Vanderbilt Law Review

Volume 14
Issue 4 *Issue 4 - October 1961*

Article 7

10-1961

Bills and Notes -- 1961 Tennessee Survey

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BILLS AND NOTES—1961 TENNESSEE SURVEY

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The Tennessee courts decided three cases involving commercial paper this year. The Tennessee Supreme Court decided one case which, unless it is clarified in the near future, may upset principles which were heretofore well-established. Of the two cases decided by the appellate courts, one adopted a rule well-known in other jurisdictions, and the other adopted a sound minority view on a question not settled by the Uniform Negotiable Instruments Law.

I. ACCOMMODATION PARTIES—EVIDENCE TO PROVE

In *Cross v. Miner*,[1] the Tennessee Supreme Court was faced with the simple situation of an accommodated payee of a promissory note suing his accommodating party upon the note.[2] Apparently defendant had not designated himself as an accommodation party, so the issue was whether defendant might introduce parol evidence to prove that that was his status. Section 64(3) of the N.I.L.[3] places liability on a party signing for the accommodation of the payee only to parties subsequent to the payee. A necessary implication of this statute is that the accommodation party be allowed to present parol evidence when the suit is between the immediate parties to the note. Otherwise, there would be no possible way for an accommodation party to show that he signed to accommodate the payee rather than the maker.[4]

The court reached this result by holding that parol evidence was

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1. 338 S.W.2d 619 (Tenn. 1960).

2. Although the court does not relate the parties in this manner, its statement of facts shows that the note had been accepted by the payee before the accommodation party signed the note, and that he signed it at the request of the payee, so that the payee could discount the note at a bank. 338 S.W.2d at 620.

3. TENN. CODE ANN. § 47-164(3) (1956).

4. Security Sav. Bank v. Carlson, 210 Iowa 1117, 231 N.W. 643 (1930); St. Sav. Bank v. Markworth, 203 Iowa 461, 212 N.W. 729 (1927); BRITTON, BILLS AND NOTES § 233 (1943). See also UNIFORM COMMERCIAL CODE § 3-415, which provides the same result, but clarifies the rules applicable to accommodation parties by combining them all in one section, and by expressly spelling out the rules regarding oral proof.

admissible in this case, but did so by a route which is analytically difficult to follow. The court's announced theory was that there had been a condition placed *upon the delivery* of the note, and this condition had not been met. This appears to be a legal fiction, and one resorted to in no other jurisdiction. I am unable to find any condition upon delivery in the facts stated in the opinion, and the court does not state the precise nature of the condition, nor what evidence was presented to show it. Thus it is impossible to know whether any non-stated extraordinary agreement, unstated in the court's discussion of the facts, was made between the litigants. The possibility seems remote, but that is the only kind of condition which would be relevant under section 16 of the N.I.L.,[5] cited by the court as authority for its ruling. Any presentment, demand, or notice conditions imposed upon the payee would not be relevant because they arise only after the obligation itself has become unconditional.

Although the result of the case is correct, it is certain to create problems for litigants and courts in future cases. Until this case, the Tennessee law in this area had been rather clear. *McConnell v. McCleish & Thomas*[6] had held in 1929 that an accommodated party could not successfully sue his accommodator, and the court recognized this point in *Cross*. Parol evidence was admitted in *McConnell*, as it has been in all previous accommodation paper cases,[7] without hesitation, seemingly with the common sense knowledge that it would have to be admitted for the statutes on accommodation paper to have meaning.

A future case may easily present facts in which the accommodated party can show that there was no extraordinary agreement placing a condition upon delivery. In such a case, two possible solutions to the problem litigated in *Cross* will probably be available to Tennessee's trial courts. One is to impose by fiction a condition upon the delivery of all accommodation paper, since the supreme court seems to have done so in *Cross*. This may give the proper practical result, but it is indefensible theoretically and will only further confuse the law in this area.[8] It is also arguable that this is the only

5. TENN. CODE ANN. § 47-116 (1956).
6. 159 Tenn. 520, 19 S.W.2d 251 (1929).
7. See, *e.g.*, *In re* Templeton's Estate, 201 Tenn. 431, 300 S.W.2d 613 (1957); Finley v. First State Bank, 13 Tenn. App. 128 (M.S. 1931); Bank of Rockwood v. Foster, 12 Tenn. App. 418 (E.S. 1930).
8. It is unclear whether the court's ruling applies only to suits by the accommodated party against his accommodator, or also includes all suits upon commercial paper where a signor desires to show that he is only an accommodation party. The latter interpretation seems more valid, since the court did not expressly recognize the relationship between the parties in *Cross*. If correct, this may mean that there is a fictionalized condition upon the delivery of all accommodation paper. Such a condition, being unknown, is unfulfillable by its very nature. According to N.I.L. § 16, an unfulfilled

solution available to the trial courts, since the supreme court's announced theory did not encompass the prior common sense viewpoint.

A sounder solution for the trial courts would be to continue to use the common sense evidence rule of the earlier cases in admitting parol evidence in accommodation paper cases between the immediate parties. Such an interpretation would not continue the fictional condition invented by the supreme court and therefore would not increase the confusion generated by *Cross,* but it would permit the continued introduction of parol evidence where proper. Further, the *Cross* ruling should not be regarded as in conflict with the earlier cases. Although the court did not sanction the use of the doctrines of the prior cases, *Cross* may be read as only providing *one* theory for the introduction of defendant's evidence, not as stating *the* rule for the admission of such evidence. The non-exclusive reading should be adopted to prevent the destruction of sound prior theories.

II. Holder in Due Course—Effect of Willful Ignorance

Woodward v. Bruce[9] was a suit to cancel instruments on the grounds of fraud. Complainant had executed a contract and a promissory note, but the court found, as a matter of fact, that they had been procured as a result of fraud.[10] Thus, the contract could be rescinded. The promissory note had been passed on to two subsequent purchasers; however, both of them argued that they were holders in due course and therefore not subject to the original defenses. The court held, again as a matter of fact, that the first subsequent purchaser had been an actual participant in the original fraudulent dealings, and therefore he could not be a holder in due course.

The second purchaser, however, had had no part in the original dealings, and claimed to know nothing about that transaction. Since the first purchaser's title was defective, the burden of proof was on the second purchaser to show that she was a holder in due course under section 59 of the N.I.L.[11] Section 52(4) defines a holder in due course as one who takes without notice of defects, and section 56[12] defines notice as actual knowledge of the defect or such knowledge that the taking of the instrument is in bad faith. The court held that

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condition upon delivery renders the obligation incomplete and revocable between the immediate parties. Thus, under the court's conditional delivery doctrine, no accommodation party could ever be liable to a payee, whether the payee was the party accommodated or not.

9. 339 S.W.2d 143 (Tenn. App. W.S. 1960).

10. The court characterized the contract as "made for insufficient consideration by a person of weak mind in necessitous circumstances," which "amounts to constructive fraud." *Id.* at 149.

11. Tenn. Code Ann. § 47-159 (1956).

12. Tenn. Code Ann. §§ 47-152(4), -156 (1956).

the second purchaser had not carried her burden of proving lack of the latter type of knowledge, and that if she were ignorant of the fraud in the original transaction, it was because she had intentionally remained so in bad faith. Therefore, she was not a holder in due course and was subject to the original defenses.

The American courts which have considered the issue, including those in Tennessee, have consistently held, since the passage of the N.I.L., that failure to inquire about defects under "suspicious circumstances" cannot act as constructive notice so as to affect the title of a holder in due course.[13] The rule has not been altered by *Woodward*. Instead, the well-known test of "willful ignorance" was recognized and applied. While the "suspicious circumstances" doctrine was an objective test—What would a reasonably prudent man have done? —the "willful ignorance" doctrine is a subjective test—What was the purchaser's state of mind? The court in *Woodward* relied primarily upon the prior dealings of the same kind between the defendants and the fact that in at least one prior instance their notes had been purged of $5000 usury,[14] rather than relying solely upon the circumstances surrounding the transaction in question. Thus a finding of bad faith on her part depended upon a showing that she intended to remain ignorant, not on the fact that she did remain ignorant. This is a sound clarification of the term "bad faith."

III. DUAL SIGNATURE CHECKS—NEGLIGENCE PERMITTING FORGERY—FICTITIOUS PAYEES

A corporation and an "independent sub-contractor" set up a bank account in the sub-contractor's name to carry out a construction job. Checks from the account, signed by both the sub-contractor and a corporation officer, were used to pay the sub-contractor's workmen. The sub-contractor made up many false reports with respect to the time actually worked by employees, and caused checks to be issued to pay for this falsely reported work. The workmen did not receive these checks; instead the sub-contractor forged their signatures thereon, cashed the checks, and appropriated the funds for his own uses. In *McCann Steel Co. v. Third National Bank*,[15] the corporation sued the drawee bank on these checks when the facts came to light.

13. The "suspicious circumstances" rule was adopted in England at one time, Gill v. Cubit, 3 B. & C. 466, 107 Eng. Rep. 806 (K.B. 1824), but later overruled, Crook v. Jadis, 5 B. & Ad. 910, 110 Eng. Rep. 1028 (K.B. 1834). Tennessee followed the earlier rule until the adoption of the N.I.L., which rejects that rule through § 56. Corinth Bank & Trust Co. v. Security Nat'l Bank, 148 Tenn. 136, 252 S.W. 1001 (1923).

14. Providence A.M.E. Church v. Sauer, 323 S.W.2d 6 (Tenn. App. W.S. 1959).

15. 337 S.W.2d 886 (Tenn. App. M.S. 1960).

The court first ruled that the corporation had an equitable interest in the account,[16] and that the sub-contractor was not an agent of the corporation. The bank then argued that the corporation was negligent in not taking precautions against such payroll padding, and that, since the payees were fictitious, the checks were payable to bearer, and no endorsement was required. The court overruled both of these arguments, and the corporation recovered the amount of the checks.

The first argument was based on section 23 of the N.I.L.,[17] which says that if a bank pays a check upon a forged endorsement, it is responsible for the loss so long as the depositor has not been guilty of negligence. The question was whether the corporation had been negligent. The court agreed with the bank that "the most elementary investigation" by the corporation would have prevented the losses. However, the court refused to require the corporation to make such an investigation, or to hold that failure to investigate was negligence. Thus the bank could not escape liability on this ground.

An earlier Tennessee case[18] had held a depositor negligent when its employee had padded the payroll and forged endorsements on the checks thus obtained. This case was distinguished solely on the ground that there was an agency relationship between the person making out the checks fraudulently and the depositor in the earlier case and none in *McCann*. Thus the court seems to have set up two standards of negligence, which depend upon the agency relationship between the defrauder and the depositor. One must check the work records for payroll-padding by employees, but need not check for such padding by independent contractors. In view of the accessibility of the different records, this would seem a defensible rule.

The second argument was based on section 9(3) of the N.I.L.,[19] which makes bearer paper of any check made payable to a fictitious person,[20] when "such fact was known to the person making it so payable." The question, on dual signature paper, is whether the word "person" encompasses both signers or only the signer who makes out the check. If both are encompassed, the fraud of only one will not make the paper payable to bearer, and a proper endorsement is still required. If only the "dominating" signer is encompassed, it becomes bearer paper, and later forged signatures are irrelevant.

16. The contract of deposit was held not to control in view of the bank's actual knowledge of the corporation's interest. *Id.* at 891.
17. TENN. CODE ANN. § 47-123 (1956).
18. U.S. Guar. Co. v. Hamilton Nat'l Bank, 189 Tenn. 143, 223 S.W.2d 519 (1949), cited at 337 S.W.2d 893.
19. TENN. CODE ANN. § 47-109(3) (1956).
20. It is well settled that a fictitious payee may be a real person as long as that person is intended by the drawer to have no interest in the check. BRITTON, BILLS AND NOTES § 149 (1943).

Both interpretations have been given to the N.I.L. section by courts of sister states. The majority view is that only the knowledge of the "dominating" signer is relevant.[21]

Tennessee joined the minority view, the court holding that the paper was payable to order only, because one of the dual signers, the corporation, did not know the payee was fictitious. Thus the bank was liable for paying improperly endorsed paper. Even though it is the minority view, this view seems to have the sounder policy reasoning supporting it, as has been pointed out by several authors.[22] Thus, the use of cosigner paper will continue to protect employers in Tennessee from this type of fraud. If banks feel overburdened by the increased risks involved, their only defense seems to be to refuse to accept accounts requiring cosignatures.

21. See the cases collected in Morris, *Fictitious Payees on Checks Requiring Dual Signatures*, 1961 WIS. L. REV. 439. Only one prior case, from Oregon, has been found holding the minority view. The U.C.C. has recognized the problem and follows the majority view. UNIFORM COMMERCIAL CODE § 3-405, comments 3(f), (g).

22. BRITTON, BILLS AND NOTES § 150 (1943); Morris, *op. cit. supra* note 21.