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Dean Jellison

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only person to twice be elected president of the Montana State University Alumni Association. He is married to the former Mildred Lore of Billings, also an MSU graduate.

COLLATERAL DEFENSES TO NEGOTIABLE INSTRUMENTS

This paper has been prepared in an effort to clarify the law relating to the right to set off¹ a claim arising out of a collateral transaction in an action on a negotiable instrument by one who is not a holder in due course.

An examination of this problem involves an analysis of some fundamental propositions applicable to the *Uniform Negotiable Instruments Law*. This act shall hereafter be referred to as the *N I L*.

As to the construction of the *N I L*, Brannan² quotes Mr. Eaton³ as expressing the weight of authority and the better view. The following extract is taken from Mr. Eaton's article:

“. . . It ought to be interpreted in such a way as to give effect to the beneficent design of the Legislature in passing an Act for the promotion of harmony upon an important branch of the law. Simplicity and clearness are ends especially to be sought. The language of the act is to be construed with reference to the object to be attained. Its words are to be given their natural and common meaning, and the prevailing principles of statutory interpretation are to be employed. Care should be taken to adhere as closely as possible to the obvious meaning of the act, without resort to that which had theretofore been the law of any particular commonwealth, unless necessary to dissolve obscurity or doubt, especially in instances where there was a difference in the law of the different states.”⁴

¹In *Teeters v. City Nat. Bank of Auburn* (1938) 214 Ind. 498, 14 N.E. (2d) 1004, 118 A.L.R. 383, set-off was defined as “the right which exists between two persons, each of whom under an independent contract, express or implied, owes an ascertained amount to the other, to set off their mutual debts by way or deduction so that, in an action brought for the larger debt, the residue only after such deduction may be recovered.” It must be remembered that the right of set-off is statutory, and that the statutes and the constructions thereof vary as to the time when the claims must have matured and as to the parties against whom the set-off is available. See 2 WILLISTON ON CONTRACTS (Rev. ed. 1936) § 432, p. 1245.

²BEUTEL, BRANNAN'S NEGOTIABLE INSTRUMENTS LAW (6th ed. 1938) p. 100.

³President of the National Conference of Commissioners on Uniform State Laws during the early years of its history.

⁴Eaton, *Decisions on Negotiable Instruments*, 14 HARV. L. REV. 88, 93 (1913).

An examination of the *N I L* as an entity will indicate that *Article IV*, entitled "Rights of the Holder," is the Article which contains the provisions pertinent to this discussion. Section 52 establishes the qualifications for a holder in due course. Section 57 defines the rights of a holder in due course. Section 58, entitled "When Subject to Original Defenses," defines the rights of one not a holder in due course, as follows:

"In the hands of any holder other than a holder in due course, a negotiable instrument is subject to the same defenses as if it were non-negotiable . . ."

The language of these sections, taken literally, makes it very clear that unless a holder meets the requirements set up for a holder in due course, Section 58 will define his rights. In other words, a holder is either black or he is white, and there is no gray.

It should also be noted that this Section does not provide that the instrument loses its negotiable character if it is not in the hands of a holder in due course. The instrument remains negotiable, but this holder gets no benefit from that fact. As we shall see later, there is some confusion on this point.

One very fundamental proposition cannot be overlooked in construing Section 58. The overwhelming weight of authority supports the proposition that the *N I L* is not applicable to non-negotiable instruments.⁵ If this principle is kept in mind, an examination of Section 58 can lead to only one conclusion; that if an instrument is to be subject to the same defenses *as if it were non-negotiable*, then the *N I L* will not govern those defenses.

If the *N I L* has an application to non-negotiable instruments, then the law pertaining to those instruments must be the same law that existed in each jurisdiction prior to the enactment of the *N I L*. From this, it is a necessary conclusion that the law of each jurisdiction will determine the 'defenses' to which a holder not in due course of a negotiable instrument is subject.

That this conclusion was the one intended by the drafters of the *N I L* is indicated by the *Commissioner's Note* to Section 58:

"(a) It is not deemed expedient to make provisions as to what equities the transferee will be subject to; for the matter may be affected by the statutes relating to set-off and counter-claim. On the question wheth-

⁵The remaining portion of this section is not pertinent here. It provides: "But a holder who derives his title through a holder in due course, and who is not himself a party to any fraud or illegality affecting the instrument, has all the rights of such former holder in respect to all parties prior to the latter."

⁵ UNIFORM LAWS ANNOTATED (1943) § 190, p. 700.

er only such equities may be asserted as attach to the bill or whether equities arising out of collateral matters may also be asserted, the decisions are conflicting. In an act designed to be uniform in the various states, no more can be done than fix the rights of holders in due course.'"

The conclusion from this must be that the rights of a holder not in due course are to be determined by treating the instrument as though it were non-negotiable, thus subjecting it to the law applicable to non-negotiable instruments in the particular jurisdiction.

An example of the effect of a proper application of Section 58 can be found in *Litcher v. North City Trust Co.*⁸ Prior to the adoption of the *N I L*, Pennsylvania law apparently had allowed a set-off to be interposed against a holder of a non-negotiable instrument, but had not allowed a set-off to be interposed against a holder of a negotiable instrument, regardless of whether or not he was a holder in due course. In this case, where a set-off was sought to be set up against a holder not in due course of a negotiable instrument, the Court considered Section 58, and decided that this section made it imperative to allow a set-off against this holder, since this was the rule applicable to non-negotiable instruments, and the section specifically provided that the rule applicable to non-negotiable instruments was to be applied to one who was not a holder in due course.

The result of the *Litcher* case is in accord with the intent of the section, for it appears that this section was designed to eliminate any confusion which might arise from the fact that an instrument might be given special treatment if it was negotiable, even though it were not in the hands of a holder in due course.

But, an examination of the cases that have construed Section 58 indicates that a considerable confusion exists as to its true import, due at least in part to a tendency to extract statements from context.

Even so eminent an authority as Professor Chafee apparently has overlooked the full import of the *N I L* and, especially, of Section 58. Writing on the rights of the holder of overdue paper,⁹ he suggests that this holder is entitled to more protection than he presently receives. While Chafee only considers the *N I L* in passing, his language is misleading, and, perhaps, even

⁸BEUTEL, *op. cit.*, p. 33.

⁹(1933) 111 Pa. Super. 1, 169 A. 409.

¹⁰Chafee, *Rights in Overdue Paper*, 31 HARV. L. REV. 1104, (1917).

incorrect. After saying that the Act apparently leaves the problem untouched, which is, in a limited sense, correct, he says:

“ . . . By Section 57 a holder in due course holds the instrument ‘free from any defect of title of prior parties.’ This may imply that a purchaser after maturity, not being a holder in due course, is subject to such defects, but such an implication is not necessary. The law ought not to be crystalized by vague inferences, especially as the section which provides for persons who are not holders in due course subjects them only to ‘defenses’ and does not touch claims to ownership.’”¹⁰

Since, by Section 52, a transferee after maturity can not be a holder in due course, there is more than a ‘vague inference’ expressed in Section 58, which provides that in the hands of any holder other than a holder in due course, the instrument shall be subject to the same defenses as if it were non-negotiable. It is true, as has been suggested, that in some jurisdictions the law prior to the *N I L* gave a preferred position to a negotiable note even in the hands of a holder not in due course. But, the clear language of the *N I L*, as was shown in the *Litcher* case, has changed this rule, thus removing some of the uncertainty that existed under the prior rule.

The Professor may present a valid argument for changing Section 52 so that a transferee of an overdue instrument may be a holder in due course, but as the law now stand the transferee should be in the same position as the transferee of a non-negotiable note under similar circumstances.

The leading American case on the question of whether a set-off would be available against a negotiable instrument in the hands of a holder not in due course would seem to be *Chandler v. Drew*.¹¹ This case, decided long before the *N I L* was even envisioned, established the proposition that, while a holder not in due course took subject to equities and defenses, a set-off was not a defense, strictly speaking, and would not be allowed as against a holder not in due course.

This rule seems to have been uniformly followed up to the time of the *N I L*, although it was modified to some degree by statutes.

There have been many cases decided on the question of set-off since the adoption of the *N I L* and it would be beyond the scope of this paper to analyze all of them. It should be sufficient to discuss a few of them in order to demonstrate some of the more

¹⁰*id.*, p. 1140.

¹¹(1834) 6 N.H. 469, 26 Am. Dec. 704.

typical approaches taken by the courts and the results reached by these approaches.

An exhaustive opinion on this question appears in *Stegal v. Union Bank & Federal Trust Co.*¹³ The facts in that case, insofar as they are pertinent here, are very similar to those in the *Litcher* case.¹⁴ The defendant, in an action on a negotiable instrument by one who was not a holder in due course, sought to set-off certain deposits which he had in the payee bank at the time it became insolvent. The Virginia statute allowed a set-off against a non-negotiable note, but in spite of this fact, the Court held that the set-off would not be allowed here.

Although the reasoning of the Court is not entirely clear, it would appear to be essentially as follows: By the law merchant, a set-off is not a defense, and the *N I L* is a codification of the law merchant. Therefore, a set-off is not a defense as the term is used in Section 58 of the *N I L*. If the term 'defenses' were construed to include set-off, this would change the law in those jurisdictions which, prior to the *N I L*, had not allowed a set-off as a defense in a suit on a negotiable instrument that was not in the hands of a holder in due course. The final conclusion is that set-off is not included in 'defenses' as that term is used in Section 58, but that this does not operate to repeal any statutes accord with the intent and logical construction of the *N I L*.

Several criticisms may be made of this approach. In the first place, it could be suggested that the *N I L* is not, strictly speaking, a codification of the law merchant. It is true that the Act was based on the law merchant to a great degree, but this does not mean that it did not make substantial changes in the law merchant. A much more accurate statement is that the *N I L* is a codification of the prior law relating to negotiable instruments.¹⁴ In the next place, it will be noted that there is an assumption in the reasoning of the case that the term 'defenses' was to be construed so that the same defenses would be allowed in every jurisdiction enacting the *N I L*. If the *N I L* is not applicable to non-negotiable instruments, and Section 58 provides that an instrument is to be treated "as if it were non-negotiable," then it would seem clear that the 'defenses' will vary in each jurisdiction as the law applicable to non-negotiable instruments varies.

For these reasons, it is submitted that the *Stegal* case is wrong, and that the result reached by the *Litcher* case is more in accord with the intent and logical construction of the *N I L*.

¹³(1934) 163 Va. 417, 176 S.E. 438, 95 A.L.R. 582.

¹⁴*supra*, note 9.

¹⁴*supra*, note 6, p. 690 cites cases.

The statement found in *Worden v. Gillett*¹⁵ that Section 58 "does not enlarge the scope of the statute of set-off" must not be taken at its face value. As has been suggested, in some jurisdictions Section 58 does enlarge the scope of the statute of set-off, for it makes a set-off available in a situation where it had not been available before. Where, as in Florida, the statutes of set-off apparently did not allow a set-off against a non-negotiable instrument in the hands of an assignee or transferee, the statement is correct, but it would not be correct in all jurisdictions.

An example of the result to be reached by a blind following of a statement of this kind is the dictum in the South Dakota case of *Harris v. Esterbrook*.¹⁶ There, a transferee without indorsement was suing on a negotiable promissory note. The maker sought to set-off deposits in the payee bank, which had become insolvent. The Court finally decided that if a right of set-off had existed it had been lost by a subsequent withdrawal of the deposits, but, in reaching its conclusion, the Court discussed the matter of set-off in this situation.

The Court admitted that the holder was not a holder in due course and that he took subject to equities and defenses. It cited a statute which would apparently allow a set-off against a non-negotiable instrument in the hands of an assignee. However, citing the early case of *Chandler v. Drew*,¹⁷ the Court said that a set-off was not a defense within the meaning of the term 'equities and defenses.' The Court quoted from *Worden v. Gillett*¹⁸ and, referring to Section 58, said that the statutes were the same.

As has been suggested, the statement from *Worden v. Gillett* was correct in Florida, but it was not correct in South Dakota. The Court should have applied the rule expressed in the *Litcher* case,¹⁹ which changes the older rule of *Chandler v. Drew*.²⁰

Because the language used by the courts is so ambiguous and misleading, it is doubtful that any rule can be said to express a majority view. The situation is further complicated by the fact that a court adopting the construction suggested by this paper may just assume that a holder not in due course takes subject to a set-off without any discussion. For instance, the Washington Court has apparently assumed that a set-off is available in that jurisdiction without even mentioning Section 58.²¹

¹⁵ (1923) 275 F. 654, 656.

¹⁶ (1929) 55 S.D. 543, 226 N.W. 753, 70 A.L.R. 241.

¹⁷ *supra*, note 11.

¹⁸ *supra*, note 15.

¹⁹ *supra*, note 8.

²⁰ *supra*, note 11.

²¹ *Hanson v. Roesch* (1918) 104 Wash. 257, 176 P. 349.

It is clear that the result reached in the *Stegal* case and in *Harris v. Esterbrook* is contradictory to the language of the Section, if the Section is construed according to the ordinary meaning of its words, and that the true import of Section 58 is that a negotiable note in the hands of a holder not in due course shall be subject to the same defenses as is a non-negotiable note in the particular jurisdiction. Thus, whether a set-off is allowed will depend on the law of the jurisdiction,²³ and the matter is not controlled by the *N I L* except as suggested above.

The precise problem of whether a set-off is to be allowed against a negotiable instrument not in the hands of a holder in due course has never come before the Montana Court, but it is likely that the Court will allow the set-off when the question does come before it.

In order to understand the Montana position, it might be well to consider the status of the substantive law of set-off before examining the effect of the *N I L*.

There is a definite inconsistency in the language used in the Montana statutes. Section 58-303²⁴ provides that the assignee of a non-negotiable instrument shall be "subject to all equities and defenses existing in favor of the maker at the time of the indorsement." Section 93-2802²⁵ provides that an action by an assignee of a thing in action shall be :

" . . . without prejudice to any set-off or other defense existing at the time of, or before, notice of the assignment, but this section does not apply to a negotiable promissory note or bill of exchange, transferred in good faith and upon good consideration before maturity."²⁵

²³Nearly all states allow a set-off against a non-negotiable contract that has been assigned, but since the matter is statutory, the statutes and the constructions thereof vary greatly from state to state. The principal variation among the states is on the time element, that is, when the claims must have matured in relation to each other and to the assignment. In 2 WILLISTON ON CONTRACTS (Rev. ed. 1936) § 432, p. 1246, it is said that "the only questions should be, (1) did the claim against the assignor exist whether matured or not, before notice of the assignment, and (2) were both claims matured when the set-off was asserted." This is the rule adopted by the *Restatement*. See *RESTATEMENT, CONTRACTS*, § 167. There is a definite conflict among the states as to whether the claim sought to be used as a set-off must have existed before the transfer, or whether it need only have existed before notice of the transfer, but the better view would seem to be the one adopted by Professor Williston and by the *Restatement*. For a full discussion of the merits of this view, see Williston, *supra*, § 432.

²⁴R.C.M. 1947.

²⁵*Id.*

²⁶The latter portion of this section states an exception to the operation of

Section 93-2802 immediately follows the section²⁶ which provides for suits by the real party in interest, and was enacted at the same time as that section. In view of this, it is not surprising to find the Court holding that Section 93-2802 is merely a procedural statute, and that Section 58-303 governs the substantive law applicable to non-negotiable instruments. This is the position of the Court in *Stadler v. First Nat. Bank*,²⁷ where the Court ruled that a set-off, to be allowed, must have existed as a present right at the time of the assignment. The Court relied in part on Section 93-3409 which contains language that supports the idea that the nature of a set-off is such that the demands must have existed at the same time. In reaching its conclusion, the Court cited authority from other jurisdictions to the effect that, while notice is required before other defenses will be cut off, the set-off must have existed as a present right at the time of the assignment.

In the latter case of *Cornish v. Woolverton*,²⁸ the Court apparently was misled by this reference to the law of other jurisdictions, for it cited the *Stadler* case as laying down the rule that notice was required to cut off the possibility of a defense arising out of subsequent dealings between the debtor and the assignor. In the *Cornish* case, the Court refused to allow a defense of payment, because notice of the assignment had been given before the payment was made.

Following the language of the *Cornish* case, the Court held,

the rule laid out in the section. The precise meaning of the term "transferred" as it is used here is not clear. It could be argued that the language used here was merely intended to exclude holders in due course from the rule. If this idea were adopted, the "transfer" would have to be by indorsement. However, it is equally arguable that no indorsement is needed to "transfer" an instrument and that a "transferee" without indorsement of a negotiable instrument could come within this exception, even though he would not be a holder in due course. This problem was discussed but not decided in *Harris v. Esterbrook*, *supra*, note 16. No direct authority on this point has been found.

While it is impossible to give a decisive answer to this problem, it should be noted that if Section 58 is given the effect favored by this comment, the problem will disappear. If the exception merely applies to holders in due course, there is no problem, for they take free of equities and defenses under the N I L. If the exception is construed to include a transferee without indorsement, then Section 58 would operate to repeal it by implication for a transferee of a negotiable instrument without indorsement is not a holder in due course, and he would take subject to the same defenses as if the instrument were non-negotiable. The law applicable to non-negotiable instruments is set out in the first portion of the section, so the latter portion could have no effect.

²⁶R.C.M. 1947 § 93-2801.

²⁷(1899) 22 Mont. 190, 56 P. 111.

²⁸(1905) 32 Mont. 456, 81 P. 4.

in *Erlandson v. Erskine*,²⁹ that payment made after the assignment, but before notice thereof, was a good defense. In holding this way, the Court is requiring notice before some defenses are cut off. Since the better view would seem to be that notice should be required before any defense is cut off, including set-off,³⁰ it is submitted that the Court should modify the rule of the *Stadler* case, and allow a set-off if it existed before notice of the assignment.³¹

Except as to the question of the time at which the claim must exist, it is clear that a set-off is available against the holder of a non-negotiable note in Montana.

There remains the question of whether or not a holder of a negotiable instrument who is not a holder in due course will be subject to a set-off. The fact that the *N I L* deals only with negotiable instruments has been recognized and the Court has said:

"The Negotiable Instruments Act deals with negotiable instruments only so long as they are in the hands of holders in due course. If in other hands, they are subject to the same defenses as if non-negotiable."³²

This language still leaves room for a decision that a set-off is not a defense as that term is used here, but it should be pointed out that Montana has never ruled that a set-off is not a defense, nor has it ruled that a set-off is not available as against a holder not in due course of a negotiable instrument. Thus, some of the barriers that have misled courts in other jurisdictions are not before the Montana Court.

It should also be noted that Section 93-2802, which has been given at least some substantive effect, speaks of "set-off or other defense," which could be construed as legislative recognition of the fact that a set-off is a defense.

There is also the fact that the Court has spoken of negotiable instruments as losing their "negotiable character" when they are transferred to holders not in due course.³³ If this language were followed literally, it would be at least some authority for holding that an instrument not in the hands of a holder in due course

²⁹(1926) 76 Mont. 537, 248 P. 209.

³⁰*supra*, note 22.

³¹Under statutes similar to those of Montana, California has held that an assignee of a chose in action takes it subject to any set-off or other defense existing at or before notice to the obligor of the assignment. See *McCabe v. Grey* (1862) 20 Cal. 509; *McKenney v. Ellsworth* (1913) 165 Cal. 326, 132 P. 75.

³²*Anderson v. Border* (1925) 75 Mont. 516, 525, 244 P. 494.

³³*First Nat. Bank v. Grow* (1920) 57 Mont. 376, 188 P. 907.

should be treated as if it were non-negotiable. It must be remembered, however, that this language is not technically correct. The instrument is still negotiable, but the holder not in due course is precluded from taking advantage of the negotiability of the instrument.

The conclusion to be drawn from the foregoing material must be that the correct rule under the *NIL* and the Montana statutes is that a holder not in due course of a negotiable instrument is subject to a set-off arising from a collateral transaction, and that this is likely to be the rule that Montana will adopt.

DEAN JELLISON.

WHAT IS THE NATURE OF THE MONTANA CONSTITUTION?

A familiar constitutional doctrine declares that a state constitution is not a grant of, but a limitation upon, power. Inherent in this statement is the contrast that authority for Federal activity must exist within the scope of delegated power—either enumerated or implied in the Federal Constitution—whereas authority for state activity exists unless the activity be forbidden, expressly or impliedly, by the state constitution, or the superior Federal Constitution. State authority otherwise is plenary.

As a working principle the majority of states have found it unnecessary to qualify the doctrine further than to assert that the constitution is an instrument of limitation upon *legislative* authority.¹ Where more fully refined the doctrine has been taken to mean either:

- (1) the constitution is a limitation upon legislative power but a delegation of judicial and executive power, or
- (2) the constitution is a limitation upon each of the departments of government.²

Relying on three cases the editors of *CORPUS JURIS SECUNDUM* present Montana as being the only state holding the latter view.³ The purpose of this comment is to question our unique stand and by consideration of the Governor's office under the Constitution suggest what may be a less defeasible position.

From 1895 to 1916 the Montana Supreme Court had need in

¹C.J.S. *Constitutional Law*, § 70, p. 134, gives Connecticut as holding that their legislature acts under delegated power.

²C.J.S. *Constitutional Law*, § 70, footnote 88.

³Mont.—State ex rel. DuFresne v. Leslie, 50 P.2d 959, 100 Mont. 449, 101 A.L.R. 1329—Great Northern Utilities Co. v. Public Service Commission, 293 P. 294, 88 Mont. 180—Hilger v. Moore, 182 P. 477, 56 Mont. 146.