Prudential Finance Corporation v. Kutcheran et al[1]

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With the growth of the sale of household and personal goods on the extended payment plan, the promissory note, the conditional sales contract, and the finance company have become inseparable parts of the procedure whereby the merchant realizes immediate cash from the extended obligations of the purchaser. The very existence of the seller's business depends on his ability to convert these obligations into cash, and the finance company standing ready and willing to buy them has become an essential part of retail selling on the time payment plan.[2]

The fact that our prosperous economy now depends so much on consumer credit raises sharply the following important question. What is the effect upon the holder of a promissory note, in fact collateral to a conditional sale agreement, of his being assignee of the agreement or even of his knowledge of its existence? In other words is the finance company as holder of a note made by the purchaser and payable to the seller, a holder in due course, or does the mere knowledge of assignment of the agreement deprive him of that status?

This problem has been the subject of recent extensive analysis by those seeking a less favourable interpretation, to the holder, of the relevant sections of the Bills of Exchange Act. Thus some decisions especially of the Quebec courts have sought to make it extremely difficult for a finance company taking as endorsee of the note to qualify as a holder in due course. Other Canadian jurisprudence is resisting this novel trend. The latter focuses upon a very definite and decided line of thought which will profoundly affect the nature of a relationship governing the sales organization and the finance company. This critique will attempt to clarify the rationale underlying current jurisprudential trends and establish a more predictable base for solving future problems.

An important decision of the Ontario Court of Appeal — *Prudential Finance Corporation* v. *Kutcheran et al*[3] poses the legal issue

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1 (1964) 45 D.L.R. 2d 402.

2 *Federal Discount Corporation* v. *St. Pierre and St. Pierre*, 32 D.L.R. 2d 86.

3 (1964) 45 D.L.R. 2d 402.

under discussion and provides its solution in a manner both logical and consistent with sound principles.

Briefly the facts are:

Conditional sale purchasers, the defendants signed a promissory note for the balance of the purchase price of a freezer chest. The condition of sale endorsed on the contract and incorporated into it by reference contained in these clauses.

> 5. Purchaser acknowledges that the agreement and the completion certificate constitute the entire contract and that there are no representations, warranties or conditions, expressed or implied statutory or otherwise, other than contained herein...
>
> 6. Purchaser takes notice that this agreement together with vendor's title to, property in and ownership of said goods and said note are to be forwith assigned and negotiated to Prudential Finance Corporation and that said corporation shall not be affected by any equities existing between vendor and purchaser and that all payments are to be made to said corporation.

The defendant claimed that the vendor's sales agent had orally represented that they were entitled to rescind and return the goods if they were not satisfied.

The trial judge held that the plaintiff could not sue as a holder in due course because the promissory note was signed contemporaneously with the conditional sales agreement in the usual terms and was given as collateral thereto.

At this point it is most interesting to note an obiter judgment by Casey J., in *Elmhurst Investment Company* v. *Allard*[4] which states in essence that if the holder of a cheque finds his right to claim in an agreement in writing seperate and distinct from the cheque, he does not enjoy the advantages conferred by the Bills of Exchange Act on a holder in due course and the drawer of the cheque is free to urge any defence that may be open to him.

> "If the plaintiff had the cheques and nothing else I would be obliged to decide whether it was a holder in due course. But if the plaintiff finds its rights to an agreement evidenced by a writing other than the cheques, it cannot invoke the advantages given by the act to a holder in due course."[5]

These remarks might be qualified if applied to a specific case based on its peculiar facts, but the statement that they apply in every such case without exception destroys the concept of negotiability of commercial paper. Our jurisprudence has constantly maintained that although originally attached to a conditional sales contract which may stipulate such agreement, the document sued upon is nevertheless

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[4] [1963] B.R. 236.
[5] [1963] B.R. 244.

a valid promissory note and a negotiable instrument,[6] and if the action is based on the note, the holder is presumed by law to be a holder in due course.[7]

In *Rapid Discount* v. *Foscolo*,[8] the court expounded a rather strange principle; that is, if the finance company to whom the note is negotiable does not become an assignee of the conditional sales contract, the contract does not affect it, but if it purchases both the note and the contract then, if the contract is in any manner impugnable, so is the note.

> "La demanderesse, avant d'acquérir un billet... avait l'obligation de faire une enquête minutieuse sur la nature du contrat qui accompagnait le billet négocié." Un examen du contrat, de sa nature et des circonstances qui l'ont entouré...[9]

Under similar circumstances, in *City Loan Finance Corporation* v. *Larocque*,[10] Jean J. held that a finance company, even though it had knowledge of a contract to which the note was collateral, was not obliged closely to investigate the circumstances of the contract, and could as a holder in due course sue the maker.

In *Rapid Discount Corporation* v. *Geintzer*,[11] Trudel J., was of the opinion that because in conditional sales contracts, both the dealer and the finance company know that the cheques issued by the purchaser are given as collateral to such contract, therefore the validity of payment depends upon the legality of the sales contract. This imputes to the finance company all the defects, risks and imperfections of the agreement. A similar view was advocated in *Consumer Acceptance Corporation* v. *Gendron*.[12]

The latest of this line of decisions is *Circle Acceptance Corporation* v. *Sigouin*.[13] There the court imposed upon the finance company the onerous burden of investigating the circumstances of the contract and even after the latter had ascertained the real nature of

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[6] *Commercial Acceptance Corp.* v. *Cormier* [1960] C.S. 161, *Lecompte* v. *O'Grady* [1930] C.S. 517.

[7] *Bank of Montreal* v. *Amibeault* (1939) 65 K.B. 1, *Duplessis* v. *The Edmonton Portland Cement Company* (1917) 55 S.C.R. 623, *Killoran* v. *The Monticello State Bank* (1921) 61 S.C.R. 520, *Laurentide Acceptance Company* v. *Corneau* (1952) S.C. 379, *Standard Credit Corporation* v. *Poissant* (1956) S.C. 83.

[8] [1963] C.S. 615.

[9] *Ibid* at p. 621.

[10] [1963] C.S. 683.

[11] [1963] C.S. 454.

[12] [1962] C.S. 203.

[13] [1963] C.S. 97. See case comment by Warren A. Black in (1964-65) 10 McGill L. J. 172.

the transaction existing between its customer and the party who entered into such a sales contract the finance company was still subject to all equities as between its customer and the party.

Surely this general condemnation of the position of the finance company not only is repugnant to legal principle, but taken seriously, would deprive commercial paper of mercantile utility.

The rapid growth of consumer credit and with it the event of the finance company makes it imperative to clarify the true interpretation applicable in law, therefore it is essential to analyze the ratio of the decision in *Prudential Finance Corporation* v. *Kutcheran et al.*[14]

The Canadian *Locus Classicus* is the Supreme Court judgment of *Killoran* v. *Monticello State Bank.*[15] Duff J., (as he was then), stated the relevant principle in these words:

> "In each case there is it is true on the same piece of paper, one of these instruments and a collateral agreement is no part of the instrument sued upon. By its express terms indeed, it is not to qualify the absolute obligation of the promissor or to affect the contractual rights of the parties in such a way as to impair the negotiability of the note." [16]

It was held that the note stood separate and apart from the agreement and unaffected by it even in the hands of a holder who knew of the collateral agreement, and not withstanding that the notes in the case had not been detached from the rest of the documents.

This case was followed and applied in *Union Acceptance Corporation Ltd.* v. *St. Amour,*[17] where it was held that a holder in due course of a note was not precluded from suing the maker thereon merely because the latter had given the note to secure the balance of the purchase price of goods which turned out to be defective and had to be taken back by the seller, a *fortiori* when the conditional sales contract contained a stipulation that the note was given as a negotiable instrument and the holder would not be affected by any equities as between seller and buyer.

The law in the relevant Canadian cases is uniform. The finance company, the holder of a note, relies on the presumptions of the Bills of Exchange Act. Whatever the buyers' complaint, short of a real defence such as *forgery, incapacity* and *non est factum,* the holder is entitled to succeed to the full value of the note. The facts of concurrent execution and concurrent transfer of the contract (even

[14] (1964) 45 D.L.R. 2d 402.
[15] (1920-21) 19 S.C.R. 528.
[16] *Ibid* at p. 531.
[17] [1957] O.W.N. 261.

when the note and the contract are printed on the same sheet of paper)[18] and of knowledge by officers of the finance company at the time of the transfer that the seller has not then delivered the goods [19] or otherwise fulfilled his obligations under the contract have been considered and held irrelevant to the rights of a holder of a note, because the existence of fraud by which the seller induced the buyer to purchase does not *per se* affect a holder without notice of the fraud or of circumstances so suspicious that failure to inquire constitutes bad faith.[20]

Arrangements between the seller and buyer subsequent to the transfer which qualify or nullify, as between seller and buyer, the original obligation [21] and acceptance of payment by the seller, when the documents call for payment directly to the finance company,[22] are equally irrelevant.

Even though the endorsee takes an assignment of the contract the most he will learn in the typical case is that the seller has obligations to perform — e.g. deliver the goods — or that if the goods are defective the seller will have some duty to fulfill his obligation to the buyer to deliver the goods of contract quality.

Even so the assignee — endorsee is entitled to assume that the dealer will in fact fulfill his obligation.

Complaints by the buyer that he has been a victim of fraud or that he has not received the goods at the agreed time or at all, or that the goods are defective etc.... will not arise until some time after the assignment and negotiation to the finance company.

The *Killoran* [23] case is authority not only for the proposition that a note is not affected by agreement, therefore in principle, the waiver clause is superfluous, but also for the proposition that if there is a

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18 *Killoran* v. *Monticello State Bank, Supra* note 14, *Aetna Factors Corp. Ltd.* v. *Breau* 1958, 15 D.C.R. (2d) 326. *Bank of Nova Scotia* v. *Philpott* (1930) 2 W.W.R. 128. *Canyon Securities Ltd.* v. *McConnell* 17 D.L.R. (2d) 730, *Commercial Acceptance Corp.* v. *Carrier* [1960] S.C. 161, *Union Acceptance Corp. Ltd.* v. *St.Amour* [1957] O.W.N. 261.

19 *Canyon Securities Ltd.* v. *McConnell* 17 D.L.R. (2d) 730.

20 *Sheffield* v. *London Joint Stock Bank* (1888) 13 A.C. at page 333, *Jones* v. *Gordon* (1877) 2 A.C. 616.

21 *Aetna Factors Corp. Ltd.* v. *Breau, Supra* note 18, *Rand Investments Ltd.* v. *Wallberg* (1961) 34 W.W.R. *Standard Credit Corp.* v. *Poissant,* 1956 S.C. 83, *Union Acceptance Corp.* v. *St. Amour, Supra* note 18.

22 *Traders Finance Corp. Ltd.* v. *Buffone* [1960] O.W.N. 364, *Chevalier* v. *Jette* [1956] S.C. 247.

23 (1962) 40 Can. Bar Rev. 461 *Can. Aeceptance* v. *Glovinsky* (1931) 69 Que. S.C. 206.

waiver clause it binds the buyer in a question with the holder of the note.

It is of the utmost importance to distinguish *Prudential Finance Corporation* v. *Kutcheran et al*[24] from *Federal Discount Corporation Ltd.* v. *St. Pierre and St. Pierre.* In the former case there was no close and intimate a relationship between the vendor and the plaintiff such as to fix the plaintiff with knowledge of the alleged collateral agreement — over and above the written conditional sales contract — made between the salesman and the defendant. The application of the principle derived from *Federal Discount Corporation* v. *St. Pierre*[25] on its peculiar facts is extremely limited. In that latter case, plaintiff finance company was fully aware of the general course of operation employed by its associate, Yarncraft Industries, of home knitting contracts to purchasers whom plaintiff itself undertook to finance in the resulting sales. The words, impressed by a rubber stamp of the finance company on certain defendant's documents, "Note — payments must be made regardless of the amount earned from Knitting",[26] proved that the plaintiff knew that the purchasers of home knitting machines would be left with the impression that the money to meet the installment of purchase price would be forthcoming from earnings under the home knitting contract.

Mere knowledge of a contract collateral to a promissory note does not impose a burden upon the finance company to investigate the circumstances. In *Federal Discount* the facts made it impossible for the finance company to deny that it had knowledge of the stipulations written into the contract from which it could be clearly inferred that payment of the cheques was conditional upon the earnings derived from the sale of knitted goods to a subsidary of Fair Isle (the knitting machine company).

It is interesting to note that the leading Quebec case of *Commodity Discount* v. *Briand*[27] closely resembles *Federal Discount Corporation Ltd.* v. *St. Pierre*[28] and deals with the exact identical knitting company scheme.

Although the contract contained clauses similar to those quoted in *Prudential Finance* v. *Kutcheran et al*,[29] there is an important

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24 *Op. cit.*, at p. 402.
25 *Op. cit.* at p. 86.
26 *Ibid.* at p. 99.
27 [1962] C.S. 543.
28 *Op. cit.* ,at p. 86.
29 *Op. cit.*, at p. 402.

distinguishing fact. The finance company, of its own volition, investigated each contract to verify whether any customer had been promised something in addition to what was in that contract. This was fatal as it fixed the finance company with knowledge that certain transactions were indeed fraudulent, thereby imposing a strict legal duty to investigate thoroughly each contract, but it was not the mere assignment of the contract which placed upon the holder any duty to scrutinize the transaction as between the immediate parties.

The reasoning followed by Batshaw, J. is directly applicable to the circumstances depicted in that case but should not be applied recklessly in deciding cases whose fact patterns bear no resemblance to it whatsoever.

So long as there are no circumstances connected with the finance company's acquisition of the promissory note and collateral agreement, of a nature to indicate to it or cause it to suspect that the payee's title may be defective the finance company is under no duty of investigate the transaction between the immediate parties.

It is both reasonable and logical to expect regular arrangements between the finance company and the sales company for the purpose of discounting the latter's commercial paper. To claim that the sales company must search for a different independant finance company to discount a sales contract, each time a customer wishes to purchase an article is ridiculous. In fulfilling its vital economic function, the finance company is entitled to the protection afforded a holder in due course in the same manner as any other lender.[30]

There can be no doubt that everyday commercial life demands that the utility of Bills of Exchange be not impaired and that a holder acquiring a bill in good faith should not be required to inquire into its pedigree.

This protection is absolutly essential if commercial transactions are to be carried on effectively in an economy which is irreconciliably committed to the phenomena of consumer credit !

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30 The latest jurisprudence is once again reflecting this interpretation *Poncelle Inc.* v. *Horne* [1964] R.L. *Commodity Discount Ltd.* v. *Baker* [1961] O.W.N. 277. *Imperial Investment Corp.* v. *Mazur* [1963]S.C.R. *Industrial Acceptance Corp.* v. *Rochfort* [1961] C.S. 421. *Banque Mercantile du Canada* v. *Emond* [1964] C.S. 591. *Canadian Imperial Bank of Commerce* v. *Lessard et un autre.* [1964] C.S. 57.