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NOTES AND COMMENTS

Bills and Notes—Finance Companies—Holders in Due Course

The Negotiable Instruments Law expressly sets out the requirements which one must meet in order to become a holder in due course of a negotiable instrument. N. I. L. § 52 provides: "a holder in due course is a holder who has taken the instrument under the following conditions: . . . (3) that he took it in good faith and for value; (4) that at the time it was negotiated to him he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it." The last of these requirements is given fuller meaning by N. I. L. § 56 which provides: "To constitute notice of an infirmity in the instrument or defect in the title of the person negotiating the same, the person to whom it is negotiated must have had actual knowledge of the infirmity or defect, or knowledge of such facts that his action in taking the instrument amounted to bad faith."

In spite of the definiteness with which these requirements are set out, the courts have experienced considerable difficulty, especially in recent years, in applying them to a particular class of holders—finance companies. This difficulty, and a resulting inconsistency in the decisions, is not without cause. A brief analysis of the factual situation out of which these cases arise and of several of the cases themselves will show the source of this conflict.

The notes on which the finance companies seek to recover arise out of a tri-partite transaction in which the buyer purchases certain goods on credit from a dealer, executing his note and a conditional sales contract to the dealer. The dealer, in accordance with previous arrangements, immediately transfers the note and the conditional sales contract to the finance company. As a part of this arrangement, the finance company usually furnishes the dealer with blank forms for the notes and the contracts, with tables from which to compute the amount of installment and interest payments, and in other ways participates in the transaction in varying degrees.

The problem resulting from the above course of dealings between the finance company and the dealer was clearly pointed out by the Maryland court in *Griffin v. Baltimore Federal Savings & Loan Ass'n*,[1] where the court said: "The conflict between the desire on the one hand to protect the conditional vendee from abusive practices and the neces-

[1] 204 Md. 154, 159, 102 A. 2d 804, 806 (1954).

sity on the other hand of preserving the free negotiability of commercial paper has given rise to a divergence of opinion on this point. . . ."[2] In approaching this problem, courts have taken different positions with respect to the conflict.

One view which denies the finance company the status of a holder in due course and which seems to be gaining more support from the courts is very strongly expressed in *Buffalo Industrial Bank v. De Marzio.*[3] There the New York court said that the finance companies have become de facto departments of the businesses without which these businesses could not operate, and that any idea of their being separate organizations was a mere fiction. The court added: "To pretend that they are separate and distinct enterprises is to draw the veil of fiction over the face of fact."[4] The more typical statement of this view is that the finance company is so closely connected with the transaction that it will not be heard to say that it is a holder in due course.

Probably the most influential case espousing this view is *Commercial Credit Co. v. Childs.*[5] In this case the note was attached to the con-

[2] It was unnecessary for this court to indicate its view as to the proper solution of the conflict because of a Maryland statute which provides that when a note is given as a part of an installment transaction, it is to refer to the agreement out of which it arose and, in the hands of any subsequent holder, is to be subject to the same defenses that the buyer could assert against the seller. Another case in which a statutory provision was construed to prevent the finance company from being a holder in due course is General Electric Contracts Corp. v. Heimstra, 69 S. D. 78, 6 N. W. 2d 445 (1942), where the statute defined "seller" as any person who sells goods or "any legal successor in interest" of such person. These statutes seem to represent a retreat from the strict "actual notice" and bad faith requirements of the N. I. L. Also, it is interesting to note that the Uniform Commercial Code has adopted less stringent requirements, under which these same results could possibly be reached. It provides:

"Section 1-201. General Definitions.

(19) 'Good faith' means honesty in fact in the conduct or transaction concerned.

(25) A person has 'notice' of a fact when
- (a) he has actual knowledge of it; or
- (b) he has received a notice or notification of it; or
- (c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists.

"Section 3-302. Holder in Due Course.

(1) A holder in due course is a holder who takes the instrument
- (b) in good faith including observance of the reasonable commercial standards of any business in which the holder may be engaged; and
- (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person."

The above provisions would replace N. I. L. § 52 and N. I. L. § 56. The "has reason to know" and "reasonable commercial standards" provisions of the above sections would, seemingly, enable the courts more readily to deny the finance company the position of a holder in due course. For a discussion of these provisions and the "good faith rule" generally, see Note, 30 N. C. L. REV. 395 (1952).

[3] 162 Misc. 742, 296 N. Y. Supp. 783 (City Ct. Buffalo 1937), *rev'd on other grounds*, 6 N. Y. S. 2d 568 (Sup. Ct. 1937).

[4] Buffalo Industrial Bank v. De Marzio, 296 N. Y. Supp. 783, 785-786 (City Ct. Buffalo 1937).

[5] 199 Ark. 1073, 137 S. W. 2d 260 (1940). This case is discussed in Notes, 53 HARV. L. REV. 1200 (1940), 20 U. OF CIN. L. REV. 123 (1951). Also see Note, 128 A. L. R. 729 (1940).

tract, both were executed at the same time, and on the back of each was a printed assignment to the finance company. Immediately after the instruments were executed they were assigned to the finance company. The Arkansas court held that the finance company was so closely connected with the transaction that it could not maintain that it was a holder in due course; that for all intents and purposes the finance company was a party to the instrument from the beginning.[6]

Another case attracting considerable attention is *Commercial Credit Corp. v. Orange County Machine Works.*[7] There the facts were similar to those in the *Childs* case, but there was also evidence that the finance company had been twice consulted by telephone as to the details of the transactions. The California court in holding that the finance company was not a holder in due course said that it had actively participated in the transaction from its inception.

In *Mutual Finance Co. v. Martin,*[8] in addition to the facts that were present in the *Childs* case, these further facts appeared: the finance company's name was in bold print at the top and throughout the body of the contract and the note, and its office was designated as the place of payment. On the day before the sale took place, the finance company investigated the buyer's credit standing, approved the terms of both instruments, and agreed to purchase them as soon as the transaction was consummated. The Florida court also relied on the "close connection" between the finance company and the dealer to deny the finance company the position of a holder in due course.[9]

Another group of cases appear to be distinguishable from those just considered in that they find an agency relationship to exist between the finance company and the dealer, impute the agent's knowledge to the principal, and thereby hold that the finance company is not a holder in due course. Actually, however, in many of these cases this distinction appears to be one of labeling only, as the courts rely on the same factors on which the cases previously considered relied, and place con-

[6] Here the finance company brought an action to recover possession of the goods. It is usually held that in a suit to recover the goods, the buyer may assert any defense that he has against the seller, even against the seller's transferee. 2 WILLISTON, SALES § 332 (Rev. ed. 1948). This possible distinction has apparently been ignored by the courts following the *Childs* case. See Note, 152 A. L. R. 1222 (1944), where the writer attempts to weave a pattern of consistency into the cases on the basis of this distinction.

[7] 34 Cal. 2d 766, 214 P. 2d 819 (1950). This case is discussed in Notes, 28 NOTRE DAME LAW. 257 (1952), 23 So. CALIF. L. REV. 580 (1950).

[8] 63 So. 2d 649 (Fla. 1953).

[9] Other cases denying the finance company the status of a holder in due course because of the close relationship between it and the dealer are Schuck v. Murdock Acceptance Corp., 220 Ark. 56, 247 S. W. 2d 1 (1952); International Harvester Co. of America v. Watkins, 127 Kan. 50, 272 P. 139 (1928); C. I. T. Corp. v. Emmons, 197 So. 662 (La. 1940); General Motors Acceptance Corp. v. Swain, 176 So. 636 (La. 1937); Taylor v. Atlas Security Co., 213 Mo. App. 282, 249 S. W. 746 (1923).

siderable weight on the *Childs* case. Typical of this group of cases is *Palmer v. Associate Discount Corp.*,[10] where the United States Court of Appeals for the District of Columbia Circuit, in reaching the above result, relied heavily on the printed forms used in carrying out the transaction. It pointed out that the name of the finance company appeared on the face of these forms in large type and that under five different types of assignments, printed on the back, the dealer assumed the obligation of repurchasing the automobile in case of default. These assignments incorporated various agreements ranging from a full repurchase to the payment of a certain sum for a release. The court said that the forms clearly showed that they were prepared for use in the financing of automobile installment sales, that they revealed the dealer and the finance company to be closely associated in the business, and that the provisions in the printed assignments were particularly suggestive of a close relationship between the dealer and the company. The finance company, the court concluded, was acting as the dealer's agent in demanding payment on the note.[11]

The above cases illustrate that the courts have come to use "closely connected," "active participation," or similar terms in describing varying degrees of *actual* participation by the finance company in the original transaction between the dealer and the purchaser. Some of these courts, in so doing, have failed to examine the facts to determine whether there was "actual notice" or bad faith as required by the N. I. L., but have relied on this "closeness" in itself to infer such notice or bad faith. Further, it appears that some of these courts have used this as a device to arrive at results that are somewhat doubtful[12] under the N. I. L., as they, in justifying the results reached, look beyond the N. I. L. to policy considerations.[13]

[10] 124 F. 2d 225 (D. C. Cir. 1941).

[11] Other cases where an agency relationship was found to exist are United States v. Schaffer, 33 F. Supp. 547 (D. Md. 1940); Bastian-Blessing Co. v. Stroope, 203 Ark. 116, 155 S. W. 2d 892 (1941); International Harvester Co. v. Carruth, 23 So. 2d 473 (La. 1945).

[12] In many of these cases there is nothing to indicate that such facts were present as to charge the finance company with "actual notice" or bad faith, and the courts relied on this "closeness" alone to deny the finance company the status of a holder in due course.

[13] These policy considerations relate mostly to the inequality in the bargaining positions of the finance company and the buyer and the ability of the finance company to bear more readily any resulting loss. It is also contended that marketability is not seriously affected as the notes retain their negotiable quality in the hands of persons beyond the finance company. This contention seems to ignore the practical consideration that there must be some large primary market, as finance companies, for these papers which are executed on a mass scale today, and that by denying the finance companies the protection of being holders in due course, the existence of such a market would be adversely affected. There would probably be a reduction in the size of the market and an increase in the amount of financing charges, both of which would limit the accessibility of this market to the public.

A recent case[14] taking a more discriminating approach to the problem deserves attention. There the finance company was founded by certain dealers for the express purpose of providing financing services solely to the members of a dealer association of which some of them were members. The finance company, which had purchased notes from a particular dealer over a four year period, supplied blank forms containing a printed assignment, furnished financial statement forms, and purchased the instruments immediately upon the completion of the transaction. The defendant purchaser contended that the finance company was so closely associated with the transaction as to make it an original party. In rejecting this contention the Wisconsin court expressly refused to follow the *Childs* and *Martin* cases, which, according to the court, held that the supplying of forms by the finance company to the dealer tended to establish direct participation by the finance company in the transaction between the dealer and the purchaser.

The court then pointed out the following: a large segment of our economy is dependent upon this source of credit. For the finance company to purchase these instruments executed on forms with which it is not familiar necessitates either the delay of an investigation or the taking of considerable risk by the finance company, either of which could seriously impair the usefulness of this method of financing. By furnishing its own forms the finance company avoids both of these dangers. The court concluded that it could see no reason why finance companies supplying such forms should be held thereby to have made the dealers their agents or to have participated in the sale.

Another case, in which the Louisiana court approaches the problem with considerable frankness, is *White System of New Orleans v. Hall.*[15] Here again the finance company furnished forms and installment tables and agreed in advance to purchase the notes as soon as the sale was completed. The court, in finding that the finance company was a holder in due course, recognized that there was some justification in the view that the finance company was using the N. I. L. as a shield to get an unfair advantage over the purchaser, but said that steps to correct this would have to be taken by the legislature and not by the courts in view of the clear provisions of the Negotiable Instruments Law.[16]

[14] Implement Credit Corp. v. Elsinger, 268 Wis. 143, 66 N. W. 2d 657 (1954), *rehearing denied*, 67 N. W. 2d 873 (1953).

[15] 219 La. 440, 53 So. 2d 227 (1951).

[16] Other cases holding that the course of dealings between the finance company and the dealer did not prevent the finance company from being a holder in due course are Citizens & Southern National Bank v. Stepp, 126 F. Supp. 744 (N. D. Fla. 1954) (The court distinguished this case from the *Martin* case, *supra* note 8, in that here the name of the finance company did not appear in the forms furnished; other finance companies, as well as the plaintiff purchased these instruments; and there was no participation in the transaction by the finance company.); Allied Building Credits, Inc. v. Mathewson, 335 Mich. 270, 55 N. W. 2d 826 (1952); Mayer v. American Finance Corp. 172 Okla. 419, 45 P. 2d 497 (1935).

If, in fact, there is present a situation so fraught with the possibility of fraud or unfairness that the statutory provisions of the N. I. L. are not adequate, then it seems that legislation is the only sound solution. Nothing but uncertainty can arise out of an encroachment upon these statutory provisions by judicial decisions. Undoubtedly this situation presents a ripe opportunity for collusion between unscrupulous finance companies and dealers to take unfair advantage of the buyer.[17] Clearly in some cases the finance company has actually participated in the transaction to such an extent that it cannot be a holder in due course within the statutory provisions. But in other cases there is no evidence of such direct participation in the transaction by the finance company as would charge it with "actual notice" or bad faith as required by the N. I. L. In the absence of additional legislation, it is submitted that innocent finance companies that come within the definition of a holder in due course under the existing statutes, should not be deprived of that position because of a tendency of the courts to "catalogue" them in the same class with unscrupulous companies by the indiscriminate or deliberate use of such terms as "close connection." Such a result seems especially unreasonable in the light of the fact that a certain amount of participation by the finance company, as pointed out earlier, is essential in order to avoid unreasonable delay or risks.[18]

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State Tort Claims Act—Construction

In three recent cases[1] the question whether the North Carolina Tort Claims Act[2] should be strictly or liberally construed has been presented to the court. In *Lyon & Sons v. Board of Education*,[3] the issue was

[17] In Davis v. Commercial Credit Corp., 87 Ohio 311, 94 N. E. 2d 710 (1950), the court found that the finance company engaged in a conspiracy with the dealer to defraud the buyer. But for something of a reversal of the usual situation see Mutual Finance Corp. v. Dickinson, 123 N. J. L. 62, 7 A. 2d 859 (Sup. Ct. 1938) and Motor Finance Corp. v. Huntsberger, 116 Ohio St. 317, 156 N. E. 111 (1927), where the courts indicated that if any collusion existed, it was between the purchaser and the dealer.

[18] Another problem which frequently arises is whether the simultaneous execution of the note with a conditional sales contract destroys its negotiability. According to the weight of authority it does not. Commercial Credit Corp. v. Orange County Machine Works, 34 Cal. 2d 766, 214 P. 2d 819 (1950); Mutual Finance Co. v. Martin, 63 So. 2d 649 (Fla. 1953); Implement Credit Corp. v. Elsinger, 268 Wis. 143, 66 N. W. 2d 657 (1954), *rehearing denied*, 67 N. W. 2d 873 (1955); 2 WILLISTON, SALES § 332, p. 291 (Rev. ed. 1948). But some cases have held that negotiability is destroyed. Note, 98 U. OF PA. L. REV. 244 (1949).

[1] Floyd v. State Highway and Public Works Commission, 241 N. C. 461, 85 S. E. 2d 703 (1955); Alliance Co. v. State Hospital at Butner, 241 N. C. 329, 85 S. E. 2d 386 (1955); Lyon & Sons v. Board of Education, 238 N. C. 24, 76 S. E. 2d 553 (1953).

[2] N. C. GEN. STAT. § 143-291 *et seq.*, as amended in 1953.

[3] 238 N. C. 24, 76 S. E. 2d 553 (1953). Discussed in note, 32 N. C. L. REV. 242 (1954), as to subrogation.