Montana Law Review

Volume 3
Issue 1 *Spring 1942*

Article 7

January 1942

Bills and Notes: Negotiability of Bills and Notes Secured by Collateral Agreements

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Treating the latter quotation from the text as controlling, even then the case helps us little in interpreting the *Rossberg* case, or in clarifying the law as to admissions in Montana, because the Court does not suggest why the statement would not be so admissible. It admits the statement on other grounds.

It should be realized that statements which are spontaneous exclamations must automatically be admitted under principles of evidence, though statements not admissible under evidence rules should not be excluded automatically if there is agency involved. The authority of the agent to make such statements, not merely to do the act in connection with which the statements are made, should be inquired into to determine whether or not they are admissible against the principal's interest under rules of agency law. The term *res gestae* should be wholly repudiated as a principle of agency.

It is submitted that both the legal basis for, and the authority upon which the *Callahan* rule is predicated are so questionable that the Montana Supreme Court would be justified in reexamining the entire question of an agent's admissions against his principal.

—Bill Hirst.

BILLS AND NOTES: NEGOTIABILITY OF BILLS AND NOTES SECURED BY COLLATERAL AGREEMENTS

Uncertainty and confusion exist in Montana with respect to the negotiability of instruments, otherwise negotiable, which are secured by collateral agreements.[1] The extent of the confusion can best be determined by comparing the Montana decisions upon the subject with the rules formulated by the weight of authority in other states. Clarity in presentation of those rules demands a classification of the fact situations with regard to the form of the instruments involved as follows: (1) Instruments containing no reference to the collateral agreement. (2) Instruments containing a mere reference to

[1]The word "secured" as used in this discussion extends not only to those situations where a collateral agreement is given as security for payment of a bill or note, but to the cases where the collateral agreement is the consideration for which the instrument is given or the transaction giving rise to it.

No attempt is made herein to analyze the cases involving the right of a transferee of a bill or note secured by a collateral agreement to claim as a holder in due course where the agreement shows on its face an infirmity in the bill or note or a defect in the title of the person negotiating it.

the collateral agreement. (3) Instruments containing upon their face statements that they are "subject to" the collateral agreement, or containing words of similar import. (4) Instruments which incorporate into their terms the conditions of the collateral agreement.

In the cases where a bill or note was secured by a collateral agreement without reference thereto the courts have generally held the instrument negotiable.[2] Though all of the states have adopted the rule of construction that several contracts relating to the same matters, between the same parties, and made as parts of substantially one transaction, should be construed together, the courts have steadfastly maintained that, in the absence of a reference to the collateral agreement upon the face of a bill or note, they shall remain separate instruments for the purpose of determining negotiability.[3]

The weight of authority holds an instrument negotiable which contains upon its face a mere reference to a collateral agreement as the consideration for which it was given, the transaction out of which it arose, or the security for payment of the debt.[4] In one case the note recited that "This note, including all installments thereof of even date herewith, is identified with a conditional sales agreement covering a certain motor vehicle"[5]; in another case a rent note recited "Value received in rent for store No. 443 Camp Street for month of April, 1920, as per lease this date"[6]; in still another case a

[2]Hayward Lumber & Investment Co. v. Naslund (1932) 125 Cal. App. 34, 13 P.(2d) 775; Baird v. Meyer (1927) 55 N. D. 930, 215 N. W. 542, 56 A. L. R. 175.

[3]George A. Hubbard v. Robert B. Wallace Co. (1926) 201 Ia. 1143, 208 N. W. 730; 10 C. J. S., *Bills and Notes*, §44(b).

[4]Williamson v. Craig (1927) 204 Ia. 555, 215 N. W. 664; Davis v. Union Planters Nat. Bank & Trust Co. (1937) 171 Tenn. 383, 103 S. W.(2d) 579. And for an unusual extension of the rule see the case of Camp v. Dallas Nat. Bank of Dallas (1931) 36 S. W. (2d) 994. 7 AM. JUR., *Bills and Notes*, §112; 3 R. C. L., *Bills and Notes*, §110 and §112.

A statement on the face of an instrument that it is payable *according to* the tenor of a collateral agreement is generally held a mere reference. Campbell v. Equitable Securities Co. (1902) 17 Colo. App. 417, 68 P. 788. *Contra:* People v. Gould (1932) 347 Ill. 298, 179 N. E. 848 (The words "according to" were held equivalent to the words "subject to" and rendered the note nonnegotiable.).

Slaughter v. Bank of Bisbee (1916) 17 Ariz. 484, 154 P. 1040 (Reference to "*contract of even date*" was written on face of note; held negotiable.); Utah Irr. Co. v. Allen (1924) 64 Utah 511, 231 P. 818, 37 A. L. R. 651.

[5]Trice v. People's Loan & Investment Co. (1927) 173 Ark. 1160, 293 S. W. 1037. *Contra:* Hamilton v. Vero Beach Reserve Mortgage Co. (1932) 107 Fla. 65, 144 So. 362 (Words "identified with" held equivalent to the words "subject to.").

[6]Tyler v. Whitney-Central Trust & Savings Bank (1924) 157 La. 249, 102 So. 325. *Accord:* International Finance Co. v. Northwestern Drug

bill of exchange recited on its margin "Trade Acceptance. The obligation of the acceptor of this bill arises out of the purchase of goods from the drawer."[7] In each case the court held that the terminology used constituted a mere reference to the collateral agreement, the instruments remaining negotiable.

If reference is made to a collateral agreement by writing upon the face of a bill or note the words "subject to," or words of similar import, the instrument is nonnegotiable under the almost universal rule.[8] But, in order to render a bill or note subject to the collateral agreement, the words used must show clearly and unequivocally that the drawer or maker intended to burden the instrument with the conditions of the security. The tendency of the courts since the Negotiable Instruments Law has been to construe bills and notes in favor of negotia-

Co. (D. C., 1922) 282 Fed. 920; Culbreath v. Guiterman, Rosenfield & Co. (1927) 217 Ala. 259, 115 So. 303. *Contra:* Continental Bank & Trust Co. v. Times Publishing Co. (1917) 142 La. 209, 76 So. 612, L. R. A. 1918B, 632 ("as per", "in accordance with ", and "subject to" given same effect); International Finance Corp. v. Calvert Drug Co. (1924) 144 Md. 303, 124 A. 891, 23 A. L. R. 1162.

[7]McCornick & Co., Bankers v. Gem State Oil & Products Co. (1923) 38 Idaho 470, 222 P. 286, 34 A. L. R. 867. *Accord:* International Finance Co. v. Northwestern Drug Co., *supra* note 6; First Bank of Marianna v. Havana Canning Co. (1940) ..... Fla. ....., 195 So. 188; Arrington v. Mercantile Protective Bureau, Inc. (Tex. Civ. App., 1930) 15 S. W. (2d) 663.

[8]Words "subject to" on face of instrument: Verner v. White (1926) 214 Ala. 550, 108 So. 369; Musto v. Grosjean (1929) 208 Cal. 453, 281 P. 1022; Gaines v. Fitzgibbons (1929) 168 La. 260, 121 So. 763; Fayetteville Bldg. & Loan Ass'n. v. Crouch (1934) 115 W. Va. 651, 177 S. E. 532.

Words of similar import as the words "subject to": Commercial Credit Co. v. Seymour Nat. Bank (1938) 105 Ind. 524, 15 N. E. (2d) 118 (Note recited "This note is deposited . . . under the provisions of a certain trust indenture . . . . This note to be valid must bear the Trustee's certificate of authentication.") ; First Nat. Bank in Salem v. Morgan (1930) 132 Ore. 515, 284 P. 582; 3 R. C. L., *Bills and Notes*, §69.

If a bill or note recites that its *maturity shall be in conformity with* the terms of a collateral agreement, the weight of authority holds the instrument nonnegotiable. Westlake Mercantile Finance Corp. v. Merritt (1928) 204 Cal. 673, 269 P. 620, 61 A. L. R. 811; First Nat. Bank of Statesville, N. C. v. Power Equipment Co. (1930) 211 Ia. 153, 233 N. W. 103; Lane Co. v. Crum (Tex. Civ. App., 1927) 291 S. W. 1084. *Contra:* Heller v. Cuddy (1927) 172 Minn. 126, 214 N. W. 924.

A few jurisdictions distinguish between situations where the words "subject to" or words of similar import are inserted in the body of the bill or note and where the same words are written over or around the body of the instrument. Newman v. Schwarz (1934) 180 La. 153, 156 So. 206.

There is a tendency of the courts to hold an instrument negotiable which is subjected to the terms of a collateral agreement, if those terms are not incompatible with negotiability. Krause v. Lehigh Valley Coal Co. (1939) 172 Misc. 2, 14 N. Y. S. (2d) 206.

bility, resolving all doubts accordingly.[9] In the case of *Lubin v. Pressed Steel Car Co.*[10] an instrument was held negotiable which recited that it was "issued under and . . . secured by an Indenture . . . to which reference is hereby made for a statement of the rights of the holders . . . ", the court going as far as reason and precedent would allow to favor negotiability.

If the provisions of a collateral agreement are incorporated bodily into the terms of an instrument otherwise negotiable, and are of such character that they render the order or promise conditional or uncertain, there is no doubt that the negotiability of the instrument is destroyed.[11] The weight of authority holds an instrument nonnegotiable which provides that the conditions of a collateral agreement "shall be incorporated," or other words to that effect.[12] However, the tendency of the courts today is to hold instruments negotiable which incorporate by reference the conditions of a collateral agreement, if those conditions are not incompatible with negotiability.[13] It is submitted that the weight of authority rule is the better. The principle is undisputed that a negotiable bill or note must carry upon its face the entire contract of the parties thereto, and it is impossible to say that the principle is complied with where the instrument upon its face requires the owner or holder to take note of the terms and conditions of another agreement to ascertain the complete order or promise.[14]

The rules discussed apply with equal effect whether a bill or note is secured by a mortgage on real estate,[15] a chattel mort-

[9]McCornick & Co. v. Gem State Oil & Products Co., *supra* note 7; First Nat. Bank in Salem v. Morgan, *supra* note 8; 10 C. J. S., *Bills and Notes*, §42(c).

[10](1933) 146 Misc. 462, 263 N. Y. S. 433. The instrument involved in this case was a corporate bond; but it is now settled that the rules as to the negotiability of bills and notes are applicable to bonds of all kinds. BRANNAN, NEGOTIABLE INSTRUMENTS LAW (6th ed. 1938), §1, p. 107; SMITH & MOORE, CASES ON BILLS AND NOTES (4th ed.), footnote p. 1.

[11]Kerr v. Staufer (1927) 52 S. D. 223, 217 N. W. 211.

[12]Detroit Trust Co. v. Detroit City Service Co. (1932) 262 Mich. 14, 247 N. W. 76 (Note referred to trust deed "as though it were recited herein.") ; King Cattle Co. v. Joseph (1924) 158 Minn. 481, 198 N. W. 798. *Contra:* Ferring v. Verwey (1930) 200 Wis. 631, 229 N. W. 46. For a complete discussion of the doctrine of incorporation see 13 NOTRE DAME L. R. 133.

[13]Gerrish v. Atlantic Ice & Coal Co. (1935) 80 F.(2d) 648; Mortgage Bond Co. v. Stephens (1937) 181 Okla. 182, 72 P.(2d) 831.

[14]For further discussion of the subject see 104 A. L. R. 1378; 75 A. L. R. 1210; 45 A. L. R. 1074. The California law is digested in 22 CALIF. L. REV. 677.

[15]First Nat. Bank of Birmingham v. De Jernett (1935) 229 Ala. 564, 159 So. 73.

gage,[16] a deed of trust,[17] a conditional sales contract,[18] an escrow agreement,[19] a pledge agreement,[20] or other type of collateral contract.[21]

In Montana the controversy as to the effect of the execution of a collateral agreement upon the negotiability of a bill or note originated with the case of *Cornish v. Woolverton,*[22] decided in 1905. In that case the note recited "This note and these coupons . . . are secured by mortgage of even date herewith, . . ." The mortgage contained provisions for the payment by the mortgagor of taxes, liens and incumbrances, and insurance premiums upon the premises mortgaged, and stated that, upon default in the payment thereof, the mortgagee should pay the charges and add the amount so paid to the debt secured. The note was held nonnegotiable. The court reasoned that the note and mortgage constituted a single contract under the rule of construction declared by the Civil Code[23] that several contracts relating to the same matters and executed at substantially the same time must be taken together, that the promise to pay was burdened with the conditions of the mortgage as to anyone taking the note with notice of the mortgage, and that the mere reference upon the face of the note sufficed to put every holder thereof upon notice of the mortgage, *ipso facto* destroying the negotiability of the note.

In the case of *Buhler et al. v. Loftus et al.,*[24] decided in 1917, a note, otherwise negotiable, was secured by a mortgage upon realty; subsequently the payee indorsed the note without recourse and transferred it and the mortgage to the defendant by a written assignment. No reference to the mortgage appeared upon the face of the note. The maker of the note sued to cancel it and the mortgage for the alleged fraud of the payee. The note was held nonnegotiable in the hands of the defendant transferee, the court stating that

"It did . . . not come into his hands as a courier without

[16]Cook v. Parks (1933) 46 Ga. App. 749, 169 S. E. 208.
[17]Commercial Credit Co. v. Seymour Nat. Bank, *supra* note 7.
[18]Legal Loan & Investment Ass'n. v. Arnold (1941)..... Mo. ....., 150 S. W. (2d) 544; Shawano Finance Corp. v. Julius (1934) 214 Wis. 637, 254 N. W. 355.
[19]Williams v. Silverstein (1931) 213 Cal. 269, 2 P.(2d) 165.
[20]Jewell v. Norrell (1941) 65 Ga. 862, 16 S. E.(2d) 797.
[21]Newman v. Schwarz, *supra* note 8 (rent note); First Nat. Bank in Salem v. Morgan, *supra* note 8 (stock subscription contract); Coleman v. Valentin (1917) 39 S. D. 323, 164 N. W. 67 (land contract); McCarty v. Allen (Tex. Civ. App., 1938) 113 S. W.(2d) 974 (vendor's lien).
[22]32 Mont. 456, 81 P. 4, 108 Am. St. Rep. 598.
[23]Civil Code 1895, §2207; R. C. M. 1935, §7533.
[24]53 Mont. 546, 165 P. 601.

> luggage, but as a nonnegotiable instrument, subject to all equities existing in favor of J. M. Buhler (plaintiff) at the time he (defendant) received it."

The decision turned upon the provision of the Civil Code[25] that the recovery of a debt or the enforcement of a right secured by a mortgage must be by foreclosure of the mortgage. The court reasoned that a note secured by a mortgage was nonnegotiable in the hands of one who took it with notice of the mortgage, that the written assignment of the note and mortgage gave the transferee sufficient notice of the mortgage, and that the defendant took the note as a mortgage note, collectible only by foreclosure, contrary to the inherent character of a negotiable instrument. Noteworthy is the fact that the court said its decision was based upon the express holding of the *Cornish* Case, although the court in the *Cornish* Case refused to discuss the section of the statute which was held controlling in the *Buhler* Case.

The court in *Buhler v. Loftus* did not decide what the rights of a subsequent indorsee of the note without notice of the mortgage would be. This question remained unanswered until the decision in the case of *Wood v. Ferguson et al.*[26] in 1924, which case reaffirmed the rule of the *Buhler* Case to the extent that it held a note nonnegotiable in the hands of an indorsee with notice of the mortgage security, but added that, if the instrument were indorsed by him to one who had no knowledge of the mortgage, the latter could claim as a holder in due course. The decision is worthy of note because the court for the first time applied the test of notice of the mortgage to determine the position of the transferee as a holder in due course, instead of to determine the negotiability of the note. But, in *Barnes et al. v. Rowles et al.*,[27] decided in 1929, the court, in determining that the defendant payee was not liable as indorser of a note which he had indorsed in blank and delivered with an assignment of the mortgage to plaintiffs, held the *Cornish* and *Buhler* cases decisive, saying that "Under the authorities cited, the notes are nonnegotiable."

Summarizing these decisions, we must conclude: (1) An instrument secured by a mortgage is burdened with the conditions of the mortgage in the hands of anyone who has knowledge of its existence, whether the knowledge is acquired by a reference upon

[25]Revised Codes 1907, §6861; R. C. M. 1935, §9467.
[26]71 Mont. 540, 230 P. 592.
[27]84 Mont. 393, 276 P. 15, 79 A. L. R. 717. The cause of action in this case arose before the 1923 amendment, *infra* in body of article, went into effect.

the face of the instrument or by actual notice where no reference is made to the collateral agreement. (2) An instrument which is nonnegotiable in the hands of one with notice of the mortgage may be held negotiable in the hands of a subsequent indorsee without notice of the mortgage.

The immediate result of the decisions in the *Cornish* and *Buhler* cases was a commercial dilemma; if a bill or note was secured by a collateral agreement, there was a grave possibility that it would be held nonnegotiable even though it did not refer to the security; on the other hand, the absence of collateral security increased the difficulty of discounting the instrument. Apparently intending to remedy that situation, the legislature in 1923 amended the Revised Codes of 1921, Section 8412, by adding subdivision 5 which provides:

> "An instrument otherwise negotiable in character is not affected by the fact that it was at the time of the execution or subsequently secured by mortgage on real or personal property."

It is submitted that the amendment clarifies the situation in but one important aspect: It should prevent further application, in the determination of the negotiability of an instrument secured by a mortgage, of the statutory requirement that every debt secured by mortgage shall be enforced by foreclosure. But, consider the questions, all judicially unanswered at present, which may reasonably be expected to arise in applying the amended statute. Should an instrument which contains no reference to a mortgage given to secure it now be held negotiable in the hands of a person who takes it with knowledge of the mortgage?[28] What will be the effect upon the negotiability of a bill or note of a mere reference therein to a mortgage? What effect has a reference which subjects the instrument to a mortgage? What of a reference which incorporates into the instrument the terms of a mortgage? Does the amendment apply regardless of the form of the mortgage, or must the security adhere to the statutory form of mortgage? Are the rules formulated with respect to mortgage instruments applicable in determining the negotiability of instruments secured by other forms of collateral agreements? A careful analysis of the phraseology of the 1923 amendment leads to the conclusion that, regardless of the intention of the legislature, the amendment fails to provide a ready answer to these relevant questions.

[28]See Barnes v. Rowles, *supra* note 27, containing indecesive dictum that "The amendment was evidently made for the purpose of obviating the result of the decisions" in the Cornish and Buhler cases.

It is submitted, therefore, that the rule of the *Cornish* Case remains unaltered, and future decisions upon the subject must turn entirely upon the acceptance or rejection of the *sine qua non* of that decision—upon the effect to be given the statutory provision that "Several contracts relating to the same matters, between the same parties, and made as parts of substantially one transaction, are to be taken together,"[29] in the determination of the negotiability of bills and notes secured by collateral agreements. It must be remembered that the law of negotiable instruments arose and developed as an inherent part of the law merchant, that the Negotiable Instruments Law was substantially a copy of the English Act which codified the law merchant, and that the Negotiable Instruments Law, the purpose of which was to secure uniformity of holdings throughout the United States, has been adopted by the state of Montana.[30] So, although a bill or note and a collateral agreement executed to secure it must be construed together in conformity with the statutory rule of construction, the negotiability of the instruments and the status of the indorsee thereof as a holder in due course should be determined solely by the rules stated by the Negotiable Instruments Law. Only by properly blending the precedents of the law merchant with the requirements of modern commercial enterprise can workable rules be formulated to determine the negotiability of instruments secured by collateral agreements. The present rules in this state are definitely unsatisfactory, and it is to be hoped that the situation will be promptly remedied by legislative enactment or judicial interpretation overruling the decision of the *Cornish* Case and establishing the following principles: (1) A bill or note, otherwise negotiable, should not be held nonnegotiable simply because it is secured by a collateral agreement. (2) Only when the order or promise is burdened with the conditions of a collateral agreement should the instrument be rendered nonnegotiable; an instrument which is made subject to the terms of a collateral agreement should be held nonnegotiable; an instrument which bodily incorporates the terms of a collateral agreement should be held negotiable unless the order or promise to pay is rendered conditional or uncertain; and an instrument which incorporates the terms of a collateral agreement by stating that the said terms "shall be incorporated herein," or words to that effect, should be held nonnegotiable. (3) An instrument which contains a mere reference to a collateral agreement as the consideration for which it was given, as

[29] *Supra*, note 23.
[30] Ch. 121 LAWS OF MONTANA 1903; R. C. M. 1935, §§8401-8597, inclusive.

the transaction out of which it arose, or as the security for payment of the debt, is not burdened with the conditions of the agreement and should be held negotiable. (4) These rules should be applied with equal effect whether a bill or note is secured by a mortgage or by any other form of collateral agreement. (5) Notice of the existence or terms of a collateral agreement, of itself, should not prevent the transferee of a bill or note from taking it as a holder in due course.[21]

—Arthur T. Ratcliffe.

CONTRACTS: RIGHTS OF PERSONS NOT A PARTY TO A CONTRACT TO SUE IN MONTANA

The question of the rights of a third party to sue upon what are commonly styled contracts for the benefit of third parties continues to be a subject of litigation in Montana.[1] In a recent Montana case, *Kelley v. Montana Power Company*[2] which the Court stated involved a contract for the benefit of a third party, the beneficiary failed in a suit against the defendant corporation which the Court treated as the promisee of a contract for the benefit of a third party.[3] The Court's dictum is that the beneficiary would have a cause of action under section 7472, R. C. M. 1935 against the promisor.[4]

The foregoing section reads:

> "A contract made expressly for the benefit of a third person may be enforced by him at any time before the parties thereto rescind it."

Under this provision there has been much litigation in Montana as to the liability of the promisor to the beneficiary. The beneficiaries fall by definition into three classes: (1) incidental,

[21]Of course, one who takes a bill or note with notice of the terms of a collateral agreement which disclose an infirmity in the bill or note or a defect in the title of the person negotiating it does not become a holder in due course under the provisions of R. C. M. 1935, §§8459(4), 8461, and 8463, although the bill or note is negotiable in form. However, as pointed out *supra*, note 1, this comment does not deal with cases involving that situation.

[1]This note is primarily concerned with the rights of the beneficiary to sue the promisor and not with the various defenses that the promisor may set up in a suit.

[2](October 16, 1940) 111 Mont. 118, 106 P. (2d) 339.

[3]The terms of the contract are not set forth in the case; hence, it is impossible to tell whether it involves a contract for the benefit of a third person about which there may be some question.

[4]See 111 Mont. 118, 122, 106 P. (2d) 339, 340.