Begging the Question: Schwegmann Bank and Trust Co. of Jefferson v. Simmons and the Issue of "Notice" to Holders in Due Course

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Begging the Question: *Schwegmann Bank and Trust Co. of Jefferson v. Simmons* and the Issue of "Notice" to Holders in Due Course

**INTRODUCTION**

In the recent case of *Schwegmann Bank and Trust Co. of Jefferson v. Simmons*, the United States Fifth Circuit Court of Appeals was faced with having to articulate the proper tests for the requirements of "good faith" and "without notice of a claim or defense" for holder in due course status. In *Schwegmann*, the defendant, Dr. Simmons, had executed a promissory note as part of an investment in a limited partnership. After being transferred several times, the note was eventually pledged as security for a loan agreement in which Schwegmann Bank was a participating bank. Dr. Simmons, the maker of the note, made payments to Schwegmann Bank for some time, but eventually defaulted on the note. The bank sought to enforce the note, claiming it was a holder in due course and was therefore not subject to defenses the maker might have against the note. The trial court found in favor of Schwegmann Bank, concluding that the bank was a holder in due course.

On appeal, the court of appeal upheld the trial court's decision, focusing primarily on the issue of good faith; in particular, whether the proper test for the good faith requirement should be an objective or subjective standard. By relying on prior case law, which had failed to adequately distinguish between the requirements of good faith and notice, the court seemed to blur these two requirements and formulated a test that provides little guidance for lower courts. The court applied a subjective test for both the "good faith" and "without notice" requirements, stating that a more subjective inquiry must be performed in determining holder in due course status.

While the outcome of the case may have been correct in terms of which party prevailed, the reasoning expressed by the court with regard

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1. 880 F.2d 838 (5th Cir. 1989).
3. Simmons claimed failure of consideration, federal securities law violations, and fraud. He contended that Schwegmann Bank could not be in good faith and had notice of these defenses because the bank was aware that the real estate scheme was an investment risk and that Schwegmann had evidence that Q-L or Quinn-L was in poor financial
to the notice requirement accomplishes little to clear up the confusion over good faith and notice. Furthermore, because the Louisiana Supreme Court has yet to directly address this topic, the *Schwegmann* decision is of particular importance; it will no doubt be looked to by lower courts in Louisiana as authority on the U.C.C.'s requirements for holder in due course status.4

This paper will focus on the Fifth Circuit's failure to adequately address the requirement of "without notice" for holders in due course, and will attempt to clarify what the drafters of the U.C.C. meant by "without notice" of a claim or defense.5 First, a look at the background of the statutes and their treatment in other jurisdictions is necessary because Louisiana's version of the U.C.C. is similar to versions in other jurisdictions, as was Louisiana's version of the old Negotiable Instruments Law (N.I.L.).6 The *Schwegmann* decision and recent Louisiana jurisprudence will be analyzed to highlight the area of confusion that has arisen in regard to the tests that should be used for determining "good faith" and "without notice" of a claim or defense. Finally, a more appropriate test for interpreting the requirement of "notice" will be suggested.

**STATUTORY BACKGROUND**

Attaining the status of a holder of commercial paper in due course is desirable in that such status shields the holder from any claims of ownership, and most defenses, that the maker and third parties might have against the instrument. Examples of such defenses are failure of consideration or failure of the transferor to fulfill an underlying obligation.7 In order to be a holder in due course, a holder8 of a negotiable condition. These facts would hardly constitute "notice" of these defenses under any standard, therefore the outcome of the case was properly decided. However, the court's failure to treat "notice" as a separate issue, while affirming a summary judgment, calls into question the validity of the court's approach.

4. As a federal court sitting in diversity, the *Schwegmann* court was bound to apply Louisiana law. Erie R. Co. v. Tompkins, 304 U.S. 64, 58 S. Ct. 817 (1938).

5. La. R.S. 10:3-302 (1983) and U.C.C. § 3-302 (1987). This note is not concerned with distinctions between constructive and actual notice, or the definition of "notice" in other parts of the U.C.C. For a thorough discussion of these topics, see Blum, Notice to Holders in Due Course and Other Bona Fide Purchasers Under the Uniform Commercial Code, 22 B.C.L. Rev. 203 (1981).

6. Louisiana's version of the N.I.L. was found in Title 7 of the Louisiana Revised Statutes.


8. La. R.S. 10:1-201(20) (1983) and U.C.C. 1-201(20) (1987): "Holder" means a person who is in possession of a document of title or an instrument or certificated investment security drawn, issued, or indorsed to him or his order or to bearer or in blank.
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12. See supra note 6.
14. N.I.L. § 56:
   To constitute notice of an infirmity in the instrument or defect in the title of
   the person negotiating the same, the person to whom it is negotiated must have
   had actual knowledge of the infirmity or defect, or knowledge of such facts
   that his action in taking the instrument amounted to "bad faith."
15. La. R.S. 10:1-201(19) (1983) and U.C.C. § 1-201(19); see also McDonnell, supra
   note 13, at 601.
(c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists.  

Particular instances of "notice" of a claim or defense are also outlined under the U.C.C.  

A party can acquire notice of a claim or defense by observing that the instrument has been altered, that payment is overdue, that the instrument has been marked paid, or otherwise acquires notice of a contractual defense of the maker.  

The last method requires an interpretation of the definition of "notice."  

17. La. R.S. 10:3-304 (1983). The statute defines notice to the purchaser as follows:  

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 obligation of any party is voidable in whole or in part, or that all parties have been discharged.  

2. The purchaser has notice of a claim against the instrument when he has knowledge that a fiduciary has negotiated the instrument in payment of or as security for his own debt or in any transaction for his own benefit or otherwise in breach of duty.  

3. The purchaser has notice that an instrument is overdue if he has reason to know  
   (a) that any part of the principal amount is overdue or that there is an uncured default in payment of another instrument of the same series; or  
   (b) that acceleration of the instrument has been made; or  
   (c) that he is taking a demand instrument after demand has been made or more than a reasonable length of time after its issue. A reasonable time for a check drawn and payable within the states and territories of the United States and the District of Columbia is presumed to be thirty days.  

4. Knowledge of the following facts does not of itself give the purchaser notice of a defense or claim  
   (a) that the instrument is antedated or postdated;  
   (b) that it was issued or negotiated in return for an executory promise or accompanied by a separate agreement, unless the purchaser has notice that a defense or claim has arisen from the terms thereof;  
   (c) that any party has signed for accommodation;  
   (d) that an incomplete instrument has been completed, unless the purchaser has notice of any improper completion;  
   (e) that any person negotiating the instrument is or was a fiduciary;  
   (f) that there has been default in payment of interest on the instrument or in payment of any other instrument, except one of the same series.  

5. The filing or recording of a document does not of itself constitute notice within the provisions of this Chapter to a person who would otherwise be a holder in due course.  

6. To be effective notice must be received at such time and in such manner as to give a reasonable opportunity to act on it.  

18. Id.; see also J. White and R. Summers, supra note 10, at 627.
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According to the U.C.C. definition, a person has notice, even though he may not have "actual knowledge" of a claim or defense, if he has "reason to know" that a claim or defense exists. 19 The official comments to the U.C.C. indicate that the "reason to know" portion of the definition of notice is intended to bring a degree of objectivity to the concept of "lack of notice." 20 The comments define a "reason to know" as:

[It]entended to exclude mere suspicion, as distinguished from definite information... It is also intended to make clear that the test is an objective one, and that the holder's testimony that he did not know is not conclusive. 21

The premise that the drafters intended "without notice" to be something more than a totally subjective inquiry is further bolstered by the fact that the legislature of New York, a state where the bankers' lobby is quite formidable, had hotly debated the issues of good faith and notice prior to adopting the U.C.C. 22 The objective concept embodied in the notice provision of the original U.C.C. was thought to impede negotiability by subjecting would-be holders in due course to the overly broad hindsight of triers of fact. 23 Eventually, New York modified Section 3-304 so that the element of "knowledge which amounts to bad faith" found under the N.I.L. was retained in the New York statute. 24

In light of this background, it is understandable that courts often merge the "without notice" and the "good faith" requirements. The same facts and circumstances that must be examined in order to determine good faith must also be looked at to determine notice. Additionally, the more objective requirement of notice contains a sub-part that is subjective—one must first determine what facts and circumstances were known to the would-be holder in due course at the time of purchase. 25 However, it is clear that once this threshold subjective inquiry is answered, a further analysis is required in order to determine if the "without notice" requirement has been fulfilled. What a person did not

20. U.C.C. § 3-304, Notes and Comments to Tent. Draft No. 3, § 46 (1949): "Reason to know. This is intended to exclude mere suspicion, as distinguished from definite information... It is also intended to make clear that the test is an objective one, and that the holder's testimony that he did not know is not conclusive."
21. Id.
22. See McDonnell, supra note 13, at 601 n.121.
know may allow him to clear the hurdle of good faith, but that same lack of actual knowledge will not automatically satisfy the notice requirement.

The drafters of the U.C.C. disentangled the issues of good faith and notice in an attempt to make it clear that two distinct elements must be proven by one claiming to be a holder in due course. Under the N.I.L., tying the element of notice to the concept of "bad faith" proved troublesome to many courts. However, under the U.C.C., interpretations of the issue of "notice" have proven to be anything but uniform among the various jurisdictions. Even accepting the contention that the issue of notice is intended to be subject to a different inquiry than that of good faith, the difficult question arises as to what burden should be imposed on a purchaser of negotiable paper seeking holder in due course status.

The following sections will deal with an analysis of the various approaches taken by the courts in interpreting, and in many cases misinterpreting, the U.C.C. provisions on good faith and notice.

TREATMENT IN OTHER JURISDICTIONS

There appear to be the two primary lines of thought as to what duties are to be placed on a purchaser in regard to the issue of notice. The first is known as the "inferable knowledge" or "reasonable inference" test. This test is based on a determination that, judging from all the facts and circumstances known to the purchaser at the time of purchase, the purchaser could or could not have reasonably inferred that a claim or defense to the instrument exists.

The case often cited as representing a classic "inferable knowledge" approach is *Eldon's Super Fresh Stores, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* In this case the plaintiff had written a check and delivered to its agent, with instructions that the agent was to use the check to pay a debt owed by the plaintiff. Instead of using the check as instructed, the agent gave the check to the payee in satisfaction of the agent's personal debt.

In finding that the payee had become a holder in due course, the court determined that the test to be used is one in which the trier of

27. See W. Hawkland and L. Lawrence, supra note 25, at 418.
28. Id.
29. Id.
30. 296 Minn. 130, 207 N.W.2d 282 (1973); see also St. Paul Fire & Marine Ins. Co. v. State of Salem, 412 N.E.2d 103 (Ind. App. 1st Dist. 1980) (knowledge that holder almost bankrupt not notice when he is cashing a large check); Wohlrabe v. Pownell, 307 N.W.2d 478 (Minn. 1981) (knowledge that transferor is a known embezzler held not to be notice).
fact looks to see if the holder of the instrument had knowledge of facts from which he should have inferred the claim or defense in question. The court went on to state that

having notice by way of the "inferable knowledge" test is something more than failure to make inquiry about an unknown fact. Failure to make such inquiry may be negligence and lack of diligence, but it is not notice of what he might discover.31

Under this standard, the court looked at the facts known to the defendant at the time he took possession of the instrument and determined that he could not have inferred from these facts that a claim or defense to the instrument existed.

The other approach to the issue of notice has been called the "duty of inquiry" test.32 Under this standard, a purchaser has notice of a claim or defense if, at the time he purchased the instrument, the facts and circumstances known to him would lead a reasonable man to inquire further, and the purchaser failed to make such inquiry.33

A case that represents the "duty to inquire" approach is *E. Bierhaus & Sons, Inc. v. Bowling.*34 This case involved a suit by the holder of a check that had been dishonored by the drawee bank. The holder brought an action against the maker of the check claiming holder in due course status. A third party had, without authorization, filled in the blank portions of the check and presented it to the holder as payee. The court found for the maker, stating that the holder was not a holder in due course because he had received dishonored third-party checks from that same person in the past and should have questioned of the maker as to the third party's authority. The court reasoned that

where matters are known to a holder or are brought to his attention which would put a reasonably prudent man on inquiry, such inquiry must be made at the peril of being deprived of holder in due course status.35

Using this standard, the court determined that the defendant should have inquired further into the circumstances surrounding the transaction to determine if a claim or defense to the instrument existed.

Although these two approaches would often lead to the same result, some commentators are of the opinion that disqualifying a would-be

31. 296 Minn. at 138, 207 N.W.2d at 288.
32. See W. Hawkland and L. Lawrence, supra note 25, at 419.
33. Id.
34. 486 N.E.2d 598 (Ind. App. 1st Dist. 1985); see also Farmers and Merchants State Bank v. Western Bank, 841 F.2d 1433 (9th Cir. 1987) (bank had notice of a check kiting scheme when it suspected the scheme but postponed investigation until after the loss was shifted to the payor bank).
35. 486 N.E.2d at 604, 605.
holder in due course for failing to inquire as to the propriety of the instrument would place too great a burden on purchasers of negotiable instruments and would detrimentally affect negotiability. On the other hand, stating that an objective test is to be applied, without imposing some commercially reasonable duty to inquire might undermine the intent of the drafters of the U.C.C. to make good faith and notice separate criteria.

An alternative to the above mentioned approaches is that taken in Kaw Valley State Bank and Trust Co. v. Riddle. In this case, a seller of machinery had discounted a note to the plaintiff, Kaw Valley Bank. The maker of the note, Riddle, was a prospective purchaser of equipment but had never received any consideration for the note. The maker and the transferror of the note made an agreement prior to the transfer of the note that the note would be destroyed and a new one, based on different consideration, would be substituted in its place. The maker had no knowledge of the transfer of the note until the transferor was placed in receivership, and no demand for payment was made on the maker until suit was filed.

In its analysis, the court first recognized the distinctions between good faith and notice, and then fashioned a compromise between the reasonable inference and duty of inquiry approaches, establishing a standard based on commercial reasonableness. The court looked to see what facts and circumstances were known to the bank at the time of the transaction, and then examined these facts and circumstances in light of “commercial reasonableness” to see what the bank should have known in regard to the issue of notice. Applying this standard, the court found that it was reasonable to conclude that the holder had notice of a claim or defense, precluding holder in due course status.

This standard, however, has not been the standard applied in Louisiana.

TREATMENT IN LOUISIANA COURTS

Many of the Louisiana courts that have dealt with the issue of the proper standard to apply have stumbled over many of the same obstacles that befell the Schwegmann court, namely, they have merged the concepts of good faith and notice and have used imprecise language in articulating their conclusions.

36. See W. Hawkland and L. Lawrence, supra note 25, at 421; see also McDonnell, supra note 13, at 604.

37. One should keep in mind that an inquiry into whether or not a purchaser had “notice” of a claim or defense is really only relevant when in fact there is a valid claim or defense.

One of the cases cited in Schwegmann, Asian International, Ltd. v. Merrill Lynch, Pierce, Fenner and Smith, Inc.,9 confused the two requirements when it declared that good faith is to be determined by a "reasonableness" standard. In this case, the payee of a check brought suit against the holder, alleging that the agents who had endorsed the check had no authority to do so. The payee further alleged that he had received no consideration for the transfer. The appellate court concluded that the defendant was a holder in due course, but in so doing used an incorrect standard when it stated that "reasonableness" was the test to be used in deciding the issue of good faith. The Asian International court borrowed this test from an earlier decision, Commercial National Bank in Shreveport v. Calk,40 a case decided under the N.I.L., which used a reasonableness standard to analyze the issue of notice. Under the N.I.L., determining what constituted notice required a more subjective "bad faith" inquiry.41 This questionable interpretation, and the Asian International court's reliance on it, led to misinterpretation of the U.C.C.

Interestingly, the same circuit had taken a different position on the issues of good faith and notice only one year prior to Asian International in the case of Republic of Texas Savings Association v. First Republic Life Ins. Co.42 In Republic of Texas, the first circuit, recognizing that there was a dearth of Louisiana jurisprudence interpreting the U.C.C., declared that the "reasonable man test" was not to be used in examining the requirements of good faith or notice and stated that both inquiries require "a more subjective test."43 The court drew its authority for this statement from a New York federal district court case that had applied New York commercial law.44 As mentioned earlier, New York is one of only two states that equates "notice" of a claim or defense to "bad faith" on the part of the holder. Accordingly, the New York court centered its discussion around what constituted "bad faith," and concluded that bad faith may be defined as "nothing less than guilty knowledge or willful ignorance," a purely subjective standard.45 This "willful ignorance" standard was adopted by the first circuit and er-

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39. 435 So. 2d 1058 (La. App. 1st Cir. 1983).
42. 417 So. 2d 1251 (La. App. 1st Cir.), writ denied, 422 So. 2d 161 (1982).
43. Id. at 1255.
45. Id. at 1119, citing Manufacturers & Traders Trust Co. v. Sapowitch, 296 N.Y. 226, 72 N.E.2d 166 (1947).
roneously applied to the "notice" requirement under Louisiana's U.C.C. in Republic of Texas.

Other Louisiana decisions have picked up on the language of these two previous cases in analyzing holder in due course issues. In the recent case of Thompson v. H & S Packing Co., Inc., the first circuit relied on Asian International as controlling authority as to whether or not a party has fulfilled all of the requirements for holder in due course status, thus perpetuating the suspect "reasonableness" approach. In Thompson, a corporation had executed a promissory note in order to repurchase stock from one of its shareholders. The note was subsequently endorsed to the plaintiff as security for a loan. The corporation refused to make payments on the note, claiming it had a prior agreement with the original payee by which the original payee agreed to accept a discounted amount as full payment on the note. In finding that the transferee was a holder in due course, and, therefore, not subject to any defenses of the corporation, the court stated that "good faith is determined on a reasonableness standard, in that the facts must be such as would necessarily put a reasonable person on inquiry to ascertain the true facts."

In Arthur Dooley & Son of Louisiana, Inc. v. Johnson, the fifth circuit adopted almost verbatim the rationale used by the court in Republic of Texas. In Arthur Dooley, a corporation sued the depositary bank of one of its subcontractors, alleging that the bank had negligently accepted unauthorized checks of the corporation and was, therefore, not a holder in due course. The corporation had discovered that the subcontracting company was secretly operated by one of the corporation's own employees as part of a scheme to embezzle money. The corporation sued the bank for cashing the checks made out to the subcontractor, claiming that the bank should have required the employee to personally endorse the checks. Finding that the checks on their face met all requirements of negotiability, the court then considered whether the bank was in good faith or had notice of defenses. The court cited Republic of Texas as controlling and determined that the depositary bank was a holder in due course of the checks because the bank's knowledge did not amount to notice of a claim or defense under the willful ignorance standard.

Equating bad faith with notice as the Republic of Texas and Arthur Dooley courts did was clearly something the drafters of the U.C.C. intended to avoid when they redefined notice and omitted the "bad faith" language used by the N.I.L. Likewise, merging good faith and

46. 540 So. 2d 371 (La. App. 1st Cir. 1989).
47. Id. at 375.
48. 422 So. 2d 1270 (La. App. 5th Cir. 1982), writ denied, 429 So. 2d 152 (1983).
49. Id. at 1274, 1275.
50. See supra note 13 and accompanying text.
notice by evaluating both elements in light of a reasonableness standard, as did the *Asian International* and *Thompson* courts, is an incorrect approach. With this backdrop, the case of *Schwegmann* was appealed to the United States Fifth Circuit in search of the proper standard to apply for notice.

**Schwegmann**

To restate the salient facts in *Schwegmann*, the defendant, Dr. Simmons, had executed a promissory note as part of an investment in a limited partnership. After several transfers, the note was eventually pledged as security for a loan in which Schwegmann Bank was a participating bank. After Dr. Simmons defaulted on the note, the bank brought suit, claiming it was a holder in due course and was therefore not subject to any defenses Dr. Simmons might have against the note.¹¹

Dr. Simmons alleged that Schwegmann was not a holder in due course because the bank had not taken the instrument in good faith and without notice of possible defenses to the instrument.⁵² The court rejected Dr. Simmons' position and found the bank to be a holder in due course.

In reaching its conclusion, however, the *Schwegmann* court erred in failing to recognize the distinctions between good faith and notice when it superimposed the subjective requirement of good faith onto the lack of notice analysis. Prefacing its discussion, the court stated that cases from other jurisdictions would be persuasive because Louisiana's version of U.C.C. Article 3 is basically the same as that of other states.⁵³ The court looked to Louisiana cases and concluded that there was conflicting authority as to whether good faith and notice should be determined on the basis of a subjective or objective inquiry. The plaintiff, Schwegmann Bank, relied on *Republic of Texas Savings Association*⁵⁴ and *Arthur Dooley*⁵⁵ to support its position that good faith and notice were essentially subjective standards. Dr. Simmons cited *Asian International*,⁵⁶ which held that good faith and notice are to be determined on a reasonableness standard. As explained earlier, both positions appear to be incorrect under the U.C.C. The U.S. Fifth Circuit recognized that good faith should be determined by a subjective inquiry. Thus, the *Asian*

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¹¹. Bank of Commerce of Shreveport (BOC) had exceeded its lending limits and sought out Schwegmann as a participant in order to placate the Federal Reserve.

⁵². Supra note 3.

⁵³. Louisiana did make minor modifications to the wording of § 3-305, dealing with the "real" defenses to which even a holder in due course is subject. Compare U.C.C. § 3-305 (1987) with La. R.S. 10:3-305 (1983).

⁵⁴. 417 So. 2d 1251 (La. App. 1st Cir.), writ denied, 422 So. 2d 161 (1982).

⁵⁵. 422 So. 2d 1270 (La. App. 5th Cir. 1982), writ denied, 429 So. 2d 152 (1983).

⁵⁶. 435 So. 2d 1058 (La. App. 1st Cir. 1983).
International court’s clearly erroneous conclusion that the good faith issue is subject to an objective standard no doubt weakened, in the eyes of the Schwegmann court, the validity of the treatment of “lack of notice” as an objective standard in Asian International.

Ironically, the Schwegmann court pointed out that good faith and notice were treated differently under the U.C.C. than under the N.I.L., yet the court eventually ignored the distinction between the two requirements in its own analysis. The court resolved this conflict by rejecting the reasonableness approach and adhering to the prior United States Fifth Circuit decision of Bricks Unlimited, Inc. v. Agee, which had also applied essentially a subjective test to the issues of good faith and notice.

The Fifth Circuit’s reliance on the Bricks Unlimited decision may have been misguided, however, because that case had focused primarily on the issue of good faith. Referring to General Investment Corp. v. Angelini, a New Jersey case, the Bricks Unlimited court correctly stated that good faith was a subjective requirement and that there was no duty to inquire into the propriety of the instrument unless the circumstances indicated a “deliberate desire” on the part of the holder to evade knowledge. The Bricks Unlimited court, like the court in Schwegmann, allowed the issue of notice to be subsumed by the issue of good faith and failed to adequately address the notice requirement. These conclusions were based on the policy grounds that imposing these “duties of inquiry” would create intolerable burdens on modern business.

The Schwegmann court used this language to dispose of the good faith issue, finding Schwegmann Bank to be in good faith, but went further with the “deliberate desire” concept, applying essentially the same rationale to the issue of notice as it had to the issue of good faith. The Schwegmann court looked favorably upon the policy reasons enunciated in Bricks Unlimited and made short work of the notice requirement, giving it only a parenthetical comment stating that the words “reason to know,” found in the definition of notice, guarded against “willful ignorance.” The same standard was subsequently used by the Schwegmann court in its discussion of notice when it cited Republic of Texas. The court then affirmed the decision of the lower court granting holder in due course status to Schwegmann Bank.

57. 880 F.2d 838, 841-42 (5th Cir. 1989).
58. 672 F.2d 1255 (5th Cir. 1982).
59. 880 F.2d at 842.
60. 58 N.J. 396, 278 A.2d 193 (1971).
61. Id. at 197.
63. 880 F.2d at 842 (citing Republic of Texas); U.C.C. § 1-201(19) (1987).
64. 880 F.2d at 842.
The court should have recognized, however, that good faith and notice are intended to be measured by different standards. Schwegmann Bank clearly passed the good faith test, as it was shown that the bank was subjectively in good faith when it took the instrument. As to the notice issue, the facts that Schwegmann Bank knew about the dealings that gave rise to Dr. Simmons' stopping payment of the note do not appear to rise to the level of "notice" of Dr. Simmons' defenses. The facts that the bank was exposed to did not compel further investigation into the underlying transaction; the actions of the bank in accepting the note fell within commercially reasonable standards. While it seems to have made no difference in the outcome of the case, the court may have set erroneous precedent by applying a subjective test to the notice issue.

The drafters of the U.C.C. had a purpose in establishing good faith and notice as separate criteria, and it is error for the courts to ignore clear statutory law. An objective evaluation of what a party knew or should have known, based upon the commercial reasonableness of the transferee's actions in light of the facts and circumstances known to him at the time of transfer, is the extent of the requirement under the U.C.C. An analysis such as the one undertaken by the court in Schwegmann does little to guide lower courts in interpreting Louisiana's commercial statutes; such an analysis also fails to provide purchasers or makers of negotiable instruments the kind of commercial predictability necessary to assess the risk involved.

**PROPER APPROACH: THE KAW VALLEY MODEL**

The following section outlines the proper approach under the U.C.C. in determining whether a party has notice of a claim or defense.

Given the advantages that holder in due course status affords, it would be unjust to allow too lax an inquiry into what the purchaser knew or should have known. The resolution of the problem of what burden should be placed on a purchaser might well lie somewhere between an easily circumvented "reasonable inference" test and the overly demanding "duty of inquiry" standard.65

The determination of whether or not a party has notice is necessarily fact bound, and formulation of a bright-line test is a difficult task. Nevertheless, a case from which a workable approach can be derived is Kaw Valley State Bank and Trust Co. v. Riddle.66 In this case, the Supreme Court of Kansas, recognizing the distinctions between good

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65. Supra note 34 and accompanying text.
faith and notice, stated that "reason to know" appears to be "premised on the use of reasonable commercial practices."\textsuperscript{67}

In denying holder in due course status to the plaintiff, the Kaw Valley court noted that the transferor of the note and the bank had occupied a close relationship with one another not only on this transaction but on many other transactions. Holder in due course status was denied not based solely on past dealings, but because the transferor had often acted as an "agent" of Kaw Valley. The bank had knowledge of the transferor's business practices. The bank knew that the consideration it had paid for the notes was not, as was represented by the instrument, already in the possession of the maker, but was to be used by the transferor to purchase future equipment. Kaw Valley did not make demand on the makers themselves, but delivered coupon books to the transferor, and relied on it for collection "as if it were the obligor or was authorized as its collection agent for this transaction."\textsuperscript{68}

Arguably, disqualifying a would-be holder in due course based solely upon his knowledge of past transactions is no less than saying a holder has a duty to inquire, which, as mentioned earlier, establishes an improper standard.\textsuperscript{69} However, the Kaw Valley court did more than simply state there was a "duty of inquiry." The court recognized something the U.S. Fifth Circuit in Schwegmann failed to recognize: the importance of distinguishing good faith from notice, and of examining all facts and circumstances known to the holder when deciding the issue of notice. The Kaw Valley court applied a commercial reasonableness standard when examining these facts and circumstances and in determining what Kaw Valley knew or had reason to know of the maker's defense. This is the optimal approach to the notice issue. It traces the requirements discussed by the U.C.C. drafters and introduces a practical test—commercial reasonableness—in determining holder in due course status. The Kaw Valley approach ensures that holder in due course status will not be freely determined, yet offers parties to commercial transactions some degree of predictability.

**CONCLUSION**

The particular facts of Kaw Valley are not important. The importance of that case lies in the approach used by the court in reaching its decision. Adopting such an approach in Louisiana would not place too great a burden on negotiability, and would serve to promote the

\textsuperscript{67} Id. at 933.
\textsuperscript{68} Id. at 935.
end of commercial predictability. If the Schwegmann court had followed this approach, it would have recognized that good faith and notice are two distinct criteria that should be measured by different standards. The court should have applied a subjective inquiry only to the requirement of good faith, then should have gone a step further and analyzed what the purchaser knew or should have known about possible claims and defenses at the time of purchase. The purchaser's actual or constructive knowledge should depend on what is reasonable under accepted commercial standards. Whether the purchaser should have investigated further would depend upon whether his actions, based on the facts known to him, constituted a commercially reasonable activity.

When faced with these issues again, Louisiana courts would do well to ignore the faulty analysis used by the Fifth Circuit in Schwegmann and prior Louisiana state court decisions, and adopt the Kaw Valley approach of distinguishing the concepts of good faith and notice.

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