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THE IMPUTED NEGOTIABILITY OF SECURITY INTERESTS UNDER THE CODE

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The maximization of commercial activity in our economy has accentuated the demand for greater predictability in the law of commercial transactions. Responding to this demand, the sponsors of the Uniform Commercial Code have set out, among other things, "to simplify, clarify and modernize the law governing commercial transactions." The Code is thus the product of an unprecedented effort in a common law jurisdiction to integrate a mass of related statutory and decisional rules covering a wide range of mercantile dealings. Although the Code does not comprehend all areas of commercial law, and its future extension into other areas is a recognized possibility; it is, nevertheless, manifest from the pattern of the Code, especially from its careful definitions and cross references between interrelating sections, that the statute is meant to be a coherent whole. In view of the magnitude of the Code, the full im-

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1. UNIFORM COMMERCIAL CODE § 1-102(2) (a). References to the Code are, unless otherwise indicated, to the 1958 Official Text with Comments, as adopted by the American Law Institute and the National Conference of Commissioners on Uniform State Laws.
2. Although the Uniform Commercial Code, unlike its counterparts in the civil law orbit, does not cover an area defined, analytically or functionally, by a clearly recognizable overall principle, its coverage can be defended on the pragmatic grounds that the individual Articles involve either subjects presently covered by somewhat obsolete uniform acts, or related subjects, such as secured transactions, as to which uniformity and improvement of the present law appear desirable. Future extension of the Code into other areas of commercial law is not hereby precluded.
3. The “Official Comments” were, according to the Code’s sponsors, partly intended “to aid in viewing the Act as an integrated whole.” The sponsors explained further:

This Act purports to deal with all the phases which may ordinarily arise in the handling of a commercial transaction, from start to finish.

Because of the close relationship of each phase of a complete transaction to every other phase, it is believed that each Article of this Act is cognate to the single broad subject “Commercial Transactions,” and that this Act is valid under any constitutional provision requiring an act to deal with only one subject.

Comment to Uniform Commercial Code Title. The Code has been aptly described as [a] comprehensive project in that it attempts to correlate several bodies of existing law, organizing them in one statute so that their parallels and variations and their impact on each other can be grasped. Important parts of the Code are concerned with defining the spheres of the several bodies of law, clarifying their interaction and resolving conflicts.

1955 N.Y. LAW REVISION COMM’N REP. vol. 1, at 125.
plications of its provisions can hardly be grasped even by those most familiar with them, including the draftsmen and sponsors, and accordingly some interstices and conflicts among its provisions are bound to appear in the course of its application. Orderliness, selectivity and comprehensiveness being fundamental problems in any codification, evaluation of the merit of a code must be founded on an assessment of the draftsmen's success in coping with these problems.

With the exceptions of articles 1 and 10, which respectively contain general provisions and provisions for an effective date and repealer, each of the Code's articles is devoted to a particular corpus of commercial law. As a part of the task of integration, the Code draftsmen have delineated and clarified the interaction of rules stated in each of the articles. This paper, concerning itself with a search for a definition of the relationship between a negotiable note and a security interest, will survey first the state of the law outside the Code and then look to the Code for illumination. The inquiry will include an evaluation of the impact upon each other of the rules laid down for perfecting security interests in personal property and the rules governing negotiable notes. The former

4. Even during the formative years of the Code, one of those who collaborated on it had expressed awe at its expansiveness and complexity: "With all the good will and industry in the world, it will be years before the bench and bar have mastered the intricacies and explored the implications of so massive a statute." Gilmore, On the Difficulties of Codifying Commercial Law, 57 Yale L.J. 1341, 1356 (1948). The far-reaching and subtle impact of the Code on a substantial amount of existing statutory and decisional law has also been noted with some concern as to the consequent task put thereby on the lawyer.

It [the Code] would also modify the operation of many statutes of general application, such as the statute of frauds, statutes of limitation, procedural statutes or statutes limiting common law doctrines like the requirement of consideration for contracts, or the privilege of infants to disaffirm their contracts. Even where it does not purport to govern the question, the Code assumes and relies for amplification much law outside its own provisions, including the entire body of the law of contracts, agency, and equity, and much of the law of suretyship, insolvency, evidence and procedure. Relatively few lawyers are, through their own experience and practice, expert in all of this law as it relates to even two or three of the topics dealt with in the Code. An even smaller number are sufficiently expert in all of this law as applied to the entire subject matter of the Code to appraise, from their own experience, the interaction of the several parts of the Code and its total effect on the law.

1955 N.Y. Law Revision Comm'n Rep. vol. 1, at 17. The abundance of interpretative, clarificatory and supplementary official comments appended by the sponsors to the sections of the Code has led observers to say that "the Code as elaborated by the Comments resembles a textbook of the law." Id. at 22.

5. Professors Patterson and Schlesinger, writing on "Problems of Codification of Commercial Law" for the New York Law Revision Commission in connection with the latter's study of the Code, state "five principal characteristics" of a "code": "Orderly, authoritative (i.e., enacted as legislation), selective (i.e., only the leading rules), comprehensive (i.e., all of the leading rules) and unified (i.e., on a single subject matter)." 1955 N.Y. Law Revision Comm'n Rep. vol. 1, at 37.

are contained in article 9 of the Code, which sets out "a comprehensive scheme for the regulation of security interests in personal property and fixtures"; the latter are in article 3 of the Code, which comprehends the rules for what are traditionally regarded as commercial paper—drafts, checks, certificates of deposit and notes—and which is intended to be "a complete revision and modernization of the Uniform Negotiable Instruments Law."

I. THE PROBLEM AND ITS IMPORTANCE

Of the promissory note it has been said that "it became the vehicle for the nineteenth century transformation of the American economy both from a cash to a credit basis and from an unsecured to a secured basis." As is confirmed by the Code itself, negotiable notes and security agreements are persistently used to cover one and the same credit transaction. Sales finance companies have exploited this medium of credit selling by combining a conditional sale contract and a negotiable note. Chattel security is a recognized fellow-traveler of the negotiable note.

Our problem, which derives from the interrelationship between the negotiable note and its accompanying security, arises when the note has been negotiated to a holder in due course who then seeks to enforce the security. By statutory fiat, a negotiable note is enforceable by a holder

8. See Uniform Commercial Code § 3-104 and comment 1 to Uniform Commercial Code § 3-103.
11. See comment 4 to Uniform Commercial Code § 9-105 and comment 1 to Uniform Commercial Code § 9-308.
12. This of course excludes from consideration in this paper credit in the form of negotiable notes secured by realty, or credit in the form of negotiable bonds, however secured.
15. As to who may be a holder in due course, see Uniform Negotiable Instruments Law § 52 and Uniform Commercial Code § 3-302. For a comparison of these two sections, see Britton, Holder in Due Course—A Comparison of the Provisions of the Negotiable Instruments Law with Those of Article 3 of the Proposed Commercial Code, 49 Nw. U.L. Rev. 417 (1954). It should be noted that § 3-302 in the 1958 Official Text of the Code is slightly revised from that version of this section discussed in Professor Britton's article.
in due course\textsuperscript{16} or a transferee from such holder\textsuperscript{17} notwithstanding certain claims and defenses.\textsuperscript{18} And by the doctrine of overwhelmingly prevailing pre-Code decisions, this quality of negotiability, or at least some aspects of it,\textsuperscript{19} may be regarded as having been "imputed" or "imparted" to the accompanying security so that it shares the note's enforceability despite claims and defenses.\textsuperscript{20} The question of the extent to which the security interest acquires by imputation the note's attributes of negotiability may assume special relevance in the event of the debtor's bankruptcy. This paper addresses itself to a consideration of this question with special attention to its implications in bankruptcy.

A bankruptcy-oriented approach to a consideration of the enforceability of a security instrument is never difficult to justify. The bankruptcy of a borrower or buyer on credit is not often contemplated as a probability or even serious possibility by a creditor, but a creditor who insists on security without checking its validity should the debtor’s bankruptcy eventuate is no more farsighted than the sailor who insists on having lifesaving gear aboard without checking its watertightness before putting to sea. The impact of bankruptcy on security interests is now so well recognized that it comes close to a platitude to say that the supreme test of the worth of a security is bankruptcy.

Even a security interest which has been perfected\textsuperscript{21} against all of the

\textsuperscript{16} The rights of a holder in due course are generally stated in \textit{Negotiable Instruments Law} § 57 (but see also §§ 15 & 16) and in \textit{Uniform Commercial Code} § 3-305.

\textsuperscript{17} \textit{Negotiable Instruments Law} § 58, last sentence; \textit{Uniform Commercial Code} § 3-201.


\textsuperscript{19} For an analytical catalogue of the principal attributes of negotiability, see Gilmore, \textit{supra} note 10, at 1063-66.

\textsuperscript{20} See notes 27 and 28 infra and their accompanying texts.

\textsuperscript{21} "The security concept of ‘perfection’ . . . is a relative concept, roughly equivalent to the notion of ‘protection.’ Just as a person may be protected against one evil while exposed to another, a security interest may be perfected against certain claims and vulnerable to others." Bogert, Britton & Hawkland, \textit{Cases and Materials on the Law of Sales and Security} 435 (4th ed. 1962). The term "perfected" is used in §§ 3, 60a, 67b and 67d(5) of the Bankruptcy Act [Citations to Title 11 of the United States Code are omitted herein]. The test of perfection of a transfer in bankruptcy is made to depend almost wholly on state law. See, e.g., 3 Collier, \textit{Bankruptcy} 913-16 (14th ed. 1950) [hereinafter cited as Collier with the date of publication of the material cited]. Article 9 of the Code is supposed to use the term "perfected" in the sense that this term is used in § 60 of the Bankruptcy Act:

As in Section 60 of the Bankruptcy Act, the term "perfected" is used to describe a security interest in personal property which cannot be defeated in insolvency proceedings or in general by creditors. A security interest is "per-
bankrupt's creditors is not thereby rendered impregnable to the trustee's powers of avoidance. A fortiori, a security interest which has not been perfected against some or all of the bankrupt's creditors is a riskier security still. A security interest's unperfected status may render it vulnerable to attack by the trustee in bankruptcy as a preference under Section 60, a fraudulent transfer under section 67d or as a transfer voidable under either the "strong-arm clause" of section 70c or the power of avoidance given by section 70e.

Under section 60a(2) of the Bankruptcy Act, a transfer which has not been perfected at the time of bankruptcy "shall be deemed to have been made immediately before the filing of the petition," so that the security transfer is considered to have been made or suffered within four months before the filing of the petition, thereby establishing one of the elements of a voidable bankruptcy preference. A parallel situation is that of an unperfected fraudulent transfer under section 67d of the Act. Under the "strong-arm clause" of section 70c, if, as to any property of the bankrupt, a creditor "could have obtained a lien by legal or equitable proceedings at the date of bankruptcy," the trustee is "vested as of such date with all the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists." And, by section 70e, the trustee is empowered to avoid any

Comment 1 to Uniform Commercial Code § 9-301. It has been explained that "perfection" is "a Code term of art which describes the rights a secured party has in collateral and regulates those rights as they may come into contact or conflict with the rights of third persons, such as buyers from or judgment creditors of, the debtor." SPIVACK, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE 33 (1962). A disparity between the Code and Bankruptcy Act sense of the term "perfected" is suggested by Coogan, A Suggested Analytical Approach to Article 9 of the Uniform Commercial Code, 63 COLUM. L. REV. 1, 25-27 (1963). Mr. Coogan urges that what is really meant by "perfected" is to be gathered from a consideration of "the net effect of Sections 60 and 70c of the Bankruptcy Act," so that the term is to be correctly understood thus:

A transfer of personal property (at least personal property other than fixtures) is perfected upon the taking of whatever is the last of the steps required by state law to prevent a general creditor from thereafter obtaining by legal or equitable proceedings a lien on the collateral that would be superior to the rights of the transferee. . . .

Id. at 26.

22. Thus, security interests, though technically perfected, may be avoided as preferential transfers under § 60 or as fraudulent transfers under § 67d. Cf. Coogan, supra note 21, at 26 n.77. But see H.R. REP. No. 2320, 82d Cong., 2d Sess. 15 (1952), which, in explaining the 1952 amendment to § 67d(5), points out that "a fraudulent transfer can never 'become perfected' against creditors."

23. Section 67d(5), like § 60a(2), pertinently provides that if a "transfer is not so far perfected prior to the filing of the petition initiating a proceeding under this Act, it shall be deemed to have been made immediately before the filing of such petition." The making of the transfer within one year of the filing of the petition is one of the elements of a fraudulent transfer under § 67d.
transfer or obligation which is "fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable" under the Act.

The problem proposed to be examined here may then be nailed down to this: whether a security interest, not perfected against creditors of the debtor and therefore voidable by the latter's trustee in bankruptcy, may be immunized from attack by negotiation of the secured note to a holder in due course. That is to say, can the negotiable note shield its accompanying security interest against attack in bankruptcy?

The problem may be illustrated thus: A executes a negotiable promissory note to B and secures the note by a chattel mortgage. The mortgage is not perfected against levying creditors of A. B indorses the note, accompanied by the chattel mortgage,\(^2\) to C, who takes the note as a holder in due course. A is subsequently adjudicated a bankrupt. Can C enforce the chattel mortgage against A's trustee in bankruptcy? Or, to frame the question within the context of our inquiry, does the chattel mortgage's connection with the note serve to immunize it from attack by the trustee in bankruptcy?

No pat answer is given by the reported cases to the question posed. Surely the situation put is not an extraordinary one, and indeed there are cases where, as the subsequent discussion will confirm, the question could have been grappled with. Lack of appreciation by counsel of the involvement of the question in their case, as well as the availability of more obvious alternative theories on which to ground resolution of the challenge to the security interest, has undoubtedly contributed to the escape of this problem from recognition. Most of the cases where the issue was squarely presented and dealt with were concerned with real estate security for negotiable notes. The relevance of real estate security precedents to the present study\(^3\) is not to be dismissed out of hand, since the question

\(^2\) Of course, as many of the cases in the textual discussion to come will affirm, the negotiation of the note will carry with it the chattel mortgage, without any formal assignment or delivery of the latter. See, e.g., OSBORNE, MORTGAGES 633 n.56 (1951).

\(^3\) But see Note, The Negotiable Character of Mortgages, 2 CENT. L.J. 501 (1875).

Compare 1955 N.Y. LAW REVISON COMM'N REP. vol. 3, at 2014:

Since in many instances personal property security transactions involve small amounts, where litigation is unprofitable, or, if the amounts are large, have on one or both sides parties who are well-advised by counsel and who may in addition be governed by business practices requiring arbitration in other out-of-court settlements, the actual authority in the application of equity rules to personal property security is meager. On the other hand, the decisions regarding equity's authority in respect to real estate mortgages are relatively numerous. A constant source of uncertainty to the security lawyer is the degree to which real estate precedents are controlling when the subject-matter of security is a chattel or intangible.
of the proper interrelation between a note and its accompanying security is, we submit, largely indifferent to whether the security is personal or real property. 26

II. THE DOCTRINE OF "IMPLIED" NEGOTIABILITY: CARPENTER v. LONGAN

Ever since the United States Supreme Court's decision in 1872 of the case of Carpenter v. Longan, 27 the notion that a negotiable note imparts its character of negotiability to its accompanying security has held steady sway. 28 Carpenter v. Longan dealt with a promissory note secured by a real estate mortgage. The payee had, before maturity of the note, assigned 29 for valuable consideration the note and mortgage to a third party. The note not having been paid at maturity, the assignee sued the debtor to foreclose the mortgage. The debtor defended by alleging his delivery to the payee of certain wheat and flour, which the payee had agreed to sell and to apply the proceeds thereof to the note. In awarding full judgment to the assignee on the note and mortgage, the Court found the presence of a negotiable note decisive of the assignee's right to foreclose.

The question presented for our determination is, whether an assignee, under the circumstances of this case, takes the mortgage as he takes the note, free from the objections to which it was liable in the hands of the mortgagee. We hold the affirmative. The contract as regards the note was that the maker


27. 83 U.S. (16 Wall.) 271 (1872).


29. Strictly speaking, it is negotiation, rather than assignment, which constitutes the transferee of a negotiable instrument the holder thereof. *Negotiable Instruments Law* § 30; *Uniform Commercial Code* § 3-202(1). See, Britton, *Transfers and Negotiations Under the Negotiable Instruments Law and Article 3 of the Uniform Commercial Code*, 32 Texas L. Rev. 153, 157-59 (1953). However, the Carpenter case antedated the N.I.L. and, besides, negotiation of a note is often loosely spoken of as an assignment thereof.
should pay it at maturity to any bona fide indorsee, without
reference to any defenses to which it might have been liable in
the hands of the payee. The mortgage was conditioned to se-
cure the fulfillment of that contract. To let in such defence
against such a holder would be a clear departure from the agree-
ment of the mortgagor and mortgagee, to which the assignee
subsequently, in good faith, became a party. If the mortgagor
desired to reserve such an advantage, he should have given
a non-negotiable instrument. . . .

. . . .

The transfer of the note carries with it the security, with-
out any formal assignment or delivery, or even mention of the
latter. . . .

All the authorities agree that the debt is the principal thing
and the mortgage an accessory. . . . There is no analogy
between this case and one where a chose in action standing alone
is sought to be enforced. . . . The mortgage can have no sepa-
rate existence. When the note is paid the mortgage expires.
It cannot survive for a moment the debt which the note repre-
sents. This dependent and incidental relation is the controlling
consideration, and takes the case out of the rule applied to
chooses in action, where no such relation of dependence exists.
Accessorium non ducit, sequitur principale.30

Notwithstanding the foregoing statements of the Court as to the
effect on a mortgage of its having been given to secure a negotiable note,
it would not be fair to credit the Carpenter case with the suggestion that
the doctrine of imputed negotiability is the exclusive rule by which ques-
tions involving the enforceability of a security interest for a negotiable
note are to be resolved. On the contrary, the opinion in Carpenter inti-
mated that the protection it extended the assignee was supportable on an-
other ground, by accepting the language of a Maine case31 that "the as-
signee of a mortgage is on the same footing with the bona fide mort-
gagee. In all cases the reliance of the purchaser is upon the record, and
when that discloses an unimpeachable title he receives the protection of
the law as against unknown and latent defects."32 The defense of the
maker being one fully assertable against an assignee for present value
without regard to his good faith,33 the Court’s reference to reliance upon

30. 83 U.S. at 273-76.
32. 83 U.S. at 276.
33. On the hypothesis that the doctrine of imputed negotiability was not applicable,
the record, and its effort to analogize the assignee's position to that of a bona fide purchaser has complicated understanding of the proper role of the doctrine of imputed negotiability. This is a point to be borne in mind in the consideration of cases that have put exclusive reliance on Carpenter's enunciation of the doctrine to explain the enforceability of a security interest.

The doctrine of Carpenter v. Longan has been the subject of well-considered criticism. While nearly all the serious commentary on this doctrine was written before World War II, resurrection of the controversy over its merits is beyond the intentions of this paper. This paper is confined to an inquiry into the vitality of the doctrine in litigation attacking unperfected security interests in bankruptcy.

A. Immunization Against the Trustee's Attack. Read in the context of its factual situation, the opinion in Carpenter v. Longan can be understood as holding only that the bonafide purchaser of a mortgage securing a negotiable note is protected from "patent" equities, i.e., equities between the original parties to the security agreement. The Court's language, founding the concept of imputed negotiability on the "dependent and incidental relation" between the note and its mortgage security, has, however, encouraged the inference that third parties' equities are as well cut off by the presence of a negotiable note. Strangely enough, the cases in which the doctrine has played a prominent role in the protection from "latent" equities appear to take what is actually a tortuous way out, since the assignee of a mortgage, even when given to

the court should have subjected the assignee, regardless of his good faith, to the maker's defense of payment or equitable satisfaction. See Osborne, op. cit. supra note 24, at § 227.

34. See Britton, Assignment of Mortgages Securing Negotiable Notes, 10 Ill. L. Rev. 337 (1915); Note, The Negotiable Character of Mortgages, 2 Cent. L.J. 501 (1875); Note, 32 Ill. L. Rev. 120 (1937). For a discussion of the problems presented by nonacceptance of the doctrine, see Ross, The Double Hazard of a Note and Mortgage, 16 Minn. L. Rev. 123 (1932).


37. "Latent" equities are those in third parties or "those outside of the original debtor and the subsequent transferees in the line of ownership of the chose in action." Ibid. A distinction is drawn between latent equities in the property and latent equities in the obligation. See generally id. at §§ 229-30. Such a distinction, it has been thought, is academic for purposes of considering the imputed negotiability doctrine because "the chances of the holder ascertaining the equities are about the same in either case." Note, Negotiability of Mortgages Given to Secure Negotiable Instruments—Ohio Theories, 8 U. Cinc. L. Rev. 328, 330 (1934).
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secure a non-negotiable note, is generally protected from latent equities. Be that as it may, indiscriminate use of the doctrine to create an immunization for a security interest against latent equities or third-party claims may lead to unwarranted consequences. In this connection, it is pertinent to observe that the equities to be asserted by the trustee in bankruptcy in attacking a security interest for lack of perfection are in the nature of latent equities since they are equities belonging to creditors of the bankrupt.

First Nat'l Bank v. Brotherton, arising in a jurisdiction which had originally subjected a holder in due course to the debtor's equities, involved an attack by the trustee against a security interest on the ground that it was in fraud of the bankrupt's creditors. There, a lumber corporation, while insolvent, bought back its own shares from a stockholder. In payment for these shares, the corporation executed a promissory note secured by a real estate mortgage. The payee-stockholder transferred the note and mortgage to a bank, which took as a bona fide holder for value. Upon the lumber corporation's adjudication in bankruptcy, its trustee sued to have the mortgage cancelled as a fraud on the company's creditors. The lower court gave judgment for the trustee, but the Ohio Supreme Court reversed. Acknowledging the fraudulent nature of the mortgage in that "the mere surrender by [the stockholder] of his stock in an insolvent corporation did not constitute a sufficient consideration to sustain . . . [the] mortgage to [the stockholder]," the court stated the question it had to resolve thus: "May the invalidity of the mortgage be asserted against the bank which received it with the note which it secured, before due, for a full consideration contemporaneously advanced by it, and without either actual or constructive notice of the circumstances attending the execution of . . . the mortgage?" The court identified the right being asserted against the bank as "a latent equity in favor of persons who are not parties to the mortgage and as to whom the record contains no disclosure whatever."

[C]ases of this character are determined by the familiar rule that a mortgage is an incident to a negotiable note which it secures, and is subject to no equity which may not be asserted against the holder of the note. If it should be conceded that

38. See Osborne, op. cit. supra note 36, at §§ 229-30.
40. 78 Ohio St. 162, 84 N.E. 794 (1908).
41. See Note, supra note 37, at 331.
42. 78 Ohio St. at 171, 84 N.E. at 796.
43. Ibid.
44. 78 Ohio St. at 172, 84 N.E. at 797.
one in the position of the plaintiff in error [the bank] might, consistently with the principles of law, be required to ascertain, before purchasing, whether the mortgagor has a defense against a suit to foreclose his equity of redemption, it would not follow that he should be held to inquire of mankind with respect to latent equities.\textsuperscript{45}

Not content to rely on the doctrine of imputed negotiability, the Ohio court found support for its decision in a policy against having persons acquiring secured paper "inquire of mankind with respect to latent equities."

A third variation on the theme of these cases is afforded by \textit{Myers v. Hazzard},\textsuperscript{46} where the protection extended the transferee of a fraudulent mortgage to secure a promissory note was explained on a combination of the imputed negotiability doctrine with the analogy of the holder's position to that of a bona fide purchaser, as in \textit{Carpenter v. Longan}.\textsuperscript{47} In rationalizing its extension of the \textit{Carpenter} rule to the area of latent equities, \textit{Myers} made a careful assessment of the impact of \textit{Carpenter} on the entire question of whether a security interest given for a negotiable note should be immunized from all kinds of equities. In \textit{Myers}, the bankrupt, George Hazzard, fraudulently executed certain negotiable promissory notes, with a mortgage on a herd of cattle to secure them, to John Hazzard. John Hazzard sold the notes and mortgage to Coates, who took before maturity and without notice of the fraud. George Hazzard's assignee in bankruptcy\textsuperscript{48} sued to set aside the promissory note and the mortgage as fraudulent. The district court ruled in favor of Coates in an elaborate opinion.

The court recognized the question before it to be whether Coates, admittedly a bona fide purchaser of commercial paper secured by mortgage, "is to be regarded in the light also of an innocent \textit{bona fide} purchaser of the mortgage, so as to have the right to enforce it as against the assignee in bankruptcy of George Hazzard."\textsuperscript{49} The court then ana-
lyzed the value of the *Carpenter* case as a precedent in the resolution of the issue so stated in the following terms:

This case [*i.e., Carpenter v. Longan*] is not, . . . , as some lawyers have assumed, authority for the doctrine that the *bona fide* purchaser, without notice, of a negotiable underdue note, secured by mortgage, holds the mortgage precisely as he holds the note, subject to no defenses whatever that would not be good against the latter. In that case there was no question as to the title of the mortgagor at the time that the mortgage was given, nor as to the rights of any third party with respect to the mortgaged property, nor as to the validity or construction of the mortgage itself. It seems manifest that it was not the intention of the court to assert broadly the rule that, because a mortgage is given to secure a negotiable note, which, before maturity, is assigned to a *bona fide* purchaser, therefore no objection can be raised to the mortgage, unless it would be an objection constituting a defense to the note in the hands of such a purchaser. The court decided the case before it, and was careful to qualify its opinion by the words "under the circumstances of this case."50

Whereupon the court proceeded to explain the "true meaning and . . . proper limitations" of the imputed negotiability doctrine of *Carpenter v. Longan*:

Although the general language employed in some of the cases might seem to justify the inference that a mortgage transferred with a negotiable note before due is to be treated for all purposes as commercial paper, it is manifest that the rule thus broadly stated cannot be maintained upon principle. In many of the cases the rule is stated to be that the mortgage is regarded as following the note, and as taking the same character; but it must, of course, be understood that the mortgage takes the character of a negotiable note only in so far as in its nature it is capable of having that character imputed to it, and therefore the rule must be subject to certain modifications or exceptions. In any suit brought by the assignee of the note to foreclose the mortgage, the mortgagor may be heard to assert that the mortgage is invalid as to all or part of the property, by reason of anything that appears upon the face of the mort-

50. *Id.* at 158.
gage, or by reason of anything that the assignee is bound to know, whether the same constitutes a defense to the note or not. A third party may be heard to assert, as against the validity of such a mortgage in the hands of the assignee, that the mortgagor, at the time of the execution of the mortgage, had no power to execute it. . . . [T]here may, beyond question, be defenses to a mortgage in such a case that cannot be defenses to the note,—defenses the force and effect of which cannot be determined by an appeal to the principles of the law merchant. Of this character are objections which relate to, and in the nature of the case can only relate to, the mortgage, its construction, validity, or force and effect. They may be objections which only third parties are interested in raising. We cannot give to the mortgage all the properties of negotiable paper, nor apply to it all the principles of the law merchant, without a disregard of elementary principles.51

Implying that the doctrine of imputed negotiability has been manipulated to justify what struck the court as an "attempt to treat a mortgage for all purposes as commercial paper,"52 the court pointed out how a mortgage may be immunized against latent equities in the hands of an assignee even though the security instrument cannot be regarded as wholly negotiable:

If a negotiable promissory note, secured by mortgage upon personal property, be assigned for value, before maturity, to a purchaser without notice, to what extent is such purchaser bound to inquire as to the title of the mortgagor to the mortgaged property? As, for example, suppose the case of an insolvent, who, in contemplation of bankruptcy, fraudulently transfers his personal property to another to keep it from coming into the hands of his assignee in bankruptcy, and thereafter goes into bankruptcy; in such a case, it is, of course, clear that the assignee could recover the property from the fraudulent vendee; but if he has mortgaged it to secure a negotiable note, which is transferred before due to an innocent purchaser for value, will the latter be protected as against the claims of the assignee? Each case involving claims of this character must be determined upon the rule . . . that the assignee of the note is to be regarded as a purchaser of the mortgaged property from

51. Id. at 159.
52. Id. at 160.
the mortgagor, and to be protected to the extent that any other purchaser would be protected, and to that extent only. The purchaser of personal property from a fraudulent vendee, in good faith and without notice of the fraud, is unaffected by the equities of third parties of which he has no notice. . . . Applying this rule to the case of the assignee of a negotiable note, secured by mortgage upon personal property, under such circumstances as to make him the purchaser of the property, we reach the conclusion that in such a case as that last stated he is entitled to protection.\textsuperscript{53}

It is, however, not clear whether the court regarded his standing as a bona fide purchaser an alternative basis for its decision to free Coates of the bankruptcy assignee's claim or as an argument in addition to that derived from the doctrine of imputed negotiability.\textsuperscript{54} The two grounds are distinct, and differences in result may depend on which ground is relied on in a particular case. The bona fide purchaser approach reckons with the interrelation between the instruments embodying the obligation and the security only insofar as it accepts that the negotiation of the note constitutes a means of transferring the security; under the imputed negotiability view, the security's having "wandered in company with negotiable paper"\textsuperscript{55} is what is precisely determinative of its ability to elude latent equities. Since a holder in due course is not necessarily a bona fide purchaser and vice versa, the true rationale of this and other decisions under consideration deserves close scrutiny.

The imputed negotiability doctrine has also been taken into account by courts when considering the voidability of a preferential security interest which has come into the hands of a holder in due course of a negotiable note secured thereby. Thus, in \textit{Peninsula Bank v. Wolcott},\textsuperscript{56} the preferential security for negotiable notes was upheld against attack

\textsuperscript{53} Id. at 162-63.

\textsuperscript{54} The uncertainty in this regard is not dispelled by the court's summarization of its "conclusions in this case": (1) Coates, as the bona fide purchaser of the notes before maturity and without notice, "took the mortgage, as he did the notes, freed from equities arising between the previous parties thereto, and also freed from any latent equity existing in complainant [the assignee in bankruptcy] at the time of the assignment of the notes of which he, said Coates, had no notice," \textit{Carpenter} being cited for this proposition. (2) Coates, as the assignee of the notes and mortgage, under the circumstances, "is entitled to the same protection that would be accorded to the purchaser of property from a fraudulent vendee, in good faith and without notice of the fraud. Such a purchaser would be unaffected by latent equities of third parties of which he had no notice." \textit{Id.} at 163-64.


\textsuperscript{56} 232 Fed. 68 (4th Cir. 1916). This case was cited with approval in \textit{Matter of Lynch}, 8 Am. Bankr. R. (n.s.) 858, 862-63 (Ref. N.D.W. Va. 1926).
squarely upon the reasoning that the transferee took the security as he took the notes. The debtor in the case had executed negotiable notes secured by a deed of trust on a tract of land. The security was preferential in the hands of the first holder, but two of the notes were discounted by a bank in the usual course of its business. The maker was adjudicated bankrupt, and his creditors sought to set aside the deed of trust. Holding the deed of trust to be a valid security for the notes held by the bank, the court reasoned:

This indorsement [of the notes to the bank] carried with it the security of the deed of trust. The authorities at one time were in serious conflict on the question whether the indorsee of a negotiable note took the mortgage given to secure it subject to defenses which might have been set up against the original mortgagee; but it is now well settled by the great weight of authority that the indorsee of a negotiable note takes the mortgage given to secure it, if valid on its face, as he takes the note, freed from defenses which might have availed against the original mortgagee. Carpenter v. Longan, 16 Wall. 271. . . .

In another case involving substantially the same set of facts, the court protected the transferee of chattel mortgages voidable as preferences in the hands of the mortgagee, not on a reasoning based upon the doctrine of imputed negotiability but, rather, on the rule that the trustee cannot recover preferentially transferred property from an innocent purchaser for value. The principle of this case was codified by a 1938 amendment to section 60b of the Bankruptcy Act. By this section, as thus amended, the trustee is explicitly barred from recovering preferentially transferred property from “a bona-fide purchaser from or lienor of the debtor’s transferee for a present fair equivalent value.”

The qualification in section 60b that to be protected, the bona fide purchaser must have given present value, is significant. It is a qualification that dovetails with the generally understood conception of a bona fide purchaser in property law as one who has given present value.

57. 232 Fed. at 70-71.
58. In re Ballard, 279 Fed. 574 (N.D. Tex. 1922). This case was cited in Matter of Lynch, supra note 56, at 863, to support the proposition that “in the event a mortgage or deed of trust creates a preference as against the mortgagee, still the mortgage will be good as to the security of the notes in the hands of an innocent purchaser for value.”
59. Notwithstanding the mortgages were transferred with the negotiable notes they secured.
60. 279 Fed. at 591-92.
62. See 1 PATTON, TITLES § 13 (2d ed. 1957).
Now, when it is remembered that in the law of negotiable paper, antecedent value or a pre-existing debt is sufficient to constitute one a holder of an instrument for value and thus possibly a holder in due course, the occasion for a conflict with section 60b becomes manifest. Such an occasion presented itself in Bennett v. Semmes, a case which arose prior to the 1938 amendment of section 60b, but whether the court in this case recognized a conflict between the view that the transferees of the preferential grantee were bona fide purchasers and the view that they were holders in due course, is not clear. In this case, the bankrupt executed a deed of trust in the nature of a mortgage to secure negotiable promissory notes given to R. R delivered these notes to three banks to secure the renewal of R's notes to these banks. The court found that the notes and deed of trust were preferential in the hands of R. The issue presented for resolution was whether the banks, as "the holders of the notes secured by the mortgage, are entitled to the relief they ask, that the mortgage be decreed to be valid, as to the notes held by them, entitling them to the benefit of the lien thereof, and that they have leave to file their independent suit to foreclose it." After stating that the first question it had to answer was whether the banks were holders in due course of the notes, the court concluded that they were such holders on the reasoning that section 25 of the Uniform Negotiable Investments Law defined "value" to include an antecedent or pre-existing debt. Proceeding then to a consideration of the "only remaining question," that of the enforceability of the mortgage, the court rendered the following construction of section 60 as it then read:

Section 60 of the Bankruptcy Act . . . as amended by the act of 1910, after declaring what preferences are voidable, provides that the trustee is entitled to "recover the property (referring to the property conveyed in violation of that section), or its value from such person."

Upon facts practically identical with those in the case at bar, the United States Circuit Court of Appeals for the Fourth Circuit, in Davis v. Hanover Savings Fund Society, 210 Fed. 768, 771, 127 C.C.A. 318, held that the holder for value, in due course, of bonds secured by a mortgage on the bankrupt's

63. Negotiable Instruments Law § 25; Uniform Commercial Code § 3-303(b).
64. 287 Fed. 745 (E.D. Ark. 1923).
65. Criticism of the Bennett case has been made, however, on the assumption that there was such conflict and that the court resolved the conflict in favor of the holder in due course view. See Note, Bankruptcy and Negotiable Instruments, 64 Harv. L. Rev. 958, 960-61 (1951).
66. 287 Fed. at 747.
property, which was an unlawful preference, when assigned as collateral security for an existing indebtedness, is entitled to the lien of the mortgage. Section 70e of the Bankruptcy Act . . . which applies to fraudulent conveyances by a bankrupt, is in most respects similar to section 60, and has been uniformly construed by the federal as well as state courts, that a trustee in bankruptcy cannot recover property, fraudulently conveyed by a bankrupt to one who had knowledge of the fraudulent intent of the bankrupt, from one who became the owner thereof in due course, in good faith, and for value, without notice of the fraud . . .

It is true that section 70e expressly excepts "a bona fide holder for value," but the same rule must be applied to preferences under section 60 for a number of reasons.

(a) A recovery under section 60 is limited "to such persons," clearly referring to the person who received the unlawful preference. A careful reading of the entire section can lead to no other conclusion.

(b) A trustee in bankruptcy occupies no better position than the bankrupt, or creditors of the bankrupt, if bankruptcy had not intervened, except as expressly excepted by the Bankruptcy Act . . .

(c) Section 60 declares such preferences only voidable, and not void. A voidable transfer is good, even in the hands of the unlawfully preferred creditor, until set aside, or proceedings to set the preference aside are instituted; but an assignment or transfer from the preferred grantee to one who is a bona fide purchaser or holder for value in due course, without notice of the fraud in the original transaction, is good, and such an assignee or transferee cannot be deprived of it, or be held liable for its value, in an action by the trustee of the bankrupt estate. This applies with greater force to negotiable instruments. To hold otherwise would necessitate a purchaser of every negotiable instrument making inquiries, which the law does not require.

To place this construction on the act would greatly interfere with, if not wholly destroy, the negotiability of such instruments in the financial world. 67

67. Id. at 749-50.
Judgment was given for the banks who were held to be entitled to the lien of the trust deed, but without prejudice to any action which the trustee might elect to institute against R for the value of the preference.

The opinion makes no mention of the doctrine of imputed negotiability. It escapes understanding, however, why the court thought that the question of whether the banks were holders in due course to be relevant, or that it was the first question to be resolved, since the court itself realized that what it was confronted with was the issue as to the enforceability of the mortgage as security for the notes held by the bank. The holding-in-due-course question would appear to be relevant only had the court been invoking the doctrine of imputed negotiability to explain the enforceability of the mortgage notwithstanding its preferential character in the hands of R, or if there were involved some claim or defense to the notes themselves. The implication that the banks were bona fide purchasers overlooks the fact that the bankrupt's notes were given to the banks to secure renewal notes and, therefore, pre-existing indebtedness.\footnote{68} Whatever the rationale of the court's holding—whether an inarticulate application of the doctrine of imputed negotiability or an incorrect application of the bona fide purchaser exception read by the courts into section 60b prior to its 1938 amendment, the \textit{Semmes} case seems unsound and clearly incompatible with the "present fair equivalent value" requirement of the saving clause in section 60b.

\textbf{B. Immunization Against Other Third-Party Claims.} The impact of the doctrine of imputed negotiability on the bankruptcy trustee's position \textit{vis-a-vis} an unperfected security interest may also be gathered from a consideration of decisions that have used the doctrine to create an immunity from claims conceptually analogous to those assertable by the trustee against an unperfected security interest.

Consider, for instance, the case of \textit{Stock Growers' Fin. Corp. v. Hildreth},\footnote{69} which involved the assertion of creditors' equities by a state court receiver appointed for a mortgagor. The debtor had executed a promissory note secured by a chattel mortgage which the payee indorsed for value to a finance company. In a suit by the indorsee to foreclose the mortgage, the state court receiver's defense was that the mortgage was void as against the mortgagor's creditors for noncompliance with a
state statute requiring the chattel mortgagee to sign an affidavit of bona fides.70 Finding the finance company to be a holder in due course of the note, the court gave judgment in its favor upon an unmistakable application of the doctrine of imputed negotiability:

It is settled in this jurisdiction, and in most of the other jurisdictions where the question has arisen, that a purchaser in due course of negotiable paper takes it and any mortgage given to secure its payment free from equitable defenses between the parties thereto, as well as secret or latent defects in the mortgage. The same immunity from defenses is extended to the mortgage as to the note.71

Immunity from a variety of other third-party claims has been held to derive from the negotiable note for which the security was given. Thus, the court in one case72 relied on such reasoning in allowing the indorsee of a secured note to have priority over a prior unrecorded mortgage of which the indorser had notice. In another case,73 the court freed the indorsee from a third party's claim against the property given as collateral for the note, resting explicitly on the proposition that "where the security passes to the holder of a negotiable promissory note, nothing is a defense to the security which would not in law be a defense to the note."74 "Although," the court added, "the security may be mentioned in the note, that does not make it necessary for the purchaser to examine into the history of the security."75 The opinions in both these cases disclosed an awareness of at least one other rationale for reaching the same result. In the first case, the court also referred to the security holder's position as that of a bona fide purchaser;76 in the second, the contract on which the third party was basing his claim was void but the court mentioned this circumstance only by way of buttressing its conclusion that the filing of the contract did not give rise to constructive notice to the indorsee so as to impair his holder-in-due-course status.77 The security's

70. The statute required the affidavit to be attached to the mortgage. Ariz. Civil Code of 1913 § 4124. No such affidavit of bona fides is required under the Uniform Commercial Code § 9-203.

71. 30 Ariz. at 514, 249 Pac. at 74. Sed quare, whether the mortgage, though defectively executed, could be treated as an equitable mortgage and held assignable as such. See Karesh, Security Transactions, 10 S.C.L.Q. 114, 118-20 (1957).


73. W. W. Kimball Co. v. Mellon, 80 Wis. 133, 48 N.W. 1100 (1891).

74. 80 Wis. at 143, 48 N.W. at 1103.

75. Ibid.

76. 1 Hun at 569.

77. 80 Wis. at 143-44, 48 N.W. at 1103-04.
imputed negotiable character has also been relied on to sustain the claim of a holder in due course of a secured note to ownership of the mortgage securing it notwithstanding recordation of a prior assignment of the same mortgage by the mortgagee to another holder.78

However extensive the protection against third-party claims the cases have sometimes accorded to the security holder who is also a holder in due course of the obligation secured, this protection is not unqualified in any jurisdiction.79 No case goes so far as to enforce the security in disregard of prior recorded liens of which the holder in due course may not, technically, be on constructive notice.80 And there has been firm resistance to the use of the note as a shield against, for instance, the rights of beneficiaries of homestead legislation.81 Indeed, in a jurisdi-

80. See Orrick v. Durham, 79 Mo. 174 (1883); Logan v. Smith, 62 Mo. 455, 459-60 (1876) (dictum). Cf. Lewis v. Kirk, 28 Kan. 497 (1882) (dictum) (purchaser of mortgaged property will prevail over holder in due course of note secured by unrecorded mortgage). But cf. Gould v. Marsh, supra note 72. Sed quaere: Should distinction be made between a case where the record shows a prior lien and a case where the record shows that the debtor is not the owner of, or has no title to, the collateral? See notes 78 and 79 supra and accompanying text.
81. Berry v. Berry, 57 Kan. 691, 47 Pac. 837 (1897), in allowing the defense of the wife-mortgagor (that she signed the mortgage on her homestead under duress) to bar foreclosure by a holder in due course of the secured note, put the case against an undue extension of the imputed negotiability doctrine quite strongly:

[1]In this state, if the wife or husband does not give consent, or join in the execution, the instrument [mortgaging a homestead] does not rise to the rank of a mortgage. It is absolutely void, and not even binding upon the one who does consent. Would it be contended that a mortgage to which the wife's signature was forged, or which had never been signed by her, would follow the note and be enforceable as a security? It is unlike a case where joint consent was actually given though obtained by fraud; while here, where the consent of the wife is lacking, there is no mortgage. It would be carrying the doctrine of negotiability beyond reason, to make a mortgage which is against the statute and prohibited by the Constitution, binding and enforceable, merely because it accompanied and purported to secure a negotiable promissory note. It is not negotiable in form, and of itself has no negotiable qualities; but a rule has been established by the courts, that because of its relation to negotiable paper it is invested with negotiable character. A rule so made, applying to mortgages the principles which pertain to negotiable paper, cannot prevail over the specific provisions of the Constitution and statute. The Constitution provides that a homestead 'shall not be alienated without the joint consent of husband and wife, when that relation exists. . . . ' The same prohibition is repeated by the Legislature in one of the statutes. . . . These positive and solemn declarations cannot be overcome by a mere rule of commercial law or by any judicial dogma.

For a perceptive discussion, with stress on the Texas cases in point, of the availability of the defense of homestead as against a holder in due course seeking to enforce his security interest in a homestead, see Note, 16 TEXAS L. REV. 534 (1938). This note
tion which has been markedly partial to assignees of security interests as against latent equities regardless of whether the security is associated with a negotiable note, the equity of a *cestui que trust* has been preserved against the security in the hands of a holder in due course of the secured note.²²

III. THE NEGOTIABLE NOTE AS A SHIELD FOR AN UNPERFECTED SECURITY INTEREST IN BANKRUPTCY

To the trustee in bankruptcy, the courts' handling of the notion of imputed negotiability presents nettlesome possibilities. The suggestion that the validity of a security interest as against the trustee in bankruptcy is to be governed by the law of negotiable paper forebodes conflict with the federal policy against enforcement of unperfected security interests in bankruptcy. The trustee can derive little assurance from the decisions discussed in the preceding part, which have excepted certain third-party claims from the compass of the security's imputed immutity.²³ These holdings shrink from rejecting the doctrine of imputed negotiability but attempt to qualify it. When an explanation is ventured, the qualification is grounded on some policy consideration thought to supervene any argument for extending the principles of negotiable paper. Thus, the homestead cases point to a state constitutional or statutory provision restricting the transfer of property.²⁴ Where the right of a holder in due course to enforce his security interest has been subordinated to the right of a *cestui que trust*, recordation of the deed of trust has been taken to impart notice of the *cestui's* rights.”²⁵ The tacit premise of such a holding seems to be that the registry laws' supremacy is not to be surrendered in matters relating to the transfer or creation of interests in property.

In making unperfected security interests voidable in bankruptcy, the Bankruptcy Act generally defers to state law for the test of perfection. Thus, under section 70c, state law decides under what circumstances a creditor can “obtain a lien by legal or equitable proceedings at the date of bankruptcy” on the property of the bankrupt and what rights argues for the view that a holder in due course of a promissory note secured by a void mortgage on a homestead may well be entitled to foreclosure, not because of his status as such a holder but on estoppel or some like ground. In such a case, the author urges, “the defense is not a defense against personal liability on the note but a defense against the mortgage alone, arising out of rules of property law relating only to the security.”²⁶

Id. at 536. See Notes, 8 Tex. L. Rev. 430, 593 (1930).

82. See Note, 32 Ill. L. Rev. 120 (1937).
83. See notes 80-82 supra and accompanying text.
84. See note 81 supra.
85. See Note, 32 Ill. L. Rev. 120, 123 (1937).
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acquired by such a lien creditor. Should the state law therefore apply the doctrine of imputed negotiability against creditors of the debtor so as to validate a security interest in the hands of a holder in due course whether the interest is perfected or not, the trustee would be likewise barred from avoiding the security interest for the estate. This result is expressly contemplated by section 70e's saving clause.

The cases in which the doctrine of imputed negotiability has been invoked to prevent the trustee from recovering fraudulently or preferentially transferred property suggest further potentialities for the doctrine as a means of limiting the reach of the strong arm of the trustee in bankruptcy. To push the doctrine of imputed negotiability to the point of using it to justify enforcement in bankruptcy of an unperfected security interest is, nevertheless, insupportable. The doctrine itself suffers, as the Myers case has suggested, from the fallacy of equating the security agreement with the negotiable note. The doctrine's inarticulate assumption appears to be that the security and the note share a common susceptibility to the same defenses—i.e., that all defenses to the one are also defenses to the other and that there can be no defense against one which is not also a defense against the other. That the assumption has a limited validity is demonstrated by reference to the creditors' rights that arise under the rules for the perfection of security interests in property. These perfection rules, which generally take the form of a requirement for publicity which may be satisfied by recording or filing certain documents or by delivery of collateral to the secured party, have no counterpart in the law of negotiable paper. There are accordingly no equities of creditors involved in the execution or negotiation of this paper comparable to those involved in the creation of security interests in property. The enforcement of a negotiable obligation against the primarily liable party need not interfere with or militate against the enforcement of third parties' rights against the same debtor, but the enforcement of a security agreement is necessarily either subject to or in derogation of other parties' security interests in the same collateral. A bona fide purchaser may cut off the latent equities of third persons in property purchased but

86. 4 COLLIER ¶ 70.49 (1959).
87. An application of the doctrine of imputed negotiability would make of the transferee of a security interest given for a negotiable note "a person as to whom the transfer or obligation . . . is valid under applicable . . . State laws."
88. The doctrine, it has been observed, would "treat the mortgage securing the negotiable note not merely as an incident of it but as having actually no existence." OSBORNE, MORTGAGES 635 n.66 (1951). See also note 81 supra.
89. The rules for perfecting security interests in negotiable instruments themselves are, of course, properly part of the law on secured transactions and not of the law of negotiable paper. See UNIFORM COMMERCIAL CODE § 9-304.
he cannot take free of the patent equities discoverable by consulting the people and the records which are accessible to him in the eyes of the law. If he is taking as a holder in due course of a negotiable instrument, the law puts such a premium on the freedom of the commerce in such an instrument from restraints that the holder is relieved from worry about many of the defenses that could have been discovered by diligent inquiry. The policy favoring the imputation of negotiability to the security accompanying a negotiable instrument is extended beyond its legitimate bounds when it is invoked to protect one taking the security for or an account of an antecedent debt as against other creditors who would be able to defeat the security interest but for the circumstance of its connection with a negotiable note in the hands of a holder in due course.

The status of a holder in due course is peculiar to the law of negotiable paper. Notwithstanding any historical affinity the concept of holder in due course may have with that of a bona fide purchaser in sales or property law, there is no holder in due course of a security instrument in our law, even though the courts that have elaborated the imputed negotiability doctrine infer the existence of such a person. Indeed, the manner by which the courts have been able to deduce from Carpenter v. Longan a rule of protection against creditors' equities defies logical explanation. Carpenter's rationalization upon a contract theory of its protection of the assignee of the mortgage from the mortgagor's equity is irrelevant to the question of whether a similar protection should be given from equities of the mortgagor's creditors. Carpenter reasoned that it would be varying the original contract on the note to subject the assignee to the mortgagor's equity, and that the assignee became a party to this contract by an indorsement of the note to him. Granting arguendo that such is the import of the contract on the note, still no one would think of arguing that the mortgagor's creditors were privy to such a contract. In

90. See Beutel, Negotiability by Contract: A Problem in Statutory Interpretation, 28 Ill. L. Rev. 205, 208-10 (1933).
91. Gold Bros. Security Co. v. Fidelity Trust Co., 47 S.D. 31, 34, 195 N.W. 830, 831 (1923) (dissenting opinion): "there is no such thing as a holder in due course of a mortgage." Contra, Frystad v. Graff, 55 S.D. 523, 527, 226 N.W. 745, 746-47 (1929): "transfer of the note carried with it the security, and, if Graff was a holder in due course of the note, he was a holder in due course of the security without any formal assignment of the mortgage."
92. Cf. Comment, Extension of the Concept of Negotiability, 8 Wis. L. Rev. 272, 275 (1933).
93. It has been suggested that a debtor, by executing a negotiable note and giving security therefor, does not contract to secure the note to all subsequent indorsees as well as to the payee. See Britton, Assignment of Mortgages Securing Negotiable Notes, 10 Ill. L. Rev. 337, 357-58 (1915).
any case, the creditors' equities under the perfection statutes are ob-

viously equities against the security and not against the note.

The argument sometimes advanced that to deprive the holder in due

course of the benefit of his security interest is to detract from the negoti-

ability of the secured note, is easily disposed of. In the first place, de-

priving the holder in due course of the benefit of the security for the

note does not entail any limitation of his right to enforce the note as an

unsecured obligation. A negotiable instrument as such is never more

than that kind of an obligation. In the second place, such an argument

ignores the fact that when negotiable paper is issued with security, the

intention is less to have the paper freely circulate as currency than to pro-

vide a vehicle of investment. And, finally, even of a holder in due

course some amount of reasonable diligence, prudence, and circumspec-

tion, short of course of making inquiry of all mankind as to latent equi-

ties, is required. A note's attribute of negotiability does not imply for

the holder in due course an absolute immunity from latent equities. Thus,

if these limitations on the rights of a holder in due course of a negotiable

instrument are accepted as part of its attributes of negotiability, it would

not be putting an unreasonable restriction on the free transferability of


Vast sums of money are invested in negotiable notes secured by deeds

deeds of trust on real property and the notes themselves, being continually negotiated

by outright sales or by use as collateral security for another loan, take an im-

portant place in our commercial life. To hold that the security does not share

with its notes the immunities of negotiability, would be to put an intolerable
clog on the freedom of contract, and to the disadvantage of both the borrower

and lender. The law should follow business, and the same reasons that give a

holder in due course of negotiable paper a favored place are grounds for a de-
cision holding that the security derives negotiability.

When a borrower executes negotiable notes and a deed of trust on his

property to secure them, he knows that the notes with a memorandum thereon

of their security will probably come into the hands of innocent purchasers. To

hold that after this has happened he can withdraw the security will be to in-

troduce into a transaction that should be conclusive, a lack of finality—a never

falling course of litigation.

95. See BRANNAN, NEGOTIABLE INSTRUMENTS LAW 830 (7th ed. Beutel rev. 1948).

See generally Ross, The Double Hazard of a Note and Mortgage, 16 MINN. L. REV. 123
(1932).

96. At common law promissory notes were non-negotiable; and today, at least

for notes secured by mortgage, there does not exist the great mercantile neces-

sity that they be freely transferable as currency. The note secured by mortgage

is taken more as an investment than as a means of advancing short term credits

or providing the necessary currency of exchange. It would seem reasonable

therefore and not too great a burden to require the purchaser of a note secured

by mortgage to examine the record in order to protect himself.

Comment, Some Problems Concerning Negotiable Notes Secured by Mortgage or Deed

of Trust in California, 22 CALIF. L. REV. 677, 683 (1934). But see the excerpt from

Dashiell, supra note 94.
secured notes to bind the transferee that he ascertain from the appropriate public records the security's perfected or unperfected condition.

If by dressing the security with the note's cloth of negotiability the rules of negotiable paper should be held to govern the enforceability of the security as well as the note in derogation of the rules respecting the perfection of security interests, faith in our recording and notice-filing systems would of course be undermined. Indeed, the doctrine in its extreme form suggests that the holder in due course is free not only to enforce his security interest notwithstanding its own lack of perfection, but also in disregard of interests that are themselves duly perfected. While such a metamorphosis of a security agreement into a negotiable instrument has not been countenanced, the holder in due course still being held to be on constructive notice of prior perfected security interests,97 the doctrine of imputed negotiability is susceptible to being logically extended to absurd extremes.98 Hence, the desirability of a definitive and sensible definition of the interrelation between a negotiable note and its accompanying security with a view to clarifying the rule as to the enforceability of an unperfected security interest in bankruptcy.99

97. See Osborn, Mortgages 636 n.75 (1951); Gilmore, The Commercial Doctrine of Good Faith Purchase, 63 Yale L.J. 1057, 1066 n.23 (1954). But, of course, nothing in the records can constitute notice as would detract from holding in due course. See Uniform Commercial Code § 3-304(5); 1955 N.Y. Law Revision Comm'n Rep. vol. 2, at 939. See also Britton, Holder in Due Course—A Comparison of the Provisions of the Negotiable Instruments Law With Those of Article 3 of the Proposed Commercial Code, 49 Nw. U.L. Rev. 417, 432-33 (1954). For a suggestion that, if the negotiable instrument is part of chattel paper, constructive notice from filing may impair the transferee's holder in due course position, see Kripke, Chattel Paper as a Negotiable Specialty Under the Uniform Commercial Code, 59 Yale L.J. 1209, 1226 (1950).

98. See Pope v. Beauchamp, 110 Tex. 271, 219 S.W. 447 (1920), commented upon in Note, 16 Texas L. Rev. 534, 539-40 (1938) (notice of lis pendens held not to bar foreclosure by holder in due course of vendor's lien note although notice filed before vendor transferred lien note). Cf. Landauer v. Sublette, 126 Okla. 185, 188, 259 Pac. 234, 236 (1927) ("the doctrine of constructive notice is applicable only to a person who is dealing with the land itself, and since the purchaser of a negotiable promissory note, secured by mortgage, is not dealing in land, there is no field for the operation of the registry laws in cases of this kind"); Fortson v. Bishop, 204 Ala. 524, 527, 86 So. 399, 401 (1920): The mortgage being but an incident, attaching and attending rights created by or resulting from the negotiable character of the . . . note, the rights of the parties were and are determinable and measurable with reference to the negotiable instrument, and not with qualifying reference to the law of mortgages, or to the effect, in other circumstances, that is consequent upon the reasonable registration . . . of such conveyances of real estate.

99. Cognizance of the doctrine of imputed negotiability was taken by:


(2) The draftsmen of the Restatement of Security. See Restatement, Security §§ 34, 35(b) (1941).

(3) In 1901, some Illinois legislators. See Note, 32 Ill. L. Rev. 120, 122 n.14 (1937).
IV. The Uniform Commercial Code and Our Problem

The preceding discussion of the doctrine of imputed negotiability supports the Code sponsors' assumption that the rules on negotiable paper and the rules on perfection of security interests in personal property are sufficiently interrelated that both may integrally be fitted into a codification of commercial law. Affirming this assumption, the Code, in article 3 as well as in article 9, generally recognizes that there may be occasions where these two sets of rules intersect. Section 3-103(2) subjects article 3's own provisions "to the provisions of the Article on . . . Secured Transactions (Article 9)," and article 9, on the other hand, provides in section 9-309 that nothing in it limits the rights of a holder in due course of a negotiable instrument and that such a holder takes priority over an earlier security interest though perfected. These two provisions, whereby article 3 and article 9 appear to defer to each other in a manner reminiscent of Alphonse and Gaston, concede the possibility of argument at least that some rule in article 3 may collide with one in article 9 and that some provision in article 9 might otherwise have the effect of limiting the rights of a holder in due course as defined in article 3. The phraseology of section 9-309 and the official comment to section 3-103(2) tend nevertheless to convey the impression that the Code sponsors understood this conceded possibility to be largely theoretical except where a negotiable instrument is itself used as collateral for some other obligation. Article 9 provides special rules for the perfection of security interests in negotiable instruments, whether these instruments are by themselves or constitute part of chattel paper, but section 9-309 establishes an exception to the general operation of these rules by

100. Article 9 of the Uniform Commercial Code "does not concern land security in general, although some of its provisions, such as those relating to fixtures and crops, have an application to real estate." 1955 N.Y. LAW REVISION COMM'N REP. vol. 3, at 2015.

101. This comment reads in pertinent part:

Instruments which fall within the scope of this Article may also be subject to other Articles of the Code. Many items in course of bank collection will of course be negotiable instruments, and the same may be true of collateral pledged as security for a debt. In such cases this Article, which is general, is, in case of conflicting provisions, subject to the Articles which deal specifically with the type of transaction or instrument involved: . . . Article 9 (Secured Transactions). In the case of a negotiable instrument which is subject . . . to Article 9 because it is used as collateral, the provisions of this Article continue to be applicable except insofar as there may be conflicting provisions in the . . . Secured Transactions Article.

102. See UNIFORM COMMERCIAL CODE §§ 9-301(1) (c), 9-302(1) (b), 9-304, 9-305, 9-309, 9-312(1).

103. See ibid. and UNIFORM COMMERCIAL CODE § 9-308.
allowing the holder in due course to prevail over the holder of an earlier security interest (though perfected) in the negotiable instrument.

Section 3-305, in defining the rights of a holder in due course of a negotiable instrument, speaks of such a holder as taking the instrument free from certain enumerated claims and defenses. No mention is made in this section or in any other in the Code as to the rights of a holder in due course with respect to any collateral which may have been given to secure the instrument, even though the Code admits by its recognition of chattel paper as a distinct category of chattel security that chattel security and negotiable notes are frequent fellow-travelers. The Code therefore leaves unanswered the question as to what rights a holder in due course may have to a collateral agreement. An official comment, however, to section 3-201 provides an oblique answer to this question: "The rights of a transferee with respect to collateral for the instrument are determined by Article 9 (Secured Transactions)." The "transferee" referred to is of course the transferee of a negotiable instrument whether from a holder or not. For the comment to infer from this provision of section 3-201 the proposition it makes as to the rights of the transferee to collateral for the instrument is to assume that the transferee, who may well be a holder in due course, can derive rights to the collateral by virtue only of the provisions of article 9. And since article 9 recognizes no rights in a holder in due course, as such, to collateral, the comment is saying in effect that a holder in due course, as such, has no rights to the collateral. (Section 9-309, it will be noted, recognizes the rights of a holder in due course to the instrument itself where the instrument is the collateral, and not rights of a holder in due course to the collateral for the negotiable instrument.) Whether this comment serves as a back-handed rejection of the doctrine that a holder in due course takes the collateral security as he takes the secured note since the former is merely incident to the latter, is a question consigned to speculation.

Indeed the Code goes no farther, by way of defining generally the relationship between a negotiable instrument and its accompanying security agreement, than to resolve the conflict under the Uniform Negotiable Instruments Law as to the effect of a reference in a note to an accompanying security agreement on the negotiability of the note. The

104. For definition of "chattel paper," see Uniform Commercial Code § 9-105(1)(b).
105. See comment 4 to Uniform Commercial Code § 9-105 and comment 1 to Uniform Commercial Code § 9-308.
106. Comment 4 to Uniform Commercial Code § 3-201.
107. Comment 1 to Uniform Commercial Code § 3-201.
108. See Uniform Commercial Code §§ 3-105(1)(c), (e) & (2); comments 3, 4 & 8 to Uniform Commercial Code § 3-105.
Imputed Negotiability

The Code also defines the effect of a separate written agreement on the rights of a holder in due course with respect to the negotiable instrument. It may be said therefore that while the Code has sought to define what effect an accompanying security agreement may have on a secured negotiable instrument, it leaves largely untouched the effect of the negotiable instrument on the security agreement.

The Code nevertheless recognizes a limited role for imputed negotiability in a security agreement in section 9-206(1). Under this section, a buyer or lessee (other than of consumer goods) "who as part of one transaction signs both a negotiable instrument and a security agreement" is deemed to have agreed not to assert against an assignee any claim or defense which he may have against the seller or lessor. Such a presumed agreement "is enforceable by an assignee who takes his assignment for value, in good faith and without notice of a claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the Article on Commercial Paper (Article 3)." Here, the Code recognizes that a negotiable instrument and its accompanying security agreement may share a common vulnerability to defenses or claims. To this extent, then, the Code may be said to adopt the principle of Carpenter v. Longan. Section 9-206(1) is noncommittal on the matter of latent equities because, in speaking of enforceability over defenses not assertable against a holder in due course, it refers to the enforceability of the presumed agreement not to assert

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109. See Uniform Commercial Code § 3-119.
111. The earlier versions of § 9-206 subjected the holder in due course of a negotiable instrument given in a sale of consumer goods to the buyer's defenses against the seller. This provision was observed to conflict with § 9-309, which states that nothing in article 9 limits the rights of a holder in due course of a negotiable instrument. See Kripke, supra note 97, at 1216 n.18. Even so, it has been suggested that § 9-309 should prevail by virtue of § 3-103(2). See 1955 N.Y. Law Revision Comm'n Rep. vol. 2, at 840. It has also been criticized as conflicting with § 3-119 which provides that a holder in due course is not affected by any limitation of his rights arising out of a separate written agreement if he had no notice of the limitation when he took the instrument. See Memorandum of Milbank, Tweed, Hope & Hadley on Article 3 of the Code, in 1954 N.Y. Law Revision Comm'n Rep. vol. 1, at 198, 202. Replying to this criticism, Professor Arthur E. Sutherland remarked that "9-206 poses a special exception to 3-119." Id. at 246. The special treatment of a consumer's negotiable note has been defended as commercially sound. See Gilmore, The Secured Transactions Article of the Commercial Code, 16 Law & Contemp. Prob. 27, 46-47 (1951). The rephrasing of § 9-206 to its present form, whereby the special treatment of consumer sales is provided for in the prefatory clause ("Subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods"), was intended to allow each state to establish any special rules in conformity with local policy for consumer transactions. See 1956 Recommendations of the Editorial Board for the Uniform Commercial Code 271 (1957).
defenses against the seller or lessor—not to the enforceability of the security agreement itself.

On the whole, therefore, it is necessary to say that the Code does not define clearly its position on the doctrine of imputed negotiability insofar as this doctrine has been developed to protect a security agreement from creditors' or other third parties' equities. There is the implication conveyed by an official comment that the Code means to establish a dichotomy between a negotiable instrument and its accompanying security agreement so that no rights are obtained with respect to the latter by virtue of its having been given for a negotiable instrument. Section 9-206(1) modifies this implication by recognizing, in cases where a security agreement and a negotiable instrument are issued in the sale of nonconsumer goods, a union between these two agreements insofar as vulnerability to patent equities is concerned. The doctrine, it will be recalled, evolved and flowered under pre-Code conditions and has been regarded as compatible with the N.I.L. There being nothing in the Code which could be said to have altered these pre-Code conditions, it could be said that the Code leaves the doctrine intact. On the other hand, since there is also nothing to indicate that the Code, with its elaborate scheme of priorities, was intended to create any kind of special priority for a security interest in the hands of a holder in due course of the secured note, it can perhaps be fairly concluded that the scope of the doctrine of imputed negotiability is well confined by the Code. The latent potentiality of the doctrine for mischief gains no strength from the Code's silence.

112. See Britton, Bills and Notes 41 (2d ed. 1961).