
HOLDERS IN DUE COURSE

I. ACQUIRING HOLDER IN DUE COURSE STATUS

If you remember the rule that a holder in due course takes free of most of the defenses the parties to the original transaction have against one another, it is easy to see why it is important to determine if the person currently possessing the instrument qualifies as a holder in due course. The basic definition is found in §3-302(a), which you should read carefully.

Official Comment 4 to §3-302 makes it clear that the *payee* can qualify as a holder in due course in some rare situations. Normally, the payee is so involved in the underlying transaction that he or she has notice of problems affecting payment obligations, and thus cannot be a holder in due course. But the examples given in Official Comment 4 describe fact patterns where the payee is innocent of such knowledge and can therefore qualify for the protection given to holders in due course. See also *Eldon's Super Fresh Stores, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 296 Minn. 130, 207 N.W.2d 282, 12 U.C.C. Rep. Serv. 490 (1973), for an example of the payee as a holder in due course.

Subsection (c) gives a list of extraordinary transactions—creditors seizing instruments by judicial process, the sale of an inventoried business (a “bulk transaction”), or the appointment of the administrator of an estate containing negotiable instruments—in which the transferee is statutorily denied holder in due course status.¹

A. “Holder”

Note first of all that in order to be a holder in due course the possessor of the instrument must qualify as a *holder*. This means that the instrument must be technically *negotiable* and must have been technically *negotiated* into the hands of its current possessor (however, the named payee becomes a holder on issuance of the instrument without the necessity of a negotiation, as does anyone to whom a bearer instrument is issued). No one can be a holder in due course of a non-negotiable instrument, nor even of a negotiable instrument if there is some defect in the transfer (negotiation) process.

One technical point: the drawee bank on which a check is drawn, taking the check for payment, does not qualify as a “holder.” The reason is that an instrument must be *negotiated* to a holder, and the process by which the drawee bank acquires the instrument is not a negotiation, it is a mere surrender for payment (a “presentment”). Thus the drawee bank is not a holder, and consequently not a holder in due course.

B. “Value”

It is important to emphasize that whether or not someone qualifies as a holder in due course is measured at the moment he or she gave value for the instrument (assuming there has been a valid negotiation so as to create holder status). Things that happen after value is given (such as receiving notice of problems with the instrument) do not destroy holder in due course status once achieved.

1. In spite of §3-302(c), which would seem to reach the opposite result, the federal courts have held that federal agencies such as the FDIC when taking over failed financial institutions acquire holder in due course status as a matter of federal law. *Campbell Leasing, Inc. v. FDIC*, 901 F.2d 1244, 12 U.C.C. Rep. Serv. 2d 138 (5th Cir. 1990); but see *DiVall Insured Income Fund Ltd. Partnership v. Boatmen’s First National Bank*, 69 F.3d 1398, 28 U.C.C. Rep. Serv. 2d 589 (8th Cir. 1995). However, the federal courts have made it clear that the FDIC cannot be a holder in due course for non-negotiable instruments; *Sunbelt Savings, FSB, Dallas, Texas v. Montross*, 923 F.2d 353, 13 U.C.C. Rep. Serv. 2d 792 (1991).

What is “value”?

First of all, the *gift* of an instrument will never create holder in due course status in the donee (though the donee may get similar rights under the *shelter* rule, discussed below). The confusing part of the value requirement is that giving value is not the same thing as giving *consideration*. Read §3-303’s Official Comment 1, first paragraph. The drafters of the Code decided that one gives value only to the extent that the holder has performed the consideration or made some irrevocable commitment in connection with it. If all that has been exchanged for the instrument is an unexecuted promise and then a problem arises, the holder has the self-help remedy of refusing to perform and does not need the extraordinary status of holding in due course; thus, the holder has not given *value* under the Code. This is true even though the promise would be sufficient consideration at common law. Read §3-303 and its Official Comment and then resolve the Problems that follow.

PROBLEM 20

Joe Lunchpail arrived home one day to find a note from his wife stating that she was divorcing him and that he should get a lawyer. Since he had just been paid that day, he took his paycheck down to the law office of Nathan Novice and indorsed it over to Nathan in return for the latter’s promise to represent Joe in his divorce. Later that evening, Joe’s wife sent the sheriff to seize his paycheck. Joe laughingly referred the sheriff to his attorney. Can the sheriff succeed in wresting the check from Nathan’s hands? See §§3-306, 3-303; *Carter & Grimsley v. Omni Trading, Inc.*, 306 Ill. App. 3d 1127, 716 N.E.2d 320, 39 U.C.C. Rep. Serv. 2d 484 (1999).

PROBLEM 21

Zach Taylor bought a car for his business from Fillmore Motors, signing a promissory note for \$23,000 payable to Fillmore. Fillmore sold the note to the Pierce Finance Company for \$22,800, a \$200 discount. The car fell apart, and Zach refused to pay. Is the finance company (assuming good faith and lack of notice) a holder in due course for \$23,000 or \$22,800? See *Bankers Guar. Title & Trust Co. v. Fisher*, 2 Ohio Misc. 18, 204 N.E.2d 103 (C.P. 1964). If Millard Fillmore, the owner of Fillmore Motors, owed his mother \$21,000 and gave her the note with the understanding that the extra \$2,000 was a Mother’s Day gift, would the mother be a holder in due course for the full amount? See §3-303.

PROBLEM 22

Tom Winker tricked old Mrs. Nodding into writing a check payable to Tom (she thought he was the agent for a local charity). The check for \$1,000 was drawn on her bank, the First County Bank. Tom took the check to his bank, the Last National Bank, and, after indorsing it, put it in his checking account. Last National Bank sent the check to the First County Bank for payment, but by the time it got there Mrs. Nodding had stopped payment so that the check was dishonored and returned to Last National. Is Last National Bank a holder in due course? This question will be important if Tom has skipped town and Last National decides to sue Mrs. Nodding under §3-414.

The bank's major problem in situations like Problem 22 is in proving that it *paid* value for the check. Is the bank out of pocket anything? If so, the Code will permit the bank to recover. Thus, if the bank had permitted Tom to get the money *before* the check cleared through the drawee bank, the Last National Bank would be a holder in due course. Article 4 of the UCC (which deals with bank collection) sets out special rules for this kind of value. Section 4-211 provides that for purposes of determining its holder in due course status, a bank gives *value* whenever it has a security interest in the instrument. The situations in which this occurs are spelled out in §4-210(a). Read these sections, and consider the following case.

Falls Church Bank v. Wesley Heights Realty, Inc.

District of Columbia Court of Appeals, 1969
256 A.2d 915, 6 U.C.C. Rep. Serv. 1082

HOOD, J.

The sole issue on this appeal is whether and under what circumstances, may a depository bank achieve the status of holder in due course of negotiable paper deposited with it by a customer. The facts are undisputed.

The appellees drew a check for \$1,400.00, payable to the order of a customer of appellant bank. The customer deposited this check in his account with the bank and was given a provisional credit of this amount. The customer was permitted to withdraw \$140.00 from this account prior to the bank's discovering that appellees had stopped payment on the \$1,400.00 check. When the check was returned to the bank dishonored, the bank's customer had "skipped," leaving no credits in his account on which to charge the \$140.00. The bank, thereupon, made demand on appellees for that amount and when appellees refused, this action was brought.

At trial appellees moved for, and were granted, judgment on grounds that the bank “was an agent for collection only and did not have a security interest and was not a holder in due course for value.”

We reverse. The Uniform Commercial Code, which controls in this case, expressly provides that a bank acquires a security interest in items deposited with it to the extent that the provisional credit given the customer on the item is withdrawn. UCC §4-208 [§4-210 in the revised version of Article 4—Ed.]. It further provides that, for purposes of achieving the status of holder in due course, the depository bank gives value to the extent that it acquires a security interest in the item in question. UCC §4-209 [§4-211 in the Revision—Ed.].

We agree that appellant bank is deemed by the Uniform Commercial Code to be an agent of its customers (§4-201) but under the scheme of the Code, a “bank may be a holder in due course while acting as a collecting agent for its customer.” *Citizens Bank of Booneville v. National Bank of Commerce*, 334 F.2d 257, 261 (10th Cir. 1964). See also cases collected at 18 A.L.R.3d 1388-1391.

As a holder in due course as to \$140.00, appellant’s claim cannot be defeated except by those defenses set out in UCC §3-305(2), none of which are herein alleged. The judgment below is accordingly reversed with instructions to enter judgment for appellant.

PROBLEM 23

Same situation as Problem 22 except that when Tom deposits the \$1,000 check in his account, the account contains \$500. Later that afternoon he withdraws \$500. Is the bank a holder in due course for any amount? See §4-210(b) (the FIFO rule: First In, First Out). What result if he withdraws \$750?

C. “Good Faith” and “Notice”

To become a holder in due course, the owner of the instrument must be, in effect, a bona fide purchaser—that is, the owner must have given value for the instrument in *good faith* (defined in §1-201(19) as “honesty in fact in the conduct or transaction concerned,” but redefined in §3-103(a)(4) to include not only “honesty in fact” but also “the observance of reasonable commercial standards of fair dealing”), thus making the test one that is both subjective and objective. Read Official Comment 4 to §3-103. The holder must also be without *notice* that there are problems with the instrument.

These latter two concepts—good faith and notice—are inevitably intertwined: if, at the time value is given for the instrument, a person has *notice* of a defense the maker of a note has against the payee, the holder cannot be said to take the note with the good faith expectation that it should be paid in spite of the defense. See Annot., 36 A.L.R.4th 212. In the cases that follow, you should note how often the court fails to separate these two issues.²

General Investment Corp. v. Angelini

New Jersey Supreme Court, 1971

58 N.J. 396, 278 A.2d 193, 9 U.C.C. Rep. Serv. 1

FRANCIS, J.

The trial judge sitting without a jury, held that plaintiff was a holder in due course of a note signed by defendants Anthony V. Angelini and Dolores H. Angelini and consequently in this action brought thereon was immune from certain defenses sought to be asserted by them. Therefore, he entered judgment against defendants in the amount of \$5,363.40 plus interest. The Appellate Division affirmed the judgment in an unreported opinion. We granted defendants' petition for certification. 57 N.J. 238 (1970).

On December 10, 1966, defendants Anthony and Dolores Angelini, husband and wife, entered into a contract with Lustro Aluminum Products, Inc. for certain repair work on their home at 689 Clark Avenue, Ridgefield, N.J. It provided that Lustro, "a home repair contractor, duly licensed under the New Jersey Home Repair Financing Act, Chapter 41, Laws 1960," would

Supply & Install Gold Bond Plasticrylic Avocado Siding with Grey Sills & Trim. Apply Heavy Quilted Breather Foil on all wall areas around complete house. Corner posts to be green, all mullions to be fabricated in grey aluminum. Supply & install 2 anodized storm doors (Rear & Side Entrances).

2. Incidentally, more cases than usual appear in this segment of the book. Whether or not the holder took in good faith and without notice is largely a factual question; its resolution calls for the kind of detailed analysis only full court opinions can give. The FTC Holder in Due Course Regulation would now settle many of these cases, and all of them were decided before the revised version of Article 3 took effect, so their citations are to the 1962 version. However, the cases are all still good law, with one point only being different: the 1990 revision of Article 3 added an *objective* component to the test of good faith (which the original version lacked), so that holders must also behave in a *commercially reasonable* fashion to achieve holder in due course status. The test is no longer purely subjective, as it was when some of these cases were decided under the 1962 standard.

All overhangs & trim to be covered with special Marine Paint in grey color (as close as possible to Oxford grey trim).

This will include cleaning up job.

The cash price for the work was fixed at \$3,600 but the time payment price was \$5,363.40, payable in 84 monthly installments of \$63.85 each. Payments were to commence “60 days after completion” of the work. The agreement provided also that the Angelinis would “execute a note and application for credit, and any other appropriate instrument for the purpose of financing. . . .” On the same date as the contract, they did sign a note in the principal sum of \$5,363.40, promising to pay that amount to the order of Lustro in equal consecutive monthly installments of \$63.85 each “commencing February 19, 1967, with interest after maturity at the highest rate.” According to defendants, at the time they signed the note it was not dated and the date of commencement of payment was not set forth. Anthony Angelini testified that he was told by Lustro’s representative that the payments would not begin until he was completely satisfied with the job. The trial court found as a fact that when the note was executed it bore “no dates.”

Plaintiff General Investment Corp. is a home improvement contract financier. It deals with 300 contractors and arranges approximately 1,800 home improvement loans per year. Approximately 10 percent of its volume came from Lustro. General Investment’s representative testified that the Angelini note was purchased for value from Lustro on the day of its alleged execution, December 19, 1966. It was endorsed without recourse, except that the endorser-contractor warranted as part of the endorsement that it “has furnished and installed all articles and materials and has fully completed all work which constitutes the consideration for which this note was executed and delivered by the maker.” When the note was endorsed and delivered by Lustro plaintiff required the home improvement contract to accompany it. The two documents were separate pieces of paper but it was obvious from the contract form that they were interrelated parts of a single transaction. Plaintiff’s agent read the contract before discounting the note, and he conceded, in any event, that his experience with the nature of Lustro’s operation made him fully familiar with the terms of the contract and the note. Defendants’ contract and note to his knowledge were in the form customarily used by Lustro. He said also that in cases involving home improvement notes one of the requisites of the transaction was to obtain a copy of the work contract. Having obtained it as part of the note-discounting event, both documents were kept as part of plaintiff’s records. Thus, General Investment knew that under Lustro’s method of operation the homeowner’s obligation to commence payments did not come into being until 60 days after the

home improvements were completed. It had to know also by inescapable implication that “60 days after completion” were not just words, but that they meant after completion in a workmanlike manner.

When plaintiff’s representative received the note and contract and discounted the note, he did not inquire of the Angelinis if the work had been completed prior to or on December 19, the ostensible execution date of the note, nor did he ask Lustro for a certificate of completion signed by defendants. See N.J.S.A. 17:16-66, L.1960, c.41, §5, which provides that “[n]o home repair contractor shall request or accept a certificate of completion signed by the owner prior to the actual completion of the work to be performed under the home repair contract.” This quoted section is part of the Home Repair Financing Act of 1960 under which plaintiff knew Lustro was licensed to do business. N.J.S.A. 17:16C-93; 17:16C-77. If a request had been made by General Investment for a certificate of completion, it would have learned immediately that the work had not been completed. Instead plaintiff chose to accept the representation in the printed form of endorsement, appearing on the back of the note and above Lustro’s signature, that the work had been “fully completed” in the 10 days between the contract date, December 10, 1966 and December 19, the ostensible but false date of execution of the note.

According to Anthony Angelini’s undenied testimony, Lustro began work on his house on December 15. After working on that one day nothing further was done for several days. It never did complete the work and the part performance neither conformed to the contract nor met reasonable workmanlike standards. Ultimately Lustro became insolvent and, according to the Angelinis, the contract was never fulfilled.

The plaintiff’s testimony is to the effect that when it discounted the note, the payment commencement date appeared therein as February 19, 1967. As already noted, the trial court found as a fact that the places for dates thereon were blank at the time of its execution. At any rate, on or about December 24, 1966 the Angelinis received from plaintiff an installment payment coupon book which called for the first payment to be made on February 19, 1967. Defendants promptly returned the book to plaintiff with the advice that the contract called for payments to begin 60 days after completion of the work and that it had not been completed. Defendants also sent a copy of their letter to Lustro. Moreover, it appears that plaintiff wrote Lustro about defendants’ complaint stating that it “would appreciate your immediate adjustment of same.” This letter was a printed form, thus indicating that plaintiff was prepared for such complaints. In spite of some further correspondence and the Angelinis’ assurance that they would begin payments as soon as the work was completed, Lustro failed to perform. Some months later plaintiff filed this suit.

Plaintiff took the position in the trial court and here that it has the status of a holder in due course of defendants' negotiable note, and as such it is immune from the defense of failure of consideration. A holder in due course is defined in the Uniform Commercial Code, §3-302 as

- (1) . . . a holder who takes the instrument
 - (a) for value; and
 - (b) in good faith; and
 - (c) without notice . . . of any defense against or claim to it on the part of any person.

If the plaintiff is not such a holder it is subject to the defense of failure of consideration on the part of Lustro. *Unico v. Owen*, 50 N.J. 101, 109 (1967).

As we said in *Unico*:

In the field of negotiable instruments, good faith is a broad concept. The basic philosophy of the holder in due course status is to encourage free negotiability of commercial paper by removing certain anxieties of one who takes the paper as an innocent purchaser knowing no reason why the paper is not as sound as its face would indicate. It would seem to follow, therefore, that the more the holder knows about the underlying transaction, and particularly the more he controls or participates or becomes involved in it, the less he fits the role of a good faith purchaser for value; the closer his relationship to the underlying agreement which is the source of the note, the less need there is for giving him the tension free rights considered necessary in a fast-moving, credit-extending commercial world. [Id. at 109-110.]

Good faith is determined by looking to the mind of the particular holder. New Jersey Study Comment 1B to N.J.S.A. 12A:3-302, at p.134, §1-201(19). The test is neither freedom from negligence in entering into the transaction nor awareness of circumstances calculated to arouse suspicions either as to whether the instrument is subject to some defense not appearing on its face or whether the promise to pay is not as unconditional as it appears therein. *Joseph v. Lesnevich*, 56 N.J. Super. 340, 348 (App. Div. 1959). However, evidence of circumstances surrounding the negotiation of the note which excite question as to whether the obligation it represents is really dependent upon performance of some duty by the payee is of probative value if it provides some support for a finding of a bad faith taking by the holder. Id. at 348. Of course in evaluating the circumstances, we recognize that the unique policy considerations attendant upon consumer home repair transactions, . . . require us to closely scrutinize the existence of good faith in these situations. Ordinarily where the note appears to be negotiable in form and regular on its face, the

holder is under no duty to inquire as to possible defenses, such as failure of consideration, unless the circumstances of which he has knowledge rise to the level that the failure to inquire reveals a deliberate desire on his part to evade knowledge because of a belief or fear that investigation would disclose a defense arising from the transaction. *Id.* at 349; *First Natl. Bank of Blairstown v. Goldberg*, 340 Pa. 337, 17 A.2d 377, 379 (1941). And, in this connection, once it appears that a defense exists against the payee, the person claiming the rights of a holder in due course has the burden of establishing that he is in all respects such a holder. N.J.S.A. §3-307 [§3-308 in the Revision — Ed.].

In this case, as already noted, plaintiff required that the underlying home improvement contract be submitted with the note at the time it was discounted. Plaintiff therefore knew that the February 19, 1967 date appearing in the note as the date of commencement of the installment payments meant that the owner agreed they were to begin as the contract said, “60 days after completion” of the work. The only sensible meaning of the agreement obviously is that the Angelinis’ liability to commence payments was dependent upon completion of the improvement in a good and workmanlike manner 60 days prior to February 19. In spite of the substantial nature of the work to be performed under the contract, the fact that the note was being discounted only 10 days after execution of the contract, that the contractor’s duty was to complete the work 60 days before the first payment became due, and the knowledge that under the statute, N.J.S.A. 17:16C-66, the contractor could obtain from the owner and submit to the finance company a certificate of completion if the work had been completed, plaintiff neither demanded such a certificate nor inquired of the owner as to completion. Instead it chose to accept the contractor’s representation in the note endorsement form that he had fulfilled his contractual obligation. Such conduct justifies a strong inference that plaintiff wilfully failed to seek actual knowledge on the subject of completion because of a belief or a fear that an inquiry would disclose a failure of consideration of the note. Absence of inquiry under the circumstances amounts to an intentional closing of the eyes and mind to any defects in or defenses to the transaction. In our judgment the evidence in its totality and the inferences fairly drawn therefrom establish convincingly that plaintiff did not acquire the note in “good faith” and cannot claim the status of a holder in due course. Consequently it holds the instrument as an assignee and is subject to the defense of failure of consideration. The trial court’s holding to the contrary is so opposed to the weight of the evidence as to constitute a manifest injustice . . .

The judgment is reversed . . .

PROBLEM 24

The corporate treasurer of the Business Corporation was having major troubles paying his personal bills, so finally he decided to embark on a life of crime. He used a corporate check to pay his American Express bill, making the check out to “Amerex Corp., 770 Broadway, N.Y., N.Y. 10003” (the actual address of American Express). On the corporate check requisition form he wrote a phony explanation that this check represented shipping expenses. This caused no suspicions at Business Corporation and, thus encouraged, he did it every month for two years. When Business Corporation finally figured out what had happened, it sued American Express in quasi-contract for all the money it had received in this fashion. American Express replied that it was a holder in due course of these checks and, as such, was not amenable to this suit. Business Corporation pointed to the suspicious circumstances and to UCC §§3-302(a) and 3-307 (arguing that the corporate treasurer was a fiduciary). How should this be resolved? See *Hartford Accident & Indem. Co. v. American Express Co.*, 74 N.Y.2d 153, 542 N.E.2d 1090, 544 N.Y.S.2d 573, 8 U.C.C. Rep. Serv. 2d 865 (1989); *Grand Rapids Auto Sales, Inc. v. MBNA American Bank*, 227 F. Supp. 2d 721, 49 U.C.C. Rep. Serv. 2d 862 (W.D. Mich. 2002).

Any Kind Checks Cashed, Inc. v. Talcott

District Court of Appeal of Florida, 2002
830 So. 2d 160, 48 U.C.C. Rep. Serv. 2d 800

GROSS, J.

The issue in this case is whether a check cashing store qualifies as a holder in due course so that it can collect on a \$10,000 check written by an elderly man who was fraudulently induced to issue the check by the person who cashed it.

We hold that the check cashing store was not a holder in due course, because the procedures it followed with the \$10,000 check did not comport with reasonable commercial standards of fair dealing.

The case is the story of John G. Talcott, Jr., a ninety-three-year-old Massachusetts resident, D.J. Rivera, a “financial advisor” to Talcott, and Salvatore Guarino, a cohort of Rivera. In the mid-1990’s, Rivera sold Talcott an investment for “somewhere in the amount of \$75,000.” The investment produced no returns.

On December 7, 1999, Guarino established check cashing privileges at Any Kind Checks Cashed, Inc. (“Any Kind”) by filling out a customer card. The card included his social security number and identification by

driver's license. On the card, Guarino listed himself as a broker. That day, he cashed a \$450 check without incident.

On January 10, 2000, Rivera telephoned Talcott and talked him into sending him a check for \$10,000 made out to Guarino, which was to be used for travel expenses to obtain a return on the original \$75,000 investment. Talcott understood that Guarino was Rivera's partner. Rivera received the check on January 11.

Talcott spoke to Rivera on the morning of January 11. Rivera indicated that \$10,000 was more than what was needed for travel. He said that \$5,700 would meet the travel costs. Talcott called his bank and stopped payment on the \$10,000 check.

In spite of what Rivera told Talcott, Guarino appeared at Any Kind's Stuart, Florida office on January 11 and presented the \$10,000 check to Nancy Michael. She was a supervisor with the company with the authority to approve checks over \$2,000. Guarino showed Michael his driver's license and the Federal Express envelope from Talcott in which he received the check. She asked him the purpose of the check. Consistent with the information on the customer card, he told her that he was a broker and that the maker of the check had sent it as an investment. She was unable to contact the maker of the check by telephone. Based on her experience, Michael believed the check was good; the Federal Express envelope was "very crucial" to her decision, because it indicated that the maker of the check had sent it to the payee trying to cash the check. After deducting the 5 percent check cashing fee, Michael cashed the check and gave Guarino \$9,500. The next day she deposited the check in the company's bank.

On January 15, 2000, Rivera called Talcott and asked about the \$5,700, again promising to send him a return on his investment. The same day, Talcott sent a check for \$5,700. He assumed that Rivera knew that he had stopped payment on the \$10,000 check.

On January 17, 2000, Guarino went into the Stuart Any Kind store and presented the \$5,700 check to the teller, Joanne Kochakian. He showed her the Federal Express envelope in which the check had come. Company policy required a supervisor to approve a check over \$2,000. Kochakian noticed that Michael had previously approved the \$10,000 check. She called Michael, who was working at another location, and told her about Guarino's check.

Any Kind had no written procedures that a supervisor was required to follow in deciding which checks over \$2,000 to cash. Michael had the discretionary "decision-making power as a supervisor to decide whether or not the check [was] any good." She relied on "instinct and judgment" in deciding what inquiry to make before cashing a check. In the brief

non-jury trial, there was no evidence concerning the general practice of the check cashing industry.

Michael instructed the cashier not to cash the check until she contacted the maker, Talcott, to obtain approval. On her first attempt, Kochakian received no answer, using the number on the back of Guarino's check cashing card. When she told Guarino that she would not cash his check, he gave her another number to call, which was the same as the first number except that two numbers were reversed. On the second call, a woman answered the phone. Kochakian identified herself and asked for Talcott. Talcott approved cashing the \$5,700 check. There was no discussion of the \$10,000 check. Any Kind cashed the second check for Guarino, from which it deducted a 3 percent fee.

On January 19, Rivera called Talcott to warn him that Guarino was a cheat and a thief. Talcott immediately called his bank and stopped payment on the \$5,700 check. Talcott's daughter called Any Kind and told it of the stop payment on the \$5,700 check. There was no dispute at trial that Guarino and Rivera had pulled a scam on Talcott to get him to issue the checks. Any Kind filed a two-count complaint against Guarino and Talcott, claiming that it was a holder in due course. Talcott's defense was that Any Kind was not a holder in due course and that his obligation on the checks was nullified because of Guarino's illegal acts.

The trial court entered final judgment in favor of Any Kind for only the \$5,700 check. On the \$10,000 check, the judge found for Talcott. The court found that the circumstances surrounding the cashing of the \$10,000 check

were sufficient to put [Any Kind] on notice of potential defenses and/or infirmities. The best evidence of this is that the plaintiff attempted to contact the maker but was unable to do so on the first check, and did so on the second. The circumstances of a person describing himself as a broker, receiving funds in the amount of \$10,000 and negotiating the check for those funds at a \$500 discount are sufficient to put [Any Kind] on inquiry notice that some confirmation or explanation should be obtained.

Using the terminology of the Uniform Commercial Code, Talcott was the maker or "drawer" of the check, the person who signed the draft "as a person ordering payment." §3-103(a)(3). By Federal Expressing the check to Guarino, Talcott issued the check to him. See §3-105(a) (defining "issue" as "the first delivery of an instrument by the maker or drawer . . . for the purpose of giving rights on the instrument to any person"). Guarino indorsed the check and cashed it with Any Kind. See §3-204(a) (defining "indorsement"). Any Kind immediately made the funds available to Guarino, less its fee. Talcott stopped payment on the

check with his bank, so the check was returned to Any Kind. See §4-403 (regarding a customer's right to stop payment).

When Guarino negotiated the check with Any Kind, it became a holder of the check, making it a "person entitled to enforce" the instrument. See §§1-201(20), 3-301. As the drawer of the check dishonored by his bank, Talcott's obligation was to pay the draft to a person entitled to enforce the draft "[a]ccording to its terms at the time it was issued. . . ." §3-414(b).

Unless Any Kind is a holder in due course, its right to enforce Talcott's obligation to pay the draft is subject to (1) all defenses Talcott could raise "if the person entitled to enforce the instrument were enforcing a right to payment under a simple contract," and (2) a claim of "ecoupment" Talcott could raise against Guarino. §3-305(a)(2) and (3). Because Talcott was fraudulently induced to issue the checks, this case turns on Any Kind's entitlement to holder in due course status.

A "holder in due course" is a holder who takes an instrument without "apparent evidence of forgery or alteration" for value, in good faith, and without notice of certain claims and defenses. See §3-302(a). As the party claiming that it was a holder in due course, Any Kind had the burden to prove that status by a preponderance of the evidence. See §3-308(b); *Seinfeld v. Commercial Bank & Trust Co.*, 405 So. 2d 1039, 1041 (Fla. 3d DCA 1981).

The question for this court is whether the trial court erred in finding that Any Kind was not a holder in due course of the \$10,000 check based on the findings of fact made at trial, keeping in mind that Any Kind bore the burden of proof. That question turns on whether Any Kind acted "[i]n good faith" within the meaning of §3-302(a).

The good faith requirement of the holder in due course doctrine "has been the source of an ancient and continuing dispute." *White & Summers*, Uniform Commercial Code §17-6 (4th ed. 1995). On the one hand,

[s]hould the courts apply a so-called objective test, and ask whether a reasonably prudent person, behaving the way the alleged holder in due course behaved, would have been acting in good faith? Or should the courts instead apply a subjective test and examine the person's actual behavior, however stupid and irrespective of the reaction a reasonably prudent person would have had in the same circumstance? The legal establishment has steered a crooked course through this debate.

Id.; see Patricia L. Heatherman, Comment, Good Faith in Revised Article 3 of the Uniform Commercial Code: Any Change? Should There Be?, 29 *Willamette L. Rev.* 567 (1993).

Prior to 1992, section §1-201(19) defined “good faith” as “honesty in fact in the conduct of the transaction concerned.” Florida courts interpreted this definition as creating a subjective test. See *Cash-A-Check of S. Fla., Inc. v. Sunshine Elec. Contractors, Inc.*, 26 Fla. Supp. 2d 17, 19 (Fla. Palm Beach County Ct. 1987). For example, we wrote in *Barnett Bank of Palm Beach County v. Regency Highland Condo. Ass’n*, 452 So. 2d 587, 590 (Fla. 4th DCA 1984), that “good faith” under the holder in due course doctrine did “not include due care; rather lack of good faith must be the result of actual, not constructive, knowledge of the wrongdoing tantamount to dishonesty or bad faith.” In another case, Judge Schwartz wrote that the “Florida version of the holder in due course provision of the U.C.C. does seem to protect the objectively stupid so long as he is subjectively pure of heart.” *Seinfeld*, 405 So. 2d at 1042.

Application of *Barnett Bank’s* “honesty in fact” standard to Any Kind’s conduct in this case would clothe it with holder in due course status. It is undisputed that Any Kind’s employees were pure of heart, that they acted without knowledge of Guarino’s wrongdoing.

However, in 1992, the legislature adopted a new definition of “good faith” that applies to the §3-302’s definition of a holder in due course: “[g]ood faith” means honesty in fact and the observance of reasonable commercial standards of fair dealing.” Ch. 92-82, §2, at 759, Laws of Fla.—U.C.C. §3-103(a)(4). To the old, subjective good faith, “honesty in fact” standard, the legislature added an objective component—the “pure heart of the holder must now be accompanied by reasoning that assures conduct comporting with reasonable commercial standards of fair dealing.” *Maine Family Fed. Credit Union v. Sun Life Assurance Co. of Canada*, 727 A.2d 335, 342 (Me. 1999). No longer may a holder of an instrument act with “a pure heart and an empty head and still obtain holder in due course status.” *Id.*

Comment 4 to §3-103 attempts to shed light on how to interpret the new standard:

Although fair dealing is a broad term that must be defined in context, it is clear that it is concerned with the fairness of conduct rather than the care with which an act is performed. Failure to exercise ordinary care in conducting a transaction is an entirely different concept than failure to deal fairly in conducting the transaction.

The Code does not define the term “fair dealing.” As the Maine Supreme Court has observed, the “most obvious question arising from the use of the term fair is: fairness to whom?” *Maine Family*, 727 A.2d at 343.

Application of holder in due course status is the law’s value judgment that certain holders are worthy of protection from certain types of claims.

For example, it has been argued that application of the old subjective standard facilitated the transfer of checks in the stream of commerce; arguably one would be “more willing to accept the checks if . . . she knows . . . she can be a holder in due course of that instrument and take it free of defenses that might have existed between the buyer and the seller in the underlying transaction.” White & Summers, §17-1. In applying the new standard, “fairness” should be measured by taking a global view of the underlying transaction and all of its participants. A holder “must act in a way that is fair according to commercial standards that are themselves reasonable.” *Maine Family*, 727 A.2d at 343.

To apply the law requiring “good faith” under §3-302(a), we adopt the analysis set forth by the Supreme Court of Maine:

The factfinder must . . . determine, first, whether the conduct of the holder comported with industry or “commercial” standards applicable to the transaction and, second, whether those standards were reasonable standards intended to result in fair dealing. Each of those determinations must be made in the context of the specific transaction at hand. If the factfinder’s conclusion on each point is “yes,” the holder will be determined to have acted in good faith even if, in the individual transaction at issue, the result appears unreasonable. Thus a holder may be accorded holder in due course status where it acts pursuant to those reasonable commercial standards of fair dealing—even if it is negligent—but may lose that status, even where it complies with commercial standards, if those standards are not reasonably related to achieving fair dealing.

Id.

There was no evidence at trial concerning the check cashing industry’s commercial standards. Even assuming that Any Kind’s procedures for checks over \$2,000 met the industry’s gold standard, we hold that in this case the procedures followed were not reasonably related to achieve fair dealing with respect to the \$10,000 check, taking into consideration all of the participants in the transaction, Talcott, Guarino, and Any Kind.

Check cashing businesses are regulated by Chapter 560, Florida Statutes (2001), the Money Transmitters’ Code. See §560.101, Fla. Stat. (2001). Among the purposes of Chapter 560 are to provide for and promote:

- (b) The maintenance of public confidence in the money transmitter industry.
- (c) The protection of the interests of the public in the money transmitter system . . .
- (e) The opportunity for money transmitters to be and remain competitive with each other and with other business organizations . . .

(f) The opportunity for money transmitters to effectively serve the convenience and needs of their customers and the public . . .

(g) The opportunity for the management of money transmitter businesses to exercise its business judgment within the framework of the code.

§560.102(2). Nothing in Chapter 560 purports to alter or amend any of the provisions of Chapter 673, leading to a conclusion that the legislature did not intend to bend the holder in due course provision of the Uniform Commercial Code—Negotiable Instruments to specially accommodate check cashing businesses.

Check cashing businesses occupy a special niche in the financial industry. They are part of the “alternative financial services”³ or “fringe banking”⁴ sector, a part of the market that “has become a major source of traditional banking services for low-income and working poor consumers, residents of minority neighborhoods, and people with blemished credit histories.” Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and its Challenge to Current Thinking About the Role of Usury Laws in Today’s Society*, 51 S.C. L. Rev. 589, 591 (2000). Check cashing involves “charging a service fee for providing instant cash to unbanked customers.” Joseph R. Falasco, *Who’s Getting Used in Arkansas: An Analysis of Usury, Check Cashing, and the Arkansas Check-Cashers Act*, 55 Ark. L. Rev. 149, 156 (2002); see Drysdale & Keest, at 626. Check cashing customers “generally have limited resources available to access immediate cash.” Falasco, at 155.

Check cashing stores are often in locations where traditional banks fear to tread. Drysdale and Keest report the research that demonstrates that check cashing outlets are usually located in lower income neighborhoods:

For example, the Federal Reserve Bank of Boston looked at multi-census tract areas in cities in New England where check cashers were most densely clustered—Boston, Hartford, and Providence. The Boston study found that the cities with high [check cashing outlet] clusters tended “to have high percentages of low- and moderate-income census tracts and households,” high percentages of households below the poverty level, and higher shares of households on fixed incomes (either public assistance or social security). More dramatic is the Woodstock Institute’s study of the relative distribution of banks and [check cashing outlets and currency exchanges] in Chicago,

3. See, e.g., John Burton et al., *The Alternative Financial Sector: Policy Implications for Poor Households*, 42 *Consumer Interests Ann.* 279, 279 (1996).

4. See John P. Caskey, *Fringe Banking: Check Cashing Outlets, Pawnshops, and the Poor* (1994).

which examines specific census tracts. This study found that the currency exchanges are predominately located in lower income, minority communities. The currency exchange to bank ratio in five predominately minority communities with median household incomes below \$22,000 exceeded ten to one. The lowest income communities, with median incomes of \$7908 and \$12,570, each had twelve check cashers for every one or two banks.⁵

Drysdale & Keest, at 629 (footnotes omitted). In such areas, the typical check presented for cashing is not a large one—a paycheck, child support, social security, or public assistance check. Section 560.309(4)(b) contemplates that such checks will be presented at check cashing outlets; it limits the fee charged for the payment of “any kind of state public assistance or federal social security benefits payable to the bearer.”

Attractions of check cashing outlets are convenience and speed. As the amicus points out, many check cashing businesses are open twenty-four hours a day, seven days a week. Unlike banks, check cashing stores cannot place a hold on a check before releasing funds. The Florida Administrative Code requires payment to be made “immediately in currency for every payment instrument received by a person engaging in the activities of a check casher.” Fla. Admin. Code R. 3C-560.804(1). The statute and administrative rules also contemplate that a check cashing business will engage in various types of “verification” of a check. §560.309. Rule 3C 560.801 of the Florida Administrative Code permits a check casher to collect the “direct costs associated with verifying a payment instrument holder’s identity, residence, employment, credit history, account status, or other necessary information.” (Italics supplied). “Other necessary information” could include long distance or telephone charges incurred to contact the drawer of a check.

Against this backdrop, we cannot say that the trial court erred in finding that the \$10,000 check was a red flag. The \$10,000 personal check was not the typical check cashed at a check cashing outlet. The size of the check, in the context of the check cashing business, was a proper factor to consider under the objective standard of good faith in deciding whether Any Kind was a holder in due course. See *Maine Family*, 727 A.2d at 344.

Guarino was not the typical customer of a check cashing outlet. As the trial judge observed, because of the 5 percent fee charged, it is unusual for a small businessman such as a broker to conduct business

5. The two studies referred to in this paragraph are Lesly Jean Paul & Luxman Nathan, *Check Cashers: Moving from the Fringe to the Financial Mainstream, Communities & Banking* (Federal Reserve Bank of Boston) 5, 8 (1999), and Woodstock Inst., *Reinvestment Alert: Currency Exchanges Add to Poverty Surcharge for Low Income Residents* (1997).

through a check cashing store instead of through a traditional bank. Guarino did not have a history with Any Kind of cashing checks of similar size without incident. The need for speed in a business transaction is usually less acute than for someone cashing a paycheck or welfare check to pay for life's necessities. The need for speed in cashing a large business check is consistent with a drawer who, for whatever reason, might stop payment. Fair dealing in this case required that the \$10,000 check be approached with a degree of caution.

If a drawer has a right to stop payment of a check, and a traditional bank usually places a hold on uncollected funds after a payee deposits a check into an account, then the legal dispute after a stop payment will usually be between the drawer of the check and the payee, the two parties that had the dealings leading to the payment. Thus, where a check is cashed at a bank or savings and loan, the law will often place the loss on the wrongdoer in the underlying transaction. This is a desirable goal.

Where a check cashing store releases funds immediately, the holder in due course doctrine steps in, frequently putting the loss on a wronged maker, in furtherance of the policy that facilitating the transfer of checks benefits the economy. In this case, the policy reasons behind easy negotiability do not outweigh the reasons for caution. Very loose application of the objective component of "good faith" would make check cashing outlets the easy refuge of scam artists who want to take the money and run. The concept of "fair dealing" includes not being an easy, safe harbor for the dishonest.

To affirm the trial court is not to wreak havoc with the check cashing industry. Verification with the maker of a check will not be necessary to preserve holder in due course status in the vast majority of cases arising from check cashing outlets. This was neither the typical customer, nor the typical transaction of a check cashing outlet.

We disagree with the amicus, who worries that requirement of verification by the maker in this case "would inhibit the long standing policy of the free negotiation of instruments." Again, this is not the usual case. Also, as White and Summers have written, "there has been debate about the importance of the holder in due course doctrine in facilitating" check transactions. The Federal Trade Commission's abolition of the holder in due course doctrine in most consumer credit transactions has "not had the catastrophic impact upon the consumer market that some predicted. Indeed, twenty years from now we may conclude that it caused barely a ripple on the consumer credit pond." White & Summers, §17-1.

The legislature's addition of an objective standard of conduct may well have the effect of "slowing the 'wheels of commerce'" in some transactions. *Maine Family*, 727 A.2d at 344. However, by adopting changes to the "good faith" standard in the holder in due course doctrine, the

legislature “necessarily must have concluded that the addition of the objective requirement to the definition of ‘good faith’ serves an important goal. The paramount necessity of unquestioned negotiability has given way, at least in part to the desire for reasonable commercial fairness in negotiable transactions.” *Id.* In this case, reasonable commercial fairness required Any Kind to approach the \$10,000 check with some caution and to verify it with the maker if it wanted to preserve its holder in due course status.

Affirmed.

QUESTION

Would a check cashing business be in good faith if it acquired a postdated check before the date of the check? See *Buckeye Check Cashing, Inc. v. Camp*, 159 Ohio App.3d 784, 825 N.E.2d 644 (2005).

Winter & Hirsch, Inc. v. Passarelli

Illinois Appellate Court, 1970

122 Ill. App. 2d 372, 259 N.E.2d 312, 7 U.C.C. Rep. Serv. 1210

MCCORMICK, J.

This appeal is taken from an order denying a motion to vacate a judgment by confession. The judgment was entered against the defendants, Dominic and Antoinette Passarelli, on behalf of the plaintiff, Winter & Hirsch, Inc. Defendants made a motion before the trial court to vacate the judgment; the motion was denied, and from that order of the trial court this appeal is taken. The questions before this court are: 1) whether the loan entered into between the parties provided for a usurious rate of interest, and 2) whether the plaintiff was a holder in due course of the note evidencing the loan in question.

The defendants first contacted the Equitable Mortgage & Investment Corporation (hereinafter referred to as Equitable), attempting to secure a loan. Equitable is a brokerage firm which makes its profit by selling loan contracts to finance companies at a discount. In this case Equitable was to lend the defendants \$10,000. Of the several provisions in the note, we will consider the following: 1) a provision whereby the defendants agreed “for value received” to repay a total of \$16,260 over a period of 60 monthly payments of \$271 each; and 2) a confession of judgment clause. The promissory note signed by the defendants provided for payment to the bearer and was secured by a trust deed.

The maximum legal rate of interest which could have been charged the defendants was exceeded by Equitable, and it is uncontested that Equitable charged a usurious rate of interest. The question to be resolved by this court, however, is whether the defense of usury is available for use against the plaintiff, who claims to be holder in due course of the promissory note and therefore claims to have taken it free from the defense of usury. In the trial court the defense of usury was rejected and judgment was entered against the defendants based on the court's conclusion that the plaintiff was a holder in due course of the promissory note.

In this appeal the defendants pray that the trial court's order be reversed and that the loan be held to be usurious. Defendants further ask that the trial court be directed to enter an order allowing them twice the rate of interest, plus attorney's fees and court costs. They seek this relief based on Ill. Rev. Stat. 1965, c.74, 6. At the time of the original transaction that section allowed one aggrieved by the imposition of a usurious rate of interest to be freed of the obligation to pay any interest at all, but an amendment to the statute, in effect at the time of trial, granted one the right to a penalty in the amount of double the usurious interest charged, plus attorney's fees and court costs.

Defendants defaulted on the note and the plaintiff obtained a judgment by confession. At the trial the defendants attempted to show that before the plaintiff purchased the note it knew of the usurious interest being charged, and consequently could not have become a holder in due course. Defendants point out that the loan application which the defendants filled out on January 7, 1963, has on it the name of the plaintiff. They also call attention to the testimony of Dominic Passarelli that he had been told by an agent of Equitable that Winter & Hirsch might give them \$10,000. By the terms of the promissory note the monthly payments were to be made at the office of Ralph E. Brown, an attorney for plaintiff.

The most compelling fact presented to the court is that plaintiff issued a check to Equitable for \$11,000 on February 18, 1963, with the notation on the stub that the funds were for "the Passarelli deal," but the defendants did not receive the \$10,000 until February 28, 1963, ten days later. In other words, the plaintiff had extended the money to Equitable for the Passarelli loan prior to the time the defendants executed the note which plaintiff claims to have bought from Equitable. This fact renders inapposite an entire series of cases upon which plaintiff relies. Those cases hold that a loan may be discounted at more than the usury rate if the purchaser is without knowledge that the note was originally tainted with usury. *Stevenson v. Unkefer*, 14 Ill. 103; *Sherman v. Blackman*, 24 Ill. 345; *Colehour v. State Sav. Institution*, 90 Ill. 152. The critical factual distinction between those cases and the one before us is that the plaintiff in the instant case provided the money for the usurious loan before the loan was actually made, whereas in

the cited cases the party claiming to be the innocent holder of the usurious note had purchased it subsequent to its execution.

On oral argument counsel for plaintiff argued that there must have been a clerical error in the dates, and that no loan company would have given out money without the loan contract in its possession. The insurmountable difficulty with counsel's argument is that the date of the check issued to Equitable (February 18) and the date of the note executed by the defendants (February 28) are clearly established through the admission into evidence, without objection, of the check issued to Equitable and the note signed by the defendants. This court must accept those dates as accurate.

From these dates it appears that the plaintiff was a co-originator of the note since it advanced the funds for the usurious loan before the loan was formalized. As a co-originator it is charged with the knowledge of the terms of the loan, and that knowledge includes information regarding anticipated return on its investment. Such information should have made it clear that a usurious rate of interest was being charged the defendants; nevertheless, the plaintiff still elected to consummate the transaction, and it must now accept the consequences.

We note, however, that the plaintiff has argued that it did not give the \$11,000 to Equitable until after it saw the loan contract; in other words, that it was a purchaser of the note after it had already been executed. Although the facts do not sustain this contention because of the respective dates on which the check to Equitable was issued and the note signed by the defendants, even if that version were correct, we would hold for the defendants.

If the note was seen, as alleged by plaintiff, prior to its giving Equitable \$11,000, then the plaintiff also saw that the defendants had signed a note promising to repay \$16,260. From the face of the note one cannot ascertain the principal amount the defendants had received; it can only be known that "for value received" the defendants agreed to repay \$16,260. We feel, however, that as reasonable businessmen, assuming *arguendo* that plaintiff did not know the truth, it should have raised the question of why Equitable was willing to sell a \$16,260 note for \$11,000. The difference between what the plaintiff was paying Equitable and the amount of the note was a charge beyond that permitted under the usury statute, and plaintiff should, therefore, have inquired how much money the defendants were receiving. We cannot permit parties to intentionally keep themselves in ignorance of facts which, if known, would defeat their unlawful purpose. The Uniform Commercial Code (Ill. Rev. Stat. 1965, c.26, §3-304(1)) provides that when an instrument is so incomplete as to call its validity into question, a purchaser of that instrument is on notice of the possibility of a claim against it [in the Revision see §3-302(a)(1) — Ed.]. In this case we

feel that the instrument, without the information as to the principal sum of the loan extended to the defendants, was “so incomplete” as to call its validity into question after plaintiff learned that it was able to buy it for only \$11,000.

In *Springer v. Mack*, 222 Ill. App. 72, the court said at p.75:

The question of usury was discussed exhaustively and the authorities reviewed in the case of *Clemens v. Crane*, 234 Ill. 215, where it was held in substance, that in determining whether the essential elements of usury are present in a particular case, the intention of the parties, as the same appears from the facts and circumstances of the case, may be considered in connection with other evidence. The court also said, p.230:

“The form of the contract is not conclusive of the question. The desire of lenders to exact more than the law permits and the willingness of borrowers to concede whatever may be demanded to obtain temporary relief from financial embarrassment have resulted in a variety of shifts and cunning devices designed to evade the law. The character of a transaction is not to be judged by the mere verbal raiment in which the parties have clothed it, but by its true character as disclosed by the whole evidence. If, when so judged, it appears to be a loan or forbearance of money for a greater rate of interest than that allowed by law, the statute is violated and its penalties incurred, no matter what device the parties may have employed to conceal the real character of their dealings.”

By failing to include the principal amount loaned to the borrower on the face of the loan contract or note, a subsequent purchaser of that contract is able to say “I had no idea that usury was involved. I simply bought the paper because it was a good buy.” If the principal amount were shown, however, all subsequent purchasers would be put on notice if usury were involved, and they could not avoid their own involvement in the charging of a usurious rate by the purchase of such paper.

We feel we are justified in saying that where it appears from the facts and circumstances of the particular transaction under review that a reasonably prudent businessman would have found the purchase suspicious, he should inquire as to the truth. One should become suspicious when, as here, he is himself able to purchase paper at a price which is in itself so far below the amount to be repaid from the borrower that because of that differential the contract would have been usurious had it been the original transaction. The suspicion should be all the more compelling when the paper is bought from a broker or other company that is in the business of selling such paper. Since brokers are in the business of selling loan contracts for a profit, they are likely to have loaned out less than the amount for which they are willing to sell the contract to another. Thus, if one is able to buy a loan contract from a broker for \$11,000, it is more

than likely that the broker had loaned some figure less than the \$11,000, and the broker's profit then becomes the difference between the amount he actually loaned and that for which he sold the contract. It would then appear likely that when this difference is itself usurious, the original transaction was also. *Stevenson v. Unkefer*, 14 Ill. 103, and similar cases do not dictate a contrary result . . .

Under the circumstances, if the plaintiff was a purchaser, as it claims to be, it was on notice of a defense, since section 3-304 [in the Revision, §3-302(a)(1) — Ed.], chapter 26 of Ill. Rev. Stat. 1965 provides:

- (1) The purchaser has notice of a claim or defense if
 - (a) the instrument is so incomplete, bears such visible evidence of forgery or alteration, or is otherwise so irregular as to call into question its validity, terms or ownership or to create an ambiguity as to the party to pay. . . .

This code provision is consistent with the earlier definition of “notice” found in section 1-201(25), chapter 26, providing:

- A person has “notice” of a fact when . . .
 - (c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists.

The intendment of these provisions would seem to be an attempt to prevent those dealing in the commercial world from obtaining various rights when, from a reasonable inquiry into the true facts that person would have discovered that a fact existed which prevented him from obtaining the rights which he was seeking. Under the circumstances in the present case, it is fair to say that the plaintiff had “reason to know” there was a good defense against the note in question. Even the earlier cases point out that notice of usury destroyed one's rights in the note. . . .

The judgment of the Circuit Court is reversed, and the cause is remanded with directions to enter a judgment for defendants and for further proceedings in conformity with this opinion.

Reversed and remanded with directions.

LYONS, J. concurs. [The dissenting opinion of BURKE, J., is omitted.]

QUESTION

Would the Federal Trade Commission holder in due course rule (see page 24) apply to the promissory note signed in this case if the transaction had taken place after May 14, 1976 (the effective date of that rule)?

PROBLEM 25

Fred wrote a check on January 5, 2012, but mistakenly put down "2011" as the year. He saw his error, crossed out the last digit, and wrote "2" above it. Can anyone become a holder in due course of this instrument?

PROBLEM 26

Ace Finance Company was the payee on a promissory note signed by John Maker. On its face, the note calls for John to make 12 monthly interest payments before the note matures. Ace sold the note at a discount to Big Town Bank (BTB). If the note has written on it, in big letters, a penciled notation, "Missed Paying First Installment," can BTB ever qualify as a holder in due course? See §3-304(b) and (c) and its Official Comment 2.

PROBLEM 27

Dan Drawer wrote a check dated April 30 to Dr. Paine, his dentist, for \$80, in payment for services rendered. Dr. Paine was not aware that the check fell to the floor behind his desk, where it lay until the end of August, when the janitor found it. Dr. Paine then indorsed the check over to his local grocery store on August 31, and it bounced on September 3, when the drawee bank informed the manager of the grocery store that Dan had stopped payment because the dental work had been done badly. Is the grocery store a holder in due course? See §3-304(a)(2).

PROBLEM 28

When Ellen Brown found out that the computer she had purchased didn't work, she was furious and decided not to pay the promissory note she had signed. The note stated that it was "payable at Busy State Bank" (which in this case means that the bank would pay the note when presented and then expect reimbursement from the maker; cf. §4-106(b)). Harold Slow, the head cashier at the bank, took Ellen's phone call and promised not to pay the note when it was presented. Four months went by, and, on one hectic afternoon, the bank paid the note by accident. Slow

said he had forgotten the request not to pay. The bank now demands payment, claiming to be a holder in due course. Is it?

Problem 28 involves the *forgotten notice doctrine*, which under the NIL permitted a holder to *forget* notice and thus become a holder in due course if sufficient time passed between the notice and the acquisition of the instrument. See *First Natl. Bank of Odessa v. Fazzari*, 10 N.Y.2d 394, 179 N.E.2d 493, 233 N.Y.S.2d 483 (1961) (“[W]e think that the doctrine should be applied with great caution in the case where a simple promissory note is involved. A lapse of memory is too easily pleaded and too difficult to controvert to permit the doctrine to be applied automatically irrespective of the circumstances surrounding each transaction and the relationship of the parties.”). Does the UCC retain the *forgotten notice doctrine*? See §1-201(25), and in particular the last sentence and Official Comment 25 thereto; *McCook County Natl. Bank v. Compton*, 558 F.2d 871, 21 U.C.C. Rep. Serv. 1360 (8th Cir. 1977).

PROBLEM 29

Giant Earthmovers bought some machinery from Tractors, Inc., and in payment executed a promissory note payable to the order of Tractors for \$2,000. Tractors sold the note without indorsement to the Friendly Finance Company for \$1,500. The maker of the note refused to pay the note when it matured, stating that the machinery did not operate properly. Friendly decided to sue Giant Earthmovers, and the day before the lawsuit was filed, Friendly’s lawyer noticed that the note had never been indorsed by Tractors, Inc. He had Tractors’ president specially indorse the note over to Friendly right away, and then the suit was filed. Is Friendly a holder in due course? See §3-203(c) and its Official Comment 3, and Case #4 in Official Comment 4; *Ballengue v. New Mexico Fed. Sav. & Loan Assn.*, 109 N.M. 423, 786 P.2d 37, 11 U.C.C. Rep. Serv. 2d 124 (N.M. 1990).

Jones v. Approved Bancredit Corp.

Delaware Supreme Court, 1969
256 A.2d 739, 6 U.C.C. Rep. Serv. 1001

HERRMANN, J.

The dispositive question in this appeal is whether the plaintiff finance company is a holder in due course of the defendant’s note. We hold that the finance company was not a holder in due course under the party-to-the-transaction rule.

I

The relevant facts are undisputed for present purposes.

The defendant, Myrtle V. Jones, owned a lot of land in Delaware and wished to have a house built on it. She responded to a newspaper advertisement by Albee Dell Homes, Inc. (hereinafter "Dell"), a sales agency for pre-cut homes in Elkton, Maryland. After selecting a type of house from various plans presented, Mrs. Jones signed a purchase order contract and credit application and made a deposit. Several weeks later, Dell's representative presented to Mrs. Jones for signature a series of documents evidencing an obligation of \$3,250,⁶ to be paid by Mrs. Jones in monthly installments over a period of years for the house. The documents evidencing the obligation included the following papers: a mortgage; a judgment bond and warrant; a promissory note; a construction contract; a request for insurance; an affidavit that the masonry work and foundation were completed and paid for (when in fact none of the work had been commenced); and an affidavit that no materials were delivered or work started as of the date of the mortgage.

Mrs. Jones demurred to the signing of the mass of documents thus placed before her and stated that she would like to consult her attorney before signing because she did not understand the documents. Dell's representative objected, stating that it was not necessary for Mrs. Jones to have an attorney; that it would be a waste of money to do so; that he would advise her. Although Mrs. Jones reiterated her wish for an attorney several times, Dell's representative insisted upon her signing the papers then and there, stating that it was necessary to do so if the work was to start seasonably. He assured her that Dell would take care of the entire situation to her satisfaction. Mrs. Jones finally acquiesced and signed all the documents. Immediately thereafter, the paper was endorsed and assigned by Dell to the plaintiff Approved Bancredit Corp. (hereinafter "Bancredit") which paid Dell \$2,250.00 for the \$3,250.00 note.

During the construction, an employee of the builder drove a bulldozer into the side of the partially completed house and knocked it off its foundations. Thereafter, the builder refused to go forward with the work. Dell disclaimed responsibility on the ground that the damage to the structure was a result of a "cave-in" and was "a work of God." The structure was left in a dangerous condition with the water-filled basement constituting an attractive nuisance to children. The County authorities

6. The principal amount of the obligation was \$2,500. The balance consisted of "charges."

demanded that this unsafe condition be rectified. Mrs. Jones consulted an attorney who notified Dell and Bancredit that Mrs. Jones would be obliged to remove the remnants of the building and fill the basement, in order to make the area safe, unless another satisfactory course of action was suggested. There was no reply and the demolition was accomplished at Mrs. Jones' expense. Later, Dell closed its office and terminated its business except for the servicing of certain contracts through a representative in Delaware.

Thereafter, Bancredit brought this action against Mrs. Jones, seeking foreclosure on the mortgage and collection of an unpaid balance of \$2,560.23, with interest. Mrs. Jones interposed several defenses, mainly that of fraud by Dell. During pretrial proceedings, the action developed into a suit upon the promissory note, which Bancredit contended was secured by the mortgage and was negotiable in its hands as a holder in due course by assignment of Dell. Thereupon, Bancredit moved for summary judgment on the ground that the defenses claimed against Dell were not available against it as a holder in due course. The Superior Court denied summary judgment, stating that Mrs. Jones should have the opportunity to "demonstrate the precise relationship" between Dell and Bancredit. Thereafter, depositions were taken and the following facts, inter alia, appeared regarding that relationship:

Dell and Bancredit were both wholly owned subsidiaries of Albee Homes, Inc. (hereinafter "Homes"). The business of the parent corporation was to process pre-cut lumber and sell pre-cut homes. It had between 50 and 70 sales agencies in 19 states. Dell was its Maryland sales agency. Ninety-nine percent of Bancredit's business came from Dell and the other wholly owned sales agency subsidiaries of Homes; it was organized for this purpose. Bancredit examined into the laws of the various states in which the sales agencies operated and prescribed the forms of contracts and financing documents to be used by each agency, including Dell, in concluding a transaction. Homes and Bancredit had the same officers and directors; Homes named the directors and officers of Dell. Checks of Bancredit, issued to consummate a financing transaction like that entered into by Mrs. Jones and Dell, were countersigned by Homes. During the construction of a house, Bancredit routinely requested and received progress reports. Specifically, the manager of Bancredit testified on deposition that Bancredit was a "finance department" of Homes; that each transaction of Dell, like the transactions of each of the other sales agencies, was approved in advance by Bancredit; that the first paper received was the application of the purchaser for extension of credit which was reviewed and passed upon in advance by Bancredit, with directions back to Dell as to any special condition to be imposed upon the

purchaser in connection with the loan under consideration. Bancredit had the exclusive power of approval, condition, or rejection of a transaction tendered by the sales agency.

As the result of a pretrial conference, the trial judge stated that with a full understanding of the evidence to be adduced by each side at trial, he had concluded that a directed verdict in favor of Bancredit must necessarily result because, in his opinion, Bancredit was a holder in due course and the defenses sought to be interposed by Mrs. Jones were not available to it. Each of the parties then made a detailed offer of proof on the record and, thereupon, the Superior Court entered judgment for Bancredit on the ground that it was a holder in due course. Mrs. Jones appeals.

II

The question before us has not been heretofore answered by this court. It is a difficult question, as to which the authorities are in sharp conflict.

In dealing with the holder in due course status, a basic problem has been recognized by the courts in cases involving the financing of installment sales, especially of consumer goods and household improvements. The problem arises from the increasingly apparent need for a balancing of the interest of the commercial community in the unrestricted negotiability of commercial papers, on the one hand, against the interest of the installment buyers of the community, on the other hand, in the preservation of their normal remedy of withholding payment whenever there has been misrepresentation, failure of consideration, or other valid reason for refusal to pay. This problem and this need have given rise to this concept: The more the holder knows about the underlying transaction which is the source of the paper, the more he controls or participates in it, the less he fits the role of good faith purchaser for value, and the less justification there is for according to him the protected status of holder in due course considered necessary for the free flow of paper in the commercial world.

The rule, balancing the needs of the installment-buying community and the commercial community, has evolved in various ways. Many courts have solved the problem by denying holder in due course status to the finance company where it maintains a close business relationship with the dealer whose paper it buys; where the financier is closely connected with the particular credit transaction under scrutiny; or where the financier prescribes to the dealer the forms of the papers, the buyer signs the purchase agreement and the note concurrently, and the dealer endorses the note and assigns the contract immediately thereafter. In such

situations, many courts look upon the transaction as a species of tri-partite transaction; and the tenor of the cases is that the finance company, in such situation, should not be permitted to hide behind “the fictional fence” of the UNIL or the UCC and thereby achieve an unfair advantage over the purchaser. See *Unico v. Owen*, 50 N.J. 101, 232 A.2d 405 (1967); *Buffalo Industrial Bank v. DeMarzio*, 162 Misc. 742, 296 N.Y.S. 738 (1937).

The rule of balance thus evolved is exemplified by *Mutual Finance Co. v. Martin*, 63 So. 2d 649 (Fla. 1953). There a finance company was held not to be a holder in due course where it appeared that the finance company furnished to the payee electrical appliance dealer the form of conditional sales contract and promissory note with its name imprinted thereon; that before the sales transaction occurred the finance company had investigated the purchaser’s credit standing, had approved the proposed terms and agreed to purchase the contract and note in the event the transaction was consummated; that over a period of years immediately prior to the transaction, the finance company had provided much financing for the dealer in other transactions. In holding that, under those circumstances, the finance company was sufficiently a party to the transaction to deprive it of holder in due course status, the Supreme Court of Florida stated:

... It may be that our holding here will require some changes in business methods and will impose a greater burden on the finance companies. We think the buyer—Mr. & Mrs. General Public—should have some protection somewhere along the line. We believe the finance company is better able to bear the risk of the dealer’s insolvency than the buyer and in a far better position to protect his interests against unscrupulous and insolvent dealers. . . .

If this opinion imposes great burdens on finance companies it is a potent argument in favor of a rule which will afford protection to the general buying public against unscrupulous dealers in personal property. . . .

Another leading case supporting the rule of balance is *Commercial Credit Co. v. Childs*, 199 Ark. 1073, 137 S.W.2d 260 (1940), wherein the automobile sales contract, note, and assignment forms were attached together, were furnished by the finance company, and were all executed on the same day. The Supreme Court of Arkansas there stated:

We think appellant was so closely connected with the entire transaction or with the deal that it can not be heard to say that it, in good faith, was an innocent purchaser of the instrument for value before maturity. . . . Rather than being a purchaser of the instrument after its execution it was

to all intents and purposes a party to the agreement and instrument from the beginning. . . .

See also *Commercial Credit Corporation v. Orange County Machine Works*, 34 Cal. 2d 766, 214 P.2d 819 (1950), where the Supreme Court of California held:

When a finance company actively participates in a transaction . . . from its inception, counseling and aiding the future vendor-payee, it cannot be regarded as a holder in due course. . . .

And in *Unico v. Owen*, 50 N.J. 101, 232 A.2d 405 (1967), wherein the finance company was formed expressly to handle the financing of sales by the dealer exclusively, the Supreme Court of New Jersey summarized its position on the question before us as follows:

For purposes of consumer goods transactions, we hold that where the seller's performance is executory in character and when it appears from the totality of the arrangements between dealer and financier that the financier has had a substantial voice in setting standards for the underlying transaction, or has approved the standards established by the dealer, and has agreed to take all or a predetermined or substantial quantity of the negotiable paper which is backed by such standards, the financier should be considered a participant in the original transaction and therefore not entitled to holder in due course status. . . .

The factual situation in the *Unico* case is especially analogous to the instant case.

The divergent line of cases, reflecting an underlying conflict in policy considerations, accords determinative importance to the maintenance of a free flow of credit. These cases protect the finance company from purchaser defenses on the ground that this is an overriding consideration in order to assure easy negotiability of commercial paper and the resultant availability of the rapid financing methods required by our present-day economy. The cases of both lines of authority are collected at *Annots.*, 128 A.L.R. 729 (1940), 44 A.L.R.2d 8, 134-157 (1955), 4 A.L.R.2d Later Case Serv. 929 (1965). See also *Swanson v. Commercial Acceptance Corporation* (9th Cir.), 381 F.2d 296 (1967); 39 S. Cal. L. Rev. 48, 68-74 (1966); 10 Vill. L. Rev. 309 (1965); 65 Colum. L. Rev. 733 (1965); 53 Harv. L. Rev. 1200 (1940); 1958 Wash. U.L.Q. 177; 35 U. Chi. L. Rev. 739 (1968); 939 Minn. L. Rev. 775 (1954).

Under the totality of facts and circumstances of this case, we hold that the rule of balance should be adopted and applied; that it should operate in favor of the installment buyer for the reason that, in our

opinion, Bancredit was so involved in the transaction that it may not be treated as a subsequent purchaser for value. By reason of its sister corporation relationship to Dell and the established course of dealing between them, Bancredit was more nearly an original party to the transaction than a subsequent purchaser of the paper; and, for the reasons of fairness and balance stated in the foregoing authorities, Bancredit should be denied the protected status of holder in due course which would prevent Mrs. Jones from having her day in court on the defenses she would have otherwise had against Dell.

The rule we here adopt must be applied carefully because of the delicate balance of the interests of the installment buying community and the commercial community. But the need for special care in application should not foreclose the adoption of the rule and its application in a proper case. In this day of demonstrated need for emphasis upon consumer protection and truth in lending, special consideration must be given to preventing the misuse of negotiable instruments to deprive installment purchasers of legitimate defenses. In a proper case, such as the one before us, this becomes the controlling consideration.

For the reasons stated, we conclude that the Superior Court erred in holding that Bancredit was a holder in due course. Accordingly, the judgment below is reversed and the cause remanded for further proceedings consistent herewith.

This decision is typical of a large number of cases in which the courts have held that the buyer-transferee of the paper is too “closely connected” with the seller-transferor to be permitted to obtain holder in due course status. The doctrine has been chiefly of benefit to consumers, but it has been applied in purely commercial settings. See, e.g., *St. James v. Diversified Commercial Fin. Corp.*, 102 Nev. 23, 714 P.2d 179, 1 U.C.C. Rep. Serv. 2d 121 (1986). Following are some of the tests the courts use to assess the connection.

- (1) Is the buyer-transferee the alter ego of the seller-transferor? Do they have the same officers, same personnel, same location?
- (2) Who drafted the original promissory note?
- (3) Is the buyer-transferee mentioned in the note?
- (4) Does the seller-transferor sell paper to other buyers, or is the buyer-transferee the only market?
- (5) Did the buyer-transferee get involved in the transaction by which the note was created? Did it, for instance, conduct a credit investigation of the maker?

- (6) Did the buyer-transferee have some knowledge of the seller-transferor's poor past performance of similar contracts?

If the court concludes that the buyer-transferee is too *closely connected* to the seller-transferor, the court has a variety of ways to deny holder in due course status to the plaintiff. It can say that the plaintiff was not acting in *good faith*, that the plaintiff had notice of underlying defenses, or that the plaintiff is the same entity as the seller-transferor and can stand in no better situation.

In light of this problem, what would you advise Bancredit to do in the future to become a holder in due course of notes that pass through the hands of payees like Dell?

Lest you get the idea that in promissory note lawsuits the finance company always loses (which is not even vaguely true), read the following case. It makes the important point that knowledge of the underlying transaction is not the same thing as notice of a claim or a defense arising out of that transaction.

Sullivan v. United Dealers Corp.

Kentucky Court of Appeals, 1972
486 S.W.2d 699, 11 U.C.C. Rep. Serv. 810

REED, J.

The sole issue presented is whether appellee, United Dealers Corporation, a finance company, was a holder in due course of a promissory note executed and delivered by appellants, James Earl Sullivan and Norma Jean Sullivan, his wife, in payment for building materials and labor furnished by Memory Swift Homes, Inc., the payee of the note.

Memory Swift Homes, Inc., contracted with the Sullivans to construct a prefabricated dwelling house for them. The contract was dated March 26, 1963, and on April 9, 1963, the Sullivans executed and delivered to Memory Swift, the contractor, their promissory negotiable note in the sum of \$18,224.64 secured by a mortgage on the real property and the improvement to be located thereon. On the same day, the contractor negotiated the note and assigned the mortgage to the finance company.

On June 25, 1963, the finance company negotiated the note to a bank which took the instrument with right of recourse. After the negotiation of the note to the finance company but prior to its negotiation by the finance company to the bank, the Sullivans delivered written statements to the finance company that the foundation of the house had been properly installed and also certified that all framing members in the house were

properly and sufficiently nailed to make it a sound and sturdy structure and that all work had been performed in a workmanlike manner.

Beginning in August 1963, the Sullivans made several monthly payments according to the terms of the note but then defaulted. The last monthly payment was made in April 1966, but this covered the monthly installment due in August 1965. On April 25, 1966, the bank transferred the note back to the finance company, for value, without recourse. The finance company then instituted action against the Sullivans for collection of the note and foreclosure of the mortgage. The Sullivans pleaded that the finance company was not a holder in due course of the note and that the contractor had constructed the house in an unworkmanlike manner by reason of which they had been damaged; they sought to assert their claim against the contractor as a defense against the finance company. The parties to the action failed to demand a jury trial and, with their consent, the factual issues were tried by the court without a jury.

The trial court found from the evidence that the finance company was a holder in due course of the note; therefore, the defenses arising from the alleged breaches of contract by the contractor and payee of the note were held nonassertable against the finance company. Judgment was entered for the unpaid balance of the note and foreclosure of the mortgage was ordered. The Sullivans appeal and argue the single proposition that the finance company did not become a holder in due course at the time the note was transferred and negotiated to it by the payee. We affirm the judgment of the circuit court.

The entire case for the Sullivans may be summarized by the following quotation from the brief filed on their behalf:

The testimony shows that the appellee [the finance company] was cognizant and knew about this contract. The appellee [the finance company] had done around \$500,000 with Memory Swift Homes, Inc., over a period of a number of years beginning in 1951. The appellee also knew at the time they purchased this note and mortgage that no work had been performed on the construction of the house. The appellee [the finance company] knowing about this contract, they were put on notice that there *might be* a defense on the note because of the faulty construction of the dwelling house and is, therefore, not a holder in due course and did not take the instrument in good faith—that is the note and mortgage. [Parenthetical expressions and emphasis supplied.]

Notice, in order to prevent one from being a bona fide holder under the law merchant, or a holder in due course under the NIL or the Commercial Code, means notice at the time of the taking or at the time the instrument is negotiated, and not notice arising subsequently. The time

when value is given for the instrument is decisive. The moment value is given without notice the status as a holder in due course generally is definitely and irrevocably fixed. The Commercial Code, which has been adopted in Kentucky, provides that to be effective notice to a purchaser must be received at such time and in such manner as to give a reasonable opportunity to act on it. K.R.S. §3-304(6) [in the Revision see §3-302(f) — Ed.]. See 11 Am. Jur. 2d, Bills and Notes, §428, pp. 458, 459.

Where a close business association between the payee and one who purchases an instrument from him implies the knowledge of such facts as to show bad faith or renders himself a participant in the transaction between the payee and the maker, a finding that such purchaser is not a holder in due course has been regarded as supportable. See 44 A.L.R.2d 154. In *Massey-Ferguson v. Utley, Ky.*, 439 S.W.2d 57 (1969), we discussed several aspects of the basic problem. Therein we expressed the thought that the policy of the Commercial Code was to encourage the supplying of credit for the buying of goods by insulating the lender from lawsuits over the quality of the goods. The insulation provided, however, appears intended primarily for finance institutions acting independently to supply credit, rather than to protect a manufacturer who finances his own sales either in his own name or by a dominated and controlled agency.

In the case before us, there is no allegation of fraud involving the payee of the note and the finance company. There is no claim any fact existed that the finance company could have discovered at the time of the transfer of the instrument and that would have indicated any deficiency or defect. The maker of the note represented that the state of facts at that time was one of compliance by the contractor with the duties imposed by the contract. The evidence failed to demonstrate any direct connection between the contractor and the finance company except a frequent course of dealing between them. In short, the evidence failed to demonstrate any bad faith on the part of the finance company at the time of the negotiation and transfer of the note to it. All of the evidence demonstrated a complete lack of notice to the finance company that would justify a finding that it failed to acquire the status of a holder in due course.

The judgment is affirmed.

All concur.

D. The Shelter Rule

It has always been a basic rule of the common law that the unqualified transfer of a chose in action places the transferee in the transferor's shoes and gives the transferee all the rights of the transferor. This rule is

codified in §3-203(b), where it is made clear that even holder in due course rights can pass to a person not otherwise entitled to them. Because the transferee of a holder in due course takes shelter in the status of the transferor, §3-203(b) is called the *shelter rule*. Read §3-203(b) and its Official Comments, paying particular attention to Comment 4 and the examples therein. (Similar shelter rules abound throughout the UCC: for sales of goods, see §2-403(1); for documents of title, see §7-504(1); and for investment securities, see §8-302(a).)

PROBLEM 30

Happy Jack, the used car salesman, sold Manny a lemon car for his business, taking in payment a promissory note for \$2,000 made payable to the order of Happy Jack. Jack discounted the note with Alfred, a local licensed money broker, who paid him \$1,700 and took the note without knowledge of the underlying transaction. Alfred's daughter Jessica had a birthday shortly thereafter, so Alfred indorsed the note in blank and gave it to her as a present. When the note matured, Manny refused to pay it to Jessica—the car had fallen apart, and he felt that he shouldn't have to pay for a pile of junk. Is Jessica a holder in due course?

PROBLEM 31

If in the above Problem Jessica had thereafter made a gift of the note to her husband, Lorenzo, would Lorenzo have holder in due course rights? Does it matter if Lorenzo, prior to the gift, knows of Manny's problems with the car? If Manny won't pay, is Alfred liable to Lorenzo? See §§3-305 (a)(2) and 3-303.

PROBLEM 32

After Lorenzo (from the last Problem) acquired the note, he sold it for \$1,800 to Portia, a local attorney. She had no notice of problems with the instrument. When she presented it to Manny for payment, he refused to pay and instead filed for bankruptcy. May she recover from Alfred? See §3-305 (b). If she does and prevails, Alfred will reacquire the instrument. Does the shelter rule give him Portia's holder in due course rights? Does Alfred reacquire his *original* holder in due course status when he gets the instrument back? Could he sue Jessica or Lorenzo? See the following discussion.

Reacquisition of an instrument. If Alfred is forced to pay Portia, he will get the instrument back into his possession. In such a case, §121 of the now-repealed NIL provided that on reacquisition a holder “is remitted to his former rights as regards all prior parties.” See Chafee, *The Reacquisition of a Negotiable Instrument by a Prior Party*, 21 Colum. L. Rev. 538 (1921).⁷ Thus, if Alfred used to be a holder in due course, on reacquiring the instrument he would get that status back vis-à-vis parties prior to his first holding. Although the UCC never expressly states the same rule, the idea is implicit throughout the Code, and the NIL rule is therefore still the law. As to the issue of whether Alfred can sue Jessica and Lorenzo, we will explore the liability of an indorser in the next chapter.

Section 3-207 provides that when a previous holder reacquires the instrument, he or she has the power to strike the intervening indorsements. As one court explained:

Intervening indorsements simply vanish from the chain of title when called by a reacquirer. That concept is the obvious product of the principle that permits the current holder of a negotiable instrument to sue its predecessor in the indorsement chain, in which event that party can in turn look to its own predecessor. If those lawsuits up the chain would ultimately lead back to the current holder, that pointless circular process is best avoided by the cancellation of the intervening indorsements and the discharge of those intermediate parties from liability.

Resolution Trust Corp. v. Juergens, 965 F.2d 149, 154, 18 U.C.C. Rep. Serv. 2d 484, 491 (7th Cir. 1992).

Triffin v. Somerset Valley Bank

New Jersey Superior Court, Appellate Division, 2001
343 N.J. Super. 73, 777 A.2d 993, 44 U.C.C. Rep. Serv. 2d 1200

CUFF, J.A.D.

This case concerns the enforceability of dishonored checks against the issuer of the checks under Article 3 of the Uniform Commercial Code (UCC), as implemented in New Jersey in N.J.S.A. 12A:3-101 to 3-605.

Plaintiff purchased, through assignment agreements with check cashing companies, eighteen dishonored checks, issued by defendant Hauser Contracting Company (Hauser Co.). Plaintiff then filed suit in the Special Civil Part to enforce Hauser Co.’s liability on the checks. The trial

7. Section 3-207 discusses reacquisition, but the rules therein are not relevant to the issues raised by the preceding Problems.

court granted plaintiff's motion for summary judgment. Hauser Co. appeals the grant of summary judgment. It also argues, for the first time, that plaintiff lacked standing to file suit against Hauser Co. We affirm.

In October 1998, Alfred M. Hauser, president of Hauser Co., was notified by Edwards Food Store in Raritan and the Somerset Valley Bank (the Bank), that several individuals were cashing what appeared to be Hauser Co. payroll checks. Mr. Hauser reviewed the checks, ascertained that the checks were counterfeits and contacted the Raritan Borough and Hillsborough Police Departments. Mr. Hauser concluded that the checks were counterfeits because none of the payees were employees of Hauser Co., and because he did not write the checks or authorize anyone to sign those checks on his behalf. At that time, Hauser Co. employed Automatic Data Processing, Inc. (ADP) to provide payroll services and a facsimile signature was utilized on all Hauser Co. payroll checks.

Mr. Hauser executed affidavits of stolen and forged checks at the Bank, stopping payment on the checks at issue. Subsequently, the Bank received more than eighty similar checks valued at \$25,000 all drawn on Hauser Co.'s account.

Plaintiff is in the business of purchasing dishonored negotiable instruments. In February and March 1999, plaintiff purchased eighteen dishonored checks from four different check cashing agencies, specifying Hauser Co. as the drawer. The checks totaled \$8,826.42. Pursuant to assignment agreements executed by plaintiff, each agency stated that it cashed the checks for value, in good faith, without notice of any claims or defenses to the checks, without knowledge that any of the signatures were unauthorized or forged, and with the expectation that the checks would be paid upon presentment to the bank upon which the checks were drawn. All eighteen checks bore a red and green facsimile drawer's signature stamp in the name of Alfred M. Hauser. All eighteen checks were marked by the Bank as "stolen check" and stamped with the warning, "do not present again." Each of the nine payees on the eighteen checks are named defendants in this case.

Plaintiff then filed this action against the Bank, Hauser Co., and each of the nine individual payees. Plaintiff contended that Hauser Co. was negligent in failing to safeguard both its payroll checks and its authorized drawer's facsimile stamp, and was liable for payment of the checks.

The trial court granted plaintiff's summary judgment motion, concluding that no genuine issue of fact existed as to the authenticity of the eighteen checks at issue. Judge Hoens concluded that because the check cashing companies took the checks in good faith, plaintiff was a holder in due course as assignee. Judge Hoens also found that because the checks appeared to be genuine, Hauser Co. was required, but had failed, to show that plaintiff's assignor had any notice that the checks were not validly drawn. . . .

As to the merits of the appeal, Hauser Co. argues that summary judgment was improperly granted because the court failed to properly address Hauser Co.'s defense that the checks at issue were invalid negotiable instruments and therefore erred in finding plaintiff was a holder in due course. . . .

As a threshold matter, it is evident that the eighteen checks meet the definition of a negotiable instrument. N.J.S.A. 12A:3-104. Each check is payable to a bearer for a fixed amount, on demand, and does not state any other undertaking by the person promising payment, aside from the payment of money. In addition, each check appears to have been signed by Mr. Hauser, through the use of a facsimile stamp, permitted by the UCC to take the place of a manual signature. N.J.S.A. 12A:3-401(b) provides that a "signature may be made manually or by means of a device or machine . . . with present intention to authenticate a writing." It is uncontroverted by Hauser Co. that the facsimile signature stamp on the checks is identical to Hauser Co.'s authorized stamp.

Hauser Co., however, contends that the checks are not negotiable instruments because Mr. Hauser did not sign the checks, did not authorize their signing, and its payroll service, ADP, did not produce the checks. Lack of authorization, however, is a separate issue from whether the checks are negotiable instruments. Consequently, given that the checks are negotiable instruments, the next issue is whether the checks are unenforceable by a holder in due course, because the signature on the checks was forged or unauthorized.

N.J.S.A. 12A:3-203 and N.J.S.A. 12A:3-302 discuss the rights of a holder in due course and the rights of a transferee of a holder in due course. Section 3-302 establishes that a person is a holder in due course if:

- (1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity; and
- (2) the holder took the instrument for value, in good faith, without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, without notice that the instrument contains an unauthorized signature or has been altered, without notice of any claim to the instrument described in 12A:3-306, and without notice that any party has a defense or claim in recoupment described in subsection a. of 12A:3-305.

Section 3-203 deals with transfer of instruments and provides:

- a. An instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument.

b. Transfer of an instrument, whether or not the transfer is a negotiation, vests in the transferee any right of the transferor to enforce the instrument, including any right as a holder in due course, but the transferee cannot acquire rights of a holder in due course by a transfer, directly or indirectly, from a holder in due course if the transferee engaged in fraud or illegality affecting the instrument.

The official comment to N.J.S.A. 12A:3-203 adds that in situations where a transferee does not take the instrument by indorsement (as in this case), the transferee still assumes the rights of the transferor, so long as the transferee can show that the transferor had valid rights to the instrument, and that the transferee acquired the instrument in accordance with section 3-203's requirements. Specifically, Comment 2 reads:

Subsection (b) states that transfer vests in the transferee any right of the transferor to enforce the instrument "including any right as a holder in due course." *If the transferee is not a holder because the transferor did not indorse, the transferee is nevertheless a person entitled to enforce the instrument under Section 3-301 if the transferor was a holder at the time of transfer. Although the transferee is not a holder, under subsection (b) the transferee obtained the rights of the transferor as holder. Because the transferee's rights are derivative of the transferor's rights, those rights must be proved.* Because the transferee is not a holder, there is no presumption under Section 3-308 that the transferee, by producing the instrument, is entitled to payment. The instrument, by its terms, is not payable to the transferee and the transferee must account for possession of the unindorsed instrument by proving the transaction through which the transferee acquired it. Proof of a transfer to the transferee by a holder is proof that the transferee has acquired the rights of a holder. At that point the transferee is entitled to the presumption under Section 3-308.

Under subsection (b) a holder in due course that transfers an instrument transfers those rights as a holder in due course to the purchaser. The policy is to assure the holder in due course a free market for the instrument.

[N.J.S.A. 12A:3-203, Comment 2 (emphasis added).]

The record indicates that plaintiff has complied with the requirements of both sections 3-302 and 3-203. Each of the check cashing companies from whom plaintiff purchased the dishonored checks were holders in due course. In support of his summary judgment motion, plaintiff submitted an affidavit from each company; each company swore that it cashed the checks for value, in good faith, without notice of any claims or defenses by any party, without knowledge that any of the signatures on the checks were unauthorized or fraudulent, and with the expectation that the checks would be paid upon their presentment to the

bank upon which the checks were drawn. Hauser Co. does not dispute any of the facts sworn to by the check cashing companies.

The checks were then transferred to plaintiff in accordance with section 3-203, vesting plaintiff with holder in due course status. Each company swore that it assigned the checks to plaintiff in exchange for consideration received from plaintiff. Plaintiff thus acquired the check cashing companies' holder in due course status when the checks were assigned to plaintiff. See N.J.S.A. 12A:3-203, Comment 2. Moreover, pursuant to section 3-203 (a)'s requirement that the transfer must have been made for the purpose of giving the transferee the right to enforce the instrument, the assignment agreements expressly provided plaintiff with that right, stating that "all payments [assignor] may receive from any of the referenced Debtors . . . shall be the exclusive property of [assignee]." Again, Hauser Co. does not dispute any facts relating to the assignment of the checks to plaintiff.

Hauser Co. contends, instead, that the checks are per se invalid because they were fraudulent and unauthorized. Presumably, this argument is predicated on section 3-302. This section states a person is not a holder in due course if the instrument bears "apparent evidence of forgery or alteration" or is otherwise "so irregular or incomplete as to call into question its authenticity." N.J.S.A. 12A:3-302(a)(1).

In order to preclude liability from a holder in due course under section 3-302, it must be apparent on the face of the instrument that it is fraudulent. The trial court specifically found that Hauser Co. had provided no such evidence, stating that Hauser Co. had failed to show that there was anything about the appearance of the checks to place the check cashing company on notice that any check was not valid. Specifically, with respect to Hauser Co.'s facsimile signature on the checks, the court stated that the signature was identical to Hauser Co.'s authorized facsimile signature. Moreover, each of the check cashing companies certified that they had no knowledge that the signatures on the checks were fraudulent or that there were any claims or defenses to enforcement of the checks. Hence, the trial court's conclusion that there was no apparent evidence of invalidity was not an abuse of discretion and was based on a reasonable reading of the record.

To be sure, section 3-308 (a) does shift the burden of establishing the validity of the signature to the plaintiff, but only if the defendant specifically denies the signature's validity in the pleadings. The section states:

In an action with respect to an instrument, the authenticity of, and authority to make, each signature on the instrument is admitted unless specifically denied in the pleadings. If the validity of a signature is denied in the pleadings, the burden of establishing validity is on the person claiming validity, but the

signature is presumed to be authentic and authorized unless the action is to enforce the liability of the purported signer and the signer is dead or incompetent at the time of trial of the issue of validity of the signature.

[N.J.S.A. 12A:3-308(a) (emphasis added).]

Comment 1 explains that a specific denial is required

to give the plaintiff notice of the defendant's claim of forgery or lack of authority as to the particular signature, and to afford the plaintiff an opportunity to investigate and obtain evidence. . . . In the absence of such specific denial the signature stands admitted, and is not in issue. Nothing in this section is intended, however, to prevent amendment of the pleading in a proper case.

[N.J.S.A. 12A:3-308, Comment 1.]

Examination of the pleadings reveals that Hauser Co. did not specifically deny the factual assertions in plaintiff's complaint.

Even if Hauser Co.'s general denial was sufficient, the presumption that the signature is valid still remains, unless Hauser Co. satisfies the evidentiary requirements of N.J.S.A. 12A:3-308. Comment 1 to that section explains that even when the defendant has specifically denied the authenticity of a signature, the signature is still presumed to be authentic, absent evidence of forgery or lack of authorization. Comment 1 states:

The burden is on the party claiming under the signature, *but the signature is presumed to be authentic and authorized* except as stated in the second sentence of subsection (a). "*Presumed*" is defined in Section 1-201 and means that until some evidence is introduced which would support a finding that the signature is forged or unauthorized, the plaintiff is not required to prove that it is valid. The presumption rests upon the fact that in ordinary experience forged or unauthorized signatures are very uncommon, and normally any evidence is within the control of, or more accessible to, the defendant. *The defendant is therefore required to make some sufficient showing of the grounds for the denial before the plaintiff is required to introduce evidence.* The defendant's evidence need not be sufficient to require a directed verdict, but it must be enough to support the denial by permitting a finding in the defendant's favor. Until introduction of such evidence the presumption requires a finding for the plaintiff.

[N.J.S.A. 12A:3-308, Comment 1 (emphasis added).]

Here, Hauser Co. has not provided any evidence of the invalidity of the signature. Hauser Co.'s reliance on conclusory statements does not

constitute such a “sufficient showing.” See *Coupounas v. Madden*, 401 Mass.125, 514 N.E.2d 1316, 1320 (1987) (defendant disputing validity of notes “had to do more than ‘call into question’ the ‘integrity’ of the notes”).

In addition, as a matter of summary judgment, Hauser Co.’s reliance on its answer, amended answer and Mr. Hauser’s affidavit as material, disputed facts is inadequate. In order to defeat a motion for summary judgment, a party must show that there are genuine issues of material fact. *Brill*, supra, 142 N.J. at 540, 666 A.2d 146. “Bare conclusions in the pleadings, without factual support in tendered affidavits, will not defeat a meritorious application for summary judgment.” *United States Pipe and Foundry Co. v. American Arbitration Ass’n*, 67 N.J. Super. 384, 399-400, 170 A.2d 505 (App. Div. 1961); see also *Brae Asset Fund v. Newman*, 327 N.J. Super. 129, 134, 742 A.2d 986 (App. Div. 1999). Hauser Co. provided no factual evidence tending to disprove the authenticity of the signature, relying instead on self-interested and conclusory statements. Consequently, the trial court did not err in finding that Hauser Co. had failed to provide any evidence of the invalidity of the checks.

In conclusion, we hold that Judge Hoens properly granted summary judgment. There was no issue of material fact as to: (1) the status of the checks as negotiable instruments; (2) the status of the check cashing companies as holders in due course; (3) the status of plaintiff as a holder in due course; and (4) the lack of apparent evidence on the face of the checks that they were forged, altered or otherwise irregular. Moreover, Hauser Co.’s failure to submit some factual evidence indicating that the facsimile signature was forged or otherwise unauthorized left unchallenged the UCC’s rebuttable presumption that a signature on an instrument is valid. Consequently, the trial court properly held, as a matter of law, that plaintiff was a holder in due course and entitled to enforce the checks.

Affirmed.

It may seem unfair to give holder in due course status to non-purchasers and those who take with notice of defenses, but on reflection the unfairness disappears. If the rule were otherwise, the current holder would simply pass the instrument back up the chain until it reached a former holder in due course, who would then reacquire that status, sue the instrument’s creator, and prevail. The shelter rule accomplishes the same result without all these maneuvers and has the further benefit of promoting commercial confidence in the soundness of the instrument once it has floated through the hands of multiple purchasers.

II. REAL AND PERSONAL DEFENSES/CLAIMS

A. Defenses Against a Holder in Due Course

Holder in due course status has as its primary attribute the ability to enforce the instrument free from the usual legal excuses that could be raised in an ordinary contracts action. The key Uniform Commercial Code section reaching this extraordinary result is §3-305, to which we now turn.

Section 3-305 is difficult to read, primarily because a number of the concepts therein are complicated to sort out. Let's take it a point at a time.

First of all, the *obligor* mentioned throughout §3-305 is the party to the instrument who is being sued by the holder of the instrument. Thus, the obligor could be the drawer of a draft, the maker of a note, or someone who indorsed the instrument. In the next chapter, we shall discuss the nature of the obligations these parties incur by virtue of having signed the instrument in one of the above capacities.

A "defense," of course, is the legal excuse the obligor may have to avoid paying the obligation. Subsection (b) tells us that a holder in due course takes subject to the defenses listed in subsection (a)(1), meaning that these defenses, if true, defeat the right of the holder in due course to enforce the instrument. Defenses that are good against a holder in due course are commonly called *real defenses*, a label you might wish to write next to §3-305(a)(1). Subsection (b) tells us that a holder in due course is not subject to the defenses raised in subsection (a)(2), the so-called *personal defenses*.

Subsection (b) also states that a holder in due course holds free of "claims in recoupment" per §3-305(a)(3), but what does that mean? Recoupment is the legal ability to *subtract* from any payment due the amount the person trying to collect the debt (or that person's predecessor) happens to owe the debtor. For example, if I owe you \$500 pursuant to our contract, and, as a result of your breach of that same contract, you have caused me \$200 worth of damages, my claim in recoupment permits me to subtract those damages and only pay you \$300. A claim in recoupment is so similar to a defense that the original version of Article 3 seemed to lump it in with the other personal defenses, but the revised version of Article 3 gives it its own special treatment (leading to awkward references throughout to a "defense or claim in recoupment"). Read Official Comment 3 to §3-305.

PROBLEM 33

Stephen Maturin bought a sailboat from Jack Aubrey, paying \$500 down and signing a \$1,000 promissory note for the balance due. Maturin loved everything about the boat except its color, and he promptly repainted it his favorite color, black. Prior to the sale Aubrey had told Maturin that the boat was constructed so that it wouldn't sink even in the roughest weather. This proved to be untrue when the sailboat went down in the first storm that came along, and it cost Maturin \$300 to have it dredged from the bottom and restored. In the meantime, Aubrey had given the promissory note to his father as a birthday gift, and the father presented it to Maturin for payment at maturity. May Maturin assert his damages against the father's demand for payment? Same result if the boat never sank, but Aubrey's dog bit Maturin on the leg one week after the delivery of the sailboat, and Maturin incurred \$100 in medical bills as a consequence? See *Zener v. Velde*, 135 Idaho 352, 17 P.3d 296, 42 U.C.C. Rep. Serv. 2d 1073 (Idaho App. 2000).

Federal Deposit Insurance Corp. v. Culver

United States District Court, District of Kansas, 1986
640 F. Supp. 725, 1 U.C.C. Rep. Serv. 2d 1585

O'CONNOR, J.

This matter comes before the court on defendant's motion to dismiss for lack of personal jurisdiction, on plaintiff's motion for summary judgment, and on defendant's motion for leave to file a demand for jury trial out of time. After reciting the material facts (construed most favorably to defendant), we will address these pending motions.

In 1984, defendant entered into a business arrangement with a Mr. Nasib Ed Kalliel. Kalliel was to assume control over the financial aspects of defendant's farm, while defendant was to manage the farming operation—receiving both a salary and a share of the profits. In July or August of that year, defendant informed Kalliel that he urgently needed money in order to stave off foreclosure. One week later, \$30,000.00 was wire-transferred from the Rexford State Bank in Rexford, Kansas, to defendant's bank in King City, Missouri. Although defendant knew that the money had come from the Rexford State Bank, he thought that Kalliel would be responsible for its repayment.

About one week later, defendant was approached by a Mr. Jerry Gilbert, whom defendant believed was working for Kalliel. Gilbert told defendant that "Rexford State Bank wanted to know where the \$30,000.00 went, . . . for their records." Gilbert presented defendant with a document and asked defendant to sign it. Apparently, Gilbert either

told defendant, or at least led him to believe, that the document was merely a receipt for the \$30,000.00 he had received. In any event, defendant signed the document without thereby intending to commit himself to the repayment of any money.

The document defendant signed was a preprinted promissory note form. As might be expected, the form contained a number of blanks into which the parties were expected to insert terms specific to their own transaction. At the time defendant signed the document, none of those blanks had been completed. Thus, the note contained no execution date, no maturity date, no principal amount, and no interest rate. The name of the payee, "THE REXFORD STATE BANK, Rexford, Kansas," was printed on the note at that time. Moreover, the note did provide that the principal and accrued interest were to be paid to the payee "at its offices."

Although defendant assumed that the figure \$30,000.00 would eventually be written on the document, some unknown individual completed the note as follows:

- (1) The principal amount was shown as \$50,000.00;
- (2) the execution date was shown as August 2, 1984;
- (3) the maturity date was shown as February 2, 1985; and
- (4) the interest rate was shown as 14½ percent per annum until maturity, and 18½ percent per annum thereafter.

Although defendant received only \$30,000.00, the Rexford State Bank did deposit the full \$50,000.00 in an account controlled by Kalliel. The \$30,000.00 apparently came from that account.

Eventually, the note was returned to the Rexford State Bank. When that bank became insolvent, the Federal Deposit Insurance Corporation ["FDIC"] was appointed as its receiver. In its *corporate* capacity, the FDIC then purchased a number of the bank's assets from the receiver—including the note at issue here. At that time, the FDIC had no actual knowledge of the events that had transpired prior to its purchase of the note. As of yet, defendant has made no payment of either principal or interest.

Other than receiving the \$30,000.00 wire-transfer from the Rexford State Bank, and then signing the note naming the bank as payee, defendant has had no other relevant contact with the state of Kansas. . . .

II. PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT

. . . Recognizing that "[t]here is no doubt that state and federal law provide the Federal Deposit Insurance Corporation with holder in due course status in the instant litigation" (Defendant's Brief of May 2, 1986, at 11), defendant concedes that the "personal" defenses of fraud in the

inducement, estoppel, and failure of consideration would be ineffective against plaintiff's claim. See *F.D.I.C. v. Vestering*, 620 F. Supp. 1271 (D. Kan. 1985). Accordingly, defendant seeks to assert the "real" defense of fraud in the factum. See K.S.A. 84-3-305(2)(c) [in the Revision see §3-305(a)(1)(iii) — Ed.]. Plaintiff denies that the facts as alleged by defendant constitute fraud in the factum. Alternatively, even assuming that defendant can establish the elements of fraud in the factum, plaintiff contends that such a defense is ineffective against the FDIC because of the doctrine enunciated in *D'Oench, Duhme & Co. v. F.D.I.C.*, 315 U.S. 447 (1942), and codified at 12 U.S.C. §1823(e). Because we conclude that defendant cannot demonstrate fraud in the factum, we do not reach plaintiff's arguments regarding *d'Oench, Duhme* and section 1823(e).

The "fraud in the factum" defense is codified at K.S.A. 84-3-305(2)(c) [in the Revision see 3-305(a)(1)(iii) — Ed.], which provides as follows:

Rights of a holder in due course. To the extent that a holder is a holder in due course he takes the instrument free from . . .

(2) all defenses of any party to the instrument with whom the holder has not dealt *except* . . .

(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*.

(Emphasis added.) As suggested by our factual summary, defendant contends that he signed the note under the misapprehension that it was merely a receipt. He thus denies having knowledge of the document's "character" at the time he signed it. Moreover, because the note's execution date, maturity date, principal amount and interest rate were all blank at the time he signed it, defendant contends that he had neither knowledge nor reasonable opportunity to obtain knowledge as to the note's "essential terms."

To determine whether these facts fit the definition of fraud in the factum, we look elsewhere in the Kansas Uniform Commercial Code. For instance, Official UCC Comment 7 to §3-305 provides this advice:

Paragraph (c) of subsection (2) is new. It follows the great majority of the decisions under the original Act in recognizing the defense of "real" or "essential" fraud, sometimes called fraud in the essence or fraud in the factum, as effective against a holder in due course. The common illustration is that of the maker who is tricked into signing a note in the belief that it is merely a receipt or some other document. The theory of the defense is that his signature on the instrument is ineffective because he did not intend to sign such an instrument at all. Under this provision the defense extends to an instrument signed with knowledge that it is a negotiable instrument, but without knowledge of its essential terms.

The test of the defense here stated is that of excusable ignorance of the contents of the writing signed. The party must not only have been in ignorance, but must also have had no reasonable opportunity to obtain knowledge.

(Emphasis added.) A portion of the 1983 Kansas Comment to this same section offers guidance as to the proper construction of the term “excusable ignorance.” The Comment provides as follows:

Kansas decisional law would seem to be in accord on the possibility of fraud in the factum as a real defense, the decision in *Ort v. Fowler*, 31 Kan. 478, 2 P. 580 (1884), being a good example of facts not satisfying the defense because of the failure of the maker to satisfy a standard of conduct comparable to that required by this subsection.

Given this Kansas Comment’s reference to *Ort*, an examination of the facts and the holding in that case should be useful in determining whether defendant showed “excusable ignorance” in mistaking the note at issue here for a receipt.

In *Ort*, a farmer was working alone in his field. A stranger came up to him and represented himself to be the state agent for a manufacturer of iron posts and wire fence. After some conversation, the stranger persuaded the farmer to accept a township-wide agency for the same manufacturer. The stranger then completed two documents which he represented to be identical versions of an agency contract. Because the farmer did not have his glasses with him and, in any event, “could not read without spelling out every word,” 31 Kan. at 480, the stranger purported to read the document to the farmer. No mention was made of any note. Both men signed each document, with the farmer not intending to sign anything but a contract of agency. Ultimately, it was established that at least one of those documents was a promissory note. A bona fide purchaser of that note brought suit against the farmer, and the farmer attempted to defend the action on the basis of fraud in the factum. After the trial court rejected that defense, the farmer appealed.

The Kansas Supreme Court, in an opinion by Justice David Brewer (later a United States Supreme Court Associate Justice), phrased the issue on appeal as follows: “A party is betrayed into signing a bill or note by the assurance that it is an instrument of a different kind. Under what circumstances ought he to be liable thereon?” 31 Kan. at 482. Three alternative answers were then suggested:

One view entertained is, that as he never intended to execute a bill or note, it cannot be considered his act, and he should not be held liable thereon any more than if his name had been forged to such an instrument. A second view is, that it is always a question of fact for the jury whether under the circumstances the party was guilty of negligence. A third is the

view adopted by the trial court, that as [a] matter of law, one must be adjudged guilty of such negligence as to render him liable who, possessed of all his faculties and able to read, signs a bill or note, relying upon the assurance or the reading of a stranger that it is a different instrument.

Id. Defendant herein would obviously prefer either the first or second alternative. The court, however, made its preference clear:

We approve of the latter doctrine. It presents a case, of course, of which one of two innocent parties must suffer; but the bona fide holder is not only innocent, but free from all negligence. He has done only that which a prudent, careful man might properly do, while on the other hand the maker of the note has omitted ordinary care and prudence. A party cannot guard against forgery; but if in possession of his faculties and able to read, he can know the character of every instrument to which he puts his signature; and it is a duty which he owes to any party who may be subsequently affected by his act, to know what it is which he signs. By his signature he invites the credence of the world to every statement and promise which is in the instrument he has subscribed; and he is guilty of negligence if he omits to use the ordinary means of ascertaining what those provisions and statements are. If he has eyes and can see, he ought to examine; if he can read, he ought to read; and he has no right to send his signature out into the world affixed to an instrument of whose contents he is ignorant. If he relies upon the word of a stranger, he makes that stranger his agent. He adopts his reading as his own knowledge. What his agent knows, he knows; and he cannot disaffirm the acts of that agent done within the scope of the authority he has intrusted to him.

Id., 31 Kan. at 482-483 (emphasis added). Although *Ort* is of rather ancient vintage, this aspect of the decision has been cited with approval as recently as 1966. See *Mid Kansas Federal Savings & Loan Assn. v. Binter*, 197 Kan. 106, 110, 415 P.2d 278, 282 (1966).

It is obvious from reading defendant's deposition that he is able to read and understand the English language. Thus, under the rule announced in *Ort*, defendant was negligent in relying on Gilbert's assurance that the note was only a receipt. Given the 1983 Kansas Comment referring to the *Ort* absence-of-negligence standard as "comparable to that required by [K.S.A. 84-3-305(2)(c)]," we must also conclude that defendant has failed to show the "excusable ignorance" necessary to establish fraud in the factum. In the words of the statute, we conclude as a matter of law that defendant had a "reasonable opportunity to obtain knowledge of [the document's] character" before he signed it.

Defendant's second argument, assuming that we reject his contention that he neither knew nor had reasonable opportunity to know

the “character” of the document he signed, is that he had no such opportunity to learn of the note’s “essential terms.” Because the note’s execution date, maturity date, principal amount and interest rate were all blank when defendant signed the note, he asserts that he had no (let alone a reasonable) opportunity to learn of those terms. On its face, this argument has great appeal; but defendant’s reliance thereon is foreclosed by other Code provisions.

Questions arising from incomplete instruments and material alterations are governed by K.S.A. 84-3-115 and -407, respectively. The former provides as follows:

(1) When a paper whose contents at the time of signing show that it is intended to become an instrument is signed while still incomplete in any necessary respect it cannot be enforced until completed, but when it is completed in accordance with authority given it is effective as completed.

(2) *If the completion is unauthorized the rules as to material alteration apply (section 84-3-407).*

K.S.A. 84-3-115 (emphasis added). Because defendant claims not to have authorized anyone to complete the note as it now reads, we are referred by part (2) of this section to K.S.A. 84-3-407. The latter statute provides, in part, as follows:

(3) A subsequent holder in due course may in all cases enforce the instrument according to its original tenor, *and when an incomplete instrument has been completed, he may enforce it as completed.*

K.S.A. 84-3-407(3) (emphasis added). As a holder in due course, plaintiff is thus entitled to enforce this note as it was eventually completed—and not merely as defendant would have authorized it to be completed.

The fraud allegedly committed by Gilbert does not affect this conclusion. We learn from Official UCC Comment 4 to K.S.A. 84-3-407 that “this result is intended even though the instrument was stolen from the maker or drawer and completed after the theft.” In other words, one who signs an instrument before all essential terms have been completed creates a “blank Check” that may be enforced by a subsequent holder in due course according to any terms that are completed by an intervening holder. See K.S.A. 84-3-305, Kansas Comment 1983. That was precisely what happened here. Defendant executed the note in blank; an intervening holder completed the note as it reads today; and plaintiff, as a holder in due course, is entitled to enforce the note according to its present terms. Defendant’s only legal recourse is against the intervening holder who actually completed the note without defendant’s authorization. As between

the parties now before the court, we must grant plaintiff's motion for summary judgment. . . .

See Annot., *Fraud in the Factum*, 78 A.L.R.3d 1020.

PROBLEM 34

When Ronald Rube, newly rich, moved to New York City, he was impressed by the Brooklyn Bridge when first he saw it. Simon Mustache, a con man, told Rube that he was the owner of the bridge (a lie, of course), and offered to sell it to Rube for \$2,000,000 (described as "a bargain"). Rube paid \$20,000 cash as a down-payment and signed a promissory note, payable to Mustache, for the rest. Mustache negotiated the note to a finance company, which claimed to be a holder in due course. When Rube discovered that Mustache lacked title to the bridge, he refused to pay the note. Does he have a real defense of fraud here?

PROBLEM 35

A child prodigy, Thomas Minor, had been playing the piano since he was three and making professional tours of the world since he was twelve. He looked much older than his seventeen years. He signed a promissory note for \$800 payable to the order of Merry Music Company as payment for a piano, planning to tour with it. The company was unaware of Minor's age. The payee indorsed the note over to the Big National Bank for \$725. When the first payment came due, Minor refused to pay. He told the bank to come pick up the piano—he was disaffirming the sale. Who wins?

PROBLEM 36

Childe Harold, also age 17, received a check for \$1,000 from his employer and decided to use it to buy a car from Byron Auto Sales, a used car dealership. He picked out the car he wanted, indorsed the check in blank, and handed it over to the salesman. Byron Auto Sales indorsed the check on the back and cashed it at its own bank, the Crusaders National Bank. Before this bank could present the check to the drawee bank, Childe Harold decided to buy a horse instead of an automobile, so he returned the car to the dealer and asked for the check back. Informed that the bank

had it, Childe Harold called up the bank and informed it of his rescission of the contract. When the bank refused to return the check to Childe Harold, he filed suit, asking the court to restrain the bank from presenting the check to the drawee and to order replevin of the check. How should the court rule? It is clear that a holder in due course takes subject to the defense of infancy, but does he take subject to a claim to the instrument based on infancy? See §§3-202, 3-305(a) and (b), and 3-306.

Mental incapacity. Notes signed by those who are mentally incompetent are *void* or *voidable* depending on the equities of the situation (i.e., the knowledge of the person dealing with the incompetent, the benefit received by the incompetent, the degree of incompetency, etc.). If someone has been judicially declared incompetent, his or her instruments are more likely to be declared void (hence a nullity) than if no adjudication has taken place. See Annot., Insanity as Defense Against Holder in Due Course, 24 A.L.R.2d 1380.

Sea Air Support, Inc. v. Herrmann

Nevada Supreme Court, 1980
613 P.2d 413, 29 U.C.C. Rep. Serv. 918

PER CURIAM.

Ralph Herrmann wrote a check for \$10,000 payable to the Ormsby House, a hotel-casino located in Carson City, Nevada, and exchanged it for three counter checks he had written earlier that evening to acquire gaming chips. The Ormsby House was unable to collect the proceeds from the check because Herrmann had insufficient funds in his account. The debt evidenced by the check was assigned to Sea Air Support, Inc., dba Automated Accounts Associates, for collection. Sea Air also was unsuccessful in its attempts to collect and, therefore, filed this action against Herrmann to recover \$10,567.

The district judge dismissed the action on the ground that Sea Air's claim is barred by the Statute of Anne. Sea Air appeals the dismissal. We are asked to reconsider the long line of Nevada cases refusing to enforce gambling debts. We refuse to do so, and affirm the dismissal.

Nevada law incorporates the common law of gambling as altered by the Statute of 9 Anne, c.14, 1, absent conflicting statutory or constitutional provisions. N.R.S. 1.030; *West Indies v. First National Bank*, 67 Nev. 13, 214 P.2d 144 (1950); *Burke v. Buck*, 31 Nev. 74, 99 P. 1078 (1909). The Statute provides that all notes drawn for the purpose of reimbursing or repaying any money knowingly lent or advanced for gaming are "utterly void, frustrate, and of none effect." Despite the fact that gambling, where licensed, is legal

in Nevada, this court has long held that debts incurred, and checks drawn, for gambling purposes are void and unenforceable. *Corbin v. O'Keefe*, 87 Nev. 189, 484 P.2d 565 (1971); *Wolpert v. Knight*, 74 Nev. 322, 330 P.2d 1023 (1958); *Weisbrod v. Fremont Hotel*, 74 Nev. 227, 326 P.2d 1104 (1958); *West Indies*, 67 Nev. at 31; *Burke*, 31 Nev. at 80; *Evans v. Cooke*, 11 Nev. 69 (1876); *Scott v. Courtney*, 7 Nev. 419 (1872).

In this case, Herrmann's \$10,000 check clearly was drawn for the purpose of repaying money knowingly advanced for gaming. See *Craig v. Harrah*, 66 Nev. 1, 201 P.2d 1081 (1949). The check is void and unenforceable in this state. If the law is to change, it must be done by legislative action.

Sea Air seeks to avoid the defense that the check is void and unenforceable because of gaming purpose by claiming to be a holder in due course, immune to most defenses. N.R.S. 3-305. "A holder in due course is a holder who takes the [negotiable] instrument (a) For value; and (b) In good faith; 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." N.R.S. 3-302(1). Sea Air promised to take "such legal action as may be necessary to enforce collection" of the \$10,000. The promise to perform services in the future does not constitute taking for value under N.R.S. 3-303. Anderson, 2 Uniform Commercial Code (2d ed.) §3303:3. In addition, Sea Air had at least constructive notice of a defense against collection because the check was payable to a casino, and Sea Air knew the check had been dishonored. Consequently, Sea Air is not a holder in due course. The action was properly dismissed.

Affirmed.

QUESTION

If Sea Air had been a holder in due course, would it have been able to enforce the check? See §3-305(a); *Casanova Club v. Bisharat*, 189 Conn. 591, 458 A.2d 1, 35 U.C.C. Rep. Serv. 1207 (1983). It should be noted that following the decision in *Sea Air Support*, the Nevada legislature amended its gaming laws to permit casinos to sue on credit instruments received in payment of gambling debts. Nev. Rev. Stat. 463.368.

Kedzie & 103rd Currency Exchange, Inc. v. Hodge

Illinois Supreme Court, 1993
156 Ill. 2d 112, 619 N.E.2d 732, 21 U.C.C. Rep. Serv. 2d 682

FREEMAN, J.

We consider here whether a holder in due course of a check is precluded from payment as against the drawer where the check was given

in exchange for contract services for which the provider was required to be, but was not, a licensed plumber. We conclude such a claim is not precluded.

BACKGROUND

Pursuant to a written “work order,” Fred Fentress agreed to install a “flood control system” at the home of Eric and Beulah Hodge of Chicago for \$900. In partial payment for the work, Beulah Hodge drafted a personal check payable to “Fred Fentress—A-OK Plumbing” for \$500 from the Hodges’ joint account at Citicorp Savings.

The system’s components were not delivered to the Hodges’ home as scheduled. And, when Fentress failed to appear on the date set for installation, Eric Hodge telephoned him to announce the contract “cancelled.” Hodge also told Fentress that he would order Citicorp Savings not to pay the check Fentress had been given.

Records of Citicorp Savings confirm acknowledgment of a stop-payment order entered the same day.

Nevertheless, Fentress presented the check at the Kedzie & 103rd Street Currency Exchange (Currency Exchange), endorsing it as “sole owner” of A-OK Plumbing, and obtained payment. However, when the Currency Exchange later presented the check for payment at Citicorp Savings, payment was refused in accordance with the stop-payment order.

The Currency Exchange, alleging it was a holder in due course (see Ill. Rev. Stat. 1989, ch. 26, par. 3-302), then sued Beulah Hodge, as drawer of the check, and Fentress for the amount stated. Hodge, in turn, filed a counterclaim against Fentress. Hodge also moved to dismiss the Currency Exchange’s action against her (see Ill. Rev. Stat. 1989, ch. 110, par. 2-619). The disposition of Hodge’s motion gives rise to this appeal.

Hodge asserted a defense provided by 3-305 of the Uniform Commercial Code (UCC) (Ill. Rev. Stat. 1989, ch. 26, par. 3-305). Under that section, the claim of a holder in due course of a negotiable instrument may be barred based on “illegality of the transaction.” (Ill. Rev. Stat. 1989, ch. 26, par. 3-305(2)(b).)⁸ Hodge contended Fentress was not a licensed plumber as was required under the Illinois Plumbing License Law (see Ill. Rev. Stat. 1989, ch. 111, pars. 1101 through 1140). The director of licensing and registration of the Chicago department of buildings and the keeper of plumbing licensing records of the Illinois Department of Public Health provided affidavits supporting that contention. Hodge asserted that, because Fentress was in violation of the Illinois Plumbing License Law, his promised performance under the

8. [Now §3-305(a)(1)(ii) — Ed.]

contract gave rise to the requisite “illegality” to bar the Currency Exchange’s claim for payment.

The circuit court granted the motion and dismissed the Currency Exchange’s action against Hodge. The appellate court, with one justice dissenting, affirmed. (234 Ill. App. 3d 1017.) Pursuant to Supreme Court Rule 315(a) (134 Ill. 2d R. 315(a)), we allowed the Currency Exchange’s petition for leave to appeal.

DISCUSSION

... The Illinois Plumbing License Law requires that all plumbing, including “installation . . . or extension” of “drains,” be performed by plumbers licensed under the Act. (Ill. Rev. Stat. 1989, ch. 111, pars. 1102(5), (8), 1103.) The affidavits establish that Fentress was not licensed either by the City of Chicago or the State of Illinois. That failure is a violation of the Illinois Plumbing License Law and is punishable as a misdemeanor. Ill. Rev. Stat. 1989, ch. 111, pars. 1103, 1128. . . .

... The concern is whether noncompliance by Fentress with the Illinois Plumbing License Law gives rise to “illegality of the transaction” with respect to the contract for plumbing services so as to bar the claim of the Currency Exchange, a holder in due course of the check initially given Fentress.

The issue of “illegality” arises “under a variety of statutes.” (Ill. Ann. Stat., ch. 26, par. 3-305, Uniform Commercial Code Comment, at 66 (Smith-Hurd Supp. 1992).) In view of the diverse constructions to which statutory enactments are given, “illegality” is, accordingly, a matter “left to the local law.” (Ill. Ann. Stat., ch. 26, par. 3-305, Uniform Commercial Code Comment, at 66 (Smith-Hurd Supp. 1992).) Even so, it is only when an obligation is made “entirely null and void” under “local law” that “illegality” exists as one of the “real defenses” under 3-305 to defeat a claim of a holder in due course. (Ill. Ann. Stat., ch. 26, par. 3-305, Uniform Commercial Code Comment, at 66 (Smith-Hurd Supp. 1992).) In effect, the obligation must be no obligation at all. If it is “merely voidable” at the election of the obligor, the defense is unavailable. Ill. Ann. Stat., ch. 26, par. 3-305, Uniform Commercial Code Comment, at 66 (Smith-Hurd Supp. 1992).

Historically, this court has recognized “illegality” to arise only in view of legislative declaration affecting both the underlying contract or transaction and the instrument exchanged upon it. (*Pope v. Hanke* (1894), 155 Ill. 617, 628-30; *Town of Eagle v. Kohn* (1876), 84 Ill. 292, 295-96.) A contract or transaction which is void must certainly negate the obligation to pay arising from it as between the contracting parties. (*Pope*, 155 Ill. at 626; *Kohn*, 84 Ill. at 296.) But, unless an instrument memorializing the

obligation is also made void, an innocent third party who has no knowledge of the circumstances of the initial contract or transaction may yet claim payment of it against the drawer or maker. *Pope*, 155 Ill. at 626; *Kohn*, 84 Ill. at 296.

Thus, “illegality” has been held to defeat the claims of holders in due course in cases involving contracts of a gaming nature or for retirement of gambling debts. [Citations omitted.] Owing to a deep-seated hostility toward nongovernmental-sanctioned gambling, our legislature has declared that any instrument associated with such activity is void, independent of the status of who may possess it. [Citations omitted.] The absence of similar legislative declaration as for an instrument given upon a usurious contract must account, in part, for the conclusion that usury has not been held to give rise to “illegality” as a defense against a holder in due course. [Citations omitted.]

That the existence or absence of legislative declaration controls the issue was recognized by our appellate court in *McGregor v. Lamont* (1922), 225 Ill. App. 451, a case involving circumstances similar to those here. John T. Lamont was the maker of a note used to pay for shares of stock issued by the Corn Belt Farmers’ Cooperative Association (Association). Lamont’s note subsequently came into the possession of Robert Roy McGregor, a holder in due course. When Lamont failed to pay on the note, McGregor filed suit and obtained a judgment against him.

Lamont moved to vacate the judgment. Lamont asserted that the purchase of the shares of stock was void under the Illinois Securities Law because the Association had not complied with its requirements. Because the transaction was void, Lamont concluded, the note given in payment must also be void despite McGregor’s status as a holder in due course.

The appellate court noted that the Illinois Securities Law did, indeed, make transactions for the sale of shares of stock void based on noncompliance with the Law’s requirements. (*McGregor*, 225 Ill. App. at 453-454, 455.) But the court noted that only the “sale and contract of sale” of shares of stock were expressly made void, not instruments exchanged upon such contracts. (*McGregor*, 225 Ill. App. at 455.) Absent legislative declaration making such instruments void, the court declined to recognize a defense to McGregor’s action for payment on the note. *McGregor*, 225 Ill. App. at 455.

The same rule obtains in New Jersey. In *New Jersey Mortgage & Investment Corp. v. Berenyi* (App. Div. 1976), 140 N.J. Super. 406, 356 A.2d 421, a holder in due course of a note was permitted to maintain a claim for its payment even though the note had been initially obtained by a corporation in a transaction which violated an injunctive order. No statute rendered the note void, and the holder in due course had no knowledge or notice of the injunction. (*Berenyi*, 140 N.J. Super. at 408,

356 A.2d at 423.) But in *Westervelt v. Gateway Financial Service* (Ch. Div. 1983), 190 N.J. Super. 615, 464 A.2d 1203, the “illegality” defense was held to bar the claim of a holder in due course of a secondary mortgage and note because New Jersey’s Secondary Mortgage and Loan Act specifically made void “[a]ny obligation on the part of the borrower arising out of a secondary mortgage loan.” (*Westervelt*, 190 N.J. Super. at 620, 464 A.2d at 1205.) *Westervelt* involved what *Berenyi* did not: applicability of a direct statutory expression that an instrument, itself, arising from a particular contract or transaction was void. *Westervelt*, 190 N.J. Super. at 623, 464 A.2d at 1207.

Several other jurisdictions also find reason to draw a distinction between the voidness of a negotiable instrument and the underlying contract or transaction upon which it is exchanged. (See Annot., 80 A.L.R.2d 465, 472-476 (1961) (summarizing several state decisions in which holders in due course were permitted to claim payment of instruments executed in favor of foreign corporations doing business in states without complying with local licensing requirements).) Although recognition of that distinction is not universal (see *Columbus Checkcashiers v. Stiles* (1990), 56 Ohio App. 3d 159, 565 N.E.2d 883; *Wilson v. Steele* (1989), 211 Cal. App. 3d 1053, 259 Cal. Rptr. 851 (holding that “illegality” need only be present in the underlying contract between an unlicensed contractor and the drafter of a negotiable instrument to bar the claim of a holder in due course)), we are convinced it remains the better rule.

A plaintiff is precluded from recovering on a suit involving an illegal contract because the plaintiff is a wrongdoer. (See *Bankers Trust Co. v. Litton Systems, Inc.* (2d Cir. 1979), 599 F.2d 488, 492 (citing the Restatement of Contracts and Restatement (Second) of Contracts).) Enforcement of the illegal contract makes the court an indirect participant in the wrongful conduct. See *Litton*, 599 F.2d at 493.

But a holder in due course is an innocent third party. (*Litton*, 599 F.2d at 492-493.) Such a holder is without knowledge of the circumstances of the contract upon which the instrument was initially exchanged. (Ill. Rev. Stat. 1989, ch. 26, par. 3-302(1)(c) (defining a holder in due course, in part, as a holder who is “without notice . . . of any defense against or claim to [the instrument] on the part of any person”).) The same rationale that precludes recovery by a wrongdoing plaintiff is inapplicable in determining such a holder’s right to claim payment. (*Litton*, 599 F.2d at 492-493.) Enforcement of that claim does not sully the court. *Litton*, 599 F.2d at 492-493.

The holder in due course concept is intended to facilitate commercial transactions by eliminating the need for “elaborate investigation” of the nature of the circumstances for which an instrument is initially exchanged or of its drafting. (*Litton*, 599 F.2d at 494.) If “illegality” means

simply negation of the initial obligation to pay, a holder in due course enjoys no more protection than a party to the original contract or transaction. The “real” defense of “illegality” is reduced to a “personal” one. See *Vedder v. Spellman* (1971), 78 Wash. 2d 834, 839-840, 480 P.2d 207, 210 (Neill, J., concurring).

It is, therefore, not enough simply to conclude that the initial obligation to pay arising from a void contract or transaction is void. Negation of that obligation as between the contracting parties has little bearing on whether a holder in due course of an instrument arising from the contract or transaction should nevertheless be permitted to make a claim for payment.

The “local law” (Ill. Ann. Stat., ch. 26, par. 3-305, Uniform Commercial Code Comment, at 66 (Smith-Hurd Supp. 1992)) of this state has been formulated upon this court’s recognition, in cases predating the UCC, of legislative prerogative regarding negotiable instruments. In adopting the UCC and, in particular, 3-305, our legislature chose to confer upon a holder in due course of a negotiable instrument considerable protection against claims by persons to it. Our legislature also continues to declare certain obligations void because of the circumstances of the agreements from which they arise and without regard to the status of who may claim ownership. (Ill. Rev. Stat. 1989, ch. 38, par. 28-7(b) (subjecting “[a]ny obligation” made void by reason of gambling to be “set aside and vacated” by any court).) The selective negation of obligations reflects a legislative aim to declare what will and will not give rise to “illegality” in cases now governed by the UCC. As legislative direction indicates which obligations are always void, legislative silence indicates when the protection afforded a holder in due course must be honored.

We therefore reaffirm, today, the view this court has consistently recognized in cases predating the UCC. Unless the instrument arising from a contract or transaction is, itself, made void by statute, the “illegality” defense under §3-305 is not available to bar the claim of a holder in due course.

CONCLUSION

To determine whether Hodge is entitled to a judgment of dismissal, we need not engage in an analysis aimed at characterizing the contract between Fentress and the Hodges. Whether the underlying contract should be considered void because Fentress was not licensed as required by the Illinois Plumbing License Law is not dispositive of the Currency Exchange’s right, as a holder in due course, to claim payment of the check. It is relevant only to determine whether the Illinois Plumbing License Law provides that any obligation arising from a contract

for plumbing services made in violation of its requirements is void. It does not.

For the reasons stated, the judgments of the appellate and circuit courts are reversed, and the cause is remanded to the circuit court for further proceeding. Judgments reversed; cause remanded.

BILANDIC, J., dissenting . . .

The plain language of §3-305 and the comments to §3-305 make it clear that where the illegality of a transaction renders the obligation of the maker of an instrument a nullity, the illegality of the transaction can be raised as a defense by the maker of the instrument, even against a holder in due course. Section 3-305 does not state that illegality is a defense only where the instrument arising from a contract or transaction has been expressly declared void by the legislature due to the illegality of the transaction. Had the legislature intended for illegality to be a defense only where it had expressly declared an instrument void due to the illegality of the underlying transaction, it could easily have said so in §3-305. It did not say so, however.

The only inquiry necessary to resolve the issue presented in this case, then, is whether the contract between Hodge and Fentress is void on the grounds of illegality. The comments to the UCC instruct that one must look to Illinois statutory and case law to determine whether the underlying contract was illegal and, as a result of that illegality, void. (Ill. Ann. Stat., ch. 26, par. 3-305. Uniform Commercial Code Comment, at 66 (Smith-Hurd Supp. 1992).) An examination of the statute providing for the licensing of plumbers, the public policy behind that statute, and Illinois case law concerning the illegality of contracts made in contravention of professional licensing laws establishes that the contract between Hodge and Fentress is illegal and void.

The Illinois Plumbing License Law (Ill. Rev. Stat. 1989, ch. 111, par. 1101 et seq.) specifically prohibits the performance of plumbing work by nonlicensed plumbers. Pursuant to the Act, “all plumbing shall be performed only by plumbers licensed under the provisions of this Act.” (Ill. Rev. Stat. 1989, ch. 111, par. 1103(1).) The Act imposes criminal penalties on anyone performing plumbing services without a license. (Ill. Rev. Stat. 1989, ch. 111, par. 1128.) The rationale behind the prohibition of plumbing work by nonlicensed plumbers is set forth in the Plumbing License Law. The portion of the Law setting forth its purpose and underlying policy states:

It has been established by scientific evidence that improper plumbing can adversely affect the health of the public. . . . Faulty plumbing is potentially lethal and can cause widespread disease and an epidemic of disastrous consequences.

To protect the health of the public it is essential that plumbing be installed by persons who have proven their knowledge of the sciences of pneumatics and hydraulics and their skill in installing plumbing.

Consistent with its duty to safeguard the health of the people of this State, the General Assembly therefore declares that individuals who plan, inspect, install, alter, extend, repair and maintain plumbing systems shall be individuals of proven skill. . . . [T]his Act is therefore declared to be essential to the public interest. (Ill. Rev. Stat. 1989, ch. 111, par. 1101.)

Here, the contract between Hodge and Fentress presents the kinds of dangers the Illinois Plumbing License Law was intended to guard against. Affidavits attached to Hodge's 2-619 motion to dismiss, which were not contradicted by the plaintiff, establish that Fentress was not a licensed plumber. The affidavits also establish that Hodge and her husband, Eric, believed that Fentress was a licensed plumber at the time they contracted with him for plumbing services. Had Fentress performed the work required of him pursuant to the contract with Hodge, it is likely that his work would not have conformed to acceptable plumbing standards and would have posed the kinds of dangers which the Plumbing License Law was intended to prevent. . . .

The majority asserts that to bar recovery by the Currency Exchange in this case would be unfair because the Currency Exchange is an innocent third party which had no knowledge of the circumstances of the contract between Hodge and Fentress. However, section 3-305 clearly provides that the general policy favoring free negotiability is not absolute. There is a competing policy disfavoring certain transactions, such as those involving infancy, duress, illegality or misrepresentation as to the true nature of an instrument (i.e., fraud in the factum). (Ill. Rev. Stat. 1989, ch. 26, par. 3-305.) Pursuant to §3-305, the Currency Exchange takes a check subject to these and certain other real defenses. The Illinois legislature has provided that, by definition, a holder in due course is one who does not have notice of any of the real defenses listed in §3-305. (See Ill. Rev. Stat. 1989, ch. 26, par. 3-302(1)(c).) By statute, the innocence of the holder in due course cannot defeat *any* of the real defenses listed in §3-305, including illegality. Accordingly, the argument that the Currency Exchange could not have known that the underlying transaction was illegal is simply misplaced. Such reasoning would lead to the conclusion that all of the defenses listed in §3-305 should be unavailable to defeat the claim of a holder in due course, a conclusion obviously contrary to the provisions of §3-305.

For the above reasons, I dissent. I would affirm the judgment of the appellate court which affirmed the circuit court's dismissal of the Currency Exchange's action against Hodge.

PROBLEM 37

When she heard her creditors fighting over priorities on her doorstep, Elsie Maynard knew that she had no choice but bankruptcy. Among the debts that she reported to the bankruptcy court was the loan she had taken from Point National Bank, which was evidenced by a promissory note she had signed. In due course the bankruptcy proceeding culminated in the judge's ordering that Elsie be discharged from all her scheduled debts. Two years later, the promissory note surfaced in the possession of Shadbolt State Bank, which claimed quite convincingly to be a holder in due course. Must Elsie pay? See §3-305(a)(1) and (b).

A Little Lecture on Discharge as a Real Defense. Subsection (b) to §3-302 tells us that:

Notice of discharge of a party, other than discharge in an insolvency proceeding, is not notice of a defense under subsection (a), but discharge is effective against a person who becomes a holder in due course with notice of the discharge. . . .

What does this mean? Well, first of all, as the above Problem illustrates, discharge in bankruptcy *is always a real defense*, regardless of what the subsequent holder knows or doesn't know at the time of acquisition of the instrument. Any other discharge that the Code or common law creates is not effective against a holder in due course *unless* that holder, at the time of acquisition, knew of the discharge, in which case the discharge is, in effect, a real defense and assertable against the holder in due course. For example, suppose that there are four sureties who have signed their names as indorsers on a promissory note. The current holder of the note decides to excuse one of them from future liability, and so draws a line through that surety's name, thus discharging that person from all liability (see §3-601 and its Official Comment). Even a later holder in due course of the note, seeing the line drawn through the former surety's name, would know that that surety is no longer liable on the note, and therefore could only enforce it against the other obligors.

PROBLEM 38

Malvolio, a traveling salesman, bought a new car from Valentine Auto Sales, signing a note for \$18,000. The payee discounted the note for \$16,800 to the Orsino Finance Company, which notified Malvolio that he should make all future payments to them. Malvolio immediately sent them a check

for the outstanding balance (he had come into some money when his aunt died). He asked for the note back, but Orsino was evasive. A week later Malvolio received a note from the Olivia Finance Company saying that his note had been assigned to them and that he should direct his payments to their office. When Malvolio protested, they made holder in due course noises and became quite nasty. Malvolio, worried, comes to you for advice. What should he do? See §3-501(b)(2); read §§3-601 and 3-602. For the result in the 2002 version of Article 3, see §3-602(b). Does Malvolio have remedies outside the Code? Think back to your course in Contracts.

B. A Special Note on Forgery

Forgery creates very complicated problems under the Code, and these will be dealt with later. The important issue for now is whether forgery is a real defense under the Code, so that it can be raised against a holder in due course, or a personal defense, so that it cannot. The answer to this question lies in §3-401(a): “A person is not liable on an instrument unless (i) the person signed the instrument . . .” and in §3-403(a):

Unless otherwise provided in this Article or Article 4, an unauthorized signature is ineffective except as the signature of the unauthorized signer in favor of a person who in good faith pays the instrument or takes it for value . . .

Consider the following Problem.

PROBLEM 39

Jimmy Slick, an expert con man, went into John’s Jewelers and told John, the owner, that he was Milton Money, the richest man in town. John was too awed to ask for identification. Slick then picked out several very expensive pieces of jewelry and signed Money’s name to a promissory note to pay for them. Slick skipped town with the jewelry. When the note matured, the Tenth National Bank (a holder in due course to whom John has negotiated the paper) presented it to Milton Money for payment. May Money refuse to pay a holder in due course?

The answer to this Problem is obviously that Money is not liable, but as an attorney how do you get away from the all encompassing language of §3-305(a) and (b)? Read §3-305(a) and (b) again and see if you can determine how Money’s forgery defense fits into the statute.

Additionally, if the forgery is of a name necessary to a valid negotiation, there can be no holder in due course following the forgery because no later transferee will qualify as a *holder*. See the discussion *supra* at pages 32-34.

PROBLEM 40

When Barbara Shipek was off to Las Vegas for a fun weekend, she bought a traveler's check for \$3,000 from Octopus National Bank (ONB). The payee line on the traveler's check was blank, but the bank had her sign a line on the check indicating the name of the remitter (see §3-103 (a)(11)). The check contained another blank for a countersignature, under which was printed a statement that the bank would pay the traveler's check only if the remitter re-signed the check on this blank at the time of negotiation to the payee. On Ms. Shipek's first night in Las Vegas a thief stole her purse, getting the traveler's check as part of the booty. The thief apparently forged Ms. Shipek's name on the countersignature line and negotiated the check to Vegas Check-Cashing City, an entity listed as payee when the check was presented by Vegas Check-Cashing City to ONB for payment, by which time Ms. Shipek had phoned the bank and told them what had happened. You are the attorney for the bank. Should it pay the traveler's check to Vegas Check-Cashing City? See §§3-104(i) and 3-106(c) with its Official Comment 2.

C. *Procedural Issues*

One does not have to be a holder in due course in order to sue on the instrument; a "person entitled to enforce the instrument," a phrase defined in §3-301, may do so. Generally a "person entitled to enforce the instrument" means the *holder* of the instrument (someone in possession pursuant to a valid negotiation), though the phrase does include some non-holders—namely, someone who gets holder rights under the shelter rule (or a depositary bank per §4-205), the rightful owner of a lost instrument (§3-309), or the defendant in a successful restitution action (§3-418(d), yet to be discussed). Only if a defense or claim to the instrument arises will the holder's due course status become relevant, at which time the holder has the burden of establishing the position as a holder in due course. Read §3-308(b).

As mentioned above, and elaborated on later in the forgery discussion, a holder must take through a chain of indorsements that is free of

forgeries affecting the title. When the genuineness of signatures becomes an issue, §3-308(a) allocates the procedural burdens. Read it.

Virginia National Bank v. Holt

Virginia Supreme Court, 1975

216 Va. 500, 219 S.E.2d 881, 18 U.C.C. Rep. Serv. 440

COMPTON, J.

... In May 1974, the plaintiff, Virginia National Bank, filed a motion for judgment against the defendants, Edgar M. Holt and Gustava H. Holt, his wife, jointly and severally, seeking recovery of the face amount of a "Homestead Waiving Promissory Note," plus interest and attorney's fees. The instrument, payable to the order of the Bank and allegedly made by the Holts to evidence an indebtedness, was dated December 12, 1973, was due 90 days after date, and was in the amount of \$6,000.

Edgar M. Holt was duly served with process, but failed to appear on file pleadings in response. A default judgment in the amount sued for was entered against him in August 1974.

In her pleadings, Gustava H. Holt generally denied liability and specifically denied that the instrument was signed by her. On November 20, 1974, judgment was entered on a jury verdict in her favor and we granted the Bank a writ of error.

The dispositive issue is whether the evidence relating to the genuineness of Mrs. Holt's signature on the instrument presented a question of fact to be decided by the jury. We hold that it did not and reverse.

We will summarize only the evidence pertinent to the issue we decide. Testifying for the Bank was one of its commercial loan officers, who did not handle the Holt transaction but through whom the instrument in question was introduced into evidence, and two other witnesses, one of whom was an expert in handwriting analysis, whose statements supported the Bank's position that the signature on the note was in fact the defendant's.

Mrs. Holt did not appear at the trial, but her attorney endeavored to show that his client did not execute the instrument. During cross-examination, the loan officer, over the Bank's objection based on the hearsay rule, was required to answer whether he was present during the taking of Mrs. Holt's discovery deposition in July 1974 when she "denied that she signed the note." The record shows that the witness responded, "Yes, I was. Somewhat surprised." No other statement was elicited by defendant's counsel from any of the Bank's witnesses which would support the defendant's claim that she did not sign the writing.

The only evidence offered in the defendant's behalf was a set of answers previously filed by the Bank to six interrogatories propounded by her attorney. Those responses indicated that the Bank did not know of any witness who saw the defendant sign the note or who heard her admit that she signed it. They further indicated that the Bank had no information that she ever authorized her husband to sign her name to any promissory note or that she ever ratified any act of his in signing her name to such a writing.

By a motion to strike at the conclusion of the evidence, and again by a motion to set aside after the verdict, the Bank moved for judgment in its favor contending, as it does on appeal, that the foregoing hearsay testimony on cross-examination was erroneously admitted and, in the alternative, that even if such evidence was properly received, the defendant had failed, as a matter of law, to overcome the presumption established by §3-307 [§3-308 in the Revision—Ed.] that her signature was genuine and authorized. The trial court, in refusing to sustain the motion to strike and in overruling the motion to set aside, ruled that the question of whether the signature was genuine was for the jury. This was error.

Section 3-307, *inter alia*, sets out the burden of proof in an action which seeks recovery upon an "instrument" and deals with issues arising, in such a suit, from a challenge of the genuineness or authorization of signatures. 2 R. Anderson, Uniform Commercial Code §3-307:3 (2d ed. 1971). Under that section, each signature on an instrument is admitted unless, as in this case, the "effectiveness" of the signature is put in issue by a specific denial. The burden of establishing the genuineness of the signature is then upon the party claiming under the signature and relying on its "effectiveness," but such party is aided by a presumption that it is genuine or authorized. In this context, "presumption" means that "the trier of fact must find the existence of the fact presumed unless and until evidence is introduced which would support a finding of its nonexistence." Code §1-201(31).

The effect of the presumption is to eliminate any requirement that the plaintiff prove the signature is authentic until some evidence is introduced which would support a finding that the signature is forged or unauthorized. §3-307, Official Comment 1. It is based upon the fact that in the normal course of events forged or unauthorized signatures are very uncommon, and that evidence of such is usually within the defendant's control or more accessible to him. *Id.* Therefore, under §3-307, the party denying a signature must make some sufficient showing of the grounds for the denial before the plaintiff is put to his proof. The evidence need not be sufficient to require entry of summary judgment in the defendant's favor, "but it must be enough to support his denial by permitting a finding in his favor." *Id.* "Until the party denying the signature

introduces such sufficient evidence, the presumption requires a finding for the party relying on the effectiveness of the signature.” §3-307, Virginia Comment. See 2 F. Hart & W. Willier, *Commercial Paper Under the Uniform Commercial Code* §2.07(2) (1975).

An application of the foregoing analysis of the statute to the facts of this case demonstrates that the Bank was entitled to entry of summary judgment in its favor at the conclusion of all the evidence, since no material issue of fact requiring resolution by a jury was presented. Rule 3:18.

The defendant’s specific denial put the genuineness of the defendant’s signature in issue. Because of the foregoing presumption, the signature, which appeared to be that of Gustava H. Holt, was presumed to be genuine and the defendant was thus required to present “sufficient evidence” in support of the denial of genuineness. This she failed to do. We will assume, but not decide, that the disputed answer during cross-examination was properly admitted in evidence. Nonetheless, we conclude that this bit of testimony is insufficient to sustain a finding that the signature was forged or unauthorized. Furthermore, the answers to interrogatories furnish no support to the defendant’s claimed defense. A forgery or an unauthorized signature may not be shown by merely demonstrating the plaintiff’s apparent lack of evidence on that issue.

We hold, therefore, that the defendant has failed, as a matter of law, to make a sufficient showing to support a finding that she, or her authorized representative, did not in fact write her name on the instrument. The presumption then requires a finding that the signature on the instrument is genuine and effective. Accordingly, production of the instrument entitled the Bank to recover, because the defendant established no defense, 3-307(2), and it was error to submit the case to the jury. For these reasons, the judgment in favor of Gustava H. Holt will be reversed and final judgment will be entered here in favor of the Bank.

Reversed and final judgment.

QUESTION

Would it have been sufficient to overcome the presumption if Mrs. Holt had taken the stand and denied the signature? See *Metropolitan Mortgage Fund v. Basiliko*, 407 A.2d 773, 28 U.C.C. Rep. Serv. 100 (Md. App. 1979); *Freeman Check Cashing, Inc. v. State*, 97 Misc. 2d 819, 412 N.Y.S.2d 963, 26 U.C.C. Rep. Serv. 1186 (Ct. Cl. 1979); *Bates & Springer, Inc. v. Stallworth*, 56 Ohio App. 2d 223, 382 N.E.2d 1179, 26 U.C.C. Rep. Serv. 1181 (1978).

D. Defenses Against a Non-Holder in Due Course

Read §§3-305(a) and (b) and 3-306 carefully. Note the legal result: all *claims* and both real and personal *defenses* may be asserted against anyone who does not qualify as a holder in due course.⁹ The most common personal defenses are *want of consideration* (no consideration) and *failure of consideration* (breach of contract, called a *claim in recoupment* in the Revision).

Herzog Contracting Corp. v. McGowen Corp.

United States Court of Appeals, Seventh Circuit, 1992
976 F.2d 1062, 18 U.C.C. Rep. Serv. 2d 1170

POSNER, Circuit Judge.

The district judge granted summary judgment in favor of Herzog Contracting Corporation in its diversity suit to enforce two promissory notes, aggregating \$400,000, against the issuer, McGowen Corporation. The appeal raises a tangle of jurisdictional and substantive questions, the latter governed, the parties agree, by Indiana Law. . . .

The next jurisdictional issue requires us to delve into the facts. In 1989 Herzog, the plaintiff, bought the assets of Tru-Flex Metal Hose Corporation from McGowen, the defendant, and formed a wholly owned subsidiary of Herzog (also called Tru-Flex) to hold them, to which Herzog assigned the asset purchase agreement. The agreement called for annual payments from Tru-Flex to McGowen of \$500,000 for five years. The two promissory notes, both demand notes, were issued by McGowen to Tru-Flex later in 1989. The parties have radically different positions on the purpose of the notes. Herzog claims that it loaned McGowen \$400,000 and the notes are McGowen's promises to repay the loan. McGowen acknowledges having received the \$400,000 but denies that it was a loan, contending instead that it was partial prepayment of the next year's installment due under the asset purchase agreement and that the only purpose of the notes that it gave Tru-Flex was to enable it (that is, McGowen) to postpone the realization of taxable income to the following year by making the \$400,000 payment look like a loan.

The parties soon fell to squabbling and Herzog refused to make further payments under the asset purchase agreement, precipitating a suit

9. The only claim a non-holder in due course takes free of is a perfected security interest in non-negotiable instruments, and then only if they are purchased for value in the ordinary course of business without notice of the security interest (§9-330). This is an Article 9 matter, and at this point don't worry what it means.

by McGowen against Herzog in an Indiana state court for breach of contract that remains pending. At about the same time that the state court suit was brought, Tru-Flex assigned McGowen's promissory notes to Herzog, which shortly afterward brought this suit to enforce them. . . .

We come to the merits. The case was decided on summary judgment and there has been no determination of the truth of McGowen's claim that the promissory notes were never intended to be presented for payment. So we must assume that the claim is true. The question is whether, as the district judge held, solely on the basis that the notes are "clear and unambiguous," they are enforceable regardless of what the parties actually intended.

They would be if enforcement were being sought by a holder in due course, UCC §3-305, Ind. Code §26-1-3-305, but Herzog concedes that it is not that. It places its case on the parol evidence rule. The promissory notes are unambiguous—they promise Herzog a specified sum of money on demand—and their terms cannot be varied by extrinsic evidence. At first glance Herzog's argument seems a complete nonstarter. A holder of a promissory note who is not a holder in due course takes the note subject to "all defenses of any party which would be available in an action on a simple contract," UCC §3-306(b) [§3-305(b) in the Revision—Ed.], and one of those defenses, notwithstanding the parol evidence rule, is that the parties did not intend to create an enforceable contract. 2 E. Allan Farnsworth, *Farnsworth on Contracts* §7.4, at p.212 (1990); James J. White & Robert S. Summers, *Handbook of the Law under the Uniform Commercial Code* §2-10, at p.78 (1980). "It is well settled that whatever the formal documentary evidence, the parties to a legal transaction may always show that they understood a purported contract not to bind them; it may, for example, be a joke, or a disguise to deceive others." In re H. Hicks & Son, Inc., 82 F.2d 277, 279 (2d Cir. 1936) (L. Hand, J.); see also *Nice Ball Bearing Co. v. Bearing Jobbers, Inc.*, 205 F.2d 841, 845 (7th Cir. 1953). The deceived others may, of course, be able to object to the attempt to prove the contract a sham, as in *Central States, Southeast & Southwest Areas Pension Fund v. Gerber Truck Service, Inc.*, 870 F.2d 1148 (7th Cir. 1989) (en banc), and *FDIC v. O'Neil*, 809 F.2d 350 (7th Cir. 1987), but that is not a factor here. More to the point, a minority of jurisdictions "have refused to admit such evidence [i.e., that the purported contract was a joke, a disguise, in short a sham of some sort] where the purpose of the sham agreement was offensive to public policy." 2 Farnsworth, *supra*, §7.4, at p.212 n.4; see Annot., "Admissibility of Oral Evidence to Show That a Writing Was a Sham Agreement Not Intended to Create Legal Relations," 71 A.L.R.2d 382, 393-397 (1960); 67 A.L.R.2d Later Case Service 555 (1984), and for an illustrative case *Kergil v. Central Oregon Fir Supply Co.*, 213 Or. 186, 323 P.2d 947 (1958).

We prefer the majority rule, illustrated by our decision in *Nice Ball Bearing Co. v. Bearing Jobbers, Inc.*, *supra*, so will apply it here in default of any Indiana cases on the question. Apart from the fact that the minority rule rewards a party to the sham agreement and imposes a punishment that may be disproportionate to the promisor's misconduct, it invites a collateral inquiry into the character of the alleged "sham." Here the party accused of shamming by his fellow shammer was angling for a tax advantage. Did that make the transaction a "sham"? Despite the doctrine of tax law that substance prevails over form, *Gregory v. Helvering*, 293 U.S. 465 (1935); *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988), many transactions that would strike a nonspecialist as contrived purely to avoid taxes are entirely lawful. Must we therefore, to resolve this case, decide whether McGowen's effort to postpone its tax liability for the sale of Tru-Flex was one of them? We trust not.

But we are not done. In the face of the principle that any defenses to a contract are available in a suit on a promissory note unless the plaintiff is a holder in due course, some courts enforce the parol evidence rule more broadly in such suits than in suits to enforce ordinary contracts. Annot., "Admissibility of Parol Evidence to Show That a Bill or Note Was Conditional, or Given for a Special Purpose," 54 A.L.R. 702, 717-718 (1928). In *Perez-Lizano v. Ayers*, 695 P.2d 467, 469 (Mont. 1985), for example, the court refused to allow the admission of parol evidence to show that the note was a sham. One of the cases in this line is an Indiana case, *Highfield v. Lang*, 394 N.E.2d 204, 206 (Ind. App. 1979). But it is readily distinguishable from our case; and we have found two recent cases from other jurisdictions in which courts admitted parol evidence to show that a promissory note was not intended to be enforceable. *American Underwriting Corp. v. Rhode Island Hospital Trust Co.*, 303 A.2d 121, 125 (R.I. 1973); *Simpson v. Milne*, 677 P.2d 365, 368 (Colo. App. 1983). The second was a case of a sham; the parol evidence was that the notes in suit "were executed as a fiction to satisfy plaintiff's wife, who was near death, and who strongly felt that [the defendant and his wife] still owed [the plaintiff and his wife] money from prior business transactions." *Id.*

Despite these last two cases and despite UCC §3-306(b), the parties have tacitly agreed that the applicability of the parol evidence rule to this case is governed not by general contract law but by a special doctrine that allows parol evidence to show, against a plaintiff who is not a holder in due course, that the delivery of the negotiable instrument that he is suing to collect was "for a special purpose." *Brames v. Crates*, 399 N.E.2d 437, 441 (Ind. App. 1980); UCC §3-306(c); Ind. Code §26-1-3-306(c). This approach is understandable though not inevitable. While §3-306(b) subjects the nonholder in due course to "all defenses" that the original promisor would have had, implicitly including the defense that the

promise was not intended to create enforceable rights, §3-306(c) deals with some of these defenses in greater detail. This could be taken to imply that the defense that no enforceable rights were intended to be created is to be analyzed in accordance with the “special purpose” doctrine that predates the Code, though a likelier inference is that the draftsmen wanted simply to make sure that no defense was overlooked.

However this may be, Herzog argues that the special-purpose doctrine is limited to allowing the promisor (McGowen here) to defend by showing that his obligation to make good on the note was subject to a condition precedent, which is not the case here. For it is McGowen’s contention not that something had to happen before Herzog could demand payment, but that Herzog could never demand payment. Parol evidence is always admissible to prove a fraud, *Franklin v. White*, 493 N.E.2d 161, 165 (Ind. 1986); *In re Estate of Fanning*, 333 N.E.2d 80, 85 (Ind. 1975); *Kruse Classic Auction Co. v. Aetna Casualty & Surety Co.*, 511 N.E.2d 326, 330 (Ind. App. 1987), but McGowen does not contend that when Herzog agreed to the scheme for making the prepayment of the purchase installment look like a loan it intended to double-cross McGowen by demanding payment of the notes. If there was a fraud, it was against the Internal Revenue Service, though no one is arguing this. With fraud out of the picture and the scope of the parol evidence rule applicable to promissory notes conceded by McGowen to be governed by §3-306(c) rather than §3-306(b), McGowen is left with the special-purpose doctrine and Herzog concludes that a sham case is outside that doctrine, which, as we have noted, he believes to be limited to conditions precedent.

There are cases, none from Indiana, on both sides of the question whether “delivery for a special purpose” is limited to conditions precedent, although the majority view is that it is not. Compare *Perez-Lizano v. Ayers*, supra, 695 P.2d at 469-470, with *American Underwriting Corp. v. Rhode Island Hospital Trust Co.*, supra, 303 A.2d at 125. Text and history can help us choose between these positions, though history more than text. Section 3-306(c) expressly recognizes a defense of “nonperformance of any condition precedent,” making the “special purpose” defense redundant on Herzog’s construal of it. But redundancy is built into §3-306(c), as we have seen, and maybe this is another example of it. So let us turn to history.

Until sometime after the middle of the nineteenth century, courts were highly reluctant to admit parol evidence, in suits on promissory notes, for any purpose other than to prove fraud or mistake. John Barnard Byles, *A Treatise on the Law of Bills of Exchange* 169 note I (4th Am. ed. 1856). A little later, they were allowing such evidence in three additional types of cases: delivery of the note together with a mortgage deed, with the note as additional security for payment of the mortgage; delivery of the note to escrow; and delivery contingent on the satisfaction

of a condition precedent. *Id.* at 112-113 (14th ed. 1885). Some courts also allowed the admission of parol evidence “to show that a contract signed and delivered was never intended to be the real contract between the parties.” *Id.* at 113 note o. One case—oddly enough it is factually similar to ours—used the term “special purpose” to describe the defense in a “no obligation” or “sham” case. *Juilliard v. Chaffee*, 92 N.Y. 529, 534 (1883). And when the English codified their law of negotiable instruments in 1882, they expressly allowed evidence (other than against a holder in due course) that delivery had been “conditional or for a special purpose only, *and not for the purpose of transferring the property in the bill.*” James W. Eaton & Frank B. Gilbert, *A Treatise on Commercial Paper and the Negotiable Instruments Law* 697 (1903). The meaning brought out by the words that we have italicized seems unmistakable: the “special purpose” defense encompassed all cases in which the negotiable instrument had not been intended to create an enforceable obligation. Byles, *supra*, at 122 (17th ed. 1911).

The American Negotiable Instruments Law—the first statute drafted by the National Conference of Commissioners on Uniform State Laws—copied the English provision word for word. Joseph Doddridge Brannan, *The Negotiable Instruments Law Annotated* 129 (4th ed. 1926); see also *id.* at 135-41. Later, however, darkness descended, and we find some authorities distinguishing among condition cases, no-obligation cases, and special-purpose cases. Annot., “Admissibility of Parol Evidence to Show That a Bill or Note Was Conditional, or Given for a Special Purpose,” 20 A.L.R. 421, 490, 498-502 (1922); 4 William D. Hawkland & Lary Lawrence, *Uniform Commercial Code Series* 3-306:07, at p.481 (1990). This proliferation of unhelpful distinctions was abetted by the fact that the Uniform Commercial Code, in recodifying negotiable instruments law, dropped the explanatory phrase “and not for the purpose of transferring the property in the bill” from the formulation of the special purpose defense. But this was done without any intention of changing the meaning of the defense as it had appeared in the Negotiable Instruments Law. “Notes and Comments to Tent. Draft No. 2—Art. III,” 3 *Uniform Commercial Code: Drafts* 186-187 (Elizabeth Slusser Kelly ed. 1984). Certainly nothing in the history of the Uniform Commercial Code suggests a purpose of abolishing the “no obligation” defense and returning to the law as it existed before the Civil War. The tendency of our law for almost a century has been to relax strict rules, perhaps because of growing (though possibly misguided and even sentimental) confidence in the ability of judges and juries to resolve factual questions (such as, What was the purpose of McGowen’s notes?), with reasonable accuracy and at reasonable cost, by sifting testimony. The legal realists who, led by Karl Llewellyn, drafted the Uniform Commercial Code were leaders in the

movement to soften the contours of strict common law rules. See, e.g., UCC §§2-103(1)(b), 2-204, 2-205.

It hardly matters whether the no-obligation cases are subsumed under the special-purpose defense or set off by themselves or, as seems simplest and therefore—no other values being at stake so far as we can see—preferable, assimilated to the general contract doctrine that allows parol evidence to show that a contractual-looking document was not intended to be binding. The office of the parol evidence rule is to prevent parties to a written contract from seeking to vary its terms by reference to side agreements, or tentative agreements reached in preliminary negotiations. 2 Farnsworth, *supra*, §7.2, at p. 197. In the case of a condition precedent the promisor is not trying to vary the terms, but to deny the enforceability of the promise by pointing to some condition that has not been fulfilled. The distinction may seem fine-spun and even arbitrary, but it has been deemed consistent with the policy behind the parol evidence rule, or at least a tolerable qualification of it. 2 *id.*, §7.4, at pp. 211-215. Two points can be made on behalf of the distinction. The weaker, as it seems to us, is that without such an exception the rule would work dramatic forfeitures, by preventing a party from showing not merely that the terms were somewhat different from what they appeared to be but that he had never agreed to do or pay anything. The stronger point is that the parol evidence rule, properly understood, is not a rule imposed on contracting parties from without but merely an inference, drawn from the language of the document, that the parties intended it to be the complete statement of their agreement, extinguishing any agreements that might have emerged from the preliminary negotiations. *Patton v. Mid-Continent Systems, Inc.*, 841 F.2d 742, 745 (7th Cir. 1988); 2 Farnsworth, *supra*, §§7.2, 7.3, at pp. 197-198. The document is unlikely to reveal whether the parties intended it to be taken seriously, and if it does not, there is no basis for applying the rule. *In re H. Hicks & Son, Inc.*, *supra*, 82 F.2d at 279.

At all events, to allow parol evidence to expose a sham case such as this is alleged to be would make no greater inroads into the parol evidence rule than the cases on conditions precedent do. *McGowen* is not trying to change the terms in the promissory notes, but to show that the notes were not in fact intended to create a legally enforceable obligation. They were, not to put too fine a point on it, intended to fool the Internal Revenue Service. Herzog, perhaps fearing that it will be found to have been a party to this little deception, does not argue that *McGowen*'s unclean hands should forfeit its right to make a sham-transaction defense, if there is such a defense, and we think there should be because we can think of no principled distinction between it and the condition-precedent defense that Herzog concedes is valid.

The policy of the law is to facilitate negotiability by allowing assignees of negotiable instruments to take free of defenses not obvious on the fact of the note. *Northwestern National Ins. Co. v. Maggie*, No. 92-1037 (7th Cir. Sept. 23, 1992). But that policy is expressed in the doctrine of holders in due course. *Id.* Herzog made no effort to discount the notes to one who would have been such a holder and therefore could have enforced the notes against McGowen regardless of the oral agreement not to enforce them on which McGowen relies in this suit.

The judgment is reversed and the case remanded for further proceedings consistent with this opinion.

QUESTION

How would this case be decided under the 1990 Revision? See §§3-117 and 3-105(b), plus the latter's Official Comment 2.

E. Jus Tertii

It is a basic rule of law that litigants must succeed or fail on the basis of their *own* rights and not the rights of others. The rights of another, called *jus tertii*, are available to other litigants only in special circumstances. Sureties, called "accommodation parties" in the Code, are permitted, with some exceptions, to raise the defenses of their principals (called "accommodated parties"); see §3-305(d). And, as we shall see when we get to the issue of restrictive indorsements, §3-206(f) permits an obligor to refuse payment if doing so would violate the terms of a restrictive indorsement.

The Code's general prohibition against using *jus tertii* is found in §3-305(c), which you should now read. Note two important things about it. The first is that the claims of another may always be asserted if that person joins the lawsuit. The second is that §3-305(c)'s last sentence permits one *jus tertii* to be asserted against a non-holder in due course: the instrument has been lost or stolen so that the current possessor is not the true owner. If this latter *jus tertii* could not be raised, then the obligor would be exposed to the possibility of double payment when the true owner showed up.

PROBLEM 41

Craig Covey was the maker of the following promissory note, which he signed in order to buy a computer:

I, Craig Covey, promise to pay to bearer the sum of \$5,000, on demand. I also promise to buy the bearer lunch on the date of presentment.

The note was given to his uncle, who had loaned him the money for the purchase. The uncle sold the note to the Stonewall Finance Company in return for a check for \$4,500. Stonewall Finance Company's check bounced, and the uncle was very angry. He went down to the finance company's office and found that there was a sign on the door saying "GONE OUT OF BUSINESS." The next day the note was stolen from the office of the Stonewall Finance Company and later surfaced in the hands of Jane Eleanor, an innocent purchaser for value, who presented it to Craig for payment. In the meantime both his uncle and the Stonewall Finance Company had contacted Craig and asked him to refrain from paying the instrument, the uncle pointing to the bounced check and Stonewall to the fact that the note had been stolen from it. Is Jane a holder in due course? If not, can Craig raise the suggested *jus tertii* against her? If Craig wants to pay Jane, can his uncle stop him? See §3-602.

F. Conclusion

Reference has already been made to special statutes and rules (such as the FTC regulation) that restrict the holder in due course doctrine in consumer transactions. But these statutes do not cover the whole consumer field; for example, a couple signing a promissory note to a bank for a home improvement loan can still lose a lawsuit to a holder in due course. Should the doctrine be wiped out completely in consumer transactions? In commercial ventures? Professor Grant Gilmore, one of the original drafters of the Uniform Commercial Code, has commented:

The "holder in due course" concept was worked out by Lord Mansfield and his successors in the late eighteenth and early nineteenth centuries against a business background in which bills of exchange and promissory notes did in fact circulate and could be expected to pass through a number of hands before being retired. As the modern banking system developed, instruments gradually ceased to circulate. In this century nothing is rarer than a true negotiation to a third party purchaser for value—the use of negotiable notes which pass from dealer to finance company in the attempt to carry out consumer frauds is hardly a "true negotiation." The whole "holder in due course" concept could usefully have been abolished when negotiable instruments law was codified at the end of the nineteenth century. In fact it was preserved like a fly in amber both in the N.I.L. and in its successor, Article 3 of the Uniform Commercial Code. Indeed our codifications typically preserve once vital but now

obsolete concepts in much the same way that our museums preserve the ancient artifacts of bygone civilizations.

G. Gilmore, *The Death of Contract* 108 n.18 (1974). Professor Gilmore developed this idea more fully in a fascinating article: Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 *Creighton L. Rev.* 441 (1979). A leading article containing the same theme is Rosenthal, *Negotiability—Who Needs It?*, 71 *Colum. L. Rev.* 375 (1971). However, one wonders if this is still true in the twenty-first century where it is very common for promissory notes to be bundled and placed in trusts (a form of “securitization”) and then sold to investors, who are certainly innocent parties, the very sorts of entities needing holder in due course protection.

QUESTION

If Article 3 were amended to eliminate the concept of holding in due course, commercial paper would legally resemble nothing more than simple contracts. Would we then need Article 3 at all?

