

BOSTON COLLEGE LAW REVIEW

VOLUME XXII

JANUARY 1981

NUMBER 2

NOTICE TO HOLDERS IN DUE COURSE AND OTHER BONA FIDE PURCHASERS UNDER THE UNIFORM COMMERCIAL CODE†

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Notice is the "legal cognizance of a fact."¹ The basis of the doctrine of notice in commercial law is the principle that a person should be accountable for his state of mind at the time he entered into a transaction. Information that he possessed when contracting bears upon that state of mind and is frequently an important consideration in determining his rights and obligations not only vis-a-vis the other party to the transaction, but also in relation to third parties whose rights may have been affected by the transaction.²

This article seeks to analyze the role and the nature of the doctrine of notice as it is found in the Uniform Commercial Code (U.C.C. or Code). The discussion will be divided into two parts. The first will deal with the general principles of notice that underlie all of the articles of the U.C.C. Particular attention will be paid to those principles applicable to the notice requirements of a bona fide purchase. The second will examine the concept as it has developed in relation to a special class of bona fide purchasers, the holder in due course of a negotiable instrument. The doctrine of holder in due course is singled out for special treatment because it has dominated the area of notice and has received considerable attention by the courts, the commentators, and the U.C.C. draftsmen. The holder in due course, however, cannot be viewed in total segregation. The general themes of the doctrine of notice permeate the U.C.C. as a whole, and intertwine from one article to the next. Therefore, in treating notice under separate heads, one is forced to remain conscious of the frequent overlap

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¹ G. BISPHAM, *PRINCIPLES OF EQUITY* 371 (5th ed. 1893) [hereinafter cited as BISPHAM]. Long, *Notice in Equity*, 34 HARV. L. REV. 137, 140 (1920) [hereinafter cited as Long], defines notice as "knowledge of a fact either actually possessed by a person or imputed to him by law." See also J. POMEROY, *EQUITY JURISPRUDENCE* 1109 (4th ed. 1918) [hereinafter cited as POMEROY].

² "The legal relations of a person are frequently affected by his knowledge, or by the existence of facts because of which he is treated, for the purpose in question, as if he had knowledge. To express the idea that legal relations may be changed because of knowledge, or some-

and to view the two parts which follow as different in emphasis and detail rather than in fundamental content.

I. GENERAL PRINCIPLES OF NOTICE UNDER THE U.C.C.

A. *Notice as a Factor in Bona Fide Purchase*

The concept of bona fide purchase has had an association with the doctrine of notice both at common law and under the U.C.C. Under early law, when courts were confronted with a dispute between a person who had acquired a right in property and one who had a prior conflicting right in the same property, they favored the prior right on the basis that first acquired interests should be protected against rights that come into existence later in time. This solution accorded with the general principle of equity jurisprudence that a prior equity prevails where two equities are in conflict.³ In time, however, both the demands of equity and the exigencies of commerce called for the relaxation of that rule in a number of areas. It was recognized that the ends of justice and commerce would be well served by insulating the rights of certain transferees of property from the assaults of third parties who claimed a prior interest. Yet the prior equities were strong and would not give way entirely. Accordingly, in order to prevail, it was necessary for the subsequent purchaser to show that he acquired the property in good faith, for value, and without notice of the prior adverse claim — that he was a bona fide purchaser.⁴

The traditional conception of bona fide purchase was preserved in the U.C.C.⁵ and manifests itself in many Code provisions. The most obvious examples are the holder in due course of a negotiable instrument under article 3,⁶ and the holder of a negotiable document under article 7.⁷ In addition, there are

thing equivalent to it in the particular case, the word 'notice' is used." RESTATEMENT (SECOND) OF AGENCY § 9, Comment (a) (1958).

³ Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057 (1954) [hereinafter cited as Gilmore]; BISPHAM, *supra* note 1, at 369-71, traces the roots of the doctrine of notice. He notes that in conflicts between legal titles it was not relevant that the later party had knowledge of an adverse claim when he acquired his rights. However, where equitable rights were concerned, a person who acquired title with knowledge that it was affected by an equity would take subject to that equity; *see also* Long, *supra* note 1, at 138; J. STORY, COMMENTARIES ON EQUITY JURISPRUDENCE § 411, at 399 (1836) [hereinafter cited as STORY].

⁴ This short account is obviously a broad generalization, subject to myriad qualifications. No attempt is being made to encapsulate the growth or extent of the doctrine of bona fide purchase in a few sentences. This passage merely serves to alert the reader to the fact that the modern-day doctrine of bona fide purchase has ancient roots which can be traced both to equity jurisprudence and to mercantile common law. A fuller account of the development and bounds of the doctrine in different areas of the law may be found in POMEROY, *supra* note 1, at §§ 735-785; Gilmore, *supra* note 3; STORY, *supra* note 3, at 396.

⁵ There is no definition of bona fide purchaser in the general definition section, U.C.C. § 1-201.

⁶ The holder in due course's ancestry is discussed in text at notes 102-28 *infra*.

⁷ U.C.C. § 7-501(4) states that a negotiable document of title is "duly negotiated" when "it is negotiated . . . to a holder who purchases it in good faith, without notice of any defense against or claim to it on the part of any person and for value . . ." *Id.* The section goes on to list as a further requirement that it be taken in the regular course of business or financing. *Id.* The heavily mercantile nature of negotiable documents has resulted in the retention of this

a number of other sections that define and deal with bona fide purchasers, for example, section 6-110, which relates to purchase from a bulk transferor,⁸ section 8-302, which governs purchases of securities,⁹ and section 9-301(1)(c), which preserves the rights of one who purchases property subject to an unperfected security interest.¹⁰ The concept of bona fide purchase also underlies the status of buyer in the ordinary course of business as defined in section 1-201(9),¹¹ and consequently it is imported into other sections of the Code where the quality of being in the ordinary course of business is a prerequisite for protection.¹²

latter requirement as an ingredient of holding in due course. See Comment 1 to § 7-501. The section is interpreted in *Cleveland v. McNabb*, 312 F. Supp. 155 (W.D. Tenn. 1970). Gilmore, *supra* note 3, at 1076-81, traces the history of negotiable documents or title, and in so doing illustrates that the protection of a bona fide purchaser in this area is a rather recent development.

⁸ U.C.C. § 6-110(2) provides: "When the title of a transferee to property is subject to a defect . . . then . . . a purchaser for value in good faith and without . . . notice [of such defect] takes free of such defect." *Id.*

⁹ U.C.C. § 8-302 defines a bona fide purchaser of a security as one who purchases for value, in good faith and without notice of an adverse claim. Upon attaining that status he acquires rights to the security free of any such adverse claims. U.C.C. § 8-302(3). Prior to the enactment of the U.C.C. securities were governed, if they were bonds, by the Negotiable Instruments Law (N.I.L.) and, if they were share certificates, by the Uniform Stock Transfer Act. Under those statutes a bona fide purchaser was given rights similar to those contained in the present U.C.C. § 8-302. Bonds were considered to be negotiable instruments within the Negotiable Instruments Law so that its provisions relating to holding in due course applied to them. Those provisions are discussed fully below. Section 7(1) of the Uniform Stock Transfer Act provided that if there were certain specified defects in the title to the certificate its transfer could be rescinded except as against a purchaser for value in good faith and without notice of any facts making the transfer wrongful.

¹⁰ *Whitmire v. Keyton*, 12 U.C.C. REP. SERV. 1203, 1208-09 (Tenn. 1973).

¹¹ A buyer in the ordinary course of business is one who "in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods buys in ordinary course from a person in the business of selling goods of that kind" U.C.C. § 1-201(9). Quite apart from the course of business requirement, this purchaser does not quite fit into the traditional mold of a bona fide purchaser. Although the good faith element is expressly called for, and the value element is implicit in the word "buys," the requirement of notice in an objective sense is not present. He will only be disqualified from the status if he actually knew that the sale was in violation of third party rights. That test is an entirely subjective one, and is more closely allied to the question of his good faith than to any conception of notice.

Prior to 1956, the predecessor of this section of the U.C.C. had no requirement of good faith and lack of knowledge. Those requirements were added upon the recommendation of the New York Law Revision Commission. According to the reasons for change published in the 1956 Recommendations of the Editorial Board of the U.C.C., "[t]he 'without knowledge' addition spells out one important type of dishonesty."

The wording of the section closely parallels that of its predecessor, § 1 of the Uniform Trust Receipts Act, which called for new value, good faith, and lack of actual knowledge. The import of the distinction between subjective knowledge and objective notice is dealt with below.

¹² See, e.g., U.C.C. § 2-403(2), U.C.C. § 9-307(1). Section 2-403 provides for a slightly deviant type of bona fide purchaser. The relevant portion of the section allows "[a] person with voidable title . . . to transfer a good title to a good faith purchaser for value." At first blush the definition has a missing ingredient — it does not require that the purchaser lack notice of any defect in title. If the section is compared with two of its predecessors, section 24 of the Uniform Sales Act, and section 9(2) of the Uniform Trust Receipts Act, both of which required lack of notice, the omission becomes more glaring. The omission of the notice standard in the case of

The three common law elements of a bona fide purchase — value, good faith, and lack of notice — are thus well established under the U.C.C. This article, of course, focuses on the latter of these three ingredients and much of the following discussion of the doctrine of notice is oriented towards its application in the context of bona fide purchase.¹³

good faith purchasers is puzzling. It is possible that the term "good faith purchaser" was simply a translation of its Latin equivalent and that the omission of the notice requirement was inadvertent. The indications, however, are to the contrary. The official comment to the May 1949 Draft of the equivalent section (there numbered § 2-405) states "three basic requirements which must be fulfilled before the purchaser can take a better title than his transferor has. He must take in good faith as that term is defined in the article. There must be delivery to the transferee. The transferee must give value for the goods." These words would indicate that the omission was intentional. One court, at least, has so treated the omission of the requirement of notice. In *re Samuels & Co.*, 526 F.2d 1238 (5th Cir. 1976) declared: "Lack of knowledge of outstanding claims is necessary to the common law [bona fide purchaser] and is similarly expressly required in many Code [bona fide purchaser] and priority provisions. . . . But the Code's definition of an Article Two good faith purchaser does not expressly or impliedly include lack of knowledge of third-party claims as an element." *Id.* at 1243-44 (citations omitted).

In the case of a merchant, the specific definition of good faith in U.S.C. § 2-103(b) imposes, in addition to the general subjective honesty test of § 1-201(19), a requirement of "the observance of reasonable commercial standards of fair dealing in the trade." Therefore, in determining whether a merchant qualifies as a good faith purchaser under § 2-403, the court is able to conduct an inquiry into his subjective honesty, and also to investigate whether or not his behavior measures up to the objective standards of fair dealing in the trade. In come cases that will allow an inquiry into the question of whether or not he had notice of a defect in the sellers' title. Even where a merchant is involved, however, this general objective test of good faith will not necessarily be coextensive with the standards set for establishing the lack of notice as a prerequisite for bona fide purchase.

In the case of non-merchants, the objective definition of good faith in § 2-103(b) does not apply, and the inquiry will simply be whether the person took in good faith as defined generally in § 1-201(19). Notice of prior or adverse claims will be irrelevant except insofar as they bear upon the question of his honesty.

Those courts and commentators that have interpreted § 2-403 for the most part have not required the absence of notice as an element of good faith purchase under the section. *See In re Samuels & Co.*, 526 F.2d 1238 (5th Cir. 1976); *National Car Rental v. Fox*, 500 P.2d 1148 (Ariz. 1972); *In re Bowman*, 25 U.C.C. REP. SERV. 738 (N.D. Ga. 1978); *Maurice Shire, Inc. v. Gerald Modell, Inc.*, 19 U.C.C. REP. SERV. 1096 (N.Y. 1976); *Atlas Auto Rental Corp. v. Weisberg*, 54 Misc. 2d 168, 281 N.Y.S.2d 400 (1967); *Landrum v. Arbruster*, 28 N.C. App. 250, 220 S.E.2d 842 (1976). Cases such as *National Car Rental* illustrate the sometimes fine dividing line between cases in which suspicious circumstances will lead to a finding of bad faith, and those in which it will lead to a finding only of objective notice. *See also* 3 WILLISTON ON SALES 376 n.17 (4th ed. 1974); R. NORDSTROM, HANDBOOK OF THE LAW OF SALES 515 (1970); R. DUESENBERG & L. KING, SALES & BULK TRANSFERS UNDER THE UCC § 10.06(1), at 10-48 n.17. *Cf. Hollis v. Chamberlain*, 243 Ark. 201, 419 S.W.2d 116 (1967), in which the court confused good faith purchase under § 2-401 with bona fide purchase generally, and similarly lumped together the issues of good faith and notice.

¹³ It is not suggested that the notice provisions in the U.C.C. are only of relevance in the area of bona fide purchase. There are situations far removed from any issue of bona fide purchase in which an inquiry into when the giving or receipt of notice is apposite. For example, the presence or absence of notice may in some cases have a bearing on the rights of parties to a transaction *inter se*. The U.C.C. abounds with situations in which proper notification is a condition precedent to the creation, enjoyment or protection of rights. The following random selection illustrates the point: Appropriate notification by a seller of goods is often an element in the proper delivery of goods, U.C.C. § 2-503(1), or will bear upon his rights to cure a defective delivery,

To understand notice requirements in this context, it is first necessary to recognize the distinction between taking without notice and another element of a bona fide purchase, taking in good faith. Undeniably, there is a close relationship between taking without notice and taking in good faith. The connecting link between the two concepts lies in the factual undergrowth from which they emerge. It often happens that the very facts that establish that a purchaser had notice of an adverse interest in property will also cast doubt upon his good faith in purchasing it.¹⁴ In some areas that factual proximity has had the effect of merging the concepts so that they appear as a single standard to be satisfied by the same criteria. This amalgamation became established doctrinally in some areas of the law, so that the test for bona fide purchase became a unilateral one, involving only value and good faith. The essence of notice was merely an ingredient in defending the issue of good faith. It is one of the theses of this article, however, that such a merger is not justifiable under the U.C.C. The U.C.C. requires that both good faith and lack of notice be established as a prerequisite for the status of bona fide purchaser and prescribes different standards for the determination of those separate elements. In certain situations a single set of facts may establish both elements, but this must be recognized as a consequence of the factual setting rather than the legal principle. In the following discussion, this theme of the interrelationship between notice and good faith will constantly recur.

B. *The Definition of Notice Under the U.C.C.*

Notice is defined in section 1-201(25) of the U.C.C. The section provides not only a definition but also a statement of principle that applies to every one of the large number of sections in which the words "notice," "knowledge," or "reason to know" have been used. The definition section is therefore pervasive and operates as a springboard to the interpretation of any section in which notice has a bearing on the rights of a party. Section 1-201(25) reads as follows:

A person has "notice" of a fact when

- (a) he has actual knowledge of it; or
- (b) he has received a notice or notification of it; or
- (c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists.

A person "knows" or has "knowledge" of a fact when he has actual knowledge of it. "Discover" or "learn" or a word or phrase of similar import refers to knowledge rather than to reason to know.

U.C.C. § 2-508, or will affect his remedies on breach, U.C.C. § 2-706. Similarly, a buyer's right of rejection, U.C.C. § 2-602, revocation, U.C.C. § 2-608, and his right to damages, U.C.C. §§ 2-607, 2-714, will in many cases depend upon notification. A holder's right against prior parties is often dependent upon proper notice of dishonor, U.C.C. § 3-501. The protection of a bulk transferee against creditors of the transferor is heavily dependent upon proper notification, U.C.C. §§ 6-104, 6-105. In some cases a secured party is also required to give notice in order to protect his rights. *See, e.g.,* U.C.C. §§ 9-318, 9-312(3).

¹⁴ *See, e.g.,* *Branch Banking & Trust v. Gill*, 293 N.C. 164, 184, 237 S.E.2d 21, 32 (1977); *In re Itelab, Inc.*, 197 F. Supp. 5, 8 (E.D.N.Y. 1961).

The time and circumstances under which a notice or notification may cease to be effective are not determined by this Act.¹⁵

In essence the section states that a person has notice in three different situations: first, where he has actual knowledge of the relevant facts; second, where he has received a notice or notification of the relevant facts; and third, where he has knowledge of other facts which lead to the inference that he should have known the relevant facts. In the remainder of this subsection the parameters of these categories shall be explored.

1. Actual Knowledge — The Distinction Between Notice and Knowledge

As previously noted, the doctrine of notice is a formula by which the law ascertains whether or not a person should be treated as having knowledge of some fact at a given point in time. The ultimate question is whether or not the person had knowledge of the fact. The means of answering it is through the doctrine of notice. It follows that notice and knowledge are intimately related concepts. They are not, however, interchangeable. If the law required simply that knowledge be determinative of legal rights, there would need to be only a factual inquiry into the state of mind of the relevant person. The doctrine of notice, however, goes beyond knowledge encompassing situations where knowledge, though not necessarily possessed, is nevertheless attributed to a person. Thus, the distinction between knowledge and notice lies in the difference between factual and legal conclusions.

Knowledge is the narrower factual concept. It describes the state of the conscious mind of a person and connotes a conscious awareness of fact or condition. By contrast, notice is a legal conclusion, a term of art which may or may not be coextensive with knowledge.¹⁶ The distinction may be illustrated by a simple example. If P purchases property from S knowing that T has an existing interest in the property, then P's knowledge of that interest will usually also constitute legal notice of the interest. However, this is not always true. For example, where a statute requires T to record his interest in public records in order to effectuate it against other purchasers from S, P's factual knowledge of T's interest will not be the equivalent of legal notice. Legal notice of T's interest would be constituted only by a proper recording, and P's knowledge or lack of it is immaterial. Even in the absence of a recording statute, there are situations in which P will be treated as having knowledge that he does not actually possess. These situations usually occur where it is found that P's lack of knowledge arises from some fault or neglect on his part.

The U.C.C., in accordance with pre-Code conceptions, carefully distinguishes knowledge from notice. While the whole of section 1-201(25) defines situations in which notice will be present, only subsection (a) of that section

¹⁵ U.C.C. § 1-201(25).

¹⁶ Seavey, *Notice Through an Agent*, 65 U. PA. L. REV. 1, 2 (1916) [hereinafter cited as Seavey]; Merrill, *The Anatomy of Notice*, 3 U. CHI. L. REV. 417 (1936) [hereinafter cited as Merrill]; RESTATEMENT (SECOND) OF AGENCY § 9, Comment (c); Long, *supra* note 1, at 140, 141.

relates to actual knowledge.¹⁷ The distinction is not merely a theoretical nicety. Throughout the U.C.C. the draftsmen have used it deliberately to separate those cases in which a person is accountable only for his factual state of mind,¹⁸ from those in which he is accountable not only for his actual awareness of facts, but also for that awareness attributed to him by the wider principles of notice.¹⁹

2. The Distinction Between Actual and Constructive Notice

Notice itself traditionally has been divided into two sub-categories — actual notice and constructive notice. This dichotomy has been preserved in the U.C.C. In its extreme form actual notice coincides with knowledge. In that form, the person charged with notice would have, as a matter of proven fact, actual, present, and conscious awareness of the facts with which he is charged. Conversely, constructive notice represents, in its clearest sense, a legal presumption that the person charged with notice is aware of facts that are recorded or published in a prescribed form. The person is treated as having knowledge

¹⁷ The language in question is that which provides that actual knowledge of a fact constitutes notice of it. The idea is further expanded by the definition of "knows," "knowledge," "discover," and "learn" in the penultimate two sentences of subsection (25).

¹⁸ Thus, the provision in § 6-104(3) that excuses a transferee from responsibility for omissions from a list of creditors drawn up by a bulk transferor unless he has knowledge of such omission, has been interpreted to penalize such a bulk transferee only in the case of actual knowledge of the omission. *Federal Ins. Co. v. Pipeco Steel Corp.*, 125-N.J. Super. 563, 312 A.2d 510 (1973); *Adrian Tabin Corp. v. Climax Boutique, Inc.*, 34 N.Y.2d 210, 313 N.E.2d 66, 356 N.Y.S.2d 606 (1974).

Similarly, knowledge of the contents of a financing statement provided for in § 9-401(2) means actual knowledge. In *re Computer Careers Inst.*, 9 U.C.C. REP. SERV. 930, 932 (E.D. Tenn. 1971); see also *Matter of Luckenbill*, 156 F. Supp. 129, 131 (E.D. Pa. 1957); In *re Dennis Mitchell Indus., Inc.*, 419 F.2d 349, 359 (3d Cir. 1969); *Franklin Nat'l Investment Corp. v. American Swiss Parts Co.*, 42 Mich. App. 211, 214, 201 N.W.2d 673, 674 (1972); In *re Komfo Products Corp.*, 2 U.C.C. REP. SERV. 1107 (E.D. Pa. 1965); In *re County Green*, 438 F. Supp. 693, 697 (W.D. Va. 1977). But see In *re Enark Indus., Inc.*, 19 U.C.C. REP. SERV. 685 (N.Y. 1976). Cf. *First State Bank v. United Dollar Stores*, 571 P.2d 444, 448 (Okla. 1977), in which the court exhibits some confusion as to the meaning of knowledge as used in § 9-401(2) and defines it as actual knowledge and reason to have actual knowledge.

Knowledge of a security interest under § 9-301(1)(b) (1962 Official Version) means actual knowledge. *United States v. Ed Lusk Constr. Co.*, 504 F.2d 328, 331 (10th Cir. 1974); *Gulf Oil Co. v. First Nat'l Bank*, 503 S.W.2d 300, 307 (Tex. 1973); *Clark Oil & Refining Co. v. Lid-dicoat*, 65 Wis. 2d 612, 223 N.W.2d 530 (1974).

Knowledge of a purchaser under § 9-301(1)(c) means actual knowledge. *Whitmire v. Keylon*, 12 U.C.C. REP. SERV. 1203, 1208-09 (Tenn. 1973); *Bloom v. Hilty*, 427 Pa. 463, 468, 234 A.2d 860, 862 (1967).

Knowledge of a purchaser under § 9-313(4)(a) (1962 Official Version) means actual knowledge. *Northwest Equipment Sales Co. v. Western Packers, Inc.*, 20 U.C.C. REP. SERV. 210, 214 (9th Cir. 1976).

A general discussion on the significance of knowledge in article 9 priority contests (under the 1962 official text) may be found in Felsenfeld, *Knowledge as a Factor in Determining Priorities under the U.C.C.*, 42 N.Y.U. L. REV. 246 (1967).

¹⁹ E.g., *Victory Nat'l Bank v. Oklahoma State Bank*, 520 P.2d 675, 678 (Okla. 1973); *National Trailer Convoy Co., Inc. v. Mount Vernon Nat'l Bank & Trust Co.*, 420 P.2d 889, 893 (Okla. 1966).

of the facts whether or not he actually knew them. The presumption arises entirely out of proper completion of some recognized formal act.

Although the distinction between actual and constructive notice is universally recognized, the dividing line between the two forms of notice has been the subject matter of some dispute. The older commentators on the doctrine of notice tended to base their differentiation on the question of whether notice was established by evidence of knowledge or as a result of some presumption or inference of law. This distinction between actual and constructive notice was blurred, however, because different commentators and courts drew the borderline in different places. For example, Story treated as actual notice only those cases in which direct evidence of knowledge was established.²⁰ In cases where notice was inferred as a result of a presumption of law built upon circumstances that reasonably should have promoted further inquiry, Story classed the notice as constructive. A similar distinction was advocated by Bispham who defined actual notice as notice established either directly or by implication from the facts and constructive notice as notice established by an irrebuttable conclusion of law.²¹ Pomeroy's test was whether notice was determined by inference of facts from evidence, in which case it is actual notice, or whether it was based on a presumption of law arising from certain factual findings, in which case it is constructive notice.²² These various theories presented few problems in clear-cut cases in which actual knowledge was proven, or in which there was a clear legislative enactment that created a fiction of notice regardless of any actual appreciation of the facts. In the grey area in between these poles, however, confusion reigned. In cases where there was some imputation of knowledge, it was difficult to decide whether the notice fell on one side of the line to become actual, or on the other to become constructive. The conflicts in the commentaries mirrored those in the courts.²³

More recent writers have devised a test with a stronger rational base. It applies a less flexible and more constant standard. For example, Seavey advocated a straightforward test for distinguishing between actual and constructive notice.²⁴ The test eschewed the evidence-oriented approach that caused the prior confusion, and fixed upon the heart of the real distinction between constructive and actual notice. It revolved around the question of whose actions are relevant, the party claiming the rights, or the party who is to be charged with the notice. If, on the one hand, the state of mind of the party to be charged was conclusive of whether or not he takes subject to the prior claim, then any evidence and presumptions from evidence that go to establishing this state of

²⁰ STORY, *supra* note 13, at 387.

²¹ BISPHAM, *supra* note 1, at 379. Bispham's fact/law distinction brings him a little closer to the later writers discussed *infra* at notes 24-25.

²² POMEROY, *supra* note 1, at 1108.

²³ The confusion is well described by Long, *supra* note 1, at 151; 1 M. MERRILL ON NOTICE §§ 14-17 (1952). A short survey of the pre-Code writings and cases on the doctrine of notice can be found in *Study of the U. C. C. Article 1 — General Provisions*, 1 N.Y. Law Rev. Comm'n Report 1269 (1955) [hereinafter cited as N.Y. Law Rev. Comm'n Report].

²⁴ Seavey, *supra* note 16, at 2, 10. See also Merrill, *supra* note 16, at 427; Long, *supra* note 1, at 151.

mind must be seen as establishing actual notice. If, on the other hand, the state of mind of the party to be charged was irrelevant and the only inquiry was whether or not some formal act was properly performed by the party seeking to protect the prior rights, then the notice resulting from the formal act was constructive notice or, as Seavey terms it, "absolute notice."

Seavey's distinction has formed the basis of the definition of notice in the Restatement (Second) of Agency.²⁵ This school of thought admits of only one situation in which constructive notice will be imputed to a person. This occurs where an irrebuttable conclusion of notice is created against one person as a result of the act of another. In such a case, the act, typically registration or notification in some form, is prescribed by a law that provides that the act itself creates legal consequences against all persons in the class affected, regardless of whether notice or knowledge on their part can be established. The state of mind of the person to be charged with notice is irrelevant to the inquiry, which centers solely around the question of whether or not the formal act was correctly and adequately performed. This distinction is far preferable to the one suggested by Story, Bispham, and Pomeroy because it distinguishes the two categories of notice on the basis of the one feature which in fact distinguishes them. Constructive notice is essentially formal in nature, while actual notice rests upon the appreciation of the relevant party.

²⁵ Section 9 of the Restatement provides:

- (1) A person has notice of a fact if he knows the fact, has reason to know it, should know it, or has been given notification of it.
- (2) A person is given notification of a fact by another if the latter
 - (a) informs him of the fact by adequate or specified means or of other facts from which he has reason to know or should know the facts; or
 - (b) does an act which, under the rules applicable to the transaction, has the same effect on the legal relations of the parties as the acquisition of knowledge or reason to know.
- (3) A person has notice of a fact if his agent has knowledge of the fact, reason to know it or should know it, or has been given a notification of it, under circumstances coming within the rules applying to the liability of a principal because of notice to his agent.

RESTATEMENT (SECOND) OF AGENCY § 9 (1958).

The dichotomy between notice deriving from the state of mind of the person charged, § 9(1), and that deriving from the act of the person giving the notice, § 9(2), is clearly demarcated, and is reinforced by the comments to the section. Comment (f) states: "knowledge is subjective to one having it Notification, however, is a juristic act which determines the rights of the parties, sometimes irrespective of knowledge by the recipient." Cf. RESTATEMENT (SECOND) TRUSTS § 297 (1959):

A person has notice of a breach of trust if

- (a) he knows or should know of the breach of trust, or
- (b) by statute or otherwise he is subjected to the same liabilities as though he knew or should have known of the breach of trust, even though in fact he did not know and had no reason to know of the breach of trust.

Comment (b) emphasizes that "[i]f an instrument is properly recorded [under a recording statute], third persons are thereby given notice of the provisions of the instrument to the extent provided for by the statute, even though in fact they have no knowledge or reason to know of the existence or provisions of the instrument."

Id.

The distinction is not merely one of theory or semantics. If the scope of a formal or absolute standard for notice is not clearly defined there is the danger of impermissible fictions or presumptions being raised in cases where they are not appropriate. It is important that the courts understand when notice is to be determined by legal fiction and when it is to be established only on the facts proved directly or by inference.²⁶

The U.C.C. does not expressly distinguish constructive notice from actual notice. In fact, the term "constructive notice" does not appear in the U.C.C. at all. Nevertheless, it is clear that the draftsmen sought to promulgate a test in the U.C.C. which is in line with that set out by Seavey and the Restatement (Second) of Agency. This intent does not appear from the express wording of section 1-201(25) nor from the official comments to the section.²⁷ A proper construction of the wording of the section, however, can compel no other conclusion but that constructive notice, in the sense of formal absolute and irrebuttable notice, can be used in situations where it is specifically provided for in the U.C.C.²⁸ or in some other statute that is clearly applicable under the circumstances.²⁹

3. Constructive Notice Under the U.C.C.

Under the U.C.C. there are several situations where authority may be found for charging a person with constructive notice. These situations can be arranged into three broad categories. The first is where a person is charged

²⁶ Sometimes courts confuse the terminology, even under the U.C.C. In *Miriani v. Rodman and Renshaw, Inc.*, 358 F. Supp. 1011, 1013 (N.D. Ill. 1973), the court incorrectly used the term constructive knowledge when it referred to the "reason to know" test of § 1-201(25)(c). See also *Ibanez v. Farmers Underwriters Ass'n*, 14 Cal. 3d 390, 534 P.2d 1336, 121 Cal. Rptr. 256 (1975).

²⁷ The same is true of the official comments to prior drafts of the section, which dates back in its present form to the 1950 draft. In the 1949 Official Draft of the U.C.C. there was no provision in article 1 equivalent to the present § 1-201(25). Instead, the definition of notice was found in some of the specific articles. For the purposes of article 8, notice was defined in § 8-104. Although the definition was not as detailed as that in § 1-201(25), the official comment expresses an enlightening and, it is submitted, a generally applicable observation: "Under this article, notice contemplates actual notice and 'reason to know.' Constructive notice is rejected as a general concept and is recognized only in those specific instances where express provision is made . . ." U.C.C. § 8-104 (1949 Official Draft).

²⁸ *Matter of Luckenbill*, 156 F. Supp. 129 (E.D. Pa. 1957); *Federal Ins. Co. v. Pipeco Steel Corp.*, 125 N.J. Super. 563, 312 A.2d 510 (1973); *First State Bank v. United Dollar Stores*, 571 P.2d 444 (Okla. 1977). Section 9-318, which requires notification to an accounts debtor, requires actual notification and the filing of a financing statement does not constitute proper notification under the section. In *re Chase Manhattan Bank v. New York*, 367 N.Y.S.2d 580 (App. Div. 1975), *aff'd*, 40 N.Y.2d 590, 357 N.E.2d 366, 388 N.Y.S.2d 896 (1976); *Bank of Salt Lake City v. Church of Jesus Christ of Latter Day Saints*, 534 P.2d 887 (Utah 1975). Similarly, filing will not constitute notice to a holder in due course under § 3-304(5). See *National Surety Fire v. Mazzara*, 268 So. 2d 814 (Ala. 1972); *Stewart v. Thornton*, 116 Ariz. 107, 568 P.2d 414 (1977).

²⁹ It is not uncommon for notice by recording to be provided for in a statute which dovetails with the U.C.C. Certificate of title statutes are an obvious example. They provide for the perfection of a security interest in the goods covered by the certificate (typically automobiles) by notation on the certificate. Such a mode of perfection is recognized expressly by § 9-302(3)(b).

with notice of a fact because he received notification of it. The second is where a person is held to have constructive notice of facts contained in the body of a negotiable instrument, document, or security. The third is where a person is charged with facts appropriately recorded in public records.³⁰

Constructive notice through notification is the only category that applies generally throughout the U.C.C. because it is the only one provided for in section 1-201(25). The other forms of constructive notice are confined to the specific articles in which they appear. Section 1-201(25)(b) provides that notice of a fact will be imputed to a party if he receives notification of that fact. Section 1-201(26) states that a person³¹ receives notification when it comes to his attention or where, in appropriate circumstances, it is delivered to his place of business or to a place nominated by him.³² Beyond its general application through section 1-201(25), constructive notice by notification is also provided for in several specific U.C.C. provisions. Under these provisions it is not always necessary for notification to be received. In some instances notification need only be given. Notice is given in terms of section 1-201(26) when a person takes such steps as may be reasonably required to inform the party to be notified in the ordinary course.³³ Each section of the U.C.C. that calls for notification will itself indicate specifically the yardstick by which notification is to be measured. Some allow notification simply by the completion of the act of giving notice,³⁴ while others require not only that notice be given, but that it be received as well.³⁵ Section 1-201(25) falls into the latter category, and therefore constructive notice of a fact will only be attributed to a party who has received notice.

When such notation is duly made, it operates as constructive notice of the interest of the secured party. In *re Pollack*, 3 U.C.C. REP. SERV. 267 (D. Conn. 1966); *National Trailer Convoy Co. v. Mount Vernon Nat'l Bank & Trust Co.*, 420 P.2d 889, 893 (Okla. 1966).

³⁰ A related form of constructive notice is that arising from the presumption that parties know the law. Thus, in *Dempsey Tegler & Co. v. Otis Oil & Gas Corp.*, 293 F. Supp. 1383, 1387 (D. Colo. 1968), the court suggested that, where a Colorado statute required a counter signature on a share certificate, a purchaser of the certificate would be on notice of an irregularity where the counter signature was absent. See also *Stewart v. Thornton*, 116 Ariz. 107, 568 P.2d 414 (1977).

³¹ "Person" includes both individuals and organizations. See U.C.C. § 1-201(30). The specific rules regarding notice to organizations are discussed in text at notes 96-101 *infra*.

³² Section 1-201(26) provides:

A person "notifies" or "gives" a notice or notification to another by taking such steps as may be reasonably required to inform the other in ordinary course whether or not such other actually comes to know of it. A person "receives" a notice or notification when

(a) it comes to his attention; or

(b) it is duly delivered at the place of business through which the contract was made or at any other place held out by him as the place for receipt of such communications.

³³ See, e.g., *Eastern Air Lines v. McDonnell Douglas Corp.*, 532 F.2d 957, 973 (5th Cir. 1976); *Steelman v. Associates Discount Corp.*, 121 Ga. App. 649, 175 S.E.2d 62 (1970); *Mallicoat v. Volunteer Finance*, 57 Tenn. App. 106, 112-13, 415 S.W.2d 347, 350 (1966).

³⁴ There are many such sections. The point is illustrated by a few random examples of sections which by use of the words "notify" or "give notice" require only that notice be given, irrespective of receipt. E.g., U.C.C. §§ 2-207(2)(c), 2-503, 2-503(1), 2-504(c), 2-508, 2-615(c), 2-705(3).

³⁵ See Comment 26 to U.C.C. § 1-201. A few random examples of sections which re-

The term "received" is a term of art, and does not necessarily require the actual acquisition of the relevant information by the person to be notified. Receipt may occur in two settings in accordance with section 1-201(26). The first arises where the notification given comes to the attention of the recipient. The second occurs where the notification is delivered to the recipient but does not necessarily come to his attention.

Under the first situation, it is significant that section 1-201(26)(a), literally interpreted, requires only that the notification, not its subject matter, come to the attention of the person to be charged. Under that interpretation, the requirements of section 1-201(25)(b) are fulfilled when the recipient becomes aware of the notification, whether or not its actual content is assimilated by him. For example, if notice of a fact is given in a letter sealed in an envelope, the crucial event for the purposes of establishing notice under 1-201(26)(a) is the receipt of the envelope, even if it is never opened and read. Obviously the subject matter of the letter is relevant in order to assess whether the act of notification is properly performed, but that is a different issue from whether notice is received.³⁶ Although some may urge a less literal approach to section 1-201(26)(a),³⁷ it seems that the wording interpreted in its strict grammatical sense correctly reflects the intent of the draftsmen.³⁸

The second setting in which receipt may occur is, if anything, more remote from the idea of physical receipt than the first. Subsection (b) of section 1-201(26) does not even require that the recipient become aware of the notification, or that he be physically present at the premises where it is delivered. Subsection (b) requires delivery of notice, but it would be mistaken to interpret that term as requiring any transfer of notice in tangible form. While delivery is not defined in the U.C.C., it is well established that the term does not imply the physical delivery of written notice. It only requires that steps be taken that may be reasonably expected to inform in the ordinary course.³⁹ This is in keeping with the general approach of the U.C.C., which does not require written notice

quire both the giving and receipt of notification include U.C.C. §§ 2-209(5), 2-309(3), 9-112(b), 9-304(3), 9-318(1)(b).

³⁶ This view is expressed in Note, *Notice and Good Faith Under Article 3 of the U.C.C.*, 51 VA. L. REV. 1342, 1345 (1965) [hereinafter cited as Virginia Note]. The notification must in any event be intelligible and must fulfill the function intended. A purported notification which fails to do that is not a notification at all, even if it is properly received. In some cases the content of notification may be specifically governed by a particular section, e.g., U.C.C. §§ 2-605, 3-508(3), 6-107, 9-312(3)(b), in which case the specific language, as well as this general principle, must be complied with. Questions of content, time, and general reasonableness of notification are peripheral to the present issue and are not dealt with here.

³⁷ 1 R. ANDERSON, U.C.C. 115 (2d ed. 1971) suggests that such a literal approach be avoided.

³⁸ Compare U.C.C. § 2-201(2) with § 1-201(20). Section 2-201(2) provides not only that a writing must be received, but also that the party receiving it has reason to know its contents. Surely one should assume that the draftsmen said what they intended, and that they would not have fallen prey to so basic a grammatical gaffe.

³⁹ *Page v. Camper City & Mobile Homes Sales*, 297 So. 2d 810 (Ala. 1974); *Smith v. Butler*, 311 A.2d 813 (Md. 1973); *International Paper Co. v. Margrove, Inc.*, 75 Misc. 2d 763, 348 N.Y.S.2d 916 (1973).

unless it so prescribes it either expressly⁴⁰ or by the use of the word "send."⁴¹

Because receipt of notice sufficient for the purposes of sections 1-201(25) and (26) frequently may amount to something less than the actual communication of information, section 1-201(25)(b) may properly be viewed as a constructive notice provision. Yet there is a measure of ambiguity in the section. By its nature, constructive notice is measured by an absolutely objective standard. No account whatever is taken of the state of mind of the person sought to be charged. In the case of notification, that standard would be fully met if the mere dispatch of the notification qualified as notice. Where receipt is required, however, it is arguable that notification is more closely akin to actual notice in its wider sense. It could be argued that all section 1-201(25)(b) does is set up a factual inference that upon receipt of notification the recipient would, if acting reasonably, become aware of its contents. It is submitted, however, that the constructive notice interpretation is preferable because notice is irrebuttably concluded upon the showing of a receipt. As previously noted, the definition of receipt provided in section 1-201(26) does not require an inquiry into the state of mind of the recipient, and such an inquiry is essential in making a determination of actual notice.⁴²

In addition to constructive notice through notification, there are two other forms of constructive notice that must be considered. These types of constructive notice are derived from specific provisions of the U.C.C. and are applicable only to certain transactions. First, constructive notice may arise in some specific cases as a result of a notation on a negotiable instrument, document or security. Section 3-304(1)(a) charges the purchaser of a negotiable instrument with notice of various matters which appear from the instrument itself.⁴³ Similarly, section 8-304 holds the purchaser of a certificated security accountable for certain specified facts which appear from the security itself.⁴⁴ Finally, under section 7-502(d) the holder of a negotiable document⁴⁵ has absolute notice of

⁴⁰ See, e.g., U.C.C. §§ 2-616, 9-114(1)(b), 9-312(3)(b), 9-505(2).

⁴¹ The word "send" is defined in § 1-201(38) to require the physical transmission of written notice. See, e.g., *Edmondson v. Air Service, Co.*, 123 Ga. App. 263, 180 S.E.2d 589 (1971); *Hall v. Owen County State Bank*, 370 N.E.2d 918 (Ind. 1977); *Atlas Constr. Co. v. Dravo Doyle Co.*, 3 U.C.C. REP. SERV. 124 (Pa. 1965). Several courts, however, have refused to penalize a party who failed to send written notice even though the section in question required that notice be "sent." These courts preferred to weigh all the circumstances surrounding the notification, and to decide whether, in sum, the steps taken to notify were reasonable. *Hall v. Owen County State Bank*, 370 N.E.2d 918 (Ind. 1977); *Crest Inv. Trust, Inc. v. Alatzas*, 264 Md. 571, 287 A.2d 261 (1972); *DeLay First Nat'l Bank & Trust Co. v. Jacobson Appliance Co.*, 196 Neb. 398, 243 N.W.2d 745 (1976).

⁴² There is at least one court that has not placed this interpretation of absolute notice upon the notification provisions of § 1-201(25)(b). In *Exxon Corp. v. Raetzer*, 533 S.W.2d 842 (Tex. 1976), the court did not confine itself to the question of whether or not notification was received by the issuer of a certificated security under § 8-405, but inquired into the content of such notification and found it to be inadequate to convey notice of the relevant facts, on the basis of the "reason to know" standard of § 1-201(25)(c).

⁴³ U.C.C. § 3-304(1)(a) is discussed in text at notes 130-50 *infra*.

⁴⁴ *Morgan Guaranty Trust Co. of New York v. New England Merchants Nat'l Bank*, 22 U.C.C. REP. SERV. 490, 497 (D. Mass. 1977).

⁴⁵ Under U.C.C. § 7-501(4) a holder is one who purchased the document in good faith,

any defenses or claims which arise under the terms of the document.⁴⁶ In each of these cases it is the notation of the fact on the writing itself that is relevant, and the subjective state of mind of the purchaser is of no significance.

Second, the most obvious provision for constructive notice is found in the recording provisions of article 9.⁴⁷ The holder of a security interest in goods may, by recording his interest in the appropriate public records, charge certain other persons with notice of that interest irrespective of whether the recording itself or the facts recorded ever came to their attention.⁴⁸ The sole relevant criterion is whether or not the act of recording was correctly performed, and the state of mind of the person to be charged is irrelevant.⁴⁹

4. Actual Notice Under the U.C.C.

While constructive notice arises in a narrow area, circumscribed by specific authorization and presumption of law, actual notice occupies a broad terrain. Its territory begins with the most obvious form of actual notice, actual direct knowledge, and it moves through gradations of inference and presumption until it reaches its other extreme, at the very borders of constructive notice. For the purposes of analysis these gradations can be organized into two broad categories.⁵⁰ The first category is that of actual notice proper. This category includes situations in which actual notice is shown to have existed by either direct or circumstantial evidence. The second category comprises situations in which the evidence falls short of establishing actual knowledge but it establishes cir-

without notice of any defense against or claim to it on the part of any person, for value, and in the regular course of business or financing.

⁴⁶ Concededly, U.C.C. § 7-502(1)(d) is more akin to questions of form and contract liability than to the question of notice. It provides that

a holder to whom a negotiable document of title has been duly negotiated acquires thereby

. . . (d) the direct obligation of the issuer to hold or deliver the goods according to the terms of the document free of any defense or claim by him except those arising under the terms of the document or under this Article.

⁴⁷ See, e.g., U.C.C. §§ 9-302, 9-312, 9-313, 9-401, 9-402. No attempt is made here to list definitively all the sections in article 9 which bear upon perfection by filing.

⁴⁸ Obviously, this is a broad generalization which ignores the complexities of perfection by filing under article 9. A careful study of that area is well beyond the scope of this article, and is not attempted.

⁴⁹ The illustrative function of this reference to article 9 necessitates a broad generalization. There are, of course, situations in which the state of mind of the person to be charged is relevant to the question of notice. U.C.C. §§ 9-307(1), 9-308, 9-312(3) and 9-401(2) serve as examples of such situations.

⁵⁰ The idea of breaking up actual notice into different categories is not new. Earlier writers went to great pains to distinguish various degrees of actual knowledge. Thus, Bispham divided actual notice into implied or presumptive notice on the other. BISPHAM, *supra* note 1, at 379. A frequently used distinction was that between express notice and implied notice. The terminology varied, see 1 N.Y. Law Rev. Comm'n Report, *supra* note 23, at 269, for a list of the various terms used, but in essence it boils down to a description of the distinctions between actual notice arising from direct actual knowledge, and actual notice inferred from circumstances. See also the analysis by Long, *supra* note 1, at 144. Merrill, suggested a distinction which is found at the base of the dichotomy used both in the RESTATEMENT (SECOND) OF AGENCY, see note 41 *supra*, and U.C.C. — between notice derived from actual knowledge, and that derived from reason to know. Merrill, *supra* note 16, at 432.

cumstances from which such actual knowledge can be imputed to the person to be charged, not so much as a matter of fact, but as a matter of law. Although it is normally possible to glean from the facts whether actual notice derives from evidence or imputation, in some cases the factual setting can be rather ambiguous, and it may not be clear whether knowledge has been circumstantially proven or imputed.⁵¹

The two categories seek to reach the same results by a different inquiry. The first attempts to establish actual knowledge through a pure interpretation of facts. The second concedes that the facts do not establish actual knowledge but asserts that the facts are sufficient to establish, as a matter of principle, that actual knowledge would have been obtained had the person acted in a reasonable manner, and, therefore, it imputes knowledge as a matter of law. If on the basis of a factual inquiry it is established on the balance of probabilities that actual knowledge existed, there is no need for an inquiry of the second type.

The first category, involves actual notice in the purest sense.⁵² It is at this point that actual knowledge and notice coincide. The gradations in this first category, therefore, are more evidentiary than conceptual: In this category,

[t]he existence of actual notice is purely a question of fact, and like any other fact, notice may be proven either (1) directly, by evidence bringing the fact of knowledge of the prior claim home to the party, or (2) indirectly, that is by circumstantial evidence.⁵³

Therefore, the distinction here is simply between direct evidence of the person's state of mind and indirect evidence which establishes that state of mind by a preponderance of the evidence.⁵⁴ Whether the knowledge is directly proven or inferred from the circumstances, the end result is a finding that the person to be charged with knowledge had such knowledge as a matter of fact. That finding results in the legal conclusion that he had actual notice of the fact in question.

⁵¹ *E.g.*, in *Frequency Electronics, Inc. v. National Radio Co., Inc.*, 20 U.C.C. REP. SERV. 680, *aff'd on other grounds*, 20 U.C.C. REP. SERV. 684 (S.D.N.Y. 1975), a holder of a note was treated as having notice through failure to conduct further inquiries which should reasonably have been conducted. The facts of the case would equally admit of a holding that on the probabilities, he had actual knowledge.

⁵² Pre-Code writers and U.C.C. § 1-201(25)(a) agree that actual notice is constituted by a showing of actual knowledge. Long, *supra* note 1, at 148; Merrill, *supra* note 16, at 418; BISPHAM, *supra* note 1, at 379; POMEROY, *supra* note 1, at 1111. *See, e.g.*, *First Nat'l Bank v. Otto Huber & Sons, Inc.*, 394 F. Supp. 1234 (D.S.D. 1975).

⁵³ Long, *supra* note 1, at 144. Although the words are Long's, the classification here is not in accord with Long's analysis. He includes under the head of circumstantial evidence establishing actual notice, situations which would here fall into the second category of actual notice. It is submitted that the dichotomy based on the question of whether notice is proven or inferred despite lack of proof, better serves to clarify this area.

⁵⁴ For examples of cases in which the court found, on weighing the evidence, that actual notice, in the form of actual knowledge existed under § 1-201(25)(a), see *HML Investment Co. v. Siciliano*, 103 N.J. Super. 27, 246 A.2d 502 (1968); *First State Bank & Trust Co. v. George*, 519 S.W.2d 198 (Tex. 1974). By contrast, circumstantial evidence was not sufficiently strong to establish knowledge in *In re County Green Limited Partnership*, 438 F. Supp. 693 (W.D. Va. 1977).

The distinction between actual notice which is proven and actual notice which is imputed is that in the case of imputed actual notice there is no factual finding that the person to be charged had actual knowledge. On the contrary, the facts tend either to afford no conclusion at all on the person's awareness of the relevant facts, or to indicate that he was unaware of them. The salient inquiry, therefore, becomes whether or not knowledge of such facts may be ascribed to him in the absence of any clear showing that he was aware of them. Thus, the first category is concerned only with knowledge subjectively determined, while the second encompasses knowledge objectively determined.

It is this second genre of actual notice that has so frequently been misnamed constructive notice.⁵⁵ Although, like constructive notice, it involves the attribution of knowledge not necessarily actually possessed, it differs from constructive notice significantly because it is concerned with the state of mind of the person to be charged.

In pre-Code law the behavior of the person to be charged was measured against that of the reasonable person. If a reasonable person would have had knowledge of the fact in question, then such knowledge was imputed to the person to be charged. In general, the imputation arose where there were facts that reasonably should have stimulated inquiry. The party concerned must have been presented with the means of acquiring knowledge and with some indication that it would be worthwhile or prudent to use those means.⁵⁶ For example, notice existed where the evidence indicated that the person was aware of circumstances that should have led him to the ultimate facts as a matter of logical inference, or where the facts known should have excited sufficient suspicions to compel him to investigate further. If the person to be charged failed to draw the appropriate inferences or failed to investigate when it would have been reasonable for him to do so, he nevertheless is charged with the knowledge that he would have obtained had he acted in the expected way.⁵⁷ If he was

⁵⁵ See text at note 20 *supra*. Long observed:

[T]he means of knowledge are in equity equivalent, not to notice, but to *knowledge*, and the party is held to have actual notice because he has the legal equivalent of knowledge. But it is a serious mistake to call this constructive notice, which under statutes requiring actual notice, will not suffice unless the term "constructive" is here used to denote a special kind of actual notice, which, of course, introduces confusion.

Long, *supra* note 1, at 147. Long goes on to say that cases in which a person fails to use these means of knowledge should not be regarded as part of the doctrine of notice at all, but as a kind of estoppel. *Id.* at 148. The confusion in terminology finds its way into court opinions even today. *E.g.*, *Security State Bank v. Baty*, 439 F.2d 910 (10th Cir. 1971), in which the court apparently uses the words "constructive notice" where it means "reason to know."

⁵⁶ See generally Long, *supra* note 1, at 144-46; 1 N.Y. Law Rev. Comm'n Report, *supra* note 23, at 270; POMEROY, *supra* note 1, at 597; Merrill notes:

One who does not know a fact affecting his legal position may nevertheless be conscious of other facts so strongly indicating the existence of the ultimate fact, that a man of ordinary prudence would inquire concerning it or conduct his business as though it existed.

Merrill, *supra* note 16, at 419.

⁵⁷ Merrill devotes attention to describing the various situations in which circumstances have been held to have stimulated inquiry. 1 M. MERRILL ON NOTICE chs. 4-6 (1952). A similar catalogue is avoided here in favor of a more generalized statement of principle. The rule must of

spurred to inference or inquiry but unjustifiably failed to reach the conclusion that a reasonable person would have reached, then similarly his lack of actual knowledge of the relevant facts would not avail him.⁵⁸

Where actual knowledge was imputed, it was immaterial whether the failure to acquire actual knowledge was the result of bad faith or negligence.⁵⁹ This fact was significant in the context of bona fide purchasers because it provided a clear distinction between the requirements of good faith and lack of notice. As a result of this division, pre-Code notice rules could not be treated merely as attempts to impose penalties on persons who deliberately avoided information. The good faith requirement served this function. Instead such rules had to be the product of efforts to insure that commerce was carried on in a responsible and diligent fashion.

Section 1-201(25)(c) is an heir to these standards. It imputes notice of a fact to one who had reason to know of that fact. The phrase "reason to know" comes from section 9 of the Restatement (Second) of Agency.⁶⁰ The commentary to section 9 shows that the test in the Restatement for determining when a person has reason to know is closely related to the test for imputed actual knowledge in pre-Code law.⁶¹ While this test has been described as an objective

necessity be a generalized one, as it is not possible to lay down any rigid guidelines on which circumstances should trigger inquiry. The facts of each case must be looked at. *See also* STORY, *supra* note 3, at 389.

⁵⁸ Long, *supra* note 1, at 146.

⁵⁹ At this point it is probably worthwhile once again to recognize that both in pre-Code law and under the U.C.C. the requirements of good faith and notice are separate and distinct, and must both be satisfied according to their independent criteria. The fact that the same circumstances may go to satisfying both sets of criteria does not alter that principle. *See, e.g.,* Branch Banking & Trust v. Gill, 293 N.C. 164, 237 S.E.2d 21 (1977). POMEROY, *supra* note 1, at § 596-87. Pomeroy's text has to be considered cautiously in that it adopts an approach to the distinction between actual and constructive notice which is entirely different from that adopted herein. *See* text at note 22 *supra*.

⁶⁰ The text of § 9 is set out in note 25 *supra*.

⁶¹ Comment (d) to § 9 states:

A person has reason to know of a fact if he has information from which a person of ordinary intelligence, or of the superior intelligence which such person may have, would infer that the fact in question exists or that there is such a substantial chance of its existence that, if exercising reasonable care with reference to the matter in question, his action would be predicated upon assumption of its possible existence. The inference drawn need not be that the fact exists; it is sufficient that the likelihood of its existence is so great that a person of ordinary intelligence, or of the superior intelligence which the person in question has, would, if exercising ordinary prudence under the circumstances, govern his conduct as if the fact existed, until he could ascertain its existence or non-existence. The words "reason to know" do not necessarily import the existence of a duty to others to ascertain facts; the words are used both where the actor has a duty to another and where he would not be acting adequately in the protection of his own interests were he not to act with reference to the facts which he has reason to know. One may have reason to know a fact although he does not make the inference of its existence which would be made by a reasonable person in his position and with his knowledge, whether his failure to make such inference is due to inferior intelligence or to a failure properly to exercise such intelligence as he has. A person of superior intelligence or training has reason to know a fact if a person with his mental capacity and attainments would draw such an inference from the facts known to him. On the other

one, the description is not entirely accurate because the test contains both an objective and a subjective element. In the first instance it requires a subjective inquiry in order to establish that the person had actual knowledge of certain secondary facts. This involves an inquiry into the state of mind of the person concerned. It is an inquiry that is not satisfied merely by showing that a reasonable person would have known the secondary facts. The party himself must have known them. Nevertheless, once the subjective baseline is established either directly or circumstantially,⁶² the court is able to apply an objective test and to inquire how a reasonable person⁶³ would have responded to the secondary facts.⁶⁴

The precise scope of the party's duty to inquire is clearly established under the U.C.C., as it was in pre-Code law. There is no general duty of inquiry imposed in all cases, nor is there any obligation on a person to treat every transaction with the greatest of suspicion, irrespective of whether or not any danger signals are present. Furthermore, even if danger signals do appear, the courts have tended to look at them carefully, trying to establish just what should be the reasonable reaction to those signals.⁶⁵ Facts that are equivocal or ambiguous may not be strong enough to stimulate the type of investigation needed to unearth, or to direct the transferee's attention to, the true state of affairs.

hand, "reason to know" imports no duty to ascertain facts not to be deduced as inferences from facts already known; one has reason to know a fact only if a reasonable person in his position would infer such fact from other facts already known to him

Id.

⁶² On the question of evidence required, the same principles apply as will apply in the case of proving direct knowledge of ultimate facts.

⁶³ In determining the subjective baseline, account must be taken, not only of the knowledge of the party, but also of the particular attributes of the party which bear upon his appreciation of the knowledge. Thus, in *Weller v. American Tel. & Tel. Co.*, 290 A.2d 842 (Del. 1972), the court, in deciding whether the plaintiff had notified the issuer of a stock certificate of a forgery within a reasonable time of her having notice of it under § 8-405(1), took into account the age and ill health of the plaintiff and her trust in the forger.

⁶⁴ Virginia Note, *supra* note 36, at 1347; Note, *Holders in Due Course, The Requirements of Good Faith and Notice*, 28 MD. L. REV. 145, 153 (1968). Further support may be found for this view in the official comments to § 3-304 in the 1949 Official Draft of the U.C.C. At that time notice was defined in article 3. The purchaser of an investment was charged with notice if, *inter alia*, he had, upon all the facts and circumstances known to him, reasonable grounds to believe that there was an infirmity in the instrument. The section is considered more fully below. For the present purposes the official comments to the section are helpful insofar as they address the meaning of the words "all the facts and circumstances known to the purchaser." *Id.* The comment states that those words are intended to mean that "the purchaser may act upon the aggregate of what he knows where a reasonable man in his position would do so." *Id.* See also *Cleveland v. McNabb*, 312 F. Supp. 155 (W.D. Tenn. 1970); *Ibanez v. Farmers Underwriters Ass'n*, 14 Cal. 3d 390, 534 P.2d 1336, 121 Cal. Rptr. 256 (1975); *Suit & Wells Equipment Co. v. Citizens Nat'l Bank*, 282 A.2d 109 (Md. 1971).

⁶⁵ *Slaughter v. Jefferson Fed. Sav. & Loan Ass'n*, 19 U.C.C. REP. SERV. 171, 179 (D.C. Cir. 1976); *Morgan Guaranty Trust Co. of New York v. New England Merchants Nat'l Bank*, 22 U.C.C. REP. SERV. 490 (D. Mass. 1977); *Salter v. Vanotti*, 26 U.C.C. REP. SERV. 964 (Colo. 1979); *Eldon's Super Fresh Stores, Inc. v. Merrill Lynch*, 207 N.W. 2d 282 (Minn. 1973); *Exxon Corp. v. Raetzer*, 533 S.W.2d 842 (Tex. 1976). But cf. *Hollywood Nat'l Bank v. I.B.M. Corp.*, 38 Cal. App. 3d 607, 113 Cal. Rptr. 494 (1974) (The court applied the subjective-

Further, the transferee is not required to brood or speculate but must be alert only to those facts that compel attention.⁶⁶ In addition, there is a requirement that some rational and discernible nexus exists between what is known to the transferee and what is inferred from that knowledge. The link must be one that would be expected to be made rather readily.⁶⁷

A few illustrations of the way in which courts have linked primary information to notice of ultimate facts seems to demonstrate that the approach to the "reason to know" standard has been a careful, fact-oriented one. For example, as a general rule, a transferee of property will not be held to have reason to know of a third-party interest in property transferred merely because he knew that the property was involved in a relationship or underlying transaction between his transferor and a third party. This remains true even if the transferee knew that his transferor had not completed performance in the underlying transaction.⁶⁸ In order for him to be charged with notice of a claim or defense relating to the property, the transferee must have had more information. He must have had an indication that something had gone sour in the underlying transaction that might compromise his transferor's right to the property in question.⁶⁹

Similarly, the majority view is that knowledge of a transferor's parlous financial circumstances will not of itself give a transferee reason to know that there is something amiss in the transaction. Such knowledge is too generalized to act as a warning in a specific contractual setting.⁷⁰ A stronger warning signal

ly oriented approach normally associated with the inquiry into a purchaser's good faith. In so doing the court misconstrued the standards set out by § 1-201 and confused the requirements of good faith and notice.). A similar commingling of the good faith and the notice standards apparently occurred in *Jeanette's Frocks, Inc. v. First Produce State Bank*, 137 N.W.2d 205 (Minn. 1965), and in *Colin v. Central Pennsylvania Nat'l Bank*, 18 U.C.C. REP. SERV. 188 (E.D. Pa. 1975).

⁶⁶ *Exxon Corp. v. Raetzer*, 533 S.W.2d 842 (Tex. 1976).

⁶⁷ Sometimes the language used by courts interpreting the provisions of § 1-201(25) of the U.C.C. is remarkably reminiscent of that employed by courts dealing with the subjective standard of § 56 of the N.I.L. See text at notes 108-13 *infra*. Doubtless, some courts have continued to be influenced, albeit unconsciously, by the subjective standard. An indication of this influence appears from the regularity with which courts unquestionably cite pre-Code cases when interpreting § 1-201(25)(c). See, e.g., *Exxon Corp. v. Raetzer*, 533 S.W.2d 842, 846-48 (Tex. 1976).

⁶⁸ *Jaeger & Branch, Inc. v. Pappas*, 20 Utah 2d 100, 443 P.2d 605 (1967). In the area of negotiable instruments this concept finds expression in the provisions of § 3-304(4), set out in note 115 *infra*, which differentiate knowledge of such underlying data from facts that properly can be described as danger signals. See *Stewart v. Thornton*, 116 Ariz. 107, 568 P.2d 414 (1977); *Leninger v. Anderson*, 255 N.W.2d 22, 28 (Minn. 1977); *Commerce Trust Co. v. Denson*, 437 S.W.2d 94, 96 (Mo. 1968); *Cheltenham Nat'l Bank v. Snelling*, 326 A.2d 557, 560 (Pa. 1974).

⁶⁹ See, e.g., *Salter v. Vanotti*, 26 U.C.C. REP. SERV. 964 (Colo. 1979) (danger signals were present in the terms of an executory contract); *Davenport v. Unicapital Corp.*, 230 S.E.2d 905 (S.C. 1976) (mere provision of usurious interest in an accompanying contract was held to place the holder of an instrument on notice of a defense).

⁷⁰ In the area of negotiable instruments, banks have been held not to be on notice of a defense to an instrument negotiated by a customer merely because they were aware of the customer's financial instability. *Texico State Bank v. Hullinger*, 75 Ill. App. 2d 212, 220 N.E.2d 248 (1966). Cf. *Citizens Nat'l Bank v. Fort Lee Sav. & Loan Ass'n*, 89 N.J. Super. 43, 213 A.2d 315 (1965) (reaching the same conclusion based on a test of good faith). *Bowling Green, Inc. v.*

is needed.⁷¹ Even knowledge that the transferee is bankrupt and that the transfer might be voidable as a preference in bankruptcy will not of itself constitute notice of a superior claim to the property.⁷² Further, in cases where property is acquired at a bargain price or at a substantial discount, notice is not generally provided unless the price is so absurdly low that a conclusion of illicit dealing is irresistible.⁷³ There are surely some factors that will act as stronger indicia that there is something unwholesome in the transaction, yet even in such cases, one would be hard-pressed to suggest that an absolute presumption of notice arises. In each case the totality of the circumstances must be examined and the link established.⁷⁴

A final illustration of the general principle enunciated here is afforded by those cases where the transferee and transferor have an intimate relationship. In such cases, it is sometimes argued that the relationship should compel a finding that the transferee had notice of any defense arising out of a transaction between the transferor and a third party. This argument achieved prominence in cases where a consumer gave a negotiable instrument to a retailer in exchange for goods. The seller then negotiated the instrument to a third party that claimed to be a holder in due course. Where the seller and the holder had a close relationship in which the holder dealt frequently with the seller and exercised a measure of control over its credit operations, it was sometimes held that the holder could not be a holder in due course. Because of its close connection with the seller, the holder was treated as a party to the original transaction. In *Unico v. Owen*,⁷⁵ a pre-Code case, the court based its rationale not on the notice provision of the U.C.C., but on the theory that the holder must, by virtue of its

State Street Bank & Trust Co., 307 F. Supp. 648 (D. Mass. 1969), *aff'd*, 425 F.2d 81 (1st Cir. 1970); Commerce Bank v. Edco Financial Serv., 379 F. Supp. 293 (E.D. Mo. 1974); Bierschwale v. Oakes, 497 S.W.2d 506 (Tex. 1973).

⁷¹ For an example of a case in which such stronger signals accompanied knowledge of the debtor's financial difficulties, see *Shaffer v. Brooklyn Park Garden Apts.*, 20 U.C.C. REP. SERV. 1269 (Minn. 1977). Conversely, signals were held not to be strong enough in *Nicklaus v. Peoples Bank & Trust Co.*, 258 F. Supp. 482 (E.D. Ark. 1965), *aff'd*, 369 F.2d 683 (8th Cir. 1966).

⁷² In the case of negotiable instruments there is clear authority that notice of a claim to the instrument will not be derived from the mere fact that the holder knew that the transferee of the instrument was bankrupt, or that the transfer was a voidable preference under bankruptcy law. This authority emerges from the drafting history of § 3-304. See text at note 160 *infra*. It would seem that the rationale behind the rule in the case of negotiable instruments would apply equally to other forms of property.

⁷³ *Miriani v. Rodman & Renshaw, Inc.*, 358 F. Supp. 1011 (D. Ill. 1973); *Stewart v. Thornton*, 116 Ariz. 107, 568 P.2d 414 (1977); *Hopkins v. Kemp Motor Sales*, 139 Ga. App. 471, 228 S.E.2d 607 (1976).

⁷⁴ Even where a person habitually cashed checks payable to others, that in itself was insufficient to establish that the bank had reason to know that the person had acquired the checks illicitly. *Jeanette Frocks, Inc. v. First Produce State Bank*, 137 N.W.2d 205 (Minn. 1965).

⁷⁵ 50 N.J. 101, 232 A.2d 405 (1967). *Unico* was based on prior case authority, which is cited in the opinion, and also in *Jones v. Approved Bancredit*, 256 A.2d 739 (Del. 1969). See also *Mann v. Leasko*, 179 Cal. App. 2d 692, 4 Cal. Rptr. 124 (1960). A discussion of authority extant prior to *Unico v. Owen* can be found in Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 S. CAL. L. REV. 48, 60-77 (1966).

involvement in the affairs of the seller, be treated as a participant in the original sale.

Many cases decided under the U.C.C. have followed *Unico v. Owen*. Some have based their decisions on the same grounds,⁷⁶ but other courts reached equivalent results based on different theories. Some courts have based their decisions on a finding that the holder knew enough about the original transaction to call into question its good faith in taking the instrument.⁷⁷ Other courts have reasoned that the relationship between the holder and the seller put the holder on notice of defenses arising out of the original transaction.⁷⁸

In this last group of cases, when considering the relationship between holder and seller in the light of the U.C.C.'s notice provision, the courts have not imposed any absolute standard, but have looked at all the circumstances, including that relationship and course of dealing, in order to decide whether the holder had reason to know of the defense.⁷⁹

Where the court undertakes such a factual inquiry, to determine whether a person had reason to know a particular fact, the object is to determine the person's state of mind by a substantially objective standard. Consequently, where a person is found to have reason to know a fact, he may be deemed to have actual notice of it. This form of actual notice is often confused with constructive notice because the actual knowledge of the person is immaterial. It is distinguished from constructive notice, however, because there is no set of circumstances that will give rise to an irrebuttable presumption of notice.

C. Special Problems of Notice

1. Forgotten Notice

A possible exception to the general principles of actual and constructive notice is the doctrine of forgotten notice. Both under pre-Code law and under the U.C.C., the essential time for measuring the absence or presence of notice is the time that the rights in question were acquired. Certainly, notice acquired after that time cannot be relevant.⁸⁰

⁷⁶ See, e.g., *Jones v. Approved Bancredit*, 256 A.2d 739 (Del. 1969).

⁷⁷ *U.S. Finance v. Jones*, 229 So. 2d 495 (Ala. 1969); *American Plan Corp. v. Woods*, 16 Ohio App. 2d 1, 240 N.E.2d 886 (1968) (this case was decided on good faith principles, but relied on the *Unico v. Owen* rationale too); *Norman v. World Wide Distributors, Inc.*, 202 Pa. Super. 53, 195 A.2d 115 (1963).

⁷⁸ See cases cited at note 79 *infra*. See also HART & WILLIER, COMMERCIAL PAPER UNDER THE U.C.C., 2 BENDER U.C.C. SERVICE § 11.07(2).

⁷⁹ *Waterbury Sav. Bank v. Jaroszewski*, 4 Conn. Cir. 620, 238 A.2d 446 (1967); *Calvert Credit Corp. v. Williams*, 244 A.2d (D.C. 1968) (the U.C.C. is not cited); *Kaw Valley State Bank & Trust Co. v. Riddle*, 549 P.2d 927 (Kan. 1976).

⁸⁰ A general principle, which filters throughout the U.C.C., is that notice must be received in a way and at a time that will enable the person notified to act effectively in the light of the information received. E.g., Comment 8, to § 2-706; § 3-304(6); Comment 5 to § 9-504. Clearly there is no justification for attributing notice to a person retrospectively. See also *McCook County Nat'l Bank v. Compton*, 558 F.2d 871 (8th Cir. 1977); *Slaughter v. Jefferson Fed. Sav. & Loan Ass'n*, 19 U.C.C. REP. SERV. 171 (D.C. Cir. 1976); *Third Nat'l Bank v. Hardi Gardens Supply*, 380 F. Supp. 930 (M.D. Tenn. 1974); *Manufacturers & Traders Trust Co. v.*

There has long been confusion, however, on the question of whether or not notice acquired prior to the crucial date but subsequently forgotten will be attributable to a person at the crucial date.⁸¹ The general principle under pre-Code law was that actual notice would be ascribed to a person either where it exists in fact or where, under the circumstances, the person had reason to know of the facts in question. The Restatement (Second) of Agency treats the case of forgotten notice in the light of that general principle,⁸² and a reading of all but the last sentence of section 1-201(25) could lead to the conclusion that the U.C.C. deals with forgotten notice in the same way. If the evidence established that knowledge once had was not forgotten, despite the protestations to the contrary by the party to be charged, then section 1-201(25)(a) applies because it would have been shown that the party had actual knowledge of the relevant fact at the crucial time. If a person did not have actual knowledge of the relevant facts at the crucial time but such knowledge at a prior time, then the "reason to know" standard of section 1-201(25)(c) would apply. If it could be established that the circumstances of the transaction as a whole were such that it was not reasonable for him to have forgotten the information, actual notice would exist.

Unfortunately, the draftsmen were unwilling to allow the language of the section to stand on its own and they incorporated the final sentence in section 1-201(25) which declares that "[t]he time and circumstances under which a notice or notification may cease to be effective are not determined by this act."⁸³ In the only substantive comment to the section the draftsmen explain

Murphy, 369 F. Supp. 11, 13 (W.D. Pa. 1974); *Bowling Green, Inc. v. State Street Bank & Trust Co.*, 307 F. Supp. 648 (D. Mass. 1969); *Waterbury Sav. Bank v. Jaroszewski*, 4 Conn. Cir. 620, 238 A.2d 446 (1967).

⁸¹ In commenting upon this confusion Merrill suggested that it was possible and desirable to set up rather clear rules to determine those cases in which notice once received may be forgotten and those cases in which notice once received may be considered unforgettable. He argued that in some cases forgetfulness would be excusable but in others notice should be treated as always being present from the time of its receipt onward, or at least until it could be reasonably regarded as no longer relevant. He set out five categories in which notice could properly be treated as unforgettable, and in so doing attempted to analyze the diverse treatment of forgotten notice in pre-Code law. In essence, his theory appears to be nothing more than a long-winded statement of the general principle of pre-Code law that actual notice will be ascribed to a person either where it exists in fact or where, under the circumstances, the person had reason to know of the facts in question. M. MERRILL ON NOTICE 443, 455 (1952); Merrill, *Unforgettable Knowledge*, 34 MICH. L. REV. 474, 486 (1936).

⁸² RESTATEMENT (SECOND) OF AGENCY § 9(1), set out fully in note 25 *supra*, prescribes the general test. Comment (d) speaks of forgotten notice as follows:

Further, a person has reason to know facts only if the circumstances are such that any unconscious knowledge would be made conscious if such person were to meet the required standards with reference to memory, consideration for the interests of others, or, in some instances, consideration for one's own interests. Thus, one who had no reason to remember facts once known would not at a later time have reason to know the facts.

⁸³ U.C.C. § 1-201(25). Apparently the wording was added in 1957 to appease New York banking interests. See Penney, *New York Revisits the Code: Some Variations in the New York Enactment of the U.C.C.*, 62 COLUM. L. REV. 992, 998-99 (1962) [hereinafter cited as Penny]; Braucher, *U.C.C. Article 3 — Commercial Paper — New York Variations*, 17 RUTGERS L. REV. 57, 66-67 (1962) [hereinafter cited as Braucher].

these words by saying "the last sentence [of] the act leaves open the time and circumstance under which notice or notification may cease to be effective. Therefore such cases as *Graham v. White Phillips Co.* . . . are not overruled."⁸⁴ By the addition of the last sentence in the section and the comment the drafters of the Code have tended to confuse an area that was quite capable of being dealt with under the general principles of notice set out in the earlier part of the section. It seems that the draftsmen did not wish to disturb the doctrine of forgotten notice as it had developed in the cases. The difficulty is, however, that there had been no doctrine of forgotten notice that had acquired general recognition. More important, even if such a general doctrine did exist, *Graham v. White Phillips Co.*⁸⁵ did not pretend to enunciate it.

In *Graham v. White Phillips Co.* the United States Supreme Court had to decide whether or not White Phillips Company, the purchaser of stolen negotiable coupons, should prevail over the original owner of the bonds.⁸⁶ In order to decide the question, the Court had to determine whether White Phillips was a holder in due course of the bonds as defined in sections 52 and 56 of the Negotiable Instruments Law (N.I.L.).⁸⁷ This issue turned on the question whether or not White Phillips had either actual knowledge of the infirmity or defect in the instrument or knowledge of such facts that its action in taking the instrument amounted to bad faith.⁸⁸ The evidence showed that notice of the theft was received by the company, but that it failed to take adequate steps to disseminate the contents of the notice to its officers. As a result of the faulty communication, the appropriate officers had no actual knowledge of the theft at the time that the bonds were purchased. It was an *accepted* factual basis of the opinion that the company's action was negligent.

The Court held a person may still be a good faith purchaser even though he has negligently forgotten notice once received.⁸⁹ The test to be applied is one of simply honesty. Although the existence of notice may go to establish a lack of honesty, the purchaser may, by showing that the notice was forgotten, rebut any presumption of knowledge, and hence of dishonest conduct.

The Court in enunciating the above principle clearly was confining itself to cases involving bona fide purchasers of negotiable instruments under the provisions of the N.I.L. and under the common law relating to negotiable instruments that existed prior to the enactment of that statute. These principles varied from those applied in other areas.⁹⁰ In the case of negotiable instruments the test was a purely subjective, "good faith" one. In cases outside of the law of negotiable instruments, the courts recognized that the presence or absence of notice could be determined objectively,⁹¹ and that negligence was a relevant consideration.

⁸⁴ U.C.C. § 1-201(25), Comment 1 (citations omitted).

⁸⁵ 296 U.S. 27 (1935).

⁸⁶ *Id.* at 28.

⁸⁷ *Id.* at 29.

⁸⁸ This is the test prescribed by § 56 of the N.I.L. for determining whether or not a purchaser of an instrument had notice. It is discussed more fully at notes 102-13 *infra*.

⁸⁹ 296 U.S. at 32.

⁹⁰ See text at notes 102-13 *infra*.

⁹¹ See text at notes 59-61 *supra*.

Section 1-201(25)(c) likewise provides for an objective assessment of notice. In that light, the doctrine of forgotten notice as set out in *Graham v. White Phillips Co.* is entirely inapposite. It is not defensible in its present general setting, nor is it valid any more even in the case of negotiable instruments.⁹² Even under the N.I.L. it was only a minority rule.⁹³ Consequently, the reference to the *Graham v. White Phillips Co.* and the disclaimer concerning the doctrine of forgotten notice is baffling. It can only lead to misinterpretations of section 1-201(25) and a resulting dilution of the "reason to know" standard that is there set out.⁹⁴ Fortunately, there are cases decided since the enactment of the U.C.C. in which the doctrine of forgotten notice has been treated with a healthy degree of skepticism.⁹⁵

The conclusion that must be reached is that a doctrine of forgotten notice is incompatible with the treatment of notice under the U.C.C. Each case in which notice has been forgotten must be determined on the general standard by taking account of the circumstances generally and deciding whether or not it was reasonable in the light of those circumstances for the purchaser to have forgotten the notice.

⁹² See text and notes at notes 118-19 *infra*.

⁹³ See W. BRITTON, *BILLS & NOTES* 269-71 (2d ed. 1961) [hereinafter cited as BRITTON]; Merrill, *The Wages of Indifference*, 10 TEMPLE L.Q. 147 (1935), points out that the rule in *Graham v. White Phillips*, based as it was on the law of Michigan and Illinois, represented the law of a minority of states. It did not represent the majority view in pre-Code law, which tended, even in the case of negotiable instruments, to bind a purchaser to notice received and forgotten. See *First Nat'l Bank v. Fazzari*, 10 N.Y.2d 394, 179 N.E.2d 493, 223 N.Y.S.2d 483 (1961). This case has been the subject of many commentaries. See, e.g., Comment, 26 ALB. L. REV. 344 (1962); Note, 47 CORNELL L.Q. 670 (1962).

⁹⁴ The troubling effect of the language is illustrated by *McCook County Nat'l Bank v. Compton*, 558 F.2d 871 (8th Cir. 1977). The court found a lack of notice on the simple basis that the holder of an instrument, even if it received notice, could reasonably have forgotten it under the circumstances. On the facts, the finding is perfectly compatible with the objective test set out in § 1-201(25)(c). However, the remarks by the court in relation to the forgotten notice doctrine illustrate the import of the final sentence of § 1-201(25) and its potentially damaging effect on the viability of the objective test both in the case of negotiable instruments and generally. After tying the forgotten notice doctrine to the subjective good faith standard as enunciated in *Graham v. White Phillips Co.*, the court remarks that "[the forgotten notice] doctrine is still vital [as] is evidenced by the commentary to the corresponding U.C.C. provision § 1-201(25) which states that by leaving open the time or circumstances under which notice or notification ceased to be effective, cases such as *Graham v. White Phillips Co.*, *supra* are not overruled." *Id.* at 875.

⁹⁵ *Morgan Guaranty Trust Co. of N.Y. v. Third Nat'l Bank*, 529 F.2d 1141, 1144 (1st Cir. 1976), involved a purchase by a bank of U.S. Treasury bills which had been stolen. Notice of the theft had been given to the bank but had not filtered through to the appropriate officers because the bank failed to exercise due diligence in disseminating the information. The question was whether the bank qualified as a bona fide purchaser without notice under § 8-302. The bank argued for the application of a subjective test based on the final sentence of § 1-201(25) and the reference to *Graham v. White Phillips* in the official comment to the section. The court rejected the bank's argument:

We note that Third Bank has cited no case that suggests that Massachusetts has ever followed the doctrine of notice forgotten in good faith, much less that it will follow it now that Massachusetts has adopted the Uniform Commercial Code. Although there may be circumstances in which Massachusetts would hold that a notification had ceased to be effective, we do not believe, in view of the objective

2. Notice to an Organization

In substance, the doctrine of notice applies equally to individuals and organizations. Where an organization is involved it becomes necessary, however, to determine when notice received by a representative of an organization becomes binding on the organization itself. Sections 1-201(27)⁹⁶ and (28)⁹⁷ are designed to deal with that question. The sections apply equally to cases of notice, knowledge, and notification, and deal with all forms of notice provided for in 1-201(25). Of course, facts derived from constructive notice and ultimate facts derived from reason to know need not be brought to anyone's attention. Therefore, notwithstanding its first sentence, section 1-201(27) is only relevant to situations in which the issue of actual knowledge is at stake. The section thus applies in order to attribute to the organization actual knowledge of ultimate facts and also actual knowledge of base facts that ground a reason to know.

Under 1-201(27), in order for an organization to have notice it is necessary to show that the person conducting or involved in the transaction in question had notice of the facts.⁹⁸ The time from which he will have such notice is the time at which the facts come to his attention. The section prescribes an objective test for establishing when such notice is brought to the attention of the individual concerned. Under this test, notice will be deemed to have been brought to an individual's attention either when it is in fact brought to his attention or when it should have been brought to his attention if the organization had exercised proper diligence.⁹⁹ This test engrafts a further layer onto the

criteria of § 1-201(25), (27) . . . that Massachusetts will adopt a purely subjective test to determine the continued effectiveness of a notification to an organization.

Id. at 1144. *See also* *Garner v. First Nat'l City Bank*, 465 F. Supp. 372, 383 n.17 (S.D.N.Y. 1979).

⁹⁶ U.C.C. § 1-201(27) provides:

Notice, knowledge or a notice or notification received by an organization is effective for a particular transaction from the time when it is brought to the attention of the individual conducting that transaction, and in any event from the time when it would have been brought to his attention if the organization had exercised due diligence. An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.

⁹⁷ U.C.C. § 1-210(28) defines what is meant by an organization:

"Organization" includes a corporation, government or governmental subdivision or agency, business trust, estate, trust, partnership or association, two or more persons having a joint or common interest, or any other legal or commercial entity.

⁹⁸ In *Mid Continent Nat'l Bank v. Bank of Independence*, 532 S.W.2d 569 (Mo. 1975), knowledge of an employee of a bank relating to a fraud was attributed to the bank. Note, however, it is only knowledge of appropriate employees with proper capacity that is chargeable to the organization. *Bank of Salt Lake v. Corp. of the President of the Church of Jesus Christ of Latter Day Saints*, 534 P.2d 887 (Utah 1975); *Millman v. State Nat'l Bank of Md.*, 323 A.2d 723 (D.C. 1974).

⁹⁹ In *Transamerica Ins. Co. v. United States Nat'l Bank*, 276 Or. 945, 558 P.2d 328

objective-subjective inquiry that must be conducted under section 1-201(25). For example, normally in an inquiry aimed at establishing whether or not an individual had reason to know a fact, it must first be decided subjectively that he had notice of base facts and then objectively that he had reason to know the ultimate fact. If the person in question is not an individual but an organization represented by its officer, then the first inquiry regarding notice of base facts will be answered affirmatively not only if he had subjective knowledge of the base facts, but also if those facts were available to the organization and would have been brought to his attention had the organization exercised due diligence.

The determination of this last issue turns upon the reasonableness of an organization's routines for communicating information, and its proper compliance with those routines.¹⁰⁰ This test is once again a mixture of objective as well as subjective criteria.¹⁰¹ The word "routines" connotes that there must be established patterns of conduct. Therefore, an organization that has not established objectively reasonable patterns of conduct apparently will not be treated as diligent even if on a particular occasion diligent effort was made to communicate a notice to the person dealing with the matter.

Although the issue of notice to an organization complicates the inquiry, the basic doctrine remains unaltered. Just as in the case of an individual, the question is whether the person or persons completing the transaction knew or reasonably should have known of any adverse claims. Furthermore, the answer is arrived at in the same manner. Actual notice may be established by showing actual knowledge of the ultimate facts, or by showing awareness of secondary facts that reasonably impute knowledge of the ultimate facts. Similarly, constructive notice may be applied to an organization in any situation where it may be used against an individual.

II. THE DOCTRINE OF NOTICE AS IT RELATES TO NEGOTIABLE INSTRUMENTS

A. *Good Faith and Notice in Pre-Code Law: The Origins of Sections 3-302 and 3-304*

Traditionally, questions of notice in relation to negotiable instruments have been dealt with somewhat differently from questions of notice in other areas. Under the U.C.C. the approach has become more unified, but the traditional separation has not been laid firmly to rest. Besides the general definitions of notice in article 1, article 3 has its own specific provisions which bear upon the questions of notice insofar as it relates to the status of holder in due course of a negotiable instrument. The sections in question are section 3-302, which sets out the requirements that have to be met before a holder can qualify as a holder in due course, and section 3-304, which deals in detail with issues of

(1976), the court directed that evidence to establish what information bank employees possessed should be limited to that which the jury could reasonably find would have come to their attention had the bank exercised due diligence.

¹⁰⁰ This test of due diligence was only added in 1962.

¹⁰¹ *Morgan Guar. Trust Co. v. Third Nat'l Bank of Hampden Co.*, 529 F.2d 1141 (1st Cir. 1976); *Appeals of Reeves Sound Craft Corp.*, 2 U.C.C. REP. SERV. 210, 223 (A.S.B.C.A. 1964); *Ford Motor Credit Co. v. Patchogue Truck & Equipment Co.*, 5 U.C.C. REP. SERV. 1272 (N.Y. 1969).

notice in the case of negotiable instruments. Before examining these sections, however, it is necessary to take a brief look at the law as it existed prior to the enactment of the U.C.C., and to recognize that the clear distinction between notice and good faith as it exists in the U.C.C. was not always as well defined.

The term "holder in due course" is recognized today as a label describing the possessor of certain rights in a negotiable instrument. Because a holder in due course is a bona fide purchaser of the instrument, he takes it free of any equities that might have attached to it.¹⁰² As the phrase suggests, at common law the status of holder in due course could be attained only by one who acquired an instrument in the due course of his business. This meant not only that the holder had to be involved in a trade where negotiable instruments were customarily employed as a medium of exchange,¹⁰³ but also that the acquisition had to occur in the due, or regular, course of that trade. Due course taking involved both good faith, measured subjectively, and reasonable conduct, measured objectively in the context of the prevailing standards of the trade.¹⁰⁴ Thus, a holder who failed to ascertain facts that would have been exposed by a diligent investigation would not be viewed as fulfilling the requirements of taking in the due course of trade.

This objective aspect fell into disuse by the early nineteenth century leaving only the purely subjective test. It was briefly revitalized, however, in the case of *Gill v. Cubitt*¹⁰⁵ in which the King's Bench held that the failure to investigate circumstances that would have excited the suspicions of a prudent man was equivalent to bad faith. *Gill v. Cubitt*, therefore, proposed not only a subjective inquiry into a purchaser's state of mind in order to establish his good faith, but also an inquiry into his behavior based on an external standard. The objective standard, however, was rejected again a few years later in *Goodman v. Harvey*,¹⁰⁶ which measured the purchaser's good faith only on the basis of his factual honesty. Under *Harvey*, if he had actual knowledge of defenses or claims relating to the instrument, he would not satisfy the requirement of good faith. The absence or presence of such knowledge could not be imputed to him on the basis of a standard of behavior objectively determined.

A similar subjective test of good faith was applied in the United States in *Goodman v. Simonds*,¹⁰⁷ which formed part of American law up to the time that

¹⁰² The rights of a holder in due course are described generally in U.C.C. § 3-305.

¹⁰³ Cf. U.C.C. § 7-501(4) (the status of holder of a negotiable document is open only to those who are regularly in the business of acquiring such paper).

¹⁰⁴ Rightmire, *The Doctrine of Bad Faith in the Law of Negotiable Paper*, 18 MICH. L. REV. 355, 356-57 (1920) [hereinafter cited as Rightmire]; K. LLEWELLYN, *THE COMMON LAW TRADITION* 410-19 (1960) [hereinafter cited as LLEWELLYN].

¹⁰⁵ 107 Eng. Rep. 806 (K.B. 1824). The case and its context are commented upon, *inter alia*, in Rightmire, *supra* note 104; Palmer, *Negotiable Instruments under the U.C.C.*, 48 MICH. L. REV. 225, 279 [hereinafter cited as Palmer]; Fagan, *Commercial Bad Faith in the Law of Negotiable Instruments*, 25 FORDHAM L. REV. 449, 460 (1956); Penney, *supra* note 83; BRITTON, *supra* note 93, at 244. See *Van Horn v. Van De Wol, Inc.*, 6 Wash. App. 959, 497 P.2d 252 (1972); *Industrial Nat'l Bank v. Leo's Used Car Exch., Inc.*, 291 N.E.2d 603 (Mass. 1973).

¹⁰⁶ 111 Eng. Rep. 1011 (1836). See also commentaries cited in notes 104 & 105 *supra* for an analysis and commentary upon that case.

¹⁰⁷ 61 U.S. 343 (1857). See commentaries cited in note 105 *supra*. See also Re, *Negotiable Instruments*, 26 ST. JOHN'S L. REV. 26, 55 (1951) [hereinafter cited as Re]; Comment, 30 N.C. L.

the N.I.L. was drafted. Under the *Simonds* approach, as long as there was no actual knowledge of some claim or defense, and as long as the acquisition was concluded honestly, there was no imputation of notice to the holder based on an expectation of reasonable diligence. In this respect a bona fide purchaser of a negotiable instrument was held to a lesser degree of circumspection than a bona fide purchaser of other property.

Subsequently, the N.I.L. codified the common law approach, treating the absence or presence of notice as an aspect of the inquiry into the good faith of the purchaser of the instrument.¹⁰⁸ Thus, notice of an infirmity in an instrument would be constituted only by knowledge of such facts that would make the taking of the instrument tantamount to an act of bad faith.¹⁰⁹ Accordingly, the general rule under the N.I.L. was that the holder would be charged only with notice of facts beyond those appearing on the instrument only where he actually knew such facts or where, in circumstances falling short of actual knowledge, he failed so grossly to make an inference or an inquiry as to lead to the conclusion that he deliberately and dishonestly had turned away from knowledge.¹¹⁰ Neither mere suspicion¹¹¹ nor negligence would be a bar to holder in due course status. Nevertheless, the unequivocal subjective standard was not applied universally or consistently during the currency of the N.I.L. Although the majority of courts applied the subjective test, many courts groped for an objective standard under the N.I.L. and reached out for such a standard wherever possible.¹¹² The resultant confusion persisted up to the enactment of the U.C.C. and, in fact, continued in cases decided under the Code.¹¹³

The drafters of the U.C.C. followed the dominant themes of the common law and the N.I.L., but they attempted to resolve the chaos that had attended the development of the doctrine of notice to holders in due course. Sections

REV. 395, 397 (1952); Note, *Notice of Defects in Negotiable Instruments*, 38 HARV. L. REV. 321 (1923) [hereinafter cited as Harvard Note]; Note, *Holders in Due Course, The Requirements of Good Faith and Notice*, 28 MD. L. REV. 145, 150 (1966); Note, *Relation Between Bad Faith and Notice Under the N.I.L.*, 81 U. PA. L. REV. 617 (1933) [hereinafter cited as Pennsylvania Note]; N.Y. Law Rev. Comm'n Report, *supra* note 23, at 205 (1954).

¹⁰⁸ Rightmire, *supra* note 104, at 364; Pennsylvania Note, *supra* note 107, at 619.

¹⁰⁹ Section 52(4) of the N.I.L. required that in order to be a holder in due course of an instrument, a holder must take it without "notice of any infirmity in the instrument or defect in the title of the person negotiating it." That phrase is expanded upon in § 56 which states:

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.

¹¹⁰ See commentaries cited in note 105 *supra*. Further case citations are collected in BEUTEL'S NEGOTIABLE INSTRUMENTS LAW 722 (7th ed. 1948).

¹¹¹ Obviously where suspicious circumstances exist the line between a negligent failure to heed them and a deliberate or studied disregard of them may be a difficult one to draw. A case decided under the U.C.C. serves as an example. In *Norman v. World Wide Distributors, Inc.*, 202 Pa. Super. 53, 195 A.2d 115 (1963), the court treated a disregard of suspicious circumstances as a deviation from the good faith standard of § 3-302, rather than on the basis of notice.

¹¹² Palmer, *supra* note 105, at 280; Fagan, *supra* note 105, at 463-65; Virginia Note, *supra* note 36, at 1343-44; Harvard Note, *supra* note 107, at 321; Pennsylvania Note, *supra* note 107, at 620.

¹¹³ See notes 117 & 127 *infra*.

3-302(1)¹¹⁴ and 3-304¹¹⁵ are the successors to N.I.L. sections 52 and 56.¹¹⁶ Although many traces of the pre-Code law may be found in these sections there are significant changes, one of the most important of which is the separation of the requirements of good faith and notice.¹¹⁷ Under section 3-302(1)(b) of the

¹¹⁴ U.C.C. § 3-302 provides:

- (1) A holder in due course is a holder who takes the instrument
 - (a) for value; and
 - (b) in good faith; and
 - (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person.

Id.

¹¹⁵ Section 3-304 is set out here in its entirety. Only subsection (1) of that section in fact corresponds to section 56 of the N.I.L.:

§ 3-304: Notice to Purchaser.

- (1) The purchaser has notice of a claim or defense if
 - (a) the instrument is so incomplete, bears such visible evidence of forgery or alteration, or is otherwise so irregular as to call into question its validity, terms or ownership or to create an ambiguity as to the party to pay; or
 - (b) the purchaser has notice that the obligation of any party is voidable in whole or in part, or that all parties have been discharged.
- (2) The purchaser has notice of a claim against the instrument when he has knowledge that the fiduciary has negotiated the instrument in payment of or as security for his own debt or in any transaction for his own benefit or otherwise in breach of duty.
- (3) The purchaser has notice that an instrument is overdue if he has reason to know
 - (a) that any part of the principal amount is overdue or that there is an uncured default in payment of another instrument of the same series; or
 - (b) that acceleration of the instrument has been made; or
 - (c) that he is taking a demand instrument after demand has been made or more than a reasonable length of time after its issue. A reasonable time for a check drawn and payable within the states and territories of the United States and the District of Columbia is presumed to be thirty days.
- (4) Knowledge of the following facts does not of itself give the purchaser notice of a defense or claim
 - (a) that the instrument is antedated or postdated;
 - (b) that it was issued or negotiated in return for an executory promise or accompanied by a separate agreement, unless the purchaser has notice that a defense or claim has arisen from the terms thereof;
 - (c) that any party has signed for accommodation;
 - (d) that an incomplete instrument has been completed, unless the purchaser has notice of any improper completion;
 - (e) that any person negotiating the instrument is or was a fiduciary;
 - (f) that there has been default in payment of interest on the instrument or in payment of any other instrument, except one of the same series.
- (5) The filing or recording of a document does not of itself constitute notice within the provisions of this Article to a person who would be a holder in due course.
- (6) To be effective notice must be received at such time and in such manner as to give a reasonable opportunity to act on it.

U.C.C. § 3-304.

¹¹⁶ Official Comments to U.C.C. §§ 3-320 and 3-304.

¹¹⁷ In *Industrial Nat'l Bank v. Leo's Used Car Exch., Inc.*, 291 N.E.2d 603 (Mass. 1973), the court pointed out that the question of good faith is determined by an inquiry into the honesty of the purchaser, and not into his diligence or negligence. Those considerations, however, go to the question of notice. *Id.* at 606. See also *Oscar Gruss & Son v. First State Bank of*

U.C.C., a holder who seeks the status of holder in due course must establish¹¹⁸ that he took the instrument in good faith. The draftsmen of the U.C.C. originally attempted to make this test of good faith subject not only to the honesty of the holder, but also to reasonable commercial standards. The attempt, however was foiled¹¹⁹ and the test of good faith continues to be satisfied, as it was in pre-Code law, by a showing of subjectively honest conduct.¹²⁰ Nevertheless, the objective test is not entirely dead. In addition to establishing that he was honest and therefore in good faith, under section 3-302(1)(c) the holder also has to show¹²¹ that he took the instrument without notice of any claim or defense¹²² to the instrument.¹²³ As the following examination of section 3-304 reveals, this

Eldorado, 24 U.C.C. REP. SERV. 1251, 1259 (7th Cir. 1978); *Suit & Wells Equipment Co. v. Citizens Nat'l Bank*, 282 A.2d 109 (Md. 1971); *First State Bank & Trust Co. v. George*, 519 S.W.2d 198 (Tex. 1974).

¹¹⁸ The burden of establishing both good faith and lack of notice is placed upon the holder by § 3-307(3) which requires him to establish by affirmative proof all the elements of § 3-302. *See, e.g.*, *United Securities Corp. v. Bruton*, 213 A.2d 892 (D.C. 1965); *HIMC Investment Co. v. Siciliano*, 103 N.J. Super. 27, 246 A.2d 502 (1968); *Oklahoma Nat'l Bank v. Equitable Credit Finance Co.*, 489 P.2d 1331 (Okla. 1971); *Peoples Bank of Aurora v. Haar*, 421 P.2d 817 (Okla. 1966). *But see* *Western State Bank v. First Union Bank & Trust Co.*, 360 N.E.2d 254 (Ind. 1977). The position is the same in article 8, in which one who claims the status of a bona fide purchaser bears the burden of showing that he satisfied the prerequisites of the status. *Oscar Gruss & Son v. First State Bank of Eldorado*, 24 U.C.C. REP. SERV. 1251, 1262 (7th Cir. 1978). This burden only arises if the defendant first established the existence of a viable defense. *Hollywood Nat'l Bank v. I.B.M. Corp.*, 38 Cal. App. 2d 607, 113 Cal. Rptr. 494 (1974) (relating to securities under article 8); *Ritz v. Karstenson*, 39 Ill. App. 3d 877, 350 N.E.2d 870 (1976) (relating to a holder in due course of an instrument).

¹¹⁹ LLEWELLYN, *supra* note 104, at 181 n.182, attributes this failure to "[t]he blinder and less informed of the New York City bar, the bankers in general, and history-ignorance" The 1952 official text of the U.C.C. required that a holder, in order to acquire the status of a holder in due course, take the instrument "in good faith, including observance of . . . reasonable commercial standards" U.C.C. § 3-302(1)(b) (1952 version). Llewellyn saw this inclusion of an objective criterion as a return to the common law from which the courts had strayed. The provision was generally criticized during the hearings before the New York Law Revision Commission as renewing an objective test that had not been required either during or prior to the currency of the N.I.L. *See* N.Y. Law Rev. Comm'n Report, *supra* note 23, at 203; Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798, 812-22 (1958); Penney, *supra* note 83, at 998-99; Braucher, *supra* note 83, at 66-67; *see also* *Third Nat'l Bank v. Hardi Gardens Supply of Ill., Inc.*, 380 F. Supp. 930 (M.D. Tenn. 1974). The element of reasonable commercial standards of course remains part of the requirement of good faith for a merchant in article 2.

¹²⁰ *Third Nat'l Bank v. Hardi Gardens Supply of Ill., Inc.*, 380 F. Supp. 930 (M.D. Tenn. 1974); *Central Bank & Trust Co. v. First Northwest Bank*, 332 F. Supp. 1166 (E.D. Mo. 1971), *aff'd*, 458 F.2d 511 (5th Cir. 1972); *Industrial Nat'l Bank v. Leo's Used Car Exch., Inc.*, 291 N.E.2d 603 (Mass. 1973); *Mid Continent Nat'l Bank v. Bank of Independence*, 523 S.W.2d 569 (Mo. 1975); *McConnico v. Third Nat'l Bank*, 499 S.W.2d 894 (Tenn. 1973); *Von Gohren v. Pacific Nat'l Bank of Washington*, 505 P.2d 467 (Wash. 1973); *Van Horn v. Van De Wol, Inc.*, 6 Wash. App. 959, 497 P.2d 252 (1972).

¹²¹ On the question of burden of proof, *see* note 118 *supra*.

¹²² Essentially, a defense is a right to resist payment in a suit on the instrument while a claim is a right to the instrument based on an equity of ownership in the instrument. *See* *Fulton Nat'l Bank v. Delco Corp.*, 128 Ga. App. 16, 195 S.E.2d 455 (1973); *Lakeshore Commercial Finance Corp. v. Bradford Arms Corp.*, 45 Wis. 2d 313, 173 N.W.2d 165 (1970).

¹²³ *See* cases cited in note 117 *supra*.

requirement compensates for the subjective good faith test and reintroduces the objective element into the determination of the holder in due course status.¹²⁴ Consequently, the holder in due course once again is treated more like a bona fide purchaser in other areas.

When the U.C.C. was first drafted, some commentators lamented this tampering with traditional principles, and they expressed concern that such tampering would result in the imposition of a greater burden of inquiry on the holder of an instrument, thereby impairing the free movement of commercial paper.¹²⁵ Notwithstanding that criticism, the change sought to clarify and rationalize what had been a confused area of law. Some courts readily grasped the import of the new provisions of the U.C.C., and interpreted them in accordance with their spirit and purpose.¹²⁶ Others continued to base their opinions on cases decided under the N.I.L., apparently oblivious to the different approach of the two statutes.¹²⁷ This regrettable trend has continued to ob-

¹²⁴ *Fireman's Fund Ins. Co. v. Security Pacific Nat'l Bank*, 85 Cal. App. 3d 797, 149 Cal. Rptr. 883 (1978); HART & WILLIER, COMMERCIAL PAPER, 2 BENDER'S U.C.C. SERVICE § 1105, point out that it could be dangerous to distinguish good faith and notice on the basis of the subjective or objective criteria for determining their absence or presence. They feel that such a distinction involves a risk of generalization in a case where clear statutory language exists. Nevertheless they concede the distinction is useful. In fact it is indispensable to any inquiry into the principles that underlie the distinction.

¹²⁵ Britton, *Holder in Due Course — A Comparison of the Provisions of the N.I.L. with Those of Art. 3 of the Proposed Commercial Code*, 49 NW. U.L. REV. 417 (1954) [hereinafter cited as Britton].

¹²⁶ See cases cited in note 117 *supra*. In *Oscar Gruss & Son v. First State Bank of Eldorado*, 24 U.C.C. REP. SERV. 1251 (7th Cir. 1978), the Seventh Circuit observed that the confusion that has arisen in cases decided after the U.C.C. resulted from the pre-Code mingling of good faith and notice requirements, and noted that the confusion has made the resolution of disputes in the area more complex than need be. See also *Salter v. Vanotti*, 26 U.C.C. REP. SERV. 964, 967 (Colo. 1979).

¹²⁷ There are several cases in which the spectre of the N.I.L.'s purely subjective standard has manifested itself to haunt post-Code courts. In *Universal C.I.T. Corp. v. Ingel*, 347 Mass. 119 (1964), the Massachusetts court initially held that the notice contemplated by § 3-302 (1)(c) was subjectively determined. The court revised that view and the official report of the case was amended to bring the opinion into accord with the objective criteria set out in § 1-201(25). The First Circuit appeared to labor under a similar misconception of the notice standard in *Bowling Green, Inc. v. State Street Bank & Trust Co.*, 425 F.2d 81 (1st Cir. 1970), in which it stated that "[t]he code defines 'good faith' as 'honest in fact' . . . an essentially subjective test which focuses on the state of mind of the person in question. The code definition of notice . . . (in § 1-201(25)) while considerably more prolix, also focuses on the actual knowledge of the individuals allegedly notified." *Id.* at 85. The court below in that case did not seem to entertain the same misconceptions. *Bowling Green, Inc. v. State Street Bank & Trust Co.*, 307 F. Supp. 648 (D. Mass. 1969). In *Citizens Nat'l Bank v. Fort Lee Sav. & Loan Ass'n*, 89 N.J. Super. 43, 213 A.2d 315 (1965), the court unquestioningly applied pre-Code authority based on the subjective test of the N.I.L. in determining whether or not a purchaser of an instrument had notice under § 3-302 of New Jersey's U.C.C. The court ignored § 3-304 and its new standards. See also *Third Nat'l Bank v. Hardi Gardens Supply of Ill., Inc.*, 380 F. Supp. 930 (M.D. Tenn. 1974); *O.P. Ganjo, Inc. v. Tri-Urban Realty Co.*, 108 N.J. Super. 517, 261 A.2d 722 (1969). In *St. Cloud Nat'l Bank & Trust Co. v. Sobriana Constr. Co.*, 302 Minn. 71, 224 N.W.2d 746 (1974), the confusion appears to have caused one of the parties to have missed a valuable argument which was not raised on appeal. See also HART & WILLIER, COMMERCIAL PAPER, 2 BENDER'S U.C.C. SERVICE § 11.05.

fuscate an area that now should be clear and has cast doubt upon the standard of inquiry expected of the holder of a negotiable instrument.¹²⁸

The preceding discussion outlined the general approach adopted by article 3 to the question of notice to holders in due course, and it showed the considerable confusion generated as a result of some courts' continued adherence to policies the U.C.C. sought to abandon. In the ensuing section, an examination of section 3-304 will reveal the detailed provisions that give effect to the U.C.C. approach. It will demonstrate that continued reliance on cases decided under the N.I.L. or at common law is inapposite.

B. *The Notice Requirements of Section 3-304*

1. Constructive Notice

The U.C.C.'s constructive notice provision for holders in due course is found in section 3-304(1)(a). It is the successor to section 52(1) of the N.I.L.¹²⁹ Section 52(1) represented the one exception to the general rule that the N.I.L. was concerned only with the factual state of mind of the holder. Under section 52(1), where the instrument was not regular or complete upon its face, it was not relevant to inquire into the holder's subjective appreciation of the patent irregularity.¹³⁰ Notice of the irregularity would be attributed to him whether or

¹²⁸ There is some indication that this confusion between objective and subjective standards has not been confined to article 3, and that it has occasionally spilled over into other areas of the U.C.C. See, e.g., *Hollywood Nat'l Bank v. I.B.M. Corp.*, 38 Cal. App. 3d 607, 113 Cal. Rptr. 494 (1974), in which the court merged the concepts of good faith and notice in the case of a bona fide purchaser under § 8-302. Notwithstanding any pre-Code authority, there is no longer cause for such a merger. The U.C.C. requires both standards to be met. Cf. *Matthysse v. Securities Processing Services, Inc.*, 444 F. Supp. 1009 (S.D.N.Y. 1977) (interpreting New York's variation of § 8-304, which includes the following language as subsection (3): "Except as provided in this section, to constitute notice of an adverse claim or a defense, the purchaser must have knowledge of the claim or defense or knowledge of such facts that his action in taking the security amounts to bad faith.").

Two states, New York and Virginia, have deliberately retained the subjective standard of § 56 of the N.I.L., which they incorporated into § 3-304 by a non-uniform subsection 3-307(7) which reads as follows:

In any event, to constitute notice of a claim or defense, the purchaser must have knowledge of the claim or defense or knowledge of such facts that his action in taking the instrument amounts to bad faith. If the purchaser is an organization and maintains within the organization reasonable routines for communicating significant information to the appropriate part of the organization apparently concerned, the individual conducting the transaction on behalf of the purchaser must have the knowledge.

New York subsequently amended this subsection by the deletion of the final sentence.

This non-uniform provision, which followed upon a recommendation of the New York Law Revision Commission, gutted the reformist ingredient of section 3-304 and was received with misgivings by commentators at the time of its enactment. See Braucher, *supra* note 83, at 67-68; Penney, *supra* note 83, at 998-1000; Virginia Note, *supra* note 36, at 1353; Penney, *A Summary of Articles 3 and 4 and Their Impact in New York*, 48 CORNELL L.Q. 47, 59-61 (1962).

¹²⁹ N.I.L. § 52(1) provides in relevant part: "A holder in due course is a holder who has taken the instrument under the following conditions: (1) That it is complete and regular upon its face" *Id.*

¹³⁰ *Id.* Rightmire, *supra* note 104, at 364-65; Harvard Note, *supra* note 107; BRITTON, *supra* note 93, at 283.

not he examined the instrument, and whether or not he was aware of the irregularity.¹³¹ Under both statutes such notice attributed to a purchaser acts as an absolute bar to his acquisition of holder in due course status. A purchaser who fails to achieve the status takes subject not only to defenses that arise from the infirmity itself, but also to all other defenses on the instrument that may be raised against one who is not a holder in due course.¹³² The purchaser's knowledge or lack of knowledge of such defenses is just as irrelevant as his state of knowledge with regard to the infirmity on the instrument.

Despite these general similarities, the U.C.C. and the N.I.L. are distinctly different in approach. While section 52(1) of the N.I.L. imposed the broad and rather vague standard that the instrument must be complete and regular on its face, section 3-304(1)(a) eschews that broad statement of principle, and instead sets out a catalogue of facts that lead to the same basic conclusion — that the instrument was incomplete or irregular. By being more specific, the U.C.C. draftsmen hoped to eliminate some of the difficulties that arose from the imprecise wording of its predecessor.¹³³ In addition, the draftsmen chose to use superlative language in order to emphasize that the purchaser of an instrument only is treated as having constructive notice of material, almost glaring, irregularities in the instrument. Consequently, the holder is only accountable for those irregularities which would excite suspicion in a reasonable person¹³⁴ that the instrument is not viable either in regard to its terms or in regard to its title.¹³⁵

The irregularity must of course be in the instrument itself, not in some ac-

¹³¹ BRITTON, *supra* note 125, at 434; Virginia Note, *supra* note 36, at 1352.

¹³² BRITTON, *supra* note 125, at 434; Virginia Note, *supra* note 36, at 1352. *See also* Citizens State Bank v. Pauly, 152 Kan. 152, 102 P.2d 966 (1940) (the irregularity in the note rendered it non-negotiable). Keisel v. Baldock, 55 Okla. 487, 154 P. 1194 (1915).

¹³³ *See* § 3-304, Comment 2. One example of such a difficulty that has been avoided by the more precise working of § 3-304(1)(a) is the treatment of blanks under the N.I.L. and the U.C.C. Under the N.I.L. a person could not be a holder in due course of an instrument that contained a material omission. All blanks had to be filled in before the holder in due course took the instrument. *See* N.I.L. § 4; F. BEUTEL, BRANNAN'S NEGOTIABLE INSTRUMENTS LAW 694-97; BRADY, BANK CHECKS § 8.12, at § 8.24 (5th ed. 1979) [hereinafter cited as BRADY]. Under the U.C.C. an omission of material matter from an instrument will not preclude the acquisition of holder in due course status unless the omission calls into question the validity of the instrument. A holder could, for example, fill in its own name on an instrument that omits the name of the payee and still qualify as a holder in due course. *United States v. Second Nat'l Bank*, 502 F.2d 535 (5th Cir. 1974).

¹³⁴ The effect of the irregularity must be measured against the objective standard of a reasonable person exercising normal commercial practices. *Western State Bank v. First Union Bank & Trust Co.*, 360 N.E.2d 254 (Ind. 1977).

¹³⁵ Comment 2 to § 3-304 talks of alterations that do not excite suspicion, and concludes by observing: "[i]rregularity is properly a question of notice to the purchaser of something wrong, and is so treated here." *See also* Morris, *Negotiable Instruments under the U.C.C.*, 64 W. VA. L. REV. 457, 509 (1962); *First Nat'l Bank v. Otto Huber & Sons, Inc.*, 394 F. Supp. 1284 (D.S.D. 1975). Irregularities of this type should be distinguished from matter on the instrument that goes to the very negotiability of the instrument itself. If the instrument is rendered non-negotiable because it contains a conditional promise, or is uncertain as to time of payment or amount payable then the transferee of the instrument is deprived of the status of holder in due course absolutely, not because he has notice of the defect attributed to him, but because the nature of the instrument is such that it cannot be held in due course.

companying document, for the absolute notice provisions of section 3-304(1)(a) to apply.¹³⁶ It is not necessary, however, that the irregularity be intrinsic in the instrument itself and determinable without reference to any outside circumstances. The question whether or not an instrument is irregular must be tested not only in the light of the provisions of the U.C.C. or any other applicable statute, but also in the light of the likely reaction of a reasonable person in the commercial context. Therefore, even if the instrument is intrinsically sound, in the sense that it is fully negotiable and valid under article 3, it may still be irregular if it is so unusual that it would be viewed with suspicion in the relevant commercial setting.¹³⁷

In sum, if the instrument is blighted by an irregularity of sufficient magnitude, then under section 3-304(1)(a) the holder is charged absolutely with notice of the irregularity irrespective of his appreciation of it. If the irregularity or infirmity is of lesser dimensions, then subsection (1)(a) will not apply, and the impact of the irregularity will be judged by the standards set out in sections 3-304(1)(b) and 1-201(25) for determining actual notice.¹³⁸ In the latter instance, the purchaser will be found to have notice of a claim or defense that emerges from an irregularity only if he had actual knowledge of such claim or defense or reason to know of it.¹³⁹

Most courts do not articulate, or even recognize this distinction. As a result, the inquiry into notice in the case of irregularities on an instrument is often dealt with in a rather amorphous way.¹⁴⁰ Nevertheless, the results usually conform with the underlying spirit of the section, and support the general proposition that irregularities, omissions, or alterations on an instrument that a reasonable person would not accept as immaterial will not preclude the holder of the instrument from acquiring it in due course. On the basis of this princi-

¹³⁶ *Leininger v. Anderson*, 255 N.W.2d 22, 28 (Minn. 1977).

¹³⁷ *Western State Bank v. First Union Bank & Trust Co.*, 360 N.E.2d 254 (Ind. 1977), held that even where certificates of deposit were valid and negotiable under article 3 and other statutory requirements, they would be irregular under § 3-304(1)(a) if they so deviated from accepted banking customs that a reasonably prudent man exercising normal commercial judgment would be put on notice that there was something irregular about them. The court held that where such irregularity arising out of usage or custom is in issue, the burden is on the person relying on the usage to prove it.

¹³⁸ See, e.g., *Fireman's Fund Ins. Co. v. Security Pacific Nat'l Bank*, 85 Cal. App. 3d 797, 149 Cal. Rptr. 883 (1978); *O.P. Ganjo, Inc. v. Tri-Urban Realty Co.*, 108 N.J. Super. 517, 261 A.2d 722 (1969).

¹³⁹ This issue is discussed in text at notes 150-54 *infra*. Of course, it is conceivable that a purchaser might have notification of an irregularity, in which case notice by notification may be ascribed to him. As a practical matter, notification is not likely to arise as an issue in this context.

¹⁴⁰ A review of the cases cited in notes 141-43 *infra* will attest to this amorphous treatment. See also *Sun & Sand, Inc. v. United California Bank*, 24 U.C.C. REP. SERV. 667 (Cal. 1978). This approach is understandable in view of the fact that circumstances are often ambiguous and will support either an argument based on the irregularity of the instrument or on the purchaser's reason to know of a defense or claim. See, e.g., *Winter & Hirsch, Inc. v. Passarelli*, 122 Ill. App. 2d 372, 259 N.E.2d 312 (1970), in which the court would have treated as an irregularity under § 3-304(1)(a) circumstances that would have been handled more comfortably under § 3-304(1)(b). In addition, the fact that both the constructive notice standard and the "reason to know" test contain, in different measures, a degree of objectivity, it is rather easy to think of them in the same light. *Western State Bank v. First Union Bank & Trust Co.*, 360 N.E.2d 254 (Ind. 1977).

ple, purchasers of instruments have been held to be holders in due course where the instrument in question contained blanks,¹⁴¹ where it was obviously completed by someone other than the drawer,¹⁴² where it was altered,¹⁴³ or where there were discrepancies between words and figures.¹⁴⁴ This approach is a revolutionary one. In fact, as a general rule section 52(1) of the N.I.L. similarly was interpreted to apply only to material irregularities¹⁴⁵ and the substance of the law in this area has not changed significantly.

This rule, which applies to irregularities in form, applies equally to notations, memoranda, or other facts appearing on the instrument. Either those facts on the instrument will be significant and suspicious enough to be held against the purchaser under subsection (1)(a) irrespective of his awareness of them, or they will be considered along with any other relevant facts, in determining whether under subsection (1)(b) the holder had actual notice of some claim or defense.¹⁴⁶ Purely narrative matter on an instrument is not sufficient to put a purchaser on notice of some claim or defense arising out of the transaction or relationship described in the narration unless there is some danger signal that would alert the purchaser to such defense.¹⁴⁷

Although the results reached by the courts under the approach of N.I.L.

¹⁴¹ *United States v. Second Nat'l Bank*, 502 F.2d 535 (5th Cir. 1974).

¹⁴² *Steelman v. Associates Discount Corp.*, 121 Ga. App. 649, 175 S.E.2d 62 (1970); *Saka v. Sahara-Nevada Corp.*, 92 Nev. 703, 558 P.2d 535 (1976); *Central State Bank v. Kilroy*, 57 A.D.2d 940, 395 N.Y.S.2d 78 (1977). In fact, express statutory language supports this holding. U.C.C. § 3-304(4)(d) provides that it is only knowledge of improper completion, not mere knowledge of fact of completion of the instrument that will constitute notice of a defense or claim. See also U.C.C. § 3-115, which creates a presumption of authorized completion.

¹⁴³ In *National State Bank of Elizabeth v. Kleinberg*, 4 U.C.C. REP. SERV. 100 (N.Y. 1967), a note for \$52,000 was stated on its face as being payable in ten weekly installments of \$1,000, and an eleventh installment of \$41,000. The amount of the balance was altered to \$42,000. The court allowed the alteration as the correction of an arithmetical error which obviously appeared from the face of the instrument. But see *National Acceptance Corp. v. Henne*, 194 So. 2d 434 (La. 1967), in which the amount written on the instrument in ink by the drawer was erased and new figures typed over the erasure. The alteration was obvious to the eye, and was held to render the instrument irregular on its face under § 52(1) of the N.I.L. The same result would follow under U.C.C. § 3-304(1)(a).

¹⁴⁴ *McCook County Nat'l Bank v. Compton*, 558 F.2d 871 (8th Cir. 1977).

¹⁴⁵ A collection of pre-Code cases can be found in F. BEUTEL, *BRANNAN'S NEGOTIABLE INSTRUMENTS* LAW 692-97.

¹⁴⁶ Some matter on an instrument, for example a restrictive endorsement, or an endorsement without recourse will be governed by specific rules set out in the U.C.C. See U.C.C. §§ 3-205, 3-206, 3-414. The fact that an instrument was signed without recourse was not treated as an infirmity under the N.I.L., nor it is so treated under the U.C.C. See *Werbel v. Mullen*, 11 N.J. 40, 93 A.2d 367 (1952). However, the taker of an instrument bearing such a qualified endorsement is held to such endorsement, not by operation of the doctrine of notice, but on principles of contract liability under article 3.

¹⁴⁷ U.C.C. § 3-304(4). See also, e.g., *Eldon's Super Fresh Stores, Inc. v. Merrill Lynch*, 296 Minn. 130, 207 N.W.2d 282 (1973). A similar approach was adopted under the N.I.L. It was only clear irregularities appearing on the face of the instrument that would fall within the constructive notice provisions of § 52(1). Thus a purchaser would be charged with notice of a material blank in the instrument, or a mark of dishonor or restrictive endorsement. However, where a fact noted on the instrument fell short of an irregularity it would be treated in the same way as a fact dehors the instrument, and the holder would be charged with notice of such fact only if the provisions of § 56 were satisfied. See generally *Harvard Note*, *supra* note 107, at 321.

section 52(1) are generally consistent with the underlying purpose of U.C.C. section 3-304(1), use of this outmoded methodology should be avoided as contrary to the literal terms of section 3-304(1). Section 3-304(1) forms part of the analytic scheme established under the U.C.C. to unify the notice doctrine in commercial law. Failure to adhere to the scheme either because of an application of outmoded standards, or by a disregard of the distinction between absolute and actual notice frustrates that goal.

2. Actual Notice

The treatment of actual notice in article 3, is found in section 3-304(1)(b)¹⁴⁸ and in sections 3-304(2)-(6). These sections must be read in conjunction with section 1-201(25).¹⁴⁹ In this light the holder is charged with notice of a claim or defense under section 3-304(1)(b) where he had actual knowledge,¹⁵⁰ notification,¹⁵¹ or reason to know¹⁵² either that the obligation of a party was voidable or that all parties had been discharged.

Actual knowledge of the voidability or discharge corresponds in some measure to the standard set out by section 56 of the N.I.L.,¹⁵³ although the divorce of the good faith and notice requirements does theoretically restrict the inquiry. Under section 56 it was necessary not only to investigate the presence of knowledge in the mind of the holder, but also to make a determination of the effect of that knowledge on his bona fides in taking the instrument. The wording of section 3-305(1)(b) requires only a consideration of the absence or presence of actual knowledge and does not prescribe the further step of assessing the holder's honesty in taking the instrument in the light of that knowledge. The distinction is not usually significant for practical purposes because it follows as a matter of course in most cases that one who takes with knowledge of such infirmities will lack good faith in acquiring the instrument.

Section 3-304(1)(b) nevertheless is radically different from N.I.L. section 56 because it charges a holder with notice not only where he has actual knowledge but also where he has reason to know of the voidability or discharge. As a result, the holder of an instrument is judged under section 3-304(1)(b) in the same way as other bona fide purchasers are judged under the U.C.C., using the yardstick of reasonable diligence to decide whether notice of a fact should be attributed to him.¹⁵⁴ As is the case with notice under subsection (1)(a), if the

¹⁴⁸ The section is set out in full in note 115 *supra*.

¹⁴⁹ The section is set out in full in the text at note 15 *supra*.

¹⁵⁰ U.C.C. § 1-201(25)(a).

¹⁵¹ U.C.C. § 1-201(25)(b). A discussion of the meaning of notification may be found in the text at notes 31-42 *supra*. As indicated there, notice by notification is a variety of constructive notice, not actual notice.

¹⁵² U.C.C. § 1-201(25)(c). Note that recording is ineffective as constructive notice to the holder of a negotiable instrument. This accords with the general principle and is also specifically provided for in §§ 3-304(5) and 9-309. *See also* National Surety Fire v. Mazzara, 268 So. 2d 814 (Ala. 1972).

¹⁵³ Billingsley v. Mackay, 382 F.2d 290, 291-92 (5th Cir. 1967) (Heebe, J., dissenting).

¹⁵⁴ Von Gohren v. Pacific Nat'l Bank of Washington, 8 Wash. App. 245, 505 P.2d 467 (1973). *See also* cases cited in notes 68-74 *supra*.

holder is charged with notice of a claim or defense under subsection (1)(b) he will not enjoy the protection afforded to a holder in due course, and will take subject to any defenses that may be asserted against a holder on the instrument whether or not they have any relationship to the defense of which he has notice.¹⁵⁵ Although the nature of the inquiry under section 3-304(1)(a) is similar to other notice inquiries under the U.C.C., its scope is far narrower.

As the plain wording of section 3-304(1)(b) indicates, only notice of two particular types is relevant to the question whether or not a holder has notice of a claim or defense. The first type is notice that the obligation of any party is voidable in whole or in part. The second is notice that all parties have been discharged.¹⁵⁶ Section 3-304(1)(b) therefore requires a double inquiry. First, it must be established whether there are facts that would render the obligation of a party voidable or would discharge all parties. Second, it must be ascertained whether the purchaser of the instrument had notice of such facts.

The provision which relates to notice that all parties have been discharged appears to be of little practical significance. Discharge is governed by part 6 of article 3. Section 3-601 sets out an index of the situations in which the liability of a party may be discharged. However, both sections 3-602 and 3-305(2)(e) make it clear that such a discharge will not avail against a holder in due course who has no notice of it. This aspect of section 3-304(1)(b) therefore seems to be functionless for if the holder had noticed that all parties were discharged he would not have been successful in suing any of them in the first place. Each of them could have raised the defense of discharge against him under section 3-305(2)(e).¹⁵⁷

The issue of what constitutes a voidable obligation is addressed in comment 3 to section 3-304. The comment distinguishes defenses that would avoid the original obligation on the instrument from those that are in the nature of set-offs or counterclaims. Section 3-306 permits an obligor on an instrument to assert all defenses against a holder that could be asserted in an action on a simple contract. That would include not only defenses that arise out of the contract itself but also those that derive from collateral relationships and would be available to the defendant as a set-off against the contractual obligation. Although a set-off may be raised against one who is not a holder in due course, comment 3 makes it clear that notice of set-off will not preclude attainment of holder in due

¹⁵⁵ BRITTON, *supra* note 125, at 436, illustrates the principle by the following example: A payee obtains the instrument fraudulently from the drawer. An agent of the payee negotiates the instrument to the holder in payment of his own debt, in circumstances in which the holder is charged with notice of the payee's claim to the instrument. That notice disqualifies the holder from being a holder in due course and he would be subject not only to a claim to the instrument by the payee, but also to the personal defense of fraud (in the inducement) by the drawer. *See also* WHITE & SUMMERS, UNIFORM COMMERCIAL CODE 477 (1972); BRITTON, *supra* note 93, at 117.

¹⁵⁶ The N.I.L.'s formulation was indifferent; it required that the holder take the instrument without "notice of any infirmity in the instrument or defect in the title of the person negotiating it." N.I.L. § 52(4).

¹⁵⁷ Virginia Note, *supra* note 36, at 1353.

course status. To make an obligation voidable the defense must inhere either in the obligation that underlies the instrument or in the instrument itself.¹⁵⁸

Although comment 3 to section 3-304 mentions only defenses and says nothing of claims, the section by its terms extends both to claims and defenses, and the omission in the comment should not be interpreted to suggest the contrary. It is certainly conceivable that in some cases a claim made to an instrument by a third party will not affect the obligations of the parties to the instrument, who will be fully bound to whichever claimant is found to have title to it. In other circumstances, however, where the claimant is also a party to the instrument, his claim, if established, will result in the avoidance of his obligation to the holder under the instrument. Therefore, a drawer might draw a check in favor of a payee and issue it to him on condition that he will not deal with or negotiate it until he has performed a reciprocal obligation. If the payee, while failing to perform, does in fact negotiate the check to a third person who has notice of the breach of the condition, then that third person may not be a holder in due course. He had notice of a claim to the instrument on the part of the drawer which would render his obligation on the instrument voidable.¹⁵⁹

For the most part the provisions of U.C.C. sections 3-304 and 3-306 have successfully retained the traditional elements of notice as applied to negotiable instruments while bringing this specialized doctrine of notice more closely in line with notice requirements in other areas of commercial law. If this delicate balance is not fully understood, however, the result is likely to be greater confusion rather than less. Although precedents based on prior law or drawn from other notice provisions in the U.C.C. can be useful, blind reliance on such cases is dangerous. The notice requirements for holders in due course remain unique and must be treated as such.

C. Special Cases of Notice Under Article 3

1. Notice Where a Fiduciary Negotiates an Instrument

Subsections (2) and (3) of section 3-304 expand upon the general principles set out above. Subsection (2) deals with cases where a fiduciary

¹⁵⁸ An illustration of this principle is found in *Davenport v. Unicapital Corp.*, 230 S.E.2d 905 (S.C. 1976). The holder of the instrument was held to have notice of a defense where it was apparent from the face of an accompanying contract that an usurious rate of interest was being charged. Under a South Carolina statute, a debtor charged usurious interest may recover an amount equal to the interest provided for in the agreement plus double the interest actually paid to the creditor. That recovery may be had either in a separate action or in a counterclaim in an action on the contract. The court held that the debtor's obligation was voidable to the extent of his claim for penal damages. The case conforms to the spirit of § 3-304(1)(b). Even though the debtor's claim is in the nature of a set off or counterclaim, it arises out of the obligation underlying the instrument itself.

¹⁵⁹ In *Factors & Note Buyers, Inc. v. Green Lane, Inc.*, 102 N.J. Super. 43, 245 A.2d 223 (1968), the court, on facts similar to the situation described in the text, came to the opposite conclusion partly on the grounds that the claim arose from facts outside of the instrument rather than on the instrument itself. The opinion, which is based on the court's reading of § 3-304(4)(b) rather than on an interpretation of the provisions of § 3-304(1)(b), seems to suggest that it is only defenses arising out of the negotiable instrument itself, rather than the underlying obligation, that will be relevant in deciding whether the holder had notice. Such restriction on § 3-304 is not within the wording or the spirit of the section.

negotiate an instrument. Subsection (3) concerns notice that an instrument is overdue or has been dishonored.

Subsection (2) deals with the specific case of a fiduciary who has negotiated an instrument in breach of his fiduciary duty.¹⁶⁰ Where the purchaser of the instrument has knowledge¹⁶¹ both that the transferor is a fiduciary and that he is applying the principal's instrument to his own ends or in some other unauthorized manner, the purchaser is treated as having notice that the principal has claim to the instrument.¹⁶² As a result the purchaser does not qualify as a holder in due course.¹⁶³ Knowledge of both elements is necessary. Mere knowledge that the transferor is a fiduciary is not in itself sufficient to place the purchaser on notice.¹⁶⁴ Thus subsection (2) conforms to the general principles of notice under article 3. In fact, it seems that in the absence of subsection (2), a purchaser who had knowledge of the facts described in the subsection would be treated at least as having reason to know¹⁶⁵ of a claim against the instrument and the same result would follow.

The N.I.L. contained no provision equivalent to subsection (2), which

¹⁶⁰ Prior to the deliberations of the New York Law Revision Commission, § 3-304(2) provided for two specific cases in which a purchaser of an instrument would have notice of a claim against it. One of them related to fiduciaries, and corresponded roughly to the present provision now under consideration. The other charged a purchaser with notice of a claim if he had reasonable grounds to believe that the transfer of the instrument to him was a preference voidable under the law of bankruptcy or insolvency. That ground of notice was eliminated upon the recommendation of the Commission, 1 N.Y. Law Rev. Comm'n Report, *supra* note 23, at 206-07, 243-44, which pointed out: "If the transfer of the instrument is a voidable preference the bankruptcy court may adjudicate accordingly and the claim of the holder against the bankrupt estate will be determined on that basis. On the other hand, if the bankruptcy court does not make that determination it is difficult to see why that defense should be valid against a transferee for value." *Id.* at 207. See also *Franklin Nat'l Bank v. Sidney Gotowner, Inc.*, 4 U.C.C. REP. SERV. 953 (N.Y. 1967).

¹⁶¹ Note that the word "knowledge" is used. That means actual knowledge, not notice. The distinction is discussed in the text at notes 15-19 *supra*. Official texts of the U.C.C. up to 1952 charged the purchaser with notice of the claim against the instrument if he had *reasonable grounds to believe* that the fiduciary had acted in the manner described. In the 1957 official text the objective standard was replaced with the present subjective test of knowledge.

¹⁶² *Maley v. East Side Bank of Chicago*, 361 F.2d 383 (7th Cir. 1966); *McKirgan v. American Hospital Supply Corp.*, 37 Md. App. 85, 375 A.2d 591 (1977); *McConnico v. Third Nat'l Bank*, 499 S.W.2d 874 (Tenn. 1973).

¹⁶³ Notice under U.C.C. § 3-304(2) may not only be relevant to holder in due course status, but may also enter the question of whether or not an action based on negligence may lie against a banker. See *Swiss Baco Skyline Logging, Inc. v. Haliewicz*, 18 Wash. App. 21, 567 P.2d 1141 (1977).

¹⁶⁴ This is expressly stated in 3-304(4)(e). See also U.C.C. 3-206(4); *Fireman's Fund Ins. Co. v. Security Pacific Nat'l Bank*, 85 Cal. App. 3d 797, 149 Cal. Rptr. 883 (1978); *Leininger v. Anderson*, 255 N.W.2d 22 (Minn. 1977); *Eldon's Super Fresh Stores v. Merrill Lynch*, 296 Minn. 130, 207 N.W.2d 282 (1973); *Breslin v. New Jersey Investors*, 70 N.J. 466, 361 A.2d 1 (1976); *McConnico v. Third Nat'l Bank*, 499 S.W.2d 874 (Tenn. 1973); *Richardson Co. v. First Nat'l Bank*, 504 S.W.2d 812 (Tex. 1974).

¹⁶⁵ *Von Gohren v. Pacific Nat'l Bank of Washington*, 8 Wash. App. 245, 505 P.2d 467 (1973). Beutel, *Comparison of the Proposed Commercial Code, Article 3, and the N.I.L.*, 30 NEB. L. REV. 531, 548 (1951), says this subsection contemplates constructive notice of the principal's claim. That is a misstatement in the context of the distinctions employed in the U.C.C. The notice is actual notice based on the purchaser's reason to know (or possibly on his actual knowledge in some factual settings).

was inspired by sections 5 and 6 of the Uniform Fiduciaries Act.¹⁶⁶ Instead the N.I.L. relied exclusively on a subjective test. In spite of the subjective test prescribed by section 56, however, the N.I.L. treated knowledge regarding a fiduciary's appropriation of his principal's instrument as notice of a defect in the title of the fiduciary.¹⁶⁷

Although the term "fiduciary" is not defined in the U.C.C., it was defined in section 1(1) of the Uniform Fiduciaries Act,¹⁶⁸ and comment 5 to section 3-304 of the U.C.C. states that the U.C.C. provision follows the Uniform Fiduciaries Act.¹⁶⁹

It should be noted that subsection (2) applies only where the fiduciary has negotiated the instrument. Therefore it would have no application where the fiduciary has drawn or made an instrument on behalf of his principal in payment of his own debt,¹⁷⁰ or where he uses an instrument drawn by his principal

¹⁶⁶ See Comment 5 to § 3-304. Sections 5 & 6 of the Uniform Fiduciaries Act read as follows:

§ 5: *Check Drawn by Fiduciary Payable to Third Person.* — If a check or other bill of exchange is drawn by a fiduciary as such, or in the name of his principal by a fiduciary empowered to draw such instrument in the name of his principal, the payee is not bound to inquire whether the fiduciary is committing a breach of his obligation as fiduciary in drawing or delivering the instrument, and is not chargeable with notice that the fiduciary is committing a breach of his obligation as fiduciary unless he takes the instrument with actual knowledge of such breach or with knowledge of such facts that his action in taking the instrument amounts to bad faith. If, however, such instrument is payable to a personal creditor of the fiduciary and delivered to the creditor in payment of or as security for a personal debt of the fiduciary to the actual knowledge of the creditor, or is drawn and delivered in any transaction known by the payee to be for the personal benefit of the fiduciary, the creditor or other payee is liable to the principal if the fiduciary in fact commits a breach of his obligation as fiduciary in drawing or delivering the instrument.

§ 6: *Check Drawn by and Payable to Fiduciary.* — If a check or other bill of exchange is drawn by a fiduciary as such or in the name of his principal by a fiduciary empowered to draw such instrument in the name of his principal, payable to the fiduciary personally, or payable to a third person and by him transferred to the fiduciary, and is thereafter transferred by the fiduciary, whether in payment of a personal debt of the fiduciary or otherwise, the transferee is not bound to inquire whether the fiduciary is committing a breach of his obligation as fiduciary in transferring the instrument, and is not chargeable with notice that the fiduciary is committing a breach of his obligation as fiduciary unless he takes the instrument with actual knowledge of such breach or with knowledge of such facts that his action in taking the instrument amounts to bad faith.

¹⁶⁷ Uniform Fiduciaries Act, Commissioners note to §§ 5 and 6 suggests that the practice had grown up in the courts of abandoning the subjective good faith test for notice in cases where a fiduciary relationship appeared on the instrument, and of unconsciously substituting an objective test of negligence. See generally BRITTON, *supra* note 93, at 289-92.

¹⁶⁸ Section 1(1) of the Uniform Fiduciaries Act defines a fiduciary to include:

A trustee under any trust, expressed, implied, resulting or constructive, executor, administrator, guardian, conservator, curator, receiver, trustee in bankruptcy, assignee for the benefit of creditors, partner, agent, officer of a corporation, public or private, public officer, or any other person acting in a fiduciary capacity for any person, trust or estate.

¹⁶⁹ See notes 164-65 *supra*.

¹⁷⁰ This appears to have been overlooked in *Breslin v. New Jersey Investors*, 70 N.J.

in favor of the holder to pay not the principal's indebtedness to the holder but his own. In that type of situation the question of whether the holder had notice of a claim or defense should be determined by the general rules set out in section 3-304(1)(b). The practical result will in most cases be the same.¹⁷¹

2. Notice that an Instrument is Overdue or Dishonored

In addition to notice of defenses against or claims to the instrument, section 3-302(1)(c) penalizes those with notice that the instrument is overdue or that it has been dishonored.¹⁷² The circumstances that result in dishonor of an instrument are set out in section 3-507. A discussion of the rules relating to dishonor, and of its consequences are beyond the scope of this article, and it suffices to note that the fact of dishonor, like the fact of a claim or defense to the instrument, is a relevant issue in any inquiry relating to notice. With respect to dishonor, once it is established, the question of the holder's notice of it must be decided. If notice is established, the holder is deprived of the status of holder in due course whether or not the dishonor had any direct bearing on the defense that is to be raised.

Section 3-304, however, is silent on the question of notice relating to dishonor. Therefore, notice of dishonor must be established under the general notice provision, section 1-201(25). As a result, in many respects the notice issue in cases of dishonor will be subject to the same principles as that in the case of claims and defenses. Both actual knowledge and imputed knowledge of dishonor results in a holder being charged with notice of the dishonor. There is one significant difference between notice of dishonor and notice of claims or defenses. As was pointed out in the general discussion of section 1-201(25), constructive notice only is attributed to a purchaser in cases where it is specifically authorized by the U.C.C. In the case of matter appearing on the instrument, there is no provision in section 1-201(25) charging the holder absolutely with notice covered by section 3-304(1)(a). Accordingly, if marks of dishonor appear on the instrument itself, there is no basis for charging the holder with notice of dishonor irrespective of his state of mind.¹⁷³ There must be an inquiry into the existence of either actual knowledge or reason to know of dishonor, and in such a case the notation on the instrument will be merely a factual ingredient to be considered.

By contrast, notice that an instrument is overdue is dealt with specifically in section 3-304(3). That section sets out five separate factual settings that will result in a holder being charged with notice that the instrument is overdue. The

466, 361 A.2d 1 (1976). In *Eldon's Super Fresh Stores, Inc. v. Merrill Lynch*, 296 Minn. 130, 207 N.W.2d 282 (1973), the court recognized the point, but held nevertheless that an instrument issued to a holder must be treated the same as one negotiated to a holder.

¹⁷¹ This is because the facts will frequently lead to the conclusion that the holder had knowledge or reason to know of the principal's claim. BRADY, *supra* note 133, at § 8.17 n.16 seems to miss this point, and suggests a solution based on a breach of good faith. *Id.*

¹⁷² The N.I.L. contained an equivalent provision in § 52(2).

¹⁷³ A mark of dishonor on the instrument does not make the instrument incomplete, nor is it evidence of forgery or alteration, nor is it an irregularity which affects the validity or ownership of the instrument. Neither will it create any ambiguity as to the party to pay. Hence there is no language in 3-304(1)(a) which comfortably fits the case of dishonor.

section provides a special definition of notice. It provides that notice that an instrument is overdue is constituted only in cases in which the transferee had reason to know or actually knew of the circumstances set out.

The wording of section 3-304(3) leads to two observations. First, as in the case of notice that the instrument has been dishonored, there is no provision for constructive notice that an instrument is overdue. Therefore, the apprehension of the holder is the only relevant consideration.¹⁷⁴ Second, the standard for measuring that apprehension is different from the general standard set out in section 1-201(25)(c). The test set out in section 1-201(25)(c) has been described as a quasi-objective one in which inquiry must first be made into the purchaser's subjective awareness of base facts before a conclusion of notice of ultimate facts, predicated upon the reasonable inference from the base facts, can be drawn. That test arises from the wording in section 1-201(25) that the purchaser's reason to know derives from "all the facts and circumstances known to him" That wording is absent from section 3-304(3), and the omission has prompted at least one writer to wonder whether the quasi-objective test has been excluded from section 3-304(3) and substituted by a purely objective standard that takes the inquiry of reasonable appreciation further back into the circumstances of the transaction.¹⁷⁵ While this is a plausible reading of section 3-304(3), it is not clear that this was the intended design of the draftsmen, and there is no obvious reason for eliminating these subjective elements of the notice inquiry here.

Whether or not an objective or quasi-objective test is employed, section 3-304(3) by its terms defines what facts must be served to establish notice that the instrument is overdue, and, therefore, it must be interpreted as being exhaustive of the situations in which such notice is attributed to a holder. The holder only is charged with notice where he has reason to know either (a) that the principal amount¹⁷⁶ or any part of it is overdue,¹⁷⁷ (b) that there is a default in another instrument of the same series¹⁷⁸ and that such default has not been cured, (c) that there has been an acceleration of the instrument, (d) that the instrument is a demand instrument¹⁷⁹ and demand has already been made at the

¹⁷⁴ The cases have not clearly articulated this distinction. In *Srochi v. Kamensky*, 118 Ga. App. 182, 162 S.E.2d 889 (1968), the fact that the note was overdue both appeared from its face, and was found to have been known by the holder.

¹⁷⁵ Virginia Note, *supra* note 36, at 1349. The official comment is not much help in deciding whether or not the omission was deliberate. Comment 7 speaks of notice only in general terms, as does comment 1 to § 3-302.

¹⁷⁶ The section applies only to notice that the principal amount is overdue. Notice that interest is overdue is not enough to place the purchaser on notice, and is specifically excluded by § 3-304(4)(f). The rule is a codification of case law under the N.I.L. *See supra* note 107, at 54-55.

¹⁷⁷ This subsection applies to instruments payable at a definite time, as defined in § 3-109. *See generally* *E.F. Corp. v. Smith*, 496 F.2d 826 (10th Cir. 1974); *Srochi v. Kamensky*, 118 Ga. App. 182, 162 S.E.2d 889 (1968); *Capital Investors Co. v. Estate of Morrison*, 484 F.2d 1157 (4th Cir. 1973).

¹⁷⁸ Default on an instrument other than on the same series does not constitute notice and is excluded expressly in § 3-304(4)(f). *Central State Bank v. Kilroy*, 57 A.D.2d 940, 395 N.Y.S.2d 78 (1977).

¹⁷⁹ Defined in U.C.C. § 3-108.

time of taking it, or (e) that the instrument is a demand instrument and he is taking it more than a reasonable length of time after its issue.¹⁸⁰

In general, section 3-304(3), covering notice that an instrument is overdue or has been dishonored, and section 3-304(2), covering notice of a principal's claim where an instrument has been negotiated by a fiduciary, are primarily clarifying provisions. They describe when circumstances exist that make it reasonable to impute knowledge of a defect in an instrument. Although they are specialized provisions, they are not truly exceptions to the doctrine of notice provided in article 3.

CONCLUSION

The edges of the doctrine of notice have been tattered and frayed for a long time. Confusion has resulted not only from different conceptual definitions, but also from a failure to keep principles separate and distinct. The enactment of the U.C.C., with its generally straightforward and universal approach to notice, granted an opportunity to clarify and rationalize the confusing complexities which had developed in pre-Code law. In many cases the spirit of the U.C.C. has been conscientiously applied, yet for a number of reasons, ranging from the accommodation of the special interests of commercial groups on the one hand, to sloppy statutory interpretation on the other, the pre-Code conceptions continue to cling tenaciously to the doctrine of notice almost twenty years after its reform. Perhaps it is time to look more carefully at the purpose of and the place occupied by the doctrine in the U.C.C.

¹⁸⁰ Section 3-304(3)(c) specifies that a reasonable time after issue, in the case of a domestic check, is presumed to be 30 days. As comment 7 to § 3-304 indicates, the presumption may be overturned under § 1-201(31) by evidence showing a different period to be reasonable under the circumstances of the case. In the case of instruments which are not domestic checks (or where a period other than 30 days is alleged as a reasonable time for the life of a domestic check) the circumstances of the case, including the nature of the instrument, trade usage, and banking practices will have to be looked at in order to establish the appropriate period. U.C.C. § 3-503(2). *See also* Gill v. Commonwealth Nat'l Bank, 504 S.W.2d 521 (Tex. 1973).