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VARIABLE INTEREST RATES AND NEGOTIABILITY: CONFLICT AND CRISIS

JANINE S. HILLER*

Commercial paper and the requirements for negotiability are time-honored concepts. Generally, attorneys, courts, and financial institutions are well versed in the traditional elements of a negotiable instrument and can easily identify the listed requirements which qualify an instrument as negotiable under the Uniform Commercial Code (UCC or the Code). However, an emerging body of law casts doubt on the uniformity of the definition of a negotiable instrument. Moreover, a controversy stems from the use of variable or adjustable interest rates and the resulting question raised concerning the sum certain element of negotiability. Because a sum certain is not defined in the UCC, the question of whether a variable interest rate satisfies the requirement of a sum certain is the crux of the debate.

The courts are split over this issue. One viewpoint favors predictability while another promotes flexibility. The legislatures have also been inconsistent. Although there is a proposed uniform amendment dealing with the issue, state statutes addressing the problem are anything but uniform. This inconsistent treatment of adjustable rate instruments is wreaking havoc on the ability of federal agencies to deal with one of the biggest financial fiascos this country has ever faced: bank failures. The questionable negotiability of a bank's assets can compromise the ability of the Federal Deposit Insurance Corporation (FDIC), or the ability of the Resolution Trust Corporation (RTC), to effectuate the sale of those financial assets upon a bank's demise. In addition, non-negotiability costs consumers and businesses more in interest payments because of the added risk the bank must assume without being able to confer "holder in due course" status to a buyer of the adjustable rate paper. A holder in due course is defined under the Code as one who takes a negotiable instrument for value, in good faith and without knowledge of a claim or defense or that the instrument is overdue.

This article will first discuss the cases and statutes addressing variable interest rates and negotiability. Trends are identified and analyzed as several of the highest state courts have recently ruled on the issue, with those states and additional states consequently enacting relevant statutory amendments. Next, the implications of the

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1. In this article, the terms variable and adjustable are used synonymously. They refer to an interest rate that changes from time to time, depending on a rate that is determined at a future date, not a rate that can be determined from the face of the instrument.
4. See infra notes 148-78 and accompanying text.
5. See infra note 181 and accompanying text.
6. U.C.C. § 3-302 (1987); see also id. § 3-303 (taking for value); id. § 3-304 (notice); id. § 1-201 (good faith).
debate will be defined and discussed. Emphasis will be placed on the effect this has on the RTC's ability to recoup a large amount of bank and thrift losses. Lastly, conclusions are reached regarding the desirability of adjustable interest rate negotiable instruments. In the 1980s, this issue was only being initially recognized, while in the 1990s, the ramifications and policies involved are already being hotly debated. The categorization of variable rate documents as negotiable or non-negotiable will significantly impact the costs passed on to individual consumers, as well as determine the finances of the country needed to deal with the monolithic problem of bank failures.

I. Historical Background

A brief history of the law of negotiability is helpful in understanding the present discussion of statutory construction. Negotiable instruments were first created in England in the 1660s.7 The common law reflected the negotiability concept in the Law Merchant.8 Later, the usage and practices in the Law Merchant were codified in the English Bills of Exchange Act of 1882.9 To be negotiable, the instrument was required to be in writing, signed by the maker or drawer, and to unconditionally promise to pay a sum certain in money. No particular wording was necessary,10 as the English courts held that "[t]he act was made for the advancement of trade, and ought, therefore, to receive a liberal construction."11 Interest was not collectable unless stated; however, the general provision "bearing interest" was sufficiently definite without stating a particular rate of interest.12

In the United States, the Negotiable Instruments Law (NIL) was enacted unanimously, by the states, by 1924.13 A sum certain was required for the paper to qualify as negotiable, and an instrument providing for payment "with interest" was specifically allowed.14

In contrast to the general statement of an undetermined amount of interest allowed by the NIL, the UCC took no such stance. The UCC was adopted by all fifty states and is in use today.15 The Code adopted the basic structure of the NIL, but added particular provisions to deal with identified problems.16 It is important to note that there is no particular definition of a sum certain. However, section 3-106(1) was added to address the past problem of changing post-maturity interest

11. Id.
12. Id. at 231.
15. See Fisher & Jennings, supra note 13, at 668.
rates. It allows a negotiable instrument to be payable "(a) with stated interest or by stated installments; or (b) with stated different rates of interest before and after default or a specified date."17 The added verbiage "stated interest" seems to be a significant departure from the more flexible position taken by the NIL in the phrase "with interest."18 It also varies from the liberal construction accorded interest payments under the Law Merchant. The comments to section 3-106 specifically state: "The computation [of the payment] must be one which can be made from the instrument itself without reference to any outside source, and this section does not make negotiable a note payable with interest 'at the current rate.'"19 These comments have been cited often by courts deciding the negotiability of variable rates that cannot be ascertained by reference only to the four corners of the document.20

Courts also find relevant section 1-102, which states in relevant part:

(1) This Act shall be liberally construed and applied to promote its underlying purposes and policies.

(2) Underlying purposes and policies of this Act are
   (a) to simplify, clarify and modernize the law governing commercial transactions;
   (b) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties;
   (c) to make uniform the law among the various jurisdictions.21

The comments to this section explain that

[t]his Act is drawn to provide flexibility so that, since it is intended to be a semi-permanent piece of legislation, it will provide its own machinery for expansion of commercial practices. It is intended to make it possible for the law embodied in this Act to be developed by the courts in the light of the unforeseen and new circumstances and practices.22

Thus, the debate has been drawn; uniformity and the specific four corners limitation in the comment to section 3-106 have been balanced against the policy of expanded commercial practice and flexibility expressed in section 1-102 and its comments.

17. U.C.C. § 3-106(1)(a) & (b) (1987). The remainder of § 3-106 allows a negotiable instrument to be payable "(c) with a stated discount or addition if paid before or after the date fixed for payment; or (d) with exchange or less exchange, whether at a fixed rate or at a current rate; or (e) with costs of collection or an attorney's fee or both upon default." Id. § 3-106(1)(c)-(e). The section further states, "Nothing in this section shall validate any term which is otherwise illegal." Id. § 3-106(2).


20. But see id. § 3-118(d) (stating that a provision simply for "interest" means the judgment rate of interest, which must be determined from an outside source).

21. Id. § 1-102(1)-(2).

22. Id. § 1-102 cmt. 1.
As the language and intent of the Code is debated, variable interest rate instruments continue to be utilized in great numbers. Variable rate loans represented 60% of the total loans made in 1984. In 1990, the majority of loans continued to include adjustable interest rates. The benefits of adjustable interest rates accrue to both the borrower and lender. Borrowers are protected in times of declining interest rates and can obtain a lower rate even when rates are high. Banks can offer better adjustable rates because they do not need to hedge against inflation, and are protected because the rate will increase if the market conditions change. In times of high interest rates, the variable rate promotes more affordable rates for consumers and businesses. In short, variable rate instruments have become a permanent financial vehicle. The courts and legislatures should carefully consider the economic impact that their treatment of adjustable rate paper will create.

II. The Early Case Law

Prior to the 1980s, no case directly ruled on the effect of variable rates on negotiability. Several cases held that interest at the legal, maximum rate did not effect negotiability. Such rates were not variable, even though they required reference to an outside source. In addition, one court held that a variable interest rate did not render the negotiable interest too indefinite for enforcement between the parties, although it did not address the sum certain ramifications.

However, during the 1980s, several courts directly analyzed the effect of variable interest rates on negotiability. At first, the majority of courts decided that variable interest provisions rendered the instruments nonnegotiable. However, within a short time period, three of these cases were reversed to allow for negotiability of variable rate instruments. By the end of the decade, eight state laws had been drawn into question. The law was divided; Georgia, Illinois, and New York viewed

variable interest rate instruments as negotiable, while Vermont, Virginia, Texas, Oklahoma, and Missouri held that variable rates destroy negotiability.\textsuperscript{31}

In 1982, Georgia became the first state to address negotiability in \textit{McIntosh v. McClendon}.\textsuperscript{32} In a cursory opinion, void of supporting rationale, the court held that a holder in due course would prevail, even when the interest rate was tied to a fluctuating prime rate.\textsuperscript{33} By inference, the variable rate satisfied the sum certain requirement.

The Vermont Supreme Court was the first court to specifically hold that the sum certain requirement could not be met by a variable interest rate.\textsuperscript{34} The court emphasized that the amount due must be determined by looking to the document itself, and that reference to an outside rate did not satisfy that requirement. In this case, a third party was not trying to become a holder in due course, but non-negotiability prevented the maker of the note from arguing the impairment of collateral defense granted in article 3.\textsuperscript{35}

In \textit{Northern Trust Co. v. E. T. Clancy Export Co.},\textsuperscript{36} a federal district court, applying Illinois law followed the non-negotiability route. \textit{Northern Trust} involved an export arrangement whose financing involved a bank's purchase of the buyer's note, endorsed by the seller. The note provided for interest at 0.5% over the bank's prime rate. When the buyer defaulted, the bank sued the seller on its endorsement.\textsuperscript{37} The district court focused on the comments in section 3-106 to help explain the sum certain. The court impliedly equated the comments' example of lack of a sum certain when interest is payable at the "current rate," with a variable rate.\textsuperscript{38} Additionally, because the bank's rate could not be determined except through reference to an outside source, it did not meet the comments' description of the "four corners" test. Thus, the seller could not be held liable under his endorsement, because the note was non-negotiable.\textsuperscript{39}

The \textit{Northern Trust} decision was short-lived. In 1987, an Illinois court of appeals decided that a variable rate note was negotiable. In \textit{Klehm v. Grecian Chalet Ltd.},\textsuperscript{40} the interest rate varied at stated times in accordance with the prime rate published in the \textit{Wall Street Journal}. The court dispensed with the issue summarily, stating, "Clearly, the note states a rate of interest which varies on specified days and comports with the definition of a sum certain as found in section 3-106(b)."\textsuperscript{41} No mention or consideration was given to the fact that the reference to the \textit{Wall Street Journal}'s} prime rate was outside the instrument. In the court's opinion, the

\textsuperscript{31} See infra notes 32-67 and accompanying text.

\textsuperscript{32} 290 S.E.2d 157 (Ga. App. 1982).

\textsuperscript{33} Id. at 159.

\textsuperscript{34} \textit{Farmer's Prod.}, 481 A.2d at 1065.

\textsuperscript{35} Id.

\textsuperscript{36} 612 F. Supp. 712 (E.D. Ill. 1985).

\textsuperscript{37} Id. at 712.

\textsuperscript{38} Id. at 715.

\textsuperscript{39} Id.

\textsuperscript{40} 518 N.E.2d 187, 192 (Ill. App. 1987).

\textsuperscript{41} Id. at 192.
definiteness of the change dates and the source for the rates seemed to satisfy the Code's certainty requirement.

Later that same year, two other courts reached the opposite result from the clear result found by the court in Klehm. In Taylor v. Roeder, the Virginia Supreme Court was the first court to provide, through its majority and dissenting opinion, a comprehensive analysis of the competing issues and arguments in the variable interest rate debate. The makers issued a note, secured by a deed of trust, on their house. When the house later sold, the settlement attorney forwarded the payoff to the payee bank. Unknown to the makers or the attorney, the payee bank had transferred the mortgage to a pension fund as collateral. The bank did not forward the payoff to the pension fund and subsequently went bankrupt. The pension fund sued the makers on the note, and the makers defended because of their payment. If the fund was a holder in due course, then they could collect, regardless of the personal defense. Otherwise, the fund could not collect, because there was no notice of the transfer, or assignment, of a non-negotiable contract.

The majority opinion analyzed section 3-106 and its comments, concluding that the drafters of the code did not intend to include variable interest rates within the definition of the sum certain. In particular, the court found persuasive the statement in comment 1 that "[t]he computation must be one which can be made from the instrument itself without reference to any outside source." However, the court held that the overriding interest in this case was the uniformity and predictability of the Code. The court realized the extent to which variable interest rates were used, but found that the "relative predictability of results" was the "overriding benefit" of the Code. Thus, the court declined to look beyond the definition and comments of section 3-106.

The dissent focused on its description of the overall purpose of the UCC — to provide a flexible legislative framework which would be able to accommodate evolving commercial practices. Because a sum certain is never specifically defined in the Code, and because of the widespread commercial acceptance of variable interest rates, the dissent would recognize "custom and usage, as the commercial market has," and would find for negotiability. Thus, the two basic UCC policies, predictability and flexibility, were identified as conflicting values in

42. 360 S.E.2d 191 (Va. 1987).
43. Id. at 192-93.
44. Id. at 193-94.
45. Id.
46. Id. at 194.
47. See supra note 19.
48. Taylor, 360 S.E.2d at 195.
49. Id.
50. Id. at 196. The dissent would limit negotiability to variable rates that can be determined readily.

Id.
this case. This basic conflict between policies continues throughout subsequent cases.

In 1988, a Missouri appellate court cited and followed the Taylor decision. The court, in Centerre Bank of Branson v. Campbell, could have easily avoided the issue because the note in question called for interest at "bank rates" — a phrase that would be so indefinite as to be non-negotiable even in those state courts that recognized negotiability when variable interest rates are readily ascertainable. However, the court emphasized the language of the Code and the reference to the outside source as determining factors for non-negotiability.

Two New York cases present the different sides of the negotiability issue. In 1987, in National Union Fire Insurance Co. v. Tegtmier, the variable interest rate applied only to the time period subsequent to default. The court correctly found that negotiability was "irrelevant" after default. However, like the Missouri court, the court continued to review and adopt the reasoning in Taylor.

Shortly after National Union, the New York legislature amended section 3-106 to include, as a sum certain, interest rates determined from outside and "readily ascertainable" sources. In 1989, the federal district court was once again asked to decide the impact of a variable interest rate, since the disputed instrument was signed prior to the legislative amendment. The district court reversed itself, saying that the National Union decision was "no longer relevant" because of the intervening amendment. In essence, the court held that its decision was erroneous, because the legislation was enacted to "clarify any confusion" regarding the negotiability of variable interest rate documents.

Also in 1989, a federal circuit court denied negotiability to a variable rate instrument. However, this result was overturned in 1991 by an Oklahoma Supreme Court decision, addressing the same fact situation.

Finally, cases decided under Texas law in the 1980s and 1990s did little to clarify the situation, instead causing confusion over the issue in that state. In fact, a cursory count of cases in both the 1980s and 1990s, including state and federal decisions, shows two Texas lower appellate court decisions and seven federal

51. 744 S.W.2d 490 (Mo. Ct. App. 1988).
52. See infra notes 89-114 and accompanying text.
53. Campbell, 744 S.W.2d at 498.
55. Id. at 1273.
56. Id.
59. Id. at 1220.
60. Id. at 1219.
61. Doyle v. Trinity Sav. & Loan Ass'n, 869 F.2d 558 (10th Cir. 1989).
62. See infra notes 81-90 and accompanying text. The Tenth Circuit relied upon the decision of the Oklahoma Court of Appeals, which was reversed by the Oklahoma Supreme Court. Doyle, 869 F.2d at 560.
court decisions denying negotiability, and agreeing to the negative effect of variable rates on negotiability.\textsuperscript{64} One Eighth Circuit case,\textsuperscript{65} applying Texas law, found variable rates did not destroy negotiability. The number of cases alone implies an urgency and continuing ambiguity about the question. The issue was finally laid to rest in 1992 by the Supreme Court of Texas.\textsuperscript{66} Indeed, as in Texas, the trend in the first years of the 1990s has been to reverse the weight of opinion created in the 1980s.

III. Recent Case Decisions

Within the past two-plus years, courts that addressed the issue of whether variable rate notes are negotiable were more likely than in previous years to hold that negotiability remained intact. During 1991 and 1992, six courts decided the issue and four found in favor of negotiability. The three state courts and one federal court confirmed variable rates as a sum certain,\textsuperscript{67} and the two courts reaching the opposite result were lower federal courts.\textsuperscript{68} The following discussion will explain these recent cases, beginning with those federal courts that followed in the steps of Taylor by rejecting adjustable rate as a sum certain.

A. Federal Decisions Against Negotiability

In Chemical Bank \textit{v.} D3J Associates,\textsuperscript{69} decided in April 1991, the federal district court of Maryland denied a motion for summary judgment made by Chemical Bank, who argued they were entitled to summary judgment because of their holder in due course status.\textsuperscript{70} The court reasoned that Chemical Bank was not a holder in due course because the variable rate in the note rendered it non-negotiable. Therefore, one cannot be a holder in due course unless the paper is first negotiable. The district court had to determine Maryland law, whose courts had not yet addressed

\begin{itemize}
  \item[65.] See Tanenbaum \textit{v.} Agri-Capital, Inc., 885 F.2d 464, 466-69 (8th Cir. 1989) (applying Texas law).
  \item[66.] See \textit{infra} notes 108-14 and accompanying text.
  \item[70.] \textit{Id.} at *3.
\end{itemize}
the effect of variable interest rates on negotiability. The court noted that because the number of courts favoring non-negotiability outnumbered those favoring negotiability, it could not "overlook the overwhelming authority" in rendering its decision. The court also cited the comment to section 3-106 as supporting authority.

The rationale in Chemical Bank is weak. Instead of analyzing the competing arguments and rendering a decision based on legislative intent, policy reasons, commercial practices, or statutory interpretation, the court merely pointed to a number of decisions on one side of the issue. The court could have argued that consistency is a strong consideration when applying the UCC, and therefore given deference to the majority viewpoint. However, according to the court's citations, fewer than ten courts had decided this issue at the time, several of which were lower, federal district courts. In actuality, seven jurisdictions had almost evenly split along both sides of the issue at the time of the Chemical Bank decision. The state of the law did not represent the "overwhelming majority" indicated by the court. Because of its lack of analysis, Chemical Bank does not add significantly to the debate over the variable interest rate and sum certain requirement.

A few months after Chemical Bank, in July 1991, another federal district court dispensed with the negotiability argument for adjustable interest rates. In New Connecticut Bank and Trust v. Stadium Management, it was decided that neither Connecticut nor Massachusetts law would recognize adjustable rates as a sum certain. New Connecticut Bank and Trust Company (New Connecticut) was the assignee of almost ten million dollars worth of variable rate notes and guarantees made by Commonwealth Sports Properties, Inc. (Commonwealth) and the guarantors. New Connecticut purchased the notes from the FDIC when the original payee, Connecticut Bank and Trust, was declared insolvent. Commonwealth and the guarantors admitted they had not made payments on the notes but argued several defenses to their liability. The court identified the impairment of collateral defense as the only one which could have a factual basis and categorized it as a "lender liability" theory of relief. Because the court did not use the UCC impairment of collateral defense, which had been argued in McIntosh v. McClendon, it reached the opposite result from that early Vermont case. In McIntosh, lack of negotiability prevented the makers of a note from arguing impairment of collateral.

71. Id. The legislature had subsequently passed an amendment to § 3-106 which included variable rates within a sum certain. However, the court declined to give it retroactive application, or to consider it a codification of existing law. Id. See infra notes 137-44 and accompanying text for a discussion of the question of retroactivity.
73. Id.
74. See supra note 31 and accompanying text.
76. Id. at 208 n.4, 209.
77. Id. at 206.
78. Id. at 207.
80. McIntosh, 290 S.E.2d at 158.
Connecticut, the district court found that reference to an outside source to determine
the interest rate destroyed negotiability. Although it recognized the change in
commercial usage, the court held that "[t]he primary importance of the Uniform
Commercial Code is the certainty and uniformity which it provides for commercial
transactions. Any deviations from traditional, accepted interpretations of the Code,
should, therefore, come from the legislature and not from the courts."\(^\text{81}\) Since the
note was non-negotiable, the FDIC was not a holder in due course, and the claim
of impairment of collateral could be pursued.\(^\text{82}\)

In FDIC v. Hershiser,\(^\text{83}\) the court was less concerned with commercial practices
and more concerned with the preservation of the nation's banking system.\(^\text{84}\) Through
a bank failure, the FDIC obtained a variable rate $10,500,000 note that was in
default. The makers alleged certain personal defenses, and the FDIC claimed holder
in due course status. Without referring to any particular state law, the court analyzed
the UCC section and its purpose for the sum certain requirement. It found that
purpose to be the protection of third parties, so they would not be disadvantaged
"thus protecting the commercial value of the note."\(^\text{85}\) The conclusion of the court
was:

> Given the court's reasons for providing FDIC with status equivalent to
> that of a holder in due course, I find that where, as here, the variable
> interest rate is tied to a readily ascertainable commercial or financial
> index by way of a specific formula such that the interest owed can be
> readily calculated, the note does contain a promise to pay a "sum
certain"."\(^\text{86}\)

The court seemed to be establishing a federal rule, specifically for application to the
federal takeover of banks,\(^\text{87}\) and adopting the concept of a federal holder in due
course for that circumstance.\(^\text{88}\) Its language, however, was close to that of many of
the state statutes that have been passed to address the issue of the sum certain and
variable interest rates.\(^\text{89}\)

B. State Courts

The state court decisions in the 1990s were vastly different from the federal courts.
In Trinity Savings and Loan Association v. Goss,\(^\text{90}\) the Oklahoma Supreme Court
was faced with a variable interest rate note that had allegedly been materially and

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\(^{81}\) New Connecticut, 132 B.R. at 209 (citations omitted).
\(^{82}\) Id. at 210.
\(^{84}\) Id. at 542.
\(^{85}\) Id.
\(^{86}\) Id. at 542-43.
\(^{87}\) Id. The court states that its opinion is for "these purposes," thereby limiting the scope of its
application. Id. at 542.
\(^{88}\) The federal holder in due course is discussed infra notes 146-78 and accompanying text.
\(^{89}\) See infra notes 118-44 and accompanying text.
\(^{90}\) 813 P.2d 492 (Okla. 1991).
fraudulently altered. The Gosses financed their home with Trinity Savings and Loan (Trinity), and executed a note that stated an initial interest rate of 12.5%. The effective rate was sixteen and one-half percent, but the note featured negative amortization and graduated payments. Trinity offered the note for sale to the Federal National Mortgage Association (FNMA), but FNMA balked upon realizing that the effective rate was stated in the note as 12.5%, rather than 16.5%. Trinity claimed that it obtained a correction initialed by the Gosses, and then sold the note to FNMA. The Gosses denied signing or initialing a change and alleged a material alteration.

The relevant issue was whether FNMA was a holder in due course, because that status would allow it to collect on the note as originally drawn. The Gosses argued that FNMA could not be a holder in due course because the variable rate note did not contain a sum certain for negotiability. The Oklahoma Supreme Court noted the controversy surrounding the question and the "meritorial argument on both sides." However, it decided to follow the more rational, albeit difficult decision to hold the variable rate as a sum certain and the note as negotiable. The court recognized the apparent conflict with its decision and the comment to section 3-106. However, it emphasized that the comments are unofficial, and that the official text of section 1-102 declares an intent to "aid in the continued expansion of commercial practice." The court addressed the concern that because the rate was only determinable from an outside source that it would disadvantage a third party by pointing to the "advent of mass communication facilities offering ready access to such sources." Thus, the comment to section 3-106 was largely negated by the developments of technology.

Therefore, because of the widespread use and acceptance of variable rate notes, and because of the ease of communicating a change in the rate, the court decided in favor of negotiability. As the Oklahoma Supreme Court stated:

[F]or this court to construe the note as anything other than negotiable would in our opinion thwart the basic mandate laid down by the drafters that the code remain flexible and responsive to the business community. Moreover, we see it as our responsibility to recognize and adopt established business practices.

91. *Id.* at 493.
92. *Id.* at 494.
93. *Id.* at 496; see also U.C.C. § 3-407 (1987).
94. *Trinity Sav. & Loan*, 813 P.2d at 497.
95. *Id.*
96. *Id.* at 498.
97. *Id.*
98. *Id.* The court also urged legislative adoption of a state draft revision of the Code, which would allow negotiable instruments to specifically include variable rate instruments. *Id.* at 499-500. This amendment was subsequently passed. See infra note 128.
Nearly a year later, in April 1992, the Superior Court of New Jersey agreed with the rationale in *Trinity*. The case of *Carnegie Bank v. Shalleck* presented a complicated series of facts, in which an intermediary financial marketer arranged financing for Shalleck's company, through the newly formed Carnegie Bank. The loan was made by Carnegie Bank to the intermediary, who then pledged a personally guaranteed note and personal mortgage from Shalleck as collateral for that loan. In short, Shalleck then alleged fraud by the intermediary, and attempted to use this as a defense to payment on the note that was pledged as collateral. Carnegie Bank foreclosed on its security, claimed holder in due course status, but Shalleck argued that his variable rate note was non-negotiable, therefore preventing Carnegie from attaining holder in due course status. The trial court found that there was fraud perpetrated against Shalleck by the intermediary, and this defense could be used against Carnegie because the variable rate note was non-negotiable.

The New Jersey Superior Court reversed the finding of non-negotiability, following very closely the rationale used in *Trinity*. First, it noted the lack of a definition of sum certain in the Code, and the split of opinion in the different jurisdictions. Although the court agreed that the comment to section 3-106 seemed to require computation of the interest rate without reference to an outside source, an opposite viewpoint was reflected in specific subsections of section 3-106 which allowed reference to an outside source for exchange rates, collection, and attorney's fees. Thus, the court found "the language in the Code itself more compelling than one of its Comments." In addition, the Code reflected a commitment to flexibility in order to be responsive to evolving commercial practices, as contained in the language of section 1-102. The court interpreted a lack of a definition of sum certain as an invitation by the drafters of the Code to apply current, accepted commercial practice. Also, the development of variable interest rates was seen as a positive step to promote the public policy of affordable home ownership. In conclusion, the New Jersey court held that the sum certain required "commercial certainty and not mathematical certainty," so as to satisfy "both the predictability and flexibility contemplated by the Code."

The most recent case is *Amberboy v. Societe de Banque Privee,* decided by the Supreme Court of Texas in April 1992, within days of the New Jersey

101. Id. at 391-93. The facts of the case were more complex than the detail given here, but are not relevant to the reasoning.
102. Id. at 393.
103. Id. at 395-96. New Jersey enacted a revised statute, after the note was signed, including an adjustable rate in the definition of a sum certain. See infra note 130 and accompanying text.
105. Id.
106. Id. at 397-98.
107. Id.
108. Id. at 398.
109. 831 S.W.2d 793 (Tex. 1992)
opinion. The Supreme Court of Texas accepted certification of the question of whether variable interest rates destroy negotiability from the Fifth Circuit Court of Appeals. As the court noted, there is no scarcity of opinion as to the effect of variable rates in Texas. According to the court, at least three federal district court cases, apparently applying Texas law, held variable rate notes non-negotiable, and two cases in the Texas court of appeals ruled the same. The majority opinion in Amberboy overruled the conflicting Texas lower court decisions, and indicated that the federal courts had "guessed" incorrectly concerning Texas law.

The court began by noting that there was no definition of a sum certain in the Texas UCC, but that section 3-106 gave exceptions to the basic "four corners" requirement. Thus, in reference to the requirement that the sum certain be found within the document, the court said that "the Code itself evidences that this is not intended to be a rigid, absolute rule." Also, the policy of flexibility and responsiveness to modern commercial practice was reflected in the Code's section 1-102. Variable rates were not used in the 1950s and 1960s, when the Code was written and adopted. However, variable interest rates began to be used in the 1970s, and actually dominated in the 1980s. The court recognized that the new development and use of variable rates comports with the Code's "fundamental purpose" to reflect business practices. In response, the Texas Supreme Court followed previous holdings that the certainty required by the Code was commercial certainty rather than mathematical certainty. Therefore, when variable rates are public, or "readily available" to the public, the certainty requirement is satisfied, and the document is negotiable.

The dissent began by noting cases, in Texas and elsewhere, that had held variable rate documents to be non-negotiable. It called these cases the "overwhelming majority." It relied heavily on these cases and their interpretation of the Code, citing Taylor for the proposition that the statutory intent and construction required strict adherence to the four corners rule except for the enumerated exceptions. The dissent did not address the majority's reasoning concerning evolving commercial practices and the overall purpose of the Code.

Thus, the cases deciding the fate of variable rate instruments are divided. The

110. Id. at 793.
111. Id.
112. Id. at 797.
113. Id.
114. Id. at 794.
115. Id.
116. Id. at 797-98.
117. Id. at 801; see also Chemical Bank v. D3J Assoc. Ltd Partnership, No. CIV.A.HAR-90-75, 1991 WL 58049, at *3 (D. Md. Apr. 15, 1991) (using, in federal court, the same rationale of "overwhelming authority" when deciding Maryland law).
118. Amberboy, 831 S.W.2d at 801-02. The dissent also objected because although the instrument called for an interest rate determined by the prime rate established by the bank, the bank had never had its own prime rate. Thus, the interest was not readily ascertainable. Id. at 803.
119. There are two recent state court unpublished opinions that render conflicting conclusions. Although these unpublished opinions have no precedential value, they do indicate that the conflict is
statutory amendments to provide for negotiability do little to promote uniformity on the issue.

IV. Legislation

All of the courts recognized that one of the main benefits of the UCC is, somewhat obviously, uniformity. For one hundred years, the Commissioners on Uniform State Laws and their predecessors have worked towards a unified treatment of commercial paper by the states. The most recent undertaking involves a proposed revision of articles 3 and 4, which was offered for adoption by the states in 1990. A member of the drafting committee characterized the state of the law regarding variable interest documents: "[S]omewhere around one-half of the notes in circulation in this country are governed by rules no one is certain about. That must be considered as a serious problem."

To address that problem, the commissioners proposed changes to two relevant sections of the Code. First, any reference to a sum certain is deleted. Revised section 3-104(1) reads: "Negotiable instrument means an unconditional promise or order to pay a fixed amount of money with or without interest or other charges. . . ." The comment to revised section 3-112 refers to the change and explains that "[u]nder §3-104(a) the requirement of a 'fixed amount' applies only to principle." Thus, interest impliedly need not be fixed. Added language in section 3-112(b) is more specific. Specifically, section 3-112(b) provides, in pertinent part: "Interest may be stated in an instrument as a fixed or variable rate or rates. The amount or rate of interest may be stated or described in the instrument in any manner and may require reference to information not contained in the instrument." The section also provides for interest at the judgement rate if the manner for calculation is absent. The official comments describe the result: "Hence, if an instrument calls for interest, it will always be determinable."

The revised Code thus sets out a liberal, unbreakable standard for the payment of interest. Clearly, the revision does not limit the way that interest can be described, abrogating the "four corners" requirement. Indeed, it goes further than almost all of the court decisions, by eliminating any necessity for the interest rate to be readily ascertainable. The revised Code position arguably "promot[es]...
certainty of legal rules and reduce[s] litigation costs and risks\(^{128}\) by enveloping any instrument, regardless of how interest is computed. This is contrary to the court decisions that limited their finding of negotiability to instruments with readily ascertainable interest rates.\(^{129}\) It is also contrary to most of the state statutes that modified their provisions to include variable rates within the definition of a sum certain. So far, seven states have adopted the revised Code version.\(^{130}\) Twenty states have a "non-uniform" amendment which, nevertheless, will recognize the negotiability of the adjustable rate documents.\(^{131}\)

In actuality, fourteen states\(^{132}\) based their amendment of section 3-106, the sum certain section, on an earlier discussion draft circulated by the National Conference of Commissioners on Uniform State Laws. The 1987 Discussion Draft amended section 3-106 by adding a subsection that read:

A rate of interest that cannot be circulated by looking only to the instrument is "a stated rate of interest" in subsection (1) if the rate is readily ascertainable by a reference in the instrument to a published statute, regulation, rule of court, generally accepted commercial or financial index, compendium of interest rates, or announced rate of a named financial institution.\(^{133}\)

Even within this group of states, there is little uniformity. For example, several states add that the rate can be announced "or established,"\(^{134}\) therefore liberalizing the standard for the referenced source. Virginia adds the word "established,"\(^{135}\) without the "or," thereby restricting the definition. Oregon deletes the "readily ascertainable" standard, thus coming closer to the result under the revised Code.\(^{136}\) Further deviations from the Discussion Draft section are found that are less substan-

\(^{128}\) Miller, supra note 120, at 104-05.

\(^{129}\) See supra notes 89-114 and accompanying text.


\(^{131}\) See infra notes 128-33 and accompanying text.


\(^{133}\) U.C.C. § 3-106(2) (Discussion Draft 1987).

\(^{134}\) California, Florida, Kentucky, Maryland, and Washington add these words. See supra note 128 for the relevant citations.

\(^{135}\) See supra note 128.

\(^{136}\) See supra note 128.


The other six "non-uniform" states have relatively unique sections that nonetheless guarantee negotiability to variable rate instruments.\(^{137}\)

Twenty-seven states, therefore, have a statutory amendment that allows for the outside determination of an interest rate in a negotiable instrument. This legislative action recognizes the large extent to which financial institutions and their customers, commercial and consumer, have accepted and utilized adjustable rate loan documents. The nonuniformity of those statutes, however, presents a dilemma which needs to be addressed.\(^{138}\)

Since almost all of the state statutes were passed within the last four years, another major problem emerges. Variable rates have been in use since the early 1980s. In the states that have statutory amendments, retroactivity becomes an important question. Florida includes in its notes to the amendment that "the Legislature intends to clarify and confirm existing laws."\(^{139}\) It is abundantly clear, therefore, that the Florida statute should be applied to any instrument, even those entered into before the statute's passage. Other states do not provide for this clarity, although it would have wise to do so, and therefore three courts have been forced to address this issue. In *First City Federal Savings Bank v. Bhogaonker*,\(^{140}\) the court approached the issue by using the same reasoning as did the Florida legislature. Without discussion of retroactivity, it simply held that the New York Amendment clarified the law, rather than creating a different law.\(^{141}\) The New Jersey Superior Court specifically addressed retroactivity of the statute, noting that it is generally not favored.\(^{142}\) However, it did recognize three exceptions; if retroactivity was intended, if expectations would be enhanced, or if the statute was ameliorative.\(^{143}\) Since other state courts had ruled that variable rate notes were non-negotiable, the New Jersey court found that "[t]he clear implication is that . . . the Legislature wanted to clarify New Jersey's position on the issue, before any decisions were rendered."\(^{144}\) In contrast, a federal district court, applying Maryland law, reached the opposite result using the same reasoning.\(^{145}\) This court also recognized that other states had found for non-negotiability, but denied that this implied that the legislature was confirming state law. Instead, it found that "[i]t is likely that knowledge of case law interpreting similar provisions in other states prompted the legislature to act so as to alter what it thought was the existing law in Maryland."\(^{146}\) Indeed, the district court ruled that application of state law would

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138. See infra notes 194-201 for further discussion of nonuniformity.


140. See supra note 59 and accompanying text.

141. See supra note 61 and accompanying text.


143. Id. at 396-97.

144. Id. at 397. The court also found that the amendment enhanced the parties' expectations. Id.


146. Id. at *3.
preclude negotiability of variable rate notes and declined to apply the statute retroactively because of the lack of evidence of legislative intent to do so.147

Because of the lack of uniformity, and the uncertainty surrounding retroactive application of the amendments, state legislation has not sufficiently accomplished the objective of encompassing variable rate instruments in the realm of negotiability. Thus, the statutory law leaves conflicting and unresolved issues, similar to the case law. The ramifications of the conflicting and uncertain state of the law are significant on several levels.

V. Implications

The traditional significance of negotiable paper is that it is the first step to obtaining the protected status of holder in due course. Only certain enumerated real defenses are good against a holder in due course.148 The holder in due course is immune to any other claim or defenses to payment. Thus, the negotiability of an instrument generally obtains its significance when the paper has been transferred to a third party, and the third party is claiming the status and protection of a holder in due course. Within recent years, the holder in due course status has become particularly important to the holder of a large amount of commercial paper — the federal agencies handling insolvent financial institutions.

A. The FDIC and Variable Interest Rates

During the 1980s and into the 1990s the failure of banks and savings institutions skyrocketed. Record numbers of banks and thrifts became insolvent149 and were taken over by the appropriate federal agency. The result was a cost to taxpayers estimated in the hundreds of billions of dollars and the enactment of new legislation that restructured the agencies overseeing the crisis.150 The Resolution Trust

147. Id. See also supra notes 70-74 and accompanying text for further discussion of the case.
148. U.C.C. § 3-305 (1987). The section defines the real defenses as:
(a) infancy, to the extent that it is a defense to a simple contract; and
(b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and
(c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and
(d) discharge in insolvency proceedings; and
(e) any other discharge of which the holder has notice when he takes the instrument.
Id.; see also id. § 3-3-6 (listing rights when not a holder in due course).
150. Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) Pub. L. No. 101-73, 103 Stat. 1833; see Boss & Watson, supra note 149, at 310-11. FIRREA abolished the Federal Savings & Loan Insurance Corporation, and transferred its duties to the RTC and FDIC. The RTC will act as conservator or receiver for failed thrifts until August 9, 1992, at which time the FDIC will be appointed in that capacity. Id.
Corporation and the FDIC are presently the agencies that handle bank and thrift failures, and their ability to efficiently process these institutional bankruptcies has been hindered by the lack of clear negotiability for variable rate financial instruments. In essence, the FDIC would like to claim holder in due course status so that it, or its assigns, would not be liable for any defense, except the limited real defenses. The FDIC's ability to defeat the claims or defenses of a maker can be based on several theories, one of which is the federal holder in due course. Therefore, a brief discussion of these theories is warranted.

The power of the FDIC to collect payment of a debt owed to an insolvent bank over the defense of the maker was first addressed in the case of D'Oench, Duhme, and Co., Inc. v. FDIC. At the core of this case was the attempt of an insolvent bank to fraudulently bolster the appearance of its assets by a sham agreement. D'Oench, Duhme, and Co. signed a demand note payable to Belleville Bank and Trust Co. in order to cover the fact that bonds issued to the banks were past due. In the receipt for that note was the express statement that the notes would not be repaid. This arrangement, however, allowed the bank to show the notes as an asset without showing the bonds as a past due obligation. When the FDIC took over the Belleville Bank it had no knowledge of the statement on the receipt. The FDIC sought to enforce the notes, but D'Oench, Duhme, and Co. defended the action based on the statement on the face of the receipt.

The Supreme Court decided that because the case was based on a federal question, federal common law should apply. It reviewed the provisions of the Federal Reserve Act and stated that "these revisions reveal a federal policy to protect respondent [FDIC], and the public funds which it administers, against misrepresentations as to the securities or other assets." Based on this policy, the Court denied the petitioners the ability to argue their defense based on a secret agreement. The concurring opinion of Justice Jackson is also important. Justice Jackson explained that the federal government has the power to develop common law with regard to specific federal statutes, even though it has no general common law. In applying this concept to the particular case, he noted that the FDIC's creation was based upon the goal of restoring credibility to the banking industry.

151. For purposes of simplicity, in this article the FDIC will be used as the agency dealing with bank and thrift failures, and the discussion applies to the RTC, as well.
154. Id. at 457.
The goal could only be accomplished if the FDIC can rely on the face value of banking paper and their representations.\textsuperscript{155}

Following \textit{D'Oench}, Congress passed section 1823(e) as part of the Federal Deposit Insurance Act of 1950.\textsuperscript{156} The section requires four elements to be present in order to enforce an agreement which would be a defense against the FDIC. These four requirements are: that the "agreement" be in writing, contemporaneous, have been approved by the directors or loan committee of the bank, and have continuously been a record of the bank.\textsuperscript{157}

Some courts have compared section 1823(e) protection to the holder in due course under commercial law.\textsuperscript{158} Another view, however, is that this authority was not granted to the FDIC under section 1823(e), but that the FDIC could obtain protection similar to that of a holder in due course status by means of federal common law.\textsuperscript{159} In \textit{Gunter v. Hutcheson},\textsuperscript{160} the court found that section 1823(e) did not prevent noteholders from arguing the defense of fraud. Therefore, the court followed a theory of federal common law to address the situation. It applied the analysis in \textit{United States v. Kimbell Foods Inc.},\textsuperscript{161} to determine federal common law.

\textit{Kimbell Foods} addressed the question of whether federal liens by the Small Business Administration outweighed liens by other creditors. In deciding that the state law of liens should apply, the court in \textit{Kimbell Foods} used a two-step analysis. First, it required that the question involved arise out of a federal program created by Congress. Once achieving that step, the court balanced the question of whether nationwide uniformity was required, whether specific objectives of the federal program needed federal common law to be effective, and whether established state law of commercial transactions created assumptions that should be protected.\textsuperscript{162}

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{155} \textit{Id.} at 473. \\
\item \textsuperscript{156} 12 U.S.C. § 1823(e) (1988). \\
\item \textsuperscript{157} 12 U.S.C. § 1823(e) (1988 & Supp. III 1991). The section initially read:

No agreement which tends to diminish or defeat the right, title or interest of the FDIC Corporation in any asset required by it under this section, either as security for a loan or by purchase, shall be valid against the Corporation unless such agreement (1) shall be in writing, (2) shall have been executed by the bank and the person or persons claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the bank, (3) shall have been approved by the board of directors of the bank or its loan committee, which approval shall be reflected in the minutes of said board or committee, and (4) shall have been, continuously, from the time of its execution, an official record of the bank.

\item \textsuperscript{158} See, e.g., FDIC v. Rosenthal, 477 F. Supp. 1223, 1226, (E.D. Wis. 1979), aff'd mem., 631 F.2d 733 (7th Cir. 1980); FDIC v. Rockelman, 460 F. Supp. 999, 1003 (E.D. Wis. 1978). \\
\item \textsuperscript{159} See FDIC v. Wood, 758 F.2d 156, 159 (6th Cir.), \textit{cert. denied}, 474 U.S. 944 (1985). \\
\item \textsuperscript{160} 674 F.2d 862, 867 (11th Cir.). \textit{cert. denied} 459 U.S. 826 (1982). \\
\item \textsuperscript{161} 440 U.S. 715 (1979). \\
\item \textsuperscript{162} \textit{Id.} at 727-29.
\end{enumerate}
\end{footnotesize}
The Gunter court applied the Kimbell Foods analysis, noting that the creation of the FDIC was under federal statute, and proceeded to balance the other factors.\textsuperscript{163} The court first explained methods available to the FDIC to take over failed banks. Noting that the FDIC has a choice between paying outright the claims of customers or arranging a purchase and assumption transaction, the court emphasized the importance of the latter method of dealing with failed banks.\textsuperscript{164} Under the statutory language, an FDIC may only enter into a purchase and assumption transaction when it would lessen the liability of the entity or provide needed banking services to the community.\textsuperscript{165} The Gunter court decided that it would be virtually impossible for the FDIC to take the swift action necessary for determining liability and utilize a purchase and assumption transaction if it were required to follow different state laws and to individually assess the collectability of each asset.\textsuperscript{166} Thus, the court decided to apply federal common law and allow the FDIC, in a purchase and assumption transaction, to take paper free of the defense of fraud. For the FDIC to be able to defend against this defense it has to take the note "for value in good faith and without actual knowledge of the fraud at the time the FDIC entered into the purchase and assumption agreement."\textsuperscript{167}

Other cases have applied either an analysis to the holder in due course status in state law, or called the FDIC a holder in due course by federal common law. The case of FDIC v. Wood\textsuperscript{168} distinguished between the state holder in due course doctrine and the federal protection of the FDIC by describing the holder in due course doctrine as the "bright line elaboration on the good faith requirement."\textsuperscript{169} The court stated that "it is inappropriate to apply those [technical holder in due course] requirements to a government agency crucial to the existence of the modern banking system when they are without purpose."\textsuperscript{170} The court indicated that because the FDIC could act in good faith without meeting the strict requirements of the holder in due course status, that due to the policy behind the FDIC, they should be given the same protection. To do otherwise would interfere with the purchase and assumption transaction which the Wood court called "a dramatically effective way for the FDIC to fulfill its purpose."\textsuperscript{171} The court noted that this policy should not be disruptive to state commercial law since the note in question could have just as easily found its way into the hands of a holder in due course.

In Campbell Leasing v. FDIC,\textsuperscript{172} decided in 1990, the court found that the FDIC was immune to the defenses of tortious interference with leasing of an asset and

\textsuperscript{163} Gunter, 674 F.2d at 869.
\textsuperscript{164} Id. at 872.
\textsuperscript{166} Gunter, 674 F.2d at 869.
\textsuperscript{167} Id. at 873.
\textsuperscript{168} 758 F.2d 156 (5th Cir.), cert. denied, 474 U.S. 944 (1985).
\textsuperscript{169} Id. at 160.
\textsuperscript{170} Id.
\textsuperscript{171} Id.; see also Langley v. FDIC, 484 U.S. 86 (1987) (interpreting §1823(e) and reversing Wood to the extent that fraud and misrepresentation are covered).
\textsuperscript{172} 901 F.2d 1244 (5th Cir. 1990).
other personal defenses to liability. This analysis was based on the FDIC's status as a holder in due course under federal common law. The court stated that "this rule promotes the necessary uniformity of law in this area while it counters individual state laws that would frustrate basic FDIC objectives." An analysis is necessary to decide whether federal common law should apply to the specific question of the negotiability of variable interest rate instruments. The first consideration under Kimbell Foods is whether a uniform federal rule is required. With regards to the holder in due course, it has been argued that the Uniform Commercial Code, since it is adopted in all states, provides such a uniform rule. However, the Uniform Commercial Code is not standard in all states in deciding the effect of variable rates on negotiability. Twenty-seven states have amended their statutes to include variable interest rates as a sum certain, and it is likely that other states will soon follow because of the proposed amendments circulating. Thus, a uniform federal rule is necessary because to hold otherwise "would frustrate attempts to promote the stability of, and confidence in, the nation's banking system." The second factor enunciated in Kimbell Foods is whether the particular purpose of the federal program would be frustrated without a federal uniform rule. The court noted that the primary purpose of the FDIC is to ensure "depositors sound, effective, and uninterrupted operation of the banking system with resulting safety and liquidity of bank deposits."

Many courts have explained the benefits of using the purchase and assumption transaction in order to accomplish the uninterrupted and efficient access to banking services when a bank fails. Courts have noted that these purchase and assumption transactions allow the FDIC to maintain the bank's goodwill and therefore recover a greater amount of the bank's worth by selling its assets to a takeover bank. In contrast to liquidating a failed bank, the purchase and assumption transaction must take place very quickly, literally overnight in some instances. Therefore, the FDIC does not have the time to individually assess the assets of the failed bank. If it were required to do so because of the non-negotiability of the instruments and their

173. Id. at 1249.
174. In 1991, the Fifth Circuit denied the FDIC holder in due course status, based on a variable interest rate, which it found destroyed negotiability. Although the court recognized the need to protect the FDIC, it would not allow it to "transmute lead into gold." The opinion was later withdrawn on procedural grounds. Sunbelt Sav. v. Montross, 923 F.2d 353 (5th Cir. 1991), withdrawn sub nom. RTC v. Montross, 944 F.2d 227 (5th Cir. 1991); see also Hershiser, 777 F. Supp. at 542-43 (stating that variable rates do not destroy negotiability for limited purpose of protecting banking system). See supra notes 82-88 and accompanying text.
175. See supra notes 121-25 and accompanying text.
susceptibility to defenses, then the purchase and assumption transaction would not be possible. In 1989, 84% of bank failures were the subject of purchase and assumption transactions. The FDIC estimated that over one hundred million dollars was saved by arranging these purchase and assumption transactions, as premiums paid by assuming banks amounted to forty million dollars. Thus, it is evident that the purchase and assumption transaction is an efficient method for the FDIC to handle a failed bank's assets, although it would be precluded if variable rate instruments, representing a large percentage of a bank's assets, were held to be non-negotiable.

The last factor in determining whether a federal common law rule is needed is whether commercial relationships would be upset at the state level by a federal rule. The effect of a variable interest rate is not uniform throughout the states. In those states where a variable rate interest is allowed as a sum certain, it obviously would not disrupt any transactions. In states where the courts have decided that variable rates do not meet the sum certain requirement, state commercial relationships may be upset. However, the majority of states have statutes providing that variable interest rates do not destroy negotiability. In those states without a statute, or with contrary court decisions, the question remains as to whether ruling variable rate interest instruments to be negotiable would alter the parties' expectations in the transaction. Thus, by this analysis, the variable interest rate should not affect the FDIC's federal holder in due course status. However, several federal courts have already ruled to the contrary, while only one has ruled for negotiability. Therefore, variable interest rates continue to be a major problem for the FDIC.

B. Commercial Expectations and Cost

Commercial expectations are not only a consideration in applying federal common law, but they should also be considered when deciding the basic question of negotiability for adjustable rate notes. The assumption may be that the parties initially transacted based on the expectation that no holder in due course could exist because of the instrument's variable interest rate and its non-negotiability. However, this assumption may be false. Two empirical studies of the mortgage market were undertaken after the court decisions denying negotiability in Illinois and New York, in order to assess the impact of those decisions on interest rates. The premise of these studies was that if variable interest rates were found to be non-negotiable, then this could be tested in the market by following the interest rates on variable

180. Id. at 161.
181. See FDIC 1989 REPORT, supra note 149, at 12.
182. Id.
185. See Hiller & Ferris, supra note 26, at 48.
rate mortgages following the court decisions. If negotiability did not matter, that is, if the parties were already negotiating on the premise that variable rate paper was non-negotiable, then no change should be found in the interest rates following the decisions. However, the opposite result was found in both of these studies. Interest rates rose after the decisions in Illinois and New York. This reflects the fact that negotiability and the ability to take paper as a holder in due course does in fact represent a cost to the bank, which is passed on to the customer by means of a higher interest rate. Most importantly, these studies show that the parties did not consider their variable interest rate notes to be non-negotiable. If the court decision merely reflected the parties understanding, then interest rates should have shown no change. Because in both of these studies the interest rates increased after the court decisions, it can be extrapolated that the parties did not consider variable rates to destroy negotiability. Therefore, banks raised interest rates to reflect their increased risk in issuing non-negotiable paper. Far from disrupting the commercial expectations of the parties, finding variable rate instruments to be negotiable would reinforce the expectations of the parties. In addition, it would reflect the growing trend to adopt an amendment to the UCC that specifically allows variable interest rates in the sum certain requirement.

Additionally, the empirical studies show that there is a cost to business and consumers, in higher interest rates, when variable rates are non-negotiable. Higher interest rates in states where the variable rate instruments are non-negotiable result in several implications for that community. First, higher interest rates affect investment. Businesses must consider interest rates, a factor in the cost of capital, when deciding whether to expand or to locate in a particular area. Therefore, the higher interest rates caused by non-negotiability may be one factor that could result in lower business investment in non-negotiability states.

Non-negotiability will also, very significantly and negatively, affect the residential mortgage market. Mortgage rates will be higher when variable rate notes are considered non-negotiable. At least two ramifications of higher mortgage rates exist. First, consumers will be forced to buy less expensive houses, and marginal buyers may be completely precluded from the home market. Secondly, the implication for the construction industry is that it will not be as prosperous because of the effect on homebuyers. The builder may actually feel the effect twice: once when faced with higher rates at the bank himself and again when the market is narrowed because of the effect on the buyer's ability to afford the home.

The non-negotiability of variable interest rate notes also affects the secondary mortgage market, which is composed primarily of governmental, or quasi-governmental entities. The Federal National Mortgage Association (Fannie Mae) purchases and sells mortgage loans while acting as a clearinghouse for matching supply and demand of mortgage funds. The Government National Mortgage

187. This argument assumes that the results of a study of commercial rates would parallel the studies of residential mortgage rates.
188. See Hiller & Ferris, supra note 25, at 268-70, for a description of the secondary mortgage market.
Association (Ginnie Mae) promotes home ownership of low and middle income houses by guaranteeing and packaging the loans in the secondary market. Because of the large participation of these entities in the secondary market, it is estimated that 80% of the forms used in residential closings are uniform. The effect of non-negotiable variable rate paper was summarized in the amicus brief of the pertinent federal agency submitted to the court in Taylor:

There is no practical degree of review in connection with loan purchases that would provide the same safeguards as holder-in-due-course status. The non-applicability of this status to adjustable rate loans would not result in more policing of the primary market but rather in increasing the yield requirements for those loans without the benefits of holder-in-due-course status to compensate for their additional risk.

Therefore, Ginnie Mae would not be able to guarantee as many low to middle income home loans, and affordable housing would be restricted. Residential closing forms could not be standard because of the different category of loans as negotiable or non-negotiable. The costs to lenders and buyers in the secondary market would increase because of the additional burden of determining the unclear distinction between those notes that will or will not be negotiable. The negative effect of non-negotiability of adjustable rate mortgages on the secondary market thus "seems unquestionable."

The impact of non-negotiability on commercial expectations, as well as on costs to consumer and businesses alike, are varied and far reaching. Variable rates are not a temporary phenomenon, and those places where they are not negotiable can expect a higher cost of capital resulting in less investment and a lesser ability to provide affordable housing. The impact on the secondary residential mortgage market fuels some of these costs and additionally inhibits their power to encourage standardized and less costly forms for these transactions.

VI. Analysis and Recommendations

An analysis of the case law, legislation, and impact of non-negotiable adjustable rate documents is essential to reaching a recommendation of what, if anything, should be done to address the issue. First of all, the court decisions are definitely divided. However, a trend toward finding for the negotiability of variable interest rate instruments is clearly emerging. An analysis of the rationale behind each side of the issue supports the continuation of the trend.

The primary reasons given by the various courts for their rulings against negotiability were: (1) the comment to section 3-106 clearly excepts current or bank rates from a sum certain because of the reference to an outside source; (2)

189. Id. at 269-70.
191. Amicus Curiae Brief at 7, Taylor.
192. Id. at 5.
uniformity and predictability; and (3) the weight of authority from other courts. A closer look at these reasons reveals that, as time progresses, each one loses its basis for validity. First, the revised article three allows for negotiability of adjustable rates, as did the 1987 Discussion Draft. The comments in the Discussion Draft indicated that the changes were in response to case law and "to make clear" that these instruments are negotiable. This implies that the drafters of the Code never intended to exclude variable rates from a sum certain. Indeed, adjustable rates that are familiar today were unknown when the Code was written. Second, uniformity and predictability are presently in disarray. The changes in legislation, in piecemeal progression, and the conflicting court decisions have already ended any possible uniformity and predictability. The lack of uniformity also impacts the last consideration, the weight of authority. Although more cases have followed the non-negotiability rationale, the cases are duplicative, as they are from the same jurisdiction, with several of these having been overturned. A poll of the jurisdictions shows an even 6-6 split between the authority. The weight shifts in favor of negotiability when one considers that one federal district court case decided the outcome for two states, and that all other past federal district court decisions against negotiability have been reversed. In addition, the recent trend is towards finding for negotiability.

Those courts ruling in favor of negotiability have emphasized their reasons as: (1) favoring flexibility as outlined in Code section 1-102; (2) the lack of a definition of a sum certain; and (3) custom and usage that readily accepts variable interest rates. All of these factors are reflected in the revised sections of the UCC. The sum certain requirement is dropped, and the accepted custom of using adjustable rates is clearly included within the negotiability framework. The flexibility of the UCC to deal with developing practices is reaffirmed.

Twenty-seven states have adopted an amendment that provides for the negotiability of variable interest rate instruments. However, only six states have adopted the uniform amendment. The legislative route of addressing adjustable rate paper, which could have solved the problem of nonuniformity, has instead added to the dilemma. Many of the states patterned their amendments after the 1987 Discussion Draft proposed by the Commissioners. The final proposal was significantly different from the 1987 version. Thus, instead of beginning the process towards uniformity with states already in agreement, the Commissioners began with a deficit. States that already debated and analyzed the problem, and agreed with the first draft, must now be convinced that the final proposal is better. The lack of a "readily ascertainable" standard for determining the interest rate is likely to provoke debate. An unpublished rate may increase the transaction costs of a third party.

194. See Robert G. Ballen et al., Commercial Paper, Bank Deposits and Collections, and Other Payment Systems, 44 BUS. LAW. 1515, 1552 (1989) (stating that "we are doomed to a period of non-uniformity").
195. See supra notes 121-25 and accompanying text.
196. See supra note 128.
197. See supra note 129.
198. See Frank P. Darr, The Negotiability of Variable Interest Notes, 33 ST. LOUIS U. L.J. 103, 131
and therefore decrease the transferability of the paper. On the other hand, it is very clear, and thus predictable, that if the principle amount of debt is stated, then the interest calculation will not destroy negotiability. Thus, litigation costs will decrease, because there will be no doubt as to whether the calculation is readily ascertainable or fits the definition of the discussion draft. The Commissioners must have believed that the benefits of the final draft outweighed the head start they would have achieved by staying with a discussion draft already adopted by numerous states. It is now imperative for them to pursue uniformity on this issue and to once again convince those states of the necessity of change.

If the Commissioners do not succeed in achieving uniformity, then an argument can be made that federal legislative action is necessary. This argument is made with due trepidation, because commercial law has traditionally been the province of the states. The Commissioners' work on the revised articles 3 and 4 of the UCC is at least in part because of a desire to maintain commercial rules within the bounds of state law. Without delving into the intricacies of federal jurisdiction, a preliminary case can be made for federal intervention. The banking industry is already highly regulated by the federal government, the secondary market for commercial paper is dominated by quasi-governmental agencies, and efficient, effective interstate and international commerce is dependent upon uniform rules of negotiability and commercial paper. If the states cannot arrive at a consensus, then the United States Congress should consider providing the necessary uniformity by federal statute to avoid further disruption of commerce and commercial relationships. While awaiting state action, federal common law should be interpreted to include variable interest rates as a sum certain, so that the FDIC can continue to utilize the most cost-effective method of handling failed financial institutions and maintaining public confidence.

VII. Conclusion

The issue of adjustable rates and the requirement of a sum certain for negotiability was slow to be recognized but is now building to a critical point. The lack of uniformity in case law and statutes has had a costly effect on businesses, consumers, the government, and on all of us as taxpayers. It is time for the end of a rigid application of negotiability rules to variable rate instruments, and time to work towards the essential uniformity that is the only solution to an ever-increasing problem.

(1988).
199. See Miller, supra note 116, at 104-05.
200. Id. at 120-21.
201. This is based on the Commerce Clause. U.S. CONST. art. I, § 8.