Opinion No. 65-222

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BY: OPINION OF BOSTON E. WITT, Attorney General Wayne C. Wolf, Assistant Attorney General

TO: W. J. Upton, Commissioner of Banking, State Banking Department, Santa Fe, New Mexico

QUESTION

STATEMENT OF FACTS

A State Chartered Bank desires to purchase certain promissory notes from a customer. This customer of the Bank obtains the notes by virtue of the sale of heavy machinery and equipment. The purchaser of the equipment is the maker of the note, and the customer is the payee of the note. The Bank's customer will endorse the note when it is sold to the Bank. By separate dealer agreement, the Bank is obligated, on default of the note by the maker to obtain from the purchaser of the equipment the security described in the security agreement and deliver this security to the Bank's customer, the dealer. Upon this delivery of the security, the customer of the bank would become liable on his endorsement on the note purchased by the Bank. These notes would not be purchased by the Bank without recourse.

Section 48-22-24, N.M.S.A., 1953 Compilation (Supp. 1965) provides as follows:

"DIVERSIFICATION OF LOANS AND INVESTMENTS. -- A. A state bank shall not extend credit directly by means of discount of notes, issuance of letters of credit, acceptance of drafts or otherwise, or purchase any bond, note, bill of exchange or any evidence of indebtedness, when by reason of such extension of credit or purchase, the totals of such obligations so acquired which are held by the state bank will exceed:

. . .

(2) Twenty per cent [20%] of the capital and surplus for obligations of the same obligor.

. . .

C. In calculating for the purposes of this section, the obligations of a single obligor or the obligations of a specified class, there shall be included:

(1) The direct liability of the maker.

. . ."

QUESTION

Are the notes to be purchased by the bank in the above statement of facts "obligations" of the customer of the bank within the meaning of Section 48-22-24, N.M.S.A., 1953 Compilation (P.S.)?

CONCLUSION

No.

OPINION

*{*363}* ANALYSIS

Prior to 1963, the applicable portion of the New Mexico Statutes governing limitations on loans and investments of State banks was found in Section 48-3-9, N.M.S.A., 1953 Compilation which was repealed by the 1963 Act. The applicable portion of the Amendment is quoted in the Statement of Facts of this opinion.

The older Section provided that "no bank shall become the creditor of any person, firm or corporation including in the liabilities of any such firm the liabilities of the members thereof, and including in the liabilities of any person, the liabilities of any firm of which said person is a member, in an amount exceeding twenty per cent [20%] of its capital and surplus, but the discount of bills of exchange drawn against actually existing values, loans upon produce in transit and upon warehouse and elevator receipts of the collateral having an actual market value in an excess of the papers secured shall not be considered as money borrowed; . . ." Thus, the old act excluded from the twenty per cent limitation the purchase of the negotiable paper secured by collateral with an actual market value in excess of the paper purchased. Thus, we clearly see that the present transaction as described in the Statement of Facts would have been permitted under the old Statute.

It is also clear that the 1963 Act prohibits the extension of credit directly by means of purchase *{*364}* of obligations of the same obligor. It therefore, becomes incumbent upon us to determine whether or not the paper described in the Statement of Facts constitutes an obligation of the customer of the Bank, or an obligation of the purchaser.

First, we turn to existing New Mexico Law in order to understand the position of an endorser of a promissory note which is secured by real or personal property. In the Case of **Pacific National Agricultural Credit Corporation v. Hagerman,** 39 N.M. 549, 51 P. 2d, 857, the New Mexico Court determined that the endorser of a promissory note was a surety for the payment of that note. In this particular case the principal stockholder of a cattle company endorsed the note of the company to the holder of the note. His endorsement was placed on the note in connection with a transaction by which an old note of $ 50,000 had been cancelled and a new note for $ 62,000 was executed and endorsed. The agreement accompanying this transaction was that the

additional $ 12,000 was to be used for the expenses incident to the running of livestock. Of the $ 12,000, $ 1,913.90 was diverted by the holder of the note to the payment to itself of accrued interest on an old loan. This diversion was made without the consent or knowledge of the endorser. Although he had ascertained that this diversion had taken place, he did not protest it. Suit was eventually brought upon the note and the defense was raised that the diversion of $ 1,913.90 released the endorser from his obligation on the note. Our Supreme Court held that no duty rested upon this endorser after he had ascertained that the diversion had been made to protest the same but that he was released from liability on the note on the grounds that the action of the holder of the note had destroyed the liability of the endorser, surety. The decision in the **Hagerman** Case was reaffirmed by our Court in **J. R. Watkins v. Eager,** 56 N.M. 385, 244 P. 2d, 540.

It appears from these decisions, therefore, under the Case Law in New Mexico, that before the adoption of our Uniform Commercial Code, the endorser of the negotiable paper was not directly obligated on this paper but he stood in the position of surety and until default in the payment by the maker of the note, he was not obligated thereon. We note that the Uniform Commercial Code which New Mexico has adopted states: "Subject to any necessary notice of dishonor and protest, the holder has **upon dishonor,** an immediate right of recourse against the drawers and the endorsers." Section 50A-3-507, N.M.S.A., 1953 Compilation. It is clear from this provision of the Code that the holder's right of recourse on the instrument insofar as endorser is concerned comes only upon dishonor of the instrument.

A general statement of the aforementioned rule as enunciated by the Case Law of the State of New Mexico and the Uniform Commercial Code is found at 11 **Am. Jur.** 2d pp. 607 through 609. **Am. Jur.** 2d states as follows:

"It is clear that the endorser is not a party primarily liable, as is the maker or acceptor of an instrument. The obligations of a maker and of a mere endorser of a negotiable paper, are, under the law, essentially different -- that of the maker being absolute while that of an endorser is contingent. The endorser of a negotiable instrument is accordingly secondarily liable.

Turning again to the Uniform Commercial Code we note that it provides in Section 50A-3-414, N.M.S.A., 1953 Compilation that:

"(1) Unless the endorsement otherwise specifies (as by such words as "without recourse") every endorser engages that upon dishonor and any necessary notice of dishonor and protest he will pay the instrument according to *{*365}* its tenor at the time of his endorsement to the holder or to any subsequent endorser who takes it up even though the endorser who takes it up was not obligated to do so."

From this subsection we ascertain that the contractual liability of an endorser is secondary even though he may have waived notice of dishonor. His liability is still contingent upon dishonor of the instrument by the maker. Therefore, we are firmly

convinced that the status of an endorser under the Uniform Commercial Code as we now have the same in New Mexico is identical with his status under the Case Law of New Mexico as it existed prior to the adoption of the Uniform Commercial Code.

Under these conditions, it is our opinion that a surety is not the obligor referred to in Section 48-22-24, N.M.S.A., 1953 Compilation. Instead, the obligor under Section 48-22-24, supra, would be the purchaser of the equipment securing the promissory notes. This conclusion is enhanced by Subsection (C) of Section 48-22-24, N.M.S.A., 1953 Compilation (Supp. 65). In paragraph 1 of Subsection (C) of the Statute provides that in calculating the obligations of a single obligor there shall be included the direct liability of the maker. Nowhere does that Section mention the liability of the endorser as being included in the obligations of a single obligor.

We also note that it would be quite easy for the bank to take the promissory note directly from the purchaser of the piece of equipment, thus eliminating the endorsement of the dealer of that equipment. Under such a situation it is obvious that the Bank could continue to finance the purchase of this equipment without violating the provisions of section 48-22-24, supra, but, the Bank would not have the additional benefit of having the dealer's endorsement upon the note. In such a situation, the protection of the Bank is therefore weakened although, compliance with the Statutory Section is evident. We do not feel that such was the intent of the Legislature. We therefore must conclude that the obvious meaning of the Section is to include the obligations of the Purchaser of the equipment rather than the obligations of the dealer in computing the total obligations of a single obligor under Section 48-22-24. Our interpretations of a single obligor under Section 48-22-24. Our interpretation would enable the bank to complete the same transaction with the additional protection of having the endorsement of a surety on the promissory note.

The conclusion we have reached is in accord with the treatment afforded national banks under the Federal Law. The applicable provision of Federal Law is Title 12, United States Code, Section 84 (2). This Section provides:

"Obligations arising out of the discount of commercial or business paper actually owned by the person . . . negotiating the same shall not be subject under this Section to any limitation based upon such capital and surplus."

This provision first came into the Federal Law with the original banking act enacted by the Thirty-eighth Congress of the United States. Originally it was Chapter 106 of the Laws of 1864 and it may now be found at 13 Stat. 108. As first enacted this Section provided:

"That the total liabilities to any association, of any person, or any company, corporation, or firm for money borrowed, including in the liabilities of a company or firm, the liabilities of the several members thereof, shall at no time exceed one-tenth part of the amount of the capital stock of such association actually paid in: **Provided,** that the discount of bona fide bills of exchange drawn against actually existing values, *{*366}* and the

discount of commercial or business papers actually owned by the person or persons, corporation or firm negotiating the same shall not be considered as money borrowed."

Under this statutory provision, several cases have been decided in the Federal Court concerning what obligations should be included in computing the total liability of any person to a national bank.

Perhaps the most important of these is **Gamble v. Brown,** 29 Fed. 2d 366. In this Case the master had apparently included the amount of the liability of an endorser of some notes in determining his total liability to the bank . . . In other words, his liability as surety or endorser was added to his direct liability for money borrowed by himself. The Court stated that this result was contrary to the long continued practice of the comptroller of currency to hold liability incurred by one person as surety or endorser from money borrowed by another should not be included in the total computation. In other Federal cases the circuit courts have refused to include the liability to a bank under the statutory debt limitation. See for instance **Hyde v. United States,** 14 Fed. 2d 816; and **Reed v. Aron,** 113 Fed 2d 249.

We therefore conclude that the transactions outlined in the Statement of Facts do not come within the Debt Limitation Provision found in Section 48-22-24, N.M.S.A., 1953 Compilation. We note, however, that in the event the contingent Liability of the endorser should become absolute upon default occurring then, at that point the promissory note would become a direct obligation of the endorser to the bank and after the debt limit is reached in such a manner no further advances could be made to that dealer on his own credit.