Volume 6 | Issue 3 Article 4

1961

Comments

Various Editors

COMMENTS

FEDERAL JURISDICTION—CHOICE OF LAW—FEDERAL LAW OF NEGOTIABLE INSTRUMENTS.

The concept of a federal common law of negotiable instruments, though not new, has not often been rendered articulate. It may be that the courts themselves have yet to admit that a problem has been created by the interaction of the concepts of federal supremacy and the law merchant. Indeed, the very nomenclature "federal law of negotiable instruments" is a deceptive caption and one which affords little warning to the unwary of the intricate constitutional law problem subsisting just below the surface of this particular branch of the law merchant. The purposes of this comment are to demonstrate the existence of such a problem, to investigate its intricacies and to propose a solution of it.

The problem of the federal common law arose in the now famous case of *Swift v. Tyson*.[1] The command of the Federal Judiciary Act of 1789,[2] that the federal courts apply the laws of the several states when the constitution, treaties, or federal statutes were not involved was interpreted by Mr. Justice Story only to require the federal courts to apply the statutory laws of the states and not the common law. In *Swift*, the central issue was whether an antecedent debt was "value" so as to make one who took the instrument for such a debt a holder in due course. The Court refused to apply New York common law to the matter and instead applied the law of the "commercial world." In 1937, the Supreme Court overruled *Swift v. Tyson* by the decision in *Erie R.R. v. Tompkins*,[3] wherein Justice Brandeis, speaking for the majority of the Court and interpreting the same statute,[4] stated that there was no federal common law and, that except where the Constitution or a congressional act was involved, the federal courts must apply both the statutory and the common law of the states.[5]

The federal district courts acquired jurisdiction in both the *Erie* and *Swift* cases by reason of the diversity of citizenship of the litigants.

1. 41 U.S. (16 Pet.) 1 (1842).
2. Federal Judiciary Act of 1789, 28 U.S.C. § 1652 (1959).
3. 304 U.S. 64 (1938).
4. Federal Judiciary Act of 1789, 28 U.S.C. § 1652 (1959).
5. 304 U.S. 64, 78 (1938).

However, the language of Justice Brandeis was so broad and has been so widely cited that the bounds of the decision have not yet been defined. The *Erie* doctrine has not always been limited to diversity cases and, thus the federal courts have decided in cases where jurisdiction was not based upon diversity of citizenship that there was no federal law on the subject and that state law would apply.[6] The basic problem posed by the question "what is the extent to which the *Erie* doctrine should be applied?" goes to the heart of the federal system and the interaction of state and federal law.

The scope of this comment, however, encompasses only a small part of that vast area of conflict aroused by the *Erie* doctrine, the area of negotiable instruments as affected by the federal common law. *Swift v. Tyson* was interpreted to mean that the federal courts would follow a federal common law in diversity cases where there was no applicable state statute; and at the time this decision was rendered, most states had not enacted comprehensive statutes governing commercial paper. *Erie* struck down *Swift* and, in effect, proclaimed that there was no federal common law of negotiable instruments and that both the case and statutory law of the state in which the federal district court sat would govern such obligations.

But if *Swift v. Tyson* was dead, its ghost appeared not long after the crepe had been taken down when the Supreme Court decided *Clearfield Trust Co. v. United States*,[7] in which it was held that the federal common law of negotiable instruments should be applied in litigation involving the federal government as drawer-drawee of a check. Certainly *Swift* and *Clearfield* are factually distinguishable, the former arising out of the federal court's diversity jurisdiction and the latter out of the federal court's jurisdiction to hear actions to which the federal government is a party. However, the language in the *Erie* case to the effect that the federal courts will apply state law except where the Constitution or a congressional act is involved, squarely presented the Court with the problem of explaining why it had decided to apply federal law to the substantive issues where neither the Constitution nor a congressional act was directly involved.[8]

But even where federal statutes and federal agencies are involved, a choice of law problem arises because the application of federal law is not automatic and, perhaps not constitutionally possible.[9] The question of the choice of law in cases involving federal statutes and federal agencies which had acquired privately executed commercial paper was suggested before the *Clearfield* case but took on a new light after that decision.

6. See Note, 53 COLUM. L. REV. 991, 999-1000 and cases cited n.51 (1953).
7. 318 U.S. 363 (1943).
8. The Court stated that the power to issue the instrument was a constitutional power and therefore federal law governed. *Id.* at 366. For a further discussion of this seemingly weak reasoning see text *infra* at notes 53-55.
9. See text accompanying note 45, *infra*.

In 1940 and 1942 the Court decided cases involving government agencies and their rights on instruments acquired by them as transferees.[10] In these cases the Court held that the law of the appropriate state would not apply to provide defenses on the instruments because federal agencies had acquired rights on them; that the operation of the government agencies would be impeded by the application of state law was the explanation given.

Quite simply, the problem is whether, having entered the business world, the federal government should be treated like a business enterprise in its commercial activities, or whether it should retain the rights and privileges of the sovereign. The federal courts, in their decisions, have emphatically chosen the latter course, but it is yet to be seen whether they can constitutionally justify such a choice and, even more important, whether they should have chosen thus. The principle that the sovereign is not to be treated like other litigants is inherent in the system of all law, and is as old as the law itself. However, this rationale is seldom rendered articulate in cases where the federal law of negotiable instruments is applied; but, rather the converse of the traditional idea of sovereignty, that is, that the federal government when dealing in the commercial field is to be treated the same as anyone else, has constantly been reaffirmed and reiterated.[11] The very fact that there is a federal law of negotiable instruments, however, belies this pious utterance; for if the government is to be treated no differently than private parties, its rights and obligations should be governed by state law. In most instances, though, if the law of the appropriate state were applied, the result would differ from that reached when the federal law is applied. This paradox will present the main area of inquiry of this comment.

Analyzing this paradox, we will consider when this federal common law will be applied, the sources from which this law is derived, and the effects of having a federal law governing negotiable instruments. These problems are certainly of great contemporary significance in light of the tremendous amount of government negotiable paper afloat and the many commercial fields into which the government has entered, in which fields it necessarily must deal with commercial paper. It should be noted, however, that while the areas into which the government has stepped are vast, the number of reported cases in these areas is quite small. Consequently, the principles which we can set down must be largely speculative, as they must be extracted and extended from those laid down in these few cases.

10. D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447 (1942); Deitrick v. Greany, 309 U.S. 190 (1940).

11. *E.g.*, Clearfield Trust Co. v. United States, 318 U.S. 363, 369 (1943).

I.

WHEN THE FEDERAL COMMON LAW OF NEGOTIABLE INSTRUMENTS IS APPLIED.

A.

When the Government is Maker of the Instrument.

In 1959, Judge Chambers, speaking for the Court of Appeals for the Ninth Circuit wrote [citing *Clearfield*], "Of course it is settled that *Erie v. Tompkins* does not apply to government commercial paper — it is purely federal business."[12] Thus, the federal law of negotiable instruments is applied. The federal courts, in cases arising since the *Clearfield* decision, have uniformly held that where the Government is the maker of the instrument, and is also involved in the litigation, the federal law of negotiable instruments will govern.[13] The reasoning behind this, as Mr. Justice Douglas indicated in the *Clearfield* case, is that the authority to issue checks has its origin in the Constitution and statutes of the United States. Therefore, when the federal government issues commercial paper, it does so in the exercise of a constitutional power or function, and such paper can be in no way dependent upon the law of any state. Thus, federal, rather than local law should govern.[14]

Another reason stated for applying federal rather than state law, where the Government is a party to the instrument, is that transactions involving federal commercial paper will occur in all of the various states, and if the law of each of these states is to be applied to the particular transaction, Government obligations will be subject to the uncertainties and vagaries resulting from divergent rules governing identical transactions. "The desirability of a uniform rule is plain."[15]

The most difficult problem arises, however, when the Court does not limit the application of federal commercial law to determinations of the rights of the Government in a particular action, but extends its appli-

12. United States v. Bank of America Nat'l Trust & Sav. Ass'n, 274 F.2d 366, 367 (9th Cir. 1959).

13. *E.g.*, Bank of America Nat'l Trust & Sav. Ass'n v. Parnell, 352 U.S. 29 (1956); Clearfield Trust Co. v. United States, 381 U.S. 363 (1943). The federal law has been most frequently applied by the federal courts to determine the nature of the Government obligation, that is, whether Government checks were "order paper," and, if so, to whose order they were drawn. The cases all involved "imposter" situations; *e.g.* National Metropolitan Bank v. United States, 323 U.S. 454 (1945); United States v. Bank of America Nat'l Trust & Sav. Ass'n, 274 F.2d 366 (9th Cir. 1959); Atlantic Nat'l Bank v. United States, 250 F.2d 114 (5th Cir. 1957); United States v. People's Nat'l Bank, 249 F.2d 637 (7th Cir. 1957); Fulton Nat'l Bank v. United States, 197 F.2d 763 (5th Cir. 1952); Continental-American Bank & Trust Co. v. United States, 161 F.2d 935 (5th Cir. 1947), *aff'd per curiam on rehearing*, 175 F.2d 271 (1949), *cert. denied*, 338 U.S. 870 (1949); United States v. First Nat'l Bank, 131 F.2d 985 (10th Cir. 1942).

14. 318 U.S. 363, 366 (1943).

15. *Id.* at 367.

cation to determine the "nature of the instrument" in a suit between two *private parties,* where the rights and obligations of the Government are not directly involved.[16] Thus, in a suit for conversion of certain negotiable federal bonds, of which the defendant claimed to be a good faith transferee, the Court held that whether or not the bonds were overdue was a matter of federal law. But the issue of "overdueness" had a direct bearing upon the good faith of the defendant, which issue, the Court further held, was to be resolved by the application of state law.[17]

One apparent effect of uniformly applying federal law to all questions bearing on the nature and characteristics of a federally issued instrument, without regard to who the parties to the controversy are, is that some of the rights of individuals involved in wholly intrastate transactions with federal paper will be governed by federal law and some of their rights will be governed by state law. Further, the line of demarcation between the areas to which state law will be applied and those to which federal law will be applied is far from clear, even though the Court has indicated that federal law will be applied to determine the character of the instrument, *e.g.,* whether it is, at the pertinent time, overdue.[18] Apparently, the reason for so doing is that the nature of the obligation of the party primarily liable on the instrument, the Government as drawer-drawee, is dependent upon whether the instrument is overdue;[19] but the obligation of the party primarily liable is not so much affected by the timely presentment of a negotiable instrument as are the rights of transferees and purchasers.[20] It follows that the effort to make the nature of federal obligations uniform does have a collateral effect on private parties, since issues affecting the nature of the instrument are to be determined by federal law at the same time that the other commercial aspects of the case are disposed of pursuant to local practices. Granted the interjection of federal law merchant into otherwise private litigation, the problem becomes one of distinguishing the hard core of the federal law merchant, promulgated pursuant to the policy of uniformity, from the balance of the commercial law, which is only accidental to the dispute, and, therefore ought to be derived from state sources pursuant to the policy of *Erie.*

The Court apparently realized the dilemma which it had created, but in an attempted resolution, it proceeded to further complicate the matter. The test promulgated to determine whether federal or state law would govern is whether the matter was "too essentially . . . private" not to be dealt with by local law.[21] However, no practical criteria for determining when a transaction is "too essentially . . . private" were set up; and

16. Bank of America Nat'l Trust & Sav. Ass'n v. Parnell, 352 U.S. 29 (1956).
17. *Ibid.*
18. Bank of America Nat'l Trust & Sav. Ass'n v. Parnell, 352 U.S. 29, 34 (1956).
19. *Ibid.*
20. See BRITTON, BILLS AND NOTES §§ 188-200 (1943).
21. Bank of America Nat'l Trust & Sav. Ass'n v. Parnell, 352 U.S. 29, 34 (1956).

although the Court said that the transaction between the litigating parties in the *Parnell* case was "too essentially . . . private," federal law was still applied to the determination of an issue fundamental to the ultimate resolution of the controversy arising out of this essentially private transaction. The contradiction involved in the Court's reasoning is apparent. And to further confuse the issue, the Court went on to say that just because they had chosen not to apply the federal law to this transaction — which was, in fact, what they had actually done — there was no reason to assume that they could not do so, or to assume that Congress was foreclosed from legislating in the field.[22]

In the *Clearfield* case, the Court did not indicate from which clause in the Constitution the federal government derives the power to issue checks, although it is probably from the banking power.[23] And more fundamentally, the Court did not discuss how it bridged the gap between the power to issue commercial paper and the power to proclaim a federal commercial law. The question is one of enumerated powers, that is, whether the power to issue commercial paper includes the power to subject the parties who become involved with that paper to a federal law. The problem was not so apparent in the *Clearfield* case, where the rights of the federal government were before the Court; but with the Court's application, in the *Parnell* case, of federal law to the rights of private parties who happen to enter into a transaction involving Government paper, the constitutional problem merits re-examination.

The Federal District Court of Maryland, perhaps leary of the constitutional problem involved, refused to allow the defendants to join prior endorsers as third party defendants, in a suit by the Government to hold defendant bank liable on its guarantee of prior endorsements.[24] Following the lead of the *Parnell* case, however, the court applied both state and federal law. Unlike the Supreme Court, though, it only applied state law to effect the decision as between the private party defendant and private party endorsers, while federal law was applied to determine the rights between defendant bank and the federal government.[25]

B.

When the Federal Government is not the Maker of the Instrument.

It is certainly understandable that most cases in which the federal common law of negotiable instruments has been invoked are those in

22. *Ibid.*

23. U.S. CONST. art. I, § 8 "Congress shall have the power to . . . pay the debts, . . . to make all laws which shall be necessary and proper for carrying into execution the foregoing powers . . . ."

24. United States v. Fidelity-Baltimore Nat'l Bank & Trust Co., 171 F. Supp. 1 (D. Md. 1958).

25. United States v. Fidelity-Baltimore Nat'l Bank & Trust Co., 173 F. Supp. 565 (D. Md. 1959). The court applied the state statute of limitations to bar the bank's recovery against prior endorsers, but allowed the Government to proceed against the bank under the *Clearfield* rule.

which the federal government is a party to the instrument. The practical reason for this is easily seen, to wit, the Government is probably involved in more litigation on its own instruments than on those which it acquires as payee or transferee, because people are, no doubt, less willing to pass defective or questionable instruments to the federal government. And as a matter of fact, the cases involving federal law and negotiable instruments of which the Government was not maker, usually arise because the makers of the instruments did not foresee that the Government would become involved.

The two major cases involving controversy over negotiable instruments to which the Government was not a party are not sources of affirmative reasons supporting the application of federal principles, but, rather, provide a rationale for applying state rules. Both *Dietrick v. Greany*[26] and *D'Oench, Duhme & Co. v. FDIC*[27] were decided before the *Clearfield* case, which was the first pronouncement of the federal law of negotiable instruments. But since *Clearfield,* both decisions have taken on a new light.

Both the *Dietrick* case and the *D'Oench, Duhme* case involved suits against accommodation makers of notes. These accommodation makers attempted to set up defenses to their liability — defenses which were valid under the rule of law of the appropriate state — but the Supreme Court held that federal policy prevented assertion of these defenses.

In *Dietrick v. Greany,* petitioner, director of a bank, executed a note to the bank to cover a transaction made illegal by the National Bank Act of 1864.[28] Respondent, receiver for the subsequently insolvent bank, sued on the instrument. The Court stated that the federal statute.[29] which made it a crime to impair the capital of a bank and thereby injure the creditors in the event of insolvency,[30] was part of a complete scheme of congressional legislation to protect national banks. But the "extent and nature of the legal consequences of this condemnation" of respondent's unlawful act "was left by the statute to judicial determination"[31] in line with the policy which Congress had adopted.[32] The Court then held that one of the "legal consequences" was that the receiver could recover on the note, notwithstanding the fact that there were available defenses to liability under the law of the state of Massachusetts. Federal law was applied by reason of Congress's provision for a comprehensive scheme of legislation covering national banks[33] notwithstanding the fact that the congressional purpose was not shown to have been thwarted by re-

26. 309 U.S. 190 (1940).
27. 315 U.S. 447 (1942).
28. NATIONAL BANK ACT, 13 Stat. 110 (1864), 12 U.S.C. § 83 (1959).
29. 40 Stat. 972 (1918), repealed, 62 Stat. 862 (1948).
30. 309 U.S. 190, 194 (1940). The Court indicates that this is the purpose of the statute.
31. *Id.* at 200.
32. *Id.* at 201.
33. Dietrick v. Greany, 309 U.S. 190 (1940).

spondent's act, that is, there was no showing that the creditors of the bank were in any way affected.[34]

The principles of the *Dietrick* case were further extended by the *D'Oench* case, which held that even though petitioner, accommodation maker of a note executed to allow a bank to carry the note on its books in lieu of worthless bonds, did not commit a crime by this act, the policy of the Federal Reserve Act[35] to protect the FDIC and the public funds which it administered precluded the application of state law on the issue of whether respondent was a holder in due course. Federal law was applied so as to make the defense of holder in due course unavailable, notwithstanding the fact that the purpose of the act to protect creditors of the bank from deceit or injury, as in the *Dietrick* case, was not thwarted.[36]

At first glance, it would not seem unreasonable to make allowance for a federal policy overriding the law of a state where the two might conflict. When the nature and purpose of negotiable instruments law is considered, however, *i.e.,* to facilitate the free flow of commerce within the workings of the commercial world which requires a complex credit system, it would seem more reasonable to subject the federal agency's dealings in commerce to the rules of the commercial world rather than to subject the commercial world to the particular rules governing the operations of the federal agency.

Since the *Clearfield* case at least one court, the Court of Appeals for the Second Circuit,[37] has refused to apply the state law of negotiable instruments to a case involving a government corporation, and has applied the federal law of negotiable instruments.[38] The reasoning of the *Clearfield* case with respect to the uniformity of government obligations was adopted and extended, the court reasoning that "such agencies being national in their scope and aim, shall not be forced to shape their transactions to conform to the varying laws of the places where they occur or are to be carried out. Uniformity is thought to be essential to the convenient and speedy dispatch of their operations."[39]

Thus it would seem that one might expect the courts to apply federal law to all negotiable instruments problems when a government corporation is a party to the litigation. Judge Learned Hand, in *New York, N.H. & H.R.R. v. RFC,*[40] wrote, "Recent decisions of the Supreme Court [citing *Dietrick v. Greany* and *D'Oench, Duhme & Co. v. FDIC,* among others] make it apparent that state statutes and state decisions are an unsafe reliance in dealing with the rights and liabilities of corporations which are federal agencies even though they be organized

34. *Id.* at 198.
35. D'Oench, Duhme & Co. v. FDIC, 385 U.S. 442, 459 (1942).
36. *Id.* at 461.
37. New York, N.H. & H.R.R. v. RFC, 180 F.2d 241 (2d Cir. 1950).
38. *Ibid.*
39. *Id.* at 244.
40. 180 F.2d 241 (2d Cir. 1950).

under a state law and made subject to suit like a private corporation."[41] Further, from the cases outlined in the previous section and those forementioned in this section the conclusion is inescapable that the federal law of negotiable instruments can be extended to cover all negotiable instruments problems in which the Government is at all involved. For it can certainly be argued that in almost any field in which the Government or a federal agency so acts as to become involved with commercial paper, either as maker, payee, holder or transferee, there has been some congressional legislative scheme enabling it to so act; and in its actions it is entitled to the protection of a uniform rule. Thus, the federal law of negotiable instruments should apply.

II.

CONSTITUTIONAL ASPECTS OF THE FEDERAL COMMON LAW.

The Supremacy clause of the Constitution[42] provides that the laws made in pursuance of the Constitution will be the supreme law of the land and that the judges of the courts of every state will be bound thereby, anything in the constitutions and laws of the states to the contrary notwithstanding. Thus it would seem that the state courts are bound to apply the federal common law of negotiable instruments whenever it is applicable, that is, when the Government is the maker of the instrument and the nature or characteristics of the instrument are at issue[43] or when the Government or a federal agency is party to the suit.[44] When the federal government is a party to the litigation, the suit will be brought in the federal courts, and the federal courts have had no difficulty applying the federal law. When a federal statute,[45] however, permits a federal corporation to be sued in a state court or where the nature of a federal instrument is at issue in a suit between private parties in a state court, there is bound to be some difficulty in applying federal law. The state courts, naturally jealous of their jurisdiction and the applicability of the law of the forum, may be understandably slow in exchanging the certainty of the negotiable instruments law of their state for the uncertainty of the federal law.[46] Furthermore, the extent to which the federal law is applicable, though conceivably to all of the issues in the particular case,[47] is really quite uncertain. In *Bank of America Nat'l Trust & Sav. Ass'n v. Parnell*,[48] the Supreme Court, sitting by reason of diversity jurisdiction and thus as if on appeal from a state court, applied both federal and state law, using the question of whether the transaction was essentially local

41. *Id.* at 244.
42. U.S. CONST. art. VI.
43. See cases cited at note 13, *supra*.
44. See text at note 13, *supra*.
45. *E.g.*, Federal Reserve Act, 12 U.S.C. § 264(j) (1959).
46. See text following note 68, *infra*.
47. See text at note 16, *supra*.
48. 352 U.S. 29 (1956).

to determine to which issues state or federal law should be applied.[49] But the Federal District Court of Maryland refused to apply federal law to a suit between private parties on a Government check,[50] and state courts have refused to apply federal law to determine the nature and effect of Government paper.[51]

The *Erie* doctrine, though, denies the existence and constitutionality of a federal common law. Mr. Justice Brandeis, speaking for the majority of the Court in *Erie,* said, "Congress has no power to declare substantive rules of common law applicable in a State whether they be local in their nature or 'general,' be they commercial law or a part of the law of torts. And no clause in the Constitution purports to confer such a power upon the federal courts."[52] Mr. Justice Field, in *Baltimore & O.R.R. v. Baugh,*[53] said:

> I am aware that what has been termed the general law of the country — which is often little less than what the judge advancing the doctrine thinks at the time should be the general law on a particular subject — has been often advanced in judicial opinions of this court to control a conflicting law of the state . . . . But, notwithstanding the great names which may be cited in favor of the doctrine, and notwithstanding the frequency with which the doctrine has been reiterated, there stands, as a perpetual protest against its repetition, the Constitution of the United States, which recognizes and preserves the autonomy and independence of the States — independence in their legislative and independence in their judicial departments. Supervision over either the legislative or the judicial action of the States is in no case permissible except as to matters by the Constitution specially authorized or delegated to the United States. Any interference with either, except as thus permitted, is an invasion of the authority of the State, and, to that extent, a denial of its independence.

The constitutional problem can thus be characterized as a conflict between the operation of the supremacy clause and the possible nonexistence of a constitutional power in the federal government to regulate transactions in commercial paper. In the *Clearfield* case, the Supreme Court summarily pronounced, without discussion, that when an instrument is issued by the government under its constitutional power, rights on the instrument are governed by federal law. But that case directly

49. See text at note 21, *supra.*

50. United States v. Fidelity-Baltimore Nat'l Bank & Trust Co., 171 F. Supp. 1 (D. Md. 1958).

51. McCollum v. Graber, 207 Ark. 1053, 184 S.W.2d 264 (1945); McMurray v. Rhode Island, Inc., 117 A.2d 114 (Munic. Ct. App. D.C. 1955); Crawford v. Alatex Constr. Serv., Inc., 120 So. 2d 845 (La. 1960). See also Stone & Webster Engineer Corp. v. Hamilton Nat'l Bank, 199 F.2d 127 (6th Cir. 1952); United States v. Arnold and S. Bleichroeder, Inc., 96 F. Supp. 240 (S.D.N.Y. 1951).

52. 304 U.S. 64, 78 (1938).

53. 149 U.S. 368, 401 (1893).

involved the rights of the Government as drawer-drawee-plaintiff in a suit in a federal court to recover on the defendant's guarantee of prior endorsements. The rights of private parties were not discussed; but the *Parnell* case, in effect, applied the federal law to the rights of private parties in a suit arising on a Government check, citing *Clearfield,* but without discussing the constitutional power to do so. It, no doubt, could be argued that the power to issue the instrument includes the power to fashion the rules of law governing it,[54] but query whether the banking power is so all embracing. Alternatively, it has been argued that the interpretation of the commerce clause may be enlarged so as to permit federal regulation of all negotiable instruments,[55] but this has not yet been done. It is submitted that such an interpretation would do much to put the cases in which the federal law has been applied by reason of the fact that a federal corporation was involved[56] on a sounder constitutional footing.

In the cases decided before *Clearfield* the basis for the application of federal law would seem to be the constitutional power of the Government to create agencies. But even more questionable than the idea that the banking power includes the power to subject transactions between private parties involving Government paper to federal regulation is the idea that the power to create agencies includes the power to subject the rights of parties to commercial paper, with which the agency subsequently becomes involved, to the federal law. Again, the panacea would seem to be expansion of the area of applicability of the commerce clause. Although this solution would apply only to instruments affecting interstate commerce, almost all the commercial paper afloat could conceivably satisfy this criterion.

III.

SOURCES OF THE FEDERAL COMMON LAW OF NEGOTIABLE INSTRUMENTS.

Once the courts have decided that federal common law applies, as they have in an undefined area of the law of negotiable instruments, they are faced with the problem of where to find it. There is no extensive compilation of federal cases in the area of negotiable instruments and other areas of the law not dealing with the Constitution, treaties, or federal statutes, simply because these areas have been traditionally within the domain of the state courts. Since the *Erie* case held that state law, as such, is to be applied in diversity cases, no federal common law has

54. See Bank of America Nat'l Trust & Sav. Ass'n v. Parnell, 352 U.S. 29, 34 (1956).

55. Dean, *Conflict of Laws Under The Uniform Commercial Code: The Case For Federal Enactment,* 6 VAND. L. REV. 479 (1953).

56. *E.g.,* D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447 (1942); Dietrick v. Greany, 309 U.S.190 (1940); New York, N.H. & H.R.R. v. RFC, 180 F.2d 241 (2d Cir. 1950).

arisen from these cases. Because of this lack of a comprehensive source of federal common law, some judges[57] have chosen to call what they apply the general common law rather than the federal common law. This change of appellation does nothing to alleviate the problem, however. The federal rule is drawn from the general common law, but from whence comes this general common law? The sources are many.

In the *Clearfield* case, Mr. Justice Douglas stated that although the law that developed under *Swift v. Tyson* was a general common law rather than a federal rule, the law of these cases would be a convenient source from which the federal courts might fashion the federal rules.[58] A path that follows the cases decided under *Swift v. Tyson* as a source of the federal law might well be questioned. At the time of *Swift* and kindred cases the law merchant, the "law of the commercial world,"[59] was to be found only in decided cases. Since the beginning of the twentieth century, however, all of the states have adopted the Uniform Negotiable Instruments Law and five states have now abandoned it in favor of the Uniform Commercial Code. The specific intention in enacting such uniform laws has been to clear up the vagaries and uncertainties of the law merchant.[60] Doubtless the uniform acts embody a great deal of the law merchant; but doubtless too, they change much of it and render more certain pronouncements upon situations previously left unsolved by the law merchant. Consequently, to look to the law merchant rather than the uniform acts to determine the federal law would seem to be a step backward, particularly in view of the fact that the laws of the various states are, for the most part, uniform in the field of negotiable instruments.

Of course, the laws of the various states,[61] including the comprehensive statutes,[62] have not been entirely overlooked as sources of the federal law. Even in *Clearfield,* the Court admitted that federal courts occasionally have taken their rule from the law of a state.[63] The basis, however, for determining from what source or sources the courts will draw the rule when the federal law of negotiable instruments is applicable has never been articulated. Hence the rights of the parties to negotiable instruments is doubly uncertain. Not only is it unclear when the courts will apply the federal common law; but once they decide that it controls, one knows not from whence it might come. Perhaps the most accurate

57. *E.g.,* Swift v. Tyson, 41 U.S. (16 Pet.) 1 (1842), which the Court in *Clearfield* cites as one of the sources of the federal law. Clearfield Trust Co. v. United States, 318 U.S. 363, 367 (1943).
58. *Ibid.*
59. Swift v. Tyson, 41 U.S. (16 Pet.) 1, 19 (1842).
60. See BEUTEL'S BRANNAN NEGOTIABLE INSTRUMENTS, 73 (7th ed. 1948); BRITTON, BILLS AND NOTES 19 (1943). See generally, BEUTEL'S BRANNAN, *supra* 1-109; BRITTON, *supra* pp. 1-22. However, while the UNIFORM NEGOTIABLE INSTRUMENTS LAW brought about a great deal more certainty, uncertainties and conflicts of interpretation still exist. No doubt this is the reason for the proposal of the UNIFORM COMMERCIAL CODE.
61. See Clearfield Trust Co. v. United States, 381 U.S. 363, 367 (1943).
62. See New York, N.H. & H.R.R. v. RFC, 180 F.2d 241 (2d Cir. 1950).
63. 318 U.S. 363, 367 (1943).

indication of the source of this federal law was articulated by Mr. Justice Jackson when he said that the courts will consider the aforementioned sources but ultimately will make up their own rule.[64] No doubt this is what every court does when it is presented with a problem of first impression and upon which the legislature has not spoken. This is unnecessary, however, in the field of negotiable instruments because the law has been codified by comprehensive statutes which cover most of the problems. Why then exchange relative certainty for almost total uncertainty?

IV.

THE EFFECT OF HAVING A FEDERAL LAW OF NEGOTIABLE INSTRUMENTS.

The effects of having a federal commercial law are difficult to discern because the very fact that we have such a "body of law" has hardly been realized. But if the courts follow the current trend — and it is not yet certain that they will[65] — the commercial world will experience a rude awakening. Among the current problems, however, is the fact that the areas of the law of negotiable instruments which have been passed upon since the *Clearfield* case are quite narrow. Because of the limited number of issues covered, there is, necessarily, a great deal of uncertainty in the areas which have not yet been covered, uncertainty both as to whether federal law will be applied and uncertainty as to what the rule will be in the event it is applied. It is not difficult to conceive of a conflict of federal interests which might cast even more doubt upon whether the federal law should be applied in certain areas. For example, suppose that as a result of the decision in the *Clearfield* case a bank which handled a great many Government checks set up a large reserve to protect itself against possible losses on Government instruments. The Commissioner of Internal Revenue would very likely disallow such a large reserve, leaving the bank in a rather undesirable position.

Another effect of the federal common law of negotiable instruments is that under the federal law the Government may recover in an action on an instrument while the losing party's recourse against the others has already been foreclosed by state law.[66] The fact that the application of the federal law of negotiable instruments depends upon the identity of

64. D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447, 469 (1942) (concurring opinion). See United States v. Cambridge Trust Co., No. 60-310-W, 1st Cir., Mar. 24, 1961.

65. See Bank of America Nat'l Trust & Sav. Ass'n v. Parnell, 352 U.S. 29, 35 (1956) (dissenting opinion of Justices Black and Douglas).

66. This problem was pointed up in Fulton Nat'l Bank v. United States, 197 F.2d 763 (5th Cir. 1952) (dissenting opinion of Rives, J.). Justice Rives stated that the federal rule, as announced in *Clearfield Trust Co. v. United States,* 318 U.S. 363, 370 (1943), was that the United States could recover if the guarantor of prior endorsements was not damaged by the operation of the federal rule. However, in the *Fulton* case, the hapless guarantor was barred by state law. See also, United States v. Fidelity-Baltimore Nat'l Bank & Trust Co., 173 F. Supp. 565 (D. Md. 1959).

the parties to the litigation necessarily undermines the stability of the commercial paper involved. And it is of prime importance that the rights of parties to commercial paper be certain, for the use of such paper is vital to the commercial world. It has been said that ninety per cent of all business transactions in the United States are settled by check.[67]

Of course there is another problem that may arise with the advent of the federal law of negotiable instruments, namely the maintenance of uniformity. It is certainly not inconceivable, due to the indefiniteness of the areas in which the law will be applied and the numerous and undefined sources from which it may be drawn, that as to questions yet unsettled there will be diverse results among the circuits. The resolution of these diverse results will place a heavy burden upon the Supreme Court[68] and prevent the Court from handling more important constitutional problems.

An analogous problem arises when the question of state court application of federal law is considered. Apparently the power of the federal government to have its own law of negotiable instruments in order to protect the uniformity of government obligations has never been challenged. The same policies which make federal law applicable in federal courts should also make it applicable in state courts, so theoretically the states should apply the federal law of negotiable instruments in certain areas, areas in which federal law may conflict with the law of the state. However, just what areas of the traditional jurisdiction of the states can be constitutionally invaded by the federal law has not been determined. Furthermore, the chances of maintaining uniformity in the law of government obligations will not be enhanced by fifty different states articulating their various opinions on what the substance of the spectral federal law is.

V.

CONCLUSION.

The *Clearfield* case and its successors have created a problem of uncertainty in the field of commercial paper. There is an indefinite number of commercial transactions which is governed by an even more indefinite body of principles. The entire problem arose out of the *Clearfield* case which simply allowed the Government to recover on a cause of action which, had the plaintiff been a private party, would have been barred by plaintiff's failure to give timely notice of a forgery. Thus, the whole problem might have been avoided had the Court employed the principle of judicial restraint and limited its decision to a holding that the failure

67. BRITTON, BILLS AND NOTES 1 (1943).
68. Mishkin, *The Variousness of "Federal Law"*, 105 U. PA. L. REV. 797, 818 (1957).

to give timely notice of a forgery does not operate to bar the sovereign's recovery; but instead it proclaimed that there was a body of substantive law applicable to Government commercial paper.[69] Subsequently, as it has been seen, this concept of a federal law of negotiable instruments has been expanded to include suits between private parties on government instruments, in which suits some of the rights of the parties are governed by the federal law and others are governed by state law. The "uncertainties which inhere in such a dichotomy" of applicable law, as evidenced by the decision in the *Parnell* case, "are obvious."[70] The solution of the problem may require an abandonment of the principle of uniformity of Government obligations, but it would bring about a greater certainty. And if that is necessary, "the business of the United States will go on without that uniformity."[71]

The underlying question is one of choice of law, and this problem exists in the entire field of negotiable instruments. Although some conflicts among the states have arisen concerning choice of law, the interstate problem is not acute because of the wide enactment of the Uniform Negotiable Instruments Act.[72] On the federal level a comprehensive choice of law rule could obviate the entire problem of the federal common law.

The merit of this solution consists largely of the relative simplicity of devising a choice of law rule as compared to the formulation of an entire body of federal substantive law of negotiable instruments.[73] Such a comprehensive rule for choice of law in the field of negotiable instruments has been proposed;[74] and, in fact, before the *Clearfield* case, the Supreme Court had decided the rights and obligations of the federal government in negotiable instruments cases under conflicts of law principles.[75] These cases have never been overruled, and perhaps the *Clearfield* case should be limited, as heretofore indicated, and the solution of the problem created by it effectuated by adoption of a definite body of choice of law rules. The solution, of course, presupposes the rejection

69. There is no doubt that the Government could have recovered under the UNIFORM NEGOTIABLE INSTRUMENTS LAW §§ 65-66, but for the delay in notice. See BRITTON, BILLS AND NOTES § 138 (1943).

70. Bank of America Nat'l Trust and Sav. Ass'n v. Parnell, 352 U.S. 29, 35 (1956) (dissenting opinion of Justices Black and Douglas).

71. Bank of America Nat'l Trust & Sav. Ass'n v. Parnell, 352 U.S. 29, 35 (1956) (dissenting opinion of Justices Black and Douglas).

72. Mishkin, *supra* note 67, at 828.

73. *Id.* at 813.

74. UNIFORM COMMERCIAL CODE § 1-105 (1952). Dean, *supra* note 54. UNIFORM COMMERCIAL CODE § 1-105 (1958).

75. United States v. Guaranty Trust Co., 293 U.S. 340 (1934). The Court held that the law of Yugoslavia governed a Government check which was sent to the payee in Yugoslavia. The Court reasoned that the validity of the transfer of the bill, which was subsequently brought into this country with the consent of the owner, is governed by the law of the place where the transfer occurred. The *Guaranty Trust* case was subsequently cited as authority by the Circuit Court of Appeals for the Tenth Circuit for the proposition that, in a suit by the United States Government on a Government issued check, Oklahoma law would apply. United States v. First Nat'l Bank of Prague, 124 F.2d 484 (10th cir. 1941).

by the Court of the policy of treating the federal government, in its commercial activities, "the same" as a private business enterprise. In addition, it does not relieve the disquieting problem of having the rights and obligations of the federal government determined by the laws of fifty different states.

A solution of this last problem could be effected by the enactment of a comprehensive federal statute and articulation of the constitutional justification therefor. Perhaps the decisions of the Supreme Court in the *Clearfield* and *Parnell* cases were intended as advisory directives to Congress to act within this area. In *Parnell,* the majority of the Court made clear its opinion that Congress had the power to legislate in this area,[76] and the dissenting opinion pointed up the need for a solution to the problem.[77] The Uniform Commercial Code certainly merits attention in the matter as the increasing consideration which it is being given by almost every state legislature indicates. Further, its enactment by Congress would almost certainly bring about an epidemic of positive legislative action within the states. Thus, the desired uniformity, not only of federal rights but of all commercial paper, would be promoted, at least within the United States. And most important, the uncertainty which has plagued this field would be eliminated.[78]

The likelihood that such an enactment would also provide special rules for transactions in Government paper is considerable because it is often difficult, and even impossible, to separate the governmental functions from the business functions of the sovereign. For example, drawing a check on a federal reserve bank to pay an income tax refund is both a governmental and a business function. If it should be found necessary to treat the Government differently from private enterprises, parties dealing with the Government will at least be apprised of this fact, because the areas in which the Government is to be treated differently will be clearly set out. Thus, the primary functions of negotiable instruments law, certainty and uniformity among equals, will be effectuated.

Robert E. Slota

76. Bank of America Nat'l Trust & Sav. Ass'n v. Parnell, 352 U.S. 29, 34 (1956).
77. *Id.* at 35 (dissenting opinion).
78. See Currie, *Federalism and the Admiralty: "The Devil's Own Mess,"* in KURLAND, THE SUPREME COURT REVIEW 158, 160 (1960).