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# Bills and Notes -- Holder in Due Course -- Finance Companies

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the well established doctrine[28] which permits the taking of jurisdiction in the first instance in order to determine jurisdiction. The refusal of the Virginia Court to make a further finding of fact left the Supreme Court in the position to dismiss the case for lack of a federal question since, theoretically, it never had one before it. This would be only a reaffirmance of the doctrine invoked in the *Rescue Army* case and not a recognition of an evasion of its mandate. It should be noted that such a disposition of the case would not prejudice the constitutional questions involved from being raised again in a subsequent case.

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**Bills and Notes—Holder in Due Course—Finance Companies**

In an era characterized by a phenomenal upward surge of retail installment purchasing,[1] the comparative serenity of appellate litigation in the field of negotiable instruments has been consistently interrupted by cases arising out of financial credit arrangements. Such arrangements consist of informal agreements, usually of long standing, between dealers and finance companies whereby the latter purchases commercial paper arising out of a sale to the consumer. The finance company usually supplies the blank forms for notes and conditional sales contracts as well as supervises, to varying degrees, the terms of credit. The question is thus presented: Do such credit arrangements cause the finance company to become an active participator in the sale to the consumer so as to preclude it from being a holder in due course of the transferred paper?

Notwithstanding the fact that the Negotiable Instruments Law sets out precise standards[2] for the determination of this question, several jurisdictions have judicially effected other criteria which, upon application to these credit arrangements, have denied the finance company the protection afforded a holder in due course.[3] In a recent case of first

[28] "Whether the statutory requirements (for appellate review) have been met is itself a federal question." Honeyman v. Hanan, 300 U. S. 14, 16 (1936).

[1] Installment credit reached an estimated total of $1,593,000,000 for the year ending March 31, 1955. This figure represents credit extended only for the purchase of consumer goods secured by the items purchased, title being held either by the retail outlets or financial institutions. 39 CONSUMER FINANCE NEWS no. 12, p. 31 (1955).

[2] N. I. L. § 52: "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 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."

N. I. L. § 56: "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."

[3] Such results are reached on the basis that when the finance company and dealer engage in preconceived credit arrangements, the company, which is better able to bear the risk of loss than the hard pressed consumer, has become a party to the original transaction and is subject to defenses available against the dealer. See

impression,[4] North Carolina was placed in accord with these jurisdictions.

In that decision, Roofing Co. negotiated to Mortgage Corp. Customer's note secured by a deed of trust. Customer, alleging fraud by Roofing Co., brought an action for cancellation of the note and deed of trust. The issue of fraud having shifted the burden of proof to the holder,[5] Mortgage Corp. introduced evidence showing that it had furnished the forms for the note and deed of trust, on the back of which appeared its name; that it had purchased similar notes over a course of dealing with Roofiing Co. without previous defenses being asserted; that the note was payable at its offices and the deed of trust named one of its officials as trustee; that it had no actual notice of any defenses Customer might have, but took the instruments in reliance on their ostensible regularity. The court held that such evidence was sufficient to support a jury finding that Mortgage Corp. could not be a holder in due course and was thus subject to defenses of Customer. In so holding, the court completely shunned the test of actual notice or bad faith and relied instead on the active role played by Mortgage Corp. in the transaction between Roofing Co. and Customer.[6]

A survey of recent case law and existing statutes reveals that the area

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Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S. W. 2d 260 (1940) (finance company supplied forms on which there was printed an assignment to the company; transfer made immediately following the sale); Commercial Credit Corp. v. Orange County Machine Works, 34 Cal. 2d 766, 214 P. 2d 819 (1950) (finance company supplied forms; twice consulted as to the dealer-purchaser transaction); Mutual Finance Co. v. Martin, 63 So. 2d 649 (Fla. 1953) (finance company supplied forms; its name in bold print on the instruments; company's office designated as place of payment); General Motors Acceptance Corp. v. Daigle, 72 So. 2d 319 (La. 1954) (finance company furnished forms, financed sale; instruments made payable at company's office). The *Daigle* case is discussed in Note, 53 MICH L. REV. 877 (1955).

In addition to the cases based on close participation, several courts have adopted an agency theory, whereby the finance company, as a consequence of the credit arrangement, is deemed to be the principal of the retailer and thus knowledge of the dealer is imputed to the company. Palmer v. Associate Discount Corp., 124 F. 2d 225 (D. C. Cir. 1941); Buffalo Industrial Bank v. De Marzio, 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). For a discussion of these cases, see Note, 33 N. C. L. REV. 608 (1955).

[4] Whitfield v. Carolina Housing & Mortgage Corp., 243 N. C. 658, 92 S. E. 2d 78 (1956).

[5] N. I. L. § 59: "Every holder is deemed prima facie to be a holder in due course; but when it is shown that the title of any person who has negotiated the instrument was defective, the burden is on the holder to prove that he or some person under whom he claims acquired the title as a holder in due course."

[6] Note, 33 N. C. L. REV. 608, 613 (1955), where the writer points out that "(N)othing but uncertainty can arise out of an encroachment upon these statutory provisions [the Negotiable Instruments Law] by judicial decision." He further comments that to undermine the position of the finance company's status as a holder in due course, when no actual knowledge or bad faith has been shown, would seriously curtail the outlet for the sale of commercial paper arising out of installment purchasing and "limit the accessibility of this market to the public." See also in this connection Note, 39 MINN. L. REV. 775, 776 (1955).

upon which the North Carolina Supreme Court has so freshly trod is in utter conflict.

In *Public Loan Corp. of Little Rock v. Terrell*,[7] an Arkansas case, buyer purchased an appliance from retailer, executing a note secured by a conditional sales contract. On the same day, retailer assigned the note and contract to finance company, which had prepared blank notes and contract forms used in the transaction. There was no evidence of actual notice or bad faith. In an action to collect on the note, buyer raised the defense of failure of consideration, the appliance being wholly defective. The court held that the defense was not tenable, since plaintiff was a holder in due course. It stated that evidence of preparing forms and taking an assignment immediately after the sale fell short of establishing actual participation; that there being no evidence of actual notice or bad faith, finance company was not precluded from being a bona fide purchaser.

It should be noticed that only some years before, this same Arkansas court held in *Commercial Credit Co. v. Childs*[8] that the finance company was not a holder in due course because it had *prepared forms* on which there was a written assignment to the company and the transfer of the note and contract *was on the same day as the sale*.[9] The *Terrell* case neither cites nor mentions the *Childs* case.

In *Clark v. Associated Discount Corp.*,[10] the Georgia court stated that merely because a note is made on a form furnished by the finance company and made payable at its offices, and the company makes inquiries as to the purchaser's credit standing does not, without more, subject the transferee to notice of any infirmity of the instrument or defect in the title.[11]

This decision should be compared with *Mutual Finance Co. v. Martin*,[12] where the Florida court held that plaintiff finance company could not be a holder in due course on ostensibly the same set of facts.

[7] 224 Ark. 616, 275 S. W. 2d 435 (1955).
[8] 199 Ark. 1073, 137 S. W. 2d 260 (1940).
[9] Also contrast with the *Terrell* case Schuck v. Murdock Acceptance Corp., 220 Ark. 56, 247 S. W. 2d 1 (1952), where the court held that the participation of the finance company in the credit arrangement was such as to prevent it from becoming a holder in due course.
[10] 92 Ga. App. 583, 89 S. E. 2d 208 (1955).
[11] See also Aid Investment & Discount, Inc. v. Younkin, 66 Ohio L. Abs. 514, 188 N. E. 2d 183 (1951), where the evidence disclosed that upon the face of the instrument, in bold type, appeared "Payable at the Office of Aid Investment & Discount, Inc." and on the reverse side appeared the plaintiff's name. The court held that this fact would not alone support the conclusion that plaintiff is not a holder in due course. "It is a custom of long standing for banking institutions to provide notes for their customers on the face of which is printed in large type 'payable at designated bank.' To hold that this in and of itself is proof that the bank is jointly interested with the payee of a note would not be a reasonable deduction; nor would the fact alone that an endorsee of a note makes inquiry as to the transaction wherein the note was given and the financial ability of the maker to pay establish any joint relationship. . . ." *Id.*, at 518, 188 N. E. 2d at 187.
[12] 63 So. 2d 649 (Fla. 1953).

Moreover, only one year after the *Martin* case was decided, a federal court sitting in the same state held that evidence showing that the finance company furnished forms to the dealer and that such forms contained an advertisement of the company was not sufficient to constitute that degree of participation necessary to render the finance company subject to defenses.[13]

There is, however, support in recent cases for the North Carolina position. In *United States v. Klatt*,[14] defendant's note was assigned to a bank before maturity, which it in turn assigned to the plaintiff after maturity. Plaintiff contended that it was immune from defenses since it derived its title from a holder in due course.[15] There was evidence that the bank supplied the forms used in the dealer-purchaser transaction together with a borrower's completion certificate required by legislation.[16] Although the court could have held the bank not a holder in due course because it was charged with notice that the purchaser's name had been forged on the certificate, it found that:

> ". . . the relationship between the payee named in the instrument in suit and the bank, as to the entire transaction giving rise to the instrument was such that the bank must be considered in effect a party to the transaction between named payee-dealer and the defendant."[17]

The use of the close participation criteria on such meager evidence undoubtedly invites criticism. But what is even more startling than the result reached is the fact that here, a bank, rather than a finance company, was held not to be a bona fide purchaser because of an "active" role played in the credit arrangement.[18] Certainly banks do not engage in the financing of consumer goods to that degree practiced by financing companies. But even in those cases where banks do so engage, the transaction is probably an isolated one, not a part of a preconceived credit arrangement which anticipates the continual flow of commercial paper. Seemingly it would follow that courts would scrutinize commer-

[13] Citizens & Southern National Bank v. Stepp, 126 F. Supp. 744 (N. D. Fla. 1954).

[14] 135 F. Supp. 648 (S. D. Cal. 1955).

[15] N. I. L. § 58: "But a holder who derives his title through a holder in due course and who is not himself a party to any fraud or illegality affecting the instrument, has all the rights of such former holder in respect to all parties prior to the latter."

[16] The loan being applied for under the National Housing Act, the borrower was required by statute to fill out a borrower's completion certificate evidencing the title of the chattel securing the loan.

[17] United States v. Klatt, 135 F. Supp. 648, 650 (S. D. Cal. 1955).

[18] See also Public National Bank & Trust Co. v. Fernadez, 121 N. Y. S. 2d 721 (Mun. Ct. N. Y. C. 1952), where the court, in denying plaintiff's motion for summary judgment, echoed the holding of the *De Marzio* case, cited note 3 *supra*, and stated that the dealer could be found to be a mere agent of the plaintiff bank.

cial transactions between banks and dealers less acutely and be guided, not by judicially created standards, but rather by the presence of actual notice or bad faith.[19]

In addition to the formula established by some courts in settling such controversies, several states have adopted legislation which virtually precludes the finance company or bank from becoming a holder in due course.[20] In essence, the fiat of these provisions is that all notes given in credit transactions and secured by a conditional sale (or chattel mortgage) shall state upon their face that they are so secured, and that no transferee of such notes shall be immune from the defenses available by the maker against the payee.[21] Since the vast majority of the cases under consideration involve credit financing by means of promissory notes secured by the retention of title of the item purchased, these statutes obviously undermine the security of the finance company's position.

The law thus remains unsettled. However, the position taken by the courts in the *Terrell* and *Clark* decisions in utilizing the standards as incorporated in the Negotiable Instruments Law is encouraging. Certainly the innocent consumer should not be subjected to the unscrupulous activities which might arise from a dealer-finance company partnership. But in such cases of close participation, recourse may be had to the elastic provisions of section 56 and if such participation renders the finance company incapable of taking the commercial paper in good faith, it will be denied the holder in due course status.

The protection of the consumer must be balanced against encouragement of credit sales essential to the maintenance of national prosperity. It is a policy conflict that cannot be arbitrarily settled; rather, there must be flexibility. It is submitted that neither the judicially created criteria of close participation, which categorically denounces the credit arrangement whether there is bad faith or not, nor the above mentioned statutes, which arbitrarily exclude an important segment of the economy from protection, affords this flexibility; that the result expressed in the *Terrell*

[19] Compare with this observation the excerpt from an address by Owen L. Coon, banker and finance company executive, concerning finance companies as opposed to banks as appropriate financing agencies for installment selling: "You must understand that the dealer is, to a great extent, a partner of the finance company. The relationship in paper form may be that of debtor and creditor. Regardless of that however, the finance company is, in many ways, the partner of the dealer and must always so remain. Bankers, on the other hand, must always shun relationships that in theory as well as in practice have possibilities of turning out to be partnerships." 23 AMERICAN J. OF INS. No. 2, 18, 20 (1946).

[20] ILL. REV. STAT. c. 95, § 26 (1953); MD. CODE ANN. art. 83, § 134 (FLACK 1951); PA. STAT. ANN. tit. 69, § 615G (PURDON, Supp. 1954).

[21] It is interesting to note that the Pennsylvania and Maryland statutes do not set out the consequences of not complying with the provisions. Only the Illinois statute states that if these provisions are not met, the chattel mortgage securing the notes "shall be absolutely void."

and *Clark* decisions should be seriously considered in the determination of future conflicts arising in this area.

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**Conflict of Laws—Workmen's Compensation—Application of Full Faith and Credit to Statutes and Awards**

Shortly after the introduction of the first workmen's compensation statutes,[1] the courts faced the problem of their application where an employee had been hired in one state and was injured in a sister state. Prior to 1932 each state decided whether the situation permitted the application of her own act.[2] The claimant, suing in the *locus delicti,* usually succeeded in invoking the application of its statute.[3] In some instances, however, certain restrictive statutory provisions prevented the state of the injury from applying her act[4] and the employee had to resort to suit in the state where his contract had been made.[5] In these cases suit had to be brought in the state of the contract in order to obtain the benefit of that state's act, as the state of the injury considered the cause of action created by the foreign act to be so interwoven with the remedy that it felt compelled not to enforce it.[6] Occasionally, the requirements

[1] Wisconsin's workmen's compensation act was the first to take effect (1911). SOMERS, WORKMEN'S COMPENSATION 32 (1954). The New York statute was the first to be declared constitutional by the United States Supreme Court. N. Y. Central Railroad Co. v. White, 243 U. S. 188 (1917).

[2] LARSON, WORKMEN'S COMPENSATION LAW § 86.20 (1954).

[3] Ocean Accident & Guarantee Corp. v. Ind. Comm'n, 32 Ariz. 275, 257 Pac. 644 (1927); Farr v. Babcock Lumber & Land Co., 182 N. C. 725, 109 S. E. 833 (1921); Interstate Power Co. v. Ind. Comm'n, 203 Wis. 466, 234 N. W. 889 (1931). However, where the statute of the place of the injury is of the contractual type, the courts have refused to apply their acts to injuries within the state, if the hiring had been elsewhere. Hall v. Ind. Comm'n, 77 Colo. 338, 235 Pac. 1073 (1925); Barnhart v. American Concrete Steel Co., 227 N. Y. 531, 125 N. E. 675 (1925).

Bagnel v. Springfield Sand & Tile Co., 144 F. 2d 65 (1st Cir. 1944), *cert. denied* 323 U. S. 735 (1944) seems to be the first case in which a court permitted recovery for an injury in the forum (Massachusetts) though all other incidents of employment were elsewhere (New York). But it is now well established that the state in which the injury occurred may give an award. Carroll v. Lanza, 349 U. S. 408 (1955); Pacific Employers Ins. Co. v. Industrial Acc. Comm'n, 306 U. S. 493 (1939).

[4] 2 LARSON, WORKMEN'S COMPENSATION LAW § 87.14 (1952).

[5] Grinnel v. Wilkinson, 39 R. I. 447, 98 Atl. 103 (1916); Gooding v. Ott, 77 W. Va. 487, 87 S. E. 862 (1916).

The United States Supreme Court has held that the state of the contract may give an award. Alaska Packers Ass'n v. Industrial Acc. Comm'n, 294 U. S. 532 (1935). Twelve states confer coverage regardless of where the injury occurred if the contract was made in the state; Nevada requires also that the employee is in regular employment in the state; California and Michigan require that the employee also be in residence there. Other states permit recovery only if more than two factors coincide; *e.g.,* N. C. GEN. STAT. § 97-36 (1950): "If the contract of employment was made in this State, if the employer's place of business is in this State, and if the residence of the employee is in this State; provided his contract of employment was not expressly for service exclusively outside of the State."

[6] In Mosely v. Empire Gas & Fuel Co., 313 Mo. 225, 281 S. W. 762 (1925), the claimant could not proceed in the Missouri court under the Kansas Work-