CIRCLE ACCEPTANCE CO. LTD. v. SIGOUIN [1]

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Promissory note — Holder in due course — Sales contract — Acceptance company deliberately refraining from investigating real nature of transaction — Absence of good faith — Bills of Exchange Act (R.S.Q. 1952, ch. 15), art. 56.

Introduction

S. 74(b) of the Bills of Exchange Act [2] states that a holder in due course "holds the bill free from any defect of title of prior parties, as well as from mere personal defences available to prior parties among themselves . . ." This privileged position originated in the law merchant, a body of usages and customs which existed before any law of negotiable instruments had developed. Its purpose was to facilitate trade, so that a merchant who took an instrument *bona fide* could be assured that his title would not later be declared invalid. However, this rule, originally created for the mercantile situation, also has become a part of household law. In the modern world, the conditional sales contract has become an accepted arrangement for those whose consumer needs outstep their income. By the process of taking a negotiable promise to pay from the purchaser and discounting it with a finance company, the vendor can realize immediate cash to finance his sales. If the purchaser fails to meet the extended time payments, the finance company takes an action on the note.

Unfortunately, many unscrupulous finance companies have attempted to rely on the privileged position of the holder in due course in order to avoid any personal defence which the buyer otherwise might have raised against the vendor. The question arises as to whether a holder in due course has a responsibility to inquire into the nature of the transaction between the original parties to the instrument. If not, a finance company or other holder could acquire an impregnable title, even when it has suspected that the original

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[1] [1963] S.C. 97.

[2] R.S.C. 1952, ch. 15.

transaction was tainted with fraud. If the holder in due course is under such a duty, the value of a negotiable promise as an instrument of credit would be weakened. This critique will attempt to provide a solution to the dilemma.

Facts and Ratio decidendi

In a recent decision of the Quebec Superior Court, *Circle Acceptance Co. Ltd.* v. *Sigouin,* this problem arose with interesting practical implications. The relevant facts were not in dispute. The defendant, Sigouin, purchased a sewing machine from Better Furniture Manufacturing Inc. by conditional sales contract, giving a promissory note for $381 (19 instalments of $19 each plus a final payment of $20) in payment thereof. The note was discounted by the furniture company with Circle Acceptance, who sued the defendant on the note as a holder in due course. The evidence established that Sigouin, who was only nineteen years old, had been induced by fraud to make the note.

The learned trial judge, Collins, J., held that the plaintiff deliberately refrained from investigating a transaction which he suspected might be fraudulent in order to avoid any knowledge which might destroy his title as a holder in due course. Thus, the plaintiff was not in the good faith required of a holder in due course, and could not recover on the note.

Considering the facts, the judgment appears to be sound in law. It is in keeping with the jurisprudence which imputes constructive notice of defects in title to a holder, when the surrounding circumstances warrant it [3]. However, Collins, J. made several statements, which if taken alone and out of context, could lead to a diminution of the value of a negotiable promise as an instrument of credit:

> "Whereas it is clear that *plaintiff made an insufficient investigation* as to the nature of the business of Better Furniture Manufacturing Inc. (which is now in bankruptcy) and *made no attempt to verify the methods and manners by which it did business with its customers* and whether or not such methods and manners were honest or fraudulent;" [4]

He adds:

> "Considering that when an acceptance company discounts a note given in connection with a sales contract, it cannot be in the good faith necessary

[3] *Raphael* v. *Bank of England* (1855) 139 E.R. 1030; *Re Gomersall* (1875-76) 1 Ch. D. 137; *Jones* v. *Gordon* (1876-77) 2 A.C. 616; *Lockhart* v. *Wilson* (1908) 39 S.C.R. 541; *Ray* v. *Willson* (1912) 45 S.C.R. 401; *Waterous Engine Co.* v. *Capreol* (1923) 3 D.L.R. 575; *Normandin* v. *La Banque de Montréal* (1927) 42 B.R. 1; *Huot* v. *Banque Canadienne Nationale* [1944] B.R. 497; *Forest* v. *Millette* [1948] R.L. 73; *Vincent* v. *Belhumeur et un autre* [1955] B.R. 443.

[4] *Circle Acceptance Co. Ltd.* v. *Sigouin, op. cit.* at p. 98. Italics added.

> to be a holder in due course *because it must ascertain fully prior to such discounting the real nature of the transaction* existing between its customers (the discounter) and the party who entered into such a sales contract with its customers..." [5]

By themselves, these remarks imply that any holder in due course, whether or not there has been anything to arouse his suspicion, must investigate the nature of the transaction between the immediate parties to the instrument. In other words, they suggest a general duty of investigation, an obligation which could lead to disastrous commercial consequences. These remarks are *obiter*, because they are not essential to the actual decision. It seems unlikely that Collins, J. intended to lay down this proposition as a general rule: he merely meant to emphasize the fact that the suspicious circumstances *in this particular case* should have prompted the finance company to make further inquiries. However, such a general statement, even though *obiter*, might be misapplied in subsequent cases. Since a study of the judgment does not reveal the nature of the suspicious circumstances, in order to avoid misinterpretation, it will be helpful to review the whole problem.

Survey of the authors and jurisprudence

In order to avail himself of the privilege granted to a holder in due course by s. 74(b), the holder must be in good faith and have no notice of defect of title [6]. According to Falconbridge:

> "Notice means actual, though not formal notice, that is to say, either knowledge of the facts, or a suspicion of something wrong, combined with a wilful disregard of the means of knowledge." [7]

If a holder takes a bill, knowing that the maker was induced by fraud, duress, illegal consideration, etc. to draw it, his title will be no better than that of the person who negotiated it to him: thus he will be subject to regular defences and will fall outside the provisions of s. 74(b).

Notice of defect of title usually refers to actual knowledge. However, what happens if a holder does not have specific knowledge of any defect, but the surrounding circumstances are suspicious, and he deliberately refrains from making inquiries for fear of discovering something which would give him actual knowledge and thus render his title defective? This situation is covered by the require-

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[5] *Ibid.*, at p. 98. Italics added.

[6] The other characteristics of a holder in due course will not be dealt with for purposes of this comment.

[7] Falconbridge, *Banking and Bills of Exchange*, 6th Edition, Toronto, 1956, p. 624. See also: *Byles on Bills of Exchange*, 21st Edition, London, 1955, p. 154.

ment of good faith in s. 56(1) (b). If a holder has reasonable grounds for believing that there is some defect of title and does not investigate, his conduct will amount to bad faith and he will forfeit the privilege of s. 74(b).

If a person sues on a negotiable instrument, his good faith is presumed. S. 58(2) of the Act reads:

> "Every holder of a bill is prima facie deemed to be a holder in due course: but if, in an action on a bill it is admitted or proved that the acceptance, issue or subsequent negotiation of the bill is affected with fraud, duress, or force and fear, or illegality, the burden of proof that he is such holder in due course shall be on him..."

The presumption is *juris tantum*.[8]

(i) The General Rule

The position of the holder in due course is well-stated by Perrault:

> "D'après ce principe (l'inopposabilité des exceptions), la personne, signataire d'une lettre de change et poursuivie par un détenteur régulier, ne peut pas invoquer, pour échapper à la condamnation demandée contre elle, les exceptions ou les moyens de défense que cette personne aurait pu faire valoir contre le preneur ou l'un des porteurs intermédiaires en raison de ses relations personnelles avec eux." [9]

This principle was illustrated in the recent case of *Imperial Investment Corporation* v. *Mazur*.[10] A used-car dealer pretended to sell a truck to Mazur and discounted the latter's note with a finance company. This was part of an arrangement whereby the dealer was supposed to remit the proceeds to Mazur's friend, who actually owned the truck. However, the dealer fraudulently kept the money and did not pay the instalments as he had promised Mazur. When the finance company sued Mazur on the note, his defence that the note was made without consideration was rejected, because the investment corporation was a holder in due course and there had been nothing to arouse its suspicion.[11]

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[8] *Tatam* v. *Haslar* (1889) 23 Q.B.D. 345; *Canadian Bank of Commerce* v. *Peebles* (1924) 1 D.L.R. 225; *Community Finance Corp.* v. *Morgan Hardware Co.* (1926-27) 31 O.W.N. 465; *Arbuthnot* v. *Campbell* (1930) 2 W.W.R. 275; *Banque de Montréal* v. *Mlle Amireault et al.* (1938) 65 B.R. 1; *Dominion Bank* v. *Fassel and Baglier Construction Co.* (1955) 4 D.L.R. 161; *State Discount Ltd.* v. *Crawford* [1960] O.W.N. 451.

[9] Perrault, *Traité de Droit Commercial*, Tome 3, 1940, p. 798.

[10] (1962) 33 D.L.R. (2d) 763.

[11] See also: *London Joint Stock Bank* v. *Simmons* [1892] A.C. 201; *Reinhardt* v. *Shirley et al.* (1894) 6 S.C. 11; *Killoran* v. *Monticello State Bank* (1920-21) 61 S.C.R. 528; *Laurentide Acceptance Corp.* v. *Lemay* [1951] S.C. 469; *Canyon Securities* v. *McConnell* (1959) 17 D.L.R. (2d) 730; *McCabe* v. *Bank of Nova Scotia* (1962) 30 D.L.R. (2d) 649; *Charbonneau* v. *Traders Finance Corporation Ltd.* [1963] B.R. 681.

Although s. 74(b) states that a holder in due course holds free from defects of title of prior parties, it does not specify any duty of investigation on his part. Since the Act is silent, it may be taken as a general rule that there is no such duty. However, the requirement of good faith imports through the back door a responsibility to investigate: if suspicious circumstances exist, good faith may require further inquiry.

> "Given facts exciting suspicion, that is, actual suspicion arising from facts known or believed to exist, and either an absence of enquiry or an enquiry which does not remove the suspicion, the situation is incompatible with good faith..." [12]

The main problem is in determining when the circumstances have become suspicious enough to put the holder in due course on guard to make further inquiries into the nature of the transaction between maker and payee.

(ii) Negligence

If the holder was negligent in omitting to make further inquiries, he may still be in good faith. S. 3 of the Act states that

> "a thing is deemed to be done in good faith within the meaning of this Act, where it is in fact done honestly, whether it is done negligently or not."

By honestly is meant

> "droiture, conduite exempte d'intention malicieuse ou frauduleuse... Il n'est pas nécessaire qu'elle soit exempte d'une certaine négligence. Quelqu'un peut avoir agi de bonne foi, même si l'on constate que l'acte qu'il posa pouvait être accompagné d'une plus grande prudence... La négligence de la part d'un détenteur... n'est donc par elle-même suffisante pour lui imputer une conduite de mauvaise foi et... lui faire perdre son recours... Bonne, ou mauvaise, foi est une question de fait laissée à l'appréciation des tribunaux." [13]

In the *Sigouin* case, this "droiture" was clearly lacking on the part of the finance company, who deliberately avoided looking into a transaction which they had good reason to suspect might be fraudulent.

It should be pointed out that some sections of the Act exclude negligence as a defence by saying that a thing must be done "in good faith and without negligence." [14] However, as a general rule, negligence is not inconsistent with good faith [15]. But it may be evidence of bad faith when considered in connection with surrounding circumstances [16].

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[12] Falconbridge, *op. cit.*, p. 625.

[13] Perrault, *op. cit.*, p. 227.

[14] For example, ss. 172 and 173.

[15] Falconbridge, *op. cit.*, p. 421; *Raphael* v. *Bank of England, op. cit.*; *Jones* v. *Gordon, op. cit.*; *Ross* v. *Chandler* (1912) 45 S.C.R. 127.

[16] *Byles, op. cit.*, p. 154; *Jones* v. *Gordon, op. cit.*

(iii) Wilful Blindness

A different situation arises when a holder is aware of suspicious circumstances surrounding a negotiable instrument, but wilfully closes his eyes to avoid discovering anything which would destroy his position as a holder in due course. In this case, he will be deemed to have had notice of defects of title which he ought to have investigated.[17]

The difference between negligence and wilful blindness is illustrated by the leading English case of *Jones* v. *Gordon*.[18] Gomersall and Searby, both of whom being insolvent, drew bills on each other for the purpose of defrauding their creditors. Bills worth £ 1727, drawn by Searby, were purchased by Jones for a mere £ 200. When Gomersall went into bankruptcy, Jones claimed against his estate for the full £ 1727. The trustee's defence was that Jones was not a holder in due course.

Their Lordships, affirming the decision of the Court of Appeal, held that Jones' wilful lack of inquiry into circumstances which invited such inquiry amounted to constructive notice that the bills were fraudulent, and thus he was not entitled to recover as a holder in due course.

This case illustrates the type of suspicious circumstances to which a holder in due course cannot close his eyes: Jones knew that Gomersall was financially embarrassed, but thought that he was still solvent; Jones admitted it was "a very risky thing"; he knew persons who could have disclosed Gomersall's exact financial status, but he refrained from inquiries; he knew that these bills had been refused by other people, presumably because it was well known that Gomersall could not meet them; a sale of bills worth £ 1727 for £ 200 must have shown that Searby was desperate; moreover, Jones, being a businessman, must have realized the probability of fraud in getting such an enormous bargain. Lord O'Hagen states that a man in good faith would have investigated further such an abnormal transaction: he had the sources of information at his disposal but did not use them, because he realized that this might lead to the discovery that the bills were fraudulently drawn and this would invalidate his claim.

Lord Blackburn makes an important distinction:

> "If he was... honestly blundering and careless, and so took a bill of exchange... when he ought not to have taken it, still he would be entitled to recover. But if the... circumstances are such that the jury... came to the conclusion that he was not honestly blundering and careless, but that he must have had a suspicion that there was something wrong, and that he refrained from asking questions, not because he was an honest blunderer or a stupid man, but because he thought in his own secret mind —

[17] See cases in footnote 3.

[18] *op. cit.*

> I suspect there is something wrong, and if I ask questions and make further inquiry, it will no longer be my suspecting it, but my knowing it, and then I shall not be able to recover — I think that is dishonesty." [19]

Thus, in the *Sigouin* case, it was unnecessary for Collins, J. to put the finance company under a duty to ascertain the nature of the contract between Sigouin and the furniture company: it would have been preferable to say that the finance company closed its eyes to suspicious circumstances, which put it in bad faith and prevented recovery on the note.

The determination of whether the circumstances have become suspicious enough to amount to bad faith is in the discretion of the court, depending on the fact patterns of each particular case. The courts have considered varying elements as evidence of bad faith. In *Kern* v. *Tamblyn*,[20] it was held that a businessman must have known that a company's property could not be pledged for a private debt; in *Samuel Creighton* v. *Halifax Co.*,[21] it was held that suspicious circumstances exist when a person takes a note knowing that a partner is using the company's security for his own personal ends and is thus exceeding his authority, although the exact details of the fraud are unknown; in *Vincent* v. *Belhumeur et un autre*,[22] a man who spent $3000 in taking a note from his brother (the payee) was presumed to know of the latter's bankruptcy; in *Swaisland* v. *Davidson et al.*,[23] a torn portion on one note, when the holder noticed an erasure attempt on a similar note, amounted to suspicious circumstances, considering that the holder was a private banker; in *Huot* v. *Banque Canadienne Nationale*,[24] public rumour in a small town was taken into account.

(iv) Speculative Surmise

It is recognized that there must be *something* to put the holder on guard.[25] This point arose in *Union Investment Co.* v. *Wells*.[26] Respondents were induced by the fraud of the payee's agent to make a promissory note bearing a fixed rate of interest. After the time for the first interest payment had lapsed, the note was endorsed to appellant company. Nothing on the face of the note indicated that the interest was unpaid. Appellant sued on the note as a holder in due course. Respondents pleaded that it was overdue when negotiated

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[19] Ibid., at p. 629.
[20] (1914) 16 D.L.R. 529.
[21] (1889-90) 18 S.C.R. 140.
[22] *op. cit.*
[23] (1884) 3 O.R. 320.
[24] *op. cit.*
[25] Falconbridge, *op. cit.*, p. 626; Byles, *op. cit.*, p. 154.
[26] (1908) 39 S.C.R. 625.

to appellant: thus the latter could not be a holder in due course and must take the note subject to the defect of title (the fraud).

The Court held (Idington and MacLennan, J.J. dissenting) that there were no suspicious circumstances which should have put appellant on guard, because the note was not on its face overdue. Since appellant could not have known that the interest had not been paid, its title was not affected by the fraud of the transferor. Duff, J. gives a clear statement of the principles involved:

> "the failure to pay the interest can be regarded as such a (suspicious) circumstance only on the hypothesis that the law imposes upon the person taking such an instrument after the time for such a payment is passed, the duty to inquire whether the payment has been made; ... it seems to one to be abundantly clear that an instrument the negotiation of which is regulated by such a rule of law is not in the full sense of the term a negotiable instrument — that is to say, it is not negotiable as the commercial currency of the country is generally..." [27]

He continues:

> "but it would be going a long way to lay down as a proposition of law that 'mere suspicion' — a speculative surmise that something might be wrong without any objective basis — could never in any circumstances be consistent with honesty." [28]

Thus, there must be more than mere speculation, which is only a possibility and not a probability.

(v) Intimate Connection between Payee and Transferee

Although Collins, J. in the *Sigouin* case does not reveal what the suspicious circumstances were, it seems evident that young Sigouin was the victim of the sharp practices of Circle Acceptance, who were primarily concerned with getting themselves into the category of a holder in due course. In many instances involving conditional sales contracts, the finance company is not an independent third party: often there is some regular arrangement whereby the payee of the note drawn by the customer has previously entered into a discounting procedure with the finance company. In such a case, the finance company should not be permitted to claim the status of a holder in due course, because its connection with the dealer may be so close that the two might be considered as engaging in one operation. Since negotiation (required by s. 56 (1) (b)) means a *real* transfer to an independent person, no real negotiation of the note will have taken place. Thus, the finance company cannot plead that when it took the note, it was unaware of the suspicious circumstances: it is presumed to know. However, if there was no previous arrangement for regular discounting of notes and the finance com-

[27] *Ibid.*, at p. 636.
[28] *Ibid.*, at p. 643.

pany is really a separate party, it should be treated like any other holder in due course, i.e. it is under no duty to investigate, unless the probability exists that something is wrong.

In *Federal Discount Corporation Ltd.* v. *St. Pierre and St. Pierre*,[29] an intimate arrangement existed between a dealer selling home knitting machines, as part of a complicated home knitting scheme, and a finance company. The court held that the finance company was not a holder in due course, because its connection with the dealer went beyond the normal business dealing between finance company and merchant. Kelly, J.A., discussing the modern type of conditional sales contract, remarked:

> "The very existence of the seller's business depends on his ability to convert into cash these obligations and the finance company, standing ready and willing to buy them, has become not only an essential part of retail selling on the time payment plan but is in effect a department of the seller's business..." [30]

Finance companies often have tried to claim they are independent agencies, although in fact they have been organized for the sole purpose of purchasing contracts or discounting notes from specific companies even before the contracts were entered into. Their aim is to obtain the position of a holder in due course, in order to avoid defences which could be set up against a mere assignee. In the *St. Pierre* case, Kelly, J. A. rightly rejects such a fiction:

> "The course of dealings between the plaintiff and the officers of Fair Isle indicates a relationship much more intimate than that of endorsee or endorser in a normal commercial transaction... To pretend that they were so separate that the transfer of each note constituted an independent commercial transaction not affected by the pre-existing arrangements between them would be to permit the form to prevail over the substance." [31]

However, not all finance companies have such a close connection with the seller, and these independent ones should not be precluded from being holders in due course. Some American states have gone so far as to deny the position of a holder in due course to a finance company [32], but this is unjust to the many finance companies who are in good faith.

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[29] (1962) 32 D.L.R. (2d) 86.

[30] *Ibid.*, at p. 98.

[31] *Ibid.*, at p. 99. It is interesting to note that the Quebec Court of Appeal deprived a finance company of the status of a holder in due course, deciding that if the holder of a cheque finds his right to claim in an agreement in writing separate and distinct from the cheque, he does not enjoy the advantages conferred by the Bills of Exchange Act on a holder in due course and the drawer of the cheque is free to urge any defence that may be open to him. See the opinion of Casey, J. in *Elmhurst Investment Company* v. *Allard* [1963] B.R. 236 at 243.

[32] Louise Korns, *Case Comment* in (1952-53) 27 Tulane Law Rev. 255 at 256.

Conclusion and personal opinion

The general rule is that the holder in due course has no responsibility to investigate the nature of the transaction between the original parties, contrary to what Collins, J. seems to imply. However, this comment has attempted to show that the necessity of good faith means that a holder in due course cannot ignore suspicious circumstances merely to get himself into the privileged category, although honest negligence will be tolerated. Moreover, mere surmise that something might be wrong is not sufficient: there must be some happening to arouse suspicion. Finally, the type of business relationship between the seller and the finance company is an element to be considered in deciding if the finance company is a holder in due course.

As mentioned above, the main difficulty is in answering the question, "When have the circumstances become suspicious enough to warn the holder in due course?" In the *Jones* case, the fact pattern clearly established that it was *probable* that there had been fraud. But what could the holder do when it is merely *possible* that something is wrong? It is submitted that the circumstances must create suspicion which goes beyond the realm of possibility and into probability. Possibility should not be sufficient, because mere speculative surmise that the title of a negotiable instrument is defective is *always* present. While the solution proposed will undoubtedly lead to the further problem of distinguishing between possibility and probability, such matters of mixed fact and law must be left to the trial judge. Moreover, it is submitted that the court must look at the circumstances from the subjective position of the particular person involved: a "reasonable man" test would destroy the concept stated above, i.e., no matter how gross a person's negligence, this will not put him in bad faith.

It is respectfully submitted that if the statements of Collins, J. are literally applied, this could lead to undesirable commercial consequences. The principle that third parties must be protected demands that the holder in due course be under no obligation to verify his title before taking an instrument. This is in accordance with the ultimate object of negotiability — circulation of the instrument similar to legal tender. As Perrault states:

> C'est ce principe de l'inopposabilité des exceptions qui permet à la lettre de change... de faciliter le règlement des obligations juridiques formées quotidiennement. Sans ce principe de l'inopposabilité des exceptions, ni l'un ni l'autre de ces titres de crédit ne pourrait tenir lieu de monnaie dans les paiements. S'il n'existait pas, il serait impossible au preneur ou à l'endossataire de faire d'une lettre de change ou d'un billet un instrument de crédit.

> Nul ne voudrait accepter l'un ou l'autre de ces titres si les signataires avaient la faculté d'invoquer vis-à-vis du détenteur les causes d'annulation ou de résolution des obligations formées entre les parties antérieures à ce détenteur. L'inopposabilité des exceptions se rattache à la nature même des titres de crédit." [33]

To permit negotiable instruments to fulfil their economic role, good faith holders must be free from the necessity to make verifications which often would be difficult or impossible. If every person who took a negotiable instrument in the course of business feared that its title might be defective, this would tend to weaken the stability of commercial transactions.

The question as to whether a holder in due course must investigate involves a conflict between public policy and private interest. For the sake of commerce, public policy requires that third parties who take an instrument in good faith should be free from any challenge to their title. On the other hand, we must not lose sight of the private interest of the maker who has been defrauded (in the *Sigouin* case, by the fraud of the furniture company). While the remarks of Collins, J. might be taken to mean that private interest should prevail, this comment has tried to show that public policy is the most important factor, although there are certain mitigating factors which help to protect the private interest.

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[33] Perreault, *op. cit.*, p. 799.