1890

Holders for Value of Commercial Paper

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C o r n e l l U n i v e r s i t y,

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Commercial paper has been defined as including "all those instruments of indebtedness which are treated and used, in the commerce of the world as the equivalents or representatives of money, or which are given the characteristics of money in the furtherance of commercial ends." As coming within this definition, it might be proper to include bills of lading, certificates of deposit, warehouse receipts and other evidences of property or debt; but that bills of exchange, promissory notes and checks are properly included there can be no question.

The origin of negotiable instruments is a subject on which authorities are not agreed. It cannot be affirmed with absolute certainty either by whom bills of exchange were invented or when they were first used. Roman law shows no trace of them as they now exist; although there is reason to believe that some method of transferring value from place to place in some way similar to the means now employed was in use among the Romans. Kent maintains that bill of exchange were used

by the Greeks; while Blackstone states that they were brought into general use by the Jews at the end of the fifteenth century, "when banished for their usury and other vices, in order the more easily to draw their effects out of France and England into those countries in which they had chosen to reside; but that they were in use in China fifty years prior to that time." "There is no certainty on the subject" says Daniell, "though it seems clear that foreign bills were in use in the fourteenth century."

When promissory notes first appeared is likewise involved in uncertainty. That the Romans made use of them and that they were then destitute of all attributes of negotiability, are undisputed facts. The use of bills of exchange in England preceded the introduction of promissory notes into that country by at least three centuries. Until the passage of an Act in the reign of Anne which placed promissory notes on the same footing as bills of exchange, so far as concerned negotiability, there had been much opposition to the practice of allowing them the same freedom of transfer that Custom had given to bills of exchange.

By the Law Merchant corporate bonds and securities could not be used as negotiable paper, for the reason that they were sealed; a seal being looked upon as fatal to the negotiability of any instrument. It is now quite generally held that the presence of a seal on a bill or note, so far from destroying, does not in any way impair its negotiability; while a corporate bond is for every purpose as negotiable as a bill of exchange, provided it contain requisite words of negotiability. Pennsylvania, however, still clings to the old rule. In Diamond vs. Lawrence County, 37 Pa. St., 373, the Court said: "We will not treat these bonds as negotiable securities. On this ground we stand alone. All the courts, American and English are against us."

The invention of bills of exchange, at whatever time or for whatever special purpose, if any it may have been, has proved a very important element in facilitating the business of the world generally and in rendering the transfer of value from place to place a matter of comparative safety. Among primitive peoples trade is carried on exclusively by barter. Buying and selling implies simply an exchange of commodities. The practice

of using some particular substance or substances as measures of value soon comes into use, and in place of barter, articles will be sold for gold or silver. Another step brings us to the system of coining and stamping pieces of metals of fixed weight. For centuries, though not without difficulties, the business of the world was carried on by these methods; but the expense of transporting gold together with the danger of loss by robbery on land and by storms on the sea, made the invention of some substitute for, and representative of money--something easily transferable--a practical necessity.

A holder for value of a negotiable instrument, as here used, is a person who has taken it bona fide, for a valuable consideration, in the usual course of business, when it is not overdue, and without notice of any facts which impair its validity between antecedent parties. Such a holder has a title unaffected by ordinary latent defects and may recover on the instrument, though as between prior parties it is without any legal validity. To constitute one such a holder, the foregoing elements, each of which will now be considered, must enter into his title.

First. He must have received it bona fide. Formerly the rule was that one taking a bill or note under suspicious circumstance or without due caution, although he gave full value for it, was deprived of the rights of bona fide holders (Gill vs. Cubitt, 3 B. & C., 466); but later decisions have completly abrogated this rule. (Goodman vs. Harvey, 4 A. & E. 870; Goodman vs. Simonds, 20 Howard, 343). It is now held in England; the United States Courts, and in many of the states,

that mere negligence, however gross, though strong evidence of, will not in and of itself amount to mala fides. There must be either actual knowledge or a wilful turning away from the evidence of defect. "The true question is not whether there were suspicious circumstances; but whether the holder took the paper without notice of any infirmity." That it was taken honestly, will repel any presumption of bad faith.

Second. He must have received on a valuable consideration. The consideration must not only be valuable as distinguished from good; but it must also not be so grossly inadequate as to indicate that the transferrer held under a defective title. (De Witt vs. Perkins 22 Wis. 473). Only that price is inadequate which falls below market value; and, it is evident that what would amount to inadequacy under some circumstances; would under others, be greatly in excess of market value. Whether the consideration, in any given case, is sufficiently large to satisfy this branch of the rule, must be determined by its own peculiar facts; the known or unknown responsibility of the maker; the time of maturity, and the financial condition of the transferrer and other

parties on the paper, being necessarily important factors in settling the question.

Third. He must have received it without notice, that is, without knowledge of any fraud, or illegality in, or failure of the consideration for which the paper was given, affecting the holder from whom he received it. (Skilding vs. Warren, 15 Johns. 270). Mere knowledge of want of consideration will not of itself impair the purchaser's title. (Grant vs. Ellicott, 7 Wend. 227). Nor is it any defence against a holder for value that he knew the note was given in consideration of an executory contract, unless he is also shown to have had knowledge of its breach. (Davis vs. McCready, 17 N. Y., 230). A transferee of accommodation paper cannot claim protection as a holder for value, if he was aware, at the time of taking it, that some condition on which the paper was given had been disregarded by the accommodated party. (Small vs. Smith, 1 Den. 583.) A purchaser cannot, as a rule, render his title unassailable by simply showing that he received no express notice of any defect or illegality in the bill or note. If the jury believe that he refrained from inquiry because of a suspicion

that by inquiring he would learn of some vice in the instrument, such fact is usually held sufficient to invaliuate it in his hands. But if having been led to believe or having suspected that the paper was not good; he may nevertheless entitle himself to all the rights of a bona fide holder, if after making honest inquiriy to the best of his ability, he fails to substantiate such general notice or suspicion of defect. Notice of fraud or other defect not rendering the note absolutely void, will not prevent a recovery, provided the title in the immediate endorser of the holder is free from impairment. To hold otherwise would greatly injure one of the essential functions of commercial paper--its capacity of circulating in the channels of trade as money. A note payable to a person as a trustee or in any other fiduciary capacity is constructive notice that the payee cannot dispose of it for his own benefit. The transferee of such an instrument takes it at his peril.

It has sometimes been held that if a paper states the consideration for which given; for example, that it was given in consideration of work to be done, the duty is thereby imposed upon a purchaser of finding out whether

or not the consideration has passed. Not to do so renders the paper worthless in his hands if it appear that the consideration has not in fact been executed. This, however, is an exception to the general rule. (Davis vs. McCready, 17 N. Y. 230.) It is thought to be unjust to burden the purchaser with the duty of seeing that the consideration has been executed merely because he happens to know what the consideration is. Instead of imposing this hardship upon the purchaser, it is considered the better policy to fasten the loss upon him who has seen fit to send his negotiable paper into the world, "in consideration of an engagement of the party with whom he deals, to do some act for his benefit in the future."

Fourth. He must have received it before maturity. The fact that an instrument is in circulation after the date on which it should have been paid, is presumptive evidence that something is wrong with it, and although the mere fact of non-payment furnishes no information of any specific matter of defence, yet it is sufficient to put a purchaser upon inquiry. An indorsee in such event takes the same title that his indorser had and is

subject to any defences that were available against him.

The mere fact that business paper was taken after maturity will not invalidate it in the hands of such holder. Some other facts--something showing the note to have had its inception in fraud or that it is tainted with other defects--must be produced before he will be precluded from recovering. In England the same rule prevails in the case of accommodation paper; but in New York and in the United Staes generally, a different rule governs the latter class of instruments; the reason for which is founded on the presumption that the accommodating party did not intend to lend his credit for an unlimited time; but rather that it was to be available for the party accommodated only before the maturity of the paper. (Chester vs. Dorr, 41, N. Y. 279.)

Transfers on the last day of grace, before the close of business hours are usually held to be before maturity (Crosby vs. Grant, 36 N. H. 273); but not in Massachusetts. (Pine vs. Smith, 11 Gray, 38.) Only equities existing between the original parties or between his immediate indorser and himself can be pleaded against a transferee after maturity. Nor is such transferee sub-

ject to any equities arising against the indorser after the transfer.

Fifth. He must have received the paper in due course of trade, that is, it must have been such a transfer as is usual according to the custom of merchants. In the application of this element of bona fide ownership, more than in any or perhaps all of the others, do we find the greatest conflict of opinion. What is meant by "due course of trade"? All agree that a transfer of the note of a third party in payment of an indebtedness created at the time, is a transfer within this branch of the rule; but as to whether the taking of the same instrument in conditional payment of, or as collateral security to, a pre-existing indebtedness will place the one so taking, in the same position, the authorities are in hopeless conflict. We find two opposing doctrines--which may be designated as the New York and the United States doctrine-- and headed respectively by Bay vs. Coddington, and Swift vs. Tyson, the latter of which was decided in the Supreme Court of the United States in 1842--about twenty years after the decision in the former case was rendered.

The New York Rule.

First, as to the New York rule as set forth in Bay vs. Coddington, 5 John. Ch. 54. Plaintiff was owner of a vessel and employed Randolph and Savage to sell her on credit, directing them to take good notes in payment and to forward the same to him. The boat was sold according to directions and notes given for the purchase price. Randolph and Savage did not transmit these notes to plaintiff as requested by him; but instead, delivered them to the defendants J. & C. Coddington who were under heavy responsibilities for them as accommodation indorsers; but at the time of the transfer in question, none of these responsibilities had matured. The defendants denied all knowledge of the manner in which the notes had come into the hands of Randolph and Savage and alleged that they believed the notes were the exclusive property of their transferrers. The opinion of the court was given by Chancellor Kent, in the course of which he said that the defendants were not bona fide holders for value, inasmuch as "the notes were not negotiated to them in the usual course of business or trade, nor in payment of any antecedent and existing

debt, nor for cash or property advanced, debt created or responsibility incurred, on the strength and credit of the notes." The rule thus laid down has been followed by the courts of a majority of the other States, notwithstanding the fact that the Supreme Court of the United States has all along taken a position directly opposed thereto. In New York a transferee is a holder for value within the rule where he has surrendered a security for the antecedent debt; or where he has received the note in payment of a previous note which was surrendered and cancelled; or where he received the note in absolute payment of an existing debt; or where he received it with a valid agreement for extension of time, or with an agreement not to sue upon an existing debt.

It is plain that in the foregoing cases, the creditor either parted with value or relinquished some valid and existing right on the faith of the collateral. To have treated him otherwise than as a holder for value would have been prejudicial to his interests, and would have placed him in a worse condition than he occupied before the deposit of the collateral.

The courts of New York, with the lapse of time, have

shown no tendency to abandon or relax the rule laid down in the principal case; but on the contrary, have followed and adhered to it with an ever increasing conviction of its jutice and wisdom.

The United States Rule.

In the case of Swift vs. Tyson, 16 Peters, 1, it was emphatically asserted that the taking of a bill of exchange, before marturity, as collateral security for a pre-existing debt is sufficient to constitute the one so taking, a holder against whom defences which might have been used against his transferrer, are not available. This expression by the court appears to have been unnecessary for the decision of the case, and for that reason Judge Catron refused to concur in that part of the opinion. The majority of the court, however, saw fit to adopt it, and although the purest obiter, it has been followed since that time by the same tribunal and has been the basis of the law on this point in many of the States. The reasoning upon which this opinion is based, is that "it is for the benefit and convenience of the commercial world to give as wide an extent as practicable to the credit and circulation of negotiable paper,

that it may pass not only as security for new purchases and advances made upon the transfer thereof; but also in payment of, and as security for, pre-existing debts," and that receiving the note of a third party as security for a pre-existing debt, is in accordance with the usual course of trade and business. The argument proceeds that to establish the opposite rule would be to impair the value by impeding the circulation of commercial paper. It is also maintained by the supporters of Swift vs. Tyson that the holder is, in such case, a holder for value, since by the mere act of taking the collateral he has impliedly agreed to an extension of time on the original indebtedness, and that if he is deprived of his security after having granted forbearance, he may suffer a loss which ought more properly to fall on the maker of the instrument. Moreover, he may thereby have been induced to rely upon the collateral instead of seeking other security upon the original indebtedness, and has thereby been further prejudiced.

It is submitted that whether or not the creditor would have taken any further means to secure his debt, had the debtor not deposited with him such collateral

security. is at the best, purely a matter of conjecture. In some cases he perhaps would have done so; while in others he would not. Nothing except the business habits of the creditor himself would afford a safe criterion for the decision of any particular case. There is, moreover, the same uncertainty surrounding the probability or improbability of the creditor's being able to obtain additional security even were he to make the attempt. Upon such uncertain and remote possibilities as the foregoing, it seems unreasonable to found a rule that the mere deposit of a negotiable note of a third person, with a creditor, no value being given, and no valuable thing or right being surrendered, shall entitle such creditor to the rights of one who has paid full value therefor, and this shut out as against him, defences which the maker or other prior party might have used against the debtor so depositing.

The receipt of paper by a receiver, assignee in bankruptcy or under the insolvent laws is not a receipt in the usual course of business. They take no better titles than their transferrers held. Parting with value even subsequently to the taking of the paper may make one

a holder for value, if such value is parted with on the faith of the collateral. The relation which the transferrer holds to the instrument is also an element to be considered. A transfer by any party other than the payee or last indorsee, where the paper is payable to order, will not in general, bring the transferee under the protection given to bona fide holders. In New York it is held that the drawee of a bill of exchange is presumed to have it in his possession for the purpose of accepting it, or that it has already been paid, in either of which events he has no right to negotiate it, either before or after maturity. (Central Bank of Brooklyn vs. Hammett, 50 N. Y. 158.) The rule in England is contrary to this and is based on the assumption that the bill may have been made for the accommodation of the drawee, which being the fact, a transfer by him would be perfectly legitimate. Our courts on the other hand, in the absence of evidence to the contrary, will presume that the bill is business paper rather than accommodation.

Accommodation Paper.

It has been said that where acommodation paper has

been taken as collateral security for an antecedent debt, there is an additional reason for treating the creditor as a holder for value. Having been made for the express purpose of enabling a party to obtain credit by its negotiation, the object is attained equally well by applying it to a debt already existing as by using it in the creation of a new debt. An instrument of this class, in the absence of restrictions upon its use, may very properly be deposited as collateral security. As was said in Lord vs. The Ocean Bank, 20 Pa. St. 384, "He who chooses to put himself in the front of a negotiable instrument, for the benefit of his friend, must abide the consequence, and has no more right to complain if his friend accommodates himself by pledging it for an old debt, than if he had used it in any other way." Even in New York, "provided there has been no fraudulent diversion of the paper, and provided no other equity exists against the party from whom it was taken", the creditor is a holder for value.

A corporation cannot issue accommodation paper unless that power is expressly conferred upon it. If, however, a corporation has issued paper of this kind, and has so issued it that its objectionable character would easily

escape detection, a recovery thereon may be had by an indorsee for value and without notice.

Mere knowledge that an instrument was made for accommodation will not deprive a purchaser of the protection afforded to bona fide holders. There must be some other fact or element present in order to impeach it in his hands. It must appear either that the paper itself bore evidence that it was not to be used in the way it was used, or it must appear that there has been a material diversion from the purposes for which the paper was created, and that the holder knew of such diversion. The question then arises as to what will amount to such a diversion as will prevent a purchaser with knowledge of the facts from recovering on the note. If the accommodating party had any interest in the special mode of negotiating the paper; for example, if he had directed that it be used in taking up other paper on which he was liable, it would be an unwarrantable diversion to use it in paying some other debt or in making a loan.. The maker is nevertheless liable if the purchaser did not know of the benefit which the accommodating party expected to derive from its negotiation in this one par-

ticular way. If the diversion is not fraudulent or prejudicial to the accommodation party, the deviation from instructions does not, in any event, affect the indorsee's title. (Duncan, Sherman & Co. vs. Gilbert, 29 N. J. L. 521.) If the purpose of the accommodation has been substantially attained, the manner in which it was attained is of little importance.

Legal Defences to Negotiable Paper.

Certain defects in negotiable instruments are available against any one seeking to enforce their payment. These may be (1) defects arising from execution by incompetent parties; (2) illegality where both the instrument and the consideration are by statute declared to be illegal and void; (3) some defence which has arisen since its execution--such as extinguishment of the contract by cancellation, alteration or release by deed after maturity; (4) where the contract is absolutely void by reason of mistake.

The ground on which a party is held to be released from liability where there has been a material alteration or forgery, is that he has a right to stand upon the contract as originally made, and cannot be compelled

to accept another even though his position under it may be better than under the original.

The liability of the maker to a third party where alterations have been made in an instrument after execution depends, as a general rule, upon whether he has used due care in drawing the instrument. If it is so carelessly or inartificially drawn as to allow alterations to be made in such a way as not to excite the suspicions of a reasonably prudent man, the maker is clearly chargeable with negligence, and will therefore in most of the States be held liable if the altered note passes into the hands of an innocent holder. (Zimmerman vs. Rote, 75 Pa. St. 188; Redlich vs. Doll, 54 N. Y. 237.) In Illinois it is said that where one makes a part of a note with a pencil, thereby rendering alteration easy, he will have to suffer the consequences if the note is subsequently altered and comes into the possession of a bona fide holder.

The Massachusetts courts have established the contrary rule, and allow no holder to recover against the maker in any event where a material alteration has been made without the latter's consent. (Greenfield Savings

Bank vs. Stowell, 113 Mass. 196.)

Equitable Defences.

This class includes only such as are available against a party whose conduct renders it inequitable that he should recover. A note made on Sunday, for example, is void by statute so far as the parties to it are concerned; but if it pass into the hands of an innocent indorsee he will take it free from the defect which tainted its inception. (Cranson vs. Goss, 107 Mass. 439.)

Duress, unless it be of such a kind and degree as wholly to take away volition on the part of the maker is no defence except against the one causing the duress or subsequent purchasers from him with knowledge thereof.

Other equitable defences are fraud, payment, accord and satisfaction, in short, anything not properly included in the class of Legal Defences.

Signing Note supposing it to be a Different Instrument.

In Wisconsin, Michigan and perhaps some of the other States it has been declared that where a person has been induced by false representation or trickery of any kind, to sign a note under the mistaken belief that he was executing a contract of agency or some other non-

negotiable instrument, he will not be liable on such note to any holder, on the ground that it has not been voluntarily executed by him. The mind of the signer did not accompany the signature and so far as he is concerned no note has been made any more than if a blank piece of paper had been delivered. The weight of authority is probably against a rule so broad as this; but confine it rather to those cases where the note has been executed by a blind or illiterate man, and without negligence. (Van Brunt vs. Quigley, 85 111. 281.) Such a person it is thought has ordinarily done all that is expected of him if he has required the instrument to be read to him. The fact that it is not read correctly is held not to imply negligence in him. (Douglass vs. Matting, 29 Iowa, 498; Chapman vs. Rose, 56 N. Y., 137.) But otherwise where one who can read, neglects to do so.

On the principle that where one of two innocent persons must suffer for the fraud of a third, the loss should fall upon him who has rendered the perpetration of the fraud possible; it is difficult to see why as between the maker and an innocent holder, the latter should ever be called upon to bear the loss. Allowing the other party

to draw the contract and trusting to his reading for a knowledge of its terms is clearly negligence on the part of the maker provided he is himself able to read. So, if the maker is unable to read and neglects to have the contract examined by some member of the family or by some one else who is near at hand and can read, he is quite if not equally as negligent. On principle, it would seem also that the maker ought to be held liable even if no one is at hand on whom he can call for an examination of the contract. The putting of such absolute confidence in the honesty of another, perhaps a stranger, falls far short of exercising the care of a prudent business man, and wherein it differs from negligence is not plainly apparent.

Blank Note entrusted to Agent.

"The act of the agent is the act of the principal when done within the scope of the former's authority" is a principle of universal application. Hence it is that where, contrary to the instructions of his principal, the agent has filled out and negotiated blank instru-

ments entrusted to his care, the principal is held liable to bona fide holders. If, however, the addition or insertion made by the agent is not in conformity with the character and object of the blank; if there is a want of harmony between the addition of the agent and the rest of the instrument, there can be no recovery against the apparent maker inasmuch as the paper itself bears evidence of defects on its face. The presence or absence of unusual and inconsistent provisions is the criterion by which is usually determined the holder's right to recover, although it has been held that mere knowledge on the part of the latter that blanks were filled by an agent is sufficient notice to put him upon inquiry.

There is a marked distinction between cases such as just described, and that other class in which an agent has written out a complete instrument over his principal's signature which has been given to him for an entirely different purpose. In the former class of cases the maker is held liable on the ground that he has reposed confidence in the person who has abused it and should therefore suffer the loss resulting from such

breach of confidence rather than the innocent holder. The agent in filling the blanks has done no more than he was expected to do, and if in so doing he has disobeyed the directions of his principal; on whom is it more just that the loss should fall than upon him who has made the agent's wrongful act possible? Where, however, a note is written out in full over the signature of the principal, the implication of an authority so to do, is reduced to a minimum or altogether vanishes. The apparent maker cannot be charged with negligence in giving his signature to others, and accordingly it follows that he is not liable to anybody on such an instrument.

London Banking Co. v. London and River Platte Bank.

This case, decided in the English Court of Appeal in 1888 deserves a passing notice as illustrating the nature of bona fide ownership in the law of commercial paper.

A. was the manager of defendants' bank and stole therefrom certain negotiable securities belonging to the bank. For a valuable consideration these were delivered

into the possession and ownership of C., who was ignorant of the fact that they had been stolen. Subsequently W.--a confederate of A.-- induced C. to accept a check for the stolen securities which were thereupon returned to A. and by him replaced in the defendants' bank. The check given to C. was not paid in full, and he therefore sought to recover the bonds in question on the ground (1) that defendants were not holders for value and (2) that the bonds had been obtained from him (C) by fraudulent means, and that he was accordingly entitled to rescind the contract.

In the trial court the defendants obtained a verdict, which on appeal was affirmed. The appellate court holding the defendants holders for value, made use of the following language: "The defendants, when A. stole these securities, could have brought an action against him for the wrongful conversion of them. When he restored them, they lost that right, for how could they bring an action for the conversion of instruments which were in their own possession." The destruction of this right of action, the court held, was a value moving from the defendants, and it was immaterial that

defendants did not, at that time, know of the conversion of their bonds by A. Nor was it material, that in place of some of the original bonds, others which had been substituted for them, were placed in the bank.

In the opinion, the court remarked that the case was absolutely new, and must be decided wholly on principle. That the decision rests upon the general principles applicable to commercial paper, cannot perhaps be questioned; but that it resulted in an equitable adjustment of the claims of the respective parties may well be doubted. A. was the agent or representative of the defendants and, as such, was held out to the public as a safe and trustworthy man. He abused the confidence of his employers; stole their bonds; placed them in the hands of an innocent holder for value, and by the perpetration of fraud upon the latter was enabled to restore them to the possession of the defendants. That, as between the bank and C., the former should be declared the rightful owner, seems contrary to common sense. It is hardly in harmony with the rule that a principal is responsible for the acts of his agent when done within the apparent scope of the latter's authority, and it

furthermore, adds one more to the list of devices for the perpetration of fraud upon the innocent.