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Bills and Notes—Negotiability by Contract Under the Uniform Commercial Code

Negotiability by contract is nothing more than a phrase used to denote an attempt to create the effects of negotiability on non-negotiable contracts. The usual provision found to impart such negotiability is an agreement in an otherwise non-negotiable contract that the obligor will not assert defenses of fraud, duress, mistake, lack of consideration, failure of consideration, or any other defense against a bona fide assignee of the contract.¹

There would seem to be no reason why the attributes of negotiability should not be added to otherwise non-negotiable contracts so long as the parties have clearly expressed their intention that the contract will have such an effect, and that such agreed stipulation is not contrary to any public policy or is in itself illegal.

The Existing Law of Negotiability by Contract

Insomuch as negotiability by contract has been adequately covered in previous articles on the law as it now stands,² it is not the purpose of this note to make an extensive study on the subject but rather to examine the effect of the new Commercial Code.

Negotiability by contract is an excellent way for bankers and businessmen to create the effect of negotiability as to instruments that do not conform to the requirements of negotiable instruments under the Negotiable Instruments Law. If there is a clear intent to waive defenses in behalf of a bona fide purchaser and if such an agreement is not contrary to public policy or illegal, there is no justification for declaring it invalid. A person may waive privileges conferred upon him by law unless the privilege is one in which public policy insists that it cannot be waived.³

Negotiability by contract becomes important in three particular instances. In the first place, where negotiable paper is supported by collateral and it is held in such jurisdiction that the collateral passes by assignment,⁴ then negotiability by contract becomes useful in reaching the effects of negotiability. If the collateral is held to pass by negotiation with the instrument,⁵ then negotiability by contract is not

¹ Beutel, *Negotiability by Contract*, 28 Ill. L. Rev. 205 (1933).

² Beutel, *Negotiability by Contract*, 28 Ill. L. Rev. 205 (1933); Note, *Elements of Negotiability by Contract*, 18 Kan. B.A.J. 136 (1949).

³ For a collection of authorities on the law of negotiability by contract see Beutel's, *Brannan Negotiable Instruments Law* 214-216 (7th ed. 1948); Beutel, *Negotiability by Contract*, 28 Ill. L. Rev. 205 (1933); Note, 18 Kan. B.A.J. 136 (1949).

⁴ See 152 A.L.R. 1222 (1944).

⁵ See note 4 *supra*.

needed since the negotiable instrument is deemed to impart the characteristics of negotiability to the collateral.

Secondly, if the instrument is in itself non-negotiable, then it is obvious that negotiability by contract is a very useful way to reach the attributes of negotiability on the secured collateral.

Thirdly, if the instrument is a chattel note, an instrument in which the note and collateral are a part of the same agreement, there is the added question as to whether the note is negotiable or non-negotiable. The better rule under the Negotiable Instruments Law would seem to be that chattel notes, otherwise meeting the requirements of the N.I.L., are fully negotiable.⁶ However, if the chattel note is held to be a non-negotiable instrument, then negotiability by contract becomes particularly helpful in reaching the effects of negotiability.

Code Provisions in General

Section 9-206(1) and (2) of the proposed Uniform Commercial Code,⁷ permit the enforcement of a contract where the buyer agrees not to assert any claims or defenses against an assignee of the contract, except where the goods dealt in are "consumer goods."⁸ When the agreement is made by a buyer of "consumer goods," it is unenforceable.

⁶ Titche, *Is the Negotiability of a Promissory Note Impaired by a Retention of Title Clause*, 7 *Tulane L. Rev.* 607 (1933).

⁷ U.C.C. § 9-206(1): "An agreement by a buyer of consumer goods as part of the contract for sale that he will not assert against an assignee any claim or defense arising out of the sale is not enforceable by any person. If such a buyer as part of one transaction signs both a negotiable instrument and a security agreement even a holder in due course of the negotiable instrument is subject to such claims or defenses if he seeks to enforce the security interest or by attaching or levying upon the goods in an action upon the instrument."

§ 9-206(2): "In all other cases an agreement by a buyer that he will not assert against an assignee any claim or defense which he may have against the seller is enforceable by an assignee who takes his assignment for value, in good faith and without notice of a claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the Article on Commercial Paper (Article 3). A buyer who as part of one transaction signs both a negotiable instrument and a security agreement makes such an agreement."

⁸ "Consumer goods" has a unique meaning in this Code. § 9-109: "Goods are (1) "consumer goods" if they are used or bought for use primarily for personal, family or household purposes; (2) "equipment" if they are used or bought for use primarily in business (including farming or a profession) or by a debtor who is a non-profit organization or a governmental subdivision or agency or if the goods are not included in the definitions of inventory, farm products or consumer goods; (3) "farm products" if they are crops or livestock used or produced in farming operations or if they are products of crops or livestock in their unmanufactured status (such as ginned cotton, wool-chip, maple syrup, milk and eggs) and if they are in the possession of a debtor from whose raising, fattening, grazing or other farming operations they derive or in which they are used. If goods are farm products they are neither equipment nor inventory; (4) "inventory" if they are held or are being prepared for sale or are to be furnished under a contract or service or if they are raw materials, work in process or materials used or consumed in a business. If goods are in-

It should be noted that under subsection (1) if a buyer of "consumer goods" signs both a negotiable instrument and a security agreement, then a holder in due course of the instrument is subject to the claims or defenses of the purchaser-maker if he attempts to enforce the security agreement, or attaches the goods in an action upon the instrument.

Moreover, under subsection (2) a buyer of goods, other than "consumer goods," who signs both a security agreement and a negotiable instrument, is considered as having made an agreement not to assert any claim or defense.

Subsection (1) which renders such agreements invalid by a purchaser of "consumer goods" is entirely new to the commercial law, making both the negotiability of paper and the enforceability of terms of assignable contracts depend upon the class of goods for which it was given. It is true such a rule of law may have its merits. Undoubtedly, the policy behind the provision is to protect the unfortunate purchaser, who is unable to obtain the required capital needed to make the purchase and is thereby forced by economic compulsion to sign a security agreement with a provision not to assert claims or defenses against an assignee of the contract. A purchaser may have no choice but to sign such an agreement if he needs the goods. The framers of the Code apparently felt that such a buyer needs the protection of the law, particularly when he may not know that the contract includes such an agreement or does not realize the effect it might have upon a defense he has against the seller.

Application and Effect of Code Provisions

At this point, it is worthy of note that the intricate problem of negotiability by contract is referred to only in this one short section. One might wonder if it is possible to cover such a complicated problem in such manner without creating numerous other problems and ambiguities.

If and when the Code is enacted, section 9-206 is likely to create numerous questions in the minds of the courts as to its application. In the first place, there is no indication in the Code as to the meaning of "claim or defense" in this section. Section 3-304 of the Code refers to "claim or defense" but it is not applicable under either subsection of section 9-206, since it applies to a defense as to negotiation. Section 9-206 is concerned with a "claim or defense arising out of the sale."

ventory they are neither farm products nor equipment." (A prospective purchaser of an instrument has no way of knowing whether the instrument is secured by "consumer goods," or by "equipment," "farm products," or an "inventory" of the same articles. It becomes important under this Code for a purchaser of an instrument to know his security.)

Under subsection (1) if a buyer of "consumer goods" signs both a negotiable instrument and security agreement as part of one transaction, even a holder in due course of the negotiable instrument is subject to any claim or defense that the purchaser-maker might have arising out of the sale. This is an entirely new limitation to the rights of a holder in due course of a negotiable instrument.⁹

Evidently a holder in due course can enforce the instrument, but will be subject to any claim or defense arising out of the sale if he attempts to attach the goods in an action upon the instrument, or tries to enforce the security interest by a proceeding under the agreement. What if the holder in due course does proceed against the goods or attempts to attach them in an action on the instrument—does the negotiable instrument become subject to the claim or defense and thereby rendered non-negotiable, or is it just a proceeding against the goods that is subject to the claim or defense?

This becomes particularly important because if it renders the instrument non-negotiable, then the holder is subject to defenses between the original parties,¹⁰ while a holder who sues on the instrument and levies on other goods of the purchaser-maker, if any, would not be subject to such claims or defenses.¹¹ So under this subsection the question as to whether a holder in due course can enforce his rights against the purchaser-maker may depend upon the manner in which he brings his action against the purchaser.¹²

Another question which arises is whether or not subsection (1) applies to a chattel note. Section 3-112(1)(b)¹³ would seem to indicate that chattel notes, otherwise meeting the requirements of Article 3, are fully negotiable. However, this section does not clear up the conflict that exists under the Negotiable Instruments Law, inasmuch as its provisions are substantially the same. Therefore the courts may still consider a chattel note as being conditional. Even though the better rule is that chattel notes may be fully negotiable, as has been pointed out,¹⁴ it is unfortunate that the drafters of the Code did not clear up this conflict once and for all.

⁹ See Negotiable Instruments Law § 57 "holder in due course holds the instrument free from any defect of title of prior parties, and free from defenses available to prior parties. . . ."

¹⁰ U.C.C. § 3-306.

¹¹ See note 7 (subsection 1) *supra*.

¹² Beutel, *The Proposed Uniform [?] Commercial Code Should Not Be Adopted*, 61 *Yale L.J.* 355-356 (1952).

¹³ U.C.C. § 3-112(1): "The negotiability of an instrument is not effected by (b) a statement that collateral has been given for the instrument or in case of default on the instrument the collateral may be sold."

¹⁴ See note 6 *supra*.

A chattel note would seem to be covered under subsection (1) since it is a "security agreement" as defined under Section 9-105(1)(h)¹⁵ of the Code, as well as "negotiable instrument" as defined under Section 3-104.¹⁶ It is inconceivable that the framers of the Code would not have had the chattel note in mind when Section 9-206 was drafted since a major portion of the transactions of this kind are handled through chattel notes.

Even though chattel notes, otherwise meeting the requirements of Article 3, may be made negotiable under Section 3-112(1)(b) of the Code, it is inescapable that they are not negotiable under section 9-206 if the maker of the instrument is a purchaser of "consumer goods." If a holder, even in due course, attempts to enforce the instrument, which by definition is a "security agreement,"¹⁷ he will be subject to "any claim or defense arising out of the sale."

As to the meaning of "claim or defense," it seems quite clear that this includes all personal claims and defenses that the purchaser-maker may have against the seller-payee. But apparently it is not intended to include defects of title or subsequent parties in all instances, or the fact that such a party was a finder of the contract or stole it. The defects of title would come within subsection (1) in a case where the seller procured the contract from the buyer by fraud, duress, or other unlawful means and, as such, an assignee could not enforce the agreement even if he took it for value, in good faith and without notice of a claim or defense. On the other hand, if an assignee procured the contract from the seller by unlawful means, or either found it or stole it, then the contract could be enforced since the alleged wrong would not come within the waiver provisions made void in subsection (1). Also supposing the original seller sold his business and the contract to another, who damaged the contract goods before delivery, then the waiver agreement would not be enforceable even if the purchaser of the business and contract sold the contract with the waiver agreement to a bona fide assignee because the claim would be one "arising out of the sale."

However, the holder, assuming that he meets the requirements of a holder in due course¹⁸ of a chattel note, otherwise negotiable, would

¹⁵ U.C.C. § 9-105(1) "In this Article unless the context otherwise requires: (h) 'Security agreement' means an agreement which creates or provides for a security interest."

¹⁶ U.C.C. § 3-104: "(1) Any writing to be a negotiable instrument within this Article must (a) be signed by the maker or drawer; and (b) contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this Article; and (c) payable on demand or at a definite time; and (d) be payable to order or to bearer."

¹⁷ See note 15 supra.

¹⁸ U.C.C. § 3-302.

not be subject to any claims or defenses of prior parties, other than those arising out of the sale, since section 9-206(1) specifically limits them to such claims or defenses. The holder might also cut off defects of title of other prior parties. If the chattel note is non-negotiable under Article 3, of course it remains so.

Therefore, a peculiar situation arises in that a holder in due course of a chattel note given for "consumer goods" will be subject to the defenses of the purchaser-maker while he will not be subject to the rights of other prior parties. Furthermore, the holder of the chattel note will not be able to enforce the note free from defenses as in the case of separate paper, since it is part of the same instrument as the security agreement. But a holder in due course of a negotiable instrument which is secured by a separate security agreement seemingly may enforce the note so long as he does not attach or levy on the "consumer goods."

Subsection (2) of Section 9-206 permits enforcement of an agreement by the buyer not to assert against an assignee "any claim or defense which he may have against the seller" where "consumer goods" are not involved. It is difficult to understand why the Code makes a distinction between "any claim or defense arising out of the sale" in subsection (1) and "any claim or defense which he [buyer] may have against the seller" in subsection (2)¹⁹ which is obviously a narrower concept. Conceivably the change would eliminate the case where an assignee of the seller's business injured the goods and transferred the note and agreement.²⁰ Subsection (2) makes it clear also that such sub-assignee may take the contract for value, in good faith, and without notice of any claim or defense, and be able to enforce the agreement.²¹

Subsection (2) also provides that "A buyer who as part of one transaction signs both a negotiable instrument and a security agreement makes such an agreement." So by this provision whenever a purchaser-maker, other than a purchaser of "consumer goods," signs both a negotiable instrument and a security agreement he is thereby deemed to have agreed not to assert claims or defenses against a holder in due course of the negotiable instrument and security agreement. Here there is a question as to whether this provision makes separate security agreements negotiable like the instrument or whether it only cuts off the defenses the purchaser might have against the seller.

¹⁹ U.C.C. § 9-206(2). Official Draft of 1952 was amended June 1, 1953 to read "any claim or defense which he [buyer] may have against the seller." It previously read, as does subsection (1), "any claim or defense arising out of the sale."

²⁰ Cf. *State National Bank of El Paso, Texas v. J. H. Cantrell*, 47 N.M. 389, 143 P.2d 592 (1943).

²¹ He is also subject to any claim or defense which would be good against a holder in due course under Article 3 of the Code.

The drafters literally have attempted to pass the attributes of negotiability on to the security agreement when it becomes part of a transaction where a negotiable instrument is given and "consumer goods" are not involved, but only to the extent of cutting off the defenses of the maker against the seller. In those jurisdictions where security agreements attached to negotiable instruments are said to be as negotiable as the instrument itself,²² this provision may have the effect of making the security agreement as negotiable as the negotiable paper to which it is attached.

However, it is doubtful whether the courts will give it such effect in those jurisdictions where a security agreement is held to pass by assignment²³ since the intent to make them negotiable is not clearly shown. Suppose an assignee does not rely upon such an agreement when the negotiable instrument is negotiated and the security agreement is assigned to him, and subsequently he proceeds against the security. Such assignee apparently should have no rights in the security where the purchaser-maker has a personal defense, unless we indulge in the obviously weak fiction that the holder in due course of the negotiable instrument, so secured has read, understood, and relied upon a promise which does not expressly appear in the security agreement.

If the paper involved is an otherwise negotiable chattel note, where the note and security agreement are part of the same paper it makes no difference whether the jurisdiction is one where the collateral passes by negotiation or assignment since section 9-309 of the Code specifically provides that such paper remains negotiable under section 3-112(1)(b).²⁴ However, if the chattel note is otherwise non-negotiable because it does not meet the requirements of Article 3 of the Code, but it contains a waiver of claims and defenses "against the seller," then such claims or defenses are deemed waived under subsection (2) of section 9-206. If the non-negotiable chattel note contains a waiver of claims and defenses other than those against the seller, then the common law of negotiability by contract becomes applicable since such a situation is not covered by the Code.

There is nothing to be gained by such unnecessary complication of an already intricate subject. When one considers that these and many other desirable results could have "all been accomplished by the simple words that 'security agreements attached to negotiable instruments are as negotiable as the instrument itself,' one sees that so

²² See 152 A.L.R. 1222 (1944); cf. Note, 29 Neb. L. Rev. 606 (1950).

²³ See note 22 *supra*.

²⁴ U.C.C. § 9-309: "Nothing in this Article except Section 9-206(1) limits the rights of a holder in due course of a negotiable instrument. . . ."

far as draftsmanship is concerned, this is truly the mad genius article of the 'Code'."²⁵

Conclusion

The major distinction between the law on negotiability by contract as it stands today and the law under section 9-206 of the Code is that under the Code a holder in due course of a negotiable instrument would be subject to a defense arising out of a sale involving "consumer goods" if he attempted to enforce the security agreement, while under the existing laws such claims or defenses could be waived unless it was one which has been declared by the legislature as incapable of being waived.

Moreover, if the instrument involved is an otherwise negotiable chattel note given for "consumer goods," under the Code a defense or claim arising out of the sale would be good against a holder in due course, but such a holder could enforce the chattel note against the claims and defenses of intervening parties. Under the existing law and subsection (2) or section 9-206, such a note would be enforceable against all parties.

Furthermore, if the chattel paper is otherwise non-negotiable and was not given for "consumer goods," and contains a waiver of defenses other than defenses against the seller, then one must revert to the law of negotiability by contract to determine its validity since the Code is silent in such a situation. But if such paper is for "farm products," "equipment," or "inventory"²⁶ and it contains a waiver of defenses against the seller, then the waiver agreement is enforceable under subsection (2) if the assignee took his assignment for value, in good faith, and without notice of a claim or defense.

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²⁵ Beutel, *The Proposed Uniform [?] Commercial Code Should Not Be Adopted*, 61 *Yale L.J.* 356 (1952).

²⁶ See note 8 *supra*.