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# Finance Company as a Holder in Due Course

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# Notes

## FINANCE COMPANY AS A HOLDER IN DUE COURSE

### A. Introduction

In order to have a progressive economy, it generally is felt necessary to pursue a policy which will give the consumer as many material advantages as possible. Financing institutions occupy a vital position in effecting this policy.[1] In the typical situation, the buyer signs for the retailer (1) a note, (2) a note attached by perforation to a conditional sales contract,[2] or (3) a conditional sales contract.[3] Since

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[1] In December 1960 there was $17,444,000,000 outstanding in automobile installment loans, and $14,664,000,000 in installment credit arising out of sales of other consumer goods. Federal Reserve System, Board of Governors, *Federal Reserve Bulletin,* 47 Fed. Res. Bull. 1391 (1961).

The importance of financing institutions to the automobile industry is exemplified in Buffalo Industrial Bank v. DeMarzio, 162 Misc. 742, 296 N.Y.S. 783, 785 (Buffalo City Ct. 1937), as follows:

> It is common knowledge that, whatever the situation as to finance companies was in the past, today they have become de facto departments of the great automobile businesses, without which these industries could no more operate than sans their assembly lines.

[2] Not within the scope of this work, but a point on which courts disagree, is whether the negotiability of these notes is destroyed by their attachment to a conditional sales contract at the time the buyer signs. It is assumed in this work that the question of the effect of attachment has been resolved in favor of negotiability.

[3] It should be pointed out that instruments not in their nature negotiable have, by means of a waiver of defense clause, been treated by many courts as if they were negotiable for the purpose of giving finance companies the status of a holder in due course. See, *e.g.,* Young v. John Deere Plow Co., 102 Ga. App. 132, 115 S.E.2d 770 (1960); National City Bank v. Prospect Syndicate, Inc., 170 Misc. 611, 10 N.Y.S.2d 759 (N.Y. Munic. Ct. 1939). The reason such contracts are treated as negotiable instruments is expressed in United States *ex rel.* Adm'r of Fed. Housing Administration v. Troy-Parisian, Inc., 115 F.2d 224, 226 (9th Cir. 1940), *cert. denied,* 312 U.S. 699 (1941), as follows:

> Since the parties might originally have put their contract in negotiable form, there would appear to be no good reason why they may not by agreement impart to it limited elements of negotiability. Buyer and seller stood on equal footing and it is evident that this clause was deliberately inserted as a means of facilitating the finance of the sale.

The typical situation is as follows: The non-negotiable contract involved contains a clause to the effect that the buyer waives his right to enforce against an assignee any claim or defense he might have against the seller. Such a clause is effective only against personal defenses that the buyer might have, and the assignee must meet the requirements of a holder in due course of a negotiable instrument. *Contra,* Commercial Credit Corp. v. Biagi, 11 Ill. App. 2d 30, 136 N.E.2d 580 (1956), where the court said the assignee would be protected by the waiver of defenses clause regardless of whether it was a holder in due course.

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the retailer usually does a large part of his business in this manner, he needs the purchase price immediately in order to restore his inventory; hence, he often negotiates or assigns to the financing institution such instruments given him by the consumer. If the finance company is considered a holder in due course of the negotiable instrument,[4] then any personal defense[5] that the consumer may have against the retailer is inoperative against the finance company Thus, the finance company can enforce the instrument against the consumer even though the consumer has not received the consideration for which he bargained.

When the financier attempts to enforce the obligation of the note upon which the buyer has defaulted, usually the seller is unscrupulous and insolvent, thereby leaving worthless any remedy that the buyer might have against the seller.[6]

Actions of a finance company such as financing all or most of the sales by a particular retailer, providing the form for the note, making the original note payable at its office, and checking the buyer s credit before the sale, have been the basis for the view that the finance company should not be treated as a holder in due course. There are decisions supporting a contrary view [7]

The following discussion is designed to (1) point out some of the conflicting decisions as well as the policy arguments to support each position, (2) attempt to reveal the position of the Uniform Commercial Code in Kentucky, and (3) recommend a logical solution to this delicate problem.

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(Footnote continued from preceding page)

Some states by statute or decision consider waiver of defenses clauses to be against the public policy of protecting innocent purchasers of consumer goods, hence, they consider them invalid. Thus it is impossible for finance companies to attain the *status* of a holder in due course by use of such a clause. However, if the waiver of defense clause is considered valid, post-1940 courts seldom have held that the finance company can be a holder in due course.

[4] Included within this reasoning is the situation where the waiver of defenses clause in the non-negotiable conditional sales contract is considered valid, thereby giving the financier, as assignee of the contract, the status of a holder in due course.

[5] Uniform Negotiable Instruments Law (hereinafter cited as N.I.L. in footnotes and text) §57 provides:

> 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.

[6] See, *e.g.*, Mutual Fin. Co. v. Martin, 63 So. 2d 649 (Fla. 1953). If the dealer is solvent, the buyer can go against him, and the problem of whether the finance company is a holder in due course does not arise.

[7] *E.g.*, Public Loan Corp. v. Terrell, 224 Ark. 616, 275 S.W.2d 435 (1955); White Sys. v. Hall, 219 La. 440, 53 So. 2d 227 (1951); Implement Credit Corp. v. Elsinger, 268 Wis. 143, 66 N.W.2d 657 (1954).

B. HISTORY AND DEVELOPMENT OF THE TRUE ISSUE

There is a real problem in defining a majority and minority view as to whether the finance company is a holder in due course. It is clear after a careful inspection of the cases that the newer view, holding a finance company which is active in the transaction responsible for the dealer's wrongs,[8] is gaining in strength, but the older view, that the finance company is a holder in due course, is still referred to as the majority view

The decisions following the so-called majority view are based on the traditional concept of the rights of a holder in due course of a negotiable instrument. Illustrative of the cases following this view is *Public Loan Corp. v. Terrell.*[9] The buyer executed a note and a conditional sales contract to the seller, the finance company having prepared the note and contract forms. On the day of the sale the note and contract were assigned to the finance company The item purchased was defective, and the buyer defaulted. The finance company sued on the note, and the buyer raised the following defenses: (1) that there was failure of consideration; and (2) that to all intents and purposes the finance company was a party to the transaction. Since the note was assigned before maturity and for a valuable consideration, and since there was no evidence of actual notice or bad faith, the court held that the finance company was a holder in due course.[10] This is the expected and logical result if negotiable instruments law is followed.

The decisions following the majority view are predicated on the fact that the financier meets the requirements of a holder in due course. As stated in the N.I.L., a holder in due course is one 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 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.[11]

The question as to what constitutes notice is treated in the N.I.L. as follows:

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[8] *E.g.*, Public Nat'l Bank & Trust Co. v. Fernandez, 121 N.Y.S.2d. 721 (N.Y. Munic. Ct. 1952); Commercial Credit Corp. v. Orange County Mach. Works, 34 Cal. App. 2d 766, 214 P.2d 819 (1950).

[9] 224 Ark. 616, 275 S.W.2d 435 (1955).

[10] Many pre-1940 cases follow this view. *E.g.*, Standard Acceptance Corp. v. Chapin, 277 Mass. 278, 178 N.E. 538 (1931); Mayer v. American Fin. Corp., 172 Okla. 419, 45 P.2d 497 (1935).

[11] N.I.L. §52.

> To constitute notice of an infirmity in the instrument or defect in the title of the person negotiating the same, the person to whom it is negotiated must have had actual knowledge of the infirmity or defect, or knowledge of such facts that his action in taking the instrument amounted to *bad faith*.[12] (Emphasis supplied.)

The difficulty in showing that the finance company has notice was increased when the courts took the position that the intent of the N.I.L. was to adopt a subjective test, thereby requiring actual bad faith on the part of the finance company.[13]

The fact that most of the cases holding for the finance company on strict negotiable instruments law were decided before 1940 should not be overlooked. The importance of the finance company in commercial transactions was not so pronounced then as it is today[14] In fact, most pre-1940 courts treated negotiations involving finance companies the same as any other negotiations, and did not seem to recognize the peculiar problems presented when a financier was involved.

Since 1940 many courts have looked behind the technical requirements to what is actually happening when a retailer negotiates commercial paper to a finance company with whom he has a close connection. The landmark case holding a finance company subject to the defenses of the buyer is *Commercial Credit Corp. v. Childs*.[15] In this case the form of the note was furnished by the finance company, and the note and contract were executed the same day the assignment was made. The court held that the finance company was so closely connected with the sale that it could not be a bona fide purchaser of the instrument and to all intents and purposes it was an original party to the transaction.[16] Other courts have followed the *Childs* case upon the theory that the seller was an agent of the finance company[17]

The true reason for the refusal of some courts to recognize the finance company as a holder in due course is to protect the innocent

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[12] N.I.L. §56.

[13] *E.g.*, Howard Nat'l Bank v. Wilson, 96 Vt. 438, 120 A. 889 (1923).

[14] In December 1960 there was $17,444,000,000 outstanding in automobile installment credit, and $14,664,000,000 in installment credit arising out of sales of other consumer goods. Federal Reserve System, Board of Governors, *Federal Reserve Bulletin*, 47 Fed. Res. Bull. 1391 (1961). In December 1939 there was $1,267,000,000 outstanding in automobile installment loans, and $1,525,000,000 in installment credit arising out of sales of other consumer goods. Federal Reserve System, Board of Governors, *Federal Reserve Bulletin*, 31 Fed. Res. Bull. 478 (1945).

[15] 199 Ark. 1073, 137 S.W.2d 260 (1940).

[16] *Accord*, Commercial Credit Corp. v. Orange County Mach. Works, 34 Cal. App. 2d 766, 214 P.2d 819 (1950); Public Nat'l Bank & Trust Co. v. Fernandez, 121 N.Y.S.2d 721 (N.Y. Munic. Ct. 1952).

[17] *E.g.*, Associates Discount Corp. v. Goetzinger, 245 Iowa 326, 62 N.W.2d 191 (1954).

purchaser. This policy is expressed in *Mutual Finance Co. v. Martin* as follows:

> [T]he buyer 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 far better position to protect his interests against unscrupulous and insolvent dealers.[18]

Because of the increased complexity of our economy, the buyer must necessarily depend more and more on the representations of others, thereby accentuating the strong need for a policy of this kind.

There are also policy considerations in support of the finance company's position. The basic premise that between two innocent parties the holder in due course will be protected, and the deep-rooted idea that the free flow of commerce should not be impaired,[19] are the principal considerations advanced by the courts.[20] The finance companies contend that the only way a large majority of the people can have many consumer items is through financing agencies, and that the financing agency cannot profitably engage in such transactions unless it is considered a holder in due course, free of claims the buyer may have against the seller.[21]

In a 1954 case,[22] a finance company, which was incorporated by members of an implement dealers association, purchased commercial paper only from members. It was incorporated for this express purpose, and supplied the blank note forms. On these facts the *Childs* doctrine easily could have been followed, but the court followed negotiable instruments law and held the finance company to be a holder in due course.

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[18] 63 So. 2d 649, 653 (Fla. 1953).

[19] See National City Bank v. Prospect Syndicate, 170 Misc. 611, 10 N.Y.S.2d 759, 765 (1939). Here the court in holding a waiver of defense agreement valid, recognized that unless the company was given the status of a holder in due course, the free flow of commerce would be obstructed.

[20] When the usual situation, where the buyer gives a note and contract to the seller who immediately assigns them to the finance company, is compared with the situation where the buyer borrows directly from the financier and then makes a cash purchase from the seller, another policy consideration is suggested in favor of the finance company. After the seller becomes insolvent why should the buyer to whom the seller has extended credit, be protected, while the buyer who pays cash to the seller is not protected? See Jones, *Finance Companies as Holders in Due Course of Consumer Paper*, Wash. U.L.Q. 177 (1958); 7 Personal Finance L.Q. 76, 78 (1953).

[21] The soundness of this argument is questioned by looking to the low percentage of net loss to average loans outstanding. In 1955 this percentage was 1.92. Federal Reserve System, Board of Governors, *Consumer Installment Credit*, 43 Fed. Res. Bull. 1317 (1957). When this is compared to the high percentage of return (including both interest and finance charges) which the finance company usually receives, the trend toward protecting the consumer is understandable.

[22] Implement Credit Corp. v. Elsinger, 268 Wis. 143, 66 N.W.2d 657 (1954); *accord*, White Sys. v. Hall, 219 La. 440, 53 So. 2d 227 (1951).

The inconsistent state of the law in this area is evident. At present, in determining whether the finance company should be a holder in due course, the real issue seems to be whether (1) to protect the consumer from unscrupulous dealers, or (2) to encourage unhampered trade through easy negotiability of commercial paper.

### C. THE STATUS OF THE FINANCE COMPANY UNDER THE UNIFORM COMMERCIAL CODE IN KENTUCKY

The requirements of a holder in due course under the Uniform Commercial Code are that the instrument must be taken (1) for value, (2) in good faith, and (3) without notice that it is overdue or has been dishonored, or of any defense or claim to it on the part of any person.[23] The requirements are essentially the same as those of the N.I.L.[24]

The drafters of the Code were confronted with whether good faith was to be determined by an objective or subjective standard. Consistent with the cases under the N.I.L., the 1957 draft of the Code made it clear that good faith is to be determined subjectively[25] Thus, there seems to be little doubt that, if based solely on the above discussed sections of the Code, there exists the same difficulty as was found in the N.I.L. in trying to keep the financier from being a holder in due course.

However, if a sales contract contains a waiver of defenses clause an additional section of the Code must be considered. The older version of section 9-206(1)[26] prevented such a contract from assuming the elements of negotiability of the attached note, therefore the waiver of defenses clause was inoperative and the financier was subject to any defenses the buyer might have against the seller. The 1957

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[23] Uniform Commercial Code (hereinafter referred to in the footnotes as UCC and in the text as Code) §3-302(1).

[24] See note 11 *supra* and accompanying text.

[25] In the 1952 draft, §3-302(1)(b) provided that a holder in due course is a holder who takes the instrument "in good faith, including observances of the reasonable commercial standards of any business in which the holder may be engaged." The 1957 draft merely requires that the holder take the instrument "in good faith," which is defined in §1-201(19) as "honesty in fact in the conduct or transaction concerned."

[26] UCC §9-206(1) (1952) provides:

> An agreement by a buyer of consumer goods as part of the contract for sale that he will not assert against as assignee any claim or defense arising out of the sale is not enforceable by any person. If such buyer as part of one transaction signs both a negotiable instrument and a security agreement even a holder in due course of the negotiable instrument is subject to such claim or defense if he seeks to enforce the security interest either by proceeding under the security agreement or by attaching or levying upon the goods in an action upon the instrument.

revision of the Code makes a substantial change in this provision. It provides that:

> Subject to any statute or decision to the contrary which establishes a different rule for buyers of consumer goods, an agreement by a buyer that he will not assert against an assignee any claim or defense which he may have against the seller is enforceable by an assignee for value, in good faith and without notice of a claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the Article on Commercial Paper (Article 3). A buyer who as part of one transaction signs both a negotiable instrument and a security agreement makes such an agreement.[27]

As applied to transactions involving non-consumer goods, the intention of this section is to give the finance company the protection of a holder in due course. This protection arises because the instrument acquires the elements of negotiability The Kentucky Court of Appeals so interpreted this section of the Code in *Walter J. Hieb Sand & Gravel, Inc. v. Universal Credit Corp.*[28]

In contracts involving the sale of consumer goods, there are at least two different interpretations of section 9-206(1) regarding the validity of a waiver of defenses clause. The first interpretation is that the phrase "subject to any statute or decision which establishes a different rule for buyers of consumer goods" leaves to the courts complete freedom in deciding the validity of a waiver of defenses clause in a conditional sales contract for consumer goods.[29] The second interpretation is that a waiver of defenses clause is valid if there are no statutes or judicial decisions to the contrary[30] This interpretation would validate waiver clauses when the case is one of first impression, while the former would leave the validity of waiver clauses to be determined by the court in such cases. From the wording of the Code the second position seems more logical.

During the limited period of time in which the Code has been in effect, the Kentucky Court of Appeals has not been called upon to interpret section 9-206(1). However, based upon their discussion of this section in the *Hieb* case and upon what would appear to be the more logical interpretation of the section, it is reasonable to assume that waiver clauses will be valid in sales of both non-consumer and consumer goods. However, if section 9-206(1) is interpreted to allow

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[27] UCC §9-206(1).

[28] 332 S.W.2d 619 (Ky. 1959). This case was decided after the adoption of the Code but before its effective date.

[29] See UCC §9-206, official comment 2, which provides that the Code "takes no position on the controversial question whether a buyer of consumer goods may effectively waive defenses by contractual clause"

[30] Note, *Finance Companies and Banks as Holders in Due Course of Consumer Installment Credit Paper*, 55 Nw. U.L. Rev. 389, 401-02 (1961).

the court the freedom of deciding the validity of the waiver of defenses clause, there remains the possibility that Kentucky will hold the clauses invalid.

Because of the serious implication of this problem, it is suggested that the Code, in an effort to establish uniformity, should have taken a definite position on this matter.[31] The result of this failure by the Code is that the different states, which have contrary statutes[32] or decisions, will arrive at different results on virtually the same facts.[33]

It seems reasonable to predict that the general "hands off" attitude of the Code will certainly limit its effect on future decisions in this area, and will leave the courts in little better position than they were before its adoption. Apparently, most courts will recognize the great need for protection of consumers, and will continue the trend started by the *Childs* case and adopt its policy However, courts which have decided for the financier under the N.I.L. may continue to do so under the Code.

D. CONCLUSION

The basic purpose behind the creation of negotiable instruments is to enable credit to be transferred easily Under the older, so-called majority view, notes taken by a seller and discounted to a financier are considered negotiable, although they are not intended to be transferred further. Since such notes lack the purpose of a negotiable instrument, they should not be treated as such. On the other hand, the strong policy of protecting the consumer has led many courts to decide against the financier. These courts at least saw the unique problem involved, and realized that the notes taken by the financier were not actually negotiable instruments. However, it is believed that these courts have not followed the right path.[34] The course that should have been taken was suggested in *White Sys. v. Hall*,[35] where the court took the position that the N.I.L. was clear, and that if the consumer needed protection from finance companies which were using the N.I.L. as a shield, then the legislature, and not the courts, should remedy the situation.

The lack of uniformity in this area of the law should be eradicated by uniform legislation. The Code has failed to accomplish this.

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[31] UCC article 3 (negotiable instruments) does not mention the peculiar problem involved, and §9-206(1), official comment 1, expressly refuses to take a position as to the validity of waiver of defense clauses.

[32] See, *e.g.*, Md. Stat. art. 83, §148 (1957); Ill. Rev. Stat. ch. 95, §26 (1953); Pa. Stat. Ann. tit. 69, §615(F) (Supp. 1961).

[33] King, *The Unprotected Consumer-Maker Under the Uniform Commercial Code*, 65 Deck. L. Rev. 207, 214-15 (1961).

[34] See 10 N.Y.U. Intra. L. Rev. 198 (1955).

[35] 219 La. 440, 53 So. 2d 227 (1951).