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Anthony V. Amodio

Frank A. Howard

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Negotiable Instruments

FINANCE COMPANY AS A HOLDER IN DUE COURSE

Modern retail dealers, not wishing to finance their credit business themselves, often make an arrangement with a finance company whereby the latter agrees to purchase all the installment notes and chattel mortgages which the dealer acquires in the normal course of his business. In accordance with this arrangement, the finance company usually furnishes the necessary blank forms for the dealings between the purchaser and the retail dealer. These forms frequently contain an assignment to the finance company which is printed on the back of the instruments. The finance company also furnishes tables from which the rate of interest and amounts of payments are computed, and, if necessary, usually will actively participate in the transaction by offering advice.

When a buyer wishes to purchase a chattel on credit from such a retail dealer, he signs the installment note and chattel mortgage made payable to the dealer. The interest rate and the amounts of payments are computed on the above mentioned tables. The dealer may request the finance company to check on the credit rating of the purchaser or contribute other aid and advice. Immediately upon completion of the dealings between the purchaser and the retail seller the finance company purchases the instruments and takes an assignment of them in accordance with the printed conditions on the back.

Should there be a default in payment by the purchaser, if the finance company institutes a suit on the note, the question arises as to whether or not they occupy the position of a holder in due course¹ so as to be immune to personal defenses² which the purchaser may have against the retailer. The majority of recent judicial rulings have not been in their favor.

In *Taylor v. Atlas Security Co.*,³ decided in 1923, there was a standing arrangement between the finance company and the used-car dealer

¹ Uniform Negotiable Instruments Act § 52, 5 UNIFORM LAWS ANN. pt. 2, 49 (1943): "A holder in due course is a holder who has taken the instrument under the following conditions:

- (1) That it is complete and regular upon its face;
- (2) That he became the holder of it before it was overdue, and without notice that it had been previously dishonored, if such was the fact;
- (3) That he took it in good faith and for value;
- (4) That at the time it was negotiated to him he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it."

² Uniform Negotiable Instruments Act § 57, 5 UNIFORM LAWS ANN. pt. 2, 181 (1943): "A holder in due course holds the instrument free from any defect of title of prior parties, and free from defenses available to prior parties among themselves, and may enforce payment of the instrument for the full amount thereof against all parties liable thereon."

³ 213 Mo. App. 282, 249 S.W. 746 (1923).

who sold the chattel, providing that the finance company would purchase all the dealer's commercial paper. Further, the blank forms used by the dealer were furnished by the finance company, and the latter was named as payee in the notes, these instruments being purchased by the finance company immediately upon completion of the sale of the chattel. In addition, in the particular transaction which gave rise to this suit, the finance company had full knowledge that the automobile sold by the dealer was worth much less than the sale price charged, and had arranged for insuring it.

The court permitted the defense of a palpable overcharge on the part of the dealer to defeat the finance company's suit to collect the balance on the unpaid note; stating that while none of the incidents of the relationship of the finance company to this particular transaction standing alone would show knowledge sufficient to prevent it from being a holder-in-due course, when taken together they raised a strong inference that the finance company had actual knowledge of the fraud perpetrated by the seller.

The decision in the *Taylor* case was restricted to a very limited factual situation and would naturally have small application as stare decisis. The necessary requirements for the court to infer actual notice on the part of the finance company were greatly reduced in *Commercial Credit Co. v. Childs*,⁴ where the finance company was denied the rights of a holder in due course by reason of the fact that it had prepared the instrument and had taken an assignment of it on the day it was completed. The forms used contained the customary printed assignment on the reverse side. It was decided that the finance company was not an innocent purchaser for value, but an actual party to the instrument, and, therefore, was subject to any personal defense which the maker might have.

In the *Childs* case it was not shown that the finance company had actual knowledge of the fraudulent nature of the transaction between the retail dealer and the purchaser, while in the *Taylor* case it was proved that the finance company had actual knowledge that the automobile was not worth the sales price. Neither was it alleged in the *Childs* case that the finance company purchased all of the commercial paper of the retail dealer as in the *Taylor* case. In the *Childs* case the retail dealer was named as payee in the note, not the finance company as in the *Taylor* case. The "closeness" of relationship between the finance company and the retail dealer was much weaker in the *Childs* case than in the previously decided *Taylor* decision, yet the court would not allow the finance company to hide behind the holder in due course veil. The decision in the *Childs* case has been followed in other jurisdictions.⁵

⁴ 199 Ark. 1073, 137 S.W.(2d) 260 (1940).

⁵ *Palmer v. Associates Discount Corp.*, 124 F.(2d) 225 (D.C. Cir. 1941); *Commercial Credit Corp. v. Orange County Machine Works*, 34 Cal.(2d) 766, 214 P.(2d) 819 (1950); *C. I. T. Corp. v. Emmons*, 197 So. 662 (La. 1940).

In *Buffalo Industrial Bank v. De Marzio*,⁶ where the relationship of the financing institution to the original transaction was nearly identical to that in the *Childs* case, it was held that the situation between the dealer and the financing agency was a factual joint enterprise, and recovery was denied. The court stated that conditional sales contracts were such an integral part of our modern complex society, that the rules of the old law merchant would not meet the prevailing sense of justice, and to permit the finance company to claim as a holder in due course would “. . . draw the veil of fiction over the face of fact.”⁷

A contrary view was taken in *White System of New Orleans v. Hall*,⁸ where the dealer sold a beverage cooler to the purchaser, the latter executing a promissory note and chattel mortgage for the balance due on the purchase price. The note and chattel mortgage were executed on forms furnished by the finance company and the interest, carrying charges, and installments were computed from tables furnished by it. The finance company also had agreed to finance the transaction before the sale was made. The purchaser contended that the finance company was an immediate party to the note since it directed the transaction and therefore would be subject to the equities and defenses that the purchaser had against the seller. The court rejected this defense, indicating that they would not follow the *Taylor-Childs* line of decisions, and ruled that the finance company was a holder in due course under this factual situation. The court stated that any inequities which might result from this decision could not be corrected by the court under the present Negotiable Instruments Law, but that remedy should come from the legislature.

In the *Taylor-Childs* line of cases, the relationship of the finance company to the transaction was considered in and of itself sufficient to raise an imputation of knowledge of the defect in the title of the dealer who negotiated the instrument. There are many cases where this same situation was present, but other facts were established which gave rise to some definite and recognized legal relationship between the dealer and the financing agency, and the decision of the court was based upon the existence of this legal relationship.

When an agency relationship is present between the seller and the finance company, supplying blank forms and rate of interest tables, passing on the purchaser's credit rating and real knowledge of details are not offered or considered as bearing directly upon negotiability. Rather, these facts bear directly upon the existence of the agency relationship itself. When they are sufficient to establish the relationship, knowledge of the seller-agent's misrepresentation is imputed to the

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

⁷ *Id.*, 296 N.Y. Supp. at 786.

⁸ 219 La. 440, 53 So.(2d) 227 (1951).

finance company as a legal incident of the relationship,⁹ and the finance company fails to satisfy the traditional definition of a holder in due course.¹⁰ Personal defenses are then allowed to be proved by the purchaser in an action on the note.¹¹ This was the situation in *International Harvester Co. v. Carruth*,¹² where, upon proof of the agency relationship, the purchaser's rescission of the contract because of a breach of warranty was held to be valid as against the finance company.

If the purchaser can prove that the financing agency stands as parent in a parent-subsidary relationship to the seller, as in *United States v. Schaeffer*,¹³ the agency law of the state will be operative in the corporate relationship. This, of course, again makes it unnecessary for the defendant to rely on the facts of "closeness" as operative in themselves. The state laws charging the parent with knowledge of the subsidiary make negotiation in the technical sense impossible between the seller and the financing agency.

This actual knowledge, which will deprive the finance company of the rights of a holder in due course, is itself not a worthwhile subject of generalization and may be cloaked in a myriad of forms. In *C.I.T. Corp. v. Emmons*,¹⁴ the buyer signed a note for the purchase price of a refrigerator. Contained in the note was a contract calling for the seller or his assignee to insure the refrigerator, which was not done. The finance company received an assignment of the note, after directing its execution. When suit was brought on the instrument, the defense of the destruction of the refrigerator by fire was sustained, for the reason that the finance company stood in the shoes of the dealer through its active role in the execution of the instrument, and, therefore, had sufficient knowledge of the terms of the contract. Thus, the court said that since the note called for insurance, if neither the seller nor the assignee having seen fit to otherwise insure the chattel, they chose to be self-insurers and must bear the loss.

Some state statutory provisions defining "seller" are construed to take the question completely out of the Negotiable Instruments Law considerations. This was the situation in *General Electric Contracts Corp. v. Heimstra*,¹⁵ where a South Dakota statute provided, "'Seller' means the person who sells or leases the goods covered by the conditional sale, or any legal successor in interest of such persons."¹⁶ The court did not consider the question of negotiability, but held the assignee of

⁹ MECHEM, AGENCY § 129 (4th ed. 1952).

¹⁰ See note 1 *supra*.

¹¹ Uniform Negotiable Instruments Act § 58, 5 UNIFORM LAWS ANN. pt. 2, 209 (1943).

¹² 23 So.(2d) 473 (La. 1945).

¹³ 33 F. Supp. 547 (D. Md. 1940).

¹⁴ 197 So. 662 (La. 1940).

¹⁵ 69 S.D. 78, 6 N.W.(2d) 445 (1942).

¹⁶ S.D. CODE § 54.0201(2) (1939).

the conditional sales contract to be the legal successor in interest of the actual seller, that is, a seller under the statute, and, therefore, the defense of breach of warranty was good against him.

Some jurisdictions deny negotiability to notes given for the purchase price of commodities sold under conditional sale contracts. In *State Nat. Bank of El Paso v. Cantrell*,¹⁷ the purchaser signed an installment note and a chattel mortgage which were both purchased by the finance company. The court held that under the Negotiable Instruments Law the finance company was a holder in due course, yet allowed the personal defense of breach of warranty to defeat recovery because the finance company had also purchased the conditional sales contract, and so ". . . was possessed not alone of the rights it conferred, but burdened as well with the obligations it imposed."¹⁸ This case lacked the aspect of assignment simultaneous with execution, the execution being dated April 24, 1938, and the assignment to the finance company May 14, 1938.

In *First & Lumbermen's Nat. Bank of Chippewa Falls v. Buchholz*,¹⁹ a coal burner sold to the defendant-purchaser was not installed in a workmanlike manner. The purchaser had signed a negotiable note and chattel mortgage for the purchase price and these instruments had been assigned to the plaintiff-financing agency. The action by the plaintiff was based upon a Wisconsin cognovit judgment; the Minnesota court stated the rule as follows:²⁰

. . . where one takes as endorsee and assignee a promissory note and a conditional sales contract representing a transaction for which the note was given and before the consideration has passed, he takes such note with notice of a condition to liability on the instrument and is prevented from becoming a holder in due course.

In *Von Nordheim v. Cornelius*,²¹ the court stated that Nebraska has long held the rule to be that:²²

. . . although a note otherwise negotiable is not rendered nonnegotiable merely by reference to collateral security, a note and a mortgage executed at the same time as a part of one transaction are to be construed as one instrument, and terms in the mortgage may render the note nonnegotiable as to all with notice thereof.

In the writers' opinion no general rules can be formulated to insure certainty of negotiability for notes issued with chattel mortgages. In those jurisdictions which follow the *Taylor-Childs* decisions it might be advisable to make a definite separation between the parties. The seller should use his own forms and prepare the instruments himself. The finance company should never actively participate in the transaction

¹⁷ 47 N.M. 389, 143 P.(2d) 592 (1943).

¹⁸ *Id.*, 143 P.(2d) at 594.

¹⁹ 220 Minn. 97, 18 N.W.(2d) 771 (1945).

²⁰ *Id.*, 18 N.W.(2d) at 774.

²¹ 129 Neb. 719, 262 N.W. 832 (1935).

²² *Id.*, 262 N.W. at 832.