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Article 6

# Status of the Transferee of Fraudulently Secured Instruments Under N.I.L. 54

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# RECENT DECISIONS

**Bills and Notes—Status of the Transferee of Fraudulently Secured Instruments Under N.I.L. 54:** On September 13th and 16th, one Sauer, president of S & S Motors, Inc., fraudulently obtained ten negotiable notes, totaling $33,094.76, from Motors Acceptance Corp. On September 16th, plaintiff bank, at Sauer's solicitation, exchanged for the notes its draft in even amount on First National Bank of Chicago. The same day, Sauer deposited the draft, presumably to the account of S & S Motors, with La Salle National Bank of Chicago. On September 18th, Motors Acceptance Corp. discovered the fraud, advised plaintiff of this fact, and plaintiff ordered the drawee of its draft to stop payment.

Between September 19th and October 15th, negotiations ensued between the Waukesha Bank, S & S Motors, La Salle National and Motors Acceptance. On the latter date, plaintiff, pursuant to demand of La Salle Bank, directed its drawee to honor the draft, and La Salle was paid.

Plaintiff sued Motors Acceptance on its notes. The parties stipulated the facts, the trial judge interpolating this statement:

> . . .if in the opinion of the court it becomes necessary in order to determine the issues in this case that evidence be presented concerning the accounts and records of S & S Motors, Inc., in the La Salle National Bank of Chicago, Illinois, and any transactions and dealings between said La Salle National Bank, S & S Motors, Inc., and the parties hereto the attorneys for the respective parties will be notified and will be given an opportunity to produce whatever evidence is admissible in relation thereto.[1]

On appeal by Motors Acceptance from an adverse judgment, the Wisconsin Supreme Court affirmed, *First National Bank of Waukesha v. Motors Acceptance Corp.*, 15 Wis. 2d 44, 112 N.W. 2d 381 (1961).

The critical issue of the case was whether or not, under the provision of N.I.L. 54,[2]

> Where the transferee receives notice of any infirmity in the instrument or defect in the title of the person negotiating the same before he has paid the full amount agreed to be paid therefor, he will be deemed a holder in due course only to the extent of the amount theretofore paid by him,

plaintiff was entitled to enforce payment of the notes as a holder in due course.[3] Defendant's contention was that, because plaintiff was aware

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[1] First National Bank of Waukesha v. Motors Acceptance Corp., 15 Wis. 2d 44, 112 N.W. 2d 381 (1961).
[2] WIS. STAT. §116.59 (1959).
[3] N.I.L. 57, WIS. STAT. §116.62 (1959), "A holder in due course holds the in-

of the fraud when plaintiff lifted its earlier countermand and caused its draft to be honored, plaintiff could qualify as a holder in due course only if its liability to La Salle Bank on the draft had theretofore become absolute. But, argued the defense, the latter liability was not absolute unless (or except to the extent that) La Salle Bank was a holder in due course of the draft. Finally, the defense contended, it was incumbent on plaintiff to establish the due course status of La Salle, under N.I.L. 59,[4] as an element of its case on the notes.

Regarding the question as one of first impression,[5] and conceding the existence of respectable differences of judicial opinion, the Court rejected the defendant's initial premise:

> We prefer . . . to adopt the construction that the quoted phrase ["paid therefor the full amount agreed to be paid"][6] means completion of the transaction at hand, which in the instant case was when plaintiff exchanged its draft for the 10 notes.[7]

It further added:

> In the instant case, sec. 116.59, Stats., would be applicable *only* if the plaintiff had received notice of the fraud before it had finished the particular settlement agreed upon for the exchange of the 10 notes. Here the settlement was complete when plaintiff gave its bank draft.[8] [Emphasis added].

The so-called "bank deposit" cases[9] were distinguished. Under their rule, a bank, which gives a deposit credit in exchange for an item subject to a prior infirmity, is entitled to recover on the item only to the extent that there was an actual withdrawal of funds prior to notice to the bank of the infirmity.[10] The rationale for this "bank deposit" rule

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strument free from any defect of title or 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."

[4] WIS STAT. §116.64 (1959), "Every holder is deemed prima facie to be a holder in due course; but when it is shown that the title of any person who has negotiated the instrument was defective, the burden is on the holder to prove that he or some person under whom he claims acquired the title as a holder in due course. . . ."

[5] *Supra* note 1, at 48, 112 N.W. 2d at 383. "This issue has never been squarely before this court."

[6] This phrase is the crucial portion of N.I.L. 54, WIS. STAT. §116.59 (1959), set forth in the text, *supra* note 2.

[7] First National Bank of Waukesha v. Motor Acceptance Corp., *supra* note 1, at 48, 49, 112 N.W. 2d at 383.

[8] *Id.* at 49, 112 N.W. 2d at 383.

[9] Hodge v. Smith, 130 Wis. 326, 110 N.W. 192 (1907); First National Bank v. Court, 183 Wis. 203, 197 N.W. 798 (1924); Northfield National Bank v. Arndt, 132 Wis. 383, 112 N.W. 451 (1907); Curry v. Wisconsin National Bank, 149 Wis. 413, 136 N.W. 549 (1912).

[10] Strictly speaking there need not be an "actual" withdrawal. If the depositor's account varies from the time the initial credit was given, the FIFO test may apply in determining to what extent the bank is a holder in due course. Thus, notwithstanding the fact that the depositor's *present* account balance exceeds the amount of the defective instrument, the bank may still be a holder in due course, to the extent it *previously* paid out money to or on account of

is obviously sound. Upon learning of the infirmity in the instrument it has taken, the bank can readily return the item to its depositor and revoke the deposit credit.[11] Thus to the extent that a bank so circumstanced may readily mitigate its own loss, by resort to the deposit in its own hands, it is denied recovery against the original defrauded party, even on negotiable paper.

The Court's ground of distinction, as stated in the principal case, is not entirely satisfying:

> Clearly the equities are not the same where the bank gives its own negotiable instrument in exchange for another. For now the bank's instrument may get into the hands of a holder in due course.[12]

The question remains: What are the respective equities if the instrument given in exchange has not, in fact, come into the hands of a holder in due course? A literal application of the "completion of the transaction at hand" theory makes this factor immaterial; for once a party has issued a negotiable instrument in exchange for another, there would appear to be no subsequent circumstance which could defeat or impair the rights of such party.

It requires little ingenuity to suggest any number of circumstances which ought, it would seem, to bear substantially on the case. Certainly, had Sauer himself reappeared with the draft, after his fraud had been disclosed, payment directly to him would have been such a circumstance. The inherent logic of the "bank deposit" rule would suggest the same result had Sauer determined, e.g., on September 16th, to deposit the draft with the Waukesha Bank in an account opened on that day. The same reasoning would apparently apply to any payment of the draft to, or specifically for the account of, either Sauer or S & S Motors.

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the depositor. Since part of the present balance may be the result of valid deposit items, only the amount of the balance still attributable to the defective instrument will be cancelled under the "bank deposit" rule. See First National Bank v. Court and Northfield National Bank v. Arndt, *supra* note 9 for a further discussion of the FIFO rule; also see BRITTON, BILLS AND NOTES §97, at 393 (1943).

[11] *See* Port Washington State Bank v. Polonia Phonograph Co., 180 Wis. 71, 192 N.W. 472 (1923), which applies the "bank deposit" rule in denying holder in due course status to plaintiff bank. *Polonia* found no equity in a bank which, with full knowledge of the infirmity in a deposited item, nevertheless permitted both the item and subsequent deposits to be applied to subsequent withdrawals.

In *First National Bank v. Court,* 183 Wis. 203, 197 N.W. 798 (1924), by contrast, "The defendant at no time during the trial submitted evidence tending to prove notice of the fraud to the plaintiff. . . . Therefore the presumption that it purchased in good faith . . . continued until overcome by rebutting evidence." *Id.* at 213, 197 N.W. at 801.

The *Court* decision gave unstinting recognition to the "doctrine that the presumption of application of payments does not apply where it will work injustice." *Id.* at 211, 197 N.W. at 801.

[12] *Supra* note 1, at 48, 112 N.W. 2d at 383. This statement is the same as that set forth in BRITTON, BILLS AND NOTES §98, at 401 (1943).

In each of these suppositions there lurks the fundamental objection to any suggestion of the principal case that the status of La Salle Bank was immaterial to Waukesha National's right of recovery. If La Salle Bank had not been, in fact, a holder in due course then it is perfectly conceivable that it may have been no more than a depositary or collecting agent of Sauer. Payment to it, under these circumstances, would hardly be more defensible than payment to Sauer himself.

It is the writer's feeling that a better solution was overlooked, by rejecting *Jerke v. Delmont State Bank*[13] on the ground that it construes "paid" in N.I.L. 54 to mean actual cash payment. In actuality, the *Jerke* case accords completely with the Wisconsin Court on the question of whether or not Waukesha National had "paid" for the notes prior to learning of the fraud. This is evidenced by its analysis of holder in due course:

> When the holder of a negotiable instrument, fraudulent in its inception, has established together with the other elements of holding in due course specified in (N.I.L. 52) that he gave for the instrument a consideration sufficient to support a simple contract,[14] *he has certainly established that he took the instrument for value* within the meaning of subdivision 3 (N.I.L. 52),[15] and he has met the burden of proving that he "acquired the title as a holder in due course" specified in (N.I.L. 59).[16] [Emphasis added].[17]

The essential difference between the two decisions lies in the respective degrees of finality attributed to the holder in due course status of the plaintiff bank. Whereas the majority opinion in the *First National* case makes this the sole criterion for allowing recovery, the *Jerke* case, while not denying the prima facie significance of this factor, qualifies the conclusiveness of the right of recovery stated in N.I.L. 57.[18]

> Some confusion has arisen in the cases by sometimes overlooking the fact that in a suit upon a negotiable instrument by the holder against the maker, the fact that the holder acquired the instrument as a due course holder does not dispose of all the rights or equities between the parties to the action. . . . *Due*

[13] 54 S.D. 446, 223 N.W. 585 (1929).

[14] N.I.L. 25, WIS. STAT. §116.30 (1959)\ provides: "Value is any consideration sufficient to support a simple contract. An antecedent or pre-existing debt constitutes value; and is deemed such whether the instrument is payable on demand or at a future time."

[15] N.I.L. 52, WIS. STAT. §116.57 (1959) defines holder in due course. "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." [Emphasis added].

[16] *Supra* note 4.

[17] Jerke v. Delmont State Bank, *supra* note 13, at 595.

[18] *Supra* note 3.

*course holding has nothing whatever to do with direct rights or equities between the holder and the maker and subsequent equities may arise, which render it impossible for the holder to enforce payment of all or part of the note, entirely regardless of the fact that he acquired it in due course. . . .*[19] [Emphasis added].

Justice Currie's dissent[20] in the instant case attempted to provide for the same considerations in a slightly different manner. He felt that the bank, in stopping payment on the draft, reversed the prior completed transaction and thereby left open the questions of whether the draft was held by a holder in due course at the time of the stop payment order. This was precisely the point argued by the defendant in seeking a reversal. In so doing defendant relied heavily on the *Jerke* case. Even if the Wisconsin Court had adopted the position taken in the *Jerke* case, it is questionable whether Motors Acceptance could have prevailed, because of the lack of any evidence indicating that First National *knew* La Salle Bank was *not* a holder in due course at the time it countermanded the stop payment order. The burden of showing such participation in the fraud is clearly upon the party relying on N.I.L. 54,[21] Motors Acceptance Corp. The following excerpt from the *Jerke* decision precisely explains the burden of proof problem:

> If, after knowledge of the original fraud, the bank paid the certificate of deposit . . . knowing that such holder was not a due course holder, then to that extent [N.I.L. 54, Wis. Stats. 116.59] would apply and because of such knowing breach of constructive trust, the bank would not be *"deemed* a due course holder" as against Jerke, regardless of the fact that it actually was a due course holder. But the burden of proving the existence of this supervening equity, arising out of the breach of constructive trust after becoming a due course holder, was upon the maker of the note. The burden placed upon the holder by [N.I.L. 59, Wis. Stats 116.64] is limited to showing the *acquisition of title in due course.* That section does not place upon the holder any burden of going further, and negativing the existence of supervening equities, which may have arisen upon subsequent facts in favor of the maker. If any such supervening equities exist, it is for the maker of the note to prove the same by the preponderance of the evidence.[22]

Since N.I.L. 59[23] presumes every holder to be a due course holder, the determination of La Salle's status would be unnecessary in the absence of any evidence by Motors Acceptance that La Salle was not such a holder in due course. Therefore, to remand the case for a new trial would be allowing reconsideration of an issue not pleaded.

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[19] *Supra* note 13, at 595.
[20] *Supra* note 1, at 51, 112 N.W. 2d at 384.
[21] *Supra* note 2.
[22] Jerke v. Delmont State Bank, *supra* note 13, at 596.
[23] *Supra* note 4.

The impact of the present case will undoubtedly produce a different aproach by parties seeking to avoid liability on fraudulently secured negotiable instruments. The decision has effectively cut off any possibility of defending successfully against the holder who took the instrument in good faith and in exchange for a negotiable instrument.

But when a fact situation arises involving an exchange of negotiable instruments, where one is subject to a prior infirmity, the following approach may be useful in setting up a valid defense, assuming the possibility that the Wisconsin Court will modify its flat rejection of the *Jerke* rationale. Unless the transferee knew of the fraud at the time of the exchange, his right to recover should not be questioned by merely asserting N.I.L. 54, or by questioning the transferee's holder in due course status. Rather, the defendant should proceed to establish:

1. The point in time at which the plaintiff was aware of the infirmity;

2. That plaintiff's negotiable instrument was *subsequently* paid to one *not a holder in due course;* and most important,

3. That plaintiff *knew* the payee was not a holder in due course.

In essence the defendant would be arguing the supervening equity of the situation,[24] and denial of recovery would be predicated upon the plaintiff's participation in effectuating the fraud, irrespective of his due course status at the completion of the original transaction.

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**Wills—Admissibility of Extrinsic Evidence in the Absence of Ambiguity:** The wills of Mr. and Mrs. George Gibbs each bequeathed one per cent of the residue to "Robert J. Krause, now of 4708 North 46th Street, Milwaukee, Wisconsin." Robert W. Krause, who resided at 2325 North Sherman Boulevard at the time the will was executed, petitioned the County Court for Milwaukee County for construction of the above provisions on the ground that he was the intended beneficiary. Both Robert J. Krause of 4708 North 46th Street and Robert W. Krause were represented at the hearing. The petitioner was permitted to introduce evidence that he was a close friend and former employee of the decedents, over the objection of the named beneficiary. He was also allowed to show that in prior

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[24] In *Home Savings Bank v. General Finance Corp.*, 10 Wis. 2d 417, 103 N.W. 2d 117 (1960), the Wisconsin Court allowed a restitutional recovery to a plaintiff who relied upon the *oral* acceptance of a sight draft. N.I.L. 132, WIS. STAT. §118.07 (1959), requires a bill of exchange to be accepted *in writing.* Yet the Court felt that the inequity of the situation justified relief even though the plaintiff was seemingly barred by the express wording of the N.I.L. It is interesting to note that principles in another field of law, restitution, took precedence over the more particular area, negotiable instruments.