Real and Personal Defenses in Actions on Negotiable Paper

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In the Index and Summary to his collection of Cases on Bills and Notes, Professor Ames classified defenses to actions on negotiable instruments as real and personal. He described a real defense as one "founded upon a right good against the world." It attaches "to the res, i.e., the instrument itself regardless of the merits or demerits of the plaintiff." A personal defense, however, is "founded upon the agreement or conduct of a particular person in regard to the instrument which renders it inequitable for him, though holding the legal title, to enforce it against the defendant."

Real defenses, continues the learned author, are based upon (a) the incapacity of the defendant to make a contract, as in the case of infants and married women at common law; (b) illegality, which by statute renders the contract absolutely void, for example, usury and gambling in many jurisdictions; (c) extinguishment, by cancellation and alteration.

Later, he refers to another species of real defense which is based on impeaching the legal existence of the instrument as defendant's contract. Examples are found in cases where promissory notes, negotiable in form, have been filled out over defendant's signature, which had been written on a piece of blank paper, without any intention of signing a contract.

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1. Ames, Bills and Notes, 811. These defenses are called "Absolute and Equities" by Bigelow, (Bills and Notes, 2d ed., 200) and "Legal and Equitable" in 8 Corpus Juris, 716.
2. Ibid. 865.
3. Nance v. Leary, 5 Ala. 370 (1843). Defendant wrote his name on a sheet of paper, for the purpose of having a bond written above it. The purpose was abandoned, but, without defendant's knowledge, the paper was taken; a negotiable promissory note was written over the signature and passed to plaintiff as a holder in due course. Caulkins v. Whisler, 29 Ia. 495 (1870). Defendant wrote his name on a blank paper to be filed as a specimen of his signature. "In the case before us," said the court, "the instrument was falsely and fraudulently made over the genuine signature of the defendant, which was obtained not for the purpose of binding him by any contract. * * * The note is a forgery and void."
Differing somewhat from those just mentioned are other cases where defendant knew that he was signing a legal document of some kind, but, without fault on his part, was tricked into believing that he was not incurring the obligation of a party to negotiable paper.4

The legal problems arising in the cases mentioned and in others to be considered later in this article, are most easily solved by applying the principles upon which real and personal defenses rest and the principles underlying the doctrine of estoppel. It is true that courts have disagreed in the application of these principles and the legislature, as we shall see, has been called upon to terminate the controversy by statutory fiat.

In the absence of specific legislation, when a party is sued upon paper of the sort described above, he "challenges the existence of the paper itself. * * * It is always competent for him to show that it is not his instrument or obligation. The principle is the same as where instruments are made by persons having no capacity to make binding contracts, as by infants, married women or insane persons; or where they are void for other cause, as for usury; or where they are executed by an agent, but without authority to bind his supposed principal. In these and all like cases, no additional validity is given to the instruments by putting them in the form of negotiable paper."5

Whether, in such cases, the defendant is in fault in delivering an instrument which turns out to be negotiable paper, is usually one of fact.6 If the jury finds that he was without fault; that he was not guilty of "laches or carelessness? in being made the victim of the trick practiced upon him, then the conclusion of law follows that he did not make the negotiable paper in suit. He has established a defense to the res in whosesoever hands it may be.

Another situation in which a real defense is available is that where the defendant has signed an incomplete note or bill, but has never delivered it, and without authority from him it is taken, completed and negotiated.9 The instrument has never been executed by the defendant. As against him it has no existence: nor is any legal fault

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4 Foster v. McKinnon, L. R. 4 C. P. 704 (1869); Taylor v. Atchison, 54 Ill. 196 (1870); Barry v. Mut. L. Ins. Co., 211 Mass. 306 (1912); Gibbs v. Linabury, 22 Mich. 479 (1871); Whitney v. Snyder, 2 Lans. (N. Y.) 477 (1870); De Camp v. Hanna, 29 Oh. St. 467 (1876); Walker v. Ebett, 29 Wis. 194 (1871).
5 Walker v. Ebett, supra, note 4.
6 Chapman v. Rose, 56 N. Y. 137 (1874).
7 Nat. Exchange Bank v. Veneman, 43 Hun (N. Y.) 241, 244 (1887); De Camp v. Hanna, 29 Oh. St. 467 (1876).
8 Lewis v. Clay, 67 L. J. Q. B. 224 (1898), and authorities cited.
imputable to him in the transaction. He did not act at his peril in signing this inchoate instrument. He was under no legal duty to anticipate and guard against criminal use of this incomplete writing. The situation is widely different from that where the defendant intrusts such incomplete document to one for the purpose of having it completed for use as a negotiable instrument. Abuse of authority thus conferred would avail the defendant as a personal, not as a real defense. The distinction lies in the intention accompanying the act of the defendant. In the former case he signs with no intention of then emitting the instrument as negotiable paper. In the latter case he does so intend.

Suppose the defendant, after signing a complete bill or note, retains it in his possession, with no present intention of issuing it, but it is stolen by the payee and negotiated to a holder in due course. Has the defendant a real defense against the holder?

At the time Professor Ames compiled his collection of cases, the decisions were at variance. Some courts held that the paper had no existence and applied the principles which governed the cases of inchoate instruments. Others insisted either that the case was one of defect of title as distinguished from non-existence, or that the defendant was estopped from showing the non-existence of the instrument because of the inherent danger to holders in due course from signing a complete bill or note.

The controversy was settled in England by the Bills of Exchange Act, and in this country by the Negotiable Instruments Law in
favor of the holder in due course. The draftsman of the American Statute states that the provision was inserted to facilitate the circulation of commercial paper, but that "it does not apply in the case of an incomplete instrument completed and negotiated without authority." Such is the construction put upon these statutes in England, in Canada and in this country.

In other words, the legislation estops the defendant from establishing a real defense when he has signed a complete negotiable instrument, but not when the instrument is incomplete. In the former case, he is bound at his peril to keep the instrument from getting into the hands of a holder in due course. In the latter case, he is not subject to that duty. And yet, the holder in due course is equally liable to imposition in the one case as in the other. In both cases, the instrument reaches him in the form of a completed bill or note. Logic seems to be on the side of Mr. Ewart's view that the holder should be able to estop the defendant from his real defense in both cases, or in neither. But English law is far from being a system of logic, and the compromise between the claims of the innocently deluded holder and the innocently despoiled defendant, which is embodied in the Negotiable Instruments Law, seems to satisfy both the creditor and debtor classes of the commercial community.

Mr. Ewart seeks support for his views of estoppel in the doctrine of market overt. But the analogy between the position of a holder in due course of negotiable paper and a purchaser of chattels in market overt appears to be accidental. The market overt doctrine was not introduced into English law for the purpose of giving to chattels the liquid quality of circulating medium, and it was subject to many limitations which have never attached to the rights of a holder.

21The English statute, (sec. 21), uses "conclusively presumed" instead of "estopped", because the latter term was not known to Scotch law, and our statute copies the language of the English act.
22Ewart on Estoppel, 436-467.
23Ewart on Estoppel, 404, quoting from Crane v. London Dock Co., 5 B. & S. 313, 318 (1864), that the law as to market overt "was established for the protection of buyers, that, if a man did not pursue his goods to market where such goods were openly sold, he ought not to interfere with the right of the honest and bona fide purchaser."
24Burdick's Law of Sales (3d ed.), 197. The suggestion of Mr. Pease (8 Col. L. Rev. 375), that the law merchant treated chattels sold at public markets and fairs, as "negotiable" is not sustained by the authorities.
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...in due course. Moreover, while modern English law seeks to facilitate the circulation of negotiable paper, it has no encouragement for market overt practices, and they have no legal status in Scotland, or Canada or this country.

Whether usury is a real defense under the Negotiable Instruments Law is a question which has received directly opposite answers from our courts. There can be no doubt, that, before the statute, it was a defense even against a holder in due course, in a jurisdiction where usury rendered the instrument "void." If, however, the usurious transaction was simply declared illegal, the defense was personal, not real. There is nothing in the Negotiable Instruments Law which expressly changes the rule. It declares that "a holder in due course holds the instrument free from any defect of title of prior parties and free from defenses available to prior parties among themselves, and may enforce payment of the instrument for the full amount thereof against all parties liable thereon." Is the maker of a negotiable note, which is declared void by statute, a party liable thereon? It would seem that he is not. Certainly a maker legally incapacitated to contract is not. Nor is the maker of a forged note, or of one which has been extinguished by cancellation or alteration. None of these cases involves a defect of title. Each is a case of an apparent though really non-existent obligation. It is submitted that the decisions are sound, which hold that the Negotiable Instruments Law has not changed the rule applicable to usury as a real defense.

The statute in question expressly declares that "absence or failure of consideration is matter of defense as against any person not a holder in due course." Professor Ames limited this personal defense to failure of consideration. A bill or note, in his opinion,

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25The case of Market Overt, 5 Coke, 83 b (1596). "If the sale be in the shop of a goldsmith, either behind a hanging, or behind a cupboard upon which his plate stands, so that one that stood or passed by the shop could not see it, it would not change the property; so if the sale be not in the shop, for that is not a market overt, and none would search there for his goods." See opinion of Blackburn, J., in Crane v. London Dock Co., supra, note 23, and authorities cited by him.
27Lowe v. Waller, 2 Doug. 736 (1781); Bacon v. Lee, 4 Ia. 490 (1851); Kendall v. Robertson, 66 Mass. (12 Cush.) 156 (1853); Chaflin v. Boorum, 122 N. Y. 385 (1890).
30Perry Savings Bank v. Fitzgerald, 167 Ia. 446 (1914); Eskridge v. Thomas, 91 S. E. (W. Va.) 7 (1916).
31N. Y. Statute, sec. 54.
32Ames' Cases, 812, sec. 5.
is "in the nature of a specialty obligatory without consideration," and the decisions, which sanctioned the defense of absence of consideration in certain cases, were deemed by him anomalous. His assertion that "prior to the case of Rann v. Hughes no authority can be found for the view that absence of consideration is a defense to an action upon a bill or note" is quite inaccurate.

The case of Brown v. Marsh, which antedates Rann v. Hughes by more than half a century, expressly decided that a negotiable "note was no more than a simple contract; that though the note itself be evidence of consideration, yet it is not conclusive evidence but turns the proof upon the defendant to show that there was no consideration given for such note; and so he [the maker] can show that it was still but a simple contract, and therefore but *nudum pactum unde non oritur actio*".

It is true that the absence of consideration as a defense to bills and notes was rarely interposed before the nineteenth century. So long as they were used for the purpose of transferring trade debts from one place to another, the question of absence of consideration would not arise, unless it were between the drawer and the payee. In such case, Gilbert lays it down as settled law, that the drawer was "not obliged to pay it to the person in whose behalf the bill was drawn, unless he had paid him a consideration." The definition of a bill given in Comyn's Digest is: "A bill of exchange is when a man takes money in one country or city upon exchange, and draws a bill whereby he directs another person in another country or city to pay so much to A. or order for value received of B. and subscribe it." In modern continental law it still represents a trade transaction; and in some countries "the nature of the value must be expressed" in the bill. In the early English cases, the custom of merchants upon which the plaintiff counted included the payment of money upon the drawing of the bill.

With the development of bills in England into a flexible paper currency following the introduction of accommodation paper,
the question of consideration as between immediate parties, and those in privity with them, came frequently before courts. While there are *dicta* in some cases supporting Professor Ames' thesis, these were expressly repudiated whenever the issue was carefully examined by the judges, and the conclusion was reached that the absence of consideration has always been available as a personal defense to an action on negotiable paper.

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40Bowers v. Hurd, 10 Mass. 427 (1813); Livingston v. Hastie, 2 Caines (N. Y.) 246 (1804).

41Hill v. Buckminster, 22 Mass. (5 Pick.) 391 (1827); Pearson v. Pearson, 7 Johns. (N. Y.) 26 (1810). In Hill v. Buckminster, Parker, J., who wrote the *dictum* in Bowers v. Hurd, said: "A negotiable promissory note given for a debt is with us evidence of payment of the debt, but where there was no previous debt or demand, the note given is *nudum pactum*. In coming to this conclusion we undoubtedly overrule some expressions in the opinion as reported in the case of Bowers v. Hurd, though the case itself was rightly decided upon other principles.

In *re* Kern's Estate, 171 Pa. 55 (1895); authorities cited in 37 Am. L. Reg. 350.