> Indeed, except for the engraving, the size of the paper and similar matters, one is hard put to it today to specify any essential difference in form between the two instruments. True, bonds are issued in series and in even denominations, usually by corporations and for long periods, but, of course, notes may be issued under exactly similar circumstances. However that may be, apparently the requirements of form were at first conveniently vague, and instruments called bonds, if payable to bearer, were perforce negotiable. It was not long, however, before the courts were holding certain bonds non-negotiable at common law, and for reasons plainly culled from the law of commercial paper,<sup>27</sup> though very little recognition of

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*Mercer County v. Hackett*, 1 Wall. 83 (1863); *Chapin v. Vermont and Massachusetts R. R.*, 74 Mass. 575 (1857); *Bunting v. Camden and Atlantic R. R.*, 81 Pa. 254 (1876); *Junction R. R. v. Cleney*, 13 Ind. 161 (1859); *Knox County v. Aspinwall*, 21 How. 539 (1858).

<sup>23</sup> See TOWNSEND, *ORIGIN AND GROWTH OF LAW GOVERNING THE TRANSFER OF MONETARY SECURITIES* (1898) 11; JONES, *CORPORATE BONDS AND MORTGAGES* (3d ed. 1907) §§ 184-185; 2 DANIELS, *NEGOTIABLE INSTRUMENTS* (6th ed. 1913) § 1486; *White v. Vermont and Massachusetts R. R.*, 21 How. 575 (1858).

<sup>24</sup> It is interesting to note that at the very time this development was taking place the Negotiable Instruments Law was just being drafted.

<sup>25</sup> DOUGLAS, *loc. cit. supra* note 3; JONES, *op. cit. supra* note 23, § 185. But *cf. Ide v. Passumpsic & Connecticut Rivers R. R.*, 32 Vt. 297 (1859) where it was said that bonds "are called bonds, or railroad bonds, but they are in fact, both the bonds and the coupons, mere bills or notes, and as strictly negotiable as bank bills;" and 4 COOK, *CORPORATIONS* (8th ed. 1923) § 767, where it is surmised that the seal may have been "looked upon as merely the signature of the corporation, thus making the instrument one not under seal and hence a negotiable note."

<sup>26</sup> For a discussion of the evolution of the corporate mortgage and bond from the simple forms employed by the Baltimore & Ohio Railroad Company in 1846 and by the New York and Erie Railroad in 1847, the latter involving an issue of \$3,000,000, to the present involved forms, see STETSON, *op. cit. supra* note 21, at 1.

<sup>27</sup> *Knight v. Wilmington and Manchester R. R.*, 1 Jones 357 (N. C. 1854) (promise in addition to the payment of money); *Ledwich v. McKim*, 53 N. Y. 307 (1873) (incomplete); *Parsons v. Jackson*, 99 U. S. 434 (1878) (uncertainty of amount); *Cronin v. Patrick County*, 89 Fed. 79 (C. C. W. D.

this fact is evinced by modern writers.<sup>28</sup>

Since the adoption of the Negotiable Instruments Law, the separate recognition of bonds as negotiable paper has become exceedingly difficult. Many cases, it is true, have hastily assumed the negotiability of the instrument in suit and proceeded to a consideration of other questions as controlled by the Act.<sup>29</sup> But when the question of form has been squarely faced, proof of custom and of commercial demand for negotiability, though recognized to exist, have been generally excluded.<sup>30</sup> In the large number of cases where bonds, after comparison with the requirements of the statute, have been held negotiable,<sup>31</sup> the courts have

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Va. 1882) (words of negotiability); *Chouteau v. Allen*, 70 Mo. 290 (1879) (uncertainty of time); *Augusta Bank v. Augusta*, 49 Me. 507 (1860) (coupons with no words of negotiability); *McClelland v. Norfolk Southern R. R.*, 110 N. Y. 469, 18 N. E. 237 (1888) (conditional promise); and see *Lockrow v. Cline*, 4 Kan. App. 716, 46 Pac. 720 (1896) (mortgage made a part of real estate note in form of a coupon bond); *Merriweather v. Saline County*, Fed. Cas. No. 9,485 (C. C. W. D. Mo. 1878) (not promise to pay money); *Blackman v. Lehman, Durr & Co.*, 63 Ala. 547 (1879) (payable upon a contingency).

<sup>28</sup> See, for example, *Aigler, Recognition of New Types of Negotiable Instruments* (1924) 24 COL. L. REV. 563, 580.

<sup>29</sup> In *re Footville Condensed Milk Co.*, 229 Fed. 698 (C. C. A. 7th, 1916); *Crittenden v. Widrevitz*, 272 Fed. 871 (C. C. A. 2d, 1921); *Murray v. Wagner*, 277 Fed. 32 (C. C. A. 2d, 1921); *Pridgen v. Baugh & Sons Co.*, 30 F. (2d) 353 (C. C. A. 4th, 1929); *Brown v. Southwestern Farm Mortgage Co.*, 112 Kan. 192, 210 Pac. 658 (1922); *First National Bank v. Brown*, 117 Kan. 339, 230 Pac. 1038 (1924); *Parks v. Hughes*, 157 La. 914, 103 So. 261 (1925); *Adrian v. Whitney Central National Bank*, 180 Mich. 171, 146 N. W. 654 (1914); *Union Trust Co. v. Tonquish Temple Association*, 247 Mich. 36, 225 N. W. 572 (1929); *Linbarger v. West New York*, 83 N. J. L. 446, 85 Atl. 235 (1912); *Kittredge v. Grannis*, 244 N. Y. 168, 155 N. E. 88 (1926); *Gruntal v. United States Fidelity and Guaranty Co.*, 254 N. Y. 468, 173 N. E. 682 (1930); *Interboro Brewing Co. v. Doyle*, 165 App. Div. 646, 151 N. Y. Supp. 325 (3d Dep't 1915); *Harter v. Peoples Bank of Buffalo*, 221 App. Div. 122, 223 N. Y. Supp. 118 (4th Dep't 1927); *Morris v. Muir*, 111 Misc. 739, 181 N. Y. Supp. 913 (Mun. Ct. 1920); *Dengler v. Paul*, 83 Pa. Super. Ct. 37 (1924); *Irwin v. Bedford County*, 151 Tenn. 402, 270 S. W. 81 (1924); *Crum v. Hanna*, 140 Va. 366, 125 S. E. 219 (1924); *Stuart Court Realty Corp. v. Gillespie*, 150 Va. 515, 143 S. E. 741 (1928); *Brokaw v. Kunze*, 127 Wash. 593, 221 Pac. 590 (1923). So also as to coupons detached from bonds. *Town of Newbern v. National Bank*, 234 Fed. 209 (C. C. A. 6th, 1916); *Wilson Adv. Corp. v. Renwick*, 197 Ill. App. 490 (1916); *Nuzman v. Bennett*, 115 Kan. 766, 224 Pac. 900 (1924); *Mississippi Power & Light Co. v. Kusterer*, 156 Miss. 22, 125 So. 429 (1930); *Greene v. Minzesheimer*, 110 N. Y. Supp. 429 (App. Term, 1908).

<sup>30</sup> *King Cattle Co. v. Joseph*, 158 Minn. 481, 198 N. W. 798 (1924); *Grosfield v. First Nat. Bank*, 73 Mont. 219, 236 Pac. 250 (1925); *Manker v. American Savings Bank and Trust Co.*, 131 Wash. 430, 230 Pac. 406 (1924); *Drouineau v. First Nat. Bank*, 244 Ill. App. 251 (1927).

<sup>31</sup> *Hibbs v. Brown*, 190 N. Y. 167, 82 N. E. 1108 (1907) (fund for payment limited); *Higgins v. Hocking Valley Railway*, 188 App. Div. 684,

too often been forced to resort to a strained or unreal construction of the Act or of the terms of the particular instrument, in order to reach the result desired—too often certainly to permit one to take much pride in this corner of the law of commercial paper.<sup>32</sup>

In view of this development, both before and since the Act, it is extremely doubtful whether the proposed amendment to Section 1, asking the courts to take up anew the question of form in the case of bonds, debentures and similar instruments, will prove particularly helpful; the habit of classifying bonds with other commercial paper for the payment of money is of too long standing. After all, who can say when an instrument is new, or when merely an old one with a new provision infringing one of the requirements of form usual to negotiable paper for the payment of money? The line is by no means easy to draw and, if nothing further were to be done, we could look forward with some confidence to a decided lack of uniformity on a point which should be very clear. Moreover, even assuming the proposed amendment when adopted would not become lost in the shuffle, a distinct possibility,<sup>33</sup> it assumes, factually, that instruments of this type are still not sufficiently definitive in form to admit of specific recognition, a point of questionable validity.

At this stage the situation has interesting philosophical aspects: shall we let things continue to evolve slowly, merely freeing the courts as proposed, so that the law may be built up case

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177 N. Y. Supp. 444 (1st Dep't 1919) (reference to indenture, tax-free covenant, acceleration); *Enoch v. Brandon*, 249 N. Y. 263, 164 N. E. 45 (1928) (reference to mortgage, acceleration, redemption, sinking fund); *Paepcke v. Paine*, 253 Mich. 636, 235 N. W. 871 (1931) (reference to indenture, holders' right to sue denied); *Bank of California v. National City Co.*, 138 Wash. 517, 244 Pac. 690, on rehearing, 141 Wash. 243, 251 Pac. 561 (1926) (tax-free covenant, reference to mortgage, acceleration, redemption); *Weber v. Keith Railway Equipment Co.*, 248 Ill. App. 258 (1928) (reference to security); *Commissioners of Cleveland County v. Bank of Gastonia*, 157 N. C. 191, 72 S. E. 996 (1911) (limitation on taxes leviable for payment). These cases, the cases in note 12 and others similar thereto are considered more in detail *infra*.

<sup>32</sup> EATON, EXPLANATORY OUTLINE OF FUNCTIONS AND REQUIREMENTS OF BANKERS, TRUSTEES, REGISTRARS, TRANSFER AGENTS AND LAWYERS IN CONNECTION WITH THE ISSUE OF INVESTMENT SECURITIES (1928) 7: "In this respect, probably far above all others, substantial developments should be expected and are needed to an extent rarely realized in full by any of the groups referred to, even by many experienced corporation lawyers." *Stetson, op. cit. supra* note 21, 66 ff.; 2 MACHEN, CORPORATIONS (1908) § 1740 A; (1928) 42 HARV. L. REV. 700.

<sup>33</sup> In a survey of the thousands of cases dealing with bills and notes decided within the last five years it is estimated that in more than one-third the courts have failed entirely to cite the Act. Beutel, *The Necessity of a New Technique of Interpreting the N. I. L.—The Civil Law Analogy* (1931) 6 TULANE L. REV. 1, 5.



by case, or shall we hasten the process by definitive legislation? In New York, after the decision of the Court of Appeals in *Enoch v. Brandon*,<sup>34</sup> certain interests, at least, had little doubt as to the proper course to pursue. In that case the court had, by a bit of tight-rope walking, successfully sustained the negotiability of the bonds before it; but it had also said distinctly that bonds to be negotiable must conform to the Negotiable Instruments Law, and it was questionable whether other issues then outstanding could meet that test. As a consequence, prompt steps were taken to include corporate bonds within the provisions of the Hofstadter Act, the legislation originally designed to cover security receipts and equipment trust certificates.<sup>35</sup> For good measure it was further provided, *ex post facto*, that the act should be construed to validate the negotiability of instruments issued prior to the effective date of the statute—a somewhat sanguine proposition at best.

That this was even worse stop-gap legislation is only too apparent,<sup>36</sup> although it does testify to the urgency of the case. It may now be said, however, that bonds of the ordinary variety are triply negotiable in New York, first by common law, next by the Negotiable Instruments Law, and lastly by the Hofstadter Act, unless the latter, being a later act specifically dealing with bonds, has limited the application of the Negotiable Instruments Law. The point is as yet undetermined. Since the provisions of the two Acts not only differ in many ways, but the one omits many provisions found in the other, the situation is one which cannot help but bring pain to the orderly soul in search for certainty.

Moreover, even if carefully drafted special legislation should be prepared for uniform adoption, a proposal which has many proponents,<sup>37</sup> is it at all clear that interim certificates, security receipts, equipment trust certificates and corporate bonds should all be treated together in a separate act? If so, might not municipal warrants, dock receipts, tax anticipation notes, sewer assessment bonds, stock purchase warrants, delivery orders and even registered bonds<sup>38</sup> be included equally well? The argument for separate legislation is that all such paper is cut to a different pattern from that used for notes, bills and checks, a proposition

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<sup>34</sup> *Supra* note 31.

<sup>35</sup> N. Y. PERSONAL PROPERTY LAW (1930) art. 8, §§ 260-262.

<sup>36</sup> The Act as applied to bonds is critically discussed in Comment (1930) 40 YALE L. J. 261.

<sup>37</sup> To be known as a Uniform Negotiable Securities Act and as such favored, with varying degrees of conviction, by most of the writers cited *supra* note 3.

<sup>38</sup> Subsequent to the decision in the Manhattan case, Mr. J. V. Kline of the New York Bar prepared a list of some 68 corporate securities of one form or another, which might well be considered in such a project.

one is inclined to agree with, at least as applied to security receipts. Furthermore, it is said, such paper is traded in by brokers in the financial district in New York, though no one has pointed out just what significance that factor has. Finally, to annihilate any possible opposition, it is asserted that "functionally" such paper is quite different from bills, notes and checks. All in all, one is reluctantly brought to the conclusion that the argument is almost wholly emotional, at least as applied to bonds, possibly another manifestation of the hostile attitude toward the Negotiable Instruments Law made fashionable by Dean Ames some thirty-odd years ago and now but slowly giving way.

This insistence upon functional difference, however, deserves further consideration. What is referred to, the transaction giving rise to the paper or the use to be made of it? Obviously the transactions giving rise to notes differ in many respects from those giving rise to corporate bonds, but that is also true of notes and checks, the one being used in credit operations, the other as a payment device. Indeed, there may be wide disparity in the transactions underlying any two notes identical in form. On the other hand, there is broad functional similarity as to all of such paper in that any of it may be sold or used as collateral.

The question of how bonds, debentures, equipment trust certificates and similar paper should be classified for purposes of legislation probably should be determined from the standpoint of convenience in drafting. It is particularly evident from this angle that the matter of first moment is to determine exactly what is sought to be accomplished. The generality that such paper should be made negotiable is not enough, since the word negotiable has no precise content.<sup>39</sup> Ordinarily it is assumed that the incident of chief significance—aside from mere transferability, which is now principally of historical interest—is the right of a purchaser from a thief to retain the paper and enforce payment of it.<sup>40</sup> But it is fully as important to the maker that payment in good faith, if made to the thief himself, for example, constitute a discharge, one of many points not considered in the Hofstadter Act.<sup>41</sup> Again, according to the common law rule alteration avoided the instrument, but it is now settled that the *bona fide* purchaser may recover according to the origi-

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<sup>39</sup> The unkind reception given by the courts to the early statutes declaring bills of lading to be "negotiable" is a case in point. See *Shaw v. Railroad Co.*, 101 U. S. 557, 563 (1879).

<sup>40</sup> "The only advantage over non-negotiability is that the purchaser from a thief is protected. Claims of legal and equitable title and defenses may be cut off by estoppel." Beutel, *op. cit. supra* note 2, at 383.

<sup>41</sup> *Cothran v. Collins*, 29 How. Pr. 113 (N. Y. 1864).

nal tenor,<sup>42</sup> a result which has now become an incident of negotiability as definitely established as the points first named. Many other illustrations, for example, the rules concerning presumptions and burden of proof, warranties upon transfer and similar matters, could be given.

In fact, realistically speaking, negotiability as applied to money instruments may well be assumed today to denote all of those incidents wherein the law as to bills and notes varies from that applicable to ordinary contracts. So defined, negotiability as applied to stock certificates, bills of lading and similar paper, is in many respects quite a different thing—as is recognized by the vague expression “quasi negotiable” sometimes used. Oddly enough, none of the proponents of special legislation appears to have made an item by item canvass to determine what should be included in special legislation concerning bonds, or, for that matter, what, if any, of the provisions of the present Negotiable Instruments Law are not satisfactory.

It seems safe to say, however, that the gulf between money instruments, of whatever type, and security receipts, for example, is much broader from the drafting viewpoint than that between bills, notes and checks, which, however broad, has been rather successfully bridged by the Negotiable Instruments Law. Many provisions inappropriate to a security receipt are needed to write a contract for the payment of money, and legislation may well be visualized as forming part of the contract. In addition to those already mentioned, the rules concerning date of payment, days of grace, the effect of transfer after maturity and many others could be instanced. The problem whether a corporation should be liable for interest upon a matured bond after depositing the proper funds at the place of payment is a further illustration.<sup>43</sup> Again, the well established rule that a purchaser, who has given value in the shape of bank credit, may only recover to the extent that the account has been drawn against, affords a somewhat nicer adjustment in the case of money instruments than has been found possible in regard to others.<sup>44</sup> It was

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<sup>42</sup> N. I. L. § 124. For a good discussion of the early cases applying note law on these points to bonds, see, *City of Elizabeth v. Force*, 29 N. J. Eq. 587 (1878) and note. No question appears to have been raised looking to a distinctive treatment of bonds.

<sup>43</sup> According to § 70, N. I. L., such facts, at least as applied to a note, would constitute a tender of payment relieving the maker thereafter of liability for interest but, according to most authority, the account would be maintained at all times at the risk of the maker (depositor). *Federal Intermediate Credit Bank v. Epstein*, 151 S. C. 67, 148 S. E. 713 (1929). See (1929) 39 YALE L. J. 277 for discussion. Further, such funds probably would not be held to constitute a trust fund for payment to bond and coupon holders in event of failure of the issuing corporation. See in re *Interborough Consol. Corp.*, 288 Fed. 334 (C. C. A. 2d, 1923).

<sup>44</sup> Section 54, N. I. L. The arguments *pro* and *con* as to the policy of this

perhaps for reasons of this character that Mr. Williston designed his first two proposed amendments to the Negotiable Instruments Law to drive a wedge between money paper on the one hand and all other types on the other.<sup>45</sup>

Moreover, it is apparent from the foregoing summary of issues that bonds will be found rather agreeable bedfellows when grouped with notes, bills and checks. Also one should not lose sight of the fact that during the thirty years or more within which the courts have actually regarded bonds and notes as being controlled by identical legislation, there has been very little question concerning any of these points. The difficulty has been almost solely with the requirements of form: how to draw long term money obligations to comply with sections 1 to 10 of the Act. That some difficulty in this connection should exist is not surprising when it is remembered that bonds, debentures and similar instruments were themselves only just taking their modern form at the time the Act was drafted.

The pertinent inquiry today, therefore, would first seem to be to determine what changes in these few sections would have to be made to bring bonds, debentures, equipment trust certificates and similar money obligations clearly within the Statute. In so doing it should not be assumed that new paper may not be developed in future, but merely that the form of these instruments, after thirty or more years of use, has now so far crystalized that there should no longer be any doubt as to their status. It is, accordingly, proposed, in what follows, to make a detailed study of the cases in which the question of negotiable form has been litigated and to propose such amendment to the Act as seems necessary.

### *References to Security Agreement*

The most prolific source of litigation concerning the negotiability of bonds has undoubtedly been the clauses referring the holder to the mortgage indenture or other security agreement. Designed in part to identify the particular bonds entitled to share in the security, they have also, of necessity, been drawn to commit the holder to the terms of the indenture, not only to define his rights

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section are stated in BRANNAN, 410-411. Such a provision is obviously unworkable in the case of commodity or security paper since the subject matter may not have a par value or be divisible. There is thus no comparable provision in the Uniform Sales Act. As to when bank credit should be regarded as value see § 29, Uniform Bank Collection Act (third tentative draft), HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS (1931) 271.

<sup>45</sup> Mr. Williston makes express mention of "corporate bonds" in connection with the proposed amendment to § 5 of the N. I. L. HANDBOOK (1927) 630.

in the security, but to clarify or limit his rights upon the bonds themselves.<sup>46</sup> These latter provisions, found usually in the security agreement, take various forms; typical is the provision lodging with the trustee sole power to sue upon the bonds, ordinarily with no obligation to bring suit except upon the demand of holders of a specified number of bonds. On the policy side such provisions are probably desirable, since, by avoiding a multiplicity of suits by holders racing for preference upon default and "strike suits" pending reorganization, fairer treatment can be accorded the general body of creditors.<sup>47</sup> The technical difficulty is that the Negotiable Instruments Law requires an "unconditional promise" to pay a sum certain in money.<sup>48</sup>

The draftsman for a bond issue is thus faced with a dilemma. On the one hand, the reference may be so ambiguous as not effectively to prevent an individual holder from resorting to independent action antagonistic to the welfare of the group of security holders similarly situated.<sup>49</sup> On the other, the provision may be so explicitly worded as to obviously condition the maker's promise, thus rendering the instrument not negotiable as a mat-

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<sup>46</sup> STETSON, *op. cit. supra* note 21, at 16.

<sup>47</sup> *Ibid.* 41, 47; EATON, *op. cit. supra* note 32, at 6; See Home Mortgage Co. v. Ramsey, 49 F. (2d) 738, 743 (C. C. A. 4th, 1931), where it was said: "The provisions are merely reasonable conditions precedent to the right of the plaintiff to bring the suit herself. They are intended for the security of all the bondholders and no doubt rendered the bonds more salable. They were designed for just such a case as is presented here, where one bondholder, or a small minority, is determined upon action which a large majority believe hostile to their interests."

<sup>48</sup> Sections 1, 3, 184.

<sup>49</sup> See Guilford v. Minneapolis, S. Ste. M. and A. Ry., 48 Minn. 560, 51 N. W. 658 (1891); Berman v. Consolidated Nevada-Utah Corp., 132 Misc. 462, 230 N. Y. Supp. 421 (Sup. Ct. 1928) (the reference was "for a statement of the nature and extent of the security, the rights of the holders of the bonds, and the terms and conditions upon which the bonds are issued and secured"); Rothschild v. Rio-Grande Western Ry., 84 Hun. 103, 32 N. Y. Supp. 37 (1st Dep't 1905) (semble); General Investment Co. v. Interborough Rapid Transit Co., 200 App. Div. 794, 193 N. Y. Supp. 903 (1st Dep't 1922).

On the other hand in Lidgerwood v. Hale & Kilborn Corp., 47 F. (2d) 318 (S. D. N. Y. 1930), the indenture restrictions against individual suit were held binding upon the holder, but here the clause read "This note . . . is entitled to all the benefits and subject to all the provisions of an agreement . . . to which agreement reference is hereby made for a description of the rights of the holders . . . and the terms and conditions upon which said notes are issued . . . to all the provisions whereof the registered owner or holder, by acceptance hereof, assents." *Accord*, Allan v. Moline Plow Co., 14 F. (2d) 912 (C. C. A. 8th, 1926). It may be said without hesitation, however, that the instruments before the court in each case were non-negotiable since the promise is almost certainly conditional. In the former case, the court distinguished Enoch v. Brandon, *supra* note 3, by saying "This is not a case where the reference to an indenture was such as to lead the holder to believe that the indenture simply added more

ter of form. This latter possibility is particularly dangerous where a broad phrase such as "subject to"<sup>50</sup> has been used in the bond, not only because it verbally imports a condition, but because in such case a court may construe bond and mortgage together to determine negotiable form, a procedure which is usually fatal to negotiability.<sup>51</sup> The usual view, apart from such clauses, is that negotiable form will be judged solely from an inspection of the instrument itself,<sup>52</sup> the actual terms of the indenture being deemed irrelevant to that inquiry.

A variety of clauses have been drafted to meet the situation and a variety of results have come from the courts. In the leading case of *King Cattle Company v. Joseph*,<sup>53</sup> the reference clause read:

"issued under and in pursuance of and are all equally secured by and are subject to an indenture . . . and hereby reference is made to said indenture and the same is made part hereof with the same effect as if herein set forth."

Excluding evidence of a custom of negotiability, the court held that the "subject to" clause of itself rendered the promise conditional. In an earlier case, *Saint Louis-Carterville Coal Company v. Southern Coal and Mining Company*,<sup>54</sup> bonds were likewise held not negotiable because of the conditional character of the promise, although the reference clause was more cautiously worded than in the *King Cattle Company* case. The provision read as follows:

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rights to what he had on the face of the note . . .," and in the latter, the recital was said to make the trust agreement "a part and parcel of the terms of the notes as effectively as if they were written into the notes themselves." See note (1931) 41 YALE L. J. 312.

<sup>50</sup> HERR, TRUST MORTGAGE FORMS (1929) 622-643, recommends as safe: "This bond is one of a series . . . issued in accordance with and equally secured by a mortgage or deed of trust . . .;" and warns against the use of "under" or "subject to" in place of "in accordance with."

<sup>51</sup> For bond cases see notes 53 and 54, *infra*. As to notes, see *Hubbard v. Wallace Co.*, 201 Ia. 1143, 208 N. W. 730 (1926); *Lockrow v. Cline*, 4 Kan. App. 716, 46 Pac. 720 (1896); *Old Colony Trust Co. v. Stumpel*, 247 N. Y. 538, 161 N. E. 173 (1928), *mem. aff'g* 219 App. Div. 771, 220 N. Y. Supp. 893 (1st Dep't 1926), *mem. aff'g* 126 Misc. 375, 213 N. Y. Supp. 536 (Sup. Ct. 1926). In the case last cited the court appears to have considered the words "subject to" sufficient to destroy negotiability regardless of what was contained in the collateral instrument. For discussion see (1928) 37 YALE L. J. 665.

<sup>52</sup> See, for example, in the case of notes, *Thorp v. Mindeman*, 123 Wis. 149, 101 N. W. 417 (1904).

<sup>53</sup> 158 Minn. 481, 198 N. W. 798 (1924).

<sup>54</sup> 194 Mo. App. 598, 186 S. W. 1152 (1916). To the same effect see *Mississippi P. and L. Co. v. Kusterer & Co.*, 156 Miss. 22, 125 So. 429 (1930).

"for the nature and extent of the security, rights of the holders of bonds, and the terms and conditions upon which the bonds are issued and secured, reference is made to the said mortgage. . . ."

On the other hand the court in *Enoch v. Brandon*<sup>55</sup> found bonds negotiable which contained the following reference clause:

"all equally secured by and entitled to the benefits of and subject to the provisions [of a mortgage] to which reference is hereby made for a description of the property mortgaged and pledged, the nature and extent of the security, the rights of the holders of the bonds with respect thereto . . . and the terms and conditions upon which said bonds are issued and secured."

The court interpreted the phrase dealing with the rights of the holders and also the reference to the conditions upon which the bonds were issued as affecting the security only.<sup>56</sup> This interpretation seems to open the door wide enough to permit a draftsman to insert in the indenture any conditions he wishes upon the principal obligation contained in the bond without thereby affecting the matter of negotiable form, although it is quite possible that the court, when faced with the issue, would close it again to deny that such conditions were binding on the *bona fide* purchaser.<sup>57</sup> Certainly it cannot be said that the present situation is a happy one; it should be possible at least to set at rest, both as to bonds and other forms of money paper, the question whether a reference to a separate writing for a statement of the holders' rights concerning the security destroys negotiability.<sup>58</sup>

To sanction such clauses, however, does not get at the heart of the matter, the extent to which the mortgage provisions are to be allowed to condition the obligation of the bond. When do

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<sup>55</sup> *Supra* note 31.

<sup>56</sup> When the reference clause admits of this interpretation there has been little difficulty. See *Bank of California v. National City Co.*, *supra* note 31. *Accord*: *Guilford v. Minneapolis, etc., Ry.*, *supra* note 49; *Brown v. Michigan Ry.*, 124 Misc. 630, 207 N. Y. Supp. 630 (City Ct. 1924). And so with notes. *Chelsea Exchange Bank v. Warner*, 202 App. Div. 499, 195 N. Y. Supp. 419 (1st Dep't 1922). The clause, "the conditions upon which said bonds are issued," would seem to come perilously close to conditioning the principal promise, but there was prior authority in accord with the interpretation adopted in *Enoch v. Brandon*. See *Higgins v. Hocking Valley Ry.*, *supra* note 31, and *Weber v. Keith Railway Equipment Co.*, *supra* note 31.

<sup>57</sup> Cases cited *supra* note 49, particularly *Rothschild v. Rio-Grande Western Ry.*

<sup>58</sup> This suggestion was made a year ago to the present draftsman in charge of N. I. L. amendments, Mr. Llewellyn, and took shape as subsection C to § 3, reading as follows:

"Section 3.—When promise is unconditional.—An unqualified order or promise to pay is unconditional within the meaning of this act, though coupled with: C. A statement of, or a reference to a separate writing for a statement of, the holder's rights concerning any security for the instrument."

limitations on the holder's rights leave off and conditions upon the maker's obligations begin? In a recent case, *Paepcke v. Paine*,<sup>59</sup> the Michigan court, following the lead of the court in *Enoch v. Brandon*, held negotiable an instrument containing a provision that:

"to the extent provided in the said Trust Agreement, all rights of action upon this Debenture are vested in the Trustee."

The court stated the familiar rule that negotiable form is to be ascertained from inspection of the instrument alone and so refrained from examining the trust agreement. It then surmised that the provision was a beneficial one, since it probably operated merely to restrain individual suit and did not give any intimation that the promise to pay or the time of payment was in any way affected. Had it been shown that under the indenture the time of payment, for example, could be deferred, not an unknown provision,<sup>60</sup> or entirely waived under certain conditions,<sup>61</sup> it is not clear what the court would have done. In a remote sense even such provisions might be said to enhance security rights—that is, of the group, though possibly not of the individual holder. At all events, it is quite clear that if such references are deemed binding on the holder the instrument in any realistic sense becomes a conditional one—and, within the spirit of the Negotiable Instruments Law, not negotiable. However much one may admire the ingenuity of the courts in handling the problem thus far, although their technique is suspiciously like that of an ostrich, it is quite apparent that the policy question whether conditions in long term investment paper are inimical to negotiability will have to be faced squarely sooner or later.<sup>62</sup>

### *Payment out of Particular Assets*

The long established rule, applicable generally to bills and notes,

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<sup>59</sup> *Supra* note 31 (issue, replevin by real owner against *bona fide* purchaser).

<sup>60</sup> See *McClelland v. Norfolk Southern R. R.*, 110 N. Y. 469, 18 N. E. 237 (1888), where this fact was said to be sufficient to render bond and coupon non-negotiable.

<sup>61</sup> In *Siebenhauer v. Bank of Cal. Nat. Ass'n*, 211 Cal. 239, 294 Pac. 1062 (1930), Water Company bonds were drawn so that in event the city purchased company land the latter's obligation on the bonds would terminate. The bonds were held negotiable for purposes of protecting a *bona fide* purchaser, but this was pursuant to special legislation making bonds negotiable "notwithstanding any condition therein or in the mortgage, deed of trust or other instrument securing the same."

<sup>62</sup> The conditions question is also important in the case of equipment trust certificate and certain municipal issues, as well as in the case of coupons, and further discussion will accordingly be deferred until those cases have been presented.



that a negotiable instrument may not be made payable out of a particular fund,<sup>63</sup> has operated to render non-negotiable two important types of investment securities and to raise considerable doubt as to the status of a third. It has been the underlying assumption, that all negotiable paper must be prepared to circulate as money that has proved the stumbling block. In long term paper, designed for investment purposes, there would seem to be no policy reason for a strict application of such a rule; a maker of investment paper should be permitted to limit payment to such funds as he may deem proper, provided only the limitation is plainly stated on the face of the instrument.

The futility of attempting to regulate the form of investment paper by the simple requirements stated in the N. I. L. is well borne out by the case of municipal bonds, which, though long regarded as negotiable by the investing public,<sup>64</sup> continue to be held non-negotiable by the courts. In a typical case<sup>65</sup> a city issued its bonds promising to pay to bearer

"out of the fund . . . known as Local Improvement Fund District No. 3032 and not otherwise [giving the holder no claim] except from the special assessment made for the improvement for which such bond was issued."

Despite evidence of a custom of negotiability, the bonds were held non-negotiable.<sup>66</sup> Again, bonds containing the following clause,

"pay to bearer . . . as authorized by Resolution No. 1123 . . . creating Special Improvement District No. 196. . . . This bond is payable from the collection of a special tax or assessment . . . within the Improvement District."

were held to be non-negotiable, even though the clause did not specifically say that the bonds were payable "only" out of the

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<sup>63</sup> N. I. L. § 3. "But an order or promise to pay out of a particular fund is not unconditional."

<sup>64</sup> 2 DILLON, MUNICIPAL CORPORATIONS (5th ed. 1911) § 879. And see the following cases where municipal issues were held negotiable, no point being made that payment was limited to any particular tax or fund, if such was the fact: *Knox County v. Aspinwall*, 21 How. 539 (U. S. 1858) (by estoppel); *Mercer County v. Hackett*, 1 Wall. 83 (U. S. 1863) (fully negotiable); *Cromwell v. Sac County*, 96 U. S. 51 (1877).

<sup>65</sup> *Manker v. American Savings Bank and Trust Co.* *supra* note 30 (issue: rights of *bona fide* purchaser in stolen bonds).

<sup>66</sup> *Accord*: *Drouineau v. First Nat. Bank*, *supra* note 30. Such special improvement bonds had very generally been held non-negotiable even before the N. I. L., at least as to defenses raised by the maker. *Northern Trust Co. v. Wilmette*, 220 Ill. 417, 77 N. E. 169 (1906); *Washington County v. Williams*, 111 Fed. 801 (C. C. A. 8th, 1901); *Kirsch v. Braun*, 153 Ind. 247, 53 N. E. 1082 (1899); *Morrison v. Austin State Bank*, 213 Ill. 472, 72 N. E. 1109 (1904); *Note* (1924) 42 A. L. R. 1027.

designated fund.<sup>67</sup> The upshot of the matter is that to deny negotiability to paper of this type not only serves no apparent purpose but violates the general understanding of all parties involved.

Equipment trust certificates, which likewise may meet all the other requirements of negotiable form specified in the Negotiable Instruments Law, are usually held to fall before the particular fund provision of Section 3. By this financing device, the trustee for an issue generally acknowledges the holder's interest and promises that

"the principal amount . . . is payable to bearer [on a day certain] at the office of the trustee . . . but only from and out of rentals received from a certain lease of railroad equipment. . . ." <sup>68</sup>

The promise of the actual borrower (the railroad), though sufficiently unconditional, is phrased merely as a guarantee of full payment of certificate and rentals. Obviously this does not meet the technical requirements of form, and such instruments are accordingly held non-negotiable.<sup>69</sup> While this result is unimpeachable under the Act, it is again contrary to good sense.<sup>70</sup>

The third situation concerns bonds issued by business trusts,

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<sup>67</sup> *Jones v. American Savings Bank and Trust Co.*, 139 Wash. 598, 247 Pac. 1017 (1926). One judge concurred in the opinion for the reason stated. Another concurred separately, regretting that he felt bound by the Manker case, *supra* note 30, in which he had dissented. Another failed to find a determinable future time. Another dissented, but a question as to the law controlling forced him to concur in the result. Three judges dissented on the theory that the provision merely indicated a fund for reimbursement, not a particular fund for payment.

It had formerly been held in Washington that the *bona fide* purchaser could be protected upon principles of estoppel, *Cuddy v. Sturtevant*, 111 Wash. 304, 190 Pac. 909 (1920), but this may no longer be possible since the Manker case. See *State ex rel. Larson v. Vancouver*, 160 Wash. 655, 295 Pac. 947 (1930). The result may be to force municipalities to accept this curb on their power to contract. See *Keck v. Yakima Savings & Loan Ass'n.*, 160 Wash. 430, 295 Pac. 483 (1931), where the provision read, "This bond is one of a series aggregating \$275,000.00 par value in amount, payable out of the Yakima County Road Refunding Bond Fund . . . and is a general obligation of said county." When it has been possible to interpret the provision as a general undertaking on the part of the issuer, the instrument has been held negotiable, though often the construction has lacked reality. *Cleveland County v. Bank of Gastonia*, *supra* note 31; *Rutledge v. Sewer District* 139 S. C. 188, 137 S. E. 597 (1927).

<sup>68</sup> For another more carefully drawn form, see *HORR, op. cit. supra* note 50, at 593-610, but it would be open to the same objection, that payment is made subject to the terms of the lease.

<sup>69</sup> *Fidelity and Deposit Co. of Md. v. Andrews*, 244 Mich. 159, 221 N. W. 114 (1928).

<sup>70</sup> Some four hundred and sixty listed equipment trusts had certificates on the security markets as of January 16, 1931. *FREEMAN AND CO., EQUIPMENT TRUST SECURITIES* (13th ed. 1931).

estates, joint stock associations and similar unincorporated organizations where it is customary for the signers to limit personal responsibility. The difficulty is due not so much to the Act as to the uncertainty concerning the status of the issuing organization. If it is not to be regarded as a separate entity, then it can be argued that the signers or their principals are personally liable and the exemption would therefore operate to make the instrument payable out of a particular fund—that is, the assets of the organization in the popular sense. There have been very few cases raising the point. In the leading case of *Hibbs v. Brown*,<sup>71</sup> the court unanimously, but for a variety of reasons, held joint stock association bonds to be negotiable, notwithstanding a clause limiting all recourse to the assets of the association and exempting the members from personal liability. The most widespread opinion in the court appeared to be that the association was an entity and, since its whole assets were obligated, the personal exemption did not infringe the Act.<sup>72</sup> Recently, in *Charles Nelson Company v. Morton*,<sup>73</sup> the California court reached a similar result in a case involving notes issued by a business trust, notwithstanding that the trustees, who were otherwise liable as partners and were the only persons incurring responsibility under the promise,<sup>74</sup> were exempted from personal responsibility.<sup>75</sup> The result, which no doubt would apply equally

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<sup>71</sup> *Supra* note 31. The case has been criticized as bad law insofar as it concerns business organization theory, but unquestionably reached a desirable result. See, (1906) 19 HARV. L. REV. 616; WARREN, CORPORATE ADVANTAGES WITHOUT INCORPORATION (1929) 470-500; Dodd, *Dogma and Practice in the Law of Associations* (1929) 42 HARV. L. REV. 977, 1007.

<sup>72</sup> On this theory, the usual form exempting officers and directors from responsibility might even give trouble, if the section were to be strictly construed; except for such exemption, an important asset of the signer corporation might consist in an action against officers and directors. See, STETSON, *op. cit. supra* note 21, at 17, for an exposition of the practical necessity of such a waiver.

<sup>73</sup> 106 Cal. App. 144, 288 Pac. 845 (1930).

<sup>74</sup> *Goldwater v. Oltman*, 210 Cal. 408, 292 Pac. 624 (1930) (trustees are personally liable on trust contracts, though members of the trust, having no control, are not). This case, the first in California on the point, repudiated dicta to the contrary, distinguishing *Old River Farms Co. v. Haegelein*, 98 Cal. App. 331, 276 Pac. 1047 (1929), and quoted with approval *Taylor v. Davis*, 110 U. S. 330, 4 Sup. Ct. 147 (1884): "When the trustee contracts as such, unless he is bound no one is bound as he has no principal. The trust estate cannot promise, the contract is therefore the personal undertaking of the trustee."

<sup>75</sup> The court said: "I do not think, however, that a note, negotiable in its general form, is rendered non-negotiable because executed by the trustee in a way to relieve him from personal liability . . . . It carries the general credit of the trustees as such . . . . The promise made on behalf of the estate, or principal, is as unconditional in its relation to the estate represented as that of an individual in relation to himself." *Supra* note 73, at 157, 288 Pac. at 850. This is simply to give the estate the status of an

to bonds, is better evidence of the need for modification of the particular fund provision of the Act than of the clarity of the court's reasoning.

### *Tax Free Clauses*

Many issues of bonds contain so-called "tax free" clauses, the purpose of which is to attract the investor by assuring him full realization of the sum promised free of any loss through taxation. It may be urged that provisions of this character should bring the negotiability of bonds so issued into question on two grounds, first as rendering the amount payable uncertain, and second as amounting to a promise to do an act in addition to the payment of money.<sup>76</sup> The few cases on the point,<sup>77</sup> however, have held, without much discussion, that such clauses do not affect negotiability.

In *Chavelle v. Washington Trust Company*,<sup>78</sup> the clause read as follows:

"All payments upon this bond, both of the principal and interest, shall be made without deduction for any tax or taxes that said [maker] may be required to pay or to retain therefrom by any present or future laws of the United States of America or of the State of Washington, said [maker] hereby covenanting to pay any and all such tax or taxes."

To the argument that the clause made the sum uncertain, the court replied that it tended rather to make payment of the amount doubly certain.

With respect to the argument that an undertaking to pay taxes is a promise to do something in addition to the payment of money, interdicted by the Act, it might be replied narrowly that payment of taxes is itself a payment of money, thus not infringing the statute. It is gladly confessed that no cases have yet been found resorting to such an argument. It is not uncommon, however, to make use of clauses somewhat broader than those involved in these cases, as where the maker undertakes to pay or reimburse the holder for any taxes levied against him.<sup>79</sup> While

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entity, which is good enough judgment, but difficult to square with the ruling in the *Oltman* case, *supra* note 73. The same difficulty is presented in the case of bonds issued in the name of an estate since it is not regarded as a legal entity.

<sup>76</sup> Both matters infringe the requirements of the N. I. L., §§ 2, 5.

<sup>77</sup> *Bank of California v. National City Co.*, *supra* note 31. With no discussion of the clause, bonds, which the opinions indicated contained similar provisions, were held negotiable in *Weber v. Keith Railway Equipment Co.* and *Higgins v. Hocking Valley Railway*, both *supra* note 31.

<sup>78</sup> 226 Fed. 400 (C. C. A. 9th, 1915).

<sup>79</sup> *E. g.*: "As provided in the mortgage, the company will reimburse to the bearer . . . any personal property tax . . . which may be legally assessed upon this bond or upon such bearer . . . by reason of his ownership hereof

no cases involving bonds have been found, the current of authority as to notes containing such clauses is uniformly to the effect that they destroy negotiability.<sup>80</sup> Whether cases will appear so holding as to bonds is, of course, not certain, but since such provisions infringe no policy of the common law, except possibly the notion that a negotiable instrument should be "a courier without luggage," a slogan long since without vitality as regards investment paper, it would seem that the Act might well be amended to make the issue less a matter of conjecture.<sup>81</sup>

*Redemption, Sinking Fund, Conversion and Acceleration Provisions*

Four provisions common in bonds are those having to do with redemption before maturity, the maintenance of a sinking fund, the conversion privilege and acceleration upon events of default of various descriptions. All such provisions have been designed to increase the attractiveness of the issue containing them to the long term investor. And, although at first sight they seem quite foreign to the simplicity of the ordinary negotiable note, it is surprising how little difficulty they have occasioned.

The privilege frequently reserved to the maker of calling in and redeeming bonds prior to their maturity date was generally held at common law not to affect negotiability;<sup>82</sup> since the adoption of the Act such provisions have been uniformly held only to make the instrument one payable "on or before a fixed or determinable future time specified therein," as sanctioned by Section 4 (2).<sup>83</sup> The discussion has not been as searching, however,

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and paid by him, if application therefor be made." *HORR, op. cit. supra* note 50, at 38. See also *ibid.* 41.

<sup>80</sup> *Bright v. Offield*, 81 Wash. 442, 143 Pac. 159 (1914); *Coolidge v. Saltmarsh*, 96 Wash. 541, 165 Pac. 508 (1917); *Smith v. Myers*, 207 Ill. 126, 69 N. E. 858 (1904); *Carmody v. Crane*, 110 Mich. 508, 68 N. W. 268 (1896); *Mechanics Bank v. Johnson*, 104 Conn. 696, 134 Atl. 231 (1926). See discussion in Comment (1926) 36 *YALE L. J.* 267.

<sup>81</sup> Following upon the *Mechanics Bank* decision, *supra* note 80, the legislature in Connecticut amended § 2 of the N. I. L. to provide that such clauses in negotiable paper do not contravene the sum certain requirement. This amendment, redrafted, has been tentatively approved by the Commissioners on Uniform State Laws, *HANDBOOK* (1931) 222. Also it is proposed to amend § 5 to sanction additional promises so long as they are designed to provide security for the principal obligation. *Ibid.* 224. These two amendments, valuable in the case of notes, would seem to remove any question in the case of bonds.

<sup>82</sup> *Dickerman v. Northern Trust Co.*, 176 U. S. 181, 20 Sup. Ct. 311 (1900); *American Nat'l Bank v. American Wood Paper Co.*, 19 R. I. 149, 32 Atl. 305 (1895); *Union Cattle Co. v. International Trust Co.*, 149 Mass. 492, 21 N. E. 962 (1889). *Contra: Chouteau v. Allen*, 70 Mo. 290 (1879).

<sup>83</sup> See *Bank of California v. National City Co.*, *Weber v. Keith Railway*

as one might wish, since little attention has been given to the fact that such issues usually provide for a specific premium to be paid on bonds redeemed before maturity. It might be argued that this renders the amount uncertain, but, quite properly, this has been looked upon as an incidental matter comparable to the uncertainty due to the necessity of adjusting the amount of interest to be paid in such a case; in other words, it is regarded as immaterial on the theory that the principal requirement of certainty has been complied with by the ultimate promise to pay a sum certain at a specified future time. On the other hand, a few issues put the clause in the form of a promise, rather than an option, to redeem a specified portion of the bonds annually.<sup>84</sup> While this might be construed to constitute a promise to do an act in addition to the payment of money, thus infringing Section 5 of the Act, it is extremely unlikely that any court will so hold. There would seem, therefore, to be little reason for a specific amendment to accommodate redemption provisions.

The same question may be raised in the case of bonds requiring the maker to establish and maintain a sinking fund either for their redemption or their ultimate payment. Such provisions obviously not only tend to enhance the value of the promise to pay but are directly and intimately related to the principal obligation. Still the technically minded might argue that they constitute a promise to do an act in addition to the payment of money. The argument is purely academic, for several bonds containing sinking fund provisions have been held negotiable.<sup>85</sup> Moreover, if Section 5 (5) is to be amended as proposed there should be no difficulty whatever, since the proposed amendment would broadly sanction any clause designed to afford additional security to the principal obligation.

The negotiability of bonds containing conversion provisions, authorizing the holder to require the maker to deliver shares of stock in lieu of payment in money, has apparently never been in serious doubt. At common law such bonds were universally held

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Equipment Co., *Enoch v. Brandon*, all *supra* note 31. See generally, Jones, *Redeemable Corporate Securities* (1931) 5 So. CAL. L. REV. 83, 96.

<sup>84</sup> So in *Union Cattle Co. v. International Trust Co.*, *supra* note 82: ". . . a sinking fund of not less than \$50,000 nor more than \$100,000 in each year shall be applied to the purchase or drawing at par of said bonds, and . . . the whole issue may be drawn at par . . ." Whether such provision will be covered by the proposed amendment to § 5, discussed *supra* note 81, is perhaps questionable since the provision is not merely a security provision, but a payment provision. Indeed, a compulsory redemption provision is apparently demanded more frequently in an unsecured issue—popularly so-called—than in a secured issue. DEWING, *FINANCIAL POLICY OF CORPORATIONS* (1926) 100.

<sup>85</sup> But without discussion of the sinking fund provision. See for example *Enoch v. Brandon*, *supra* note 31; and *Union Cattle Co. v. International Trust Co.*, *supra* note 82.

negotiable.<sup>86</sup> The argument was that, as to an instrument meeting all the other requisites of form, the privilege given the holder at his election to surrender it in exchange for stock "did not alter its character or make the promise in the alternative."<sup>87</sup> As was said in the *Hotchkiss* case:<sup>88</sup> "The special agreement as to the scrip preferred stock in no degree changes the duty of the company with respect either to the principal or interest stipulated. It confers a privilege upon the holder of the bond, upon its surrender and the surrender of the certificate attached, of obtaining full preferred stock." The common law holdings were codified by Section 5 (4) of the Act, and, though strangely few courts have seen fit to cite the section,<sup>89</sup> there would seem to be no need for amendment.

There has been some doubt expressed as to the negotiability of the conversion privilege itself, but apparently there has been no direct holding on the point. It was pointed out in the *Hotchkiss* case that the negotiability of the bond did not necessarily extend to the attached but separable scrip for preferred stock. At least so long as it remains attached to the bonds, however, such scrip and or the privilege it represents is treated as, and should be held, negotiable.<sup>90</sup> Dicta supporting the proposition may be found in three cases,<sup>91</sup> where it was said that the holder could enforce his option in his own name, apparently free of equities. The two other cases sometimes cited as containing dicta to the contrary<sup>92</sup> are perhaps explainable on the ground that the holder had failed to comply with conditions precedent to the exercise of the option stated on the face of the instrument. Any other conclusion would result in the absurdity of making the conversion privilege, in the case of a stolen bond, of no use either to the *bona fide* purchaser, who could retain the bond, or to the real owner, in whose hands the privilege would apparently be left. Until a more substantial issue can be raised, there is quite

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<sup>86</sup> *Hodges v. Shuler*, 22 N. Y. 114 (1860) (notes convertible on surrender before maturity into stock); *Dinsmore v. Duncan*, 57 N. Y. 573 (1874) (government notes convertible at maturity into bonds); *Hotchkiss v. National Banks*, 21 Wall. 354 (U. S. 1874) (bonds with attached scrip convertible into stock on presentation of scrip with the bonds); *Lisman v. Milwaukee, L. S. and W. Ry.*, 161 Fed. 472 (C. C. E. D. Wis. 1908).

<sup>87</sup> *Hodges v. Shuler*, *supra* note 86.

<sup>88</sup> *Supra* note 86, at 355.

<sup>89</sup> The one case found citing the Act accepted the provision without question. *Pratt v. Higginson*, 230 Mass. 256, 119 N. E. 661 (1918).

<sup>90</sup> See, BERLE, *STUDIES IN THE LAW OF CORPORATION FINANCE* (1928) 131, 134.

<sup>91</sup> *Denney v. Cleveland and P. R. R.*, 28 Ohio St. 108 (1875); *Hodges v. Shuler*, *supra* note 86; *Loomis v. Chicago, M. & St. P. Ry.*, 102 Fed. 233 (C. C. A. 2d, 1900).

<sup>92</sup> *Lisman v. Milwaukee, L. S. and W. Ry.*, *supra* note 86; *Gay v. Burgess Mills*, 30 R. I. 231, 74 Atl. 714 (1909).

evidently no need for special legislation to deal with the conversion privilege.

In view of the confusion in the authorities as to the effect of acceleration provisions in notes,<sup>93</sup> some apprehension might be felt as to the negotiability of bonds containing such provisions.<sup>94</sup> Apparently, however, no comparable difficulty has developed. Just why this should be true is not clear, unless indeed it is for the human reason that the "grasping creditor" in the note case becomes the "poor investor" seeking his rights against the "large corporation" in the bond case. At all events, it is clear that bonds capable of acceleration by the trustee upon specified events of default were negotiable at common law.<sup>95</sup> The same has been true without exception under the Negotiable Instruments Law.<sup>96</sup> Moreover, there has been no fastidiousness concerning the events of default; they have ranged from non-payment of installments, alone specifically sanctioned under the Act,<sup>97</sup> to non-payment of taxes or depreciation of security. Here again it would seem that no legislation is essential; the negotiability of bonds containing acceleration provisions is already better established than is the negotiability of notes and other money instruments containing like provisions.<sup>98</sup>

### *Medium of Payment*

No problem peculiar to bonds is presented by the requirement that an instrument to be negotiable must be payable in money,<sup>99</sup> though it may designate "a particular kind of current money in which payment is to be made."<sup>100</sup> The ordinary domestic bond,

<sup>93</sup> See BRANNAN, *op. cit. supra* note 2, 13-15, 19-20, 44, 46 and especially 54-58; Chafee, *Acceleration Provisions in Time Paper* (1919) 32 HARV. L. REV. 747.

<sup>94</sup> Such provisions are very frequent in bond issues. One of the most customary forms follows: "In case an event of default, as defined in the said trust mortgage, shall occur, the principal of this bond may become or be declared due and payable in the manner and with the effect provided in the said trust mortgage." HERR, *op. cit. supra* note 50, at 35.

<sup>95</sup> *Chicago & S. S. R. T. Ry. v. Northern Trust Co.*, 90 Ill. App. 460 (1900); *Dickerman v. Northern Trust Co.*, *supra* note 82; *Mason v. Frick*, 105 Pa. 162 (1884); *American National Bank v. American Wood Paper Co.*, *supra* note 82.

<sup>96</sup> Cases cited *supra* note 83.

<sup>97</sup> N. I. L. § 2(3).

<sup>98</sup> Moreover, the amendments to §§ 4 and 52 now proposed to cover the conflict in the case of paper other than bonds containing acceleration provisions, should serve effectually to dispel any doubts that might arise on the point in future as to bonds. HANDBOOK (1931) 223, 228. For a discussion of the need for such legislation see, Turner, *A Factual Analysis of Certain Proposed Amendments to the Negotiable Instruments Law* (1929) 38 YALE L. J. 1047, 1058.

<sup>99</sup> N. I. L. §§ 1(2), 184.

<sup>100</sup> N. I. L. § 6(5).



corporate or municipal or any other, occasions no difficulty, as it is designed to appeal to the eye of the investor by being made payable "in GOLD COIN of the United States of America of or equal to the present standard of fineness and weight."<sup>101</sup> Even if the United States should go off the gold standard, the contingency contemplated by the gold coin provision,<sup>102</sup> there would seem no doubt but that bonds so issued would still be payable in money within the requirements of the Act, and negotiable.

A theoretically serious and seemingly unnecessary problem, still unsettled, exists as to the negotiability of bonds, as well as of other instruments, payable here in foreign money. There appears to be little question concerning the negotiability under our law of dollar obligations, as well as foreign money obligations, payable abroad in the medium of the currency in which they are drawn.<sup>103</sup> But foreign money obligations payable in this country in the medium of the foreign currency have been regarded as presenting a different question. In an early case,<sup>104</sup> a note made and payable in New York in "Canada money" was held to be non-negotiable, and, while the case has been severely criticized, it has not been over-ruled.<sup>105</sup> No legislation peculiar to bonds, however, seems essential,<sup>106</sup> for this problem, although it may be of considerable importance in the case of bond issues, is equally important in connection with all money paper.

### *Coupons*

The device employed for more than a century, of tying up in small parcels the periodic interest obligations arising upon a bond and attaching them as separate coupons, was probably designed to facilitate interest collections on long term obligations.<sup>107</sup>

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<sup>101</sup> See HERR, *op. cit. supra* note 50, forms 60-67, 618-620, 622.

<sup>102</sup> How valuable these provisions would be in such contingency is conjectural, in spite of the decisions in *Bronson v. Rodes*, 7 Wall. 229 (U. S. 1869), and *Trebilcock v. Wilson*, 12 Wall. 687 (U. S. 1871), where the creditor was given judgment payable in coin, the medium specified, notwithstanding the Legal Tender Acts. When the medium specified, gold coin, has become no longer obtainable, at least one court has given judgment payable in legal tender paper money, *American Chiclé Co. v. Somerville Paper Box Co. Ltd.*, 50 Ont. L. R. 517 (1921).

<sup>103</sup> *Black v. Ward*, 27 Mich. 191 (1873); *Hebblethwaite v. Flint*, 185 App. Div. 249, 173 N. Y. Supp. 81 (2d Dep't 1918); see *Levy v. Cleveland, C. C. and St. L. Ry.*, 210 App. Div. 422, 206 N. Y. Supp. 261 (1st Dep't 1924) (negotiability of such bonds assumed).

<sup>104</sup> *Thompson v. Sloan*, 23 Wend. 71 (N. Y. 1840).

<sup>105</sup> *Black v. Ward*, *supra* note 103; *Brown v. Perera*, 183 App. Div. 892, 176 N. Y. Supp. 215 (Sup. Ct. 1918); *Oliphant, Theory of Money in the Law of Commercial Instruments* (1920) 29 YALE L. J. 606, 619.

<sup>106</sup> See HANDBOOK (1931) 224, 225 for the amendments now proposed.

<sup>107</sup> "The coupon is simply a mode agreed on between the parties for the

The early cases, however, regarded the coupon with some misgivings as a device to circumvent the ethical notion that interest should not itself bear interest.<sup>108</sup> And it took a long series of cases to determine the various Statute of Limitations questions, the early disposition being to regard the coupon as so far "partaking of the character" of the parent obligation, that the same period should apply to each.<sup>109</sup> As to form, the chief concern was with the seal, but this was "cried down" as in the case of bonds, before an obvious public need.<sup>110</sup> Indeed, there is little question on this score today, since seals have become obsolescent<sup>111</sup> and coupons easily satisfy the simple formal requirements specified for negotiable bearer notes.

This slow emancipation of the interest coupon as a separate instrument capable of being owned and sued upon apart from the bond never became quite complete. From the beginning, as an apron string attaching it to the mother bond, coupons carried some variation of the legend, "being six months interest then due upon its first mortgage bonds No. 000." In one sense this was merely a recital of the transaction giving rise to the instrument, and inoffensive.<sup>112</sup> It was important, but apparently so

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convenience of the holder in collecting the interest as it becomes due." *The City of Kenosha v. Lamson*, 9 Wall. 477, 484 (1869).

<sup>108</sup> In the case of *Rose v. The City of Bridgeport*, 17 Conn. 243 (1845), the court refused recovery of interest on overdue interest warrants, though it granted that other courts "under the influence produced by a different moral sense regarding the propriety of demanding interest" in such case might hold otherwise. Some fifty odd years later the question was looked upon as one of policy, not morals, and the earlier case was distinguished. *Fox v. Hartford & W. H. Horse R. R.*, 70 Conn. 1, 38 Atl. 871 (1897).

<sup>109</sup> *The City of Kenosha v. Lamson*, *supra* note 107. In subsequent cases it was decided, however, that the statute ran from the maturity of the coupon, rather than from maturity of the bond. See *Clark v. Iowa City*, 20 Wall. 583 (U. S. 1874). Recently it has been held that the coupon is so far a distinct instrument that the limitations period applicable to it should be determined without regard to the period applying to the bond. *Dickerson v. Wilkes-Barre & Hazelton R. R.*, 103 N. J. 175, 143 Atl. 618 (1926). See discussion (1929) 38 YALE L. J. 823.

<sup>110</sup> Justice Grier in *Mercer County v. Hackett*, *supra* note 64, at 95, was very positive about the thing: "When a corporation covenants to pay to bearer and gives a bond with negotiable qualities, *sic*, and by this means obtains funds for the accomplishment of the useful enterprises of the day, it cannot be allowed to evade the payment by parading some obsolete judicial decision that a bond, for some technical reason (seal), cannot be made payable to bearer." See further *Chase National Bank v. Faurot*, 149 N. Y. 532, 44 N. E. 164 (1896).

<sup>111</sup> Indeed, since coupons are themselves not under seal, there would be no question but for the close relationship they bear to the bond. The point is finally set at rest by the provision that the presence of a seal does not affect negotiability. N. I. L. § 6(4).

<sup>112</sup> "A promise is unconditional though coupled with a statement of the transaction which gives rise to the instrument." N. I. L. § 3(2).

merely for the purpose of identifying the coupon and permitting it to share later in the security provided by the mortgage. There was thus no reason for considering the recital when determining, for example, that a *bona fide* purchaser from a thief might retain the paper and enforce payment of it as a negotiable instrument.<sup>113</sup> But when the issue concerned the regularity of the transaction giving rise to the bond, the relationship became embarrassing.

In one of the many cases involving this question, *McClure v. Township of Oxford*,<sup>114</sup> coupon bonds had been issued in the name of the municipality to finance the construction of a toll bridge, but, as so often happened in such cases, the election authorizing the issue had been improperly conducted. Justice Waite, pointing to the bond reference in the coupon, said: "This puts the purchaser upon inquiry for the bonds, and charges him with notice of all they contain." Since it was possible for one familiar with the sanctioning legislation as interpreted by the court to see from the bond recitals that insufficient notice of election must have been given, recovery upon the coupons was denied. This did not mean that such coupons were not negotiable, but it did decide that the rights of a *bona fide* purchaser of a coupon could rise no higher than those of a purchaser of the relative bond.

A dozen years later the New York court, in *McClelland v. Norfolk Southern R. R.*,<sup>115</sup> was faced with the same issue, though this time it concerned the power of majority bondholders under a mortgage to postpone coupon interest payments for a period of five years. The court went further than the Supreme Court had gone and not only said by way of dictum that purchasers of such coupons are on notice of bond and mortgage provisions, but that, when rights are reserved in the mortgage to postpone payment of interest, the coupons necessarily lose their status as negotiable paper—wherefore, had the majority bondholders acted within the terms of the mortgage, the plaintiff would have had no recourse. The court in the *Carterville* case<sup>116</sup> took the language of these two courts at face value, disregarded the narrow issue,

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<sup>113</sup> The point is well settled. *Evertson v. National Bank of Newport*, 66 N. Y. 14 (1876): ". . . bonds, as well as the coupons attached thereto, have been held negotiable when payable to bearer, for the reason that they are promises to pay money in the form which, by the Law Merchant, would make them negotiable as representatives of money, the same as ordinary commercial instruments." And see *Spooner v. Holmes*, 102 Mass. 503 (1869).

<sup>114</sup> 94 U. S. 429 (1876).

<sup>115</sup> 110 N. Y. 469 (1888). The same result was reached in *Augusta Bank v. Augusta*, 49 Me. 507 (1860), by holding non-negotiable, coupons omitting words order or bearer. In *Johnson v. County of Stark*, 24 Ill. 75 (1860), the fact that payment was to be "on this coupon" was held to make it payable to bearer and negotiable.

<sup>116</sup> *Supra* note 54.

and denied the *bona fide* purchaser of coupons recovery free of defenses between the original parties.

The problem of how to draw coupons so that they will be governed by the corporate mortgage and yet retain their good standing as negotiable instruments is thus of a piece with that concerning bonds before the court in *Enoch v. Brandon*.<sup>117</sup> If anything, it is more serious, not only because the reference is more distant, from coupons to bonds to mortgage, but because it would seem impossible to take the position adopted by the court in *Enoch v. Brandon* and say that a right to postpone payment of coupons for any period or to subordinate their payment to new indebtedness, merely concerns collateral security rights and does not affect the principal obligation of the coupon. This is even more obvious in the case of a redemption bond, for surely a coupon, which has become a nullity due to redemption before maturity of the bond from which it was detached, cannot maintain its face in negotiable company. Certainly its payment must be held to be subject to a vital contingency rendering the promise conditional.<sup>118</sup> At the same time it seems imperative that some means, short of the drastic remedy of declaring such paper non-negotiable for all purposes, should be adopted to insure recognition of the controlling force of mortgage provisions.

### *Finally*

The surprising thing disclosed by this survey is that the points of friction between long term paper and the law concerning negotiable instruments generally are apparently so few in number.<sup>119</sup> Even more interesting is the fact that, in most cases, the courts, by one means or another, have been able to compose all differences amicably. Tax free covenants, redemption and conversion clauses, sinking fund provisions and acceleration agreements,

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<sup>117</sup> *Supra* note 31.

<sup>118</sup> N. I. L. § 3. It is typical to insert in the coupon the clause, "unless the bond hereinafter mentioned shall have been previously redeemed." *HORR, op. cit. supra* note 50, at 51. Moreover, the case is not helped by § 4 (2) permitting payment "on or before" maturity, for payment will *never* be made in event the bond is previously called for redemption.

On the other hand, if such a clause is not inserted in the coupon, and it is negotiated separately, it is only by forcibly declaring that the purchaser must take notice of bond and mortgage that recovery can be denied. *McClure v. Township of Oxford, supra* note 114. There is very little authority. In *Mississippi Power & Light Co. v. Kusterer & Co., supra* note 29, recovery was denied, but in that case the holder had bought bond and coupons together.

<sup>119</sup> Only issues having sufficient vitality to get before the courts have been examined. There may be others. A study of registered bonds, which it is proposed should be made negotiable much as stock certificates have been, will be published later.

together with the seal, the gold coin provision, to say nothing of the engraving, all matters betokening an era of financial well-being quite foreign to the frugal simplicity of the times which saw the promissory note evolve, have been sanctioned, almost hungrily, by the courts. Serious trouble has developed alone with regard to the provision that the promise must be unconditional, including as it does the idea that payment may not be restricted to particular assets. On this last point the courts, in the case of the equipment trust certificate and the assessment bond, have met complete defeat. Although more successful in the case of bonds containing reference provisions importing mortgage conditions, the esoteric character of some of the decisions reconciling such provisions with the usual requirements of form testifies to a desperate plight.

The logic of the situation is simply that there should be ungrudging recognition in the Negotiable Instruments Law of the fact that long term investment instruments must be accorded full negotiability—notwithstanding they are conditional in character. The apparent break from long tradition is only a seeming one since the tradition built up to fit paper designed to circulate as money has little application to investment paper.<sup>120</sup> Moreover, although we may disguise the fact as we wish, the courts have gone far toward recognizing the situation by their rulings that note and mortgage are to be construed separately in determining negotiable form, by the device of construing references in bonds importing mortgage conditions as relating to the security only and, in the case of coupons, by ruling that, though negotiable, the holder is on “notice” of the underlying transaction. Of course the Hofstadter Act<sup>121</sup> has probably gone too far in sanctioning all corporate obligations, whether conditional or not, provided only they are issued in a series under an indenture. And “any interest coupon” is a “corporate bond” within the meaning of that statute. At least, it should be possible to require that the *bona fide* purchaser be given some inkling of the nature of the conditions to which he may be subjected.<sup>122</sup>

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<sup>120</sup> This would simply mean that such paper would be negotiable in all respects except for the circumstance that the designated conditions would be operative even as against a holder in due course. See, Waterman, *The Promissory Note as a Substitute for Money* (1930) 14 MINN. L. REV. 313.

<sup>121</sup> *Supra* note 10. A considerable amount of legislation of this character may be expected. See Cal. Stat., 1921, 471; KY. STAT. (Carroll, 1930) § 3102.

<sup>122</sup> The listing requirements of the New York Stock Exchange provide among other things that, “the text of bonds should recite conditions of issuance, tax exemption, terms of redemption (by sinking fund or otherwise), convertibility, default, interchangeability or exchangeability of coupon and registered bonds, and conversion into other securities.” MEEKER, THE WORK OF THE STOCK EXCHANGE (2d ed. 1930) 564.

It is extremely difficult to draw a line in words between bonds and notes, but, since there is little need to sanction conditions in any paper other than the long term investment type, some line must be drawn. In a suggestion made last year to the committee engaged in drafting amendments to the Negotiable Instruments Law it was proposed that Section 3, defining unconditional promise, be amended as to instruments issued in a series.<sup>123</sup> The term series, probably itself sufficiently well understood without further definition, would apply to all the various types of security issues now definitely non-negotiable or in danger of being declared non-negotiable because subject to conditions or payable out of particular assets. The draftsman for the committee, with commendable, but, it is believed, excessive, caution, redrafted the amendment so that it would apply only to the particular instances which have thus far caused trouble.<sup>124</sup> Since it is thought possible, with entire safety, to fix somewhat broader boundaries within which new bond provisions may develop,<sup>125</sup> the amendment as first proposed, with some modifications, is again presented.

According to this suggestion, the Section (italicized wording being new) would read as follows:

Section 3. When promise is unconditional.—An unqualified order or promise to pay is unconditional within the meaning of this act, though coupled with:

1. An indication of a particular fund out of which reimbursement is to be made, or a particular account to be debited with the amount;
2. A statement of the transaction which gives rise to the instrument; or
3. *A statement of, or a reference to a separate writing for a statement of, the holders' rights concerning any security for the instrument.*

*A promise to pay contained in an instrument issued as one of a series, or in any relative instrument representing interest thereon, is unconditional within the meaning of this act, although coupled with a statement, or a ref-*

<sup>123</sup> See the report of the draftsman, Mr. Llewellyn, HANDBOOK (1931) 217.

<sup>124</sup> As redrafted the amendment reads:

"In the following cases the expression of particular conditions or a summary thereof with a reference to a separate writing for a full statement of such conditions shall not render the instrument non-negotiable:

(a) Where the instrument is issued and shown on its face to be issued as one of a series, and conditions are placed in the interests of the holders as a group upon enforcement by individual holders;

(b) Where the instrument is issued by a government or governmental agency and payment is limited to the proceeds of particular described taxes, assessments or similar sources of revenue;

(c) Where the instrument is issued by an unincorporated business organization, or by the representatives of an estate, and payment is limited to the particular fund constituted by the entire assets of such unincorporated business organization or estate.

Except as provided in this section, an order or promise to pay out of a particular fund is not unconditional." HANDBOOK (1931) 222.

<sup>125</sup> Clause (a), *supra* note 124, would not for example, admit the coupon condition "unless sooner redeemed"—unless indeed it could be shown to be "in the interest of the holders as a group," which is unlikely. So with other

*erence to a separate writing for a statement, of any conditions upon the holders' rights, or limitations upon the makers' obligations, and the instrument shall not thereby be rendered non-negotiable, but no such condition or limitation upon the makers' promise to pay shall affect the rights of a holder in due course unless notice of the same appears on the face of the instrument representing the principal obligation.*<sup>126</sup>

*Except as provided in this section, an order or promise to pay out of a particular fund is not unconditional.*

One trained in the individualistic tradition of the common law has a curious feeling of reluctance in resorting to legislation as a solution for a problem such as that concerning investment paper—reluctance based not so much on the fear that the amendment here proposed—or one better worded to accomplish the purpose—will not once and for all settle the status of such paper, but rather for fear that it may. Traditionally, it has been regarded as so much more sporting to hedge a problem about with doubts and queries and then to speculate on what the next court will do about it that it seems unfair to legislate. Thus has the common law advanced—the client paying the costs. But, whether sporting or not, it is conceived that advance may equally well take place—if that is a consideration—and much more speedily and economically, by the process of amendatory legislation. Of course, one does not wish continually to be tinkering with a supposedly uniform statute, but rightly or wrongly we have embarked on a project of codification in commercial matters and once in a generation or more is not too often to ask the legislature to consolidate the positions being held with difficulty by the more

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conditions. Moreover, it should not be necessary to give notice of all conditions upon coupons.

Clause (b) would apply to municipal warrants. According to one authority, "It would overwhelm municipalities with ruin to hold that such warrants or orders have the qualities of negotiable paper, especially that quality which protects an innocent holder for value from defenses of which he has no notice, actual or constructive." DILLON, MUNICIPAL CORPORATIONS (5th ed. 1911) § 856.

Clause (c) merely restates the present problem, what are "the entire assets" of an "unincorporated business organization or estate"?

<sup>126</sup> The scheme of this amendment is thus to permit bonds and coupons to be drawn subject to the terms of a designated indenture—regardless of the nature of the conditions found therein—and yet be fully negotiable insofar as most incidents of negotiability are concerned. At the same time, it is proposed to insist that notice of such conditions be given in the bond (not the coupon) to the extent that it is sought to make them effective as against a holder in due course. After all the plan of denying negotiability—for all purposes—to conditional investment paper is but a clumsy way of regulating the matter. The status of the innocent purchaser from a thief is made worse, not better, by such a solution. Indeed, viewed as a problem in regulation there is something to be said for passing the whole question of conditions over to the various state securities commissions, but it is thought that this should be done only as a last resort.

advanced courts. And bonds, moreover, have surely by now, after a century of knocking about in high financial circles, attained to sufficient respectability, as that quality is usually measured, to entitle them to at least as much consideration as their poorer relations, the other money instruments, have received.