CUTTING OFF CLAIMS OF OWNERSHIP UNDER THE UNIFORM COMMERCIAL CODE*

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I. GOODS

IN JUSTIFYING the rule that good faith purchasers of goods from a market overt took free of certain claims of ownership, Blackstone wrote: "[I]t is expedient, that the buyer, by taking proper precautions, may, at all events be secure of his purchase, otherwise all commerce between man and man must soon be at an end."¹ A generation ago, a California judge, in holding that a good faith purchaser from a bailee took subject to the true owner's claims, quoted: "Owners of goods for commercial and other purposes must frequently intrust others with the possession of them, and the affairs of men could not be conducted unless they could do so with safety."² Thus, these two gentlemen urge, respectively, that we are doomed if we do and doomed if we do not honor claims of ownership.³

Statements of this sort—predicting commercial chaos if one or the other of the conflicting doctrines for preferring or denying claims of ownership against good faith purchasers were not adopted—have rattled around in the law of sales for centuries. Blackstone doubtless fashioned his prediction of disaster from that incomparable vantage point of the realities of the commercial process, the library of an Oxford college, while the judge's insight into the impact of legal doctrine on mercantile practices was probably gained in such a nerve center of the commercial world as Bakersfield, California.

One wonders if doctrines regarding claims of ownership are more than risk-shifting devices. As such, it might be postulated that they have no more effect in guiding business conduct than the high cost of a college education has in dissuading a young man from marriage. At the moment of decision the busi-

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¹ See STORY, SALES OF PERSONAL PROPERTY 155-56 (1847).

² *California Jewelry Co. v. Provident Loan Ass'n*, 6 Cal. App. 2d 506, 513, 45 P.2d 271, 274 (1935) (Shinn, J.).

³ Carlos Israels attributes the term "claim of ownership" to Professor Chafee who differentiated between "equities of ownership" or "claims to the ownership" and "equities of defense" in his classic article *Rights in Overdue Paper*, 31 HARV. L. REV. 1104 (1918). 2 *New York Law Revision Comm'n, Hearings on the Uniform Commercial Code*, 1375 (1954). The UCC has, in substance, accepted Chafee's distinction in its use of the terms "claims" and "defenses."

nessman no more expects to lose the goods he has entrusted to another than does the prospective bridegroom anticipate a 1,300 dollar tuition bill from a University for his son. All this comes later, and the participants think it will be much later.

In America the market overt was never to open,⁴ and we were left with the stern law that no one can transfer to another a better title to goods than he himself has.⁵ The good faith purchaser from a thief or a mere bailee took subject to claims of ownership, and Justice Story had no sympathy for him, presuming that "his loss is often the result of his negligence and want of scrutiny. . . ."⁶ In the comparatively intimate commercial world of the early nineteenth century, the courts apparently expected buyers to know a good bit about the state of title of the goods they purchased. Certainly the English and American judges of this period were most reluctant to deprive the good people who owned chattels of their title even in favor of bona fide purchasers, unless the "true owners" had consented to transfer of title or were at fault in their conduct regarding the goods.⁷

The good faith purchaser took free of claims of ownership when he purchased from a fraudulent vendee⁸ (more of that later) or when he took from one clothed by the owner of the goods with indicia of ownership or apparent authority to sell.⁹ It would seem a stronger case for favoring the bona fide purchaser where actual authority to sell or pledge was given the seller by the owner and the seller merely exceeded some limitation of this authority. But the courts, as Williston says, went to extremes to protect the principal from the consequences of even slight deviations by the agent from the authority granted him.¹⁰ The refusal of the courts to protect a pledgee who advanced

⁴ 2 WILLISTON, SALES § 347 (rev. ed. 1948) [hereinafter cited as WILLISTON].

⁵ The common-law rule to this effect was enshrined in § 23 of the UNIFORM SALES ACT.

⁶ STORY, *op. cit. supra* note 1, at 156.

⁷ See *Levi v. Booth*, 58 Md. 305, 315 (1882) (Alvey, J.): "If it were otherwise people would not be secure in sending their watches or articles of jewelry to a jeweller's establishment to be repaired, or cloth to a clothing establishment to be made into garments."

⁸ UNIFORM SALES ACT § 24 reads: "Where the seller of goods has a voidable title thereto, but his title has not been avoided at the time of the sale, the buyer acquires a good title to the goods, provided he buys them in good faith, for value, and without notice of the seller's defect of title."

⁹ UNIFORM SALES ACT § 23(1), after stating that the buyer acquires no better title than the seller has, adds: "unless the owner of the goods is by his conduct precluded from denying the seller's authority to sell." *Pickering v. Busk*, 15 East 38, 104 Eng. Rep. 758 (K.B. 1812), is the leading English case on indicia of ownership. *Heath v. Stoddard*, 91 Me. 499, 40 Atl. 547 (1898), and *O'Connor's Adm'r v. Clark*, 170 Pa. 318, 32 Atl. 1029 (1895), are leading apparent authority cases.

¹⁰ 2 WILLISTON § 317. In § 317 Professor Williston collects the cases where the agent "though he may be authorized to sell the goods to some person or upon some terms, is not authorized to sell them to the person or upon the terms on which the sale was in fact made."

money to an agent possessing the authority to sell the article pledged led to passage of a series of Factors' Acts in Britain.¹¹ However, continued judicial hostility toward allowing agents to bind their principals by sales or pledges outside their actual authority manifested itself in the strict construction given to the Factors' Acts in England and America.¹²

It is in cases where possession of goods was entrusted by the owner to a party for purposes other than sale that an interesting development took place before the time of the Uniform Commercial Code. Entrusting possession alone was not enough to estop the true owner from reclaiming the article from a good faith purchaser of the bailee, and this was true even though the bailee was a dealer in the goods.¹³ It was even held that this was the result when the bailee was a dealer in the goods with the authority to exhibit the chattel for the purpose of obtaining offers of purchase.¹⁴

Thus the law scrutinized what the buyer was blind to—the purpose of possession of the person selling to the good faith purchaser. If the purpose of the bailment was sale, the good faith purchaser won; but if the purpose was storage or repair, though the bailee dealt in goods like those entrusted, the good faith purchaser lost. The courts were reluctant to go too far with this purpose-of-bailment test, however, and their refusal to do so moved Williston to observe that when owners entrust their goods to others with the authority to obtain offers only “slight additional circumstances” need be found

¹¹ For the best discussion of the early interpretation of the Factors' Acts, see BLACKBURN, *CONTRACT OF SALE* 307–20 (2d ed. 1887).

¹² Judge Crompton, like many judges before and since when it comes to legislation changing the common law, grumbled that it was impossible to tell what the Factors' Act meant: “[I]t is one of those loose enactments which conveys much difficulty. When you get to these acts of parliament the difficulty is immense.” *Baines v. Swainson*, 32 L.J.Q.B. 281, 287, 122 Eng. Rep. 460, 465 (Q.B. 1863). The power of agents to deal with goods must have been a matter of major concern in England in the nineteenth century, for as soon as the courts found or created loopholes in the Factors' Acts, Parliament would pass a new version of the statute designed to repair the damage. This kind of continuing legislative attention demonstrated a belief that the matter at hand was too important to be left to judges—especially hostile judges—and is reserved in this country for matters closest to the legislative heart, like taxation.

¹³ “[T]he *bare possession* of goods by one, though he may happen to be a *dealer* in that class of goods, does not clothe him with power to dispose of the goods as though he were owner, or as having authority as agent to sell or pledge the goods, to the preclusion of the right of the real owner.” *Levi v. Booth*, 58 Md. 305, 314–15 (1882) (emphasis in original). *But see* Lord Ellenborough's famed dictum: “If the principal send his commodity to a place, where it is the ordinary business of the person to whom it is confided to sell, it must be intended that the commodity was sent thither for the purpose of sale. If the owner of a horse sent it to a repository of sale, can it be implied that he sent it thither for any other purpose than that of sale?” *Pickering v. Busk*, 15 East 38, 43, 104 Eng. Rep. 758, 760 (K.B. 1812).

¹⁴ *California Jewelry Co. v. Provident Loan Ass'n*, 6 Cal. App. 2d 506, 45 P.2d 271 (1935); *Levi v. Booth*, 58 Md. 305 (1882); *Smith v. Clews*, 114 N.Y. 190, 21 N.E. 160 (1889); *Biggs v. Evans*, [1894] 1 Q.B. 88.

to estop the owner.¹⁵ It was a dull judge indeed who could not find sufficient additional circumstances when the need arose.¹⁶

Professor Williston's rationalization of the pre-Code entrusting cases was that courts were taking into account whether the appearance of title was created in the bailee by the original owner "for a purpose so essential and proper that the original title must be protected irrespective of the injury to the subsequent buyer."¹⁷ This appears to be a sort of commercial bailment test; we look in each case to the importance to commerce of the bailment involved rather than to the utility of protecting the buyer. If this describes what in fact the courts were doing before the Code, it poses a test so subtle as to blunt predictability and confound counsel. By what standards is the social utility of a bailment to be measured? Although it is doubtful that much weight is given in planning commercial transactions to the law of claims of ownership, certainly the commercial community was entitled to more guidance than this in allocating the loss after a wayward bailee transgressed.

In section 2-403 of the Code the bold decision is made to apply, in a limited form at least, the commercial or mercantile theory to goods.¹⁸ Any entrusting of possession of goods to a merchant who deals in goods of that kind gives him the power to transfer all rights of the entruster to a buyer in ordinary course of business.¹⁹ The buyer in ordinary course of business is one who in good faith buys goods from a person in the business of selling goods of that kind, but a buyer who takes the goods as security for or in satisfaction of a money debt is not a buyer in ordinary course of business.²⁰

The effect of these provisions is that when goods are sold in an unquestionably commercial setting, they are to be given a high degree of negotiability: Full negotiability—the right of a thief to cut off claims of ownership—was

¹⁵ 2 WILLISTON 249.

¹⁶ In *Zendman v. Harry Winston, Inc.*, 305 N.Y. 180, 111 N.E.2d 871 (1953), the court accepted Williston's invitation to find "slight additional circumstances" by holding the owner who entrusted jewelry to a dealer for the purpose of showing it to a customer estopped as against the buyer on the grounds that (1) the owner had acquiesced in the dealer's public display of the jewelry for some time and (2) there was a course of dealing between the owner and dealer whereby neither party adhered to the memorandum between them requiring the owner's consent to a sale of the item by the dealer.

¹⁷ 2 WILLISTON 243.

¹⁸ The definitive discussion of the commercial theory is found in Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057 (1954). This brilliant article has placed the whole subject of good faith purchase of goods, documents and instruments on a new footing. No one can henceforth work in this area without being Grant Gilmore's debtor.

¹⁹ UNIFORM COMMERCIAL CODE § 2-403(2). Subsection (3) defines "entrusting" to include delivery and any acquiescence in retention of possession regardless of any condition expressed between the parties.

²⁰ UNIFORM COMMERCIAL CODE § 1-201(9).

denied to goods by the requirement that the goods must be entrusted to the seller.²¹ The Code assures a genuine commercial setting by limiting the protection of buyers to cases where the goods become virtually indistinguishable from the other goods in a dealer's inventory, and the class of protected buyers is restricted to people who are essentially buyers and not creditors seeking security for or satisfaction of their debts.²² The Code does not require that the buyer in ordinary course of business receive delivery to be protected under its provisions.²³

Must it be shown that the owner of goods who entrusted them to a dealer in goods of that kind knew the character of the dealer's business before the statute acts to cut off his claim of ownership? The Code says nothing on the point. One commentator has suggested that an entruster should lose his interest only if he knew or should have known that the bailee was a dealer in goods of the kind bailed.²⁴ Such a view could lead to an unfortunate revival of a fault or consent basis for cutting off claims of ownership. The only consent necessary to bind the maker of a negotiable instrument is that he intentionally signed an instrument negotiable in form which he knew to be an obligation

²¹ The advance of goods from non-negotiability to quasi-negotiability parallels that made a half century earlier by documents of title. As will appear more fully, pp. 482-87 *infra*, documents of title were first non-negotiable. The Uniform Sales Act § 32 and the Uniform Warehouse Receipts Act § 40 bestowed quasi-negotiability on documents by allowing purchasers to take better title than their transferors only if the document was *entrusted* to the transferor by the owner. Full negotiability came to documents under the Uniform Bills of Lading Act § 31 which allows a document to be negotiated by any person in possession of it, however possession was obtained.

²² UNIFORM COMMERCIAL CODE § 2-403(2) limits the entrusting to merchants who deal in goods of that kind, while § 1-201(9) cuts down the bona fide purchaser concept to fit only those buying goods in a true commercial transaction. One would apparently qualify as a buyer in ordinary course of business only if the goods and the kind of transaction engaged in were usual in both the seller's business and the buyer's business or course of activity. Pawnbrokers are expressly excluded from the category of buyers in ordinary course of business. Note that one change made by § 1-201(9) in the traditional bona fide purchaser concept is with respect to value. The term "value" is not used in § 1-201(9), for some types of value under the traditional definition (see, *e.g.*, UNIFORM SALES ACT § 76) have no place in the sale of goods in the mercantile process; hence, "buying" under § 1-201(9) includes paying cash, buying on credit and receiving goods under a pre-existing contract for sale but excludes transfers in bulk or as security for or in satisfaction of money debts.

²³ The Uniform Trust Receipts Act definition of "buyer in the ordinary course of trade" (§ 1), which is seminal to the Uniform Commercial Code definition of the buyer in ordinary course of business, requires a delivery. We can assume from this omission that the Code draftsmen did not believe delivery to be an essential component of a sale in the ordinary course of business, and by failing to mention delivery intended to exclude it. It is unlikely that they felt delivery was such an integral part of a sale in the ordinary course of business that it need not be specifically mentioned. See a discussion on the omission of the delivery requirement in 1 NEW YORK LAW REVISION COMM'N, STUDY OF THE UNIFORM COMMERCIAL CODE 232 (1955).

²⁴ "Neither provision [§§ 2-403(2), 7-502(1)] limits the protection of the buyer to cases where the entrusting owner knows or should know the character of the warehouseman's business, but such limitation may be implied." BRAUCHER, DOCUMENTS OF TITLE 66 (1958).

to pay money.²⁵ He need not understand the significance of the words "order" or "bearer" or comprehend the harsh consequences of negotiability. The only consent that should be required in the entrusting of goods cases is that the owner intentionally entrusted goods to one who turns out to be a dealer in such goods. The buyer-in-ordinary-course-of-business status should not depend on the entruster's information or lack of it about the bailee's business, lest what was designed to be a simple, easy-to-apply rule—that one who buys from a dealer takes title to all goods entrusted to that dealer of the kind in which he deals—becomes mired down in a tedious factual inquiry about the state of the entruster's knowledge, or lack of it, about the dealer's business.

The definition of entrusting under section 2-403 includes the case where the buyer does not take delivery of goods but suffers the seller to retain possession after a sale.²⁶ Under section 25 of the Uniform Sales Act a buyer who leaves goods with his seller—even a seller who is not a professional dealer—loses as against a subsequent good faith purchaser of the goods. Thus under pre-Code law it is hard to reconcile the case of retention of possession, wherein the good faith purchaser wins, with the case of entrusting possession by the owner to a dealer, where, unless some additional basis for estoppel is found, the good faith purchaser loses. The Code narrows the application of the retention of possession doctrine to the commercial situation of a merchant retaining possession of goods he has sold and reselling them to a buyer in ordinary course of business. Since the Code protects the buyer in ordinary course of business in cases where owners bail their goods with dealers, it can now be said that the Code has quite properly placed the entrusting and retention of possession rules in a state of parity. The meat-ax approach of Uniform Sales Act section 25 which automatically cut off claims of ownership in the retention of possession cases was not accepted by the nineteenth century English courts,²⁷ and one suspects that Parliament when it wrote the rule into the Sale of Goods Act was influenced by the hoary doctrine of fraudulent conveyance law that retention of possession by a seller is a fraud on creditors.²⁸ Under the Code, it is gratifying to observe, the retention of possession doctrine finally sheds its mask as pseudo-fraudulent conveyance doctrine and takes its rightful place in the Code scheme that buyers of goods out of dealers' inventories should be secure in their titles.

What of the claim of ownership of a buyer who leaves goods purchased in

²⁵ The innumerable decisions bearing on the requisite intent of a maker of a negotiable instrument are marshalled in BRITTON, *BILLS AND NOTES* § 130 (2d ed. 1961).

²⁶ "Entrusting" includes any delivery and any acquiescence in retention of possession" UNIFORM COMMERCIAL CODE § 2-403(3).

²⁷ 2 WILLISTON § 349.

²⁸ Speaking of the case where a seller retained goods after sale and sold them later to a good faith purchaser, Lord Blackburn testily observed: "Such a question can hardly arise without a criminal fraud on the part of the vendor, and considerable negligence on the part of the purchaser." BLACKBURN, *CONTRACT OF SALE* 328 (1845).

possession of the seller only to have them seized by a creditor of the seller? Here the Code, like the Uniform Sales Act, leaves the question to the fraudulent conveyance laws of the states, with the entirely reasonable limitation that retention of possession by a merchant-seller in good faith and current course of trade and for a commercially reasonable time after a sale is not fraudulent.²⁹

How are cases to be decided under the Code where the entrusting is not in a commercial situation, that is, the entrusting or retention of possession is not with a dealer or the purchaser is not a buyer in ordinary course of business? The first sentence of section 2-403 sets forth the general rule that a purchaser of goods takes all title his transferor had or had the *power* to transfer. Section 1-103 states that the principles of the law of agency and estoppel shall supplement Code provisions. Hence, even in the noncommercial situation, facts giving rise to apparent authority to sell or apparent ownership in the vendor give him the power to convey better title to a good faith purchaser than he had.³⁰ Thus the cases where an owner entrusts goods to a bailee who is not a dealer in the goods will doubtless be resolved in about the same way as before the Code. However, the retention of possession cases in which the seller is not a merchant will be decided on a different basis under the Code than under the Uniform Sales Act. Without the absolute protection of section 25 of the Sales Act, the second buyer will win only if he can fashion a case based on estoppel, just as the buyer of goods from a bailee always had to do before the Code.

The Code retains the traditional rule that a person with voidable title has power to transfer a good title to a good faith purchaser for value.³¹ One is said to take voidable title when the owner of goods *intended* to pass title to them, but his intent was fraudulently induced.³² If the owner transfers possession of the goods without intending to pass title to the transferee, a subsequent good faith purchaser takes nothing, for there was no title to pass to him. In general the cases in this area before passage of the Code have been characterized by a shameless manipulation by the courts of what is laughingly referred to as the intent of the parties.³³

²⁹ UNIFORM COMMERCIAL CODE § 2-402(2); UNIFORM SALES ACT § 26.

³⁰ "[UNIFORM SALES ACT § 23(1)] . . . that the owner may be 'by his conduct precluded from denying the seller's authority' is comparable to the provision of Code Section 1-103 stating that 'unless displaced,' principles of law and equity including the law relating to estoppel, supplement the provisions of the Code." 1 NEW YORK LAW REVISION COMM'N, STUDY OF THE UNIFORM COMMERCIAL CODE 246 (1955). In accord is HAWKLAND, SALES AND BULK SALES UNDER THE UNIFORM COMMERCIAL CODE 104 (1955).

³¹ UNIFORM COMMERCIAL CODE § 2-403(1); UNIFORM SALES ACT § 24.

³² "Where the vendor of personal property intends to sell his goods to the person with whom he deals, then title passes, even though he be deceived as to that person's identity or responsibility. Otherwise it does not. It is purely a question of the vendor's intention." *Phelps v. McQuade*, 220 N.Y. 232, 234, 115 N.E. 441, 442 (1917).

³³ Professor Gilmore describes the concept of "voidable title" as "a vague idea, never defined and perhaps incapable of definition, whose greatest virtue, as a principle of growth, may well have been its shapeless imprecision of outline." Gilmore, *supra* note 18, at 1059.

The bad check cases are the best—or worst—examples of the intent approach to cutting off claims of ownership. Some courts have held that no title to goods passes to a buyer who pays for them with a bad check; thus he can pass no better title to a good faith purchaser. Their theory is that a seller who takes a check in payment intends to pass title only if the check is good. Other jurisdictions hold that the seller did in fact intend to pass title to the buyer, but that his intent was fraudulently induced, thus giving the buyer voidable title and the power to pass a good title to a good faith purchaser.³⁴ Legal writers—like the fictional detective Nero Wolfe—have been willing, without leaving their offices, to offer solutions to the mystery of what the seller intended. Professor Williston prefers the cases that say voidable title passes and he is quite sure that sellers do intend to pass title when receiving bad checks.³⁵ Professor Vold, who inclines toward the other view, concludes that: “With all due deference to so eminent an authority [Williston], I see the asserted facts about the intention of parties differently.”³⁶

The anatomy of intent is dissected even further in the impersonation cases. The courts have said that if I approach you purporting to be J. Paul Getty, a man of known financial repute, and induce you to sell goods to me on credit, I take voidable title and can transmit a good title to a good faith purchaser. We are told that this is true because, though you may have had some intent both to pass title to Getty *and* to the man standing in front of you, your *primary* intent was to transfer title to the person physically in your presence.³⁷ However, if I write a letter to you in which I induce you to sell me goods on credit by signing the letter, J. Paul Getty, though the seller may have intended

³⁴ The authorities are collected and exhaustively discussed in VOLD, SALES § 30 (2d ed. 1959); 2 WILLISTON §§ 346a, 346b; Corman, *Cash Sales, Worthless Checks and the Bona Fide Purchaser*, 10 VAND. L. REV. 55 (1956); Vold, *Worthless Check Cash Sales, “Substantially Simultaneous” and Conflicting Analogies*, 1 HASTINGS L.J. 111 (1950); Note, *The “Cash Sale” Presumption in Bad Check Cases: Doctrinal and Policy Anomaly*, 62 YALE L.J. 101 (1952).

³⁵ “If a seller should say ‘you must not deal with these goods, though I have put them in your hands, until I collect the check,’ that would show an intent not to transfer the property to the buyer. But where the goods are put into the buyer’s hands without more, it can hardly be doubted that the seller means to allow him to deal with them as his own; to resell them immediately if he feels inclined.” 2 WILLISTON 344.

³⁶ VOLD, *op. cit. supra* note 34, at 174. Professor Vold believes that: “There is no reason for supposing that the parties in such cases intend instead that the seller is to give utterly unsecured credit to the buyer for the interval until the check can be cashed.” Vold, *Worthless Check Cash Sales, supra* note 34, at 117.

³⁷ “Where the transaction is a personal one, the seller intends to transfer title to a person of credit, and he supposes the one standing before him to be that person. He is deceived. But in spite of that fact his primary intention is to sell his goods to the person with whom he negotiates.” *Phelps v. McQuade*, 220 N.Y. 232, 235, 115 N.E. 441, 442 (1917). The cases are collected in 3 WILLISTON § 635.

to pass title both to the signer of the letter and to Getty, his *primary* intent is to sell the goods to the person whose name is on the letter.³⁸ Similarly if I induce you to sell goods to me on credit by representing that I am the agent of J. Paul Getty, I take no title because your primary intent was to pass title to the principal; this intent cannot be fulfilled because there was no agency.³⁹

One does not mind the courts' using a fictitious intent—or any other tool they can find—to give a result that protects good faith purchasers when they deserve protecting. But as these impersonation cases indicate, sometimes the courts have been trapped in the web of their own logic. There is no rational basis for protecting a good faith purchaser from a face-to-face impersonator while refusing to protect a good faith purchaser from one who misrepresents by letter.

The Code has now spared us from the metaphysics of the intent test. It provides that when goods have been delivered under a transaction of purchase, the purchaser has the power to transfer good title to a good faith purchaser for value even though: (a) the transferor was deceived as to the identity of the purchaser, or (b) the delivery was in exchange for a check that was later dishonored, or (c) it was agreed that the transaction was to be a cash sale, or (d) the delivery was procured through fraud punishable as larcenous under the criminal law.⁴⁰

Professor Gilmore suggests that the voidable title-no title distinction developed as a means of protecting buyers in commercial situations.⁴¹ If he is cor-

³⁸ "Where the transaction is by letter the vendor intends to deal with the person whose name is signed to the letter. He knows no one else. He supposes he is dealing with no one else." *Phelps v. McQuade*, *supra* note 37, at 235, 115 N.E. at 442.

³⁹ See, e.g., *Rogers v. Dutton*, 182 Mass. 187, 65 N.E. 56 (1902). *Cf. Exeter Mfg. Co. v. Glass-Craft Boats, Inc.*, 103 N.H. 385, 173 A.2d 791 (1961) (good faith purchaser protected where agent was authorized to purchase but misrepresented true nature of the principal); *Stanton Motor Corp. v. Rosetti*, 203 N.Y.S.2d 273, 11 App. Div. 2d 296 (1960) (good faith purchaser protected where agent misrepresented not existence but extent of his agency).

⁴⁰ UNIFORM COMMERCIAL CODE § 2-403(1). ✓

⁴¹ Professor Gilmore states that: "The ingenious distinction between 'no title' in *B* (therefore true owner prevails over good faith purchaser) and 'voidable title' in *B* (therefore true owner loses to good faith purchaser) made it possible to throw the risk on the true owner in the typical commercial situation while protecting him in the noncommercial one." Gilmore, *supra* note 18, at 1060. He continues: "The cash sale theory is stated in the cases as a general rule. But in fact it is almost never applied against good faith purchasers in a commercial setting." *Id.* at 1061. Cases decided since the Gilmore article support this conclusion. See *Clanton's Auto Auction Sales, Inc. v. Young*, 217 Ga. 205, 122 S.E.2d 640 (1961) (wholesaler sent two autos to retailer on understanding they would be paid for next day; title certificates retained by wholesaler; wholesaler contemplated sale by retailer only after autos paid for and certificates delivered; retailer sold to buyer in ordinary course of business; wholesaler cannot retake auto from buyer); *Whisnant v. Don Schmid Motor Co.*, 184 Kan. 349, 336 P.2d 398 (1959) (1st dealer sold to 2d dealer in another community; 1st dealer did not deliver certificate of title to 2d; 2d dealer's check in payment was bad; 3d dealer purchased auto with no knowledge of these circumstances; 3d dealer is entitled to auto as against 1st dealer); *Stanton Motor Corp. v. Rosetti*, 203 N.Y.S.2d 273, 11 App.

rect, it is irony indeed that the role left to the voidable title concept by the Code appears to be virtually restricted to noncommercial situations. This results from the fact that the entrusting provisions of section 2-403(2) and (3) have swallowed up the commercial voidable title cases where the voidable title holder is a merchant and the good faith purchaser is a buyer in ordinary course of business. Thus the voidable title provisions of section 2-403(1) will be determinative only in cases where the voidable title holder was not a merchant or the buyer was not a buyer in ordinary course of business.

In passing, it should be noted that the Code has cleared up a troublesome problem regarding consignments. Before the Code when goods were entrusted to a retailer on consignment, the fact that title was expressly reserved in the consignor led courts to hold that creditors of the retailer could not reach the goods and that the consignor could retake the goods from a trustee in bankruptcy.⁴² Section 2-326 looks through the form of the consignment to its substance and finds it to be merely another method for financing the inventory of a merchant. As such the claim of ownership of the consignor is really a security interest, and so the Code treats it, requiring compliance with the filing provisions of Article 9, if certain alternative requirements are not met.⁴³

II. INSTRUMENTS

Article 3 contains no major changes regarding claims of ownership; none was needed. The battles Llewellyn fought in the 1940's and 1950's to protect good faith purchasers of goods from claims of ownership had been won by Mansfield with respect to instruments in the 1750's.⁴⁴ In *Peacock v. Rhodes*, 1781,⁴⁵ an order bill of exchange indorsed in blank had been stolen and purchased by the plaintiff for value in the ordinary course of business. In arguing for the defense Fearnly contended that no man is obliged to take a bill of exchange in payment, and if the purchaser of a stolen instrument is to be protected "the temptations to theft would be increased." Mansfield, in holding that purchases by the plaintiff cut off the claim of ownership, set a pattern

Div. 2d 296 (1960) (1st dealer sold auto to 2d dealer who paid with bad check; 1st dealer gave second dealer motor vehicle bureau form of certificate of sale; 2d dealer sold to good faith purchaser; good faith purchaser's subsequent vendee held entitled to auto).

⁴² 2 WILLISTON § 338 collects the cases.

⁴³ "It is difficult to justify on any logical basis making a consignment transaction an exception to the filing requirement under [Article] 9. The effect of a consignment is to separate title from possession with the accompanying hardship on those third parties relying on the possession of the retailer. Although in theory title is retained by the consignor, the actual effect of a consignment is that it is merely another device for financing the inventory of a merchant. There is no legal justification for protecting such a secret interest as against creditors." REPORT OF CALIFORNIA SENATE FACT FINDING COMMITTEE ON JUDICIARY, THE UNIFORM COMMERCIAL CODE 460 (1961).

⁴⁴ *Miller v. Race*, 1 Burrow 452, 97 Eng. Rep. 398 (K.B. 1758) (innocent purchaser of bank note took free of rights of prior owner from whom note had been stolen).

⁴⁵ 2 Doug. 633, 99 Eng. Rep. 402 (K.B. 1781).

for later and lesser judges by flatly predicting that the currency of bills and notes would come to an end if his view of the case were not adopted.⁴⁶

The Uniform Negotiable Instruments Law states that a holder in due course "holds the instrument free from any defect of title of prior parties, and free from defenses available to prior parties among themselves."⁴⁷ Section 3-305 of the Code provides that a holder in due course takes free from "all claims to it on the part of any person" The official comment assures us the intent is to safeguard the holder in due course not only against claims of legal title but also from all liens, equities or claims of any other kind.⁴⁸

With regard to goods, the Code (excepting the voidable title cases) restricts the protection of good faith purchasers to essentially commercial transactions.⁴⁹ As to instruments, however, the Code follows the Negotiable Instrument Law and the common law in granting protection to good faith purchasers whenever they meet the qualifications of holders in due course and whenever the instrument they purchase complies with all the formalities of negotiability. A negotiable instrument, now as then, is commercial by definition. Even professors and tramps, to employ that ungenerous juxtaposition used elsewhere in the comments to the Code, can make, take, negotiate and become holders in due course of instruments, although they are totally outside the mainstream of commerce.⁵⁰ The instrument is the thing, and we must sedulously guard its currency even if it means including noncommercial situations. Thus the Code continues to use the formalities for creating and transferring an instrument as the screening device for selecting the purchasers to be protected,⁵¹ and it is noteworthy that in so doing the Code draftsmen did not

⁴⁶ "The holder of a bill of exchange, or promissory note, is not to be considered in the light of an assignee of the payee. An assignee must take the thing assigned, subject to all the equity to which the original party was subject. If this rule applied to bills and promissory notes, it would stop their currency." *Peacock v. Rhodes*, *supra*, at 363.

⁴⁷ Section 57.

⁴⁸ UNIFORM COMMERCIAL CODE § 3-305, comment 2.

⁴⁹ See the discussion of UNIFORM COMMERCIAL CODE § 2-403, pp. 472-78 *supra*.

⁵⁰ Under UNIFORM COMMERCIAL CODE §§ 7-501(4), 7-502 a holder of a document of title takes free of prior defenses and claims only if the document is "duly negotiated" to him. Due negotiation requires negotiation in the regular course of business. Section 7-501, comment 1, patiently explains: "No commercial purpose is served by allowing a tramp or a professor to 'duly negotiate' an order bill of lading for hides or cotton not his own, and since such a transfer is obviously not in the regular course of business, it is excluded from the scope of the protection of subsection (4)."

⁵¹ See Gilmore, *supra* note 18, at 1068-69. Acceptance by the Uniform Commercial Code draftsmen of the same basic formal prerequisites to negotiability as existed under the Uniform Negotiable Instruments Law is persuasive that these matters have a continuing function. What is it? It is hard to maintain any longer that such formal requirements as certainty of time and sum, unconditional promises, and the presence of words of art like "order" or "bearer" are essential to the currency of instruments in commerce. The eagerness of courts to erode (in response to pressure from the commercial community) the strict formal requirements of negotiability into a bland standard of "commercial certainty" demonstrates

measurably lessen the formal requirements for creating negotiability and acquiring the status of holder in due course. (Certainly, they stayed far away from consensual negotiability.) In contrast, with respect to writings inherently restricted to the flow of commerce, like documents of title or investment securities, the test of a commercial act moves from form to function.⁵²

With regard to the rights of purchasers *not* meeting the requirements of holding in due course to take free of claims of ownership, the Negotiable Instruments Law is vague. Section 58 says that a non-holder in due course takes subject "to the same *defenses* as if [the instrument] were non-negotiable." The English Bills of Exchange Act rather clearly subjected non-holders in due course to all prior claims of ownership as well as to defenses where the instrument was taken after maturity.⁵³

Most of the controversy in this country with respect to the position of non-holders in due course has centered around the rights of parties who fail to qualify as holders in due course only because they purchased the instrument after maturity. Professor Chafee in his famous article on the problem of rights in overdue paper attempted to justify this thesis: A good faith purchaser for value after maturity takes subject to equities of defense but free of equities of ownership.⁵⁴ Chafee quotes Chief Justice Shaw with regard to overdue paper: "The question instantly arises, why is it in circulation, —why is it not paid? Here is something wrong. Therefore, although it does not give the indorsee notice of any specific matter of defense, such as set-off, payment, or fraudulent acquisition, yet it puts him on inquiry."⁵⁵ Chafee takes this to mean that a purchaser after maturity is put on inquiry as to equitable defenses, but his duty to inquire stops there. He has no duty to inquire as to equities of ownership. Chafee states: "Equities of ownership relate to the instrument as property, but maturity, like equitable defenses, relates to liability on the

this. Perhaps the only formal attribute of an instrument that has real effect on its currency is the ultimate status of negotiability. Why then leave the formal requirements of negotiability as a trap for the unschooled? Why not allow negotiability by consent of the parties? A possible justification for the Code's rejection of this is that to adopt consensual negotiability would lower the bars of negotiability too much and extend that harsh doctrine too far into noncommercial situations. To some extent at least, the ancient, if somewhat irrelevant, formalities of negotiability keep negotiable instruments in the hands of professionals and thus in the commercial process.

⁵² Under §§ 7-501(4) and 7-502 the benefits of negotiability are conferred on the holder of a document only if he takes it in the regular course of business. Under § 8-102(a)(ii) a security is an instrument of a kind commonly dealt with in securities exchanges or commonly recognized as a medium for investment. Section 8-105 makes such an instrument negotiable.

⁵³ Bills of Exchange Act, 1882, § 36(2): "Where an overdue bill is negotiated, it can only be negotiated subject to any defect of title affecting it at its maturity, and thenceforward no person who takes it can acquire or give a better title than that which the person from whom he took it had."

⁵⁴ Chafee, *Rights in Overdue Paper*, 31 HARV. L. REV. 1104 (1918).

⁵⁵ *Fisher v. Leland*, 58 Mass. (4 Cush.) 456, 458 (1849).

contracts. It is a term of the respective promises of the parties. The possession of an overdue instrument is a clear indication that there is something the matter with the promises, whether it be a defense or only financial embarrassment or procrastination, but it does not indicate in any way that the possessor wrongfully acquired the instrument from a previous owner."⁵⁶ He adds: "Instead of being a red flag to give warning of all hidden dangers, it [maturity] resembles more closely a printed placard calling attention to one special peril. A person approaching a grade crossing and seeing the sign: 'Stop, Look and Listen', is bound to watch for trains, but he does not assume the risk of a savage bulldog maintained on the railroad right of way to scare off track-walkers."⁵⁷

On one theory or another, a good many American cases have protected purchasers of overdue paper from claims of ownership. The most popular avenue to this result has been estoppel.⁵⁸ An example is *Justice v. Stonecipher*;⁵⁹ there the holder of a note indorsed it in blank and gave it to a banker with authority to collect the interest. The banker pledged it for his own benefit, and the court held the pledgee immune to the suit of the entruster, noting that the owner had voluntarily transferred the instrument to the wrongdoer and thus held him out as owner.⁶⁰ Some of the fraudulent inducement cases were handled on this same basis.⁶¹ Only a few cases went as far as Chafee would have them go, allowing a taker of overdue paper from a thief to take free of prior claims of ownership.⁶²

The Code draftsmen give the non-holder in due course the back of their legislative hand. Section 3-306 states that a non-holder in due course takes an instrument subject to "all valid claims to it on the part of any person" This is commonly believed to adopt the English view that a non-holder in due course takes subject to claims of ownership as well as defenses.⁶³ However, experience teaches that the rule of *Justice v. Stonecipher* may not be so easily

⁵⁶ Chafee, *supra* note 54, at 1126.

⁵⁸ *Id.* at 1129.

⁵⁷ *Id.* at 1122.

⁵⁹ 267 Ill. 448, 108 N.E. 722 (1915).

⁶⁰ For a case where the claim of ownership was successfully asserted against a purchaser after maturity because the owner did not voluntarily entrust the instrument to the wrongdoer, see *Gabriel v. Willis & Neighbors*, 133 Okla. 18, 270 Pac. 840 (1928).

⁶¹ See, e.g., *Gardner v. Beacon Trust Co.*, 190 Mass. 27, 30, 76 N.E. 455, 456 (1906): "But the case is very different where the owner of an overdue note transfers it under circumstances which enable his transferee to deal with it though obtained by fraud as if he were the true owner. . . ."

⁶² See, e.g., *Wolf v. American Trust & Sav. Bank*, 114 Fed. 761 (1914).

⁶³ HAWKLAND, *COMMERCIAL PAPER UNDER THE UNIFORM COMMERCIAL CODE* 90 (1959); STAFF OF TEXAS LEGISLATIVE COUNCIL, *ANALYSES OF ARTICLE 3 OF THE UNIFORM COMMERCIAL CODE—COMMERCIAL PAPER* 80-81 (1955); Note, *Article III—Commercial Paper*, 17 ALBANY L. REV. 65, 73 (1953). The New York analyst believes the point is doubtful. See 2 NEW YORK LAW REVISION COMM'N, *STUDY OF THE UNIFORM COMMERCIAL CODE* 203-04 (1955).

ended. It is probably too much to expect the enactment of section 3-306 to purge judges of their notions about estoppel and the "when-one-of-two-innocent-persons-must-suffer-by-the-act-of-a-third-person, -he-who-put-in-motion . . ." maxim. The Uniform Negotiable Instruments Law sections received frequent involuntary doses of such judicial home-remedies as estoppel, waiver and negligence. On the face of it, however, section 3-306 will give the purchaser a more difficult time in avoiding claims of ownership through the use of estoppel and related judge-made nostrums.

Why does the Code reject Chafee's persuasive argument? This writer has found no explanation of the Code position. It may be contended that the weakness in Chafee's argument lies in his supposition that maturity goes only to notice, from which he reasons that since the fact an instrument is overdue gives no notice that a prior holder wrongfully obtained possession, the purchaser of overdue paper should take free of such a claim of ownership. The origin of the maturity requirement in the law of good faith purchase lends credence to his argument. Under a commercial theory, however, maturity has come to have broader significance than notice of possible defenses. An overdue instrument is no longer in the commercial flow; it is no longer a commercial instrument, and we need adorn it with none of the extraordinary attributes of commercial instruments. An overdue instrument has fallen off the edge of the flat commercial world, and we are done with it.⁶⁴

III. DOCUMENTS

There is a dual problem in treating claims of ownership in documents of title, for consideration must be given to claims in the goods represented by the documents as well as claims in the documents themselves. First, claims in the documents will be considered.

As late as 1879, the Supreme Court could say, without appearing to be particularly wrong-headed, that a statute declaring that bills of lading "shall be negotiable and may be transferred by indorsement and delivery" meant simply to prescribe the *manner* of negotiation and not its effect.⁶⁵ The Court said:

Bills of lading are regarded as so much cotton, grain, iron, or other articles of merchandise. . . . They are, in commerce, a very different thing from bills of exchange and promissory notes, answering a different purpose and performing different functions. It cannot be, therefore, that the statute which made them negotiable by indorsement and delivery, or negotiable *in the same manner* as bills of exchange and promissory notes are negotiable, intended to change totally their character, put them *in all respects* on the footing of instruments which are the representatives of money, and charge

⁶⁴ See the analysis of the sharp distinction drawn between commercial instruments (negotiable ones) and noncommercial instruments (non-negotiable ones) in Gilmore, *supra* note 18, at 1068-69.

⁶⁵ *Shaw v. Railroad Co.*, 101 U.S. 557, 562 (1879).

the negotiation of them with all the consequences which usually attend or follow the negotiation of bills and notes. Some of these consequences would be very strange if not impossible.⁶⁶

The strange and impossible consequences of which Mr. Justice Strong wrote with such distaste, that is, full negotiability, were only a generation or so away when the words were written. But the day of full negotiability of documents was to be preceded by an interim period during which documents were more negotiable than goods but less negotiable than instruments. The Uniform Sales Act and the Uniform Warehouse Receipts Act were products of this intermediate period, and under their provisions claims of ownership in a document were cut off only when the owner had entrusted it to another who then sold to a good faith purchaser.⁶⁷ In the case of theft of a document, in a form negotiable by delivery, the owner could successfully assert his claim against the good faith purchaser. Scarcely was this halfway position codified in the Sales Act and Warehouse Receipts Act when it was abandoned in the later Uniform Bills of Lading Act which tersely provided: "A negotiable bill may be negotiated by any person in possession of the same, however such possession may have been acquired . . ."⁶⁸

The Code draftsmen seemed to have an easy task in this area; all they had to do was to follow the route laid out for them in the Bills of Lading Act and make documents as negotiable as instruments. This they declined to do. Under section 7-501, claims of ownership in the document are cut off only when the document is "duly negotiated," that is, negotiated in the regular course of business or financing.⁶⁹ Hence, in the beginning documents and

⁶⁶ *Id.* at 565. (Emphasis in original.)

⁶⁷ UNIFORM SALES ACT § 32; UNIFORM WAREHOUSE RECEIPTS ACT § 40.

⁶⁸ UNIFORM BILLS OF LADING ACT § 41. Some states changed the Uniform Sales Act and Uniform Warehouse Receipts Act to conform to the Uniform Bills of Lading Act. See UNIFORM SALES ACT § 32, statutory notes, 1 UNIFORM LAWS ANN. (1950); UNIFORM WAREHOUSE RECEIPTS ACT § 40, statutory notes, 3 UNIFORM LAWS ANN. (1959), for listings of the states that have adopted the amendment.

⁶⁹ Section 7-501(4) provides that a document is not "duly negotiated" where "it is established that the negotiation is not in the regular course of business or financing or involves receiving the document in settlement or payment of a money obligation." California Senate Preprint Bill No. 7 (1963), the version of the Code submitted to the California Legislature in 1963, omits the requirements contained in the quoted language that a due negotiation must be in the regular course of business and must not involve receiving a document in settlement or payment of a money debt. The REPORT OF CALIFORNIA SENATE FACT FINDING COMMITTEE ON JUDICIARY, THE UNIFORM COMMERCIAL CODE 526 (1961) explains the omission: "[The regular course of business requirement] in our opinion would seriously impair the negotiability of documents of title and their value for use as collateral and in other aspects of trade and commerce. So far as we know, the proponents of the Code have offered no proof that this radical new concept is necessary to correct any particular evil which has arisen under the Uniform Acts. Rather, it seems to be concerned with the hypothetical classroom situation where a professor negotiates a document of title covering hides belonging to a tramp. [See note 50 *supra*.] Nor can we see any reason to deny the status of a holder in due course to a person who receives a document in 'settlement of payment' of an obliga-

goods were treated alike—neither was negotiable—and now in the Code they are again accorded somewhat similar treatment in that each is negotiable only in essentially commercial transactions. Of course, goods are at a more rudimentary stage of development and are not given full negotiability even in the commercial setting.

When we come to non-negotiable documents, further analogizing to goods becomes idle, for section 7-504 provides that the transferee of a non-negotiable instrument acquires only the interest his transferor had or had the *actual* authority to convey. Claims of ownership that the buyer of goods might take free of by raising an estoppel argument will, under this section, prevail over a good faith purchaser of the non-negotiable document.⁷⁰ Not only is the buyer of a non-negotiable document subject to claims in the document that arose before he took the document, but he is also vulnerable to claims in the goods that his transferor may create after taking the document. Thus, the transferor may sell the goods covered by the document to a buyer in ordinary course of business and this party can cut off the transferee's claims in the goods by either obtaining the goods from the bailee or notifying the bailee before the transferee does so.⁷¹ The transferee of a non-negotiable instrument is at the mercy of his transferor until he has either notified the bailee or obtained possession of the goods. Professor Williston quietly observed: "[D]ocuments of title unless negotiable in form are not proper subjects for commercial dealings."⁷²

Nor is the lot of one who takes a negotiable document through other than due negotiation a happy one. He, too, takes only what rights his transferor had or had the actual authority to convey.⁷³ The official comments explain his plight by saying that if purchasers in the regular flow of commerce are to be protected, then, it follows—and the commentator apparently believes that it follows as the night follows the day—that purchasers outside the regular course of dealings are not to have the benefits of negotiability and must take fewer rights than if they had purchased the goods themselves.⁷⁴

With regard to claims of ownership in documents, we see the Code enforcing

tion, whereas a person who takes a document as *security* for an obligation, even a pre-existing obligation, is granted that status. Furthermore under this provision, if a person holding documents as security and who was a holder in due course agreed to accept them in settlement of the same obligation, he would thereupon lose that status. This result is irrational. But that, of course, would be the most common case where a document would be received in settlement or payment of an obligation."

⁷⁰ See UNIFORM COMMERCIAL CODE § 7-504, comment 1.

⁷¹ UNIFORM COMMERCIAL CODE § 7-504(2)(b). See the comment on this section in BRAUCHER, *op. cit. supra* note 24, at 73-75.

⁷² 2 WILLISTON 556.

⁷³ UNIFORM COMMERCIAL CODE § 7-504(1).

⁷⁴ UNIFORM COMMERCIAL CODE § 7-504, comment 1.

the mercantile doctrine with vengeance. Purchasers in the regular course of dealings are protected; those outside the pale are treated with but scant civility. In the words of the song, "you're in or you're out of the money."

Documents of title, unlike bills of exchange, are related to specific goods and their validity depends upon the extent to which they represent the goods behind them. We must, therefore, examine claims of ownership in the goods themselves and note in what degree purchasers of the documents covering the goods take free of these claims. The simple rule adopted by the early uniform acts was that a good faith purchaser of a negotiable document received such title as the person who bailed the goods had in the goods or had the ability to convey to a good faith purchaser of the goods themselves.⁷⁵ A thief or a mere bailee could not sell the goods directly and cut off claims of ownership, nor could he improve his position by bailing the goods, obtaining a document of title and selling that document.⁷⁶ On the other hand, a fraudulent vendee or an agent with indicia of ownership could sell the goods to a good faith purchaser free of claims of ownership and could accomplish the same result by obtaining a document and negotiating it.⁷⁷

The extent to which a document represented the goods and could be negotiated free of claims of ownership in the goods was, then, determined by looking to the law of the good faith purchase of goods. It is not surprising that rules developed by courts to cut off or to honor claims of ownership in goods failed to cover some situations—and produced some unfortunate results in others—that arose when negotiable documents came on the scene.

The problem was that—at least after the arrival of the UBLA—the commercial doctrine of the good faith purchaser was completely accepted as to documents and largely rejected as to goods. Hence, if the owner of goods gave a negotiable bill of lading covering the goods, the recipient could cut off prior claims of ownership by transferring it. But if the owner gave possession of the goods themselves, the recipient could, in theory, not cut off the claims. What were the courts to do with the cases where the owner of goods entrusted them to another with the authority to obtain a document of title, or with the expectation that the party entrusted would obtain a document, or

⁷⁵ UNIFORM SALES ACT § 33; UNIFORM BILLS OF LADING ACT § 32; UNIFORM WAREHOUSE RECEIPTS ACT § 41.

⁷⁶ *W.S. Brown Mercantile Co. v. Yielding Bros. Dep't Store, Inc.*, 200 Ala. 412, 76 So. 4 (1917) (crop subject to chattel mortgage bailed and warehouse receipts sold to good faith purchaser; mortgagee held to have cause of action against purchaser); see also *Kendall Produce Co. v. Terminal Warehouse Co.*, 295 Pa. 450, 145 Atl. 511 (1929)(bailee); *Gazzola v. Lacy Bros. & Kimball*, 156 Tenn. 229, 299 S.W. 1039 (1927) (bailee); *Dunagan v. Griffin*, 151 S.W.2d 250 (Tex. Civ. App. 1941) (bailee).

⁷⁷ *Standard Bank of Canada v. Lowman*, 1 F.2d 935 (W.D. Wash. 1924) (apparent authority); *Luhrs v. Valley Ranch Co., Inc.*, 27 Ariz. 206, 232 Pac. 1014 (1925) (apparent authority); *Baldwin v. Childs*, 249 N.Y. 212, 163 N.E. 737 (1928) (fraudulent vendee); *Lippencott Distrib. Co. v. Peoples Commercial & Sav. Bank*, 137 Ohio St. 399, 30 N.E.2d 691 (1940)(consignment).

knowing of the likelihood that he would obtain a document of title? Should some or all of these situations be treated as though the owner had entrusted the other person with the document itself?⁷⁸ Moreover, what disposition was to be made of cases where the owner entrusted the other party with a document and the recipient used the document to obtain the goods, let us say from a carrier, then took the goods and bailed them with a warehouse, and negotiated the warehouse receipt obtained thereby to a good faith purchaser?⁷⁹ Even here one case treated this as though the recipient had originally been entrusted with the goods themselves and refused to protect a good faith purchaser of the negotiable warehouse receipt.⁸⁰

Section 7-503 of the Code evinces recognition of the fact that documents of title raise some problems that do not appear with respect to either goods alone or instruments alone. The section reads in part:

- (1) A document of title confers no right in goods against a person who before issuance of the document had a legal interest or a perfected security interest in them and who neither
 - (a) delivered or entrusted them or any document of title covering them to the bailor or his nominee with actual or apparent authority to ship, store, or sell or with power to obtain delivery under

⁷⁸ The question is nicely raised in the sharecropper cases; there the landlord is paid by taking a share of the crop and has a lien on the crop to this extent. The landlord leaves the crop in the possession of the tenant with the authority to deal with the crop as owner and knowing of the likelihood that the crop will be warehoused. Courts have often protected purchasers of the resulting warehouse receipts: *Salt River Valley Water Users' Ass'n v. Peoria Ginning Co.*, 27 Ariz. 145, 231 Pac. 415 (1924); *Grauman v. Jackson*, 216 Ark. 326, 225 S.W.2d 678 (1950); *Commodity Credit Corp. v. Usrey*, 199 Ark. 406, 133 S.W.2d 887 (1939) (landlord held to know of custom that cotton ginner did not long retain the physical property but either sold it or stored it in a warehouse); *Buelow v. Abell*, 9 La. App. 624, 121 So. 657 (1928); *McGee v. Carver*, 141 Miss. 463, 106 So. 760 (1926). *Contra*, *Purity Feed Mills Co. v. Moore*, 152 La. 393, 93 So. 196 (1922); *Phillips v. Box*, 204 Miss. 231, 37 So. 2d 266 (1948).

⁷⁹ In *Commercial Nat'l Bank of New Orleans v. Canal-Louisiana Bank & Trust Co.*, 239 U.S. 520 (1916), *O* pledged bills of lading representing cotton to *A* Bank which then entrusted the bills to *O* on trust receipts; *O* surrendered the bills to the carrier, took possession of the cotton and warehoused it receiving warehouse receipts; the receipts were pledged to *B* Bank. The courts held for *B* Bank, reasoning that had *O* pledged to *B* the original bills of lading, *B* would clearly prevail and that the same result should follow because *A* must have contemplated that *O* would take the bills to the carrier, obtain the goods and then warehouse them.

⁸⁰ *Gazzola v. Lacy Bros. & Kimball*, 156 Tenn. 229, 299 S.W. 1039 (1927). Here *O* mailed bills of lading representing cotton to *F*, a factor, with orders not to sell the cotton until further notice; *F* used the bills to obtain possession of the cotton and warehoused it, negotiating the warehouse receipts to *A* Bank in pledge. The court held for *O* and said that since the bills were not immediately exchanged for the warehouse receipts, the latter could not be considered as derivative of the former. Thus the case is treated as though *O* entrusted mere possession of the cotton to *F* with authority only to store it. The custom of cotton factors in Memphis to warehouse all cotton sent to them for any purpose and to take out negotiable warehouse receipts to facilitate the handling of the goods was ignored by the court.

this Article (Section 7-403) or with power of disposition under this Act (Sections 2-403 and 9-307) or other statute or rule of law; nor

(b) acquiesced in the procurement by the bailor or his nominee of any document of title.

This is a difficult section to construe, but it is subject to this interpretation: If the owner of the goods entrusts a negotiable document of title representing the goods to a second party, this party can obtain the goods from the bailee (for example, a railroad) thereby discharging the document, bail the goods again and negotiate the second document, a warehouse receipt, to a good faith purchaser free of any claims of ownership on the part of the original owner without regard to the original purpose of the entrusting. If goods are entrusted by the owner to a second party, the latter can obtain a document of title and negotiate it free of any claims of ownership if the goods were entrusted to him with either the actual or apparent authority to sell, ship or store them. Moreover, if goods are entrusted to one who deals in goods of that nature (whatever the purpose of the entrusting), the recipient has the power to bail the goods and negotiate the resulting document of title to a good faith purchaser free of claims of ownership.

But the Code does not stop there; the acquiescence subsection is added. Anyone who has ever had to defend the Code in a legislative hearing knows that at some point during the discussions on Article 7, some opponent of the Code will refer to the acquiescence subsection, and with the gleam of anticipated triumph in his eye, say: "Now, what does *that* mean?"⁸¹ If one understands the issues facing the draftsman of section 7-503 he will appreciate the formidable drafting problem involved. The draftsman has attempted to meet this problem by providing that any time the owner of goods allows a document of title representing those goods to get into the flow of commercial transactions anyone taking the document in the regular course of business takes free of claims of ownership. The subsection covers the situation in which the facts do not fit well into any of the categories of subsection (a) but the owner of the goods knew the party to whom he entrusted the goods was likely to bail them and obtain a negotiable document of title. Subsection (b) provides that if he has this knowledge and does nothing about it, he should be treated as though he started the document itself in the commercial stream.

IV. INVESTMENT SECURITIES

Unlike the familiar transfer of goods, checks and notes, the transfer of investment securities is so highly specialized that despite the broad ownership

⁸¹ California Senate Preprint Bill No. 7 (1963), the version of the Code submitted to the California Legislature in 1963, omits the "acquiescence" subsection on the grounds that its meaning is uncertain and its operation would be unjust. See REPORT OF CALIFORNIA SENATE FACT FINDING COMMITTEE ON JUDICIARY, THE UNIFORM COMMERCIAL CODE 530 (1961).

of corporate securities in this country, virtually all securities transfers are controlled by an inner priesthood of a few thousand brokers, dealers and transfer agents.

The sale of securities raises some problems not encountered in the sales of goods, documents and other forms of instruments. When the unsophisticated investor sells a share of corporate stock or a corporate or government bond, he is probably not conscious of the fact that he is selling it *to* anyone—he merely signs the assignment or makes the indorsement and gives it to the clerk in the brokerage office. The impression the seller of securities gets is that his certificate is being swallowed up in the great maw of a brokerage firm, which will in four or five business days spew forth his money. That his money ultimately comes from a buyer is difficult for him to understand, for like most of us, he has little comprehension of what goes on behind the grey-flannel curtain of the brokerage houses. Similarly, the buyer who phones his broker to buy a given stock for his account is unaware that he is buying *from* anyone, and the appearance of a bright new certificate issued by the company in his name gives him no reason to reflect that the shares represented by this certificate previously belonged to someone else. Of all the worries that run through the head of a man who has just bought stock—and they are many—surely the last thing that would enter his mind is the thought that he might be getting a certificate subject to claims of ownership by those who held these shares before they were registered in his name.

To what extent are the securities buyer's expectations that he is getting clear title fulfilled under the law before and after the Code? The story of the negotiability of bonds has often been told,⁸² and only brief reference need be made to it here. For the last thirty or so years bearer bonds have for the most part been considered negotiable. This development is that rare instance in the growth of the law when two wrongs combine to make a right. First, the Negotiable Instruments Law was interpreted to cover bonds.⁸³ This should not have been done, for its effect was to apply the eighteenth and nineteenth century solutions of the NIL to the uniquely twentieth century problems of investment securities. Second, the application of the NIL to bonds meant that under precedents handed down in cases concerning bills and notes, these bonds must surely be non-negotiable due to the references in them subjecting the rights of their holders to provisions in the trust indentures or other devices securing the bonds. However, the courts rejected these precedents and by a rather violent construction of the statute gave negotiability to bearer bonds.⁸⁴

⁸² See Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1088-93 (1954); Steffen & Russell, *The Negotiability of Corporate Bonds*, 41 YALE L.J. 799 (1932).

⁸³ See *Enoch v. Brandon*, 249 N.Y. 263, 266-68, 164 N.E. 45, 46-47 (1928); *Manhattan Co. v. Morgan*, 242 N.Y. 38, 47-49, 150 N.E. 594, 597 (1926).

⁸⁴ The leading case is *Enoch v. Brandon*, *supra* note 83.

Registered bonds, of course, were beyond salvation, and they remained non-negotiable.⁸⁵

Corporate stock attained negotiability in the same two stages that documents of title were later to go through. First, limited negotiability was achieved under the common law by protecting a good faith purchaser against claims of ownership whenever the owner of the certificate entrusted it to the seller.⁸⁶ Then, in the Uniform Stock Transfer Act of 1910, full protection against prior claims was granted.⁸⁷ However, the Stock Transfer Act did not provide for cutting off the issuer's defenses upon transfer; hence, it can be said that even the Stock Transfer Act gave only quasi-negotiability.⁸⁸

If all one knew of stock transfers was what he could learn from the USTA, he would surmise that stock certificates were sold in direct seller-to-buyer transactions—much as newspapers are sold on street corners. Even though the direct seller-to-buyer transaction is the most unusual transaction in stock sales, the provisions of the Stock Transfer Act do not go beyond this elementary stage. In consequence, the Stock Transfer Act ignores many of the problems that stem from the modern brokerage method of selling stock.

The Code provides that the securities governed by Article 8 are negotiable instruments⁸⁹ and in section 8-301 states that a bona fide purchaser acquires the security free of adverse claims. The statute defines the "bona fide purchaser" as a purchaser for value in good faith and without notice of any adverse claim who takes delivery in proper form.⁹⁰ The Code makes one of its major contributions toward writing commercial laws in the light of commercial realities by going far beyond the Stock Transfer Act in attempting to delineate the rights of the parties in the vital broker-customer relationship.

A typical stock transfer will entail a number of transactions. The seller will indorse the certificate and deliver it to the selling broker, who will sell the shares on the exchange to the buying broker. The latter is acting under a purchase order given by his customer, the buyer. Delivery of the certificate from the selling broker to the buying broker may actually be made by physical delivery of the certificate, or delivery may be constructive in that the two brokers may simply settle their balance for the stock in that company traded during the day. The buying broker will then register transfer of the certificate in his own name if he is holding buyer's securities in the street name or if buyer is a margin customer; if not, he will register the certificate in buyer's name and deliver it to him after payment. It is almost beyond probability

⁸⁵ Steffen & Russell, *Registered Bonds and Negotiability*, 47 HARV. L. REV. 741 (1934).

⁸⁶ BALLANTINE, *CORPORATIONS* § 330 (rev. ed. 1946).

⁸⁷ UNIFORM STOCK TRANSFER ACT §§ 5-7.

⁸⁸ BALLANTINE, *op. cit.* *supra* note 86, § 332.

⁸⁹ UNIFORM COMMERCIAL CODE § 8-105(1).

⁹⁰ UNIFORM COMMERCIAL CODE § 8-302

that the very certificate the seller handed to the selling broker will ever reach the buyer who placed the order that resulted in its sale.⁹¹

Section 8-313 recognizes that until an identified stock certificate has been put into the buyer's name or has been confirmed by the broker as being held for him, the securities are treated by the broker very much as fungibles.⁹² Until a certificate is identified as belonging to a certain buyer, the broker is the holder of the certificate and can be a bona fide purchaser of it.⁹³ It is most unlikely that claims of ownership will survive this series of transfers. If the ultimate buyer hears of a claim of ownership regarding a given security, he is subject to this claim only in the unusual case that this very certificate is later identified as his.⁹⁴ Even then he can refuse to accept delivery of the certificate from the broker, who then will send it back to the selling broker.⁹⁵ Moreover, the fact that the original certificate, passing from the selling broker to the buying broker, contained a forged or unauthorized indorsement cannot

⁹¹ The best description of the mechanics of the stock transfer transaction is found in Carlos Israel's memorandum in 2 *New York Law Revision Comm'n, Hearings on the Uniform Commercial Code* 78-79 (1954).

⁹² Under UNIFORM COMMERCIAL CODE § 8-313 there is no delivery to the purchaser until the acts enumerated in the text have been accomplished. Comment 3 to § 8-313 speaks of "the prevalent practice of brokers of treating securities as fungible goods."

⁹³ UNIFORM COMMERCIAL CODE § 8-313(2), comment 3, states that "the broker is regarded as the holder of any securities which are not specifically identified as belonging to a particular customer." New York has amended § 8-313(2) and has added a subsection (3) as follows: "(2) The purchaser is the owner of a security held for him by his broker, but is not the holder except as specified in subsections (b) and (c) of subsection (1). Where a security is part of a fungible bulk, the purchaser is the owner of a proportionate property interest in the fungible bulk and is a bona fide purchaser if when the broker takes delivery as a holder neither he nor the purchaser has notice of any adverse claim and the purchaser takes his interest for value. (3) Notice of an adverse claim to the broker or to the purchaser after the broker takes delivery as a holder without notice of any adverse claim is not notice of the adverse claim to either the broker or the purchaser." N.Y. Sess. Laws, ch. 553, § 8-313 (2) & (3), eff. Sept. 27, 1964 (McKinney 1962). California's bill will contain the New York language above quoted and will add to subsection (3): "However, as between the broker and the purchaser, the purchaser may demand delivery of an equivalent security as to which no notice of an adverse claim has been received." FINAL REPORT OF ADVISORY COMMITTEE ON THE UNIFORM COMMERCIAL CODE, SENATE COMMITTEE ON JUDICIARY (December, 1962) (mimeographed). Language somewhat different from that in the New York statute has been recommended in the 1962 Recommendations for Amendment of the Uniform Commercial Code Proposed by the Permanent Editorial Board (mimeographed). The language quoted above as being incorporated into the California version of § 8-313(3) is taken from the Editorial Board's 1962 Recommendations, *supra*.

⁹⁴ "The Comment to § 8-313 points to the theoretical possibility of the customer receiving notice, while the security is part of such fungible bulk, of a claim of ownership of the specific certificate later identified as his, in which event he would not be a bona fide purchaser. The writer would be astonished if that case ever arises." Israel, *Article 8—Investment Securities*, 16 LAW & CONTEMP. PROB. 249, 260 (1951). The New York amendment to § 8-313, quoted in note 93 *supra*, would remove even the "theoretical possibility" of which Mr. Israel speaks.

⁹⁵ See 2 *New York Law Revision Comm'n, Hearings on the Uniform Commercial Code* 79 (1954). Note the language adopted in California allowing the customer to demand delivery of an equivalent security when he has notice of a claim. Note 93 *supra*.

be raised against a purchaser who receives in good faith a new security on registration of the transfer.⁹⁶ Such a buyer never sees the old certificate and has no notice of the fact it had a forged indorsement.

In short, the Code sees the relationship of customer to broker as going beyond mere agency. When the broker buys securities he tends to buy them in bulk and then to allocate them to his customers. In so doing he must, under the Code, warrant to his buyer the genuineness of the security.⁹⁷ The Code draftsmen have recognized that the really significant relationship concerning the buyer of stock is not that between him and the prior owner or seller, but that between customer and broker.

What the buyer is paying his broker for is a security free of claims of ownership and warranted free of forgeries. The Code goes far toward allowing him to have this, without regard to the technical designation of the broker's capacity—whether principal, agent, pledgee or whatever.⁹⁸

Other matters determined by the relationship between broker and customer are the latter's rights to reclaim his stock after bankruptcy of the broker and the rights of the customer against parties to whom a broker has wrongfully sold his stock. Under the Code once the certificate has been put in the customer's name or otherwise identified as his by the broker, the customer should be able to reclaim it from the trustee.⁹⁹ If bankruptcy occurs while the certificate is still held by the broker in bulk before he designates it for the customer or while the stock is held in the street name in a margin account, the Code

⁹⁶ UNIFORM COMMERCIAL CODE § 8-311.

⁹⁷ Under UNIFORM COMMERCIAL CODE § 8-306(5) a broker makes certain warranties to his customer; moreover, since a broker qualifies as a purchaser, he is the recipient of these warranties under § 8-306.

⁹⁸ New York has added § 8-320 which makes provisions for the transfer of securities through a clearing corporation. N.Y. Sess. Laws, ch. 553, §§ 8-102(3)(4), 8-320, eff. Sept. 27, 1964 (McKinney 1962). California has adopted these provisions in California Senate Preprint Bill No. 7 (1963). The Permanent Editorial Board recommends adoption of these changes. See 1962 Recommendations for Amendment of the Uniform Commercial Code Proposed by the Permanent Editorial Board for the Uniform Commercial Code (mimeographed). The REPORT OF THE NEW YORK CLEARING HOUSE ASSOCIATION ON THE UNIFORM COMMERCIAL CODE 30 (1961) explains the background of this section: "In order to simplify the transfer of securities, three of the larger banks and all member firms of the New York Stock Exchange have conducted a pilot operation over the past several years pursuant to which, under current procedures, balance certificates are held by the respective banks which are the transfer agents for the pilot stock. When shares of any pilot stock are transferred from one member firm to another, certificates are not delivered but a bookkeeping entry is made by the Stock Clearing Corporation and a notice of the transfer is given by the Stock Clearing Corporation to the member firms involved. While this practice is still in the experimental stage it is expected that this or something very close to it will shortly be adopted by the New York Stock Exchange and will extend to all member firms and all listed securities. Obviously this would be a tremendous step forward in the simplification of security transfers."

⁹⁹ See *Israels*, *supra* note 94, at 260.

gives the customer little help.¹⁰⁰ New York has attempted to improve the position of the customer in this situation by amending the first sentence of section 8-313(2) to read: "(2) The purchaser is the owner of a security held for him by his broker, but is not the holder except as specified in subsections (b) and (c) of subsection (1)."¹⁰¹ Clearly if the customer leaves certificates in the possession of the broker indorsed in blank or leaves them in the street name with only a bookkeeping indication that they belong to him, the broker can cut off all claims of ownership of the customer by selling them to good faith purchasers.¹⁰²

V. CONCLUSION

The widespread acceptance of the Code represents substantial progress in the long journey toward the attainment of a mercantile or commercial theory regarding goods, documents and instruments. When one buys in good faith and in the regular course of commerce he is now assured by the Code of broad protection against prior claims of ownership and defenses with respect to negotiable instruments, documents of title and investment securities. The Code's inclusion of section 2-403, granting a measure of negotiability to goods in a commercial setting, has been the most dramatic step forward. Conversely, when the buyer is out of the ordinary flow of commerce—purchasing goods from one not a merchant; taking a non-negotiable instrument; loaning money on a document of title outside the regular course of business—the Code offers no aid against claims of ownership.

The rise of the commercial theory has usually been depicted as an orderly progression of right winning out over wrong—of good over evil—not unlike the conversion of the Goths to Christianity. It is intriguing to note that many businessmen are quite unenthusiastic about this new source of solace, the commercial theory. They are content with their pagan god of original ownership and are indifferent to the new idol of the good faith purchaser. For example, in California the Code went to the legislature in 1963 with section 2-403 applying only where the goods were entrusted to a merchant for purpose of sale. Section 7-501 is changed to strike the requirement that to take a document by due negotiation (and thus to take free of claims and defenses) one must take it in the regular course of business or finance. Section 7-503, which allows an ultimate purchaser or pledgee of a document of title to win if the

¹⁰⁰ The REPORT OF THE NEW YORK CLEARING HOUSE ASSOCIATION ON THE UNIFORM COMMERCIAL CODE 28 (1961) concludes that under the 1958 version of the Code, so long as securities are held by a broker as part of a fungible bulk of similar securities held for other customers, "the positions of an adverse claimant to the security, and of creditors, including a trustee in bankruptcy, of the broker, and of the Federal government under a tax lien against the broker, would be superior to the position of the customer."

¹⁰¹ N.Y. Sess Laws, ch. 553, § 8-313(2), eff. Sept. 27, 1946 (McKinney 1962). California has adopted this wording; see note 93 *supra*.

¹⁰² UNIFORM COMMERCIAL CODE § 8-301(2).

owner of goods acquiesced in the act of the person in possession of the goods obtaining a document of title, has been scrapped.¹⁰³ Each of these provisions is a logical extension of the commercial doctrine, and each was dropped at the instance of an advisory committee representing the financial and commercial community. Is the commercial theory important only to commercial theorists seeking symmetry in the law?

Perhaps we should not wonder at the indifference of the business community to the extensions made in the Code toward the mercantile theory. Financiers, manufacturers and sellers of goods are not directly helped by giving goods a measure of negotiability. And they are quite sure that they are injured by the requirement that one can only take documents free of claims or defenses if he takes in the regular course of business. Their contention is that this provision introduces such uncertainty into the purchase or financing of documents that the basic objectives of the commercial doctrine—promotion of the free flow of commerce—is subverted. Thus the Code broadens the application of the commercial doctrine where businessmen believe they are not helped—goods—only to narrow the group protected by the doctrine where they believe they will be hurt—documents.

During the 1954 New York hearings on the Code, Professor Llewellyn was asked why he had chosen to prefer the good faith purchaser over those having prior claims of ownership. He replied: "The choice is hard, and it gives little satisfaction, either way; but the Code's choice fits more comfortably into the whole body of our commercial law."¹⁰⁴ Until the impact of the Code on business transactions is studied, there is little more that can be said.

If the Code is to stay current and vigorous, it must undergo periodic revision. This is the charge of the Editorial Board. Thus far the Code has been drafted and redrafted on the basis of how a number of experienced, responsible people thought it would work. The time has now come for detailed field studies to find how it actually is working and how it can be improved.

Improvement of the Code is not likely to be accomplished solely by the familiar practice of convening advisory groups composed of representatives of the commercial community and their lawyers. These committees are helpful, but too often they become advocates rather than objective reporters. As representatives of their business groups they find it irresistible to represent the group's interest in having the Code work a certain way. Moreover, the Editorial Board's policy of employing the very people who were most intimately involved in writing the Code to head subcommittees charged with evaluating proposed amendments to the Code justifies some skepticism. Asking these people—able as they are—to approve changes in their work has some of the aspects of asking a wife to approve her successor.

¹⁰³ Each of these amendments can be found in California Senate Preprint Bill No. 7 (1963).

¹⁰⁴ 1 *New York Law Revision Comm'n, Hearings on the Uniform Commercial Code* 59 (1954).

The science of testing attitudes and opinions has reached a high state of reliability. It is to be hoped that these techniques will come to be used in assessing the impact of the innovations in the Code on commercial practices. But professional observers must have the active cooperation of the business community. The battles for passage of the Code in the many statehouses have left an army of adherents who feel intellectually and emotionally bound up in seeing the Code work successfully. Let us hope this group will be utilized to provide a hospitable climate for continued observation and improvement of the Code.