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# Negotiable Instruments Law - "Close Connexity" and the Finance Company as a Holder in Due Course

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of reversionary rights in the sense that the lease would be extended beyond its primary term in the absence of production; or, that the lease would be valid if the mineral rights returned to the land within the primary term of the lease when the lessor had previously sold the land.<sup>42</sup> For these reasons, it is suggested that, when the doctrine of after-acquired title perfects a lease of mineral rights not owned at the time of execution but subsequently acquired, there is no violation of the policy considerations adhered to by the Louisiana Supreme Court.<sup>43</sup>

*Burrell J. Carter*

### Negotiable Instruments Law—"Close Connexity" and the Finance Company as a Holder in Due Course

Basic to the concept of negotiability is the immunity of the holder in due course<sup>1</sup> from defenses founded on defects not apparent on the face of the instrument and of which he has no knowledge.<sup>2</sup> In such a case, the holder in due course is not subject to all the defenses and equities available between the original parties to the instrument. It is this right of the holder in due course to rely on the face of the instrument that gives it much of its commercial usefulness. Maximum negotiability would be achieved by protecting the holder in due course from all defects not apparent on the face of the instrument. However, the exigencies of commercial intercourse neither require nor permit such complete negotiability.

Although problems concerning the status of a party as a holder in due course are by no means new, with the advent of post-war prosperity and the marked increase in installment purchasing of consumer goods, the courts have been faced with an increasing number of situations involving finance companies which deal in installment paper.

Ordinarily, notes on which finance companies seek to recover

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42. See note 39 *supra*.

43. See *Hicks v. Clark*, 225 La. 133, 72 So.2d 322 (1954); *Long Bell Lumber Co. v. Granger*, 222 La. 670, 63 So.2d 420 (1953); *Liberty Farms v. Miller*, 216 La. 1023, 45 So.2d 610 (1950); *Long Bell Petroleum Co. v. Tritico*, 216 La. 426, 43 So.2d 782 (1949). See also Discussion Notes, 4 *Oil and Gas Reporter* 1528-29 (1955).

1. See, generally, BRITTON, *HANDBOOK OF THE LAW OF BILLS AND NOTES* 353 *et seq.* (1943).

2. *Id.* at 407, § 100 *et seq.*

issue from a three-party transaction in which the vendee in a credit sale executes a promissory note to the vendor.<sup>3</sup> The vendor endorses the note and transfers it to the finance company. Upon default of the vendee, the finance company sues on the note and is met with some defense which the vendee has against the vendor. Under the Negotiable Instruments Law,<sup>4</sup> this defense may not be asserted against the finance company if the latter is a holder in due course. It has been suggested that some finance companies that work in "close connection" with dealers attempt to establish a holder in due course status for themselves as a shield to protect the dealer-finance company "partnership" from defenses that could normally be asserted by the purchaser. Therefore, the question arises as to when a finance company in such situations should be afforded the protection given a holder in due course. The courts are faced with the problem of either adhering to the strict limitations of the NIL and thereby precluding the successful assertion of the defense, or, on the other hand, protecting the innocent consumer who defaulted on his obligation because of some fault on the part of the vendor. The purpose of this Comment is to discuss the manner in which this problem has been treated by the courts. Emphasis will be placed on Louisiana law, but in order to treat the subject adequately, some historical background of pertinent sections of the NIL, as well as cases from other jurisdictions, will be considered.

### *Background and Development*

Section 52 of the NIL in part defines a holder in due course as a holder who took an instrument under the following conditions:

"(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."

Section 56 defines "notice" as used in Section 52(4) thus:

"To constitute notice of an infirmity in the instrument or defect in the title of the person negotiating the same, the per-

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3. See Adelson, *The Mechanics of the Installment Credit Sale*, 2 LAW & CONTEMP. PROB. 218 (1935); Myerson, *Practical Aspects of Some Legal Problems of Sales Finance Companies*, 2 LAW & CONTEMP. PROB. 244 (1935).

4. The Uniform Negotiable Instruments Law, hereinafter referred to as the NIL, adopted by Louisiana as La. Acts 1904, No. 64, p. 147, now LA. R.S. 7:1-195 (1950).

son to whom it is negotiated must have had *actual knowledge* of such facts that his action in taking the instrument amounted to *bad faith*." (Emphasis added.)

It appears that the draftsmen of the NIL intended to codify in these sections a subjective test of good faith similar to that announced in the early English case of *Goodman v. Harvey*.<sup>5</sup> Under this test, if the holder had no actual knowledge of the equity existing between the original parties at the time of the purchase, he would not be answerable for any of the equities. Also, notice is apparently the converse of good faith, as the term "notice" is defined as actual knowledge amounting to bad faith. It would seem to follow then, that a subjective test should also be used in determining if there is notice. Thus the question presented to the courts is the nature of the test to be applied, that is, whether to insist on a showing of actual knowledge or to view as sufficient a finding that the purchaser should have known of the defect.

#### *Judicial Interpretation*

A study of the jurisprudence reveals that the courts are in conflict in resolving the question of what constitutes notice as defined in the NIL. In fact, cases indicate that the courts are in the same dilemma that prevailed before the adoption of the NIL.<sup>6</sup> Certain "well-settled" rules have developed which deny an ob-

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5. 4 Ad. & E. 870, 111 Eng. Rep. 1011 (1836). In *Miller v. Race*, 1 Burr. 452, 97 Eng. Rep. 398 (1758), Lord Mansfield was of the opinion that unless the purchaser of an instrument is in bad faith, or actually knows that the instrument was stolen, he can collect on the paper. This position was affirmed in *Lawson v. Weston*, 4 Esp. 56, 170 Eng. Rep. 640 (1801), where Lord Kenyon held that there is no duty to inquire into facts surrounding the original transfer of the paper. The fact that the instrument has been stolen is relevant only if the purchaser knew of the theft when he purchased the paper. Shortly thereafter, this good faith-actual knowledge rule was disregarded in *Gill v. Cubit*, 3 B. & C. 466, 107 Eng. Rep. 806 (1824), where the English court announced that there is a duty on the purchaser to investigate suspicious circumstances, and that it is for the jury to determine if he had been prudent in the purchase of the instrument. This "suspicious circumstance" rule was short-lived, for in *Crook v. Jadis*, 5 B. & Ad. 909, 110 Eng. Rep. 1028 (1834), the court held that want of due care on the part of the purchaser is insufficient to justify the letting in of equities existing between the original parties to the instrument. The next step was for the English courts to repudiate completely the rule of *Gill v. Cubit*, and in the leading case of *Goodman v. Harvey*, 4 Ad. & E. 870, 111 Eng. Rep. 1011 (1836), it was held that gross negligence is not enough; gross negligence is evidence of bad faith, but is not the same thing. This good faith rule was adopted by the United States Supreme Court only a few years later in *Goodman v. Simonds*, 61 U.S. (20 How.) 343 (1857), but did not have the effect of establishing a uniform rule on the question of when equities existing between the original parties can be asserted against a holder of the instrument.

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

jective finding of notice in what would seem to be strong fact situations.<sup>7</sup> Knowledge that a conditional sales contract was executed simultaneously with a note does not charge the third party transferee with notice of equities existing between the original parties to the note, unless such knowledge could be obtained from the face of the instrument.<sup>8</sup> Likewise, knowledge that the contract is executory does not prevent the endorsee from being a holder in due course.<sup>9</sup> The presence of suspicious circumstances is also not a bar to the endorsee's being a holder in due course.<sup>10</sup>

On the other hand, the statement is often made that the finance company "was so *closely connected* with the entire transaction that it cannot be heard to say that it, in good faith, was an innocent purchaser."<sup>11</sup> (Emphasis added.) In such cases, the courts have justified the finding of notice by the use of an objective test based on this "close connexity" between the holder and the vendor. Such a finding may rest upon proof of one or more of the following facts: the proximity of the offices of the payee and the endorsee,<sup>12</sup> the length of time they have been acquainted,<sup>13</sup> the supplying of blank forms to the vendor with the name of the finance company printed on the reverse side,<sup>14</sup> the making of payments at the office of the finance company,<sup>15</sup> the finance company's procuring insurance on the goods for the sale of which the note was given,<sup>16</sup> the endorsee's approval of the credit sale through its credit department,<sup>17</sup> or the endorsee's knowledge of prior transactions involving dubious business ethics of the vendor.<sup>18</sup> It is apparent that where "actual knowl-

7. See notes 8, 9, and 10 *infra*.

8. *United States v. Novsam Realty Corp.*, 125 F.2d 456 (2d Cir. 1942); *BAC Corp. v. Cirucci*, 131 N.J.L. 93, 35 A.2d 36 (1944).

9. *Thal v. Credit Alliance Corp.*, 78 F.2d 212 (D.C. Cir. 1935); *Cotton v. John Dure Plane Co.*, 246 Ala. 36, 18 So.2d 727 (1944); *Reliance Equipment Co. v. Sherman*, 216 Ala. 214, 112 So. 822 (1927); *Allenberg v. Rapken and Co.*, 108 Cal. App. 99, 291 Pac. 281 (1930); *Davis v. McCready*, 17 N.Y. 230, 72 Am. Dec. 461 (1858); *Metropolitan National Bank v. Vanderpool*, 192 S.W. 589 (Tex. Civ. App. 1917).

10. *Davis v. Pennsylvania Co.*, 337 Pa. 456, 12 A.2d 66 (1940).

11. *Commercial Credit Co. v. Childs*, 199 Ark. 1073, 1077, 137 S.W.2d 260, 262 (1940).

12. *Clark v. Roberts*, 206 Mass. 235, 92 N.E. 461 (1910).

13. *Ibid. Contra, Stellwagen v. Schmidt*, 234 Ill. App. 325 (1924).

14. *Commercial Credit Corp. v. Orange County Machine Works*, 34 Cal.2d 766, 214 P.2d 819 (1950); *Mutual Finance Co. v. Martin*, 63 So.2d 649 (Fla. 1953). *Contra, Mayer v. American Finance Corp.*, 172 Okla. 419, 45 P.2d 497 (1935).

15. *Mutual Finance Co. v. Martin*, 63 So.2d 649 (Fla. 1953).

16. *Taylor v. Atlas Sec. Co.*, 213 Mo. App. 282, 249 S.W. 746 (1923).

17. *Buffalo Ind. Bank v. DeMargio*, 162 Misc. 742, 296 N.Y. Supp. 783 (City Ct. 1937), reversed on other grounds, 6 N.Y.S.2d 568 (Sup. Ct. 1937).

18. *Davis v. Commercial Credit Corp.*, 87 Ohio App. 311, 94 N.E.2d 710

edge" is found to exist from a showing that one or more of the above facts was present, the courts are employing an objective test not contemplated by the NIL. The finance company is held to have had notice because it should have known of the defect. In so doing, the courts seem to have followed at least three diverse routes in their finding of "close connexity": (a) by application of rules of agency; (b) by fictitious establishment of the finance company as a party to the instrument; (c) by recognition of certain policy considerations.

*Agency.* The party usually acquiring subjective actual knowledge of the infirmity in the instrument or defect in the thing sold is the payee-vendor. A means of imputing this knowledge to the endorsee-finance company is to find that the vendor is the agent of the finance company. In this manner the rules of agency permit the imputation of the agent's knowledge to the principal.<sup>19</sup> The converse agency situation may also exist. For example, in *Palmer v. Associate Discount Corp.*<sup>20</sup> the court found that the finance company was the agent of the vendor. In the *Palmer* case the name of the finance company appeared on the face of the forms in large type and the vendor specifically assumed the obligation of repurchasing the car in case of default in payment by the vendee. From these facts the court found that the finance company was the dealer's agent for the purpose of collecting the notes.<sup>21</sup> Knowledge of the principal was not imputed to the agent, but rather the finance company was not permitted to act as agent for collection on the notes in one instance and act as a holder in due course of the same notes in the next instance. The typical agency situation exists when the manufac-

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(1950). *Contra*, *Standard Acceptance Corp. v. Chapin*, 277 Mass. 278, 178 N.E. 538 (1931).

19. In *Merchants National Bank v. Marden, Orth and Hastings Co.*, 234 Mass. 161, 125 N.E. 384 (1919) and *Ladd v. Read*, 114 Kan. 175, 217 Pac. 273 (1923), banks were chargeable with knowledge of fraud, as the agents of the banks, the officers, instigated the transaction. See also *Titone v. General Elec. Credit Corp.*, 201 Misc. 1041, 108 N.Y.S.2d 909 (Sup. Ct. 1951); *Public National Bank & Trust Co. v. Fernandez*, 121 N.Y.S.2d 721 (1952) (agency language was used). *Cf. Mayer v. American Finance Corp.*, 172 Okla. 419, 45 P.2d 497 (1935) (no contract between the finance company and the purchaser for a loan of money either directly or by an agent); *Security Finance Co. v. Schoenig*, 292 S.W. 556 (Tex. Civ. App. 1922) (no agency); *Implement Credit Corp. v. Elsinger*, 268 Wis. 143, 66 N.W.2d 657 (1954) (supplying of forms was not sufficient evidence to establish agency).

20. 124 F.2d 225 (D.C. Cir. 1941).

21. In *United States v. Schaeffer*, 33 F. Supp. 547 (D. Md. 1940), the finance company, which was alleged to be a holder in due course, was charged with knowledge acquired by a contractor and a material company since they were acting for and on behalf of the finance company. The finance company was a subsidiary of the material company.

turer finances the sale of goods by one of its dealers, that is, when the note given by the vendee is endorsed by the vendor to the manufacturer.<sup>22</sup>

*Party to the transaction.* Another means of fictitiously transferring the knowledge of the payee-vendor to the endorsee-finance company is to find that the finance company, because of its knowledge of the circumstances surrounding the transaction, is actually a party to the instrument, and thus charged with knowledge of infirmities or defects. In the leading case of *Commercial Credit Co. v. Childs*,<sup>23</sup> the blank note, which contained on the reverse side a printed assignment to the finance company, was supplied to the vendor by the finance company. The latter took the assignment of the note on the same day that the instrument was executed by the maker-vendee. Because of this close connection with the transaction, the finance company was held to be an original party to the instrument and not a holder.<sup>24</sup> Since it is necessary that a person be a holder before he can claim the presumption that he is a holder in due course, the court allowed the defense to be asserted against the finance company.<sup>25</sup> Another way to hold that the finance company is a party to the instrument is to find that financing of the credit sale is actually a part of the business of selling. Once classified as a "part of the business," the next step is to say that the finance company is a party to the sale.<sup>26</sup> Thus, in *Buffalo Industrial Bank v. De-*

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22. *Bastian-Blessing Co. v. Stroope*, 203 Ark. 116, 155 S.W.2d 892 (1941).

23. 199 Ark. 1073, 137 S.W.2d 260 (1940).

24. The Arkansas court went even further and said that because of the close connection with the transaction the finance company "had a duty to inquire into the bona fides of the original sale." This position taken by the Arkansas court seems contrary to the settled principle that knowledge of suspicious circumstances does not impose a duty to investigate. However, it could be argued that actual knowledge is required *unless* the suspicious circumstances are so strong that to remain passive would amount to bad faith. *Sasner v. Ornsten*, 93 Cal.2d 467, 209 P.2d 44 (1949); *Christian v. California Bank*, 93 Cal.2d 230, 208 P.2d 784 (1949). This argument is weakened by the fact that some courts held that a close *business* relationship between the payee and the endorsee does not as a matter of law deny the endorsee the status of a holder in due course. See *Stellwagen v. Schmidt*, 234 Ill. App. 325 (1924) (personal relationship is not ordinarily sufficient of itself to establish notice of bad faith); *Wilson v. Gorden*, 91 A.2d 329 (D.C. Mun. App. 1952).

25. See BRITTON, *BILLS AND NOTES* § 102 (1943), and authorities cited therein.

26. *But see* *Implement Credit Corp. v. Elsinger*, 268 Wis. 143, 66 N.W.2d 657 (1954), rehearing denied, 67 N.W.2d 873 (1955). A finance company was founded by dealers for the express purpose of providing financing services solely to members of a dealer association of which some of them were members. The finance company, which had purchased notes from a particular dealer over a four-year period, supplied blank forms containing a printed assignment, furnished financial statement forms, and purchased the notes immediately upon the completion of the transaction. In rejecting the contention that the finance company was an original

*marzio*<sup>27</sup> a New York court found a bank to be part of the business of selling, even though the vendor and the bank were distinctly separate business enterprises. The decisive factor which led the court to hold that the bank was a part of the business of selling was that the conditional sales contract had been submitted to the credit department of the bank and the vendee's credit had been approved by that department before any sale was consummated. The court said that this situation was similar to the case in which the credit of the vendee was approved by a credit department of the vendor, the only difference being that the vendor was now utilizing the facilities and services of a credit department owned and operated by someone else.

*Policy considerations.* The majority of cases denying finance companies the status of a holder in due course do not adopt either the "agency" or "party to the transaction" rationalizations. Instead, actual knowledge is inferred from the close relationship of payee and endorsee.<sup>28</sup>

By finding notice from a showing of circumstances which constitute "close connection," it is obvious that justice is not being done to Section 56 of the NIL, which implies that a subjective test is to be used. Even though it could be shown that every one of the circumstances which constitute "close connection" existed in a single case, this is not proof that there was *actual knowledge* of an infirmity in the instrument or a defect in the title of the person negotiating it. All that has been shown in such a case is that there was actual knowledge of the existence of a business transaction, and as has been indicated before, this is not sufficient under the NIL to charge the holder with notice of defenses which may arise from this transaction.<sup>29</sup> It is sub-

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party to the transaction, the Wisconsin court expressly refused to follow the *Childs* case.

27. 162 Misc. 742, 296 N.Y. Supp. 783 (City Ct. 1937), reversed on other grounds, 6 N.Y.S.2d 568 (Sup. Ct. 1937).

28. In *Mutual Finance Co. v. Martin*, 63 So.2d 649 (Fla. 1953), the Florida court felt constrained to rely on the provisions of the NIL defining a holder in due course, and held that actual knowledge existed because of the close connection. The court indicated that the finance company would not be heard to deny that it did not have notice — a sort of estoppel theory. See also *Schuck v. Murdock Acceptance Corp.*, 220 Ark. 56, 247 S.W.2d 1 (1952); *International Harvester Co. v. Watkins*, 127 Kan. 50, 272 Pac. 139 (1927); *Taylor v. Atlas Security Co.*, 213 Mo. App. 282, 249 S.W. 746 (1923) (inference of actual knowledge). *Contra*, *Wilson v. Gorden*, 91 A.2d 329 (D.C. Mun. App. 1952), where it was held that a close business association between the purchaser and the payee of a negotiable instrument does not, as a matter of law, deny to the purchaser the status of a holder in due course.

29. *International Finance Co. v. Magilansky*, 105 Pa. Sup. 309, 161 Atl. 613, 614 (1932): "Granting . . . that the indorsee of the note knew that the payee



mitted that this refusal to comply with the mandate of Section 56 of the NIL is based on policy considerations which demand that the "innocent" vendee be protected. The finance company is in a better position to know the financial standing of the vendor, as it is in the business of providing credit and purchasing paper. Similarly, since the note purchasing is usually done in accordance with some prior arrangement, the finance company is in a better position to know how the vendor operates his business, the vendor's reputation as a dealer, and the quality of the goods sold or services performed. Also, if the vendee is permitted to assert his defense in the action on the instrument, time and expense are conserved, as the finance company will be allowed to call the vendor into the proceedings under the modern rules of procedure. The entire contest can be settled in one proceeding where all interested parties are present.<sup>30</sup>

Regardless of the validity of these policy considerations, it is difficult to understand how the courts can "legislate" in the face of Sections 52 and 56 of the NIL requiring *actual knowledge* of defects or infirmities.

#### *Louisiana Jurisprudence*

The adoption of the NIL in Louisiana in 1904 does not appear to have provided a solution to the problem of when defenses to an action on a note may be asserted against an endorsee-finance company. It will be recalled that Section 52,<sup>31</sup> in defining a holder in due course, declares that he is one who took the note when it was complete and regular on its face, and without notice of infirmities or defects in title that existed between the original parties to the instrument. However, as to the requirement that there be no notice in order to maintain the position of a holder in due course, the courts, in some situations, have apparently departed from the NIL definition of notice as being actual knowledge of such defects or infirmities. Also, recent cases indicate that the court has read into the requirement that the instru-

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was in the business of installing furnaces, and that it took notes of the same character as the one in suit in its various transactions, this knowledge did not charge him with notice of the infirmity of this particular note."

30. In *Implement Credit Corp. v. Elsinger*, 268 Wis. 143, 66 N.W.2d 657 (1954), it was pointed out that the "close connection" is an essential in the business of financing and that for the finance company to purchase instruments executed on forms with which it is not familiar necessitates either the delay of an investigation or the taking of considerable risk by the finance company, either of which could seriously impair this method of financing.

31. NIL § 52; LA. R.S. 7:52 (1950).

ment be complete and regular on its face, a requirement that the *transaction* from which the note arose also be complete in order that the finance company be a holder in due course.

*Notice and good faith.* It appears to be well settled that "actual knowledge" of any defect or infirmity will satisfy the requirement of notice.<sup>32</sup> In spite of the fact that the practice is much criticized, in determining whether the finance company has "actual knowledge" of defects or infirmities, the cases indicate three possible areas of inquiry: the nature of the defense being asserted by the vendee to the payment of the note, the extent of the participation by the finance company in the transaction out of which the note arises and the legal relations existing between the parties to the transaction.

*Nature of defense.* Theoretically, the nature of the defense should be of no concern in determining if such actual knowledge exists. However, as a matter of proof of the existence of actual knowledge, some conclusions may be drawn from the type of defense asserted. If the defense asserted is that of lack or failure of consideration, it is naturally more difficult to prove that the finance company had actual knowledge of the infirmity, since in order to be precluded in the successful assertion of the defense, the finance company must have acquired knowledge of such defect before the instrument was transferred to it.<sup>33</sup> The

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32. LA. R.S. 7:56 (1950); *Tyler v. Whitney-Central Trust and Savings Bank*, 157 La. 249, 102 So. 325 (1924); *Sandifer v. Stephens*, 8 La. App. 546 (1928). Only the question of "notice" is treated in this paper, but two other reasons for denying a finance company the status of a holder in due course have recently caused much litigation: incompleteness of the instrument and incompleteness of the transaction. Section 52 of the NIL provides that the instrument must be complete and regular on its face in order for the holder to be a holder in due course. In *Commercial Credit Corp. v. Freiter*, 42 So.2d 296 (La. App. 1949), no amount was stated on the notes, and the court held that Section 52 had not been complied with. In dictum in *General Motors Acceptance Corp. v. Daigle*, 225 La. 123, 72 So.2d 319 (1954), the court cited Section 52 and said that the *transaction* must also be complete before there can be a holder in due course. See *The Work of the Louisiana Supreme Court for the 1954-1955 Term* — NEGOTIABLE INSTRUMENTS, 15 LOUISIANA LAW REVIEW 344, 346 (1955). In *Allied Building Credits, Inc. v. Pierce*, 49 So.2d 403 (La. App. 1955), the court of appeal relied on this language in the *Daigle* case and held that the transaction not being complete, the note never came into existence. The note lacked a date. Again, in *General Contract Corp. v. Wyington*, 81 So.2d 148 (La. App. 1955), appears the following language: "Under the section above quoted [Section 52 of the NIL], a purchaser of a negotiable instrument is not a holder in due course until the transaction is complete." (Emphasis added.) This appears to be erroneous because a failure or lack of consideration is a *defense* to an instrument, and should have nothing to do with the question of who is a holder in due course. If the *note* is incomplete, then clearly Section 52 dictates that any person taking the incomplete note is not a holder in due course.

33. *Standard Motor Finance Co. v. Yellow Bayou Gin and Planting Co.*, 1 La.

knowledge must also be of some present defect in the consideration and not just a suspicion that there will be a failure of consideration in the future.<sup>34</sup> Mere knowledge of what the consideration was will not constitute knowledge of the fact that the consideration has failed.<sup>35</sup> For example, in *Martel v. Lafayette Sugar Refining Co.*,<sup>36</sup> the endorsee had knowledge of an express warranty made by the vendor, but did not have knowledge that there had been a breach of this warranty. The court rejected the contention that the endorsee should be held to have had knowledge of this breach. On the other hand, if the defense asserted by the vendee is that there is some defect which is apparent on the face of the instrument negotiated to the finance company, as opposed to a lack or failure of consideration, the finance company is presumed to have actual knowledge of this defect, and thus cannot be a holder in due course.<sup>37</sup> For example, if usurious interest is charged, it can be observed from the face of the note that there is a defect in the instrument.<sup>38</sup> Likewise, if it appears on the face of the instrument that the vendor agrees to purchase insurance on the goods which are later destroyed by fire, and such insurance was not procured, the finance company taking the note is held to have actual knowledge of the fact that there was such an obligation to obtain insurance.<sup>39</sup>

This distinction drawn between the case in which the defect is apparent on the face of the note and that in which it is not

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App. 424 (1925). The vice or defect in the thing sold was not discovered until sometime after the sale.

34. *Sadler v. White*, 14 La. Ann. 177 (1859); *Martel v. Lafayette Sugar Refining Co.*, 153 La. 248, 95 So. 706 (1923). Endorsee had knowledge of an express warranty made by the vendor, but had no knowledge that there had been a breach of this warranty.

35. *Bank of Eudora v. Crowe*, 2 La. App. 669 (1925). In *Tyler v. Whitney-Central Trust & Savings Bank*, 157 La. 249, 102 So. 325 (1924), the notes in controversy recited that their value is "to be received in rent."

36. *Martel v. Lafayette Sugar Refining Co.*, 153 La. 248, 95 So. 706 (1923).

37. Distinction recognized in *Commercial Credit Corp. v. Freiter*, 42 So.2d 296 (La. App. 1949) (dictum), 24 TUL. L. REV. 485 (1950). See also *White System v. Hall*, 219 La. 440, 53 So.2d 227 (1951), 27 TUL. L. REV. 255 (1953).

38. *General Motors Acceptance Corp. v. Swain*, 176 So. 636 (La. App. 1937), cited with approval in *CIT Corp. v. Emmons*, 197 So. 662 (La. 1940).

39. *CIT Corp. v. Emmons*, 197 So. 662 (La. App. 1940). The court said that the finance company had full knowledge of the vendor's contracting to purchase insurance, thus there was actual knowledge of the infirmity—failure of consideration. This was so, the court indicated, because the finance company "stood in the shoes" of the vendor so far as this obligation to purchase insurance was concerned. This writer submits that, conceding that the finance company had knowledge of the obligation to purchase insurance, there was no knowledge that there had been a breach of this obligation. Compare *Bank of Eudora v. Crowe*, 2 La. App. 669 (1925), where the court held that knowledge of what the consideration was did not constitute knowledge of the fact that the consideration had failed.

apparent from examination of the instrument is both reasonable in nature and supported by the NIL. The imposition of a duty to investigate the contents of an instrument is not the imposition of any duty to investigate "suspicious circumstances," a duty supposedly abolished by Sections 52 and 56. It is only an assumption by the court of what common sense dictates, that is, that anyone paying for an instrument reads or should read it before he purchases. However, the endorsee-finance company cannot be *presumed* to know by a mere reading of the instrument that the consideration has failed.

*Active participation in transaction.* In some situations a showing of actual knowledge of the defect or infirmity is not made, but because of its active participation in the transaction, the finance company will not be heard to say that it did not have such knowledge. This estoppel principle is applied either when the finance company had knowledge of circumstances surrounding the execution of the instrument or when the finance company, through past business experience, has acquired certain knowledge concerning the parties to the instrument in question or the merchandise being sold.<sup>40</sup> In the first situation,<sup>41</sup> it would seem that the only knowledge inferred would be that acquired by the endorsee from reading the instrument or from participating in the transaction. To hold otherwise would be to impose a duty upon the endorsee to investigate where there are suspicious circumstances arising during the transaction. However, in *Citizens Loan Corp. v. Robbins*,<sup>42</sup> in which the note was drafted in the presence of the vendor, vendee, and agent of the finance company, and the act of sale was prepared by the finance com-

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40. *But see* *Citizens Loan Corp. v. Robbins*, 40 So.2d 503 (La. App. 1949), where the note had been drawn up in the presence of the vendor, vendee, and employee of the finance company. The court held that, since the finance company "actively directed" the transaction between the vendor and the purchaser, the finance company had knowledge of defects in the thing sold. The *Robbins* case seems questionable because of the fact that the defects in the automobile were not discovered until after the finance company took the note. Also, under the established jurisprudence, the finance company should have been *presumed* to have knowledge of those defects that are apparent from the face of the instrument. In the *Robbins* case, the court of appeal inferred knowledge of failure of consideration from the fact that the finance company had drawn up the instruments for the parties. See *White System v. Hall*, 219 La. 440, 53 So.2d 227 (1951), where Justice Hawthorne questioned the *Robbins* decision, and said that the case would have been decided differently had it been before the Supreme Court. *But see* also *General Motors Acceptance Corp. v. Daigle*, 225 La. 123, 72 So.2d 319 (1954), where Justice Moise cited the *Robbins* case with approval.

41. *Pralon v. Aymond*, 12 Rob. 486 (La. 1846). The same language was used after the adoption of the NIL in *General Motors Acceptance Corp. v. Swain*, 176 So. 636 (1937) (dictum).

42. 40 So.2d 503 (La. App. 1949).

pany, the court of appeal inferred that the finance company had actual knowledge of a defect in the automobile purchased. In effect, the court said that knowledge of a failure of consideration can be inferred when the "plaintiff was so directly interested and involved in the transaction of purchase that he cannot escape the legal imputation that he stands in the shoes of the vendor." On the other hand, the Louisiana Supreme Court has held that the NIL does not permit such an inference to be drawn since this would be imposing a duty to investigate suspicious circumstances.<sup>43</sup> In the second situation, in which knowledge of defects or infirmities is inferred from appraisal of facts acquired through past experience, the court is, in effect, requiring the finance company to be "prudent," something not contemplated by the NIL. Thus, when a company subsequently financed the sale of an automobile which it had financed for another purchaser on a prior occasion, it was charged with knowledge of defects in the automobile and the title thereto.<sup>44</sup> The court reasoned that a prudent finance company would have checked to ascertain whether any previous sale of the same car had been handled by it. In a somewhat analogous situation, it has been held that an inference of actual knowledge of defects could not be drawn from the fact that the finance company had previously sued on notes negotiated to it by the same vendor.<sup>45</sup> The position taken here appears sound under the NIL, as no duty is being imposed on a holder to investigate all of the circumstances surrounding the creation and transfer of the paper.

*Legal relations between the parties.* Louisiana courts, like courts in some other jurisdictions, have relied on agency principles to find that the finance company had actual knowledge of defects or infirmities. However, in Louisiana such knowledge possessed by the agent will be imputed to the principal only where the agency is established for the purpose of selling merchandise. In *International Harvester v. Carruth*<sup>46</sup> a "business agency" was found to exist when the manufacturer financed sales made by one of its dealers. In such a situation, knowledge of a defect in the thing sold is imputed to the manufacturer, as his agent is presumed to have possessed such knowledge by virtue of the fact that he was a vendor. However, if it is found that

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43. *White System v. Hall*, 219 La. 440, 53 So.2d 227 (1951).

44. *General Motors Acceptance Corp. v. Daigle*, 225 La. 123, 72 So.2d 319 (1954).

45. *Stevens v. Brown*, 9 La. App. 463, 121 So. 305 (1928).

46. 23 So.2d 473 (La. App. 1945).

a vendor is an agent of the finance company solely for the purpose of securing a loan for one of the vendor's customers, knowledge of defects in the thing sold will not be imputed to the finance company, as the latter is engaged in the transaction only for the purpose of lending money.<sup>47</sup> The only knowledge imputed in such a case is that acquired by the agent while acting within the scope of his authority, that is, while he is negotiating a loan. Knowledge acquired while the agent is acting outside the scope of his authority, that is, while he is selling merchandise, is not imputed to the finance company.<sup>48</sup>

### *Conclusion*

In conclusion, although the Louisiana cases concerning the status of finance companies as holders in due course refer to a "close connection" or "active participation" by the finance company, most of the decisions rest upon some ground other than actual knowledge inferred from the fact of closeness of participation. This is as it should be, since to hold otherwise would be to defeat the purpose of the NIL and its function in facilitating the flow of commercial paper. While it is true that the innocent purchaser is justified in complaining when a finance company has in fact been guilty of using the NIL as a "shield," most of these cases can be solved within the framework of the NIL. Extension of protection to the consumer at the expense of negotiability and the extension of consumer credit financing are matters of public policy which should be resolved by the Legislature. In fact, the Louisiana Supreme Court has recognized that any retreat from the requirement of actual knowledge by the NIL must be made by the Legislature and not by the court.<sup>49</sup>

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47. *Standard Motors Finance Co. v. Yellow Bayou Gin and Planting Co.*, 1 La. App. 424 (1925).

48. *Ibid.*

49. *White System v. Hall*, 219 La. 440, 53 So.2d 227 (1951).