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Defenses Against a Holder in Due Course

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DEFENSES AGAINST A HOLDER IN DUE COURSE

How far can the maker of a negotiable instrument go in attacking its illegality in the hands of a transferee, by reason of (a) nondelivery, (b) fraud, (c) illegality?

The question of the right of a holder in due course of a negotiable instrument which has been stolen is commencing to come up in trial courts very frequently of late because of two peculiar circumstances. The activities of a great number of so-called investment courses dealing in commercial paper and trade acceptances obtaining negotiable instruments by fraud and even by theft and due to the fact of the so-called "liquor ring" having dealt in paper to cover whisky transactions. The public and banks in particular, have been flooded with instruments on which payment has been refused when presented and to which, on suit being brought, defences ranging from nondelivery to illegality and fraud in the inception have been interposed.

Although the precise question of the right to recover on a bill or note stolen before delivery is not a novel one, it is submitted by way of apology that on account of the increasing frequency of combinations of circumstances such as indicated above a re-examination and re-statement of the elementary propositions of law involved in this question might be pertinent at this time.

A promissory note is, of course, a chose in action. It is a mercantile chose. At Common Law there was, of course, a policy against the alienability of choses in action, and choses in action were divided in (1) parol choses and (2) specialty and mercantile choses. Strictly, at Common Law the mercantile chose which was a sealed instrument had no more particular dignity than a parol chose but later, by the custom of merchants, it attained a dignity equal to the specialty chose. The history of the development of the right to transfer specialty choses and later on the development of the doctrine of the right to transfer mercantile choses, is very interesting and occupies a very prominent place in the history of the Common Law. The real reason for the doctrine of the inalienability of choses in action was not, in reality, the objection of maintenance but was with reference to the idea of a debt, "that the credit being the personal right of the creditor, the debtor, being obliged toward that person could not by a transfer of the credit which was not an act of

his, become obliged toward another";[1] or as Ames expressed it, "A chose in action always presupposes a personal relation between two individuals. But a personal relation in the very nature of things cannot be assigned. Even a relation between a person and a physical thing in his possession as already stated cannot be transferred. The thing itself may be transferred, and, by consent of the parties to such transfer, the relation between the transferor and the thing may be destroyed and replaced by a new but similar relation between the transferee and the *res*. But where one has a mere right against another there is nothing that is capable of being transferred."[2]

In the time of Coke a specialty chose which evidenced an obligation could be transferred but it was considered that it was not the chose that was transferred but merely the paper which evidenced a chose.[3] "It is implied that if a man hath an obligation though he cannot grant the thing in action yet he may give or grant the deed, viz., the parchment to another who may cancel and use the same at his pleasure." This distinction was carried out in England as late as 1876, and the usual way in which a chose in action was attempted to be transferred was by the giving of the thing which evidenced the debt to another, coupled with a power of attorney in the name and place of that other to enforce the chose. The custom of merchants whereby a foreign bill of exchange could be assigned by the payee to a third person making that third person the legal owner of the bill as well as the equitable owner was recognized in England by the law courts as early as the 14th century and in the 17th century the same custom with reference to an inland bill as regards its transferability was recognized.[4] Promissory notes were put upon the footing of inland bills by the statutes of 7 Anne. The Common Law theory, apart from considerations of procedure, looked even with mercantile choses to the title to the paper. Even when, by the passage of the Judicature Act and by the statutes in various states, the real party in interest or the assignee of a claim was allowed to sue in his own name, all defences available against the assignor before notice of the assignment of the debt were destroyed.

[1]2 Spence: *Eq. Jur.*, 850; See also Polock, Contracts, 5th ed. 206; Holmes *Common Law*, 340-341; Maitland, 2 *Law Quarterly Review*, 495.
[2]*Select Essays on Anglo-American History*, Vol. III, page 580.
[3]Fol. 232 b 377 cited in Farrell. The Passaic Water Co., 82 N. J. 97.
[4]Clut. Bells Section 10.

The necessities of trade and commerce and the custom of merchants built up a doctrine of negotiation as opposed to assignment. The fundamental policy of the Common Law in reference to title, not only true as to real, but to chattels and to specialty choses in action was, that a wrongdoer could pass no title, and a transferee under the common law theory could never obtain better title to a thing than that of his transferor. The custom of merchants, however, and the theory of mercantile usages was to protect a purchaser for value and in good faith in the usual and ordinary course of business. In the gradual growth of importance of commercial transactions and in the growth of trading there came to be a clash between the common law theory and the mercantile theory. The custom of merchants was recognized by the English Law Courts and the theory of negotiation as opposed to assignability became recognized and that theory has been adopted in the present negotiable instrument law. Under the theory of negotiation a transferee of commercial paper obtains, if he is a *bona fide* purchaser in due course and before maturity and for value, a fresh title not dependent on the title of his transferor even if such title were defective unless he knew of the defect or unless the title of his transferor was absolutely void. Still, however, even under that theory, the title to the instrument itself had to be acquired. It would be impossible to constitute a transferee an owner of a negotiable instrument which would not exist as an instrument unless it were delivered intentionally.

What then is the situation where a negotiable instrument is executed and stolen before delivery? In general there is no contract completed and there is not title in the payee because of no delivery. Suppose, however, that after the payee has stolen it or, while in the hands of the payee and indorsed by him it were stolen, that it reached a *bona fide* purchaser for value, where is the title to the instrument? In this country prior to the passage of the negotiable instrument act there were two lines of authority, one line of authority[5] holding that a *bona fide* holder is entitled to recover under such circumstances. The reason for such holding does not clearly appear in some cases, being put on the theory of negligence in letting the paper get out of one's possession although there is not any particular quantum of evidence demanded to prove negligence; and another

[5]Mass., Tex., Minn., Ill., and La.

theory which it is submitted is really the theory, that in the interests of society and business generally it is better to protect the *bona fide* purchaser than the unfortunate maker. This theory does not seem logical because the ordinary doctrine of equity is that "where the equities are equal the legal title prevails" and there is no title in the *bona fide* holder even in the paper; because delivery is essential to give the instrumental legal existence.

The other line of authority previous to the negotiable instruments act was that the *bona fide* holder could not have title, the theory being either that delivery was necessary or that a purchaser from a thief was not a *bona fide* holder. There are dicta in accordance with this view expressed in *Andrews v. Thayer*,[6] and the question with this view was squarely decided in line with this authority in *Roberts v. McGrath*[7] and *Dodd v. Dunne*.[8] In that case *(Dodd v. Dunne)* on the question of whether there had been delivery and no negligence, the Supreme Court held that there could not be recovery even by a *bona fide* holder.

Under the negotiable instrument act it is provided that an instrument is negotiable by delivery if payable to bearer; if payable to order, by the indorsement of the holder completed by delivery.[9] And in a notation to this section in the pamphlet annoted negotiable instrument law published under authority of the Secretary of State and which until recently was obtainable, the statement is made, "A valid delivery is absolutely necessary even against a holder, otherwise in due course." That this is not true would seem apparent by a reading of Section 1675—16, part of which reads, "but where the instrument is in the hands of the holder in due course, a valid delivery by all parties prior to him so as to make them liable to him is CONCLUSIVELY presumed." And see section 1676—28 "in the hands of any holder OTHER than a holder in due course a negotiable instrument is subject to the same defences as if it were negotiable" which under the rule *expressio unius est exclusio alterius* and read with the section 1676—16, would indicate, it is submitted, a legislative intent to change the Wisconsin rule.

In the case of *Hodge v. Smith* [10] the question before the court

[6]30 Wisconsin 228.
[7]38 Wisconsin 52.
[8]71 Wisconsin 578.
[9]See section 1676, *Wisconsin Statutes.*
[10]130 Wisconsin 326.

was the effect of conditional delivery as between the parties, and the rights of a *bona fide* purchaser where not directly before the court as to this question of delivery. The court said, however, on page 333, "the authorities are not all in harmony with the foregoing. *Dodd v. Dunne*[11] is an example, but by the negotiable instrument law[12] the principle thereof was incorporated into the written rules of this state in these words,". . . , quoting the section. The learned justice (Marshall) assuming that this section had changed the rule as expressed in *Dodd v. Dunne,* it would seem that in Wisconsin under the negotiable instrument act as passed by our legislature, the fact of delivery or nondelivery in the hands of a *bona fide* purchaser is not available as a defense against him. That delivery is essential would seem to be recognized by the introduction of the fiction which finds it necessary to deem it "conclusively presumed" but whether delivery existed in fact, in the hands of a holder in due course, it is submitted is now immaterial. It is not the purpose of this summary to define what constitutes a holder in due course. Assuming, however, that one is a holder in due course of an instrument stolen, or negotiated through fraud, or originally given for an illegal purpose it is submitted that nondelivery is not a defence.

The act provides "that absence or failure of consideration is a matter of defence as against any person NOT A HOLDER IN DUE COURSE"[13] so under the familiar rule of construction it would be no defence in the hands of a holder in due course.

It is elsewhere provided (1676—25 *Wisconsin Statutes*) "the title of such person (who negotiates an instrument) is absolutely void when such instrument or signature was so procured from a person who did not know the nature of the instrument and could not have obtained such knowledge by the use of ordinary care." It is the settled rule in Wisconsin that if the maker's signature is procured by false representations as to the character of the paper, he being ignorant of the true character and being not negligent in being so ignorant, that the paper is void in the hands of a *bona fide* purchaser.

It is likewise the settled rule in Wisconsin established by the earliest decision in this state that illegality will not defeat an

[11]71 Wisconsin 578.
[12]1675-16 Chapter 356, *Laws of 1899.*
[13]1674-54 *Wisconsin Statutes.*

action upon a note by a holder in due course having no notice of the defect.[14]

In reference to forgery the act itself provides that where a signature is forged or made without the authority of the person whose signature it purports to be, it is wholly inoperative unless the party against whom it is sought to enforce such right is precluded from setting up the forgery or want of authority.[15]

Therefore, it is submitted, that the only defence against a holder in due course of a stolen note or one obtained through an illegal or fraudulent transaction, is absolutely forgery or such fraud which establishes that the maker did not know the nature of the instrument which he signed and could not have obtained such knowledge by the use of ordinary care.

In other words a negotiable instrument has two necessary formal requisites, one execution and the other delivery. Under the present state of the law in Wisconsin it is submitted that in the hands a holder in due course the only advantage that can be taken of the absence of the formal requisites is of that which deals with its execution and no advantage can be taken of the absence of that requisite which deals with its delivery.

[14]1 Wisconsin 378.
[15]1675-23.