Commercial Bad Faith in the Law of Negotiable Instruments

Edward T. Fagan, Jr.
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I. INTRODUCTION

ALTHOUGH it is generally accepted today that a subjective standard is essential for the correct determinations of good and bad faith in negotiable instruments law, the subjective element seems to have been non-existent in the law merchant as an aid in establishing due course holding. The main concern of the merchants was whether the purchaser took the instrument in the regular course of trade. If he did not take the paper in such manner then the transfer was subject to ordinary common law property rules. No other result was possible since the parties involved had failed to conform to the usages and customs of commerce and consequently were unable to fulfill the requirements necessary to establish their transactions as within the law merchant. Law merchant rules were inapplicable because such law pertained only to recognized commercial transactions between merchants.

When the common law judges incorporated the law merchant into their system, many of them sought to restate this course of business taking requirement by ruling that any purchase of a negotiable instrument outside the ordinary course of the purchaser's business was made in commercial bad faith, regardless of possible subjective faith. Whether these holdings were an accurate restatement of the law merchant requirement depends upon the correct determination of what constitutes taking a negotiable instrument within the ordinary course of business.

II. THE PROBLEM

The Uniform Negotiable Instruments Law (hereinafter referred to as the N.I.L.) makes no express recognition of a course of business taking requirement in its holder in due course definition. The failure of the statute to speak directly in this regard has led to much legal speculation as to whether the requirement should be read into the N.I.L. by implica-

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1. "The early courts do not appear to have questioned what they meant by 'good faith.' Nor to have stated just how nearly closed a purchaser might keep his eyes and still be deemed not to have 'notice' of 'infirmities' or of 'defects' in title, to use the language of N.I.L. sec. 52(4). Or, of 'facts making the transfer wrongful,' to quote from the Transfer Act. Probably they meant some such thing as the good faith of the regular course of business." Steffen, Cases on Commercial and Investment Paper 585 (2d ed. 1954).


3. Negotiable Instruments Law § 52. (Corresponding state statutes to the Uniform Negotiable Instrument Law may be found in 5 U.L.A. XV.)
tion or whether it was intentionally excluded. On this point, Professor Beutel, who is usually critical of the Proposed Uniform Commercial Code, agrees with its draftsmen in their insistence that the treatment of the matter has remained unchanged in the majority of jurisdictions since the enactment of the N.I.L. and that a taking in the course of the purchaser's business is just as much a requirement of due course holding today as it was under the law merchant. An acceptance of this contention, however, leads directly to what seems to be a contradiction within existing law.

If taking within the course of the purchaser's business is a requirement in all cases for due course holding by business men, then if an ordinary business man in the same business would not have taken the instrument under the circumstances, the taking is outside the regular course of business and the taker is not a holder in due course. Under such a requirement the circumstances surrounding the purchase transaction are conclusive in themselves in the determination of due course holding. If they establish a course of business taking, the commercial purchaser is protected with little more than lip service paid to his actual bona fides because commercial good faith is said to exist.

Such a requirement seems completely inconsistent with the common law decision to facilitate the acceptance and expedite the transfer of commercial paper by absolving the ordinary purchaser from any duty to determine its validity by investigation. The notice standard adopted to insure such result requires only that the purchaser have no actual knowledge of facts establishing a defense to or defect in the instrument and that he take it in good faith. Investigation not being a requirement under such standard, facts or circumstances which in themselves fail to establish actual knowledge or bad faith, have no bearing upon the determination of due course holding.

6. Uniform Commercial Code § 3-302, comment.
8. "The triumph of the good faith purchaser has been one of the most dramatic episodes in our legal history. In his several guises, he serves a commercial function: he is protected not because of his praiseworthy character, but to the end that commercial transactions may be engaged in without elaborate investigation of property rights and in reliance on the possession of property by one who offers it for sale or to secure a loan. As the doctrine strikes roots in one or another field, the 'good faith' component tends to atrophy and the commercial purchaser is protected with little more than lip service paid to his 'bona fides.'" Gilmore, The Commercial Doctrine of Good Faith Purchase, 63 Yale L.J. 1057 (1954).
It is obvious that to require a taking within the course of the purchaser’s business makes circumstances connected with the negotiable instrument purchase transaction conclusive in themselves on the question of due course holding regardless of the purchaser’s lack of actual knowledge of defense or title defect. It is equally obvious that the notice standard of negotiability makes such circumstances immaterial on the same question unless they establish actual knowledge in the ordinary purchaser of defense or title defect. Presuming that a course of business taking is to be retained as a prerequisite for due course holding since it was so essentially part of the law merchant, the seemingly insoluble problem which arises from these observations is how to apply both the requirement and the actual knowledge notice standard to the ordinary purchaser without contradiction being the inevitable result in many cases.

III. PROPOSED SOLUTION

Commercial paper was originated to facilitate the transfer of credits between merchants. In this regard, upon the original issue of a bill, the taker is a transferee of the credits it represents but not a purchaser of the paper since he is its first owner. Consequently, if the original issue is made as a medium of exchange for a transaction outside the ordinary course of the drawee’s business, the initial taking is not within the scope of business because the only transaction involved is one which violates commercial custom or usage. However, the basic facts change once the negotiable instrument has been issued. It then becomes a species of property in its own right although this fact has been generally disregarded in judicial determinations of whether it has been taken in the course of business. It is usually considered unimportant that a discount is involved rather than an initial delivery. It is unfortunate that this

11. Britton, Bills and Notes § 100 (1943).
12. There are several notable exceptions, however. Express recognition was made of the course of the discount trade in Briggs v. Merrill, 58 Barb. (N.Y.) 389 (1870), wherein the court, in discussing a holder who acquired the instrument by operation of law, stated at page 399, “The principle established is that neither the payee nor any holder who is not an innocent bona fide holder for value, before the note becomes due, can enforce its collection, against the maker. The law will not aid in carrying out any portion of the fraudulent bargain, but will leave all the parties who are chargeable with notice, to rely upon the option of the maker for the performance of the apparent obligation. The receiver does not stand in the situation of an innocent bona fide holder for value. He acquires title by legal process, and not in the regular course of dealing in commercial paper.”

In Kellogg v. Curtis, 69 Me. 212 (1879), the court stated at page 214, “The purchase by an indorsee, must be ‘in the usual course of business.’ These words are usually defined to mean ‘according to the usages and customs of commercial transactions.’ If the plaintiff purchased the note before maturity for value, that would be such a transaction.”

In Crosby v. Grant, 36 N.H. 273 (1858) the court recognized the importance of dis-
property aspect of the negotiable instrument, achieved through the evolution of issue, has received such scant attention in this connection because its basic importance in relation to course of business determination cannot be overemphasized. It is the one attribute of issued negotiable paper that distinguishes it from a mere exchange medium and thus serves to separate the discount transaction from transactions which relate to it.

A medium of exchange as such has no intrinsic value. It is not a commodity and cannot properly be the subject of a purchase transaction. The transfer of money, just as the transfer of credits by the original issue of a bill, is merely a means of providing representative value to bind or conclude a commercial transaction. That which is transferred is not valuable in itself. On the other hand, the negotiable instrument, once issued, is properly the subject in itself of a course of trade. In fact, the commercially recognized method of transferring such instrument has always been by a negotiation for value.\(^3\) It necessarily follows from these conclusions that receipt of value for a negotiation after issue is all that is necessary to establish the transfer as one within the ordinary course of business. The specific business or trade involved is that of discounting commercial paper.\(^4\) It further follows that the ordinary trans-

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\(^3\) Counting upon course of business taking in the following paragraphs at page 278, "But it is contended by the defendant that the court erred in limiting their instructions to the inquiry by the jury whether the plaintiff had knowledge of the defect in the note, and that they should have been instructed that if the plaintiff did not take it in the usual course of business, or if the circumstances under which he took it were such as to put him on inquiry, it was subject to the defense, in the same manner as if he had knowledge.

"The general proposition that the note, in order that it may be protected against equities as between prior parties, must be taken in the usual course of business, is undoubtedly correct. If it be received on any other footing than as a bona fide purchase by the holder, independent of any previous connection with it, or with any of the parties upon it, so that he does not take it as such paper ordinarily passes from the holder to the indorser upon a purchase and sale of the security, then he takes it, not in the usual course of business, or if the circumstances under which he took it were such as to put him on inquiry, it was subject to the defense, in the same manner as if he had knowledge.

See also, Parsons v. Utica Cement Co., 82 Conn. 333, 73 Atl. 785 (1909); Christianson v. Farmer's Warehouse Ass'n, 5 N.D. 438, 67 N.W. 300 (1896); Merchants' Bank v. McClelland, 9 Colo. 608, 13 Pac. 723 (1887).

\(^4\) Some indication of the present volume of a portion of this trade is revealed by the following excerpt from the Wall Street Journal: "investors began to balk at the return they were getting on commercial paper in December and the amount outstanding dropped below a month-earlier and year-ago levels, according to the New York Federal Reserve Bank."
The situation is not complicated by the fact that the concept of value in negotiable instruments law extends beyond money to include anything sufficient to bind an ordinary contract. Frequently the transferee instead of giving money, employs a separate transaction between him and the transferor as the basis for this value. Despite the fact that the separate transaction may in itself be outside a course of trade, the course of business taking of the instrument is not affected since value is given for its transfer and the means by which this giving is accomplished is immaterial on the due course taking issue. A contrary conclusion is reached by those holdings which require, as a further prerequisite for such taking, that the transferee conform to the custom and practice of his particular business in respect to the transaction which leads to the purchase of the paper. The following simple example serves to illustrate the error in the reasoning of such holdings and at the same time to demonstrate the validity of the opposite conclusion.

The bulk sale of an entire stock in trade and fixtures by way of winding up a business is a transfer outside the ordinary course of trade. It is so identified by statute primarily to protect the seller's creditors by requiring the prospective purchaser to give them notice of the sale before it is concluded. Consequently, any buyer in bulk, who fails to comply with bulk sales statutes is accountable to the creditors of the seller for all material acquired under such sale. If the bulk buyer gives an already issued negotiable instrument as value to conclude the bulk sale, there exists no advantage or reason for labeling the transfer of the instrument as outside the course of trade because the circumstances surrounding the bulk sale transaction and the discount transaction caution only that the title to the goods and fixtures may be defective—not the title to the

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"The bank estimated commercial paper outstanding at the end of December amounted to $1,924,000,000—a decline of 5% from November and 2% below December 1953 levels.

"Commercial paper is the money market name for short-term unsecured notes of leading business concerns. Industrial companies and smaller finance companies which borrow on commercial paper sell their notes to dealers who resell them to investors." Wall Street Journal, Jan. 18, 1955, p. 16, col. 4.

15. "It is said, however, that the note was not purchased in the usual course of business; that the plaintiff was not engaged in the business of purchasing notes. The phrase, 'in the usual course of business,' signifies, 'according to the usages and customs of commercial transactions,' and its application to the purchase of a mercantile note is not confined to persons engaged habitually in banking or purchasing notes. One who in good faith purchases a negotiable note before maturity, for value, or who takes it in payment of an antecedent debt, is not out of the usual course of business." Tescher v. Mere, 118 Ind. 586, 21 N.E. 316 (1889).


17. N.Y. Personal Property Law § 44.
instrument. Consequently the seller of the bulk goods should be able to claim that he took the instrument within the course of trade involving commercial paper discount because he gave value for it at the time of transfer. The effect of the bulk sale upon the transfer of the instrument in this example should be no more than to establish the fact that value accompanied the negotiation. While it is true that the course of business aspect of the related transaction may be pertinent for jury consideration on the question of the purchaser's good or bad faith in the discount transaction, at most it is only an evidentiary fact and not conclusive in itself on the question of due course holding.18

By distinguishing between the original issue of a negotiable instrument and its discount after issue, it can be established that the requirement of a course of business taking when applied to negotiable instruments will not necessarily conflict with the notice standard of negotiability. The course of trade in which the taker is primarily engaged has no relationship to the course of trade involving the discount of commercial paper unless the taker is in the discounting business. Consequently, if the taker is not in such business, then as long as the commercially recognized method of transferring such paper is employed, the requirement of a course of business taking is fulfilled. The only circumstance which is conclusive on the question of such taking is whether value is given for the instrument. Since the giving of value is essential, along with lack of notice, to establish any due course holding, it follows that both the actual knowledge notice standard and the course of business taking requirement can be made applicable in all due course taking determinations involving holders other than those in the business of discounting commercial paper.

IV. Course of Trade Taking in Common Law

While those not otherwise engaged in the business of negotiable instrument discount may, as an incident to or even outside of their primary

18. The most recent expression of the New York Court of Appeals which bears on the subject is Hall v. Bank of Blasdell, 306 N.Y. 336, 118 N.E.2d 464 (1954). The case treated of a grocer to whom a man named Gallegos owed a grocery bill of $100. Gallegos gave the grocer a cashier's check for $1,000 originally payable to Gallegos, which Gallegos had obtained from the defendant bank. The grocer in turn gave the debtor $880 in currency, $20 in groceries, and a settlement of the old grocery bill.

The court allowed the grocer to enforce the cashier's check against the issuing Bank of Blasdell, despite the fact that the reverse of the check bore the endorsement of the original payee to an automobile dealer in full payment for a Nash car and a reendorsement in blank by the dealer. This extraordinary story of negotiation, which possibly would have alerted a reasonable man to hidden dangers, was only material to the grocer's actual good faith since the facts established that the related transaction was one within the ordinary course of business. Here the court correctly distinguished between the discount and the grocery sale and the "commercial good faith" trap was avoided.
business, enter into its course of trade merely by employing its trade procedure of negotiation for value, it would seem that the interests of commerce demand that something more than mere compliance with transfer procedure be required of those whose business is primarily that of discounting commercial paper. In line with this observation it is submitted that an analysis of the English law wherein the rule of negotiability was formulated, with particular emphasis on the case of *Gill v. Cubitt*, will furnish proof that purchasers who are primarily in the business of discount may be required to conform to the reasonable standards of such business in order to establish their due course holding status. Furthermore, the analysis will show that this requirement does not conflict with the reasoning which motivated the actual knowledge notice standard, normally so essential for negotiability.

**A. Origin Cases**

The earliest recorded English cases which express the rule of negotiability state that if value is given for commercial paper, the course of such trade creates an instrument property right in the purchaser which is superior even to that of its true owner. It is important to note that these decisions make no reference to a course of trade other than that of discounting the paper itself. Of equal importance is the fact that in no case was the purchaser a party who was primarily in the business of discounting commercial paper. As a result, there was no necessity in these origin cases to establish other than purchaser compliance with transfer procedure. This was done by finding that the transfer was made for a valuable consideration. The *Anonymous* case in 1 Salkeld, which is a typical example of these early expressions, is brief enough to state in its entirety:

"A bank bill payable to A or bearer, being given to A and lost, was found by a stranger, who transferred it to C for a valuable consideration. C got a new bill in his own name. Et per Holt, C.J. A may have trover against the stranger who found the bill for he had not title, though the payment to him would have indemnified the bank; but A cannot maintain trover against C, by reason of the course of trade, which creates a property in the assignee or bearer."

**B. Miller v. Race**

It was not until the case of *Miller v. Race*, decided by Lord Mansfield some fifty years after the rule of negotiability was first promulgated in the common law that any mention appears of a requirement that to

come within the rule the purchaser must acquire the instrument within the course of his particular business. This case involved bank notes which had been stolen from the mails and which the plaintiff had acquired for value. Lord Mansfield stated, "It (the bank note) never shall be followed into the hands of a person who bona fide took it in the course of currency, and in the way of his business."  

This statement by Lord Mansfield must be read with an awareness that the instrument to which it referred was a bank note and not a bill of exchange. There is a broad distinction between these two instruments. A bank note, particularly a Bank of England note, has always been treated commercially as the equivalent of cash and categorized as a medium of exchange. A bank bill, such as that dealt with in the Anonymous case or a bill of exchange, is essentially a different type of instrument. A man does not take a bill as cash; but he discounts it, and by so doing becomes its purchaser, taking it within the course of such trade.

The Chief Justice stressed this feature of the bank note in the following words:

"It has been very ingeniously argued by Sir Richard Lloyd for the defendant. But the whole fallacy of the argument turns upon comparing bank notes to what they do not resemble, and what they ought not to be compared to, viz. to goods, or to securities, or documents for debts.

"Now they are not goods, not securities, nor documents for debts, nor are so esteemed; but are treated as money, as cash, in the ordinary course and transaction of business, by the general consent of mankind; which gives them the credit and currency of money, to all intents and purposes. They are as much money, as guineas themselves are; or any other current coin, that is used in common payments, as money or cash."  

Since the bank note was acknowledged to be a medium of exchange, it was not properly the subject of a purchase transaction and Lord Mansfield was correct in holding that the validity of its transfer was governed by the transaction which it served to bind or conclude. Had such transaction been outside the ordinary course of the transferee's business, it is evident that the original owner of the notes would have been entitled to their return.

It is interesting to note that Miller v. Race is the forerunner of those cases which are usually cited to prove that actual knowledge of defense or title defect is the sole notice standard for the negotiable instrument. Particularly is it interesting on this point because although it categorized the bank note as currency and therefore absolved its taker from any investigatory duty prior to its acquisition, it did not specify that other

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23. Id. at 458, 97 Eng. Rep. at 402.
24. "The notes of goldsmiths (whether they be payable to order or to bearer) are always accounted among merchants as ready cash, and not as bills of exchange." Tassell & Lee v. Lewis, 1 Ld. Raym. 744, 91 Eng. Rep. 1397 (1696).
types of negotiable instruments were to receive similar treatment. It would seem that Lord Mansfield intended the currency analogy to apply only to the bank note by the very fact that he stressed the course of business of the individual taker in connection with its acquisition.\(^\text{26}\) It may well be argued that Miller v. Race is authority only for the principle that no duty of investigation exists prior to the taking of bank notes, as distinguished from other types of negotiable instruments.

While it is arguable that the promissory note and bill of exchange, after issue, are not within the principle of Miller v. Race, it must have been apparent to Lord Mansfield that to require an investigatory duty of the ordinary purchasers of these instruments would greatly impede commercial growth. Credit is, and always has been, a vital necessity to expanding industry and volume business. Credit lies in the ability of merchants to negotiate commercial paper between themselves freely and without delay. If English trade was to obtain the credit so essential for large scale operation and if a prompt response to credit demands was to be insured, then the business man had to receive legal assurance that a minimum risk would be assumed by his participation in credit transactions.

C. Peacock v. Rhodes

Twenty-three years elapsed before Lord Mansfield had an opportunity, in Peacock v. Rhodes,\(^\text{27}\) to extend the rule of Miller v. Race to include all negotiable instruments. This case involved a stolen bill of exchange, endorsed in blank, which was negotiated to the plaintiff cloth merchant in exchange for money and cloth. The transferor was unknown to the plaintiff at the time of the sale and the defendant drawer argued that the failure to investigate prior to purchase should defeat the holder’s claim. He distinguished Miller v. Race on the ground that it pertained only to bank notes and not to bills or promissory notes.

Lord Mansfield held that while the fact that the bill was purchased from a stranger was material for jury consideration on the question of bad faith, the jury having concluded that it was taken in good faith and received in the course of trade, the case came within the principle of Miller v. Race.

Although by so ruling, the Chief Justice succeeded in giving the or-

\(^{26}\) The fact that the negotiability of bank notes depended upon the currency analogy whereas the negotiability of bills of exchange stemmed from the law merchant was recognized in Wookey v. Pole, 4 B. & Ald. 1, 105 Eng. Rep. 839 (K.B. 1820). The court stated at page 15, "The holder, bona fide, and for a valuable consideration, of a bank note or a bill of exchange, has a good title against all the world; because in the case of bank notes, they are considered as money and pass as such and it is essential for the purposes of trade, that delivery should give perfect title and because in the case of bills of exchange, this is the law and custom of merchants. . . ."

dinary purchasers of bills of exchange the same notice protection he had previously afforded transferees of bank notes, it is to be noted that he accomplished the result by a different approach. In *Miller v. Race* it was immaterial that a stranger transferred the bank note because it was used as a medium of exchange. There the sole issue was whether the transaction which the bank note served to conclude was within the ordinary course of the transferee’s business. In *Peacock v. Rhodes*, the fact that a stranger was the transferor became material on the question of bad faith. This was so because the bill itself was the subject of the sale in issue as distinguished from the sale of the cloth which related to but was separate from the discount transaction.28 The fact that a stranger bought the cloth was certainly immaterial on the question of whether the sale of the cloth was within the ordinary course of the plaintiff’s business.

When Lord Mansfield mentioned that the jury had determined the good faith of the purchaser and found that the instrument had been received in the course of trade, he was in effect stating that the jury was influenced on the good faith question by the fact that the transaction which related to the discount was one within the ordinary course of the purchaser’s business. This makes sense because if the jury was seeking to determine whether the purchaser took the instrument in good faith, the fact that the related transaction was within the ordinary course of his business was evidence tending to prove such lack of knowledge. On the other hand, if the related transaction had been outside the course of the cloth business, such fact would have been pertinent on the question of legal bad faith but certainly not strong evidence. It is therefore unfortunate that the charge given to the jury is not stated and apparently has never been available.

**D. Lawson v. Weston**

Despite these admirable efforts of Lord Mansfield to delineate the rule of negotiability and accurately define its notice standard, the erroneous reasoning in the subsequent case of *Lawson v. Weston*29 created confusion once again in the English law regarding the proper application of the rule in the evolving commercial era. The case concerned a plaintiff banking house which had discounted a bill of exchange from a stranger without inquiry. The bill having been lost, its holder had requested the defendant acceptors to stop payment. The defendants attempted to offer evidence that when bills were offered for discount to bankers, it was the

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usual practice of the banking trade that the bankers investigate both the bills and the persons offering them, prior to purchase. The purpose of this evidence was to establish that the purchase was not within the course of such trade because no investigation had been made and, therefore, the purchasing banker did not acquire a proper title. The facts afforded a perfect opportunity for a court to distinguish between the duty of the banker and the duty of the ordinary purchaser of commercial paper in respect to participation in the course of the discount trade.

Rather than make this distinction, Lord Kenyon excluded the evidence on the ground that the point was settled by the case of Miller v. Race. He decided that since the plaintiff had paid value for the instrument and taken it without actual knowledge of the title defect, the purchase was protected by the rule of negotiability. It is submitted that the error in the decision lay in his failure to appreciate that the excluded evidence pertained to the course of the discount trade, which was the very trade that was the basis of the rule of negotiability. Certainly, if the common law required that the negotiable instrument be taken within the course of trade as a prerequisite to the application of the rule of negotiability, then if the taker was in the discount trade and claimed the discount was made pursuant to such trade, evidence of the practice of those similarly engaged was highly material on the question of whether the rule was applicable. The issue of a course of business taking may be dismissed, however, by concluding from Lord Kenyon’s decision that it was no longer to be a requirement of due course holding. If so, then it is further submitted that the decision is still incorrect because the actual knowledge notice standard which normally accompanies the rule of negotiability cannot be properly applied to the purchase of negotiable instruments by those engaged in the banking business.

The redemption of negotiable bank notes by bankers comes within the ruling of Miller v. Race because the currency analogy drawn by that case would fail unless an issuing bank could redeem such notes without the necessity of investigation prior to redemption. However, redemption is quite distinguishable from purchase. When a negotiable instrument, other than a bank note, is offered to a banking institution for discount, the interests of commerce demand that an investigatory duty be made applicable to such purchase. Banks and investment houses are the depositaries of the nation’s wealth. The maintenance of a sound national financial structure requires that extraordinary precautions be taken both legislatively and judicially to insure the fact that these depositaries exercise extreme care and discretion in all monetary operations. Only

30. The importance of this has been recognized by Congress in its enactment of detailed banking legislation. See 12 U.S.C.A. (1952).
in this manner may the funds of modern commerce be adequately prote-
tected, for they are in the hands of the nations' bankers.

Apart from the economic danger, it is legally objectionable to permit
financial institutions to purchase commercial paper without prior investi-
gation into its validity. The money used by banks in making such
purchase has been committed to their care by the depositors. Despite the
debtor creditor relationship which legal analysis has established as created
by the deposit, courts have always looked upon banks as custodians
of funds and have treated them accordingly.31 The duty of care required
by law of all custodians of funds is indeed violated by bringing the use
of such money within a notice standard that condones even negligence.
It is arguable, therefore, that this condonation of negligent purchase is not
intended for the protection of bankers but for those business men who are
not equipped with the investigatory machinery that is a necessary part
of the banking trade or with the experience that normally results from a
participation in it. If the ordinary business man was required to conform
to the investigatory duty which should be demanded of the banker, then
the discounting of negotiable commercial paper would be limited to the
financial houses, for only they have the means to promptly and properly
perform such duty. This limitation would in effect abolish many of the
benefits to commerce which were intended by the rule of negotiability.

E. Gill v. Cubitt

It is quite understandable, in light of the effect which Lawson v. Weston
must have had upon the discount trade, that when Gill v. Cubitt,32 which
involved a similar fact situation, came before the Kings Bench in 1824,
the court took occasion to comment, "I think the sooner it is known that
the case of Lawson v. Weston is doubted, at least by this court, the
better."

31. "A deposit is where a sum of money is left with a banker for safekeeping, subject
to order, and payable, not in the specific money deposited, but in an equal sum. It may or
may not bear interest, according to the agreement. While the relation between the depositor
and his banker is that of debtor or creditor simply, the transaction cannot in any proper
sense be regarded as a loan, unless the money is left, not for safe-keeping, but for a fixed
period at interest, in which case the transaction assumes all the characteristics of a loan."

"When the personal property involved is money, it may be difficult, under some circum-
stances, to determine whether the transaction should be called a deposit or a loan; but the
two are not the same, and are never so regarded by anyone in business, or the ordinary
affairs of life. Certainly the thousands who daily deliver money to banks for safe-keeping,
and return in corresponding currency, do not regard the transaction as a loan, nor do they so
speak of it. . . . A deposit is for the benefit of the depositor; a loan, for the benefit of the
borrower. It is true, a deposit may also benefit the depositary but such is not the primary

33. Id. at 472, 107 Eng. Rep. at 809.
Gill v. Cubitt involved a stolen bill of exchange which was discounted by the plaintiff bill broker without making any inquiry of the person who brought it for discount. The defendant acceptor argued that the propriety of Lawson v. Weston had always been doubted and that to absolve a banker or bill broker from any duty of investigation prior to the discount of commercial paper would be the equivalent of authorizing him to advertise: “Bills discounted for persons whose features are known, and no questions asked.”

At last the high court of England had the opportunity to clearly define the limitations of the notice standard of the rule of negotiability. Not only was the opportunity available, but the Kings Bench had been alerted by problems resulting from a prior decisional error. This error could have been rectified and the necessary clarification accomplished by simply ruling that the plaintiff in the above fact situation was a bill broker and, as such, was engaged primarily in the trade of discounting commercial paper. Since discounting without inquiry was not in conformity with the ordinary practice of those primarily engaged in this trade, the plaintiff took the instrument outside the ordinary course of business and was, therefore, not a holder in due course.

The court could have taken judicial notice of the fact that the ordinary and proper practice of those engaged in the banking business was to inquire into the validity and title of commercial paper prior to purchase because such duty was required of them by law as custodians of funds. Since bankers form the greatest percentage of those primarily engaged in the business of discount, the failure of the bill broker to make inquiry prior to discount would be a violation of such general trade practice. It could have concluded, by way of dictum, that bankers were not subject to an inquiry duty in respect to bank notes because such notes were the equivalent of currency and thus distinguishable from other types of negotiable instruments.

Unfortunately, this was not the reasoning employed by the Kings Bench to justify its decision in Gill v. Cubitt that the plaintiff was not a holder in due course. The court ruled instead that no purchaser could in law be considered as acting in good faith, or with due caution or diligence, if he took a bill of exchange without inquiry into its validity or title prior to the purchase. It is frustrating to realize that the ruling was motivated primarily by the particular facts with which the bench was dealing. While the conclusion was certainly correct in the individual case, it was completely erroneous as a general principle since it destroyed the effectiveness of the rule of negotiability.

The real basis for the error in the decision lay in the court's failure...
to appreciate that discounting commercial paper is a course of trade in itself. Justice Bayley, in his concurring opinion, stated:

"If there was not due caution used, the plaintiff has not discounted this bill in the usual and ordinary course of business, or in the way in which business properly and rightly conducted would have required. But it is said that the question usually submitted for the consideration of the jury in cases of this description, up to the period of time at which my Lord Chief Justice's direction was given, has been whether the bill was taken bona fide, and whether a valuable consideration was given for it. I admit that has been generally the case; but I consider it was parcel of the bona fides whether the plaintiff had asked all those questions which, in the ordinary and proper manner in which trade is conducted, a party ought to ask."35

It has already been established by this analysis that the reason why juries were ordinarily asked to determine only whether value had been given in good faith was because all the cases, with the exception of Lawson v. Weston, had involved purchasers who were not in the business of commercial paper discount. Had Justice Bayley made this distinction, he could have correctly based his conclusion on the fact that the taking was not in conformity with discount trade practice, regardless of bona fides, and thus avoided the good faith issue. It is submitted that if he had done so, much of the present day legal conflict on these points would never have arisen. Certainly there would have been no necessity for the legal struggle in the decade that followed to free the commercial world from harsh consequences of the "suspicious circumstances" doctrine which the case established.

V. COURSE OF TRADE TAKING IN PRESENT LAW

In its anxiety to defeat this erroneous constructive notice doctrine the English Bench almost blindly embraced the opposite extreme. Good faith and lack of actual knowledge in the purchaser were soon established as the only material considerations in any due course holding determination.36 Since this accentuation of the subjective standard resulted in the almost total exclusion of objective criteria, the vast majority of common law judges abandoned any conscious effort to apply the law merchant course of trade taking requirement in a manner which would in any way limit the actual knowledge notice standard. As a consequence, the banker was afforded the same legal protection as any other negotiable instrument purchaser.37

The few British and American jurists who conscientiously continued their efforts to properly apply the requirement were forced to word their

35. Id. at 473, 107 Eng. Rep. at 809.
opinions in a manner innocuous enough to survive reversal on any issue of constructive notice. Due to this impediment, they relied upon such vague notions as "commercial bad faith" to justify their attempts to distinguish between the due course holder status of ordinary purchasers and those primarily in the business of commercial paper discount. Unfortunately their reasoning did not permit the formulation of a general principle since, by making good faith the sole issue, their conclusions were confined to the individual cases. This restricted approach, which finds its appearance notably in New York law, can best be illustrated by several New York opinions written both before and after the N.I.L.

The case of Canajoharie National Bank v. Diefendorf,35 involved a plaintiff bank which had purchased a usurious promissory note from a stranger without inquiry and which sought to avoid the defense of usury on the ground that it was a holder in due course. In affirming the judgment entered upon the verdict in favor of the defendant, the court stated:

"Without being called upon to make the explanation usually required by banking institutions in respect to the most ordinary transactions of every-day customers, this stranger, it is claimed, walked into a national bank and converted his feloniously acquired property into money, without difficulty or delay. Common prudence, and a decent regard for the rights of those who might be injured by his conduct, required more than this from the least scrupulous of men, and much more it would seem from the managers of a chartered financial institution. Such institutions have no right to advertise the purchase by them of unlawfully-acquired notes, bonds or negotiable paper, without inquiry or question. Neither have they the right to deal in such securities in defiance of the salutary rules regulating the acquisition of title to personal property. It cannot be seriously contended that a business carried on in such a manner is conducted according to the usual and ordinary course of such institutions, within the meaning of those words as used in relation to transfers of personal property. Promissory notes purchased at an usurious and illegal rate of interest before inception, and being void in the hands of their transferrer, under circumstances so strange and unusual as accompanied this transaction, cannot be said, as matter of law, to have been acquired in good faith, in the usual course of business."

Thirty years later the identical reasoning is found in a lower court opinion, subsequently affirmed by the Appellate Division. In Morris v. Muir,40 the defendant stockbrokers had established a department primarily for the buying and selling of Liberty Loan Bonds. The plaintiff's fifteen year old son had stolen several of her bonds and presented them to the defendants who bought them without inquiry. In allowing a recovery by the plaintiff and overruling the defendants' contention that they were holders in due course, the court stated:

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39. Id. at 199, 25 N.E. at 404.
"The manner in which the defendants conducted their Liberty Loan department provided an easy way for thieves to dispose of their plunder. It is a case of 'no questions asked.' I do not for a moment wish to charge the defendants with the intention of extending an invitation to bond thefts. They are men of good reputation. I believe it is only necessary to call their attention to the lack of precautionary measures and that the proper remedy will be applied."\textsuperscript{41}

The court thereupon concluded:

"Tested by the law applicable hereto, I hold that the defendants acquired the bonds in bad faith. Though they had no actual knowledge of the theft, the appearance of this immature, diseased, and degenerate boy, claiming to be the owner of the bonds and in business for himself, was sufficient to deny his right to the bonds to the mind of any person with ordinary discrimination, or at least to thrust the duty upon the defendants to make further inquiries. They had no right to deliberately shut their eyes to obvious facts."\textsuperscript{42}

In \textit{Soma v. Handrulis},\textsuperscript{43} the Court of Appeals had occasion again to employ the commercial bad faith concept when it dealt with the possible liability of the Federal Reserve Bank which had taken a diverted negotiable instrument for collection. The court stated:

"Even if the actual good faith of the Federal Reserve Bank in dealing with the instrument is not questioned, if the facts shown by the instrument itself should have led it to inquire, and by inquiry it would have discovered the true situation, in commercial sense it acted in bad faith and the law will withhold from it such protection as it would otherwise have been entitled to receive. We think the indorsement by the payee showing that she retained legal ownership of the check and its proceeds, coupled with the indorsement in blank of Sarah Alkoff importing ownership in her, put the bank on inquiry. Inquiry would have disclosed the irregular transaction and would have shown the theft of the check. Failure to make this inquiry establishes, in a legal and commercial sense, bad faith on the part of the bank and makes it liable to plaintiff for the diversion and loss of the check and its proceeds. . . ."\textsuperscript{44}

As recently as 1952, the same approach appears in a lower court action\textsuperscript{45} involving a stolen check which was cashed by the defendant who was in the check cashing business. In denying the defendant's claim that he was a holder in due course, the court held:

"The defendant offered no proof whatsoever of the identity of the person from whom he acquired the check, nor of any inquiry by him to ascertain the right of that person to negotiate the instrument. It would be reasonable to expect that one in the check cashing business, subject to license by the Banking Department of the State, would obtain the endorsement and some identification of the person presenting the check to be cashed. One would reasonably expect that this measure of precaution would be taken in the usual course of the business of cashing checks. The defendant did not attempt to explain why this was not done in this instance."

\textsuperscript{41} Id. at 741, 181 N.Y. Supp. at 914.
\textsuperscript{42} Id. at 745, 181 N.Y. Supp. at 915.
\textsuperscript{43} 277 N.Y. 223, 14 N.E.2d 46 (1938).
\textsuperscript{44} Id. at 233, 14 N.E.2d at 50.
The court is constrained to find on the record of this case that the defendant is chargeable with gross negligence or wilful ignorance either of which is construed to be lack of good faith. . . . 46

VI. COMMERCIAL BAD FAITH PROBLEM

A consideration of the reasoning in the above representative opinions leads to the conclusion that the “commercial bad faith” concept found in New York law was originally invented by jurists as a means of enabling them, at least indirectly, to properly apply the law merchant course of trade-taking requirement in the face of the actual-knowledge notice standard. The grave danger of this indirect approach lies in the fact that it can easily be misinterpreted as establishing an objective bad faith standard47 or a bad faith constructive notice concept48 applicable to all commercial due course holding determinations.

Despite this danger, unless course of trade taking can be recognized as a requirement in itself for due course holding under the N.I.L., it would seem that this commercial good faith concept is the only solution to the problem of how to deny the protection of the actual knowledge notice standard to those who are primarily engaged in the business of discounting commercial paper.

VII. PROPOSED SOLUTION

The foregoing analysis has demonstrated the tremendous difficulties which have been encountered in judicial attempts to correctly state the course of business taking requirement of the law merchant. The failure of the N.I.L. to expressly state or define such requirement is therefore quite understandable, particularly in view of the fact that if it is correctly interpreted, the present statute provides a more than adequate solution to the problem without the necessity of further clarification.

It is submitted that section 52 of the N.I.L. may be interpreted as being no more than a restatement of the accepted transfer procedure of the commercial paper discount trade. The specific requirements that the instrument be regular and complete and that it be taken by negotiation prior to maturity for value in good faith and without notice, merely establish in themselves the general requirement that the instrument be taken in the course of such trade. Had section 52 stated that a course of business taking was a further requirement for due course holding it could only have been interpreted as codifying the erroneous common law cases which

46. Id. at 215, 115 N.Y.S.2d at 326.
47. See State of the Netherlands v. Federal Reserve Bank, 99 F. Supp. 655 (S.D.N.Y. 1951), 201 F.2d 455 (2d Cir. 1953). (On appeal the case was reversed in part. However, the lower court discussion of good faith concepts was undisturbed.)
48. See Kelso & Co. v. Ellis, 224 N.Y. 528, 121 N.E. 364 (1918).
required that the instrument be taken in the course of the purchaser's particular business.\textsuperscript{49}

Since under this interpretation a course of discount trade taking requirement is the very essence of section 52 of the N.L.I., it necessarily follows that parties who are primarily engaged in the business of discounting commercial paper should be required to conform to the reasonable trade practices of the banking trade as a prerequisite for due course holding. Parties who are not so primarily engaged need only establish their conformity to the transfer procedure of the discount trade as codified in section 52 of the N.I.L. As established in section 56 of the N.I.L., the course of business aspect of any transaction related to the discount transaction is properly admissible as evidence only on the question of the bad faith of the purchaser and is never conclusive in itself on such question since bad faith is determined by a subjective standard.

\textbf{A. Stare Decisis Objection}

This novel interpretation will of course meet with immediate and vigorous objection from banking interests as a whole. A requirement that banking purchases of commercial paper conform only to an actual knowledge notice standard, or at most to a standard as vague in concept as "commercial bad faith", is much less onerous than a requirement that such purchases comply with the reasonable trade practices and usual customs of the banking industry. This is especially true in light of the fact that many such practices and customs are dictated by state banking departments and state and national bank legislation.

It is quite likely, therefore, that stare decisis will be the main objection advanced by the banking interests to this proposed solution. It will no doubt be argued that any such interpretation of section 52 is an absurdity, if only because it has never been consciously advanced nor expressly recognized in any recorded due course holding determination. Good faith has always been the controlling issue when the due course holding status of banks has been questioned, and to disturb such binding precedent by a new and untried interpretation would in effect create even more uncertainty than that which possibly exists under the present approach.

\textbf{B. Objection Refuted}

The simple answer to this objection is that stare decisis gives support rather than opposition to the proposed interpretation. This support can be found in a large body of precedent that has developed in connection

\textsuperscript{49} Wisconsin is the one state which expressly required a course of business taking for due course holding. Wis. St. § 116, 57 (1923). It appears that it has only been used, however, in connection with bank holders. See Union State Bank v. Savord, 186 Wis. 365, 202 N.W. 688 (1925).
with the application of the doctrine of *Price v. Neal.* Under this doctrine, if a drawee accepts or pays a bill, he is estopped from denying the genuineness of the drawer's signature. This estoppel is not invoked when the presenting holder knows of the forgery and conceals such fact from the drawee. Since a holder in due course does not have this knowledge, the doctrine permits him to retain the money mistakenly paid by the acceptor.

It is interesting to note that there are literally hundreds of opinions in all jurisdictions both before and after the N.I.L. which rule that when the presenting holder is a bank or financial institution, its negligence in failing to make proper inquiry at the time it purchased the forged paper will permit the acceptor to recover the money paid to such holder. In effect, it has been uniformly held in litigation involving the doctrine of *Price v. Neal* that a bank or financial institution cannot establish itself as a holder in due course and thus gain the protection of the rule's estoppel unless it takes the instrument in conformity with ordinary banking practice.

A concise statement of such reasoning is contained in the case of *Bank of Williamson v. McDowell County Bank.* In discussing the application of the *Price v. Neal* doctrine when the presenting holder was a bank, the court stated:

51. Professor Aigler concedes that "a successful defendant holder in this situation must be one with the negative virtue of not being a participator or a bad faith taker." Aigler, *Price v. Neal Under the N.I.L.*, 25 Mich. L. Rev. 743, 746 (1930).
53. Research reveals one case, Pennington County Bank v. First State Bank, 110 Minn. 263, 265, 125, N.W. 119, 121 (1910) wherein it could be argued that the actual knowledge notice standard influenced a contrary decision. It is evident however from the opinion that the majority of the bench was confused by the seeming conflict between the due course adjudications and the recovery decisions. The court stated, "The one circumstance here which can be claimed to have put the defendant upon inquiry was that Davis was an entire stranger. Such fact had been held not enough to show bad faith (citing Murray v. Lardner). Notwithstanding those authorities, I am personally of the opinion that, before a bank takes negotiable paper from a stranger and puts it off, either as owner or for collection, it is necessary for it, in order that it be considered a bona fide holder, to satisfy itself by reasonable inquiry as to the validity of the paper and that whether this defendant did take such reasonable precaution was a question for the jury. But a majority of the court held that the evidence was insufficient to justify a finding that the defendant was not a bona fide holder of the check and therefore the learned trial judge properly instructed a verdict for the defendant."
54. 66 W. Va. 545, 66 S.E. 761 (1909).
"The general practice of bankers to make reasonable inquiry as to the identity of the payee in purchasing commercial paper is matter of common knowledge and judicial cognizance. Therefore the indorsement of a purchasing bank, not qualified or limited in any respect, amounts to a representation to the drawee that this precaution has been taken. Upon that indorsement, the drawee has the right to rely to that extent, and, if identification has not been required, the indorsement amounts to an imposition by the purchasing bank upon the drawee . . . ."55

In Louisa National Bank v. Kentucky National Bank,56 the court permitted the acceptor to recover the mistaken payment from the holder bank and made the following typical observation:

"The appellant, when the check was presented to it by Benfield, failed to make any inquiry of or about him, and did not cause or have him to be identified. Its act in so paying to him the check is a degree of negligence on its part equivalent to positive negligence. It indorsed the check, and, while such indorsement may not be regarded within the meaning of the Negotiable Instrument Law as amounting to a warranty to appellant of that which it indorsed, it at least substantially served as a representation to it that it had exercised ordinary care and had complied with the rules and customs of prudent banking. . . ."57

While these cases are unique since they deal with forgery, which is usually a real defense even against holders in due course and while they may be distinguished in that their main issue did not directly involve due course holding determination, the fact remains that they require an investigatory duty of those primarily in the discount business prior to the purchase of commercial paper. This duty is recognized as the basis for the negligence which prevents the estoppel ordinarily applicable under the doctrine. It is therefore submitted that the proposed interpretation of section 52 has ample support in precedent. While novel in presentation, the interpretation is actually no more than a recognition of an approach which has existed rather obscurely in law for many years.

VIII. CONCLUSION

It may therefore be concluded that "commercial bad faith" has no place in negotiable instruments law. The sole test under the N.I.L. to determine due course holding status is whether the instrument is taken in the course of the discount trade, in good faith and without actual knowledge of facts which in themselves establish a legal defense or title defect in the instrument.

55. Id. at 550, 66 S.E. at 763.
56. 239 Ky. 302, 39 S.W.2d 497 (1931).
57. Id. at 311, 39 S.W.2d at 501.