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CHATTEL PAPER AS A NEGOTIABLE SPECIALTY UNDER THE UNIFORM COMMERCIAL CODE

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AFTER more than five years of drafting, the reporting staff of the American Law Institute and the National Conference of Commissioners on Uniform State Laws presented to the joint meeting of these organizations in Washington, D. C. on May 18-20, 1950, a "Proposed Final Draft" of the Uniform Commercial Code, which has been the major project of these organizations for the last several years.¹ It was decided at the joint meeting to consider the Code again at another joint meeting in September, 1950, with the expectation of final adoption in May, 1951, submission to the American Bar Association in September, 1951, and introduction for enactment in the state legislatures beginning in 1952. Major policy questions as to various issues of substantive law were considered and decided, presumably finally, at the May, 1950 sessions.

The scope and purposes of the Code have been described elsewhere by many writers,² including several articles by the writer and others discussing earlier drafts of the article on "Secured Transactions".³ This

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1. The Proposed Final Draft, dated "Spring, 1950" has been published in two versions, with and without the official Comments of the Reporters. Section Numbers of the Proposed Final Draft are cited herein without further reference and can be found in either edition. The Comments to the Proposed Final Draft cited herein will be found in the "Text and Comments Edition."

The draft submitted to the May, 1949, joint meeting of the two sponsor organizations at Washington, D.C. is cited herein as "May, 1949 draft." A subsequent version of certain portions of the Code published and circulated in October, 1949 is cited herein as "October, 1949 draft."

2. A series of five Comments and Notes on the Code appears beginning at 57 YALE L.J. 1360 (1948). See also Gilmore, *On the Difficulties of Codifying Commercial Law*, 57 YALE L.J. 1341 (1948); Schnader, *The New Commercial Code; Modernizing our Commercial Acts*, 36 A.B.A.J. 179 (1950); Williston, *The Law of Sales in the Proposed Uniform Commercial Code*, 63 HARV. L. REV. 561 (1950); Richter, *The Uniform Commercial Code—A Preview*, 24 J. OF THE STATE BAR OF CALIFORNIA 414 (1949).

3. Llewellyn, *Problems of Codifying Security Law*, 13 LAW & CONTEMP. PROB. 637, (1948); Dunham, *Inventory and Accounts Receivable Financing*, 62 HARV. L. REV. 583 (1949); Kripke, *The "Secured Transactions" Provisions of the Uniform Commercial Code*, 35 VA. L. REV. 577 (1949); Iretton, *The Proposed Commercial Code—a New Deal in Chattel Security*, 43 ILL. L. REV. 794 (1949); Malcolm, *Security Devices as Affected*

article will deal with an aspect of the present Article 9 on "Secured Transactions", namely the recognition of the concept of "chattel paper" as a specialty with aspects of negotiability, and the substantive treatment thereof.

The Code makes several significant changes in prevailing concepts as to negotiable and quasi-negotiable instruments. The present Uniform Negotiable Instrument Law is completely revised, one of the noteworthy changes being the deletion of investment securities from its scope, and the relegation thereof to an Article 8 on "Investment Securities", which represents a revision and expansion of the present Uniform Stock Transfer Act. The rules applicable to checks and other media in the bank collection process are likewise deleted from the Negotiable Instruments portion of the Code, and are placed in an Article 4 on "Bank Deposits and Collections", which would replace the Bank Collection Code sponsored by the American Bankers Association. What remains of the field of negotiable instruments is treated in Article 3 with a title indicating its narrowed scope, "Commercial Paper". This article, on the other hand, receives a very significant accretion of scope by being made applicable to instruments which would be negotiable except that they are not payable to order or to bearer, the only difference being that there can be no holder in due course of such an instrument.⁴ The rules for negotiable documents of title are revised in an Article 7 on "Warehouse Receipts, Bills of Lading and Other Documents of Title", which is a substitute for the Uniform Bills of Lading Act, Uniform Warehouse Receipts Act and the related portions of the Uniform Sales Act.

With this reformulation of concepts comes an innovation of similar nature, namely, the recognition of "chattel paper" as a specialty, the transfer of which is perfected by delivery rather than by assignment.

"Chattel Paper" is defined as a writing of a type whose transfer customarily requires delivery, and which evidences a security interest in, or lease of, goods.⁵ The definition is made significant by provisions

by the Proposed Commercial Code, BULLETIN OF THE ROBERT MORRIS ASSOCIATES (June, 1949).

4. § 3-705.

5. § 9-105(1)(c). The requirement that transfer must "customarily" require delivery leaves room for litigation as to custom, but it is believed that the amount of flexibility and uncertainty involved is no greater than the necessities of the case require. Custom will from time to time change. In fact, the very adoption of the Code might cause a change in business practice. The statutory provision that title to such documents passes by assignment and delivery (§ 9-303(c)) will mean that delivery is more and more relied upon as the means of passing title or effectuating a pledge, with less attention being put upon instruments of assignment. There will still always remain a fringe of cases in which it will be uncertain whether a title retention instrument is of a type which does or does not ordinarily pass by delivery. Not infrequently, for instance, a title retention clause is inserted in the standard provisions of an ordinary order form, even when a single

that transfer of title to, or a pledge of, chattel paper is completed by delivery, without the filing requirements which the Code imposes on a transfer of ordinary accounts receivable.⁶ This definition has three essential elements, one of which is not stated and exists only inferentially:

(a) The chattel paper must relate to a transaction in chattels, in which a security interest is reserved. "Security interest" has two uncorrelated definitions in the draft of the Code,⁷ but essentially for present purposes it means a contractual lien such as a chattel mortgage, or title retention as in a conditional sales contract. The reference to leases is because of the use of the "bailment lease" or other forms of lease to serve essentially the same function as a conditional sales contract.

(b) It is the kind of document which is itself deemed to be the obligation rather than evidence of the obligation, and therefore passes by delivery—in other words, a specialty.⁸

(c) Nowhere does the definition express what is obviously and necessarily implied—that the security interest secures, and the writing embodies in deliverable form, a *monetary obligation*. The failure to articulate the obvious has, the writer believes, led to emphasis wrongly diverted from the nature, and circumstances surrounding creation, of

payment in thirty days rather than instalment payments are contemplated. Such order forms showing on their face that the consideration for monetary obligation is executory do not ordinarily pass by delivery, and it is doubtful that they will ever in the future customarily pass by delivery.

Invoice forms sometimes also contain a clause reserving title until payment. But an invoice is not signed by the debtor, and doubtless would not be considered a "writing" within the meaning of the definition. At any rate, absent a written admission of the obligation by the debtor, invoices will never customarily pass by delivery unaccompanied by an instrument of assignment and warranty of validity.

6. § 9-303.

7. §§ 1-201(36), 9-105(1)(h).

8. This concept of specialty has been variously expressed: (a) "An indispensable instrument . . . means the formal written evidence of an interest in intangibles, so representing the intangible that the enjoyment, transfer or enforcement of the intangible depends upon possession of the instrument." RESTATEMENT, SECURITY § 1 comment (c). (b) ". . . a tangible token or writing, surrender of which is required by the obligor's contract for its enforcement." RESTATEMENT, CONTRACTS § 173 (b)(iv); (c) "Certain contractual rights are embodied in instruments that are more than mere evidence of a claim and are popularly referred to and regarded as if they were themselves the obligations." 3 WILLISTON, CONTRACTS § 439 (Rev. Ed. 1938).

These variations are repeated in some of the state statutes which are designed to exclude specialties from the scope of statutes dealing with assignments of accounts receivable. CONN. GEN. STAT. § 876 h (Supp. 1945) excludes accounts evidenced by a ". . . conditional sale contract and any other instrument for the payment of money, the assignment of which is usually made by endorsement on or delivery of the instrument. . . ." ILL. ANN. STAT. c. 121½, § 220 (Cum. Supp. 1949) excludes accounts represented by a "writing the surrender of which is required by the obligor's contract with the assignor for the endorsement thereof."

the obligation to the less fundamental fact that an interest in chattels is taken or retained as security. The misdirection of attention has resulted not only in faulty substantive provisions for regulation but of a failure to carry through to a logical conclusion the well-conceived recognition of chattel paper as a specialty.

I. SUBSTANTIVE REGULATION OF CONSUMERS' CREDIT PURCHASES

In drafting their definition of chattel paper, the draftsmen had in mind two prototype situations: (a) the instalment purchase of an automobile, refrigerator, or the like, in connection with which the purchaser signs a conditional sale contract or bailment lease which acknowledges that title to the chattel is retained until payment is completed; (b) a chattel mortgage on goods taken by a lender to secure a loan, which may be either for the purpose of enabling the borrower to pay cash for the goods or to give him cash for other purposes.

These are indeed the prototype situations, and the writer has elsewhere emphasized their large and increasing importance to the national economy and as a large segment of the business transactions which are the proper subject of a commercial code.⁹ These are also the transactions which have led to an outcry against alleged abuses in financing practices, primarily in inadequate disclosure of the cost, to a purchaser of consumer goods, of the privilege of buying on instalment credit instead of for cash.¹⁰

But it must be emphasized again that the social and economic importance of these transactions lies in the existence of the debts, not the existence of the security interests. The lien does not affect the operations of an automobile; it acts in traffic just like one which is free and clear. It is the debt which can be significant; the purchaser with an instalment debt does or may behave like a different economic man from the debt-free individual. Similarly, it is in the amount of the "time price differential", "service charge", or interest rate that the alleged abuses or non-disclosures may exist; it could not be demonstrated that there are any significant number of cases in which the purchaser did not fully understand the essential fact about the security interest—that he would lose his purchase if he did not pay. Yet in its provisions regulating through disclosure the purported evils in the consumer

9. Kripke, *supra* note 3, at 578 *et seq.*

10. This outcry has led to the passage of Retail Instalment Sales Acts in several states. *E.g.*, CONN. GEN. STAT. § 1277 i. (Supp. 1947); IND. STAT. ANN. § 58-901 *et seq.* (Burns 1933); MD. ANN. CODE GEN. LAWS art. 83, §§ 116-139 (Cum. Supp. 1947); MASS. ANN. LAWS c. 255, § 13 (1933); N.J. STAT. ANN. § 17: 16B-1 *et seq.* (Supp. 1949); N.Y. PERS. PROP. LAW § 64-a; OHIO GEN. CODE ANN. § 6346-15 *et seq.* (Supp. 1949); PA. STAT. ANN. tit. 69, §§ 603-637 (Supp. 1949).

The Federal Trade Commission has recently tentatively promulgated some Fair Trade Practice Rules of a similar nature. FTC NEWSPAPER RELEASE, Jan. 12, 1950.

credit field the Code focuses entirely on the lien, and loses sight of the transactions envisaged as *sale* or *loan* transactions.

Section 9-204 provides that a security interest in consumer goods is not enforceable against a debtor or his creditors or purchasers from him unless the written instrument creating the security interest conforms to the requirements of Section 9-205. Section 9-205 contains requirements for disclosure as to the arithmetic of a consumer deal which are basically similar to those found in many of the recent state statutes on the subject.¹¹ The penalty for non-disclosure, unless inadvertent, is that the lien is unenforceable. By prescribing such a penalty the draftsmen show that, unlike that ex-lawyer, W. S. Gilbert, they see no need to make the punishment fit the crime. The assumed evils of a sale of consumer goods in which the purchaser does not know the amount it costs for the privilege of paying on time have nothing to do with the question of lien. Whether or not security for the obligation is taken, the evils of overcharging or misstating the charge are the same. In fact the most conspicuous situations of high costs for the privilege of paying in instalments occur in such fields of credit sales as clothing, cheap jewelry, sets of dishes, sets of books, and sets of cooking ware. The repossession value of such articles is almost nil. Even if they had a resale value, the amounts involved would ordinarily be too small to justify the expense of sending out field representatives to repossess. Therefore, the unenforceability of the lien is of small moment to the vendor.

Conversely, unless the purchaser is judgment-proof, mere invalidation of the lien gives him no real protection, if he is still subject to suit for the debt. Moreover, as will be pointed out below,¹² in many fields of instalment sales to consumers where the potentiality for abuse is greatest, no security interest is taken or retained, with the result that the Code provisions as presently drawn are inapplicable.

Similarly, in loan situations, the "co-maker" loan without tangible chattel security is frequently interchangeable with the chattel loan, but would escape regulation under the Code.

The obvious conclusion is that, if the proposed disclosure in purchase money situations is important at all, the necessary statutory provisions belong in Article 2 on Sales as a regulation of the relationship between the seller and a consumer buyer *per se*, and they should apply in all cases of consumer purchases on instalment terms whether or not a security interest is reserved. Similarly, if loans to consumers are subject to abuse, the necessary regulation should be in a treatment

11. Note 10 *supra*. A note to §9-205 states that existing legislation may be continued in force in lieu of the provisions of §9-205. The note does not solve the technical problem of what to do when the existing legislation is less complete in applicability than §9-205—*e.g.*, when it covers sales, but not loans.

12. See page 1218 *infra*.

specifically devoted to consumer lending as such, as in existing small loan statutes, and not limited to the cases where there exists the irrelevant circumstance that the obligation is secured.

The damage to the purchaser or borrower, if any, comes from the undisclosed finance charges. This should be the measure of penalty.¹³ With the price to be paid for credit eliminated, there is no reason why the law should not lend all of its remedies, including enforcement of the lien, for the collection of the cash price of the goods, or the amount of the loan, which the debtor has certainly agreed to pay with full knowledge. Yet the Code imposes the arbitrary penalty of loss of lien in addition to the proper penalty of loss of the finance charge,¹⁴ except where the non-disclosure was in good faith.¹⁵ Moreover, it imposes this arbitrary penalty even though the purchaser may have received the essential disclosure in some other way, and may in fact have known the amount of the finance charge.

Finally, these provisions insure that in this field the Code will itself defeat its essential purpose of creating a uniformity in state law, because they do not attempt to replace the existing state laws on this subject, and because they impose a penalty which is a complete departure from all of the present laws on the subject.

II. THE CONSUMER-PURCHASER AND THE THIRD PARTY HOLDER OF HIS OBLIGATION

The draftsmen of the Code have thus far been conspicuously unsuccessful in devising a workable solution to the problem of the secured instalment obligation embodied in a negotiable note. The Proposed Final Draft is the first that came even close to an integrated treatment of the problem, which had heretofore been lost in a confusion between the treatment of negotiable instruments in the Article on Commercial Paper and an unrelated treatment of negotiable instruments when used with a secured instalment obligation in the Article on Secured Transactions.¹⁶ In the Proposed Final Draft the treatment

13. This is the penalty imposed by those of the present state statutes which specify a penalty. See note 10 *supra*.

14. § 9-205(4).

15. The penalty of losses of finance charge is also imposed in Section 9-205(4) for failure to send to the debtor a copy of the agreement within ten days after its date. The statute leaves open to unnecessary litigation the question whether the debtor's acknowledgment in the body of the instrument of receipt of a copy is conclusive evidence on that point; and whether the copy so delivered may omit specification of serial numbers or other identifying data which in some contexts are frequently supplied after the documents are fully executed. These points are covered in some of the existing Retail Instalment Sales Acts.

16. As late as the last preceding published draft, the Article on Secured Transactions contained language impairing the negotiability and, indeed, the validity of such a negotiable note in a consumer purchase situation. October, 1949 draft § 8-207(3). This was

in the two articles has correlation and, with a not too drastic technical correction, could be made workable. Moreover, while the writer happens to disagree with the underlying policy expressed, the policy is at least defensible. Unfortunately, instead of making the necessary technical correction at their May, 1950 meeting, the sponsor organizations accepted a motion of the reporters to abandon the treatment contained in the Proposed Final Draft, and to adopt as a substitute proposal a suggestion which was not precisely worded on the floor but seems to be a reversion to the treatment in the May, 1949 draft.¹⁷ In the writer's opinion, on this very difficult question where several reasonable and defensible choices of policy were available, the sponsor organizations have now gone back to the one proposal which is indefensible and which offers the consumer a wholly specious protection against the evils assumed to exist. After a preliminary comment on the scope of the problem, we shall consider both the version in the Proposed Final Draft, and the substitute accepted at the May, 1950 meeting.

This problem arises as part of the draftsmen's overall concern with the consumer's assumed unequal bargaining position in relation to the seller. They are here specifically concerned that the consumer will find a negotiable note embodying his obligation in the hands of a holder in due course, so that he has lost his opportunity to defend against payment of the price by reason of unsatisfactory merchandise or service, overcharging, failure of consideration, or similar matters. This problem is indeed an interesting one, theoretically, but the intriguing theoretical situation makes the problem loom larger than it is factually. The purchaser on time is no more likely to be dissatisfied with his purchase than any other purchaser. In the whole vast range of consumer purchase transactions, the cases of customer complaint, justified or unjustified, are infinitesimal. Even in the case of justified dissatisfaction, the seller is ordinarily able and willing to make adjustment. If he is not willing, he is, of course, legally responsible either in

entirely at variance with the section of the then latest version of the Article on Commercial Paper containing a statement of the traditional rights of a holder in due course. May, 1949 draft § 3-305. The definition of negotiability left for determination otherwise than by inspection of the instrument the question whether a note was negotiable or not, because a provision for title retention was made to affect or not to affect negotiability depending on whether it did or did not require filing in the light of the particular state law which was applicable, the particular types of goods involved, and the particular rules for filing in that state for that type of goods. May, 1949 draft § 3-103(2) (c) and Reporters' Comment 3 thereto.

17. In the May, 1949 draft § 7-612 read as follows: "A holder in due course of a note secured by a consumer's goods lien has the option of claiming as a holder in due course on the note or claiming as an assignee of the consumer lien contract. If such holder asserts rights as a holder in due course, the security interest in goods securing the note lapses. If at any time before or after judgment on the note the holder of a note asserts rights against the collateral, he has only the rights of an assignee of the chattel paper and the note and not those of a holder in due course."

a direct suit by the purchaser or at the insistence of the third party holder of the obligation if the latter has been unable to collect because of the successful assertion of defenses based on dissatisfaction with the merchandise. Therefore, the question is merely procedural, except in the comparatively few cases where the seller is unavailable or insolvent. Because of the factual unimportance of the problem in most instalment selling contexts, many of the larger finance companies in the automobile and consumer appliance fields have simplified their documentation by abandoning the use of negotiable notes. Most banks, however, appear still to be concerned with their position as holders in due course, and continue to use the negotiable note.

While the extent of the problem has been exaggerated, it does exist to a limited extent and the draftsmen of the Code have been willing to go to drastic lengths in an attempt to deal with it. To meet the problem, they first took the extraordinary step in the Proposed Final Draft of making the whole Article on Commercial Paper (the revised Uniform Negotiable Instruments Law) subject to the provisions of the Article on Secured Transactions.¹⁸ In the latter Article, so far as non-consumer transactions are concerned, there is fortunately not too much damage to customary conceptions of the consequences of negotiability. The article provides that in a non-consumer transaction the purchaser can, by giving a negotiable note or by express stipulation, agree to forego all claims and defenses against third party takers of his obligation without notice of claims, for value and in good faith, and that this agreement is valid except as to defenses which could be asserted against a holder in due course.¹⁹

When it came to the consumer-purchaser, however, the Proposed

18. § 3-103(2). This provision is almost in direct literal conflict with § 9-309 of the Article on Secured Transactions, which states that nothing in that Article limits the rights of a holder in due course of a negotiable instrument. § 9-209(3) of the same Article expressly limits the rights of a holder in due course, and § 3-103(2) is designed to give § 9-209(3) the right of way over the usual rights of a holder in course as to defenses. See Comment 5 to § 9-209. The reconciliation of the sections must lie in the fact that § 9-309 was intended to be limited to rights of a holder in due course as to title, not as to freedom from defenses.

19. § 9-209(2). Obviously, this section gives a negotiable note greater effect as a waiver of defenses than it has either under the Uniform Negotiable Instruments Law or under the Article on Commercial Paper in the proposed Code. In both of the latter, a negotiable instrument cuts off defenses only in the hands of a holder in due course or a person who claims under such a holder. The concept of a holder in due course is more narrowly restricted than the concept used in § 9-209(2), for it includes the additional standard of lack of knowledge of maturity or dishonor. UNIFORM NEGOTIABLE INSTRUMENTS ACT §§ 52, 58; Proposed Final Draft §§ 3-202, 3-206. On the other hand, the standard in § 9-209(2) gives no protection to the purchaser from a holder in due course who is not himself a holder in due course. These variations are unnecessary complications which could easily have been avoided in the drafting. Compare discussion pages 1226-7 *infra*.

Final Draft would have drastically modified the law of negotiable instruments by the provisions of the Article on Secured Transactions. In the case of a "seller's purchase money security interest in consumer goods", an agreement not to assert defenses arising out of the sales contract was stated not to be effective, and a negotiable instrument arising from the transaction was made subject to claims and defenses even though in the hands of a holder in due course.²⁰

Passing by for the moment the question of policy, it should be noted that this draft had two serious technical defects. In the first place, it did nothing to insure that the transferee of the negotiable note would know that it arose in a consumer goods transaction. The note may well be, and frequently is, a separate piece of paper containing no reference to the transaction out of which it arises. Even if the endorsee knows that the note is accompanied by a conditional sale contract, he may not know whether the commodity involved is a consumer good—a difficulty made the more acute by the fact that the definition of consumer goods depends not on the nature of the article, but on the use to which the purchaser actually puts it.²¹ These technical defects are not insuperable, and if the policy of these provisions had remained the policy of the sponsor organizations, that policy could have been effectuated by draftsmanship corrections. First, a change in the definition of consumer goods could have been made (and should in any event be made for other reasons) so that the classification of the goods does not depend on their specific use, but on their general type. Secondly, some provision could have been made for ready identification of the particular notes to which these special policy rules would apply. One such provision, informally suggested by one of the draftsmen, would be that these rules apply to any note purchased from a dealer in consumer goods. That provision would be unworkable, because it does not insure notice to a second endorsee who does not buy directly from the dealer, and it would provide no basis for distinction in the case of dealers in passenger automobiles and trucks, and other common situations of dealers selling both consumer and non-consumer goods. The more adequate solution would be a mandatory provision that every negotiable note used in a consumer goods transaction must refer to the fact that it arises in such a transaction.²² Finally, the single most advantageous solution would be

20. § 9-209(3).

21. "Consumer goods" are defined in § 9-109(1) to mean goods used for the debtor's personal, family or household purposes. Thus, a passenger automobile is or is not a consumer good depending on whether it is used for family or for business purposes.

22. The Maryland Retail Instalment Sales Act requires the note to refer to the contract. MD. ANN. CODE GEN. LAWS art. 83, § 134 (Cum. Supp. 1947). ILL. REV. STAT. c. 95, § 26 (1949) requires all notes secured by chattel mortgages to state on their face that they are so secured, and provides that they are subject to defenses in the hands of third

adoption of the suggestion made in part 3 hereof, which would result in the elimination of the present practice of embodying the monetary obligation in a separate piece of paper distinct from the security instrument.

Returning to the question of desirability of these rules, it may first be noted that the treatment in the Proposed Final Draft was another case where the draftsmen were so bemused by the security aspect of the transaction that they lost sight of its essential nature as a sale on credit. If a consumer needs protection in a sales transaction, he needs it by virtue of the sale itself and with respect to his monetary obligation. His protection should not depend on the irrelevant circumstance that a security interest is or is not reserved in connection with the extension of credit. Important types of consumer credit transactions are not secured. This is true of the home modernization transactions financed by the Federal Housing Administration under Title I of the National Housing Act,²³ and of the numerous non-insured finance plans for similar purposes offered by finance companies and banks. The commodities which are the subject of such finance arrangements are home improvements like heating systems, roofing, siding, painting, kitchen modernization, etc. No title is reserved, not only because the F.H.A. insurance plan does not contemplate such title reservation, but also because title reservation in cases like this would be of little practical utility. This type of transaction is more subject to potential abuse and to unsatisfactory performance than the typical purchase of a standard automobile or refrigerator, where title is reserved. Yet the Code does not protect the purchaser of the unsatisfactory heating system, or the painting job which was skimped on quality, against his liability to the bank or finance company which has purchased his negotiable note for the job.

Moreover, title retention is an insignificant aspect of the transaction in many fields of high pressure sales. Although clothing, jewelry, sets of books, dishes, and cooking ware are sold on time with title retention, the effect of the reservation of title is principally *in terrorem*, since these types of goods have little resale value and are seldom worth repossessing. Title retention could be cheerfully abandoned, if third party holder-in-due-course status were deemed important.

parties. A further possibility is that contained in the Pennsylvania Motor Vehicle Sales Finance Act, which forbids the use of a negotiable note which when separately negotiated would cut off defenses. PA. STAT. ANN tit. 69, § 615(g) (Supp. 1949).

The draftsmen argue that there is no likelihood that the purchaser of the note will be misled as to its nature, because the note is always accompanied by the security instrument, Comment 5 to § 9-209. This is factually inaccurate; the writer knows of cases where banks have purchased notes from furniture stores without taking assignments of the accompanying conditional sales contracts or bailment leases.

23. 48 STAT. 1246, as amended, 12 U.S.C. § 1703 (1946).

The conclusion is that if a provision denying holder-in-due-course status to a third party holder of a consumer obligation is deemed desirable, the provision should be applicable to all sales to consumers, and should appear in the Article on Sales or the Article on Commercial Paper. Instead of making this policy effective, the draftsmen procured at the May, 1950 meeting of the sponsor organizations the acceptance of a different solution which in effect nullified this policy while purporting to retain it in a different form. The present writer agrees with the nullification of the policy and disagrees with the specious retention.

The solution reached at the meeting was that a third party holder of a consumer note might enforce the note as such and take advantage of holder-in-due-course status, but that if he had recourse to the security, he became subject to defenses. This solution had previously been expressed in the May, 1949 draft,²⁴ which provided that the third party was to be subject to defenses if he enforced the security either before or after judgment on the note. The provision obviously needed restudy: it provided no answers to the question how the defenses were to be asserted after judgment and in the various events of repossession without sale, foreclosure under a power of sale, judicial foreclosure, or levy pursuant to the judgment.

More important than this technical deficiency, however, was the serious deficiency of the policy expressed. It should be borne in mind that the consumer is dissatisfied with his purchase and he either wants to return the goods or receive an adjustment in price. The draftsmen have now told him that if he can pay for what he does not want, he will be compelled to do so. If he cannot pay, the seller will be entitled to repossess, for there obviously are few equities between buyer and seller which would enable the buyer to keep the merchandise without paying for it. The consumer's protection is wholly illusory.

Moreover, there is no reason to give the consumer protection as to the security if he is not given protection as to his obligation. If the debt is one which he may properly be required to pay, it is also one as to which his security may equitably be enforced against him. Surely there is no place in the law for second-class debts which the law will recognize to the extent of judgment, but to which it will deny the contractual remedies for enforcement.

There is room for considerably more clear thinking on this question. The issue is one of public policy, and should be decided as such. Heretofore, attention has been focussed on false issues. The courts commonly find themselves dealing with an issue between an individual and a large financial institution, and in their instinctive desire to favor the little fellow they have produced some rather strange interpretations of the law of negotiable instruments. The major discussion has been

24. See note 17 *supra*.

on the question whether a note negotiable in form becomes non-negotiable because accompanied by or even attached to a conditional sale contract; or whether the financier²⁵ is in fact a holder in due course.²⁶ Three types of rationale are used:

(1) Occasional courts have held the note to be non-negotiable because of its connection with a conditional sale contract, although the note complied with the statutory standards of negotiability.

(2) More frequently, courts who would throw the loss on the financier have done so by specious grounds for denying them holder-in-due-course status, thus treating them like original parties to the purchase and sale of the goods. One such ground is that the financier furnished the forms on which the transaction was written. But this is nothing but the kind of service to attract business which has its counterparts in the furnishing of telegraph blanks by rival telegraph companies; forms of deed and real estate contracts by rival title insurance companies; etc. The essential merits of the financier's position would not really be changed if the transaction was written on the seller's own form, or even on a rival financier's form, both of which events frequently happen. Equally untenable is the argument that a financier who furnishes rate charts, consults with respect to credit terms, and pre-investigates the purchaser's credit is charged with knowledge of the conditions to liability existing between purchaser and seller. Neither negotiability nor holder-in-due-course status is ordinarily affected by knowledge of the nature of the transaction or of the fact that consideration is executory²⁷ and some very bad law is made when these statutory rules are judicially nullified in one class of situation.

(3) A more plausible version of the same contention is that the financier's advance acquaintance with the deal is so close that he lacks the innocence for holder-in-due-course status. But consideration will show that the usual types of advance participation by the financier are irrelevant circumstances. They are methods by which the seller can ascertain in advance that the financier will be interested in buying the purchaser's obligation, but they tell the financier no more about the deal than any purchaser of instalment paper can see from the documents without any advance participation. The litigation in these cases arises because the purchaser is not satisfied with his purchase;

25. The term "financier" was devised and then abandoned by the draftsmen of the Code. It is a convenient term to designate anyone who supplies the credit in a transaction, whether bank, finance company, factor, or occasional investor.

26. Many of the cases are collected in annotations in 28 A.L.R. 699 (1924); 44 A.L.R. 1397 (1926); 128 A.L.R. 729 (1940); and 152 A.L.R. 1397 (1944). The latest important case is *Commercial Credit Corporation v. Orange County Machine Works*, 32 Cal. 2d 847, 214 P. 2d 819 (1950).

27. UNIFORM NEGOTIABLE INSTRUMENTS ACT §3(2); Proposed Final Draft §3-105(1) (b) and Comment 2.

but in no case does any advance participation by the financier take the form of selling aid to the seller, or any representation by the financier, express or implied, as to the quality of the goods or the fairness of the price. The financier's participation arises only when the purchaser and seller have agreed on a commodity to be sold; at that point the question arises whether the seller can dispose of the obligation if he extends credit terms. The financier is never factually responsible for the sales aspects of the deal, and a conclusion that he is legally responsible is merely the announcement of a decision as to who shall bear a loss. The argument in terms of legal categories ("negotiable", "holder in due course") should now be abandoned in favor of a frank decision of this question on policy grounds.

Before turning to the final question whether this protection of the consumer is desirable, one other aspect of it may be mentioned. Concealed in this section of statutory drafting is a potentially important alignment of the state in an economic and legal contest between competing forms of business arrangements to finance the purchase of chattels. On the one hand is the use of the conditional sale contract or purchase money lien taken by the seller, who then realizes his cash by selling the chattel paper so arising to a "sales finance company" or to those banks which are willing to enter into relationships of this sort with dealers. On the other hand is the direct loan form under which a "small loan company" or "consumer's finance company" or consumer's department of a bank will make a direct loan to the buyer, the proceeds of which he will use to pay the seller in cash. Both transactions perform essentially the same economic function. In the loan case the financier necessarily takes free of any claims or defenses between buyer and seller, even though he is fully acquainted with the transaction and may in fact draw his check for the borrower's account to the order of the seller. The draftsmen of the Code are endeavoring to find a formula for denying the same right to be free from claims and defenses between the buyer and the seller where the financier provides the funds by the purchase of the credit instrument from the seller. The significance of this proposed disparity in risk between the two forms of legal arrangements cannot simply be evaluated. As has been indicated, in the case of the financing of new automobiles and other standard new articles made by manufacturers of national reputation and responsibility, the claims and defenses between buyer and seller are statistically unimportant. Many sales finance companies in such cases have deliberately abandoned any effort to achieve the position of a holder in due course. Where, however, one deals with used cars, or unstandardized products, or products in which the method of installation may play a significant role in customer satisfaction or dissatisfaction (heating systems, painting, roofing, etc.), the availability of financing may well depend on the ability of the financier to

obtain a legal position in which his risk is a financial and credit risk only, and not a merchandise risk of customer satisfaction with his purchase.

This points up the basic question whether the consumer purchaser should be entitled to assert defenses against a person with holder-in-due-course status. Someone will have to pay for all credit which is provided to consumers who do not pay cash. If the particular consumer can avoid his obligation where his confidence in his seller was misplaced, then those providing the credit service will have to be repaid by charging against other consumers rates which are adequate to cover the losses. The issue is whether the particular consumer should be left to litigate his dissatisfaction with the seller with whom he dealt, or whether the cost of his dissatisfaction should be arbitrarily shifted to all other consumers who use the mechanisms of consumer credit.

This very real issue of public policy has not been adequately pointed out, isolated or debated. The question has practical importance only for nonstandardized types of goods where the availability and cost of credit may well depend on this point. As long as a real demand for the credit exists, it is submitted that public policy will best be subserved by permitting the third party provider of credit to acquire a holder-in-due-course position.

III. THE SECURED INSTALMENT OBLIGATION AS A NEGOTIABLE INSTRUMENT

As part of its attempt to provide an integrated treatment to the problem of the instalment credit obligation embodied in a negotiable note, the Code provides that the negotiable instrument is part of the chattel paper.²⁸ But the Code also provides, without reconciliation, that chattel paper may not be a negotiable instrument. This is accomplished by a provision that a writing which purports to create or reserve security does not fall within the Article on Commercial Paper.²⁹

The latter provision is not well conceived. It is followed in the very next section by a provision that a writing which recites that it is secured by mortgage or reservation of title may be negotiable.³⁰ Thus, if an

28. § 9-105(1) (c). But strangely, Comment 2 to this section states that the definition of "instrument" (meaning negotiable instrument) and "chattel paper" have been made mutually exclusive.

29. § 3-104(3). Yet Comment 1 to § 9-308 (which provides that chattel paper passes by delivery) explains that the purpose of the section is to treat chattel paper like negotiable instruments.

30. § 3-105(1) (d). See also § 3-112(1) (b), which states that negotiability is not affected by a statement that collateral has been given. Both of these provisions can well be argued to be mere expansions of the long-accepted rule, UNIFORM NEGOTIABLE INSTRUMENT LAW § 3(2), embodied in Proposed Final Draft § 3-105(1) (b), that a statement of

extraneous piece of paper reserves title, and the note refers to and even parrots the words of the other document, the note may be negotiable; but if the note itself reserves title in precisely the same words as the other document might have used, the note is not negotiable.

The distinction is without merit or significance, and the denial of negotiability by reason of title retention is contrary to the more numerous and better-conceived cases under the Uniform Negotiable Instruments Act.³¹ The only reason offered by the draftsmen is that a negotiable instrument "may be taken on its face alone without looking elsewhere."³² The present writer has not succeeded in finding any meaning for this comment in its context. It cannot mean that a negotiable instrument cannot have the words about title retention, for the words are expressly authorized, so long as their origin is referred to another instrument. It cannot mean that the full measure of rights related to the obligation must be found in the monetary obligation itself, for negotiable instruments have always been accompanied and may be accompanied under the Code by instruments creating collateral for the monetary obligation. It cannot mean that the collateral must somehow be found within the four corners of the negotiable instrument, for it has always been possible to secure negotiable instruments with real estate and all manner of tangible and intangible chattels, which must be looked for elsewhere. It cannot mean that the rights in the collateral must be found in the negotiable instrument, for that is exactly what the text of the section makes impossible. And it cannot mean that the secured lender's reservation of security, if construed (somewhat illogically) as an additional covenant by the maker, violates the rule against extraneous covenants, for that rule has been seriously breached as a deliberate policy elsewhere in the same Article.³³

On principle, earlier drafts of the Code, insofar as they contained no equivalent provision denying negotiability to a title retaining instrument as such, were much more satisfactory.³⁴ The present writers'

the transaction does not make the promise conditional. This apparently is the draftsmen's view. See Comment 4 to § 3-105(1)(d). The cases under the Uniform Negotiable Instruments Act were in conflict, however. BEUTEL'S BRANNAN NEGOTIABLE INSTRUMENTS LAW § 3(2), 259-62, § 5(2), 288-9 (7th ed. 1948).

31. See cases collected in BEUTEL'S BRANNAN NEGOTIABLE INSTRUMENTS LAW § 3(2), 259-62, § 5(2), 288-9 (7th ed. 1948).

32. Comment 3 to § 3-104. The additional cliché that it is a policy of the law that a negotiable instrument must be a "courier without luggage," of course, explains nothing.

33. § 3-112(1)(c) authorizes in a negotiable instrument a promise to give additional collateral on demand. Comment 1 recognizes that this makes new law.

34. The May, 1949 draft made negotiability depend on whether the title retention or lien depended on public filing for its effectiveness. May, 1949 draft § 3-103(2)(c) and Comment 4. This involved the typical confusion between the monetary obligation and the security interest. See pages 1211-12, 1213-14, 1218 *supra*. Moreover, it made the negotiability of an instrument depend on facts and rules of law outside the instrument; the question of what state law governed; the location of the goods and the effect of removal of the

specific proposal is not only that negotiability should be permitted for title retention instruments, but that it should be encouraged by relaxing the rule against non-monetary promises³⁵ to the extent necessary to permit the usual covenants which accompany title retention—primarily those relating to the preservation of the security.

Part of the way has already been travelled. It has always been permissible to refer to the fact that the instrument is secured, and this is permitted under the Code.³⁶ A statement of the holder's rights to sell collateral is already permitted;³⁷ while it is not clear whether this refers to a *recital* of rights granted by law or extraneous contract, or to a *grant* in the note itself of rights on default, little violence to established concepts would be done by clarification in favor of the latter interpretation. As an innovation, the Code permits a covenant to furnish additional collateral on demand,³⁸ a step far more drastic than anything here proposed, and which subjects the maker to the mercies of strangers.³⁹ The only required step here would be to provide that negotiability is not destroyed by the usual covenants with respect to insurance on and preservation and use of the existing collateral.⁴⁰

Here would be a bold step worthy of the opportunity which the Code offers to legislate for the future, not the past.⁴¹ The volume of secured

goods on the question of the governing law; the filing rules of the governing state, which might depend on the nature of the goods; etc. The unworkability of the distinction has been solved in the wrong direction in the Proposed Final Draft—by denying, instead of granting, negotiability to all title retention notes.

35. § 3-104(1)(b); UNIFORM NEGOTIABLE INSTRUMENTS ACT § 5.

36. Note 30, *supra*.

37. § 3-112(1)(b); UNIFORM NEGOTIABLE INSTRUMENTS ACT § 5.

38. § 3-112(1)(c). The better-considered cases held that such a provision destroyed negotiability under UNIFORM NEGOTIABLE INSTRUMENTS LAW § 5. Cases are collected in BEUTEL'S BRANNAN NEGOTIABLE INSTRUMENTS LAW § 5, 287-8 (7th ed. 1948).

39. Since the requirement to furnish the additional collateral becomes effective "on demand," the maker might not be protected by § 1-208, which imposes an obligation of good faith in requiring additional collateral "at will." One of the draftsmen explained on the floor at the May, 1950 meeting that this section did not apply to demand obligations, although he probably would not intend his remark to apply in the present context. Even assuming good faith, is it not remarkable to subject the maker of a negotiable instrument to the judgment of persons whose identity cannot be predicted, on open-end non-monetary promises?

40. Such a liberalization of the permissible scope of the covenants in commercial paper would be insignificant compared to the freedom permitted in the Article on Investment Securities. Securities governed by that Article have the essential attributes of negotiability. § 8-301(3). Yet they may contain or incorporate by reference covenants with respect to insurance on and maintenance of collateral, and an infinite variety of covenants with respect to the issuer's conduct of business, maintenance of financial condition, etc. § 8-202(1).

41. Cf. Gilmore, *On the Difficulties of Codifying Commercial Law*, 57 YALE L.J. 1341, 1342, 1347 (1948), pointing out that the Uniform Sales Act was adopted just as its concepts and assumptions were made obsolete by twentieth century changes in the or-

instalment obligations runs into billions of dollars annually. Such obligations have become important sales aids and credit mechanisms. The Code does recognize the documents in which these secured transactions are embodied as "chattel paper," thereby giving recognition to them as a type of document which has become a significant article of commerce. It recognizes that these pieces of paper have become specialties so that the title to them passes by delivery, and a security interest in them is perfected by delivery without filing. Yet the Code fails to recognize that the essential element of chattel paper, more important than the title retention, is the promise to pay money and that this promise standing by itself satisfies all of the requirements of certainty which are the essential elements of negotiability. It is true that the ordinary conditional sale contract does not look like a traditional negotiable instrument. But any slight changes in practice resulting from the greater length of standard conditional sales contracts, and the reference therein to particularly described collateral, could be taken in stride by the financial community. The concept of a negotiable instrument as a "courier without luggage" has long since been obsolete anyway. It became an anachronism with the passing of the primitive currency, communications and banking conditions which made necessary the rigid standards of the law merchant for obligations which were to circulate as instruments of commerce. Apart from bank clearance and rediscount mechanisms, the modern typical negotiable instrument travels once in its life (if at all), into the hands of a banker or other financial institution, where it reposes until maturity. For such a life history, chattel paper is as suitable as more traditional types of negotiable instruments.

Adoption of this proposal would not necessarily foreclose a choice on the question discussed in the preceding section—whether consumer chattel paper should be subject to defenses when in the hands of a holder in due course. The present position of the draftsmen, that on some basis it should be subject to defenses, could if finally accepted be at least as readily effectuated when the security instrument was itself the negotiable instrument as it can be when the negotiable instrument is a separate piece of paper, frequently containing no reference to its origin, and capable of separate transfer.

Other aspects of negotiability—questions of title, and the consequences of indorsement—are at least as important for legal and financial purposes in the handling of chattel paper as the questions of defenses. The solution here proposed would solve many of the difficulties of chattel paper which now exist, and which would be preserved by

ganization of business, and the Uniform Conditional Sales Act was of limited usefulness because it ignored all of the problems arising from assignment of the conditional sales contract. See also Llewellyn, *Problems of Codifying Security Law*, 13 *LAW AND CONTEMP. PROB.* 687 (1948).

the Code in its present form. If this solution were adopted, an immediate change in business practice would occur, resulting in the abandonment of the present separate negotiable note with a monetary promise duplicated in the conditional sale contract or chattel mortgage. Thereby it would eliminate the dangers of double financing, which occasionally show up when the note is transferred to one credit institution and the conditional sales contract fraudulently transferred to another. It would eliminate the double handling of the overlapping instruments, which is a real problem in large-volume operations. It would give chattel paper a firm classification, making clear its status on the "notification" question and other title problems treatment of which has remained uncertain while chattel paper occupied an ambiguous position between a mere account receivable and a true negotiable instrument.⁴²

Moreover, the proposed solution would avoid the difficulties which the draftsmen have created for themselves in the current draft of the Code. This draft treats the separate negotiable instrument and the instrument creating or reserving the security interest as both constituting the chattel paper.⁴³ But this inclusion of negotiable instruments within the concept of chattel paper is lost sight of when different substantive rules for chattel paper and "instruments"⁴⁴ are stated. Thus, it is provided that a security interest in negotiable instruments can ordinarily be created only by delivery to the lender;⁴⁵ but apparently, if the negotiable instrument is part of chattel paper, the security interest in the instrument can be perfected by filing.⁴⁶ Title to an ordinary negotiable instrument depends on delivery and the holder's status as a holder in due course, which cannot be affected by constructive notice from recording.⁴⁷ But if the instrument is a part of chattel paper, constructive notice from filing may impair his position.⁴⁸ Finally, the Code's statement of priorities between conflicting assignments of chattel paper fails to consider the question of the conflict arising when each assignee obtains one of the two documents constituting the chattel paper. What happens if one assignee files, and the other later obtains assignment and delivery of the negotiable note in good faith but not as a holder in due course?

Great simplification would result from assimilating chattel paper

42. See Kripke, *supra* note 3, at 596-7.

43. § 9-105(1)(c).

44. The word "instrument" is defined in § 9-105(1)(g) to include negotiable instruments.

45. § 9-302(3).

46. § 9-303(c).

47. §§ 3-304(6), 3-305.

48. § 9-308. Perhaps this result is avoided by the overriding effect of § 9-309, which provides that nothing in this Article shall limit the rights of a holder in due course of a negotiable instrument. Compare note 18 *supra*.

to negotiable instruments. Except that a lien on chattel paper can be perfected by filing, there is little affirmative distinction taken in the Code even at present between the legal consequences of negotiability and the legal consequences of "chattel paper" status. But the legal consequences of the proposed new status are incompletely stated, and unnecessary confusion is imported by *ad hoc* sets of rules for the *ad hoc* concept of a holder of chattel paper "without notice of a claim or defense, for value and in good faith."⁴⁹ This confusion would be eliminated if chattel paper were made negotiable, and time-tested concepts and rules like those of the "holder in due course" became applicable to it.⁵⁰

49. § 9-209(2). See notes 18 and 19 *supra*, and related text.

50. Compare § 3-705, which makes all of the rules concerning negotiable instruments, except those related to a holder in due course, applicable to paper which would be negotiable if it were payable to order or bearer.