Maryland Law Review

Volume 28 | Issue 2 Article 6

Holder In Due Course - The Requirements Of Good Faith And Notice - Financial Credit Corporation v. Williams

Follow this and additional works at: http://digitalcommons.law.umaryland.edu/mlr

Part of the Commercial Law Commons, and the Contracts Commons

Recommended Citation

Holder In Due Course - The Requirements Of Good Faith And Notice - Financial Credit Corporation v. Williams, 28 Md. L. Rev. 145 (1968)
Available at: http://digitalcommons.law.umaryland.edu/mlr/vol28/iss2/6

This Casenotes and Comments is brought to you for free and open access by the Academic Journals at DigitalCommons@UM Carey Law. It has been accepted for inclusion in Maryland Law Review by an authorized administrator of DigitalCommons@UM Carey Law. For more information, please contact smccarty@law.umaryland.edu.

Holder In Due Course — The Requirements Of Good Faith And Notice

Financial Credit Corporation v. Williams[1]

Plaintiffs entered into a contract with Reynolds Engineering and Supply Company[2] whereby Reynolds agreed to install storm windows, to make certain other improvements on the plaintiffs' home, and to pay the balance then owing on the plaintiffs' automobile. In return, the

---

1. 246 Md. 575, 229 A.2d 712 (1967).

2. The record is unclear as to whether Reynolds or Peerless Construction Company was the contracting party, but as Judge Barnes pointed out, the point is immaterial for purposes of this case. *Id.* at 579 n.1, 229 A.2d at 713 n.1.

plaintiffs promised to pay $3200.00 in monthly installments. Subsequent to the execution of the contract, they executed a promissory note for $6,399.60 and a mortgage of their home to Reynolds to secure payment of this amount. Five years later the mortgage and note were purchased by defendant, Financial Credit Corporation, as a part of a package of 480 such instruments at a discount of over 80%. Two years after the sale to the defendant, plaintiffs brought an action to have the mortgage and note declared void and to recover the amounts paid thereunder. Proof proceeded on the theory that the plaintiffs' signatures on the mortgage and note were obtained by fraud[3] as well as on the theory of usury.[4] Defendant argued principally that it was a holder in due course of the note[5] and a bona fide purchaser of the mortgage.[6]

---

3. The evidence of fraud consisted of plaintiffs' uncontradicted testimony that Reynolds' agent told them the total contract price was to be $3,200.00; that the copy of the original contract given plaintiffs stated $3,200.00 to be the price; and that Reynolds' agent told plaintiffs to sign certain documents (the mortgage and note in the face amount of $6,399.60) while preventing plaintiffs from seeing the nature of the documents, assuring them the signatures were necessary to complete the formalities of the contract. It was uncontradicted that plaintiffs were not aware of the legal effect of the documents. *Id.* at 582, 229 A.2d at 714-15. The defense of fraud in the execution of the note which is a real defense and can be raised even against a holder in due course, is described in UNIFORM COMMERCIAL CODE § 3-305 (2)(c) as "such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms. . . ." This is essentially the common law and the N.I.L. test, although the N.I.L. had no provision on the point. Generally, this type of fraud is rare as it takes an unusual set of facts to constitute this defense. This may explain why neither the plaintiffs nor the court pressed the defense, which would have rendered moot any question as to the defendant's status as a holder in due course. *Compare* Universal C.I.T. Corp. v. Cyr, 160 Me. 152, 200 A.2d 213 (1964), *with* First Nat'l Bank & Trust Co. v. DeLise, 186 Pa. Super. 398, 142 A.2d 401 (1958). *See generally* W. BRITTON, BILLS AND NOTES § 130 (2d ed. 1961).

4. Plaintiffs alleged that the difference between the amount of the mortgage ($6,399.60) and the amount they promised to pay under the initial contract ($3,200.00) represented "interest" and being above 6%, was usurious. 246 Md. at 579, 229 A.2d at 713. Although the lower court found the mortgage and note usurious, the court of appeals held that there was insufficient proof to show that any part of the original contract price was usurious. *Id.* at 587, 229 A.2d at 717.

5. Financial Credit and Reynolds did not deal directly with one another and thus the facts do not warrant a discussion of the special problem of whether a finance company can be a holder in due course. As is pointed out in W. BRITTON, BILLS AND NOTES 283 (2d ed. 1961):

> In a number of cases the courts appear to have used the legal microscope to find evidence of bad faith purchases of notes by finance companies from dealers, obtained by the dealer in installment selling transactions. The evidence of bad faith purchase seems to have been found from the close association of the dealer and his discounting finance company.

See Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967), for a recent case analyzing the problems in this area. *See generally* Jones, *Finance Companies As Holders In Due Course of Consumer Paper,* 1958 WASH. U.L.Q. 177; Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test,* 39 S. CAL. L. REV. 49, 67-74 (1966); Note, *Finance Company As A Holder in Due Course,* 28 NOTRE DAME LAWYER 251 (1953); Note, *Finance Company As A Holder In Due Course,* 51 KY. L.J. 134 (1962). Littlefield discusses the three rationales courts have used to protect the consumer by refusing to grant the finance company holder in due course status, *i.e.*, principal and agent, finance company as an original party, and bad faith of the finance company.

6. The court stated, "The finding of fraud, amply supported by the evidence, means that as between the Williams and the original mortgagee, the *mortgage* was an absolute nullity. It can have no greater value in the hands of the appellant-assignee even if the assignee be deemed a bona fide purchaser for value." 246 Md. at 583, 229 A.2d at 715 (emphasis added).

Purporting to apply Section 75 of the Negotiable Instruments Law[7] (N.I.L.), which was in effect when the mortgage and note were executed, the lower court concluded that the defendant was a holder in due course of the note only to the extent of the amount it paid for the note. On appeal by both parties, the Maryland Court of Appeals increased the lower court's monetary decree[8] for the plaintiffs, holding that Financial Credit, which was aware of the bad reputation of the original mortgagee,[9] Reynolds, and which purchased the note and mortgage as a part of the purchase of 480 such instruments at an extraordinary discount of over 80%, could not have had the "white heart" of a good faith purchaser.[10] Having failed to meet its burden of proving that it took in good faith,[11] the defendant could not be a holder in due course and was thus subject to plaintiffs' defense that Reynolds had acted fraudulently.[12]

This case presents a good example of the confused state of the law of taking in good faith under the N.I.L. As is not unusual in cases decided under the N.I.L., it is difficult to tell from reading the court's opinion whether a subjective or objective test of good faith was applied. The court states:

> A purchaser lacks the good faith requisite for attaining holder in due course status only if he has actual knowledge of fraud or other defect in the instrument or if he consciously ignores facts which

---

7. MD. CODE ANN. art. 13, § 75 (1957) provided:

> When 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.

Since the total agreed consideration had been paid by defendant, the trial court improperly applied this section.

8. The lower court awarded plaintiffs a monetary decree for $682.58, the difference between the amount paid by plaintiffs to defendant on the mortgage and note, $1,386.58, and the amount paid by defendant for the note, $704.00. The court of appeals allowed plaintiffs to recover $1,013.07, representing the difference between the total amount paid on the fraudulent instrument ($4,213.07) before the plaintiffs discovered the fraud and the original contract price ($3,200.00).

9. 246 Md. at 585, 229 A.2d at 716.

10. *See* Fair Loans, Inc. v. Wilkinson, 211 Md. 216, 126 A.2d 851 (1956) and cases cited therein.

11. The court stated what would constitute lack of good faith as follows: "A purchaser lacks the good faith requisite for attaining holder in due course status only if he has actual knowledge of fraud or other defect in the instrument or if he consciously ignores facts which would lead him to discover the defect." 246 Md. at 584, 229 A.2d at 716. *See* Blacker v. Bokowitz, 219 Md. 171, 148 A.2d 382 (1959); Cooke v. Real Estate Trust Co., 180 Md. 133, 22 A.2d 554 (1941); Carozza v. Federal Fin. & Credit Co., 149 Md. 223, 131 A. 332 (1925).

12. *See* Griffin v. Baltimore Fed. Sav. & Loan Ass'n, 204 Md. 154, 102 A.2d 804 (1954), which applied § 147 of the Retail Installment Sales Act, MD. CODE ANN. art. 83, § 147 (1965 repl. vol.), to a holder in due course. § 147 states:

> If as part of an installment transaction, a note is taken by the seller or finance company, such note shall refer to the installment agreement out of which it arises and, in the hands of any subsequent holder, such note shall be subject to all defenses which the buyer might have asserted against the seller or finance company. . . .

When the principal contract was executed, the Act covered only installment contracts for sale of goods having cash value of $2,000.00 or less. In 1965, an amendment to § 152(a) extended the coverage to sales involving $5,000.00 or less. If the principal case arose today, § 147 would be applied, holding the defendant liable even though it be a holder in due course. Thus, it appears that whether a finance company can be a holder in due course is governed largely by statute.

> would lead him to discover the defect. The test is said to be subjective, for a purchaser may be a holder in due course if he purchases with a "white heart" but an "empty head" . . . . We think that, absent any contrary proof by the appellant, it must be found to have known that notes and other paper originally obtained by Reynolds Engineering were likely to be tainted with a badge of fraud.[13]

Despite its seeming approval of the subjective white heart - empty head test,[14] it is clear that the court, contrary to the requirements of the subjective test, did not require knowledge of the fraud to find a lack of good faith. The court stated that Financial Credit must have known that the note was "likely to be tainted with a badge of fraud," not that *it was tainted* with fraud. Indeed, there was no finding that the finance company had actual knowledge of the fraud.[15] The facts present in this case — defendant's knowledge of Reynolds' bad reputation[16] and the high discount at which the defendant purchased the notes[17] — are

---

13. 246 Md. at 584-85, 229 A.2d at 716-17.

14. *See* W. HAWKLAND, BILLS AND NOTES 194-97 (1956); 53 HARV. L. REV. 1200 (1940). The white heart-empty head test has also been called "the blundering fool doctrine." *See, e.g.,* Schintz v. American Trust & Sav. Bank, 152 Ill. App. 76, 78 (1909), where the court stated: "A blundering fool may therefore be found to have acted in good faith, though under like circumstances a shrewd business man might be deemed to have acted in bad faith."

15. The only evidence resembling actual knowledge was a statement by Groves, president of Financial Credit, made after extensive cross-examination, that he assumed "that somebody down the line somewhere was interested in making a profit." Record at E. 44, Financial Credit Corp. v. Williams, 246 Md. 575, 229 A.2d 712 (1967). For other cases discussing the evidence needed to show actual knowledge see Fair Loans, Inc. v. Wilkinson, 211 Md. 216, 126 A.2d 851, 856 (1956); Dean v. Eastern Shore Trust Co., 159 Md. 213, 220, 150 A. 797 (1930); Weant v. Southern Trust & Deposit Co., 112 Md. 463, 471, 77 A. 289 (1910).

16. *See* Universal C.I.T. Credit Corp. v. Ingel, 347 Mass. 119, 196 N.E.2d 847, 852 (1964). There, the court said that evidence offered by the defendants to show that plaintiff finance company and the original seller, a firm engaged in the sale of storm windows and in remodeling work — like Reynolds — had worked together on various aspects of financing and that plaintiff was aware of complaints against the seller by previous customers, together with general evidence of fraud, was properly excluded since the plaintiff finance company had "no reason to know" within § 3-302(1) and § 1-201(25) of the Uniform Commercial Code. *See* United Sec. Corp. v. Franklin, 180 A.2d 505 (D.C. Mun. App. 1962), holding, *inter alia,* that the position of a holder for value of negotiable paper is strong, and cannot be displaced by mere circumstances of suspicion growing out of unpopular business or ill reputation of his assignor. *See also* Metropolitan Discount Co. v. Fondren, 121 Ark. 250, 180 S.W. 975 (1915); State Bank v. Lawrence, 177 Ind. 515, 96 N.E. 947 (1912).

17. *But see* Home Credit Co. v. Fouch, 155 Md. 384, 142 A. 515 (1928) and Williams v. Huntington, 68 Md. 590, 13 A. 336 (1888) (where the size of the discount was held enough to support a finding of bad faith by the trier of fact); Russell v. Universal Acceptance Corp., 210 A.2d 834, 837 (D.C. App. 1965) (where the court stated: "The purchase of a negotiable note at a high discount has been held to be evidence tending to show bad faith or fraud on the part of the purchaser, especially when tied in with other suspicious circumstances."); Bowles v. Marsh, 82 A.2d 135 (D.C. Mun. App. 1951) (discount is a factor in determining whether the purchaser should have been put on inquiry as to irregularities); Matathias v. Bel-Mar Laboratories, Inc., 2 U.C.C. Rptr. 1161 (N.Y. Sup. Ct. 1965). *See generally* W. BRITTON, BILLS AND NOTES 273 (2d ed. 1961), where the author states: "Actual and potential insolvency of the issuer has much more to do with the price of commercial paper than does the possibility that it was obtained by the first holder subject to a defense . . . therefore, the purchase of an instrument at a discount, *of whatever amount,* is not, of itself, evidence of purchase in bad faith." (emphasis added).

arguably no more than suspicious circumstances, and it is a well settled principle of law that suspicious circumstances are not enough to prevent a taker from being a holder in due course.[18] It is submitted that because Financial Credit did purchase the note in subjective good faith, the actual basis of the court's decision must have been that some *objective* standard of good faith had been violated. It seems clear that the court has included an objective element in its definition of good faith by indicating that the defendant would not be a holder in due course if it consciously ignored facts which would have led it to discover the fraud.[19] If this interpretation is correct, then the Maryland court was endorsing a dual test in requiring the holder to show both subjective good faith and an absence of objective bad faith.[20] Applying this test to the facts of the case, Financial Credit purchased the note in subjective good faith, that is, it had no *actual* knowledge of the fraud, but it acted with objective bad faith by failing to meet the objective standard of freedom from notice required of a holder in due course. As will be seen later, such a *dual test* finds support under the N.I.L.

The doctrinal uncertainty in the decision in this case is not unusual among decisions under the N.I.L., and the factual test of whether the holder had knowledge that the note was "likely to be tainted with a badge of fraud" is probably fairly representative of many factual situations which have been held to prevent a holder from being a holder in due course.[21] However, because the doctrine is not clear, and because the doctrinal ambiguity presented in this and other cases under the N.I.L. seems to have carried over to cases under the Uniform Commercial Code (U.C.C.), it would seem a worthwhile inquiry to review the history of the good faith-bad faith test prior to and under the N.I.L. and to assess the probable impact of the new formulation of the rules in the U.C.C.

The basic philosophy of the holder in due course status "is to encourage free negotiability of commercial paper by removing certain anxieties of one who takes the paper as an innocent purchaser knowing no reason why the paper is not as sound as its face would indicate."[22] The requirement of innocent purchase, that is, purchase in good faith, as a condition of holding in due course, involves consideration of one of the broadest concepts in the law of commercial paper. Deciding whether in fact the purchaser is "innocent" usually depends on

---

18. *See* Valley Sav. Bank v. Mercer, 97 Md. 458, 55 A. 435 (1903), where the court held, *inter alia,* that merely suspicious circumstances sufficient to put a prudent man on inquiry, or even gross negligence on the part of plaintiff, at the time of acquiring the note, are not sufficient of themselves to prevent recovery unless the jury finds from the evidence that plaintiff acted in bad faith. *See generally* F. BEUTEL, BRANNAN'S NEGOTIABLE INSTRUMENTS LAW 772 (7th ed. 1948).

19. 246 Md. at 584, 229 A.2d at 716.

20. Other examples of situations where courts have employed the test of subjective good faith coupled with an absence of objective bad faith are: Mutual Finance Co. v. Martin, 63 So. 2d 649 (Fla. 1953); Local Acceptance Co. v. Kinkade, 361 S.W.2d 830 (Mo. 1962); Rein v. Merriell, 150 So. 2d 73 (La. 1963); Jefferson Securities Corp. v. Walsh, 134 So. 2d 107 (La. 1961). *See generally* Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test,* 39 S. CAL. L. REV. 49, 71-72 (1966).

21. *Cf.* W. BRITTON, BILLS AND NOTES 244-49 (2d ed. 1961).

22. Unico v. Owen, 50 N.J. 101, 232 A.2d 405, 410 (1967).

whether a subjective[23] or an objective[24] test is used. An examination of the cases shows both inconsistency and confusion in the application of such tests.

The original rule declared in England was that the title of a holder of negotiable paper, acquired before it was due and for valuable consideration, was not affected by the fraud of a prior party, in the absence of actual notice of such fraud and without proof of bad faith (that is, dishonesty) on the part of the holder.[25] The case of *Gill v. Cubitt*[26] represented an attempt to modify this subjective good faith standard; that case held that the negligence of a holder, in itself, prevented him from cutting off the defenses of the maker. This theory was soon tempered by the requirement that the want of care necessary to impeach the title of the holder of negotiable paper must have been gross.[27] Finally, the *Gill* doctrine was abandoned in England to protect the free flow of negotiable instruments. The original rule was restored and it was decided that nothing short of actual knowledge of defects and bad faith, in the sense of a dishonest purchase, would deprive the purchaser of the character of a holder in due course.[28] The 1857 decision in *Goodman v. Simonds*[29] expressed the prevailing view in the United States to be that of contemporary England; that is, in order to impeach the status of a holder, actual knowledge of the defense or defect must have been shown. Mere suspicion was not enough.

---

23. Subjective test of good faith: whether the holder was actually in good faith or bad faith, *i.e.*, in his own mind was his conduct honest. Graham v. White-Phillips Co., 296 U.S. 27 (1935), is regularly cited as the finest flower of the subjective theory, supporting the "forgotten notice doctrine." Scholars, however, disagree that the Supreme Court was advocating a subjective test. *See* Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1065 n.22 (1954). For other examples of courts following the subjective test see Sherwood Distilling Co. v. Peoples First Nat'l Bank & Trust Co., 193 F.2d 649 (4th Cir.), *cert. denied*, 344 U.S. 818 (1952); Driscoll v. Burlington-Bristol Bridge Co., 8 N.J. 433, 86 A.2d 201 (1952); Gramatan Nat'l Bank & Trust v. Moody, 326 Mass. 367, 94 N.E.2d 771 (1950); Fabrizo v. Anderson, 62 A.2d 314 (D.C. Mun. App. 1948); Christian v. California Bank, 30 Cal. 2d 421, 182 P.2d 554 (1947); Chicago Dist. Elec. Generating Corp. v. Evans, 117 Ind. App. 280, 69 N.E.2d 627 (1946); Cooke v. Real Estate Trust Co., 180 Md. 133, 22 A.2d 554 (1941). *See also* Note, 81 U. PA. L. REV. 617 (1933), favoring the "actual good faith test."

24. Objective test of good faith: whether the holder conformed to the standard of conduct becoming to an ordinary reasonably prudent man. *See, e.g.*, Boxell v. Bright Nat'l Bank, 184 Ind. 631, 112 N.E. 3 (1916). An extreme statement of the objective test was given in Mee v. Carlson, 22 S.D. 365, 370, 117 N.W. 1033, 1036 (1908):

> The purchaser of a negotiable note . . . cannot rely alone upon the fact that he has no information of any defense to the same in order to constitute him a purchaser in good faith, but he must go further, and show that he used the means that an ordinarily prudent man would use to ascertain the manner in which the note was obtained from the makers. He is not permitted to refrain from making inquiries, but the burden is upon him to show that he has used the ordinary means to ascertain whether or not the note is a valid note in the hands of the vendor.

25. Miller v. Race, 97 Eng. Rep. 398 (K.B. 1758).

26. 107 Eng. Rep. 806 (K.B. 1824).

27. Crook v. Jadis, 110 Eng. Rep. 1028 (K.B. 1834).

28. Goodman v. Harvey, 111 Eng. Rep. 1011 (K.B. 1836).

29. 61 U.S. 343 (1857). It appears that a lasting defect of this decision, and others in the area, is the failure of the court to distinguish between good faith and notice. A confusion in the cases between the concepts of good faith and notice has added fuel to the subjective-objective test controversy. *See generally* Mulhearn, *The Meaning of "Good Faith" in the N.I.L.*, 9 TUL. L. REV. 128 (1934).

Prior to the Negotiable Instruments Law, the general state of the law of bills and notes was one of complete confusion.[30] The primary reason for the N.I.L.'s adoption was the desirability for uniformity in the law.[31] In its treatment of the holder in due course, the language of the N.I.L. was a reiteration of the common law rule. It restated and did not remake the law.[32] The N.I.L. requirements for a holder in due course are found in Section 52. In addition to the necessity that the purchaser take complete, regular paper before maturity, that section requires:

> (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.

Although "no notice" and "good faith" were listed as separate elements under the N.I.L., most courts and writers have treated them as part and parcel of the same requirement.[33] This merging of the elements is understandable, because Section 56 of the N.I.L. defines notice in terms of bad faith:

> To constitute notice of an infirmity 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.

There is little dispute that Section 52 (3) calls for the actual (subjective) good faith test.[34] In addition, proponents of the subjective test have interpreted the words "actual knowledge" in Section 56 as negating an objective test. However, the clause "knowledge of such facts . . . [as] amounted to bad faith"[35] in Section 56 gave rise

---

30. F. BEUTEL, BRANNAN'S NEGOTIABLE INSTRUMENTS LAW 72 (7th ed. 1948).

31. Report, 54 TRANS. MD. BAR ASS'N 224 (1949).

32. *See* Note, *Notice and Good Faith Under Article 3 of the Uniform Commercial Code,* 51 VA. L. REV. 1342, 1343 (1965); Note, 81 U. PA. L. REV. 617 (1933).

33. Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test,* 39 S. CAL. L. REV. 48, 54 (1966). *See generally* F. BEUTEL, BRANNAN'S NEGOTIABLE INSTRUMENTS LAW § 52(3), at 705 (7th ed. 1948), where he directs the reader: "Other cases on good faith are collected under sec. 56"; Britton, *Holder in Due Course — A Comparison of the Provisions of the Negotiable Instruments Law With Those of Article 3 of the Proposed Commercial Code,* 49 NW. U.L. REV. 417, 430–31 (1954).

34. *See* Nichols, *Purchaser in Good Faith and Without Notice Under the Negotiable Instruments Law and the New Uniform Commercial Code,* 30 N.C.L. REV. 395, 398 (1952); W. BRITTON, BILLS AND NOTES 246 (2d ed. 1961), where the author states that "the suspicious circumstances rule has been abolished by the statute and that the original bad faith rule has been substituted therefor."

35. The much cited case of Gerseta Corp. v. Wessex-Campbell Silk Co., 3 F.2d 236, 238 (2d Cir. 1924), interpreted "bad faith" under § 56 to mean that the holder ". . . must have knowledge of facts which render it dishonest for him to take the particular piece of negotiable paper. . . . Knowledge, not surmise, suspicion, or fear, is necessary; not knowledge of the exact truth, but knowledge of some truth that would prevent action by those commercially honest men for whom the law was made. . . ."

to uncertainty and was the source of much diversity of judicial opinion. Courts had to decide whether to interpret this clause as a restatement of the subjective good faith test in its negative form[36] or whether to construe the language so as to require the use of an objective test.[37] About all that can be said is that it has always been assumed that the N.I.L. incorporated, to some extent, a subjective test[38] and that it negated the extreme objective test of *Gill v. Cubitt*.[39] In fact, more than one writer has expressed the view that the standard required by the N.I.L. has both subjective and objective aspects.[40]

Since the passage of the N.I.L. by all the states did not produce the desired uniformity in the law,[41] motivation was provided for the drafting of the U.C.C.; Article 3 of the U.C.C. was designed to replace the N.I.L.[42] The sections under the Code comparable to Sections 52 and 56 of the N.I.L. are 1-201 (19) and (25) and 3-302 (1). Sections 1-201 (19) and (25) state:

> (19) "Good Faith" means honesty in fact in the conduct or transaction concerned.
>
> (25) A person has "notice" of a fact when
>
> (a) he has actual knowledge of it; or
>
> (b) he has received a notice or notification of it; or
>
> (c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists.

Section 3-302 (1) defines a holder in due course:

> (1) A holder in due course is a holder who takes the instrument:
>
> (a) for value; and
>
> (b) in good faith; and
>
> (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person.

---

36. *See, e.g.*, Howard Nat'l Bank v. Wilson, 96 Vt. 438, 120 A. 889 (1923).

37. *See, e.g.*, Boxell v. Bright Nat'l Bank, 184 Ind. 631, 112 N.E. 3 (1916).

38. *See* W. BRITTON, BILLS AND NOTES § 100, at 246 n.14 (2d ed. 1961); Littlefield, *supra* note 33, at 54; Rightmier, *The Doctrine of Bad Faith in The Law of Negotiable Instruments*, 18 MICH. L. REV. 355 (1920); Comment, *The Effect of the Adoption of the Proposed Uniform Commercial Code on the Negotiable Instruments Law of Louisiana — Rights of a Holder*, 15 LA. L. REV. 419, 421 (1955); 81 U. PA. L. REV. 617, 623 (1933).

39. 107 Eng. Rep. 806 (K.B. 1824).

40. *See* Beutel, *The Proposed Uniform [?] Commercial Code Should Not be Adopted*, 61 YALE L.J. 334, 341 (1952); Comment, *The Meaning of "Good Faith" In the N.I.L.*, 9 TUL. L. REV. 128 (1934), where the inter-relationship of the concepts of notice good and bad faith are analyzed.

41. Beutel, *Problems of Interpretation Under the Negotiable Instruments Law*, 27 NEB. L. REV. 485, 494 (1948).

42. *See generally* Beutel, *Interpretation, Construction, and Revision of the Commercial Code: The Presumption of Holding In Due Course*, 1966 WASH. U.L.Q. 381; Miller & Crea, *The Uniform Commercial Code: Effect on the Law of Negotiable Instruments in New York*, 30 BROOKLYN L. REV. 204 (1964).

In addition to this, Section 3–304(1)[43] sets out the kinds of facts which prevent holding in due course.

Since 1957, the U.C.C. clearly seems to have incorporated a subjective test[44] of good faith, defining it, as set out above, as "honesty in fact."[45] However, the drafters embodied a more clearly objective test into the definition of notice.[46] Although 1-201 (25) (a) provides a purely subjective standard of "actual knowledge," the test for notice under 1-201 (25) (c) contains objective elements. It is not merely a test of simple negligence, however, since this subsection also contains a subjective element. Thus, the inquiry under 1-201 (25) (c) is not simply whether the person, *as a reasonably prudent man*, had reason to know, but whether "from all the facts and circumstances *known to him* at the time in question" he had reason to know. The word "known" thus refers not to facts or circumstances of which the person should have had notice, but only those within his actual knowledge.[47] If this

---

43. UNIFORM COMMERCIAL CODE § 3–304(1):

(1) The purchaser has notice of a claim or defense if:

(a) The instrument is so incomplete, bears such visible evidence of forgery or alteration, or is otherwise so irregular as to call into question its validity, terms or ownership or to create an ambiguity as to the party to pay; or

(b) The purchaser has notice that the obligations of any party is voidable in whole or in part, or that all parties have been discharged.

It is interesting to note that New York and Virginia have tacked onto § 3–304 a provision that:

> [I]n any event, to constitute notice of a claim or defense, the purchaser must have knowledge of the claim or defense or knowledge of such facts that his action in taking the instrument amounts to bad faith.

N.Y. UNIFORM COMMERCIAL CODE § 3–304(7) (McKinney 1964); VA. CODE ANN. § 8. 3–304(7) (1965). These two states have thus substantially retained the N.I.L. test of § 56.

44. 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 observance of the reasonable commercial standards of any business in which the holder may be engaged." UNIFORM COMMERCIAL CODE § 3–302(1)(b) (1952 version). This implied an objective test. In fact there are cases under the N.I.L. which apply a subjective good faith test, tempered by a reasonable commercial standards limitation. *See* Gerseta Corp. v. Wessex-Campbell Silk Co., 3 F.2d 236, 238 (2d Cir. 1924); Herg v. Caspary, 191 App. Div. 560, 181 N.Y.S. 633 (1st Dept. 1920); Rochester and C. Turnpike Co. v. Paviour, 164 N.Y. 281, 58 N.E. 114, 115 (1900). However, the provision for "reasonable commercial standards" was omitted in later versions due largely to the studies made by the New York Law Revision Commission. In a study of the consequences of the original U.C.C. § 3–302, the Commission concluded that under the N.I.L.,

> [T]he New York courts could conceivably find that a party was a holder in due course who (a) had subjective good faith, (b) was not guilty of (i) subjective or (ii) objective bad faith, but (c) did not act in such a way that he could affirmatively be said to have had objective good faith. In other words, his conduct might fail to meet the reasonable commercial standards of his business (objective good faith), and yet not be so bad as to amount to objective bad faith. . . . But under the 1952 draft of the Code this would not have been possible.

2d Report of the New York Law Revision Commission 904–05 (1955). *See* Note, 4 B.C. IND. & COM. L. REV. 452, 456 (1963), which suggests that the above is a clear statement of the underlying factors implicit in the white heart subjective test of good faith. *See also* Fagan, *Notice and Good Faith in Article 3 of the U.C.C.*, 17 U. PITT. L. REV. 176 (1956), pointing out errors in the notice and good faith concept of the Code.

45. UNIFORM COMMERCIAL CODE § 1-201(19).

46. UNIFORM COMMERCIAL CODE § 1-201(25)(c).

47. *But see* UNIFORM COMMERCIAL CODE § 3–304(3), for a purer objective notice standard. For an excellent analysis of the notice requirement of the U.C.C., see Note, *Notice and Good Faith Under Article 3 of the Uniform Commercial Code,* 51 VA. L. REV. 1342 (1965).

interpretation of the notice requirement were applied to the facts in *Financial Credit Corporation v. Williams,*[48] the question upon which holder in due course status would turn would be whether a reasonable finance company with actual knowledge that Reynolds was the original assignor and that Reynolds was a disreputable organization would have reason to know of the fraud. In other words, would a reasonable finance company with knowledge of those facts actually known to Financial Credit have reason to know of the fraud? An affirmative answer would require the conclusion that Financial Credit was not a holder in due course. Thus, the facts actually known to the purported holder are of crucial importance in the application of this test. Accordingly, if Financial Credit had *not* actually known of Reynolds' bad reputation or that Reynolds was the original assignor, it would be immaterial that a reasonable finance company would have known of these facts and consequently would have had reason to know of the fraud. Financial Credit would not fail the test of notice under 1–201(25)(c) in such a case, since on the basis of facts actually *known to it,* Financial Credit would not have had "reason to know" of the fraud.[49] The standard for the test of notice thus involves an *individualized* reasonable man, and not just the conventional reasonable man standard.

The result of using the two different standards, that is, the subjective test for good faith and the more objective test for notice, is that the requirements of "good faith" and "no notice" are entirely separated. This separation under the U.C.C. has been recognized,[50] and it is submitted that it is this factor which will help to remove the confusion and ambiguity that arose under the N.I.L. because of the two requirements being read together.[51] The fact that the U.C.C. retains the dual requirements of good faith and lack of notice lends support to the arguably valid assumption that good faith is not merely a facet of lack

---

48. 246 Md. 575, 229 A.2d 712 (1967).

49. *Cf.* Note, *Notice and Good Faith Under Article 3 of the Uniform Commercial Code,* 51 VA. L. REV. 1342, 1349 (1965).

50. *See* Braucher, *U.C.C. Article 3 — Commercial Paper — New York Variations,* 17 RUTGERS L. REV. 57, 67 (1962); Note, *Purchase in Good Faith and Without Notice Under the Negotiable Instruments Law and the New Uniform Commercial Code,* 30 N.C.L. REV. 395, 402 (1952). *But see* Universal C.I.T. Credit Corp. v. Ingel, 347 Mass. 119, 196 N.E.2d 847 (1964) and Norman v. World Wide Distributors, Inc., 202 Pa. Super. 53, 195 A.2d 115, 118 (1963). In these two cases the courts made no distinction between notice and good faith. The *Norman* court, in holding the defendant to have knowledge of all that inquiry would have revealed, stated:

> He who seeks protection as a holder in due course must have dealt fairly and honestly in acquiring the instrument as to the rights of prior parties, and where circumstances are such as to justify the conclusion that the failure to make inquiry arose from a suspicion that inquiry would disclose a vice or defect in the title, the person is not a holder in due course.

For a criticism of the *Norman* case see WILLIER & HART, BENDER'S U.C.C. SERVICE 2–510.

51. *See* Note, *Purchase in Good Faith and Without Notice Under the Negotiable Instruments Law and the New Uniform Commercial Code,* 30 N.C.L. REV. 395, 402 (1952). The author of the Note recognizes that the use of different standards separates the good faith and notice requirements. But he argues that since most cases arise on the question of "notice" with regard to certain known facts and circumstances which surround the transaction, under the U.C.C., the final determination of cases will hinge not on good faith but on notice.

of notice and that lack of notice is not merely a facet of good faith.[52] Under such an approach, courts can find the taker of a negotiable instrument to be in good faith under the purely subjective test enunciated by the Code in Section 1–201(19) and yet prevent the purchaser from attaining holder in due course status if he fails to conform to the more objective standards of notice required by Sections 3–302, 3–304, and 1-201 (25).[53] Recognizing the dual requirements, judges will not have to go through mental gymnastics in attempting to rationalize a decision which is actually based on a standard of good faith which includes objective elements of notice, but which is stated to be grounded in the purely subjective test of good faith. It is submitted that this is what the Maryland court was attempting to do in *Financial Credit Corporation v. Williams*.[54] The case was decided under the N.I.L., the court holding that the defendant failed to meet the subjective test of good faith. As was argued earlier, the defendant apparently passed the first hurdle, that is, it purchased the note in subjective good faith in that it had no actual knowledge of the fraud. However, it failed to meet the objective standard of Section 56 of taking without "knowledge of such facts that [its] action in taking the instrument amounted to bad faith." It is submitted that it was for this reason that defendant was held not to be a holder in due course. Although Judge Barnes never cited Section 56 in his opinion, it is clear that his conception of the standard of good faith required by the N.I.L. contained objective notice elements. Although cases such as this one have often reached the correct result, the failure of the N.I.L. to sufficiently separate the good faith and lack of notice requirements for holder in due course status has itself been the cause of the confusion and ambiguity in the cases. The U.C.C. has attempted to avoid this confusion by clearly separating the two requirements, setting up different standards for each. It is hoped that as cases similar to *Financial Credit* arise under the U.C.C., the courts will analyze and apply the requirements separately so that a more explicit and useful body of case law can be developed on the objective issue of what are merely suspicious circumstances and what are circumstances in which the law will, or the jury can, find that the holder of a negotiable instrument "has reason to know" that a defense or claim exists.

---

52. *See* Note, *supra* note 49, at 1357.

53. As was set out earlier in note 20 *supra,* this basically would result in a test of subjective good faith coupled with an absence of objective bad faith. The principal case was decided under the N.I.L. As was suggested initially, however, the opinion by Judge Barnes can be interpreted as using this test. Hopefully, this same test will be applied in Maryland to cases arising under the U.C.C.

54. 246 Md. 575, 229 A.2d 712 (1967).