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BILLS AND NOTES - BAD FAITH ON PART OF PLEDGEE TAKING BONDS

BILLS AND NOTES — BAD FAITH ON PART OF PLEDGEE TAKING BONDS — Defendant, a Wisconsin firm, issued certain bearer bonds [1] secured by a mort-

[1] The bonds contained the following provision:
"secured by a deed of trust . . . 'to which deed of trust reference is hereby made with the same effect as though recited at length herein, for the description of the property mortgaged, the nature and extent of the security, the rights of the holders of the bonds, and the terms and conditions upon which the said bonds are issued,

gage held by the *T* corporation, as trustee. A provision in the mortgage defining the duties of the trustee in the disposition of bonds delivered to it was incorporated into the bonds by reference. The trustee being insolvent, plaintiff bank, as pledgee of some of the bonds taken to secure personal loans to the trustee, petitioned the referee in bankruptcy [2] for permission to sell them, claiming to be a bona fide pledgee for value. *Held,* since federal courts are bound to follow state decisions interpreting state statutes declaratory of the common law,[3] the bank did not take in bad faith under Wisconsin law.[4] *Marine Nat. Exchange Bank of Milwaukee v. Kalt-zimmers Mfg. Co.*, 293 U. S. 357, 55 Sup. Ct. 226 (1934).

The doctrine of "bad faith" in the law of negotiable instruments in this country has developed in the direction of favoring the taker of such instruments. Some of the early American cases [5] borrowed the English rule of "suspicious circumstances" [6] which precluded a person from being a bona fide holder if it could be shown that he took under circumstances that would normally arouse the suspicions of a prudent purchaser. This view was definitely repudiated in 1857 by *Goodman v. Simonds* [7] which established the doctrine that the holder of a negotiable instrument, in the absence of actual knowledge, may recover, unless it is shown that his action in taking the instrument amounted to bad faith.[8] This

held and secured, and may, before their fixed maturities, be declared at once due and payable, and the manner of prepayment before maturity.'" 293 U. S. 357 at 361, 55 Sup. Ct. 226 at 227 (1934).

In Pollard v. Tobin, 211 Wis. 405, 247 N. W. 453 (1933), the Supreme Court of Wisconsin, considering an identical provision, held that negotiability of the bonds was not thereby impaired. As to the effect of similar provisions on negotiability, see cases noted in 31 MICH. L. REV. 983-987 (1933).

[2] A decision by the referee in bankruptcy granting relief was reversed by the United States District Court for Wisconsin in Kalt-zimmers Mfg. Co. v. Marine Nat. Exchange Bank, 6 F. Supp. 638 (1933). This was affirmed by the Circuit Court of Appeals for the Seventh Circuit, on the ground that "federal courts are not bound by a decision of a state court [referring to Pollard v. Tobin, supra] in the interpretation or application of a provision of a uniform law contrary to the weight of authority as established by decisions of other states." Marine Nat. Exchange Bank v. Kalt-zimmers Mfg. Co., 70 F. (2d) 815 at 818 (1934).

[3] Burns Mortgage Co. v. Fried, 292 U. S. 487, 54 Sup. Ct. 813 (1934), noted in 33 MICH. L. REV. 434 (1935).

[4] The Supreme Court of Wisconsin in Pollard v. Tobin, 211 Wis. 405, 247 N. W. 453 (1933), a case involving facts almost identical with those in the principal case, held that the pledgee did not take in bad faith under Wis. Stat. (1931), sec. 116.61. (N. I. L., sec. 56. See note 9, below.)

[5] See 3 KENT, COMMENTARIES, 2nd ed., 81-83 (1832).

[6] Gill v. Cubitt, 3 Barn & Cress. 466, 107 Eng. Rep. 806 (1824).

[7] 20 How. (61 U. S.) 343, 15 L. ed. 934 (1857).

The rule in Gill v. Cubitt lasted about twenty years when it was finally overruled by May v. Chapman, 16 M. & W. 355, 153 Eng. Rep. 1225 (1847). The latter case definitely established the doctrine of "bad faith" in England and it has not been questioned there since. See Rightmire, "The Doctrine of Bad Faith in the Law of Negotiable Instruments," 18 MICH. L. REV. 355 (1920).

[8] For an analysis of the rule in Goodman v. Simonds by Clifford, J., see Right-

rule is adopted in section 56 of the N. I. L.[9] The principal case was not one in which the infirmity or defect appeared on the face of the bond, calling for an application of the first condition stated in section 56.[10] On the contrary, the defect or infirmity, if any, had to be shown by extraneous facts, this being the usual situation in which the "bad faith" rule is applied.[11] What were the "extraneous facts" in the principal case? First, the bank knew that the pledge was being made for a personal loan. Second, the bonds received by the bank showed on their face that the pledgor was the trustee of the *mortgage* under which the bonds were secured. Third, the bonds made special reference to the mortgage, incorporating certain of its provisions, including the provision which defined the powers and duties of the trustee with reference to bonds delivered.[12] In view of these facts,[13] a court applying the test of "bad faith" might well conclude that the pledgee took in bad faith. The fact that the pledgee in the principal case was a bank tends to strengthen such view, since a court might expect a bank to exercise greater caution than would be required of an ordinary pledgee who has no special training for such transactions, nor particular familiarity with the instruments involved. If this analysis be sound, then the effect of *Pollard v. Tobin*[14] may be to disregard the second condition in section 56.[15] The chief justification

mire, "The Doctrine of Bad Faith in the Law of Negotiable Instruments," 18 MICH. L. REV. 355 at 361 (1920).

[9] "To constitute notice of an infirmity in the instrument or defect in the title of the person negotiating the same, the person to whom it is negotiated must have had actual knowledge of the infirmity or defect, *or knowledge of such facts that his action in taking the instrument amounted to bad faith.*" (Italics the writer's.) Wis. Stat. (1931), sec. 116.61, is identical.

[10] The principal case is also to be distinguished from that class of trust cases in which a third party dealing with the trustee is aware of the trust character of the property taken. See Scott, "Participation in a Breach of Trust," 34 HARV. L. REV. 454 at 463 (1921).

[11] A complete analysis of both conditions stated in section 56 of the N. I. L. is presented in Rightmire, "The Doctrine of Bad Faith in the Law of Negotiable Instruments," 18 MICH. L. REV. 355 at 364-369 (1920).

[12] A reference to this provision would have disclosed the trustee's lack of authority to pledge for personal loans. For an example of the extreme lengths to which a court may go in fastening upon a bond purchaser not only notice but adoption of provisions in the securing mortgage, see Morley v. University of Detroit, 263 Mich. 126, 248 N. W. 570 (1933), discussed in 32 MICH. L. REV. 232 (1933), and 269 Mich. 216, 256 N. W. 861 (1934), discussed in 33 MICH. L. REV. 432 (1935).

[13] It should be noted that the principal case is not authority for the proposition, as such, that a pledgee taking under such circumstances does not take in bad faith. Cardozo, J., referring to the holding in Pollard v. Tobin, 211 Wis. 405, 247 N. W. 453 (1933), said, "We are not required for present purposes to approve this doctrine or disapprove it. *Enough* [italics the writer's] that we accept it as the law of the Wisconsin court." 293 U. S. 357 at 365, 255 Sup. Ct. 226 at 228 (1934).

[14] 211 Wis. 405, 247 N. W. 453 (1933).

[15] "We interpret that decision [referring to Pollard v. Tobin, supra] as a ruling that under the Wisconsin statute notice of facts tending to put a cautious buyer upon inquiry will not defeat the title of a holder of negotiable paper, if in truth there was neither actual knowledge of an infirmity nor conscious joinder in a fraud." Cardozo,

for *Pollard v. Tobin* would seem to lie in some policy of the law of negotiable instruments which tends to treat the purchasers of such instruments with special indulgence, and while there is some evidence in the historical growth of the doctrine of "bad faith" to bear out such conclusion, it is submitted that a case like *Pollard v. Tobin* goes too far.

J. H. J.

J., in Marine Nat. Exchange Bank v. Kalt-zimmers Mfg. Co., 293 U. S. 357 at 364, 55 Sup. Ct. 226 at 228 (1934).