

SEARCHING FOR NEGOTIABILITY IN PAYMENT AND CREDIT SYSTEMS

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I. NEGOTIABILITY: AN OUTMODED SYSTEM FOR ENHANCING LIQUIDITY	956
II. THE RARITY OF NEGOTIABLE INSTRUMENTS	962
A. Nonchecking Payment Systems	963
1. Credit Cards	964
2. Letters of Credit	965
B. Credit Systems	966
1. Consumer Credit Obligations	967
a. Notes for the Purchase of Goods and Services	967
b. Notes for the Purchase of a Home	968
(1) <i>Obstacles to Negotiability</i>	969
(2) <i>The Absence of Negotiability</i>	971
2. Private Commercial Obligations	973
a. Obstacles to Negotiability	973
b. The Absence of Negotiability	976
3. Publicly Traded Commercial Obligations	978
a. Bonds	979
b. Commercial Paper	983

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I am particularly grateful for the time that the following individuals diverted from their productive pursuits to my academic inquiries: Loc McNew (of American General Corporation), Rembert R. Owen, Jr., and Jocelyn Sears (of American General Realty Advisers, Inc.); Thomas Larson (of Anheuser-Busch Companies, Inc.); Robert L. Proost and Clayton Erickson (of A.G. Edwards & Sons, Inc.); William W. Barks and Linda Jenkins (of the Boatmen's National Bank of St. Louis); H. Eugene Bradford and Christopher S. Hillcoat (of Boatmen's Trust Company); Judith C. Rebholz and Harley M. Smith (of Emerson Electric Co.); Dale Granchalek (of the First National Bank of Chicago); Susan G. Holt (of Home Savings of America, FSB); Joe DeKunder (of NationsBank of Texas, N.A.); Frank Trotter (of Mark Twain Bancshares); Daniel A. Naert (of Smith Barney, Inc.); Susan E.D. Neuberger (of The Travelers Insurance Company); and Clifford H. Stein (of Windels, Marx, Davies & Ives).

III. THE IRRELEVANCE OF NEGOTIABILITY TO THE MODERN PAYMENT SYSTEM	985
A. Reliance on the Physical Object	986
B. Signatures as a Device for Transferring Title and Accepting Liability ..	990
1. Indorsements	991
2. Drawers' Signatures	994
C. Rights of a Holder in Due Course	998
IV. PAYMENT SYSTEMS OF THE FUTURE: THE KING IS DEAD, LONG LIVE THE KING!	1004

The casual observer of the legal academy would assume that negotiability is a legal principle of foundational importance to our nation's payment and credit systems. All of the obvious indicators support that assumption. Among other things, the 1980s witnessed a major effort by the American Law Institute and the National Conference of Commissioners on Uniform State Laws to update and revise the relevant provisions of the Uniform Commercial Code.¹ Similarly, negotiability continues to occupy a safe position in law school curricula, as prominent academics at our most elite schools continue to write casebooks focusing on negotiability. Most recently, for example, Clayton Gillette, Alan Schwartz, and Bob Scott have published a prominent new casebook on *Payment Systems and Credit Instruments*, which presents a course organized around a detailed discussion of negotiability and its consequences.² And Gillette, Schwartz, and Scott are not outliers. They are working in the heartland of academic attention: This decade has produced several other major casebooks for courses with a similar focus on the principles of negotiability,³ as well as a number of

1. The revised version of Article 3 of the U.C.C. ("Negotiable Instruments") has gained broad acceptance. By early 1996, 42 states and the District of Columbia had adopted it. UNIF. COMMERCIAL CODE, 2 U.L.A. 1-2 (Supp. 1996).

2. CLAYTON P. GILLETTE ET AL., *PAYMENT SYSTEMS AND CREDIT INSTRUMENTS* (1996). The authors follow a brief introductory chapter with three lengthy chapters covering "negotiability and its consequences," "the contract liability of parties to a negotiable instrument," and "holder in due course." *Id.* chs. 2-4, at 37-299. The centrality of negotiability as an organizing principle is evident from their decision to incorporate into their chapter on holders in due course discussions of plainly nonnegotiable systems such as credit cards. *See id.* at 288-99.

3. *See, e.g.*, E. ALLAN FARNSWORTH, *CASES AND MATERIALS ON NEGOTIABLE INSTRUMENTS* (4th ed. 1993); ROBERT L. JORDAN & WILLIAM D. WARREN, *NEGOTIABLE INSTRUMENTS AND LETTERS OF CREDIT* (1992); STEVE H. NICKLES ET AL., *MODERN COMMERCIAL PAPER: THE NEW LAW OF NEGOTIABLE INSTRUMENTS (AND RELATED COMMERCIAL PAPER)* (1994); DOUGLAS J. WHALEY, *PROBLEMS AND MATERIALS ON PAYMENT LAW* (4th ed. 1995) (starting with detailed chapters on negotiability, negotiation, holders in due course, and liability on instruments). For exceptions to that approach, see EDWARD L. RUBIN & ROBERT COOTER, *THE PAYMENT SYSTEM: CASES, MATERIALS, AND ISSUES* (1989) (law-and-economics perspective that omits any extended analysis of negotiability). *See also* LYNN M. LOPUCKI, ELIZABETH WARREN, DANIEL L. KEATING & RONALD J. MANN, *COMMERCIAL*

treatises and related works that offer detailed doctrinal analyses of negotiability.⁴

But it would be wrong to accept those indicators. At least in the payment and credit contexts (the subjects on which academics have focused their analysis of negotiability), negotiability is an outmoded and decaying relic. Moreover, even in the checking system—the most significant context where negotiable instruments survive—legal and practical developments have rendered principles of negotiability all but irrelevant to the operation of the system. To be sure, I am not the first to bear witness to the declining role of negotiability. A few previous scholars, most notably Jim Rogers, have noticed some aspects of the decline in the doctrinal significance of the rules of negotiability.⁵ Others have speculated as to the limited use of negotiable instruments in modern commerce.⁶ But those limited efforts have done little or nothing to dispel the general impression that negotiability remains significant. Certainly, negotiability must be important in some context or so many people would not be devoting so much time to industrious examination and explanation of the system. Right?

No. That impression is wrong, in a most fundamental way. In an effort to lay that impression finally to rest, this Article moves beyond the existing literature in two ways. First, by looking at payment and credit systems from a broad, functional perspective, I can illustrate how underlying systemic forces (predominantly technological, but sometimes law-

TRANSACTIONS: A SYSTEMS APPROACH (forthcoming 1997) (systems perspective that relegates negotiability to a brief discussion at the close of the payment materials, which emphasizes the practical insignificance of the topic).

4. See, e.g., FRED H. MILLER & ALVIN C. HARRELL, *THE LAW OF MODERN PAYMENT SYSTEMS AND NOTES* (2d ed. 1992) (a ten-chapter treatise with seven chapters on negotiable instruments, two chapters on checks, and one chapter on payment systems other than negotiable instruments); STEVE H. NICKLES, *NEGOTIABLE INSTRUMENTS AND OTHER RELATED COMMERCIAL PAPER* (2d ed. 1993).

5. For Rogers' cogent analysis of the tension between negotiability and the doctrinal legal rules that govern the current checking system, see James Steven Rogers, *The Irrelevance of Negotiable Instruments Concepts in the Law of the Check-Based Payment System*, 65 *TEX. L. REV.* 929 (1987) [hereinafter Rogers, *The Irrelevance of Negotiable Instruments Concepts*]. For similar scholarship in the area of investment securities, see Charles W. Mooney, Jr., *Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries*, 12 *CARDOZO L. REV.* 305 (1990); James Steven Rogers, *An Essay on Horseless Carriages and Paperless Negotiable Instruments: Some Lessons from the Article 8 Revision*, 31 *IDAHO L. REV.* 689 (1995) [hereinafter Rogers, *Horseless Carriages*]; James Steven Rogers, *Negotiability, Property, and Identity*, 12 *CARDOZO L. REV.* 471 (1990). I also should mention the somewhat darker perspective offered by Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 *CREIGHTON L. REV.* 441, 446-58 (1979), which argues not that negotiable instruments law disappeared because of changes in economic conditions, but instead that bankers called it into service to further their personal interests in transactions to which negotiable instruments law never should have been applied.

6. See, e.g., RUBIN & COOTER, *supra* note 3, at 6-7.

related) have undermined the usefulness of negotiability in all of its manifestations. Like all legal institutions, negotiability was called into existence to respond to problems of a particular time and place. The complete transformation of the technology of financial activity that has taken place during the closing decades of this century has created a transactional setting that bears no significant resemblance to the pre-Industrial Revolution world in which negotiability first came to be used in payment systems. Accordingly, it should come as no surprise that it is hard to discern a useful role for negotiability in the financial world of the twenty-first century.

Secondly, and more importantly, I present several different categories of empirical evidence designed to demonstrate that my general view of the underlying technological forces is reflected in what actually has happened in our nation's financial markets. The evidence includes the results of a series of more than a dozen interviews with individuals experienced in various kinds of financial transactions.⁷ I also collected actual documents used in a variety of payment and credit transactions, enabling me to present evidence regarding the actual usage of negotiability in those contexts.⁸ Similarly, to get a firsthand look at the practicalities of check processing, I visited the check-collection facilities of two major banks located in different Federal Reserve districts.⁹ Finally, in order to evaluate the accuracy of my impressions about the irrelevance of holder-in-due-course status to the check-collection process, I conducted a survey of reported cases decided since 1985 that mention holder-in-due-course status in the checking context.

This Article presents my analysis in four steps. I start in Part I with a general discussion of negotiability that focuses on two major points. The first is an explanation of the basic premise of negotiability: a system that fosters exclusive reliance on a document can enhance the liquidity of the assets covered by that document. The second is a discussion of why that premise is obsolete: designed for transactions in a horse-and-buggy economy, negotiability's focus on physical documents imposes a significant burden on transactions in the current age of electronic information processing.

7. To enhance the accuracy and verifiability of my records of the interviews, I recorded and transcribed the interviews whenever practicable. In most of the cases in which that was not practicable, I took contemporaneous handwritten or typed notes of the interviews, from which I promptly produced a typescript record of the interview. Copies of those transcripts and records are available upon request.

8. Copies of any of the documents cited in this Article are available upon request.

9. The two banks were The Boatmen's National Bank of St. Louis and The First National Bank of Chicago.

Part II turns from the abstract analysis of Part I to present empirical evidence about actual current financial practices. The sections of Part II survey the various types of payment and credit systems used most commonly in our economy. My analysis includes the major nonchecking payment systems in which documents reflect the payment obligation (credit cards and letters of credit), as well as the most important types of credit obligations in our economy (consumer promissory notes used to purchase personal property or homes, private commercial obligations, and long-term and short-term publicly traded commercial obligations). Relying on the interviews and sample documents that I have collected, I can show that negotiability is rarely used in any of those systems.¹⁰

Analysis of the checking system is reserved for Part III. Based on my interviews and site visits, Part III shows how the exigencies of commerce have rendered the basic concepts of negotiability irrelevant to the current check-processing system. Although most previous scholars have focused on doctrinal niceties to show how the applicable legal rules can be explained without reference to traditional rules of negotiability, my focus on the practicalities of the processing system allows me to present a much broader critique. The irrelevance of negotiability is much more complete than previous scholars suggest because its cause is more fundamental than a simple revision of the applicable legal rules. The pressure of technological change has rendered the most basic features of the negotiable instrument a positive hindrance to any modern payment system. The legal rules accommodating the passage of negotiability are mere patchwork details that reflect a situation brought about by developments external to the law.

Finally, Part IV summarizes the implications of my analysis for the ongoing development of payment systems. The time has passed when it is sensible to complete payment transactions by transporting physical objects and examining them to determine the nature of the signatures that appear on them. To function effectively, a modern payment system must follow

10. I do not assert that negotiability is *never* used in *any* system. Indeed, it is clear that negotiability still plays some role in transactions that use documents of title. See, e.g., John F. Dolan, *Changing Commercial Practices and the Uniform Commercial Code*, 26 LOY. L.A. L. REV. 579, 589-92 (1993). Moreover, even in the context of payment and credit systems (the subject of this Article), my research has been limited to a survey of the major domestic systems and has focused on dispelling the notion that negotiability has any significance to the overall structure of our financial system. Accordingly, even though it is likely that negotiability persists in some range of transactions that I do not discuss, I do not think that that possibility establishes a significant role for negotiability. The fact that the transactions in which it persists are so unusual underscores my basic point: technological developments have marginalized a legal institution that once was central to financial transactions.

the lead already taken by most of the highly liquid credit systems. It must abandon all of the features that made negotiability useful in the pre-Industrial Revolution economies in which it developed. The demands of a modern economy call for payment systems that focus on data instead of documents, and that provide for contemporaneous approvals by the ultimate payor rather than the cumbersome and time-consuming clearing process that characterizes transactions using checks and other negotiable instruments.

Thus, the decline and fall of negotiability does not mean the end of the law of payment systems. It calls for new law-related systems designed to defuse the issues that arise in new data-based payment systems. To accomplish that task, the law must abandon its fixation with the paradigm of negotiability and focus instead on the practical realities of the contexts in which new payment systems are used.

I. NEGOTIABILITY: AN OUTMODED SYSTEM FOR ENHANCING LIQUIDITY

To say anything useful about negotiability, it is necessary to start by offering a general explanation of what negotiability is and why anybody would want to use it. The easiest way to do that is to work from an idealized model transaction that uses a negotiable instrument to make payment.¹¹ Because my account is designed to illustrate how the benefits of negotiability could make it a useful device in payment and credit transactions,¹² I start with a transaction in which negotiability in fact would be useful, modeled on the seventeenth- and eighteenth-century transactions in which negotiable instruments first came to play a significant role in payment transactions.¹³

Thus, posit a clothier ("Clothier") attempting to purchase wool from a wool merchant ("Merchant"). Clothier's principal source of income is from

11. I compensate for the simplification and abstraction of the discussion in this Part with the concrete empirical evidence about current usage that I present in Parts II and III of this Article.

12. Although it is feasible to use negotiability as a system to enhance the liquidity of many different kinds of assets, this Article focuses on the use of negotiability in connection with payment and credit systems, the area in which legal academics traditionally have shown the most interest. Thus, this Article does not consider the use of negotiability under U.C.C. Article 7 to cover bills of lading, warehouse receipts, or other documents of title.

13. See generally JAMES STEVEN ROGERS, *THE EARLY HISTORY OF THE LAW OF BILLS AND NOTES: A STUDY OF THE ORIGINS OF ANGLO-AMERICAN COMMERCIAL LAW* 94-124 (1995) (historical discussion of the process by which bills of exchange came to be used as payment and credit devices rather than as devices for transferring funds from one location to another).

the sale of finished clothes to a factor ("Factor") that is in the business of buying finished clothes and reselling them to retailers. In an economy in which cash was the sole nonbarter payment medium, Clothier probably would obtain cash by selling finished clothes to Factor, and then would use that cash to pay Merchant for the wool. It would be considerably more convenient, however (particularly in economies that are short of cash),¹⁴ if Clothier could pay Merchant with a bill of exchange (or some other form of instrument); with a documentary noncash payment, Clothier could pay Merchant without first obtaining cash from Factor. In the typical transaction using a negotiable instrument, Clothier would pay Merchant with a "draft" drawn on Factor. The draft would represent funds that Factor already owes, or in the future might owe, to Clothier for clothes purchased, or to be purchased, from Clothier.¹⁵ Merchant, in turn, could obtain cash by seeking payment from Factor or by selling the draft to a third party. Alternatively, Merchant could use the draft to pay for other goods and services it purchased from a third party.¹⁶

From an economic perspective, the biggest problem with that arrangement is the difficulty in which it places Merchant: how can Merchant be sure that Factor or anybody else will be willing to give Merchant money or other valuable goods and services in exchange for the draft? Absent some strong reason to expect that the draft will be valuable, Merchant will be unlikely to accept the draft without insisting upon a substantial premium over the price at which it would sell goods for cash. The rules of negotiability respond directly to that problem by making it easier for Merchant to sell the draft—by enhancing its liquidity.

The benefits of enhanced liquidity are obvious. At least in commercial contexts, an asset that is easy to sell normally is more valuable than an otherwise similar asset that is hard to sell.¹⁷ That is true both because of

14. See *id.* at 109 (describing the development of bills as a payment medium in "a community [that] is unlikely to have a sufficient volume of specie or specie substitutes to settle all of its transactions"); Gilmore, *supra* note 5, at 447 (attributing development of negotiable instruments law in part to the "chronically . . . short supply" of metallic currency).

15. In modern parlance, a draft is an instrument signed by one party (Clothier in this case) directing another party (Factor in this case) to pay money to yet another party (Merchant in this case). See U.C.C. § 3-104(e) (1991) (defining "draft" as an instrument that contains an "order"); *id.* § 3-103(a)(6) (defining "order").

16. See ROGERS, *supra* note 13, at 111-12 (describing a transaction of this type as common in England in the 17th and 18th centuries).

17. See CARL MENDER, *PRINCIPLES OF ECONOMICS* 248-56 (1950) (discussing factors affecting the "marketability" of assets); GERALD P. O'DRISCOLL, JR. & MARIO J. RIZZO, *THE ECONOMICS OF TIME AND IGNORANCE* 193 (1996) (explaining why "entrepreneur-traders will prefer holding their wealth in more marketable commodities").

the enhanced flexibility available to the owner of a readily salable asset,¹⁸ and because of the increased price that the owner is likely to obtain upon the sale of an asset that is highly liquid. Given two assets with the same expected economic productivity, the more liquid asset usually can be sold for more than the less liquid one.¹⁹ Thus, all other things being equal, rules that enhance the liquidity of negotiable instruments should enhance the relative attractiveness, and thus the relative value, of negotiable payment instruments.

The general tactic by which negotiability responds to the problem of illiquidity is to centralize all rights to the underlying asset (a right of payment in this context) in a single physical document. The classic terminology describes the obligation to pay as "merged" in the document.²⁰ That approach enhances liquidity by reducing the costs a prospective purchaser incurs in acquiring two related types of information about the asset: information about claims that undermine the value of the payment obligation that the instrument represents, and information about title to the payment obligation.

To the modern observer, the most salient enhancement of liquidity is associated with holder-in-due-course status.²¹ The value of holder-in-due-course status is that it reduces the incentive for the purchaser to inquire about claims that might undermine the value of the asset by the forceful mechanism of cutting off many of those claims. Thus, a party that follows the rules of the negotiability system when it acquires a negotiable instru-

18. See MENDER, *supra* note 17, at 249 ("[T]he commodity whose market is poorly organized can be brought to its final destination only with economic sacrifices, and in some cases not at all."); O'DRISCOLL & RIZZO, *supra* note 17, at 194 ("Liquidity provides economic agents with flexibility, flexibility that lowers cost.").

19. For an illustrative example, see Tania Padgett, *Mark Twain Stock Jumps as Bank Unveils Plan for Listing on N.Y. Exchange*, AM. BANKER, Aug. 7, 1996, at 24, which notes that the stock of Mark Twain Bancshares rose more than 2% on a day when Standard & Poors' bank index fell by 0.02%, and attributes the increased price to investors' anticipation of increased liquidity based upon an anticipated shift of trading in the stock from NASDAQ to the New York Stock Exchange.

20. As Grant Gilmore put it,

[T]he idea which was basic to the structure was the idea that the piece of paper on which the bill was written or printed should be treated as if it—the piece of paper—was itself the claim or debt which it evidenced. This idea came to be known as the doctrine of merger—the debt was merged in the instrument.

Gilmore, *supra* note 5, at 449.

21. As Jim Rogers has shown, the importance of holder-in-due-course status is a relatively recent development. See ROGERS, *supra* note 13, at 189–93.

ment takes free of most types of defenses to payment, even if those defenses would have been valid against the seller of the instrument.²²

To use my model transaction as an example, suppose that Clothier purchased wool on credit and discovered before paying for it that the wool Merchant had sold failed to conform to the agreement between Merchant and Clothier. Under ordinary contract principles, a sufficiently serious defect would entitle Clothier to withhold all or some portion of the remaining price.²³ But if Clothier had given Merchant a negotiable draft for the purchase price, and Merchant had negotiated that draft to a third party that became a holder in due course (Bank), Clothier would be obligated to pay Bank even if Merchant itself never could have forced Clothier to pay for the wool.²⁴

However unfair that rule might seem to Clothier, it can lower Clothier's overall costs if it lowers the transaction costs that Merchant must incur in obtaining cash or something else of value in exchange for Clothier's obligation to pay. By giving Bank immunity from most of the plausible defenses to payment that Clothier might assert, holder-in-due-course status can obviate the need for Bank to inquire about the existence of those defenses. Thus, the holder-in-due-course rules enhance the liquidity of obligations by enhancing the ability of a purchaser to rely solely on the document in evaluating the nature of the obligation. If the document is in proper form and the seller transfers it properly, the purchaser takes the instrument free of all but a few specialized defenses that Clothier might interpose.²⁵ If that benefit makes the instrument more valuable to Bank, then it makes the instrument more valuable to Merchant, and thus should make Merchant more willing to accept the instrument as payment from Clothier.

22. For the rights of a "holder in due course" under Article 3, see U.C.C. §§ 3-305, 3-306 (1991).

23. See *id.* § 2-717 (1995).

24. See *id.* § 3-305(a)(2), (b) (1991) (stating that a holder in due course takes free of "a defense of the obligor . . . that would be available if the person entitled to enforce the instrument were enforcing a right to payment under a simple contract").

25. The remaining defenses are the so-called "real" defenses set out in U.C.C. section 3-305(a)(1). See *id.* § 3-305(b) ("The right of a holder in due course to enforce the obligation of a party to pay the instrument is subject to defenses of the obligor stated in [U.C.C. section 3-305](a)(1)."). None of those real defenses—infancy, duress, lack of capacity, illegality of the transaction, fraud in fact (execution of the instrument without an opportunity to understand it), and insolvency—present claims likely to be raised by a party with any hope of continuing to engage in commercial transactions.

The second major benefit of negotiability is a simplification of title issues, which can lower the costs that a purchaser expends in investigating title. When a document is negotiable, substantially all of the information necessary to evaluate title to the asset appears on the face of the document in its original terms or in indorsements subsequently placed on the document. At least in the absence of forgery, a person who wishes to purchase a negotiable document can verify that the purported seller can convey good title without any inquiry other than the examination of the document. If the document is in bearer form,²⁶ then mere possession is enough to obtain title.²⁷ The inquiry is more complicated if the document is in order form, but even then the buyer need only examine the document (including any indorsements that appear on the document) to determine whether the seller is the person to whose order the document runs. If so, the seller can convey title to the purchaser by the simple acts of indorsement and delivery of the document.²⁸

Centralization of title information on the document distinguishes assets covered by negotiable documents from other kinds of assets. When a person purchases goods, for example, he ordinarily acquires only the "title which his transferor had."²⁹ Thus, a party that purchases goods without verifying the source of the seller's title must accept the risk that the seller in fact does not have good title to convey. Evaluating that risk may be more or less burdensome depending on particular circumstances, but in many cases it will be much harder for a purchaser to evaluate its seller's title to goods than it would be if the asset in question were in negotiable form. It is much easier to read the face of a check to verify that the named payee is the individual at the front of the teller line than it is to obtain and verify an invoice through which a prospective seller purchased goods that somebody wishes to buy. Similarly, the purchaser of real estate cannot satisfy itself that its seller has title solely by determining that the seller has unchallenged possession of the land. Instead, the purchaser ordinarily must review public real-estate records in order to determine whether those re-

26. To determine whether a document is in bearer form, a prospective purchaser need only compare the terms of the document and its indorsements to the statutory requirements for bearer and order form. See *id.* § 3-109 (rules for making instruments payable to bearer and to order); *id.* § 3-205(a), (b) (rules for changing the form of paper by indorsement).

27. *Id.*

28. *Id.* § 1-201(20) (1996); *id.* § 3-205(a) (1991).

29. *Id.* § 2-403(1) (1995).

ords reveal any competing claims to the land.³⁰ By obviating the need for such inquiries, negotiability can reduce the search costs that a purchaser incurs to determine whether a purported seller in fact owns the asset that the purchaser wishes to acquire.

The abstract theoretical benefits of negotiability, however, are only one side of the story. The core mechanism by which negotiability offers those benefits—streamlining investigation and transfer to focus on the physical object that represents the underlying obligation—carries with it the fatal flaw that has driven negotiability's declining relevance. Negotiability arose in an economy of payment transactions among parties well known to all. In transactions occurring during that era, both Merchant and Bank should have been familiar not only with Clothier's general financial responsibility and signature,³¹ but also with Factor's financial responsibility and its relationship with Clothier. In that context, negotiability provided a significant benefit by enabling parties like Merchant and Bank reliably to streamline a sale transaction into a simple transfer of possession of a document.³²

But times have changed and with them the size and interrelations of our economy, as well as the state of information technology. In this modern age of multiple and rapid transactions in a national and perhaps global market, negotiability's emphasis on the physical document is a hindrance rather than a benefit. In many transactions, transporting a document from buyer to seller is no longer a simple matter of pushing a piece of paper across a table. Furthermore, even if the buyer and the seller meet face-to-face, the financial institution on whom the instrument is drawn commonly is located at a distance from one or both of the parties to the underlying transaction. The frequent need to transport the document thousands of

30. See, e.g., 1 GRANT S. NELSON & DALE A. WHITMAN, *CASES AND MATERIALS ON REAL ESTATE TRANSFER, FINANCE, AND DEVELOPMENT* 213-47 (4th ed. 1992) (discussing effects of real-estate recording statutes on title to land).

31. See, e.g., Dolan, *supra* note 10, at 580 (stating that "knowledge [of other merchant's signatures] was essential to the circulation of the payments system's paper").

32. For a similar account in a related context, see Stuart Banner, "Not a Fancy Man on the Board": American Securities Regulation, 1800-1860, at 15-16 (unpublished manuscript, on file with author) (explaining how the desire to facilitate the transfer of stock certificates motivated American courts in the early decades of the nineteenth century to adopt negotiability-like rules that permitted valid transfers of stock solely by delivery of the instrument, even if the parties failed to comply with corporate charters that required stock transfers to be noted on the books of the issuer).

miles is a much more common problem now than it was in the era when our country was founded.

Similarly, with the rise of computers, it is no longer so easy to see the benefit of rules that limit the purchaser's inquiry to an examination of a physical document. In many contexts, a purchaser could examine electronically stored records much more expeditiously than it could examine the physical signatures and form of an individual document. Furthermore, the dramatic increase in the number of transactions and transacting parties makes it impractical for a party to obtain the information it needs simply from the examination of a signature. Modern technology offers mechanisms for confirming payment authorizations that are much more effective than the physical signature that is central to the negotiability system.

In sum, the historical conditions that called negotiability into service to enhance the liquidity of payment obligations have passed from our economy. In the absence of those conditions, the document- and signature-based concepts of negotiability no longer provide significant benefits to the parties that choose to use them. Accordingly, it should be no surprise to find, as Parts II and III demonstrate, that modern financial systems relegate negotiability to a position of small and continually decreasing significance.

II. THE RARITY OF NEGOTIABLE INSTRUMENTS

One of the most telling but least acknowledged facts about negotiability is the limited extent to which it still appears in payment and credit transactions. To realize just how far negotiability has fallen, one must recognize how rarely it is used. Putting checks aside for the moment,³³ none of the major payment or credit systems³⁴ in our economy appears commonly in a form that satisfies the technical requirements of negotiability. The reasons for the limited impact of negotiability differ from area to area. In some cases, direct and indirect legal restrictions reflect legislative and administrative decisions to reject negotiability for policy reasons. In most areas, however, the decline of negotiability has been driven by technological change. Thus, technological advances commonly leave negotiability with such an insignificant value to the modern transaction that the parties simply do not care whether the obligations are put in

33. Part III discusses the irrelevance of negotiability concepts to the operation of the checking system.

34. For a brief explanation of the distinction I draw between payment systems and credit systems, see LOPUCKI, WARREN, KEATING & MANN, *supra* note 3 (manuscript assign. 15, at 1-2, on file with author); *id.* (manuscript assign. 23, at 1-2, on file with author).

negotiable form. Moreover, in at least one area (commercial paper), technological developments have gone so far as to render negotiability so positively harmful that the transactions do not use instruments of negotiable form even though the positive law formally requires negotiability.

I start in Subpart A with the major nonchecking payment systems. Subpart B then considers the main forms of credit obligations: consumer promissory notes, private commercial obligations, and publicly traded commercial obligations.

A. Nonchecking Payment Systems

Aside from the obvious example of checking, few of the payment systems in common usage in this country use documents in any significant way. For example, there is no place for paper in the trillion-dollar-a-day system for wire transfers,³⁵ and no significant place for paper in the rapidly growing³⁶ debit-card system.³⁷ The paperless nature of developing payment systems involving stored-value cards and electronic money will leave negotiability similarly irrelevant to those systems.³⁸ But negotiability also is notably absent from the two common nonchecking payment systems that involve written commitments to pay: credit cards and letters of credit. Although the absence of negotiability from those systems is not surprising, it is important to understand that the absence of negotiability from those systems is not fortuitous. Those systems refrain from using negotiability because negotiability is directly incompatible with important aspects of those systems as they currently operate. Thus, a discussion of those systems

35. For statistics on the volume of wire transfers in this country, see Federal Reserve Bank Services, 60 Fed. Reg. 111, 112 (1995) (reporting an average daily volume in 1993 of about \$1.8 trillion of transfers made over Fedwire and the Clearing House Interbank Payments System (CHIPS)). For a general discussion of the wire-transfer system, see LOPUCKI, WARREN, KEATING & MANN, *supra* note 3 (manuscript assign. 20, on file with author).

36. Industry sources estimate that the number of point-of-sale debit-card terminals has grown from just 17,000 in 1986 to about 130,000 by 1993. See 1 THE BANKERS ROUNDTABLE, BANKING'S ROLE IN TOMORROW'S PAYMENT SYSTEM 51 (1994) (reporting statistics). In 1993, consumers used those terminals to conduct about 400 million point-of-sale transactions. See 2 *id.* at 97 (reporting statistics).

37. Although the Electronic Fund Transfer Act requires the institution to provide the consumer "written documentation" of each debit-card transfer, Consumer Credit Protection Act § 906(a), 15 U.S.C. § 1693d(a) (1994), the consumer ordinarily does not sign the slip. The slip is simply a record of a previously authorized transaction, which has no role in demonstrating the consumer's obligation. For a general discussion of the debit-card system, see LOPUCKI, WARREN, KEATING & MANN, *supra* note 3 (manuscript assign. 18, on file with author).

38. For a general discussion of those systems, see LOPUCKI, WARREN, KEATING & MANN, *supra* note 3 (manuscript assign. 22, on file with author).

provides a good introduction to the contextual reasons that limit the significance of negotiability in modern financial transactions.

1. Credit Cards

Credit cards are a good place to start because they are one of the most successful and common payment systems used by consumers, and because negotiability obviously has no relevance whatsoever to the credit-card system.³⁹ Although consumers ordinarily do sign credit-card slips to reflect the payment obligation when they engage in face-to-face credit-card transactions, the slip in its customary form plainly is not a negotiable instrument. Most obviously, the slip fails to satisfy the requirement that it be payable to "bearer" or "order."⁴⁰

Of course, if it were just a matter of form in the wording of the slip, the credit-card industry could obtain the benefits of negotiability by redesigning credit-card slips to put them into negotiable form. Even if the credit-card industry did so, however, federal law would prevent the institutions that purchase the slips from merchants from gaining the practical benefits of holder-in-due-course status. Specifically, the Truth in Lending Act generally requires that consumers retain defenses to payment obligations that they incur with credit cards.⁴¹

This rule reflects a firm rejection of one of the basic policies of negotiability: the idea that enhancing the liquidity of a payment instrument (in this case, the credit-card slip) provides more benefits to the parties than any harm that the payor suffers through losing the ability to assert defenses against subsequent holders of the instrument.⁴² In this area, the Truth in

39. Although the credit-card transaction involves an at least transient extension of credit to the purchaser, the fact that it provides substantially contemporaneous payment to the payee leads me to treat the credit-card system as a payment system rather than a credit system.

40. See U.C.C. § 3-104(a)(1) (1991) (negotiable instruments must be "payable to bearer or to order"); see also *id.* § 3-109 (explaining the bearer-or-order requirement).

41. Truth in Lending Act § 170, 15 U.S.C. § 1666i (1994) (allowing consumers to assert against the banks issuing their credit cards all defenses to payment that would be valid in suits on the underlying transactions); see 12 C.F.R. § 226.12(c) (1996) (regulatory explication of that rule). Although the rule is subject to a number of exceptions that might limit its effectiveness in current practice, see LOPUCKI, WARREN, KEATING & MANN, *supra* note 3 (manuscript assign. 19, at 7-10, on file with author), it would prevent the industry from making holder-in-due-course status the norm.

42. The credit-card system as it currently operates also rejects the document-centered focus of negotiability, for credit-card transactions increasingly are processed through electronic transmission of the transaction information rather than through physical transportation of the credit-card slip itself. See Jeremy Quittner, *Processing Paper on Wane, But Still Lucrative*, AM. BANKER,

Lending Act reflects the contrary view: any adverse impact on the availability of credit-card lending to consumers will be counterbalanced by the advantage that consumers gain from the right to challenge their obligation to pay for goods purchased by credit card. The continuing healthy level of credit-card transactions (1995 saw 280 million active credit-card accounts, which were used to purchase \$600 billion worth of goods and services⁴³) suggests that the rule has not unduly constricted merchants' willingness to accept credit cards.⁴⁴ At bottom, it is unlikely that the absence of holder-in-due-course status and the other benefits of negotiability has held back the credit-card industry significantly.

2. Letters of Credit

A glance at a typical letter of credit evidences a similar absence of negotiability. As with the credit-card slip, the most definitive technical defect is the absence of "bearer" or "order" language in a letter of credit.⁴⁵ As with credit cards, however, the reason for the absence of negotiability is more fundamental than some technical form of words. The most basic difficulty⁴⁶ is that a letter of credit is not intended to be an unconditional obligation of the bank that issues it. On the contrary, a letter of credit is by its nature a conditional obligation—the bank is obligated to pay only if the beneficiary or some permitted assignee of the beneficiary submits a draft

Nov. 1, 1996, at 10 (estimating that only five percent of 1996 domestic credit-card transactions would use paper-based processing).

43. *Market Shares*, NILSON REP., Apr. 1996, at 4.

44. On that point, I note that general purpose credit-card purchases grew by 18% in 1995 alone. *Id.* For a general discussion of the rise of the credit card, see Elizabeth Warren, *Mortgaging the Future: The Consumer Debt Binge of the 1980s*, at ch. 2 (Aug. 31, 1994) (unpublished manuscript, on file with author).

45. For a readily available and authoritative form, see INTERNATIONAL CHAMBER OF COMMERCE, ICC GUIDE TO DOCUMENTARY CREDIT OPERATIONS 47 (ICC Publication No. 515) (1994) [hereinafter ICC PUBL. NO. 515] (reprinting a standard form for an irrevocable confirmed documentary letter of credit). In connection with this Article, I also have reviewed the forms used by the Boatmen's National Bank of St. Louis and NationsBank of Texas, N.A. Those forms are similar in all relevant respects to the ICC form cited above. Copies of those forms are available on request.

46. There are other reasons that a negotiable letter of credit would be unpalatable to an issuing bank. The most obvious is the reluctance of banks to accept free transfers of the letters of credit that they issue. See James J. White, *The Influence of International Practice on the Revision of Article 5 of the U.C.C.*, 16 NW. J. INT'L L. & BUS. 189, 202-03 (1995) (discussing the reluctance of issuers to permit free assignment of letters of credit). The problem discussed in the text, however, seems to me to be the most fundamental and thus most generally illustrative of the difficulties of accommodating negotiability to the broad variety of payment transactions.

that complies with the conditions stated in the letter of credit.⁴⁷ Because the rules for negotiability are not sufficiently flexible to cover conditional obligations,⁴⁸ negotiability has no significant role to play in the domestic letter-of-credit system.⁴⁹

B. Credit Systems

When we turn from transactions in which payment is made contemporaneously with the underlying transaction to transactions in which payment is deferred through the extension of credit, we must confront a considerably less standardized set of systems. Because of the broad variety of mechanisms for extending credit, I cannot claim that I have surveyed all of the systems that are present in our economy. Thus, I acknowledge that there probably are some negotiable credit documents still being issued, but the evidence that I present does suggest that those documents are increasingly unusual. For purposes of this discussion, I analyze three different types of credit transactions: consumer credit obligations, private commercial obligations (promissory notes), and publicly traded commercial obligations (bonds and commercial paper).

47. See U.C.C. § 5-108(a) (1996); INTERNATIONAL CHAMBER OF COMMERCE, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS art. 9 (1993) (ICC Publication No. 500) [hereinafter UCP].

48. See U.C.C. § 3-104(a) (1991) (imposing requirement that instrument be unconditional); *id.* § 3-106 (explaining what features make an obligation unconditional).

49. Negotiability may play some limited role in international transactions, in which letters of credit are used to confirm a buyer's commitment to pay for purchased goods. See LOPUCKI, WARREN, KEATING & MANN, *supra* note 3 (manuscript assign. 21, at 2-5, on file with author) (describing that transaction); Dolan, *supra* note 10, at 588 (same). The buyer in such a transaction might present the draft to a party other than the issuer, and the party acquiring that draft might negotiate it to a holder in due course. See ICC PUBL. NO. 515, *supra* note 45, at 92-93 (describing the mechanics of such transactions). Although I have no hard evidence on the question, my sense from informal conversations with American bankers is that it is not common for such a draft to be negotiated to a party other than the issuer of the letter of credit or some other bank that has confirmed or advised the credit. In those circumstances, holder-in-due-course status would have limited relevance because the holder of the draft normally would have rights against the beneficiary directly under letter-of-credit law, without regard to rules of negotiability. See U.C.C. § 5-111 (1996). Moreover, at least one commentator believes that even in the international context, drafts are becoming less common as parties increasingly turn to simpler procedures for open-account sales. See Dolan, *supra* note 10, at 588.

1. Consumer Credit Obligations

The most significant situation in which consumers receive credit is in the form of a loan extended in connection with a purchase by the consumer. Because different legal rules have fostered practices for sales of goods and services that differ from the practices for sales of homes, I treat those two types of obligations separately.

a. Notes for the Purchase of Goods and Services

There is no need to examine the customary terms and conditions of the promissory notes that consumers sign when they receive credit in connection with their purchase of goods or services, because federal law generally bars the exercise of holder-in-due-course rights against consumers in that context.

Specifically, the Federal Trade Commission has promulgated a regulation that bars holder-in-due-course status for consumer credit transactions involving goods and services. That regulation makes it an unfair trade practice to receive a promissory note in a consumer credit sale transaction unless the note includes the following legend: "Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods and services obtained pursuant hereto or with the proceeds hereof."⁵⁰ Violation of the regulation is punishable by a penalty of up to \$10,000 for each violation.⁵¹

As the FTC explained when it adopted that regulation, the rule reflects a considered rejection of one of the cornerstones of negotiability: the benefits of holder-in-due-course status. As discussed above, negotiability rests on the idea that all parties to a lending transaction benefit from a rule that enhances the liquidity of the payment instrument.⁵² From the FTC's

50. FTC Preservation of Consumers' Claims and Defenses Rule, 16 C.F.R. § 433.2(a) (1996). The regulation requires a similar notice in transactions in which the seller receives funds generated by a loan that a separate entity issues. *Id.* § 433.2(b). The only major exception applies in situations in which the seller has no relationship with the creditor "by common control, contract, or business arrangement." *Id.* § 433.1(d).

51. 15 U.S.C. § 45(i) (1994).

52. See *supra* pp. 957-62.

perspective, by contrast, holder-in-due-course status is unfair to consumers because it "make[s] the consumer's duty to pay independent of the seller's duty to fulfill [its contractual] obligations."⁵³ Thus, the FTC reasoned, consumers should not be forced by the holder-in-due-course rule to pay for goods and services that sellers do not actually deliver to them.⁵⁴

Although the FTC legend imposes a condition on the consumer's obligation to pay that ordinarily would deprive the note of negotiability,⁵⁵ Article 3 includes a provision designed to treat a promissory note including that legend as a negotiable instrument.⁵⁶ Nevertheless, the ordinary holder-in-due-course protections of negotiability have nothing to do with enforcement of such notes. The statute expressly acknowledges that "there cannot be a holder in due course of [such an] instrument."⁵⁷ Accordingly, the consumer in this context (just as in the credit-card context) generally has the right to withhold payment from the ultimate holder of the instrument on the same terms under which the consumer could withhold payment from the merchant with whom the consumer dealt directly.

b. Notes for the Purchase of a Home

The FTC regulation does not apply to notes given in connection with the purchase of a home.⁵⁸ Accordingly, nothing in federal law prevents the issuers of home mortgages from obtaining negotiable instruments from

53. Guidelines on Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses, 41 Fed. Reg. 20,022-23 (1976).

54. See *id.*

55. See U.C.C. §§ 3-104(a), 3-106 (1991); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 14-9, at 532 (4th ed. 1995). As Michael Sturley has shown, the FTC probably did not mean to exclude consumer finance notes from Article 3 entirely, but simply wanted to preclude holder-in-due-course status. Michael F. Sturley, *The Legal Impact of the Federal Trade Commission's Holder in Due Course Notice on a Negotiable Instrument: How Clever Are the Rascals at the FTC?*, 68 N.C. L. REV. 953, 956-63 (1990). The recently added provisions discussed in the rest of the paragraph in the text solve that problem by allowing notes covered by the FTC rule to retain negotiability status as a technical matter.

56. See U.C.C. § 3-106(d) (1991).

57. *Id.*

58. Although that conclusion is not controversial, extracting it from the FTC regulations requires a trail through several definitional provisions, starting with 16 C.F.R. § 433.2, which imposes the notice requirement only on "consumer credit contract[s]." FTC Preservation of Consumers' Claims and Defenses Rule, 16 C.F.R. § 433.2 (1996). Section 433.1(i) limits that term to contracts described in sections 433.1(d) ("Purchase money loan[s]") and (e) ("Financing a sale"). *Id.* § 433.1(i). Those provisions, in turn, are limited to contracts with a "consumer." *Id.* § 433.1(d), (e). Finally, because the regulatory definition of consumer is limited to a person purchasing goods or services, a person engaged in the purchase of a home is not a consumer for purposes of the regulation. See *id.* § 433.1(b) (defining "Consumer" as someone "who seeks or acquires goods or services for personal, family, or household use").

borrowers purchasing homes. Given the ubiquitous use of a written document to reflect the borrower's obligation to pay, as well as the thriving secondary market for home-mortgage notes,⁵⁹ the home-mortgage note would seem to be the ideal arena for use of negotiability. If negotiability has faded from the home-mortgage market, negotiability is not likely to endure much longer in any significant financial market.

But a look at the current operations of the home-mortgage market reveals two related points: (I) the home-mortgage market in this country has grown too large and too complicated to rely practically on the transportation and evaluation of physical documents contemplated by negotiability; and (II) as the importance of negotiability has faded, the importance of using negotiable instruments has declined, making it uncommon for home-mortgage notes to conform to the technical limitations of negotiability. Thus, the home-mortgage market has replaced negotiability with more developed liquidity systems—principally devices for pooling and securitizing the underlying notes—that make the home-mortgage note highly liquid.⁶⁰

(1) *Obstacles to Negotiability*

It is at least plausible to believe that negotiability could work reasonably well for a market in which individual mortgage bankers issued loans to home buyers and then resold each of those loans to one of a limited number of investors active in their geographic region. The mortgage banker could indorse each of the promissory notes and then deliver each one to the investor that purchased that particular note. The investor, in turn, could hold the promissory note, receive the payments as they became due, and attend to any miscellaneous business that might arise, such as administering any escrow accounts for payment of taxes and insurance, canceling or returning the note if it was paid in full, or suing the borrower for payment upon default.

59. More than \$100 billion of home mortgages were securitized in the first quarter of 1996 alone. See Karen Talley, *Wall Street Watch: Securitization Seen Tapering off Now*, AM. BANKER, Oct. 1, 1996, at 10. That process dominates the supply of money for new mortgages (reaching 64% by the end of 1994) and is slowly converting the body of older outstanding mortgages (covering 40% of all mortgages outstanding at the end of 1994). KENNETH G. LOVE, MORTGAGE-BACKED SECURITIES: DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET 1-7 (1996).

60. As Victor Goldberg has pointed out to me, the reputation of the underwriter is a key element of those liquidity systems, because the underwriters' investment in their reputation makes it rational for investors to purchase those securities without independent investigation of the underlying assets.

The modern home-mortgage market, however, bears little resemblance to that simple idealized picture. In the first place, the benefits of specialization have resulted in an almost complete bifurcation of the duties of administration (referred to as loan servicing) from the benefits of ownership. Loan servicing generally is performed by separate companies that are paid by fees deducted from payments on the notes, and that ordinarily have little or no ownership interest in the notes in question.⁶¹ Thus, the party to whom the homeowner is obligated to make payments no longer owns the document. That situation is completely at odds with the classic idea of negotiability as a system in which the maker is obligated to pay whatever party owns the instrument from time to time.

Furthermore, the process of securitization of home mortgages has resulted in highly complicated ownership structures that render it ridiculous to focus on "possession" of the instrument by the "owner." In the ordinary case, many, if not most, home-mortgage notes are packaged shortly after issuance with a large group of similar notes. In the simplest transaction, one of the large quasi-governmental entities such as the Federal National Mortgage Association (FNMA or Fannie Mae) or the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) might purchase the entire package. Those entities, in turn, would issue a large body of securities representing minute pro rata ownership interests in each of the promissory notes covered by the package. The physical notes would not be transferred to the purchasers of the securities. Instead, they would remain "warehoused" at a central storage facility in case of the occurrence of some event that might require their physical production.⁶²

Nothing about that system resembles the classic system of negotiability. The notes are not being transferred by indorsement and delivery.⁶³ Indeed, the ultimate owners of the notes—investors in the securities that

61. See LOVE, *supra* note 59, at 1-8 ("With mortgages, the original holder generally continues to service the loan after the sale [to a mortgage securitization pool]."). Indeed, servicing has become such a completely separate function that the ability to buy and sell mortgage servicing rights can be seen as "an essential part of the mortgage delivery system." See *id.* at 1-9.

62. See, e.g., GEORGE LEFCOE, REAL ESTATE TRANSACTIONS 452-56 (1993) (summarizing the mechanics of the secondary mortgage market).

63. See, e.g., *Bankruptcy Reform Act of 1978: Hearings on S.2266 and H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary (Memorandum Submitted by the Federal Home Loan Mortgage Corporation)*, 95th Cong. 1136, 1146 (1977) ("To permit servicing to be conducted effectively and efficiently, the seller will retain unendorsed the original mortgage notes and the purchaser will not record under the various state recording statutes the purchaser's ownership interest in the [notes that it has] purchased."); Phyllis K. Slesinger & Daniel McLaughlin, *Mortgage Electronic Registration System*, 31 IDAHO L. REV. 805, 809-10 (1996) (explaining why it is impractical to execute item-by-item assignments in connection with the packaging and securitization of home-mortgage notes).

the notes support—are extraordinarily unlikely to have any idea whatsoever as to the actual location of the notes covered by their securities, much less any information about the individuals liable on those notes. Rather, they will know only that they have purchased a security bearing a specified interest rate that is backed up by an interest in a pool of home mortgages of a specified size, and that is underwritten as being of a specific quality.⁶⁴

(2) *The Absence of Negotiability*

The irrelevance of negotiability to home-mortgage note transactions is best demonstrated by the fact that the standard form of promissory note used for those transactions fails to satisfy the requirements of negotiability. Because of the strong interest in uniformity in the large securitized home-mortgage note transactions, Fannie Mae and Freddie Mac have promulgated a number of standard forms for use in those transactions. Transactions that do not use those forms are not eligible for repurchase by Fannie Mae or Freddie Mac.⁶⁵ Accordingly, although a significant number of home-mortgage notes are not securitized for various reasons, the Fannie Mae/Freddie Mac forms dominate the market, even for transactions in which the lender does not contemplate an immediate sale to Fannie Mae or Freddie Mac.⁶⁶

The most basic of these forms is the FNMA/FHLMC Multistate Fixed Rate Note—Single Family. Section 4 of that Note provides as follows:

4. Borrower's Right to Prepay

I have the right to make payments of principal at any time before they are due. A payment of principal only is known as a "prepayment." *When I make a prepayment, I will tell the Note Holder in writing that I am doing so.*⁶⁷

The italicized sentence of that provision appears to constitute an "undertaking . . . to do a[n] act in addition to the payment of money." For

64. See LOVE, *supra* note 59, at 4-105 to -106 (describing disclosure of "issue date, maturity, issuer, coupon rate, and principal balance of the mortgages in the pool"); *id.* at 4-111 to -114 (describing Ginnie Mae, Fannie Mae, and Freddie Mac disclosures related to credit issues, which do not include any information about individual borrowers, but instead statistical information about number of loans, range of loan size, geographic location, loan-to-value ratios, insurance coverage, and information about delinquencies and foreclosures in the pool as a whole).

65. See 2 NELSON & WHITMAN, *supra* note 30, at 316.

66. See *id.* For example, the note for my home is on the FNMA/FHLMC form even though it is held by a single investor.

67. FNMA/FHLMC Multistate Fixed Rate Note—Single Family § 4, *reprinted in* 2 NELSON & WHITMAN, *supra* note 30, at 317, 317.

historical reasons codified in section 3-104(a)(3) of the U.C.C., a promissory note cannot be an instrument if it contains such an undertaking: the rules of negotiability apply only to promises to pay money, not to other, non-monetary undertakings.⁶⁸ Sending a notice certainly is an act "in addition to the payment of money," and the note's language seems to constitute an "undertaking" to perform that act (albeit only on certain conditions). Accordingly, it seems unlikely that the Fannie Mae/Freddie Mac form qualifies as negotiable.⁶⁹ Thus, the rules of Article 3 (including its holder-in-due-course protections) do not apply.⁷⁰

Most people to whom I have mentioned that peculiarity find it bizarre. The requirement that a homeowner send a written notice of prepayment does not seem crucial to the administration of a mortgage note. After all, the receipt of a payment that exceeds the required minimum amount should provide some notice to the servicer. The patron of negotiability must wonder why any sensible drafter would allow all the wonderful benefits of negotiability to slip away for such a trivial provision.

But the preceding paragraphs offer an obvious answer: the benefits of negotiability have no practical significance to the operation of the current system. Parties could take advantage of those benefits only if they were willing to be careful to obtain indorsements and take possession of each promissory note that they purchased. Given the practical difficulties that would accompany any attempt to satisfy those requirements and the uncertain prospects for victory even upon full compliance with the technical

68. For a general discussion of that requirement, see FRED H. MILLER & ALVIN C. HARRELL, *supra* note 4, ¶ 2.02[3][a][ii], at 2-19 to -27.

69. Of course, it would be easy for a strong-willed court to ignore the problem and treat the document as an instrument, reasoning that the clause is not an "undertaking" because the requirement comes into effect only if the borrower voluntarily chooses to make a prepayment. That line of reasoning seems unlikely to me to persuade most courts. Remember, the issue would be most likely to arise in the context of a suit by a (presumably not impecunious) holder of the mortgage note attempting to claim holder-in-due-course status against a homeowner asserting a defense to payment of the note that would have been valid against the original lender. My sense is that most courts that let strong-willed preconceptions influence their reasoning are likely to hold preconceptions favoring the homeowner, not the holder.

70. That is not to say that no home-mortgage notes are covered by Article 3. In fact, it is quite likely that individual mortgage bankers scattered throughout the country still close home-mortgage transactions on old standard forms that do not qualify for transfer to Fannie Mae or Freddie Mac. The absence of negotiability from the most widely used forms, coupled with the market pressure to close loans that are eligible for securitization, however, should steadily drive those older forms from the market.

requirements,⁷¹ it is far more sensible to leave negotiability by the wayside in order to pursue the financial advantages promised by access to a large and highly liquid secondary market. Because the home-mortgage note market cannot practicably assure the benefits of negotiability, there is no reason why the parties drafting the notes that the system uses should take any great care to ensure that the notes retain technical negotiability. Furthermore, the absence of negotiability from the most common form of note suggests that the parties that draft those notes in fact do not take care to protect the negotiability of the obligations in question.

2. Private Commercial Obligations

Negotiable instruments are just as hard to find in the commercial context as they are in the consumer realm discussed above. With respect to privately placed obligations—the garden-variety commercial promissory note—the pattern is the same as it is in the home-mortgage market. Notwithstanding the absence of any overarching legal prohibition, a group of practical difficulties have made negotiability more trouble than it is worth, leading to a general absence of negotiability from the forms of instruments commonly in use.

a. Obstacles to Negotiability

The market for privately placed business obligations presents a situation that in some ways is diametrically opposed to the home-mortgage market. In the home-mortgage context discussed above, sales of the notes are the norm, and retention by the original issuer is an unusual occurrence. The opposite situation prevails with respect to most private commercial promissory notes: although not unheard of, sales are relatively unusual occurrences. Thus, most portfolios appear to be filled almost entirely with promissory notes issued by the original investor or some closely affiliated

71. Indeed, even if the investors in home-mortgage transactions bothered with the formalities, they would face a substantial risk of losing the benefits of holder-in-due-course status given the relatively consistent holdings barring holder-in-due-course status for holders that engage in so many transactions with an originating lender as to be “closely connected” with the originating lender. See, e.g., LOPUCKI, WARREN, KEATING & MANN, *supra* note 3 (manuscript assign. 28, at 5, on file with author) (summarizing the doctrinal basis for those holdings).

party.⁷² The relative rarity of transfer means that negotiability in this context would not face the practical difficulties of handling massive numbers of transactions that render negotiability so unsuitable for the home-mortgage market. Unfortunately for the patron of negotiability, however, the infrequency of transfer also undermines the value of negotiability because a device that facilitates transfer has little value in a market where transfer is unusual.

The reason for the rarity of transfer is not hard to discern.⁷³ As a detailed empirical study conducted by the Federal Reserve has shown, the market for private commercial loans (by which I mean loans that will not be publicly traded) is a very "information-intensive market."⁷⁴ Lending to private commercial borrowers normally entails a considerable factual investigation of the borrower and any collateral offered to secure the borrower's obligation to repay the loan.⁷⁵ Once an investor completes that investigation and advances funds to the borrower, the initial investor's store of information about the transaction allows that investor to place a higher value on the note than any third party. A rational investor purchasing such a note would have to conduct a second and largely duplicative factual investigation in order to satisfy itself that the initial investor correctly evaluated the risks and potential benefits of the transaction. Thus, to the extent that sales of such notes occur, they tend not to be the sale of an individual note for which negotiability is helpful,⁷⁶ but instead bulk sales of large groups of such notes, frequently in connection with a sale of all or a

72. See Dolan, *supra* note 10, at 586 ("The note usually sits in the vault of the commercial lender from the time of utterance until the time it is satisfied and stamped 'paid.'").

73. In addition to the general limitations discussed in the text, the securities laws may prohibit or limit transfer of some kinds of private placements. See MARK CAREY ET AL., *THE ECONOMICS OF THE PRIVATE PLACEMENT MARKET* 43-44 (Board of Governors of the Fed. Reserve Sys. Staff Study No. 166, 1993) (discussing the market for securities issued under Rule 144A).

74. See *id.* at i.

75. See *id.* at 15 ("Borrowers in the private placement market generally are information-problematic firms or, if they are not, their financings are complex enough that only information-intensive lenders are willing to buy them."); *id.* at 3 (characterizing borrowers in the bank-loan market as "substantially more information problematic" than borrowers in the private-placement market).

76. Interviews with officers responsible for servicing loans at a major life insurance company indicate that the only common circumstance in which that lender sells individual promissory notes is a circumstance in which negotiability has no relevance—a workout with the borrower in which the note is transferred to a guarantor or some other entity affiliated with the borrower. See Telephone Interview with Loc McNew, American General Corporation (Aug. 5, 1996); Telephone Interview with Jocelyn Sears, American General Realty Advisers, Inc. (Aug. 5, 1996) [hereinafter Sears Interview]. It is unlikely that the borrower or its principal purchases its own promissory note with a view to using holder-in-due-course status to enforce the note.

substantial portion of the portfolio of the original investor.⁷⁷ Moreover, in many cases, such a transaction is effected not through individual transfers of the underlying notes, but through a transfer of the stock of the company whose portfolio is being sold.⁷⁸ In sum, the relative infrequency of item-by-item transfers of private commercial promissory notes limits the benefits that investors can obtain by ensuring that those instruments are negotiable in form.

Of course, as long as the notes are sold at all, negotiability at least theoretically could provide some benefit by enhancing the value of the notes in the few transactions in which they are sold. But even in those transactions, commercial parties are unlikely to perceive a substantial benefit to obtaining holder-in-due-course status. Negotiability assumes a transaction in which the seller transfers the asset to the purchaser without any effort by the purchaser to discover the existence of any claims or defenses that might undermine the borrower's willingness to pay. Any investigation by the purchaser would put holder-in-due-course status at risk because the purchaser would be unprotected if its investigation revealed a claim.⁷⁹ Thus, a purchaser that wishes to rely on holder-in-due-course status should refrain from inquiry about the promissory note in order to ensure that it does not discover any existing claims.

Most commercial parties, however, are likely to view that strategy as something akin to sticking their head in the sand. Commercial actors are much more likely to adopt a strategy designed to flush out any claims before acquiring the note. For example, the purchaser might attempt to obtain an estoppel certificate or an acknowledgment from the borrower evidencing the borrower's obligation to pay and including a statement that the borrower does not have any defenses to payment.⁸⁰ Alternatively, the poten-

77. See Telephone Interview with Rembert R. Owen, Jr., American General Realty Advisers, Inc. (Aug. 7, 1996) [hereinafter Owen Interview]. Informal interviews with bank and insurance company executives also suggest a burgeoning market for purchases of distressed debt. Investors who specialize in holding and liquidating questionable loans purchase large packages of such loans from the portfolios of banks and insurance companies, who are anxious to enhance the credit quality of their portfolio by disposing of such loans rapidly.

78. See *id.*

79. See U.C.C. § 3-302(a)(2) (1991).

80. See Sears Interview, *supra* note 76. An estoppel certificate puts the purchaser in a better position than holder-in-due-course status because the purchaser is protected from claims that the note fails negotiability for some technical reason or that the circumstances of the purchaser's acquisition prevents it from acquiring holder-in-due-course status. See *supra* note 71 (discussing potential for "closely connected" doctrine to deprive institutional lenders of holder-in-due-course status). Also, less definitively, a purchaser probably would be able to portray itself in a better light in subsequent litigation to enforce the note if it could show that the borrower disclaimed any defenses at the time the purchaser acquired the note than if the purchaser had to

tial purchaser might send a letter to the borrower advising the borrower that the purchaser is purchasing the note and giving the borrower an opportunity to raise any defenses that the borrower might have.⁸¹ In either event, however, the purchaser would not be able to use holder-in-due-course status to defeat any claims that it discovered because it would have had notice of those claims at the time that it purchased the note.⁸² Of course, it could use holder-in-due-course status to protect itself from claims that it did not discover in spite of its inquiry, but given the purchaser's ability to rely on the borrower's express or implicit denial of any defenses, it seems unlikely that holder-in-due-course status would add any significant strength to the purchaser's claim.⁸³

b. The Absence of Negotiability

If my analysis of the limited value of negotiability in the commercial lending context is correct, one would expect to find the same relative lack of concern about maintaining negotiability in the form of the notes that appears in the home-mortgage market. To test that thesis, I examined a number of form promissory notes used by commercial-lending institutions.⁸⁴ None of those promissory notes were unquestionably negotiable. The most common problem for negotiability was the presence of a usury savings clause. The following clause is typical:

Interest paid or agreed to be paid shall not exceed the maximum amount permissible under applicable law and, in any contingency whatsoever, if Lender shall receive anything of value deemed interest under applicable law which would exceed the maximum amount of interest permissible under applicable law, the excessive interest shall

admit that it was relying on the "technicality" of holder-in-due-course status to defeat any defense that the borrower might have.

81. See Owen Interview, *supra* note 77. The potential purchaser might ask the seller to provide a warranty that the borrower has no defenses to payment. Most institutional investors, however, would be unwilling to give such a warranty because the possibility of continuing liability on the warranty effectively would prevent the investor from treating the note as completely sold: an investor giving such a warranty would have to accept the possibility that it might have exposure on the note even after the sale. See Sears Interview, *supra* note 76.

82. See U.C.C. § 3-302(a)(2)(iii)-(vi) (1991).

83. See *supra* note 80.

84. I obtained five form promissory notes: three used by insurance companies (American General Corporation, Travelers Insurance, and an anonymous New York life insurance company) and two used by depository institutions (Home Savings of America, FSB and NationsBank of Texas, N.A.). Copies of those forms are available on request.

be applied to the reduction of the unpaid Amount of Note or refunded to Maker.⁸⁵

Because that provision expressly conditions the maker's obligation to repay the stated principal and interest on the lawfulness of the negotiated payment terms, there is a strong argument that it deprives the note of negotiability.⁸⁶ Although the previous sentences of the note obligate the maker to pay a stated sum of principal and interest—a "fixed amount of money," for purposes of U.C.C. section 3-104(a)—the quoted sentence renders that obligation conditional because the borrower is obligated to pay the stated "fixed amount" only if that amount is consistent with applicable laws. If some aspect of the transaction (perhaps an aspect not evident from the face of the instrument, such as a loan application fee or other form of consideration to the lender) renders that fixed amount usurious,⁸⁷ no holder of the note would be entitled to insist upon payment of the fixed amount stated in the note. Although it is possible to advance plausible arguments to support negotiability,⁸⁸ the provision at best places a substantial cloud on the instrument's negotiability. That cloud would make it imprudent for any purchaser of such a note to rely on its negotiability.

85. NationsBank of Texas, N.A., Promissory Note (Installment) (Jan. 1992) [hereinafter NationsBank Note] (on file with author). For similar provisions, see American General Corporation, Promissory Note § 8, at 4-5 (n.d.) [hereinafter American General Note] (on file with author); Consolidated Promissory Note 3 (n.d.) [hereinafter New York Insurance Company Note] (used by anonymous New York life insurance company) (on file with author); The Travelers Insurance Company, Promissory Note § 5.1, at 17 (July 10, 1996) [hereinafter Travelers Note] (on file with author).

86. See U.C.C. § 3-104(a) (1991) (a negotiable instrument must be "unconditional"); see also *id.* § 3-106(a) (defining requirement that a negotiable instrument be unconditional).

87. See LOPUCKI, WARREN, KEATING & MANN, *supra* note 3 (manuscript assign. 23, at 14-15, on file with author) (discussing that usury problem).

88. For example, one could argue that the provision is irrelevant because it simply restates what would be implied into the note without the express condition: The maker cannot be forced to pay unlawful interest. The most obvious problem with that argument is that negotiability law treats implied conditions and express conditions quite differently. Under U.C.C. section 3-106(a), only express conditions bar negotiability. U.C.C. § 3-106(a) (1991). Thus, the implied condition limiting payment to amounts lawfully owed would not deprive the note of negotiability however much it might alter the holder's ability to enforce the letter of the note. By including an express condition, however, the parties have gone further and thus probably have deprived the document of negotiability.

Ted Janger has suggested to me that the provision is permissible because it is nothing but a description of the interest rate, something expressly permitted by U.C.C. section 3-112(b) (1991). Although that argument is plausible, it is subject to the difficulty that the clause not only limits the amount of interest to be paid, it also (at least theoretically) would justify the borrower in withholding a portion of the stated principal amount of the note.

Although they are the most common problems, usury savings clauses are not the only provisions that appear in commercial promissory notes that undermine their negotiability. For example, provisions that require notice of prepayment like the provision in the Fannie Mae home-mortgage note are not uncommon,⁸⁹ and neither are a variety of other minor provisions that impose nonmonetary obligations that probably transgress the "courier-without-luggage" restriction in section 3-104(a)(3) of the U.C.C.⁹⁰ The frequency with which such provisions appear in my sample cannot prove that *no* institutional lenders still use negotiable promissory notes, but it does provide strong support for my view that the parties in the market are driven by the same forces here as they are in the home-mortgage note context. In sum, the parties that draft both types of notes are not concerned about satisfying the technical requirements of negotiability because negotiability has no practical significance to the parties that invest in those obligations.

3. Publicly Traded Commercial Obligations

If the main reason that negotiability has nothing to offer "retail" commercial promissory notes is the difficulty of separating the payment obligation from the relationship between the borrower and the lender, then it should be fruitful to turn the search for negotiability to the impersonal market for publicly traded business obligations, where information about borrowers is publicly available to all. Here we enter an area where negotiability historically played a large role. Again, however, negotiability's ties to a rapidly receding historical context have proven its downfall. Although the end results are similar, the paths to the demise of negotiability have been slightly different in the market for long-term obligations (bonds) and short-term obligations (commercial paper). Accordingly, I discuss each of those topics separately.

89. See Travelers Note, *supra* note 85, § 3:4(b), at 12.

90. See American General Note, *supra* note 85, § 10, at 5 (representation by the borrower that the loan proceeds will be utilized for commercial, investment, or business purposes and not for personal, family, or household purposes); Home Savings of America, FSB, Promissory Note, at 1 ("Borrower agrees upon Lender's request to submit to the jurisdiction of the courts of LOS ANGELES County, the State of California."); New York Insurance Company Note, *supra* note 85, at 4-5 (agreement by the borrower that it will be liable for any damages suffered by the lender because of such matters as environmental liability or the collection by the borrower of rents after it has received notice of default); Travelers Note, *supra* note 85, § 5.11(b), at 20 (agreement by the borrower that the proceeds of the loan "will not be used for the purchase of registered equity securities").

a. Bonds

Although bearer bonds once played a large role in our economy, their demise presents a problem with negotiability not raised by the prior systems—the conflict between the privacy interests of parties to payment transactions and the desire of the government to obtain information about financial transactions. One somewhat fortuitous advantage for the negotiable instrument in the twentieth century is that it offers its holder more privacy than most alternative arrangements. Because the obligor on the instrument is obligated to pay whomever has possession of the instrument, a person can acquire a valuable right to payment but maintain anonymity until the payment actually is due. If the purchaser wishes to keep its identity anonymous, the obligor might have no record of the parties to whom it owes money and no way of knowing who those parties are until those parties present the document entitling them to payment.⁹¹

That scenario poses significant problems for law enforcement officials. For example, one industry professional to whom I spoke told a story of a common device under which a wealthy aging individual would use cash to purchase bearer bonds that would be placed in a safety-deposit box with the knowledge of the individual's children. At periodic intervals the individual would go to the safety-deposit box to remove the coupons from the bonds and have them transmitted to the issuer to receive the periodic interest payments. Upon the individual's death, the children would go to the safety-deposit box, remove the bonds, and sell them without including them in the decedent's estate. Because the government would not be able to obtain a record of the decedent's ownership of the bonds from the issuer, it would be difficult for the government to learn that the bonds had been transferred to the decedent's children without payment of the appropriate estate tax.⁹² The reason that bonds are so valuable for such a scheme is that they accrue interest while stored in the safety-deposit box; cash would not. As the individual telling me the anecdote explained: "[A] million dollars in cash isn't producing any income and the bonds are."⁹³

91. See Interview with Clayton Erickson, Manager, Municipal Trading and Underwriting, A.G. Edwards & Sons, Inc., in St. Louis, Mo. 5-6 (Aug. 1, 1996) [hereinafter Erickson Interview] (describing the inability of an issuer of bonds to give notice to holders of bonds when it calls them) (transcript on file with author). Indeed, it would be relatively easy to maintain anonymity even at the time of payment through the simple device of using a reliable intermediary to present the document evidencing the right to payment.

92. See Erickson Interview, *supra* note 91, at 6-7.

93. *Id.* at 7.

Congress responded in the Tax Equity and Fiscal Responsibility Act of 1982. In connection with the well-known provisions of the tax code that require payors of interest to report interest payments to the Internal Revenue Service, Congress enacted a provision that effectively outlawed the issuance of bearer bonds by generally barring any deduction for interest paid on a publicly traded bearer obligation with a maturity of more than a year.⁹⁴ As the legislative history explains, Congress viewed the prohibition of long-term bearer obligations as a crucial feature of a system allowing the Internal Revenue Service to monitor ownership of securities and the profits derived from them.⁹⁵

The law appears to have been effective; industry experts to whom I spoke told me that American companies have not issued bonds in negotiable form since 1982.⁹⁶ Instead, bonds are issued either in registered form or by means of a book-entry system, which dispenses with the physical document entirely and relies on entries made on the books of an agent of the issuer.⁹⁷ The book-entry securities obviously are not negotiable in the Article 3 sense of the term, because no document represents the payment obligation.⁹⁸ Similarly, the registered securities are not negotiable because they provide on their face that they cannot be transferred by delivery (even

94. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 310(b)(2), 96 Stat. 324, 596-97 (codified as amended at 26 U.S.C. § 163(f) (1994)).

95. The Senate Report explained:

The committee believes that a fair and efficient system of information reporting and withholding cannot be achieved with respect to interest-bearing obligations as long as a significant volume of long-term bearer instruments is issued. A system of book-entry registration will preserve the liquidity of obligations while requiring the creation of ownership records that can produce useful information reports with respect to both the payment of interest and the sale of obligations prior to maturity through brokers. Furthermore, registration will reduce the ability of noncompliant taxpayers to conceal income and property from the reach of the income, estate, and gift taxes. Finally, the registration requirement may reduce the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities.

S. REP. NO. 97-494, at 242 (1982), reprinted in 1982 U.S.C.C.A.N. 781, 995.

96. See Telephone Interview with H. Eugene Bradford, Senior Vice President, and Christopher S. Hillcoat, Senior Vice President, Boatmen's Trust Company (July 21, 1996) [hereinafter Bradford/Hillcoat Interview]; Erickson Interview, *supra* note 91, at 1-2; Interview with Daniel A. Naert, First Vice President-Investments, Smith Barney, Inc., in St. Louis, Mo. 1 (Aug. 9, 1996) [hereinafter Naert Interview] (transcript on file with author).

97. See Bradford/Hillcoat Interview, *supra* note 96; Erickson Interview, *supra* note 91, at 2-3; Naert Interview, *supra* note 96, at 1-3.

98. See Bradford/Hillcoat Interview, *supra* note 96; Naert Interview, *supra* note 96, at 3. For purposes of U.C.C. Article 8, book-entry securities are uncertificated securities. See U.C.C. § 8-102(a)(18) (1996) (defining "[u]ncertificated security" as "a security that is not represented by a certificate").

with indorsement); a transfer is valid only if registered on the books of the designated agent of the issuer.⁹⁹

To be sure, Article 8 allows certain purchasers of registered and book-entry securities to take free of defenses and adverse claims just as a holder in due course takes free of defenses and claims to a negotiable instrument.¹⁰⁰ But that hardly suggests that Article 8 is a continuing forum for negotiability. Article 8 offers legal rules to accommodate a system for liquidity that is as far as possible from the documentary focus of negotiability. Among other things, Article 8 grants "protected-purchaser" status for documents like registered securities that cannot be transferred solely by possession.¹⁰¹ Indeed, Article 8's abandonment of the negotiability system is shown most clearly by its willingness to grant protected-purchaser status even to purchasers that do not have possession of a document representing rights in the security.¹⁰²

The way to make sense of Article 8 is not to attempt to analogize the nonpossessory rights that it articulates to the legal rules arising from posses-

99. A typical provision states:

[T]his Debenture is transferable on the Debenture Register of the Company, upon surrender of this Debenture for transfer at the office or agency of the Company in . . . duly endorsed by, or accompanied by a written instrument of transfer in form satisfactory to the Company and Debenture Registrar duly executed by, the registered Holder hereof or his attorney duly authorized in writing, and thereupon one or more new Debentures, of authorized denominations and for the same aggregate principal amount, will be issued to the designated transferee or transferees.

American Bar Found., Model Debenture Indenture Provisions: All Registered Issues § 202, reprinted in AMERICAN BAR FOUND., COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS app. C at 13 (1986). I reviewed several registered bonds provided by Boatmen's Trust Company and Smith Barney, Inc. Each of them contained a similar provision. For a simpler standardized provision, see *Model Simplified Indenture*, 38 BUS. LAW. 741, 776 (1983), which states that "[t]he Company will pay interest on the Securities . . . to the persons who are registered holders of Securities at the close of business on the record date."

100. See U.C.C. §§ 8-202(d), 8-303 (1996).

101. Sections 8-202(d) and 8-303 extend protected-purchaser status to purchasers of a certificated security. *Id.* §§ 8-202(d), 8-303. Under section 8-102(a)(4) and 8-102(a)(15)(i), that term includes registered securities. *Id.* § 8-102(a)(4), (15)(i).

102. Section 8-202 expressly extends its protection to parties that have only indirect possession. *Id.* § 8-202(f). Section 8-303(a)(3) reaches the same result a bit less directly—by protecting the purchaser so long as it "obtains control of the . . . security." *Id.* § 8-303(a)(3). As the second paragraph of comment 2 indicates, that test permits the status to extend to holders of uncertificated securities (book-entry securities for which there is no document to possess). *Id.* § 8-303 cmt. 2. The first paragraph of that comment also allows considerable flexibility in the requirement that the purchaser obtain possession of securities for which there is a certificate. See *id.* (explaining that a purchaser can obtain control through delivery under U.C.C. section 8-301, which is met when an intermediary takes possession "on behalf of" the purchaser).

sion of negotiable instruments. Instead, the best way to make sense of Article 8 is to acknowledge that the same practical considerations that have made negotiability impractical for home-mortgage notes have rendered negotiability impractical for corporate bonds.¹⁰³ The basic problem is the immense growth in the market for securities, which results in a volume of trading unheard of even a few decades ago.¹⁰⁴ In an era of negotiable documents, each trade would be closed by a physical transfer of the relevant document from one broker to the other. Industry experts remember (with little fondness) armies of couriers scurrying up and down Wall Street in the late afternoon carrying immense numbers of securities to settle the day's trades.¹⁰⁵

The advent of electronic information systems provided an opportunity to develop a system for transferring securities that dispensed with the problems raised by the document-centered transfer mechanisms of the negotiability system. Not surprisingly, the industry has created a system that relies increasingly on central depositories (usually Depository Trust Company, commonly referred to as DTC) to hold the share certificates: transfers are made not by transportation of pieces of paper, but by electronic messages to the depository that alter the records of the depository. Accordingly, the owner need not obtain possession of the security, and thus the security need not be moved from place to place. The reasons may be slightly different from those discussed in the preceding sections, but the end result is the same. The financial institutions and practices have moved beyond the transactions for which negotiability was designed, developing new mechanisms for transfer in which documents are a hindrance rather than an aid.

103. For a thorough discussion of Article 8 and a thoughtful effort to justify its rules by reference to the modern trading system for which Article 8 was designed, see James Steven Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 43 UCLA L. REV. 1431 (1996).

104. To get an idea from stock trading, trading volume on the New York Stock Exchange was in the range of ten million shares per day during the "paperwork crunch" of the 1960s, which required the exchange to close periodically to catch up on the paperwork necessary for an era that relied on physical transfers of share certificates. See Erickson Interview, *supra* note 91, at 7 (describing the need to close the New York Stock Exchange on Wednesdays to accommodate 12 million trades per day). Volume in more recent years has exceeded 600 million shares per day without taxing the modern nondocumentary transfer systems. See Rogers, *supra* note 103, at 1445.

105. See Erickson Interview, *supra* note 91, at 7 ("A hundred runners running through Wall Street with briefcases making deliveries was not the answer.").

b. Commercial Paper

The last major credit system discussed in this Part is commercial paper, which presents perhaps the most interesting scenario—an almost complete abandonment of negotiability in the face of a legal system that at least nominally continues to demand negotiability.¹⁰⁶ Although legal academics frequently use the term “commercial paper” generically to describe all types of commercial negotiable instruments,¹⁰⁷ its meaning in the financial markets is quite different. In modern markets, references to commercial paper describe a specific type of short-term obligation issued by highly credit-worthy companies.¹⁰⁸ The key boundary to the market is formed by the provision of section 3(a)(3) of the Securities Act of 1933 that exempts from the Securities Act certain promissory notes with a maturity of less than nine months.¹⁰⁹ Large credit-worthy corporations frequently use those notes—known as commercial paper—to satisfy a significant part of their companies’ financing needs.¹¹⁰

At first glance, the applicable legal rules suggest (in accordance with the common legal usage mentioned above) that commercial paper does provide a significant continuing market for negotiability. The Securities and Exchange Commission Release that refines the terms of the section 3(a)(3) exemption states that the exemption is limited “to prime quality

106. The tax code provision that bars deductions for interest on bonds does not apply to commercial paper because, as discussed below, commercial paper always has a maturity of less than nine months. See 26 U.S.C. § 163(f)(2)(A)(iii) (1994) (prohibition on interest deduction does not apply to bearer obligations with a maturity of “not more than 1 year”).

107. See, e.g., NICKLES, *supra* note 4 (study aid on “Negotiable Instruments and Other Related Commercial Paper”); NICKLES ET AL., *supra* note 3 (casebook on “Modern Commercial Paper”); CHARLES M. WEBER & RICHARD E. SPEIDEL, COMMERCIAL PAPER IN A NUTSHELL at xix (3d ed. 1982) (“As used in the title and throughout the book, ‘commercial paper’ refers to promissory notes, drafts, checks and certificates of deposit—the subject matter of Article 3.”).

108. For a general discussion of the commercial-paper market, see MARCIA L. STIGUM, THE MONEY MARKET 1023–82 (3d ed. 1990).

109. See 15 U.S.C. § 77c(a)(3) (1994).

110. See, e.g., Telephone Interview with Thomas Larson, Associate General Counsel, Anheuser-Busch Companies, Inc. 1 (Aug. 28, 1996) [hereinafter Larson Interview] (stating that Anheuser-Busch has about \$1 billion in commercial paper outstanding) (transcript on file with author); Interview with Harley M. Smith, Assistant General Counsel, and Judith C. Rebholz, Manager-Cash & Short Term Funding, Emerson Electric Co., in St. Louis, Mo. (Sept. 11, 1996) [hereinafter Smith/Rebholz Interview] (describing Emerson Electric Co.’s \$500-million commercial-paper portfolio).

negotiable commercial paper."¹¹¹ The leading securities-law commentators have taken that statement seriously, suggesting that it imposes a specific requirement that all commercial paper be negotiable.¹¹² But a closer examination of the materials suggests that the statement should not be taken at face value. Rather, the Release appears to demand negotiability only in the sense of free transferability. It does not seem to refer to negotiability in the technical Article 3 sense. For example, Professors Loss and Seligman state that "the requirement of negotiability is not of much consequence," "[b]ecause there is little secondary trading in commercial paper."¹¹³ Similarly, Professor Lowenstein states: "Because there is not a significant secondary market in commercial paper, the requirement of negotiability does not appear to be a legal factor that issuers need consider."¹¹⁴ That view was confirmed to me in a telephone interview with an attorney working in the relevant office of the Securities and Exchange Commission. He explained: "When we say 'negotiable,' the key is that it has to be transferable."¹¹⁵

The limited force of any legal requirement of negotiability is evident from the practices of commercial-paper issuers. First, although at one time commercial paper tended to be issued in bearer form,¹¹⁶ issuers for some time have issued paper in registered form, which would not satisfy technical "negotiability" requirements.¹¹⁷ More significantly, although a few issuers apparently still issue physical pieces of paper,¹¹⁸ the clear trend in the industry is toward paperless paper, where electronic communications handle all issuance, sale, and transfer of the "paper."¹¹⁹ In that system, the issuer

111. Securities Act Release No. 4412, reprinted in 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2045-2046 (Sept. 20, 1961) (emphasis added).

112. See, e.g., 3 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION § 3.B.3, at 1190 (1989); Paul Lowenstein, *The Commercial Paper Market and the Federal Securities Laws*, 4 CORP. L. REV. 128, 142 (1981).

113. 3 LOSS & SELIGMAN, *supra* note 112, at 1190.

114. Lowenstein, *supra* note 112, at 142.

115. Telephone Interview with Joseph Babitch, Office of the Chief Counsel, Division of Corporate Finance, Securities and Exchange Commission (Aug. 28, 1996).

116. See STIGUM, *supra* note 108, at 1024-26 (reproducing commercial paper characterized as "bearer" paper, which states that it is payable "to the order of" the investor).

117. As explained above, *supra* note 99 and accompanying text, registered obligations are by definition not negotiable because they cannot be transferred by delivery and indorsement.

118. One industry professional suggested that General Electric and General Motors Acceptance Corporation still currently issue their commercial paper in documentary form. Erickson Interview, *supra* note 91, at 11.

119. The following summary of the procedures for issuing commercial paper is based on the Smith/Rebholz Interview, *supra* note 110, and on the Larson Interview, *supra* note 110, at 7, as well as a sample set of commercial-paper documents that I obtained from Anheuser-Busch Companies, Inc. in connection with the Larson Interview. Copies of those documents are available

enters into an arrangement with a central recordkeeping depository (normally DTC), under which DTC maintains a central electronic record of all of the issuer's outstanding commercial paper. Each day when the issuer wishes to issue commercial paper, its investment bank attempts to locate entities that wish to invest in the paper. Before noon, the issuer, investment bank, and investors agree upon the major terms of the transaction—the amount, interest rate, and date of maturity—and send the necessary data on to the issuer's paying agent (normally a New York bank such as Chemical Bank). The paying agent in turn sends an electronic message to DTC describing the purchases the investors have made. DTC's record of those purchases is the definitive record of the obligation. The investor's interest plainly is not negotiable because the issuer does not provide any separate promissory note payable to each individual investor. The only promissory note involved in the transaction is a master note from the issuer to Cede & Co. (DTC's street nominee) covering the issuer's entire commercial-paper program.

In sum, whatever role negotiability once might have played in the commercial-paper market, the same pressures that have limited the use of negotiability for bonds are pushing commercial paper inevitably to the same end result—an electronic transfer system in which any document is a mere vestige of former practices that have become obsolete in the face of the pressures of increasing volume and new technology.

III. THE IRRELEVANCE OF NEGOTIABILITY TO THE MODERN PAYMENT SYSTEM

Part II illustrated a wide variety of developments that have limited the use of negotiable instruments in most contexts, but it could not show that negotiable instruments have disappeared entirely. In addition to whatever scattered usages of negotiability might persist in odd corners of the financial marketplace, one major payment system remains in which the payment continues to be evidenced by a negotiable instrument—the checking system.

But the continued use of negotiable instruments in the checking system does not suggest that negotiability has any continuing significance. Rather, negotiability has little or no role in the practices by which payments are made and collected in the checking system. Although the sys-

on request. Except for the mechanics of issuance, the system closely resembles the ordinary system for book-entry securities discussed in detail in Rogers, *supra* note 103, at 1443–45.

tem has retained the technical form of negotiability, it has abandoned in practice all of the major concepts by which negotiability can facilitate transactions. The reason for this change should be clear by now: In the modern checking system, negotiability is not an aid to the effectiveness of the system, but an obstacle for the industry to overcome.¹²⁰

A. Reliance on the Physical Object

The central premise of negotiability is that assets can be transferred more readily in a system that allows a physical object to represent all rights in the assets. As Part I explained, all of the benefits that negotiability offers arise from the system's use of the document as the ultimate indicator of rights in the assets. The clearest evidence of the true irrelevance of negotiability to the checking system is the growing push to adopt "truncated" processing devices that rid the system of the physical document as much as possible.

The checking system faces the same technological pressures as the various payment and credit systems discussed in Part II, but it must deal with those pressures on a canvas of daunting size, in a system called upon to process more than sixty billion checks a year.¹²¹ The absurdity of reliance on the physical document is evidenced by the need for the banks where checks are deposited (depository banks) to sort those checks and then have them transported (normally by truck or airplane) to locations designated by the various banks on whom the checks are drawn (the payor banks).¹²² One study concludes that the current collection process expends approximately 2.5 cents to process each paper check,¹²³ but the costs can be much higher. For instance, the Federal Reserve in some cases may charge

120. My conclusion is similar in some respects to the argument presented by Jim Rogers in his work in this area. We both argue that negotiability concepts have no relevance to the modern checking system. See Rogers, *The Irrelevance of Negotiable Instruments Concepts*, *supra* note 5. My argument, however, is considerably broader, because it rests more on the physical attributes of the system than on the legal developments on which Rogers focuses.

121. See 1 BANKERS ROUNDTABLE, *supra* note 36, fig.25, at 53 (reporting statistics).

122. My description of the check-collection process is based on two site visits to check-processing centers. The first was a March 7, 1996 visit to the check-processing center for the First National Bank of Chicago [hereinafter First Chicago Site Visit]. (Because my tour at First Chicago was conducted by several different people, it is not practical to attribute information to any particular individual.) The second site visit was a September 18, 1996 visit to the check-processing center for the Boatmen's National Bank of St. Louis, where I received a tour conducted by William W. Barks, Assistant Vice President [hereinafter Boatmen's Site Visit].

123. Allen N. Berger et al., *The Transformation of the U.S. Banking Industry: What a Long Strange Trip It's Been*, 2 BROOKINGS PAPERS ON ECON. ACTIVITY 55, 69 (1995).

more than twenty-five cents per check.¹²⁴ The fact is, in the checking system just as much as in any other payment system, the notion of centralizing legal rights in the physical document is no longer the benefit it might have been centuries ago: It is an albatross that drags down the entire system.

The key intellectual challenge is to realize that however central the "document" might be to a negotiability-based system, there is no reason for the checking system to continue to operate a document-based system for collection of checks. The collection process needs to facilitate two actions by the payor bank: a decision whether to honor the check; and transmission of payment or notice of dishonor to the depository bank. Given the capabilities of existing technology, physically transporting the check from place to place is not the simplest way to perform those two functions. It makes much more sense and should be dramatically cheaper in the long run to perform those functions electronically—by a transmission from the depository bank to the payor bank advising of the deposit of the check; and a return transmission from the payor bank agreeing or declining to honor the check.¹²⁵ Indeed, the inevitability of the demise of the paper-based processing system has been obvious for so long that the revisers of Article 4 in the 1980s took several conscious steps to give the statute the flexibility to accommodate the truncated electronic system that should replace the current system over the next few decades.¹²⁶

Indeed, the beginnings of a truncated system already are in place. In 1994, some form of electronic presentment was used for over 650 million checks, which was just over one percent of the total volume.¹²⁷ For checks cleared through the Federal Reserve system, truncation is even more

124. Boatmen's Site Visit, *supra* note 122 (describing per-item charges by the Federal Reserve Bank in St. Louis that go as high as 27 cents).

125. Of course, a truncated system need not require a return transmission from the payor bank agreeing to honor the check. Like the current system, the system instead could assume that the payor bank will pay all checks unless it sends a contrary notice within some specified time. In my view, a system requiring a return message expressing a decision to honor or dishonor would be likely to expedite the system. Similar messages are characteristic in those systems that already rely on electronic presentment. See LOPUCKI, WARREN, KEATING & MANN, *supra* note 3 (manuscript assign. 18, at 3-4, on file with author) (describing authorization of payment in debit-card transactions); *id.* (manuscript assign. 19, at 3, on file with author) (describing authorization of payment in credit-card transactions).

126. See, e.g., U.C.C. § 4-101 cmt. 2 (1991) (discussing need for flexibility).

127. ECP: *Gateway to Truncation*, CORPORATE EFT REPORT, May 31, 1995, at 5 (reporting that electronic presentment doubled to about 650 million items in 1994). Electronic presentment need not involve complete truncation. As discussed below with respect to electronic cash letters, electronic presentment often still requires the depository bank to forward the paper checks to the payor bank. See *id.*

common, in the range of two percent of all checks.¹²⁸ Under that system, the check stops when it reaches the depository bank. Instead of transmitting the check to the payor bank or an intermediary, the payor bank creates a record of the check, either a photographic image or a digital record of the relevant data.¹²⁹ The depository bank then transmits an electronic message seeking collection.¹³⁰ Depending on the agreement between the parties (or, perhaps more likely in the future, on standardized rules implemented by the Federal Reserve), the message might consist of the entire image or simply include data summarizing relevant facts about the check, such as the payor bank, account number, amount, date, and payee. Ideally, the message would be sent directly to the payor bank, but currently many of those transactions still pass through an intermediary such as the Federal Reserve.¹³¹

The payor bank receiving the message has the same options as it has under the conventional paper-based clearing process—it can honor the check or dishonor it. If it chooses to dishonor the check, it advises the depository bank electronically of its decision.¹³² If the payor bank chooses to honor the check, it has no obligation to do anything.¹³³ At the end of the month, the payor bank cannot return the actual checks to its customers because those checks are still at the depository bank. Therefore, it sends its customers either images of the checks (much like the images of credit-card slips that come with American Express bills) or

128. See AMERICAN BANKERS ASS'N, CHECK PROCESSING/WHOLESALE OPERATIONS: RESULTS OF 1994 INDUSTRY SURVEY 13 (1994).

129. Banks already create photographic images when they process checks to enable them to reconstruct a check in the event that the paper object is lost or destroyed during the collection process. See Boatmen's Site Visit, *supra* note 122; First Chicago Site Visit, *supra* note 122. Some banks also create digital records as well, although that technology is only now becoming widely used. See Boatmen's Site Visit, *supra* note 122 (describing electronic cash letters).

130. See U.C.C. § 4-110 (1991) (permitting a depository bank to transmit "an image of an item or information describing the item . . . rather than . . . the item itself"); Availability of Funds and Collection of Checks (Regulation CC), 12 C.F.R. § 229.36(c) (1996) (permitting a bank to "present a check to a paying bank by transmission of information describing the check in accordance with an agreement with the paying bank").

131. See ECCS *May Significantly Improve Check Collection*, CORPORATE EFT REPORT, May 5, 1993, at 1-3 (describing electronic presentment services offered by the Federal Reserve Bank of Minneapolis).

132. See U.C.C. § 4-301(a)(2) (1991) (permitting written notice of dishonor rather than return "if the item is unavailable for return"); 12 C.F.R. § 229.31(f) (permitting return of a copy of a check "[i]f a check is unavailable for return").

133. As discussed above, it probably would be better for the system in the long run to require payors to send a return message honoring the check contemporaneously with presentment. See *supra* note 125.

detailed statements describing the transactions reflected by the checks.¹³⁴ Finally, the depository bank retains the image of the check for a period of time sufficient to resolve disputes that might arise.¹³⁵

The outmoded nature of the document-based processing system is made even clearer by the burgeoning use of electronic cash letters, also known as electronic presentment.¹³⁶ In that system, a depository bank runs checks through a machine that produces a computer file containing the relevant information about the checks and sends that file directly to the payor bank by electronic mail. The payor bank then must decide on an expedited basis whether it wishes to honor or dishonor the checks. In accordance with customary practice, the paper copies of the check are transmitted later by ordinary procedures. Because the payor bank has made and communicated all of the relevant decisions long before the paper checks arrive at the depository bank, the transportation of those checks expends a great deal of resources for no useful purpose.¹³⁷ The physical transportation of the checks, the last surviving vestige of negotiability, should succumb to budgetary pressures in the immediate future.

But there is more at stake here than cost savings. An electronic system is not only cheaper than a document-based system, it should be much faster as well. An electronic presentment system should be able to clear checks nationwide on a same-day or same-hour basis, so that check recipients would receive final payment almost immediately upon deposit. The skeptic should consider how easily banks are able to process electronic payments made by debit cards. Although there are some differences, there is no fundamental reason why the system could not develop so that payor banks respond with the same promptness to payment directions made by way of check as they presently do to payment directions made by way of a debit card.

134. See 1 BANKERS ROUNDTABLE, *supra* note 36, at 54 (discussing plans for image statement processing and for truncated statements); Boatmen's Site Visit, *supra* note 122 (same).

135. See Boatmen's Site Visit, *supra* note 122 (stating that the bank retains the information for seven years); see also U.C.C. § 4-406(b) & cmt. 3 (1996) (discussing the relation between check retention plans and the obligation of a payor bank to provide canceled checks to its customers).

136. My description of electronic cash letters is based on the Boatmen's Site Visit, *supra* note 122. For a similar but less detailed account, see ECP *May Be Best for Now*, CORPORATE EFT REPORT, May 31, 1995, at 5.

137. The reason the checks are transported is that the payor bank could not allow the depository bank to abandon transportation of the checks and move to complete truncation unless the payor bank was willing to give up the capability of providing its customers canceled checks with their statements. See Boatmen's Site Visit, *supra* note 122.

Of course, an electronic system would impose some costs on the entities that wrote checks, because they would lose the "float" they gain in the current system during the time that passes between their writing a check and the removal of the funds from their account. Unfortunately, however fond of float we may be as individuals, a system in which expedited processing minimizes the float available to check writers should improve the checking system as a whole by increasing the value of the check as a payment system. Presently, a merchant gets paid more when it gets immediate cash than when it gets a check, both because it gets use of the funds earlier, and because payment is far more certain. And the increase in certainty means that a system that provides contemporaneous clearing does something more than transfer the time value of the float from the consumer writing the check to the merchant that receives it. By increasing the certainty of collection, contemporaneous clearing lowers the costs of collection and thus increases the effectiveness of the system as a whole.¹³⁸

The ability of the system to develop such a completely electronic collection system does not prove the irrelevance of the document-based negotiability system, for current procedures still transport tens of billions of checks for physical collection each year. Nevertheless, the potential for a development that would eliminate physical collection entirely strongly suggests that the concept of negotiability no longer plays any useful role in the system. The following subparts illustrate that point by explaining the two main ways in which negotiability concepts have faded from the checking system in current practice.

B. Signatures as a Device for Transferring Title and Accepting Liability

As discussed in Part I, one of the central benefits that negotiability offers is the simplification of title transfer procedures that arises from a system in which title is transferred by delivery of the document, supplemented only by inscription on the document of any necessary signatures. Article 3 codifies those principles of negotiability with an elegant array of rules that describe what types of signatures are effective to transfer complete

138. Absent some other change to the system, contemporaneous clearing would harm consumers not only by depriving them of the float they currently have, but also by limiting their ability to stop payment. That problem, however, is not inevitable. As the credit-card system shows, it is possible for a system to provide a merchant substantially contemporaneous payment and also provide the purchaser a realistic ability to stop payment at a later date.

title to a negotiable instrument¹³⁹ and create a complex set of liabilities on the instrument depending on the type of signature.¹⁴⁰

As it happens, however, those rules have little influence on the mechanics of the check-collection process, largely because of the impracticality of determining the validity of a purported signature. Instead, for the most part the system in practice ignores the signatures (or the absence of signatures) and relies on other more effective mechanisms for limiting losses from theft and fraud.

1. Indorsements

I start with the simpler topic: the mechanisms for evaluating the transfers of an instrument that was validly issued. Under the classic principles of negotiability, a party that receives an instrument payable to order (such as a check) can transfer full rights in the instrument only by signing the instrument.¹⁴¹ Thus, the principles of negotiability contemplate a process in which a party acquiring an instrument examines the instrument in order to determine whether the required indorsements are present and then requires the transferor of the instrument to provide any necessary indorsement that is not already present.

In practice, however, many banks find it impractical to examine each check to determine if the appropriate indorsements are present. To be sure, an employee who examines a check presented for cashing or deposit at a teller window might, and probably should, examine the check to see if the appropriate indorsement appears to be present. If the indorsement is not present, the employee can ask the person at the window to add the required indorsement. As a practical matter, however, tellers frequently fail to examine checks presented for deposit.¹⁴²

139. U.C.C. §§ 3-204 to -207, 3-401 to -403 (1991).

140. *Id.* §§ 3-409, 3-412 to -415.

141. Without the indorsement, the purchaser of the instrument cannot become a holder because the seller would remain the identified person to whom the instrument is payable, *see id.* § 1-201(20) (1996), and thus, cannot become a holder in due course. *See id.* § 3-302(a) (1991) (a holder in due course must be a holder). To be sure, the transferee without an indorsement does acquire some rights in the instrument under U.C.C. section 3-203(b), including the right to enforce it under U.C.C. section 3-301(ii), but that package of rights is distinctly less than the rights as a holder in due course that it could acquire with an indorsement. *See id.* § 3-203 cmt. 2 (discussing the procedural disadvantages of failing to obtain holder status on acquisition of an instrument).

142. *See Boatmen's Site Visit, supra* note 122 (noting that tellers are particularly unlikely to notice missing indorsements on checks presented with deposits that contain numerous items).

Moreover, an increasingly large share of deposits are made at automatic teller machines where the depository bank cannot readily seek the appropriate indorsement.¹⁴³ Indeed, banks are encouraging customers to use remote deposit locations in order to save on the substantial¹⁴⁴ costs that banks incur in receiving deposits directly through tellers.¹⁴⁵ In that context, the bank cannot simply ask for the indorsement; it would have to return the check to the customer to obtain the indorsement. Although some banks do return those checks, many do not. Instead, even if they notice the absence of the indorsement, many banks simply process the check without the indorsement.¹⁴⁶

Common financing practices also make reliance on the indorsement requirement impractical. For example, one common practice requires borrowers to have their customers mail payments not to the borrower, but directly to a depository bank for deposit to a "lockbox" account. That account technically is in the borrower's name, but the depository bank ordinarily has agreed to prevent the borrower from removing funds from the lockbox without the lender's permission. The idea is that the lender can limit the borrower's ability to misuse funds it receives from its business if the lender can cause the funds to be deposited directly into an account from which the borrower cannot readily obtain the funds. In the lockbox scenario, the checks will have come straight from the depositor's customers, so none of them will bear indorsements by the customer.¹⁴⁷

Banks would be within their rights in refusing to take unindorsed checks and instead returning them to their customers. But two obvious reasons justify the common (though not universal) practice of accepting the checks. First, however central the indorsement may be to negotiating the check in the abstract, the bank in practice has little to gain by wasting the

143. See Janice Fioravante, *Marching to 2000 with a Range of Functions*, AM. BANKER, Nov. 27, 1995, at 6A (reporting that about 15% of bank customers make deposits at ATMs).

144. One industry source recently estimated the cost of a teller deposit transaction at almost three times the cost of an ATM deposit transaction (75 cents versus 27 cents). See *Technology: Shift a Gear*, BANKER, Nov. 1, 1995, at 94, available in 1995 WL 9701387.

145. See Denise Duclaux, *How to Handle Fees? Very Carefully*, AM. BANKING J., June 1996, at 32, 32-33 (reporting that within a month of the bank's imposing a three-dollar fee on deposits made at teller windows, customer deposits at First National Bank of Chicago ATMs doubled, and that ATM deposits have risen by another fifty percent since then, even though the teller-deposit fee subsequently was reduced to \$1.50).

146. See *Boatmen's Site Visit*, *supra* note 122; *First Chicago Site Visit*, *supra* note 122. In response to skeptical comments by several readers of drafts of the Article, I tested the practice empirically in February and March of 1997 by the simple device of making several ATM deposits into my personal banking account that included unindorsed checks. In each case the depository bank processed the check without inquiry or a request for indorsement.

147. See U.C.C. § 4-205 cmt. (1995).

time and effort that would be necessary to obtain its customer's indorsement. Because the payor bank is unlikely to check for the presence of an indorsement before deciding whether to honor the check, the absence of the indorsement is unlikely to affect the payor's decision whether to honor the check.¹⁴⁸ If the check in fact clears, as the overwhelming majority of checks do,¹⁴⁹ the absence of an indorsement will be irrelevant unless the drawer subsequently challenges the depositor's right to the funds. Nor will the absence of an indorsement harm the depositor bank in the unusual event that the check does not clear, because the bank's right to charge the bounced check back to its depositor does not depend on the depositor's having indorsed the check.¹⁵⁰

The second reason arises from the first. Recognizing the impracticality of requiring customer indorsements (especially in the lockbox situation), the drafters of the revised Article 4 in the 1980s added a relatively obscure provision to Article 4 (U.C.C. section 4-205) that creates an exception to the indorsement requirement for checks. Under that provision, if a customer that is a holder of an item deposits it at its bank without the required indorsement, the bank becomes a holder of the item even if the customer neglects to make the indorsement.¹⁵¹ Thus, the brief phrasing of U.C.C. section 4-205 effectively removes the indorsement requirement from the ordinary course of check processing. The fact that the provision has gained so little attention only demonstrates the irrelevance of the indorsement: enactment of that provision only reflected the obsolescence of the indorsement; it did not cause it.

That provision does not completely vitiate the need for a bank to consider indorsements, because it only forgives the absence of an indorsement of the customer. If the customer is not a holder at the time of the deposit (most likely because the customer obtained the check without obtaining an indorsement from the prior holder), then the bank will not

148. See Boatmen's Site Visit, *supra* note 122; First Chicago Site Visit, *supra* note 122.

149. A recent industry survey suggests that the rate of clearance is about 99.4% at large banks (that is, that 0.60% of processed checks are returned), but drops to about 98.5% for small banks. AMERICAN BANKERS ASS'N, *supra* note 128, tbl.33, at 37. Those statistics are consistent with the estimate I received at one of the banks I visited. The officer guiding me around the processing center estimated that only 10,000 checks are returned each day out of the 1,700,000 checks that the bank processes, a return rate of less than two-thirds of one percent. See Boatmen's Site Visit, *supra* note 122.

150. See Boatmen's Site Visit, *supra* note 122 (explaining that the right to charge back the check justifies the bank's willingness to process the check notwithstanding the absence of the indorsement); see also Rogers, *The Irrelevance of Negotiable Instruments Concepts*, *supra* note 5, at 943-46 (discussing the depository bank's rights to charge back a dishonored check).

151. U.C.C. § 4-205(1) (1995).

become a holder even under the lenient rules of Article 4. That scenario, however, is not common, because the overwhelming majority of checks are deposited directly by the original named payees; only a small percentage of checks are transferred before deposit.¹⁵² In any event, for the reasons outlined above, banks are relatively unlikely to reject a check for deposit solely because it is deposited into an account that bears a name different from the name of the payee identified on the check.¹⁵³

In sum, the central place of indorsements in transferring title and allocating liability for negotiable instruments has no significant role in the modern check-processing system. Checks are deposited, processed for collection, and paid without any significant attention to the presence or absence of the indorsements required by Article 3.

2. Drawers' Signatures

The absence of a drawer's signature is more serious than the absence of an indorsement because an instrument that does not have a valid signature of the purported drawer is completely invalid. Thus, unlike the situation with indorsements, it is much less common for the check-processing system consciously to accommodate checks that do not even purport to bear the drawer's signature.

But whatever the problem, it is not practicable for the payor bank to rely on a verification of the physical signature as a predicate for determining whether it will honor the check. The biggest problem is the sheer volume of checks that a payor bank must process. A large check-processing center will receive something on the order of one million checks each

152. Although it is difficult to obtain precise statistics, a general idea of the relative rarity with which checks are transferred before they are deposited can be obtained by comparing the size of the commercial check-cashing industry (estimated at 128 million checks in 1990) with the total volume of checks (55 billion during that same year): less than one-quarter of one percent. See JOHN P. CASKEY, *FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNHOPS, AND THE POOR* 64 (1994) (reporting that the commercial check-cashing industry cashed 128 million checks in 1990); 1 BANKERS ROUNDTABLE, *supra* note 36, at 53 (reporting a total volume of 55.3 billion checks in 1990). Two of my colleagues offered interesting anecdotes on that point. Leila Wexler explained to me that the personal checks normally offered by banks in France come preprinted in a "barred" form that prohibits negotiation of the check except in connection with a deposit by the named payee. Similarly, Lynn LoPucki told me of a cash-management account that a stock brokerage firm offers as a checking-account substitute. That account accepts checks for deposit only if the depositor is the named payee; it does not accept third-party checks.

153. See *supra* note 146.

day.¹⁵⁴ It would take an army of signature examiners to compare the signatures on that many checks with the signature cards¹⁵⁵ for the relevant accounts. To be sure, some small banks still verify signatures on the checks their customers write.¹⁵⁶ More commonly, however, banks limit signature verification to a small group of the checks that they receive.¹⁵⁷ For example, one of the processing centers that I visited examines the signatures on 20,000 checks per day, less than one-half of one percent of the checks that it receives.¹⁵⁸ Thus, although 20,000 checks per day might seem like a large number in the abstract, that sample is highly unlikely to include all of the fraudulently issued checks: the payor bank's evaluation of more than 99.5% of the checks proceeds without any examination at all of the drawer's signature.¹⁵⁹

The difficulty of determining whether a signature is valid heightens the impracticality of examining signatures. Absent a striking lack of competence, a forger with a sample of a valid signature should be able to provide a signature that would pass muster even if the check is in the small sample a bank chooses for examination.¹⁶⁰ Thus, the bank cannot be

154. See Boatmen's Site Visit, *supra* note 122 (reporting that it processes about 1,700,000 checks per business day); First Chicago Site Visit, *supra* note 122 (reporting commercial processing alone of 500,000-700,000 checks per business day).

155. The enormity of the task of examining signatures is magnified by the elaborate signature cards for large commercial enterprises, which describe dozens of people that have varying levels of authority on various accounts. See First Chicago Site Visit, *supra* note 122.

156. See AMERICAN BANKERS ASS'N, *supra* note 128, tbl.55, at 45 (reporting survey indicating that 33% of small banks, but only 7.3% of medium banks and 1.7% of large banks, verify signatures on all checks).

157. Banks understandably are reluctant to offer specifics about how they select checks for signature verification, but most appear to rely on some combination of random sampling, dollar size of check, source of deposit, type of account, and requests from their customers. See *id.* (reporting results of survey on signature-verification criteria); Boatmen's Site Visit, *supra* note 122; First Chicago Site Visit, *supra*, note 122.

158. See First Chicago Site Visit, *supra* note 122. The process for examining checks that I observed at First Chicago is impressively efficient: each examiner examines about 3500 items per day. As mentioned above, the examiners do not examine the checks to determine if they appear to bear the required indorsements; they look only at the drawer's signatures. See First Chicago Site Visit, *supra* note 122.

159. The 20,000 checks per day works out to about 5,000,000 checks per year. During the previous year, the bank's examination of 5,000,000 checks identified 500 forgeries for a total of \$1.5 million. See First Chicago Site Visit, *supra* note 122. Discovery of those forgeries may have justified the cost of the operation, but it cannot plausibly be thought to have captured all of the fraudulently issued checks.

160. To be sure, in many cases a legitimate business that takes a check may require the person writing the check to present identification to verify the check writer's identity. That practice, however, does not protect the bank at all against the common scheme in which a forger

sure that the signature is valid even on the few checks that it does examine.¹⁶¹

In the end, banks are faced with a reality in which the signature provides little significant protection against losses from fraud. To have any realistic protection against those losses, banks must move beyond negotiability and develop other, nonsignatory devices to protect themselves. The most prominent of those devices are systems in which the drawer of the check directly authorizes payment so that the payor bank can rely on that authorization rather than the signature. For example, consider the "positive-pay" system of check verification that is coming into common use for large business accounts.¹⁶² In that system, the bank provides its customer with a software package that allows the customer to send the bank a computer file at the close of each business day that describes each check that the customer has issued. When checks are presented to the bank for payment, the bank can rely on computerized sorting and analysis of the checks to determine if the checks presented for payment match checks described in the daily transmissions. If the checks are described in those transmissions, then the payor bank need not examine the signature on the check because the bank has something better than a signature to evidence the drawer's willingness to pay—a direct electronic message from the customer verifying its willingness to pay. Conversely, a check that is not described in the transmissions can be dishonored even if it is such an excellent forgery that it appears on its face to be a validly issued check.¹⁶³

It is encouraging that the checking system has begun to move beyond reliance on the signature and to develop nonsignatory devices for verifying

writes a check payable to itself, drawn on the account of some innocent third party, deposits the forged check in its own account, and absconds with the funds when the payor bank mistakenly honors the check.

161. For a general discussion of the relative difficulty of determining that a physical signature is valid, see Benjamin Wright, *Eggs in Baskets: Distributing the Risks of Electronic Signatures* 1-3 (visited Feb. 16, 1997) <<http://www.ssrn.com/cyberlaw/lawpaper.html>>.

162. A recent survey by the American Bankers Association suggests that positive-pay systems are gaining popularity rapidly, especially with large banks. See AMERICAN BANKERS ASS'N, 1994 ABA CHECK FRAUD SURVEY 66 (1994) (reporting results of 1993 survey indicating that positive-pay systems were being marketed by 54.5% of large banks, but by only 6.5% of medium-sized banks and 2% of small banks).

163. My description of positive-pay systems rests on conversations during my visit to First National Bank of Chicago. See First Chicago Site Visit, *supra* note 122. Boatmen's Bank does not yet use positive-pay systems, although it does use a similar system described as "pay-on-issue" authorization. In that system, the bank sends an electronic message to designated customers each day describing the checks that have been presented for payment. The customers compare the checks listed in the message to the checks that they have authorized and indicate to the bank directly which checks should be honored and dishonored. Boatmen's Site Visit, *supra* note 122.

the drawer's authorization of the instrument. But those nonsignatory verification devices do not solve the difficulty with physical signatures as much as they highlight two fundamental problems with a payment system that relies on physical signatures. First, a system that relies on physical signatures cannot even make a pretense of verifying the signature without comparing the signature to a specimen signature of the customer; and the logistics of getting the check to a place where it can be compared to the signature and of effecting that comparison are relatively time consuming. Second, even if the system goes to the trouble of making the comparison, the comparison of a physical signature to a specimen signature is necessarily inexact and cannot significantly deter a determined forger.

Those problems are directly attributable to the document-based system of negotiability out of which the checking system has developed. Nonsignatory verification systems may mitigate those problems, but they cannot solve them completely, if only because of the expense of grafting a universal nonsignatory verification system onto the current checking system.¹⁶⁴ To completely solve those problems, the system would have to cut loose from the documentary moorings of negotiability and move to an entirely non-documentary system, perhaps one that relies on digital signatures. A digital-signature system would fulfill the verification function much more effectively than the current system because digital signatures can be verified much more inexpensively and reliably than conventional physical signatures.

In its most common current form, a digital signature is a unique identifier that a signer imprints onto a document with a secret key (the "private key").¹⁶⁵ The process of imprinting that signature encrypts the message and performs a numerical calculation based on the text of the message to which the signature is attached; the signature appears in the form of a number (the "hash value") that is the end result of the calculation. Readers of the message can check the validity of the signature with a second key (the "public key"). Using the public key, the digital-signature software performs a second numerical calculation on the text of the signed message. If nobody has altered the message, and the signor executed it with the private key that corresponds to the public key that the software is using, then the hash value in the digital signature will bear the correct relation to

164. Most obviously, it is difficult to contemplate a system that would require consumers to make a nonsignatory verification of each check that they write.

165. For a thorough and lucid discussion of the mechanics of digital signatures, see A. Michael Froomkin, *The Essential Role of Trusted Third Parties in Electronic Commerce*, 75 OR. L. REV. 49, 51-67 (1996).

the message, so that the public-key calculation will decode the encrypted message and produce an intelligible document. If the message has been altered or if the message was encrypted without the correct private key, the public key will fail to decode the message and the forgery or alteration will be evident.

When compared to the conventional system of verifying authorizations based on physical signatures, the digital-signature system has several advantages. First, in the digital-signature system, the process of signature verification is completely objective, making the likelihood of error quite small. Second, because the process is computerized, it does not require the intervention, time, or judgment of individual employees. Third, the likelihood of forgery is considerably diminished: absent a theft of the private key, it is highly unlikely that a forger successfully could imprint a signature that would appear to be valid. Finally, and of particular importance, the use of a digital signature makes alteration extraordinarily difficult. If the document is changed after the signature is imprinted, then assuming that the altering party does not have the private key, the public-key calculation will not decode the message because the signature will not bear the proper (private-key generated) relation to the message as it reaches the reader. Thus, any attempt to verify the signature of an altered document will reveal the alteration.

In the end, the focus of negotiability on the signature is just as cumbersome as its focus on the physical check. However much sense a signature requirement might have made in simpler days when purchasers of negotiable instruments could be expected to have some personal knowledge of the parties whose signatures purported to appear on instruments, it makes no sense at all in a modern checking system that presents a single institution with millions of checks to evaluate every single day. In a world in which banks lose hundreds of millions of dollars to check fraud each year,¹⁶⁶ the ready availability of more effective and reliable substitutes indicates that the system can only be improved by a prompt move beyond a signature-based system.

C. Rights of a Holder in Due Course

To the lay observer, the most prominent attribute of negotiability is the ability of the holder in due course to defeat a variety of defenses and

166. See Jaret Seiberg, *Fed Says That Check Fraud Cost Banks and Thrifts \$615M in '95*, AM. BANKER, Oct. 17, 1996 (discussing Federal Reserve survey estimating 1995 losses from check fraud at \$615 million).

claims related to an instrument that would have been valid against prior parties to the payment transaction. In practice, however, that legal right has even less relevance to the daily operation of the checking system than the signature requirement discussed above.

The reason that holder-in-due-course status is irrelevant is simple: The parties that qualify as holders in due course in the checking system almost invariably have other remedies that in the overwhelming flow of cases are much more effective than a suit relying on holder-in-due-course status. Consider a standard check transaction based on the model transaction from Part I, in which Clothier writes a check to Merchant to purchase wool. Merchant promptly deposits the check into its account at Depository Bank. Depository Bank then forwards the check for collection to Payor Bank, the bank at which Clothier maintains its account. Next, suppose that Clothier stops payment on the check because it is unsatisfied with the wool.¹⁶⁷ Accordingly, Payor Bank dishonors the check and returns it to Depository Bank.¹⁶⁸ The only party that could be a holder in due course in the transaction would be Depository Bank. Merchant would be subject to Clothier's claims because it was the original party to the sale transaction in which Clothier issued the check.¹⁶⁹ Thus, the relevance of holder-in-due-course status to that transaction is that it would enable Depository Bank¹⁷⁰ to enforce the check against Clothier (the drawer of the check) without regard to the merits of Clothier's claims against Merchant (the original payee of the check).¹⁷¹

But that right is almost completely nugatory because the depository bank has a much more effective remedy at hand in its right of charge-back.¹⁷² The right of charge-back allows the depository bank to protect

167. See U.C.C. § 4-403 (1995) (describing a customer's right to stop payment).

168. See *id.* § 4-301(a) (allowing a payor bank to revoke a provisional settlement if it returns an item and sends written notice of dishonor by its midnight deadline).

169. See *id.* § 3-305(b) (1991) (even a holder in due course is subject to claims made against itself).

170. Depository Bank would have that right only if it became a holder in due course. Assuming that Depository Bank had no notice of Clothier's complaint, Depository Bank would become a holder in due course if it gave "value" for the check. *Id.* § 3-302(a)(2). To give value generally would require Depository to make the funds represented by the check available to Merchant for withdrawal. *Id.* § 4-211 (1995) (depository bank gives value when it obtains a security interest); *id.* § 4-210(a)(1), (2) (depository bank obtains security interest when funds are withdrawn or when credit is "available for withdrawal as of right").

171. See *id.* § 3-305(b) (1991) (holder in due course takes free of personal defenses of the obligor against a party other than the holder).

172. I am not the first academic to note the relative attractiveness of the charge-back option. Professor Rosenthal noted it 25 years ago, but concluded that banks at that time still regularly exercised their holder-in-due-course rights. See Albert J. Rosenthal, *Negotiability—Who Needs It?*,

itself directly by the simple device of charging the check back to the depositor's account, removing any provisional credit that it gave the depositor at the time of the deposit.¹⁷³ From the perspective of the depository bank, the charge-back remedy is much more effective than the right to sue the drawer offered by holder-in-due-course status. Ordinarily, the depository bank can make itself completely whole by reversing any credit in the depositor's account—making a single simple computer entry—and by sending a written notice to the depositor of the charge-back.¹⁷⁴

The bankers with whom I have discussed the topic universally agree that the depository bank normally would not respond to dishonor by pursuing the drawer. For example, one banker remarked, "I've never even heard of that."¹⁷⁵ Rather, the typical procedure upon return of a check is to charge the check back to the depositing customer.¹⁷⁶ When pressed for the existence of any alternative responses, the only practicable alternative the bankers suggested was to send the check through for collection a second time.¹⁷⁷

The aversion to relying on holder-in-due-course status to pursue the drawer is easy to understand. Where a charge-back generally should make the depository bank whole in a few moments,¹⁷⁸ the right against the drawer is much less likely to make the depository bank whole, either

71 COLUM. L. REV. 375, 382–85 (1971) (describing a "steady stream of reported cases"). He argued that the unfairness of that result to check writers justified abolition of holder-in-due-course status. *Id.* at 402. As I argue below, the current situation seems to be different from the situation he observed—in current practice, banks seem to rely on the holder-in-due-course option quite rarely. Accordingly, abolishing holder-in-due-course status would have no significant direct effect on rights against check writers.

173. See U.C.C. § 4-214(a) (1995) (allowing depository bank to charge a check back to its customer if the payor bank does not honor the check).

174. See *id.* (describing mechanics of charge-back).

175. See Boatmen's Site Visit, *supra* note 122.

176. See *id.*; First Chicago Site Visit, *supra* note 122; Interview with Frank Trotter, Director, International Markets Division, Mark Twain Bancshares, in St. Louis, Mo. (Apr. 1996); Telephone Interview with Joe DeKunder, Vice President, NationsBank of Texas, N.A. (Apr. 1996) [hereinafter DeKunder Interview].

177. See Boatmen's Site Visit, *supra* note 122; DeKunder Interview, *supra* note 176. The officer at Boatmen's explained that their large customers pay a fee to have checks under \$100 reprocessed automatically. About two-thirds to three-quarters of the checks are honored the second time through. The depository bank then charges any remaining checks back to the depositor. See Boatmen's Site Visit, *supra* note 122.

178. The only exception would be situations in which the depository bank has allowed its customer to withdraw funds represented by the check before the check has cleared. Even in that situation, the bank would have a right to recover the funds from its customer. See U.C.C. § 4-214(d)(1) (1995) (charge-back is available even after funds are withdrawn).

because the drawer is insolvent or because the drawer does not wish to pay as a result of some disagreement with the payee.¹⁷⁹

To be sure, that does not demonstrate that holder-in-due-course status never matters. After all, theoretically there should be cases in which for some reason a bank cannot charge a check back to its depositor and must rely on holder-in-due-course status to recover from the original drawer. But consider all the circumstances that would have to occur for holder-in-due-course status to become relevant to enforcement of a check: (a) a bank lets its customer withdraw uncollected funds, (b) the bank is unable to recover the funds from its customer, (c) the amount of the claim is sufficient to justify pursuing the drawer, (d) the drawer's financial strength is sufficient to make pursuit worthwhile, (e) the drawer has a defense that would be valid against the original payee,¹⁸⁰ (f) the bank successfully defeats that claim because it is a holder in due course,¹⁸¹ and (g) the bank successfully collects on its claim. The conjunction of all of those characteristics seems so rare that it resembles a stroke of lightning more than a fundamental organizing feature of the system.

179. Neither of which would be a surprising circumstance in a case in which a check was dishonored.

180. In some cases, of course, the drawer will have no valid defense, so holder-in-due-course status will not be necessary to the depository bank's action. See, e.g., *First Fed. Sav. & Loan Ass'n v. Chrysler Credit Corp.*, 981 F.2d 127, 132-34 (4th Cir. 1992) (holding that lack of good faith deprives bank of holder-in-due-course status, but allowing it to enforce checks anyway because of the failure of a drawer to establish a personal defense); *Diamond Sav. Loan Co. v. Hoisington*, No. 88AP-976, 1989 WL 104389, at *1-*6 (Ohio Ct. App. Sep. 12, 1989) (rejecting a series of purely procedural defenses interposed by the drawer), *appeal dismissed*, 550 N.E.2d 479 (Ohio 1990); see also, e.g., *Citizens First Bank v. Intercontinental Express, Inc.*, 713 P.2d 1097, 1097-99 (Or. Ct. App. 1986) (ruling in favor of bank without suggesting any defense to enforcement of the check).

181. In some cases, the bank's suit will fail because the bank will not be able to establish holder-in-due-course status. See, e.g., *M & I Marshall & Ilsley Bank v. National Fin. Servs. Corp.*, 704 F. Supp. 890, 891-92 (E.D. Wis. 1989) (bank was not a holder because it was not in possession of the check); *Great Western Bank & Trust Co. v. Pima Sav. & Loan Ass'n*, 718 P.2d 1017, 1018-21 (Ariz. Ct. App. 1986) (depository bank took subject to personal defenses because it had knowledge of them when it took a check); *Key Bank, N.A. v. Strober Bros., Inc.*, 523 N.Y.S.2d 855, 856-58 (App. Div. 1988) (notation on a check put depository bank on notice of claims). In other cases, the bank's suit may not fail directly, but the bank's efforts to establish holder-in-due-course status will require considerable litigation. See also *Robbins v. Hasan*, 625 N.Y.S.2d 160, 161 (App. Div. 1995) (affirming the trial court's denial of summary judgment for holder based on issues of fact about holder-in-due-course status); *Central Trust Co. v. Fricker*, No. 47-CA-85, 1986 WL 3921, at *1-*2 (Ohio Ct. App. Mar. 25, 1986) (reversing trial court's decision ruling against a holder for insufficient evidence and remanding for a second trial); *Oostburg State Bank v. United Sav. & Loan Ass'n*, 386 N.W.2d 53, 54-59 (Wis. 1986) (reversing a trial court's default judgment in favor of the holder and remanding for further proceedings).

To verify that hypothesis, I undertook a survey of reported cases in an effort to assess the frequency of litigation over holder-in-due-course status in the enforcement of checks. I conducted a broad search on Westlaw for all cases decided since 1985 that mention holder-in-due-course status and checks.¹⁸² Examination of the cases recovered by that search¹⁸³ revealed only fifteen cases in which a depository bank relied on holder-in-due-course status to enforce a check (a little less than 1.5 cases per year),¹⁸⁴ only one of which was decided in the last three years.¹⁸⁵ In a world in which hundreds of millions of checks bounce each year,¹⁸⁶ one or two reported opinions per year is a truly tiny number.

I generally am skeptical about the use of reported opinions as a device to discover commercial practices because of the high probability that the sample of reported cases will differ significantly from the patterns of conduct in cases that do not lead to litigation or, even if they do lead to litigation,¹⁸⁷ do not produce reported opinions.¹⁸⁸ That problem seems to

182. I ran a search in the ALLCASES database for CHECK AND "HOLDER IN DUE COURSE" AND DATE (AFT 1985).

183. I ran the search on November 25, 1996, and recovered 346 cases.

184. The search period was more than ten years, beginning on January 1, 1986, and including all cases posted to the ALLCASES database by October 4, 1996.

185. In reverse chronological order, the fifteen cases were: *Braden Corp. v. Citizens National Bank*, 661 N.E.2d 838 (Ind. Ct. App. 1996); *Nationsbank v. Cookies, Inc.*, 22 U.C.C. Rep. Serv. 2d 838 (Va. Cir. Ct. Jul. 21, 1993); *First of America Bank-Northeast Illinois v. Bocian*, 614 N.E.2d 890 (Ill. Ct. App. 1993); *National City Bank v. Azodi*, 610 N.E.2d 1232 (Ohio Mun. Ct. 1992); *Dempsey v. Etowah Bank*, 418 S.E.2d 418 (Ga. Ct. App. 1992); *Galatia Community State Bank v. Kindy*, 821 S.W.2d 765 (Ark. 1991); *Bank of New York v. Asati, Inc.*, 15 U.C.C. Rep. Serv. 2d (Callaghan) 521 (N.Y. Sup. Ct. 1991); *Vail National Bank v. Finkelman*, 800 P.2d 1342 (Colo. Ct. App. 1990); *Great Country Bank v. Dacko*, No. CV87 02 44 11, 1990 WL 290125 (Conn. Super. Ct. Jul. 20, 1990); *Union Bank & Trust Co. v. Polkinghorne*, 801 P.2d 735 (Okla. Ct. App. 1990); *First State Bank v. Tate*, No. 3, 1988 WL 77625 (Tenn. Ct. App. Jul. 28, 1988); *Huntington National Bank v. Swiger*, No. 1701, 1987 WL 18034 (Ohio Ct. App. Sep. 30, 1987); *First American Bank v. Litchfield Co.*, 353 S.E.2d 143 (S.C. Ct. App. 1987); *Valley Bank v. JER Management Corp.*, 719 P.2d 301 (Ariz. Ct. App. 1986); *Western Bank v. RaDec Construction Co.*, 382 N.W.2d 406 (S.D. 1986).

186. If I use the generous assumption that only 0.50% of all checks are returned unpaid, see *supra* note 149 (reporting evidence that between 0.60% and 1.5% of the checks are returned at a typical bank), then based on the 60-plus billion checks a year written in this country, see *supra* note 121 (reporting statistics), the volume of returned checks each year would be about 300 million.

187. Sam Gross and Kent Syverud's recent empirical study of the dynamics that force cases to trial rather than settlement underscores that problem because they provide persuasive evidence of the oddity of those few cases that proceed to trial. See Samuel R. Gross & Kent D. Syverud, *Don't Try: Civil Jury Verdicts in a System Geared to Settlement*, 44 UCLA L. REV. 1 (1996).

188. For a defense of an analysis based on studies of reported opinions, see Jason Scott Johnston, *The Statute of Frauds and Business Norms: A Testable Game-Theoretic Model*, 144 U. PA. L. REV. 1859, 1902-05 (1996). That methodology is significantly different from the directly valuable examination of reported opinions to obtain empirical data as to the factors that influ-

me particularly likely to afflict the sample I present here given the small amounts likely to be in dispute in most cases of dishonored checks. Nevertheless, taken together with the results of my interviews, the tiny number of reported cases in which depository banks rely on holder-in-due-course status to enforce checks seems to provide some support for my hypothesis.

One final qualification is necessary to complete the analysis: the possibility that holder-in-due-course status could matter in cases where the depositor was not itself the original payee because the check was negotiated to a merchant or a check-cashing service before it was deposited. But that possibility seems just as unlikely to offer great relevance to holder-in-due-course status. First, as mentioned above, it is relatively uncommon for a check to be negotiated to a third party before deposit.¹⁸⁹ Second, the bulk of the checks cashed by check-cashing services apparently are payroll checks or government support checks that are extraordinarily unlikely to be subject to personal defenses.¹⁹⁰ Indeed, when they do cash personal checks, check-cashing services normally check with the payor bank in advance to diminish the risk of dishonor.¹⁹¹ Finally, even in cases where such a check is dishonored, the value of the holder-in-due-course defense will be limited to the rare case in which the party that interposes the defense has both (I) a valid defense¹⁹² that can be defeated¹⁹³ by the check casher's holder-in-due-course status,¹⁹⁴ and (II) sufficient assets to

ence trial courts in resolving ill-defined inquiries such as the propriety of piercing the corporate veil. See Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991) (reporting the results of such an inquiry).

189. See *supra* note 152 (reporting statistics indicating that commercial check-cashing services cash less than 0.25% of checks each year).

190. See CASKEY, *supra* note 152, at 55 ("[M]any [check-cashing] outlets cash only customers' payroll or government assistance and entitlement checks.").

191. See *id.* at 55-56.

192. In some cases, holder-in-due-course status will be irrelevant because the drawer will not interpose even a personal defense. See, e.g., *Evers v. Money Masters, Inc.*, 417 S.E.2d 160, 161-62 (Ga. Ct. App. 1992) (enforcing check without suggesting that the drawer raised a personal defense).

193. In some cases, the party trying to enforce the check will face a defense that it cannot defeat even if it does have holder-in-due-course status. See, e.g., *Kovash v. McCloskey*, 386 N.W.2d 32, 32-35 (N.D. 1986) (a holder in due course cannot prevail against a party that signed check only in a representative capacity); *Columbus Checkcashiers, Inc. v. Stiles*, 565 N.E.2d 883, 885-87 (Ohio Ct. App. 1990) (a holder in due course cannot enforce a check issued in an illegal transaction); *Check Cashing Place, Inc. v. Benefit Plan Admin., Inc.*, No. 87-1329, 1988 WL 23203, at *1-*2 (Wis. Ct. App. Jan. 15, 1988) (judgment noted at 421 N.W.2d 117 (Table)) (a holder in due course cannot prevail against a drawer that did not authorize execution of check).

194. Like banks, nonbanks that attempt to enforce checks sometimes lose because they are unable to establish holder-in-due-course status. See, e.g., *Alarcon v. Ferrari*, 490 So. 2d 1047, 1048 (Fla. Dist. Ct. App. 1986) (denying holder-in-due-course status because "under the circumstances, the plaintiffs herein should have been on notice as to the need for further inquiry regard-

make pursuit of that party worthwhile.¹⁹⁵ My survey of reported decisions in this decade discovered only twelve such cases (fewer than 1.2 cases per year), only one of which was decided in the last three years.¹⁹⁶ All things considered, it seems highly unlikely that any substantial number of those cases exists.

IV. PAYMENT SYSTEMS OF THE FUTURE: THE KING IS DEAD, LONG LIVE THE KING!

The final interment of the negotiable instrument need not result in any serious dislocation for the credit and payment systems in which negotiable instruments have been used. Rather, as this Article suggests, the movement away from negotiable instruments has occurred with so little dislocation that it has passed largely unnoticed by the affected academic community.

In the generally large-dollar world of credit systems, the passage already has been completed. Negotiability is gone, not only practically but also as a matter of form. For high-credit borrowers whose obligations are publicly traded, negotiability has given way to more effective systems that record the issue, transfer, and satisfaction of the obligations electronically. Home-mortgage notes—susceptible of public trading only through securitization—have moved more slowly, but even there systems for electronic transfer are

ing the validity of the check"); *Bohmfolk v. Linwood*, 742 S.W.2d 518, 520–22 (Tex. App. 1987) (remanding for trial to allow defendant to show that plaintiff was not a holder in due course because he acquired check in a crap game). In others, they will encounter other types of procedural obstacles, some of which are of their own making. See, e.g., *Schein v. American Restaurant Group, Inc.*, 794 S.W.2d 78, 78 (Tex. App. 1990) (refusing to entertain an appeal challenging discovery sanctions against a holder after the holder voluntarily withdrew its action to enforce the check).

195. The generally poor financial condition of persons that use check-cashing services is well documented. See CASKEY, *supra* note 152, at 73–78.

196. In reverse chronological order, the twelve cases were: *Connecticut State Check Cashing Service, Inc. v. Merriam Manufacturing Co.*, No. CV-93-04606725, 1995 WL 137150 (Conn. Super. Ct. Mar. 17, 1995); *Besnier-Scerma U.S.A. v. Wisconsin Protein Corp.*, No. C4-93-812, 1993 WL 413002 (Minn. Ct. App. Oct. 19, 1993); *Kedzie & 103rd Currency Exchange, Inc. v. Hodge*, 619 N.E.2d 732 (Ill. 1993); *Dubin v. Hudson County Probation Department*, 630 A.2d 1207 (N.J. Super. Ct. Law. Div. 1993); *Wright v. Carter*, 609 N.E.2d 1188 (Ind. Ct. App. 1993); *Lloyd's Credit Corp. v. Marlin Management Services, Inc.*, 614 A.2d 812 (Vt. 1992); *Municipal Court v. Superior Court*, 12 Cal. Rptr. 2d 519 (Ct. App. 1992); *Unbank Co. v. Dolphin Temporary Help Services, Inc.*, 485 N.W.2d 332 (Minn. Ct. App. 1992); *Checks Cashed, Inc. v. Summit Communications*, No. 89-270-II, 1990 WL 37360 (Tenn. Ct. App. Apr. 4, 1990); *ABC Money Exchange, Inc. v. Consumer Protection Association*, No. 54162, 1988 WL 86758 (Ohio Ct. App. Jun. 16, 1988); *Grand Western Currency Exchange, Inc. v. A:M Sunrise Construction Co.*, 516 N.E.2d 486 (Ill. Ct. App. 1987); *North Avenue East Check Cashing v. Aluf Plastics, Inc.*, 515 A.2d 1253 (N.J. Super. Ct. App. Div. 1986).

moving into place.¹⁹⁷ Finally, in contexts involving nonuniform obligations that are not suitable for trading, the negotiable instrument has passed away for the less definitive but nonetheless forceful reason that negotiability has so little to offer the parties that they are better off focusing their attentions on more direct devices to diminish the likelihood that the borrower will become recalcitrant after the transfer.

The forces of advancing financial sophistication move just as surely to remove negotiability from payment systems. The only context in which it retains significance even as a formal matter is in the retail transaction where the payor "pays" the payee by transferring a claim against a bank.¹⁹⁸ Even in that context it appears only in the checking system, not the functionally similar card-related systems. As Part III explains, however, technological pressures have stripped all of the practical effects of negotiability from the checking system.

It is only natural to close by asking what the passing of negotiability can tell us about the future. Two implications are obvious: one related to the practical mechanisms of payment systems, and the other to the legal aspects. As a practical matter, the uniformity with which technological and practical pressures push retail payment systems suggests to me that the current melange of diverse payment options will converge into systems that are substantially identical to the consumer, differing only in the identity of the third party that ultimately commits to pay the payee. Although the available systems currently differ significantly on such fundamental questions as how the financial institution becomes obligated to pay and when the payor loses its right to stop payment, it seems clear that the future will bring all systems to the same result—final payment by the payee will be substantially contemporaneous with the underlying transaction. That contemporaneous commitment to pay already occurs in transactions with credit and debit cards,¹⁹⁹ as well as in some of the developing electronic-

197. See Slesinger & McLaughlin, *supra* note 63, at 805–07 (describing plans for a mortgage electronic registration system). Current information is available on the MERS homepage (visited Feb. 20, 1997) <<http://www.mersinc.org>>.

198. See LOPUCKI, WARREN, KEATING & MANN, *supra* note 3 (manuscript assign. 15, at 1–5, on file with author) (explaining how all payment systems involve a transfer of a claim against a financially responsible third party). I am indebted to Lynn LoPucki for numerous conversations out of which that view of payment systems developed.

199. See *id.* (manuscript assign. 18, at 3, on file with author) (debit cards); *id.* (manuscript assign. 19, at 3, on file with author) (credit cards). I do expect that consumers will retain rights to challenge payments as improper similar to the rights to challenge payments as improper that they have in the credit-card and debit-card areas but given the rarity with which those rights are exercised, their precise boundaries seem to me a detail, and not something as to which uniformity of rule has any pressing importance.

money systems.²⁰⁰ The impracticalities of the current check-collection process suggest that the "float" that the checking system provides through deferred collection cannot survive. Indeed, I would expect that the only transactions in which the payee will not obtain a contemporaneous commitment from the financial institution will be those in which payment is made with cash or some cash substitute like a stored-value card that allows the payor itself to provide a reliable indicator that payment will be forthcoming.²⁰¹

Thus, although the consumer now sees numerous systems—bank-operated check and debit-card systems, network-operated credit-card systems, and developing electronic-money and stored-value card systems not necessarily affiliated with any financial institution—the lesson from the demise of negotiability is that all the systems will converge. None of those systems can survive if they ignore the technology that makes it practical to make payments more rapidly, more certainly, or more securely. Thus, any system that fails to adopt the best technological option will follow negotiability into extinction.

The passage of negotiability also has lessons for people who design the legal aspects of financial systems. Negotiability is an area in which legal academics have not served their constituencies well. As this Article demonstrates, negotiability is now almost purely a conceptual system: an intricate and elegant array of rules for resolving hypothetical situations that do not occur with any frequency in actual financial transactions.²⁰² Yet, however severed from reality negotiability may be, legal academics continue not only to spend whole courses teaching it to their students (a waste of educational opportunity that is bad enough in itself), but also to use it as a tool for analyzing issues of significance in transactions that do occur.²⁰³

To offer a single example, consider the discussion in drafts for the recently adopted *Restatement of Mortgages* of the validity of payments that a homeowner makes to the last known holder of its mortgage. The Reporters quite sensibly concluded that such payments should bind the actual holder of the note even if (unbeknownst to the homeowner) the actual holder is a

200. See *id.* (manuscript assign. 22, at 11–18, on file with author).

201. See *id.* at 1–11 (discussing stored-value card systems).

202. See Lynn M. LoPucki, *The Systems Approach to Law*, 82 CORNELL L. REV. (forthcoming 1997) (manuscript dated Oct. 7, 1996, at 13, 26, 36–37, on file with author) (discussing purely conceptual systems and the reasons why it is not profitable to study them).

203. I thank Jim Rogers for a conversation out of which the following thoughts developed. For his analogous thoughts, see Rogers, *Horseless Carriages*, *supra* note 5, at 695–98, which discusses how the use of outmoded legal concepts obstructs clear thinking about policy issues concerning conflicting claims to ownership of securities.

third party that never receives the payment.²⁰⁴ That conclusion flies in the face of classic rules of negotiability, which use possession as the touchstone for enforceability and thus grant no credit for payments made to a party that is no longer in possession of the instrument.²⁰⁵ Working within the conceptual framework of negotiability, the Reporters were not content to justify that conclusion by reference to the obvious practicalities of the situation: it obviously makes more sense to require the servicer of a mortgage note to advise the homeowner where to send payments than it does to obligate the homeowner to investigate that question on a monthly basis.²⁰⁶ Instead, the Reporters felt compelled to present a forced and ultimately unpersuasive argument that the result called for by the practicalities of the situation could be reconciled with the rules for negotiability articulated in Article 3.²⁰⁷ The Reporters never mention that the rules of Article 3 have little or no applicability to the context in question because of the relative rarity of negotiable home-mortgage notes.

At the end, the goal of this Article, like much of my prior work, is to illustrate the importance of context.²⁰⁸ Legal academics do not add a lot of value to the financial system by attempting to fit twenty-first-century financial transactions into a system developed to facilitate pre-Industrial Revolution financial transactions. We would provide much more service if we attempted to understand the functions served by the systems that facilitate modern transactions and used that understanding to develop legal rules that enhance those systems in the contexts where they actually operate.

204. See RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 5.5 (Tentative Draft No. 5, 1996).

205. See U.C.C. § 3-602(a) (1991) (“[A]n instrument is paid to the extent payment is made . . . to a person entitled to enforce the instrument.”). A party that has sold the instrument to a third party is no longer a person entitled to enforce the instrument. Thus, payments made to such a party do not constitute payments on the instrument.

206. See RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 5.5 cmt. 9 (Tentative Draft No. 5, 1996) (“In theory the mortgagor could discover the transfer by demanding that the mortgagee exhibit the evidence of the obligation (typically a promissory note) before making each payment, but such a demand would be extremely cumbersome for both mortgagor and mortgagee, and is an entirely unrealistic expectation.”).

207. See *id.* reporters’ note. I understand from conversations with Steve Harris that discussion on the floor of the American Law Institute strongly criticized the Reporters’ efforts to accommodate their result to Article 3, and that some revision of that discussion is anticipated before final publication of the *Restatement*.

208. See Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625 (1997) (analyzing contextual reasons for the use and nonuse of secured credit); Ronald J. Mann, *The First Shall Be Last: A Contextual Argument for the Abandonment of Temporal Rules of Lien Priority*, 75 TEX. L. REV. 11 (1996) (analyzing the problems with a first-in-time rule of lien priority in the construction-loan context).