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Personal And Real Property—Local Real Estate Lien Treated as Expense of Foreclosure Sale Defeating Prior Federal Lien

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Erratum

On page 186 which read: Justice Storl should have read: Justice Story.

implies broad state regulatory authority, it is to be expected that a majority of cases in which the state exerts authority over a fund will involve a fact situation quite similar to *Thacher*. Whether this case indicates an attempt by the Court to draw a line on any growing trend toward federal pre-emption of authority in all fields involving labor relations is still open to question.

R. S. M.

NEGOTIABLE INSTRUMENTS

Restricted Application of Doctrine of Forgotten Notice

Respondent signed a paper for an employee, which the employee represented as a statement of his earnings for the year 1957. Respondent, unable to read or write English, often had his wife read important papers before he signed them. Although she was present in their home when this transaction took place, she did not read the paper. Somehow suspecting that the statement might have been a promissory note, which indeed it was, respondent thereafter consulted his attorney, who advised him to notify all banks in the county not to accept any instrument made by him payable to that employee. During his performance of this task, he entered the First National Bank of Odessa and explained his problem, in broken English, to the cashier, stating the name of the employee and that he had been deceived into signing the paper. The teller assured him "not to worry." Three and one-half months later, a regular customer of Bank to whom the note had been endorsed by the employee, presented it to the same cashier for discount and it was accepted. At maturity Bank forwarded the note to respondent's bank, which refused to honor it. Bank brought suit against respondent for the value of the note. The lower court rendered judgment for Bank, and the intermediate court reversed. On appeal, held affirmed. "Under the peculiar facts of this case" Bank could not apply the doctrine of forgotten notice since it had assured the respondent that it would not discount the note, that Bank was not a holder in due course, and that the respondent, therefore, was not liable to Bank. *First National Bank v. Fazzari*, 10 N.Y.2d 394, 179 N.E.2d 493, 223 N.Y.S.2d 483 (1961).[1]

The pertinent New York statute in this situation is Negotiable Instruments Law sections 91, 95, and 97.[2] The provisions of these sections, which are similar

1. 13 A.D.2d 582, 212 N.Y.S.2d 380 (3d Dep't 1961), reversing 22 Misc. 2d 351, 193 N.Y.S.2d 367 (County Ct. 1959).
2. N.Y. Neg. Inst. Law §§ 91, 95, 97, which provide in part:
91. 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;
2. That he became the holder of it before it was overdue, and without notice that it has been previously dishonored, if such was the fact;
3. That he took it in good faith and for value;
4. That at the time it was negotiated to him he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it.

to those embodied in the statutes of numerous other jurisdictions,[3] are clearly intended to protect a holder in due course where a court faces the task of imposing a loss upon one of two innocent parties.[4] Case law in New York has provided the balancing protection for the maker of an instrument by providing him an absolute defense against a bona fide purchaser where the signature or note was obtained through fraud in the absence of negligence by the maker.[5] Where notice of a defect is given the purchaser prior to the purchase, his negligence or lack of diligence in subsequently acquiring the instrument has been excused under the doctrine of forgotten notice. This doctrine, based upon the rationale that "the rights of the holder are to be determined by the simple test of honesty and good faith, and not by a speculative issue as to his diligence or negligence,"[6] may be stated as holding that if notice of a defect in the instrument is forgotten by the holder-to-be, the defrauded but negligent maker does not escape liability (upon the instrument) to the forgetful holder. Thus the holder is not bound by the notice given him except by the limits of good faith. Whether the transaction was made in good faith must depend upon the facts of the case. The doctrine was first set forth in *Raphael v. Bank of England*,[7] and was brought to this jurisdiction in *Lord v. Wilkinson*.[8] This theory has been followed in numerous New York cases[9] and has been applied in other United States jurisdictions in recent years.[10]

The decision in the instant case is a rare departure from the forgotten notice doctrine. The trial court without question based its decision upon the doctrine and held for plaintiff Bank,[11] citing the long line of cases in which it has been applied. In not submitting the paper presented by the employee

95. To constitute notice of an infirmity in the instrument or defect in the title of 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.

97. In the hands of any holder other than a holder in due course, a negotiable instrument is subject to the same defenses as if it were non-negotiable. But a holder who derives his title through a holder in due course, and who is not himself a party to any fraud or illegality affecting the instrument, has all of the rights of such former holder in respect of all parties prior to the latter.

3. E.g., Purdon's Penna. Stats. Ann., Title 12A, § 3-302(1); Ann. Laws, Mass., Ch. 107, § 75; Laws of Ohio (1961), Title 13, § 1301.54; Ill. Ann. Stats. Ch. 26 § 3-302(1); Gen. Stats. Conn., § 42a-3-302(1).

4. Cf. Munnich v. Jaffe, 164 App. Div. 30, 149 N.Y. Supp. 388 (2d Dep't 1914); Page v. Krekey, 137 N.Y. 307, 33 N.E. 311 (1893).

5. See Chapman v. Rose, 56 N.Y. 137 (1874); Hutkoff v. Moje, 20 Misc. 632, 46 N.Y. Supp. 905 (N.Y. City Ct. 1897); Carey v. Miller, 25 Hun 28 (1881); National Exchange Bank v. Veneman, 43 Hun 241 (1887).

6. Magee v. Badger, 34 N.Y. 247, 249 (1866); accord, Gramaton National Bank and Trust Co. v. Mikolajczak, 142 N.Y.S.2d 564, 566 (Sup. Ct. 1955).

7. 17 C.B. 161, 84 Eng. Com. Law 160, 139 Eng. Rep. 1030 (1855).

8. 56 Barbour's 593 (1870).

9. Manufacturers and Traders Trust Co. v. Sapowitch, 296 N.Y. 226, 72 N.E.2d 166 (1947); B. W. Dyer and Co. v. Monitz, Wallack & Colodney, 16 Misc. 2d 1033, 184 N.Y.S.2d 445 (Sup. Ct. 1959); National City Bank of Cleveland v. Cold Mix, 1 N.Y.S.2d 459 (Sup. Ct. 1937).

10. Graham v. White-Phillips Co., 296 U.S. 27 (1935); Merchants National Bank v. Detroit Trust Co., 285 Mich. 526, 242 N.W. 739 (1932).

11. 22 Misc. 2d 351, 193 N.Y.S.2d 367 (County Ct. 1961).

to his wife for reading, Fazzari was negligent. The Appellate Division,[12] however, by a sharply divided court, reversed, holding that the Negotiable Instrument Law, section 91, superseded the decision in *Lord v. Wilkinson*. The majority briefly stated that, in light of "modern reminder systems" used by commercial institutions, the "no notice" requirement of section 91 is controlling and the plaintiff had notice of the defect. The dissent based its decision upon the absence of bad faith and a "reasonable interpretation" of the word "notice." By deciding that Bank was not a holder in due course, this court found it unnecessary to discuss the negligence, or lack thereof, of Fazzari in the making of the note. Though it affirmed the result reached by the Appellate Division, the Court of Appeals in a unanimous opinion, declined to accept the complete repudiation of forgotten notice stated below and restricted its decision to the particular facts of the case:

> We are not prepared to reject the doctrine summarily and to hold that once notice is given it is fixed and immutable for all time as to negotiable instruments, particularly in the case where a blanket notice is broadcast with relation to stolen bonds and other securities (Kentucky Rock Asphalt Co. v. Mazza's Adm'r, 264 Ky. 158, 165, 94 S.W.2d 316). But we also think that the doctrine should be applied with great caution in the case where a simple promissory note is involved.[13]

The bases of the Court of Appeals decision were, apparently, that: (1) actual notice of the defect was given the same person who subsequently purchased the note as agent for the plaintiff Bank; (2) that person gave Fazzari express assurance that the notice was sufficient to guide the plaintiff; and (3) a transaction involving a simple promissory note lends itself to rather elementary precautionary steps in safeguarding the interests of all involved, particularly where the note is drawn upon a person residing in the same county. It is normal procedure for a bank to attempt verification of the authenticity and redeemability of an instrument. Here, then, the plaintiff Bank forgot the notice given it and failed to exercise reasonable caution in purchasing the note. The plaintiff Bank in all likelihood relied upon the endorsement and presentation of the note by one of its regular customers. This reliance should not and did not affect the decision since Bank may have recourse against the endorsers,[14] one of whom was well known to Bank. Certain factors weigh against the decision; among them are the oral nature of the notice given the Bank by a stranger, and the length of time between notice and discount, three and one-half months. Yet, restricted to its facts, the holding does not do irreparable harm to the negotiability of instruments or place unreasonable burdens of retention of notice upon commercial institutions, as argued by the New York State Bankers

12. 13 A.D.2d 582, 212 N.Y.S.2d 380 (3d Dep't 1961).
13. 10 N.Y.2d at 400, 179 N.E.2d at 496, 223 N.Y.S.2d at 487-488.
14. See N.Y. Neg. Inst. Law, art. 7, §§ 113-118.

Association in its amicus curiae brief to the Court, since the great care normally shown by an institution in such a transaction should prevent recurrence of this situation. The precedents supporting the doctrine of forgotten notice are not overruled but are restricted to application in cases where the lack of diligence of the holder is less evident. The impact of the instant decision is that it redefines the scope of the doctrine of forgotten notice to provide restricted application only as an aid in balancing the interests between the innocent but negligent maker of a note and the innocent but negligent holder, rather than universal protection for that holder.

R. S. M.

PERSONAL AND REAL PROPERTY

LOCAL REAL ESTATE LIEN TREATED AS EXPENSE OF FORECLOSURE SALE DEFEATING PRIOR FEDERAL LIEN

The defendant owned property subject to the plaintiff's mortgage. The federal government acquired a lien on all the real and personal porperty of the defendant including his mortgaged house for unpaid federal taxes. Subsequently, the local government acquired a lien on the house for local real estate taxes accruing after the filing of the federal lien. The plaintiff moved to foreclose the mortgage and asked for summary judgment providing that the property be sold free and clear of the federal tax lien but subject to the local property taxes and assessments. Summary judgment was granted by the lower court but the intermediate court ordered reversal. On appeal, *held*: reversed, two judges dissenting. State procedure determines the property interest to which a lien attaches, and in the present case, the lien attaches to the debtor's or mortgagor's interest, which is solely reflected in the foreclosure surplus. Local taxes however, are expenses of foreclosure, which must be paid before such a surplus exists. *Buffalo Savings Bank v. Victory*, 11 N.Y.2d 31, 181 N.E.2d 413, 226 N.Y.S.2d 382 (1962).[1]

Federal statute provides that the federal government acquires a lien on all real and personal property of the taxpayer for unpaid taxes,[2] and where the debtor is insolvent this federal lien has absolute priority.[3] Where there is no evidence of insolvency, the lien shall not be valid against existing mortgages and becomes valid only when properly filed.[4] New York law provides that local real estate taxes and assessments are expenses of sale,[5] and no surplus shall exist until such expenses are paid.[6] The Supreme Court has consistently stated

1. Reversing 13 A.D.2d 207, 215 N.Y.S.2d 189 (4th Dep't 1961) and reinstating 26 Misc. 2d 443, 206 N.Y.S.2d 518 (County Ct. 1960), cert. granted sub nom. United States v. Buffalo Savings Bank, 370 U.S. 915 (1962).
2. Int. Rev. Code of 1954, § 6321.
3. 31 U.S.C. § 191 (1958).
4. Int. Rev. Code of 1954, § 6323(a).
5. N.Y. Civ. Prac. Act § 1087.
6. N.Y. Civ. Prac. Act § 1082.