

CHAPTER 35

Holder in Due Course and Defenses

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Chapter Preview

The questions introduced in Chapter 34, which summarize the requirements to create negotiable instruments free of the defenses that arise from an underlying contract, are worthy of being repeated:

1. Does the paper meet the prerequisites of a negotiable instrument?
2. Has the negotiable instrument been properly negotiated?
3. Is the holder of the instrument in due course?
4. Are the defenses personal as opposed to real?

In the preceding chapter, the first two questions were examined and answered. This chapter considers questions 3 and 4 regarding holders in due course and types of defenses.

Business Management Decision

You are the senior loan officer of your bank. Among your many customers is a mobile home dealer, whose inventory your bank finances. This dealer typically takes promissory notes from its customers. The dealer then endorses these notes to your bank as partial payment for its debt. A dissatisfied customer of the dealer refuses to pay your bank until the defects with the mobile home are corrected.

Can you successfully sue this dissatisfied customer of the mobile home dealer to collect on the note? What should you do?

35.1 Status of Third Parties

The original party to whom an instrument is issued or drawn has the right to transfer the instrument to someone else. The party to whom it is transferred may be an *assignee*, a *holder*, or a *holder in due course*.

35.1a Status Possibilities

➤ Assignee

A third party becomes an **assignee** of an instrument in one of two situations. First, if the instrument being transferred does not satisfy the elements of being negotiable, the third party receiving the instrument is an assignee. Second, if the instrument being transferred is negotiable but is not properly negotiated, the third party receiving the instrument is once again an assignee. As an assignee, the third party is subject to all the defenses that could have been asserted against the assignor had that party sought collection of the instrument.

➤ Holder

If a negotiable instrument is properly negotiated, the party receiving it is a **holder**. If certain requirements are met, the holder may qualify as a **holder in due course** and have a special status [3-302]. If a holder does not qualify as a holder in due course, his/her position is equivalent to that of an assignee; and any defenses available to the original parties may be asserted against the holder.

Either the original payee or a third party may qualify as a holder of an instrument and may transfer or negotiate it. A holder may legally discharge the instrument or enforce payment in his/her own name [3-301]. A thief or finder may qualify as a holder of a bearer instrument. As we will see later, a thief or finder cannot qualify as a holder in due course because he/she gave no value for the instrument.

Case 35.1 provides a further explanation of this status as a holder. Note in this case that the payees of a note are considered as the holders of the note, the parties who can discharge the makers' liability.

Assignee

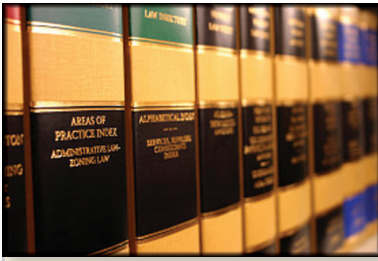
A third party who receives the right to have a contract performed and is viewed as "standing in the shoes" of the assignor and not free from the defenses that could be asserted against the assignor's claim of performance

Holder

The party to whom a negotiable instrument is issued or properly negotiated and technically satisfied irrespective of that party's actions or knowledge

Holder in due course

A holder of a negotiable instrument who takes it for value, in good faith, and without notice of defenses—free from the personal defenses on the contract that give rise to the commercial paper



CASE 35.1

Edwards v. Mesch

763 P.2d 1169 (N.M. 1988)

Supreme Court of New Mexico

Scarborough, Chief Justice

Defendants-appellants, Robert J. and Florence M. Mesch (Mesches), executed a promissory note in favor of plaintiffs-appellees, John E. and Jean M. Edwards (Edwards), as payees on March 14, 1986. The promissory note for the amount of \$6,000.00 with interest at the rate of 10% per annum on the balance was for money the Edwards had loaned to the Mesches. The Mesches subsequently defaulted on the note after making a single payment, and the Edwards brought suit to collect all unpaid principal and accrued interest. After a trial on the merits on November 11, 1987, the district court entered judgment for the Edwards in the sum of \$6,751.10, with interest on the principal balance accruing at the rate of 10 percent per annum, and awarded attorney's fees and costs to the Edwards.

On appeal, the Mesches argue that the Edwards have no enforceable rights in the note and were not the real party in interest at the time of the trial. During the trial the Edwards did not deny assigning their interests in the note to the Tres Santos Corp., a closely held corporation, 100 percent of whose shares are owned by plaintiff-appellee, John E. Edwards. The Mesches argued at trial, and again on appeal, that since the Edwards assigned their interests in the note to the Tres Santos Corp., it became the real party in interest, and thus an indispensable party to the lawsuit. This argument finds no support in legal authority.

The promissory note that the Mesches executed to the Edwards is a negotiable instrument, and as such is governed by the Uniform Commercial Code (UCC). According to the UCC, a "holder" of a negotiable instrument is "a person who is in possession of an instrument drawn, issued or endorsed to him or to his order or to bearer or in blank." Before a person can become a "holder," two conditions must be satisfied: (1) the obligation evidenced by the instrument must run to him, and (2) he must have possession of the instrument. A negotiable instrument payee (the Edwards) is always a holder if the payee has the instrument in his possession because the payee is the person to whom the instrument was issued: "It is inherent in the character of negotiable paper that any person in possession of an instrument which by its terms runs to him is a holder, and that anyone may deal with him as a holder."

The Edwards were payees and holders of the note and could enforce payment of the note after they had assigned it to the Tres Santos Corp. According to New Mexico law, "The holder of an instrument whether or not he is the owner may enforce payment in his own

name." The Mesches' argument on appeal that the district court ruling exposes them to double liability is without merit [since] "The liability of any party is discharged to the extent of his payment or satisfaction to the holder even though it is made with knowledge of a claim of another person to the instrument."

Rule 1-017 of Civil Procedure for the District Courts requires that "[e]very action shall be prosecuted in the name of the real party in interest. The capacity of an individual to sue or be sued shall be determined by the law of this state." This court has held that the test for determining who is the real party in interest is whether one is the owner of the right being enforced and is in a position to discharge the defendant from the liability being asserted in the suit. The Edwards, in the instant case, were the holders and payees on the promissory note and properly asserted their rights as plaintiffs at trial. Furthermore, the Edwards were in a position at trial to discharge the Mesches from all liabilities to any third party from the promissory note. Therefore, the arguments that the Tres Santos Corp. was the real party in interest and an indispensable party at trial are without merit.

A review of the record below reveals the district judge expended commendable effort to explain the governing principles of law and his rulings in the instant case to the Mesches. We uphold the decision of the district court and further hold that since the promissory note provides for costs and attorney's fees to payees for collection and enforcement of the note, the Edwards are entitled to recover reasonable attorney's fees on appeal.

Affirmed.

Case Concepts Review

1. Who are the makers of the promissory note? Who are the payees?
2. What procedural defense did the Mesches assert when the Edwards sued to collect payment?
3. How does the court describe the transfer of the note by Edwards to Tres Santos Corp.?
4. Should this case have been decided differently if the Edwards had negotiated the note to Tres Santos Corp. rather than merely having assigned their interest in the note? Explain.

➤ *Holder in Due Course*

If there is no claim or defense to the instrument, it is immaterial whether the party seeking to enforce it is a holder or a holder in due course. The Code makes all holders the functional equivalent of holders in due course until a defense is claimed. The burden of proving a defense is on the party asserting it. When the defense is proved, the holder has the burden of proving that he/she is a holder in due course. If the holder can prove that, he/she can enforce payment, notwithstanding the presence of a personal defense to the instrument. (Later in this chapter we discuss both types of defenses: personal and real.) A holder in due course will not be able to enforce the instrument in the event that a real defense is proven. The preferred status of a holder in due course exists only where the defense to the instrument is a personal defense.

Issues as to whether or not a party is a holder in due course usually arise when the party seeks to collect on the instrument; however, occasionally a party is sued on a negligence theory for losses incurred in transactions involving an instrument. To avoid liability, the defendant must establish that he/she is or was a holder in due course. Thus a holder in due course is free of claims and is not subject to personal defenses.

35.1b Contract Provisions

Contract provisions frequently attempt to give a status equivalent to a holder in due course to an assignee of contract. These provisions purport to waive defenses if the contract is assigned. Some states have declared such provisions to be illegal, as in against public policy if the drawer or maker is a consumer. Other states have enforced waiver of defense clauses, provided the assignee meets the requirements to qualify as a holder in due course and the defense waived is a personal defense. Thus the material in this chapter is significant for many non-negotiable contracts as well as negotiable instruments.



TOUCHSTONE

What rights do third parties have under Article 4A, concerning wire transfers? The logic of the court in the following case tracks the proper application of provisions of Article 4A.

Awal Bank, a bank in insolvency proceedings in Bahrain, owed more than \$75 million to HSBC Bank. HSBC Bank received a funds transfer of almost \$13 million to be credited to Awal's deposit account. Awal claims a mistake was made. Specifically, Awal stated it instructed the Bank of Scotland to transfer the \$13 million to its account with another bank, the Bank of Bahrain and

Kuwait, not an account with HSBC Bank. Awal notified HSBC Bank that the funds had been transferred by mistake. HSBC Bank claimed it received the funds transfer before it learned of the mistake and therefore was entitled to set off the funds received against the amount due to it by Awal. Awal's representative in bankruptcy brought suit to recover the funds from HSBC Bank.

UCC Article 4A was designed to provide clear rules for parties to follow with respect to a wire transfer, referred to as an electronic funds "transfer." It sets out a detailed scheme for analyzing the rights, duties, and liabilities of banks and their customers in connection with the authorization and verification of payment orders. Analysis of a funds transfer under these sections results in a determination of whether or not the funds transfer was 'authorized,' and provides a very specific allocation of loss.

As the Complaint framed the matter for the court, the question is whether HSBC learned of RBS' mistake prior to its asserted set-off of the funds against Awal Bank's debt. The question of notice is at the heart of the matter because Article 4A allows a sender to cancel a previous payment order as long as notice is received by the recipient "at a time and in a manner affording the receiving bank a reasonable opportunity to act on the communication before the bank accepts the payment order." § 4A-211(b). Thus, if HSBC set-off the Wire Transfer before learning of the Royal Bank of Scotland's mistake, the Complaint appears to concede that the payment order was accepted for purposes of Article 4A. If, however, HSBC had notice that the payment order had been cancelled before it accepted the payment and offset the funds against Awal Bank's indebtedness, then the payment order could not be accepted.

Because the court had to accept the factual allegations set forth in the Awal's representative's Complaint as true for purposes of the motion to dismiss, the court was required to accept the allegation of the Complaint that HSBC had notice of cancellation of the payment order before the set-off. HSBC denies this, but factual disputes cannot be resolved at this point. The Awal's representative in bankruptcy had stated a plausible claim for relief, which is consistent with Article 4A of the UCC.

[*In re: Awal Bank, BSC, Debtor in a Foreign Proceeding*, 455. *Bankruptcy Reporter* 73 (United States Bankruptcy Court for the Southern District of New York, 2011)]

35.2 Holder in Due Course

35.2a Requirements

To qualify as a holder in due course, a holder must meet three basic requirements. He/she must take the instrument (1) for value; (2) in good faith; and (3) without notice that it is overdue, that it has been dishonored, or that any other person has a claim to it or defense against it [3-302(b)].

A payee may be a holder in due course if all the requirements are met. Most payees deal with the maker or drawer. However, a payee may be a holder in due course when the instrument is not delivered to the payee by the maker but is delivered by an intermediary or agent of the maker. A payee that participates in the transaction out of which the instrument arises cannot be a holder in due course.

When an instrument is acquired in a manner other than through the usual channels of negotiation or transfer, the holder will not be a holder in due course. Thus, if an instrument is obtained by an executor in taking over an estate, is purchased at a judicial sale, is obtained through legal process by an attaching creditor, or is acquired as a transaction not in the regular course of business, the party acquiring it is not a holder in due course [3-302(c)].

35.2b Value

A holder must have given value for an instrument to qualify as a holder in due course. A person to whom an instrument was transferred as a gift would not qualify as a holder in due course. In the law of contracts, value does not have the same meaning as *consideration*. A mere promise can be consideration, but it is not necessarily value. As long as a promise is executory, the value requirement to be a holder in due course has not been met [3-303].

Whereas the original Article 3 states that an executory promise is not generally viewed as value, revisions to Article 3 now permit the holder to enjoy a freedom from defenses to the extent of the value of the performance that is rendered [3-303(b)]. For example, assume Debra issues a check for \$250 to Pauline in return for Pauline having typed four term papers of equal length. Pauline negotiates this check to Terry in payment for Terry's promise to fix Pauline's printer next week. If Debra discovers that Pauline's typing is unacceptable (perhaps due to a printing problem), Debra has a defense that can be asserted against Terry since Terry did not give value for the check. Now suppose Terry performed \$150 worth of labor on Pauline's printer before Debra discovers the defense of Pauline's defective performance. Terry can recover up to \$150 against Debra, but Debra can assert the defense to defeat Terry's claim for the additional \$100.

While a mere promise is not value, if the promise to pay is negotiable in form, it does constitute value [3-303 (b)]. A drawer who issues a check in payment for a negotiable note that he/she is purchasing from the holder becomes a holder for value even before the check is cashed.

A holder who takes an instrument in payment of an existing debt is a holder for value. Thus, if Ada owed Brenda \$500 on a past due account and transferred a negotiable instrument to Brenda in payment of such account, Brenda would qualify as a holder for value. The same holds true if the instrument is received as collateral for an existing debt, whether the debt is due or not.

A purchaser of a limited interest in paper can be a holder in due course only to the extent of the interest purchased. If a negotiable instrument is transferred as collateral for a loan, the transferee may be a holder in due course, but only to the extent of the debt that is secured by the pledge of the instrument. For example, George loans Gerry \$2,500. To secure the loan, Gerry negotiates Ron's note in the amount of \$4,000 to George. George is a holder in due course only to the extent of \$2,500.

A person who purchases an instrument for less than its *face value* can be a holder in due course to the full amount of the instrument. Cora is the payee of a note for \$1,000. She may discount the note and endorse it to Wick for \$800. Wick has, nevertheless, paid value and is entitled to collect the full \$1,000.

35.2c Good Faith

A holder must take the instrument in good faith to qualify as a holder in due course [3-302(a)(2)]. *Good faith* is defined as "honesty in fact in the conduct or transaction concerned" [1-201(19)]. If a person takes an instrument under circumstances that clearly establish that there is a defense

to the instrument, this person does not take it in good faith. Failure to follow accepted business practices or to act reasonably by commercial standards, however, does not establish lack of good faith. Good faith is a subjective rather than an objective determination. Honesty, rather than diligence or negligence, is the issue.

Taking a note on large discount does not in and of itself establish lack of good faith. A large discount may result from factors other than the existence of a defense to the instrument. The burden is on the party seeking to deny the holder-in-due-course status to prove lack of good faith. Good faith is presumed in the absence of facts to show bad faith.

35.2d Without Notice

Closely related to good faith is the requirement that the transferee must not have **notice** of the following: (1) instrument is overdue, (2) instrument has been dishonored, (3) instrument is part of a series and there is an uncured defect with respect to payment of another instrument, (4) instrument contains an unauthorized signature, (5) instrument has been altered, (6) instrument is subject to defenses, (7) instrument is subject to any claim to the instrument, and (8) instrument is subject to any claim in recoupment [3-302(a)(2)].

A person has notice of a fact if he/she has actual knowledge of it, has received notification of it, or (from the facts and circumstances known to him/her) has “reason to know” that it exists [1-201 (25)]. The law generally provides that a person has reason to know a fact if his/her information would indicate its existence to a person of ordinary intelligence (or of the intelligence of the person involved, if that is above the ordinary). A person also has reason to know the facts if they are so highly probable that a person exercising reasonable care will assume their existence.

If there is visible evidence of forgery or alteration, a purchaser is put on notice of a claim or defense [3-302(a)(1)]. Certain irregularities on the face of an instrument also put a purchaser on notice that there may be a claim or defense to the instrument. Many are obvious, such as a signature that is obviously affixed by someone else.

Notice

Evidence of a fact that occurs when a person (a) has actual knowledge of it, (b) has received notification of it, or (c) has reason to know that it exists based on all the facts and circumstances known at the time in question



TOUCHSTONE

Making the determination as to whether one has notice can be quite difficult. Consider the following case:

Plaintiff, a check-cashing service, had cashed two prior checks issued by defendant, a title insurance agency, to a particular individual, allegedly with respect to a real estate transaction. A third check was issued in an amount over \$5,000 to the same individual; this required plaintiff's employee to obtain approval to cash the check from her supervisor. The individual's last name was spelled incorrectly on the check, and the listed purpose of a loan payoff was not the same as the purpose stated by the individual (payment of a commission). However, the employee and the supervisor had called defendant, and defendant's representative had confirmed the issuance of the check in the amount shown. The supervisor had also called the bank on which the check was drawn. Defendant stopped payment on the check based on its fraudulent issuance to the individual by one of defendant's employees.

Following a bench trial, the trial court held that plaintiff, the check-cashing service, was not a holder in due course because the check-cashing transaction raised several warning signals that should have alerted plaintiff to the possibility of fraud. The court entered judgment in favor of defendant.

On appeal, the court reversed. The trial court found that the check-cashing service did not qualify as a holder in due course because the check at issue was “so irregular as to call into question its authenticity.” However, the appellate court stated under the Code that grounds for suspicion about a check will not always prevent one from taking the check as a holder in due course. Where all of the evidence available to the holder shows that it lacked notice of a defense, it becomes a holder in due course. The court also stated that to defeat the rights of one dealing with negotiable securities, it is not enough to show that he took them under circumstances which ought to excite the suspicion of a prudent man and cause him to make inquiry, but rather that he had actual knowledge of an infirmity or defect, or of such facts that his failure to make further inquiry would indicate a deliberate desire on his part to evade knowledge because of a belief or fear that investigation would disclose a vice in the transaction.

The appellate court stated that it agreed with the trial court's finding that irregularities involving the check called its authenticity into question. However, the check-cashing service investigated those irregularities in a commercially reasonable manner by calling defendant to verify the check. According to the decision, the check cashing service might have acted more cautiously and asked more questions of the person who spoke to them when they called the title company. Yet, that person's verification of the check made the decision to cash the check commercially reasonable.

Therefore, the check-cashing service was a holder in due course.

[*New Randolph Halsted Currency Exchange, Inc. v. Regent Title Insurance Agency, LLC*, 939 N.E.2d 1024 (Appellate Court of Illinois, First District, 2010)]

If an instrument is incomplete in some important respect at the time it is purchased, notice is imparted [3-302(a)(3)]. Blanks in an instrument that do not relate to material terms do not give notice of a claim or defense; but if the purchaser has notice that the completion was improper, he/she is not a holder in due course.

Knowledge that a defense exists or that the instrument has been dishonored prohibits the status of a holder in due course. In some situations, knowledge of certain facts does not, of itself, give the purchaser notice of a defense or claim. Awareness that an instrument is antedated or postdated does not prevent a holder from taking in due course. Knowledge of a separate contract is not notice. Although a defense will arise if the contract is not performed, such knowledge does not prevent one from becoming a holder in due course. Of course, if the purchaser is aware that the contract has been breached or repudiated, he/she will not qualify as a holder in due course.

Actual notice to prevent a party from being holder in due course must be received at a time and in a way that will give a reasonable opportunity to act on it [3-302(f)]. A notice received by the president of a bank one minute before the bank's teller cashes a check is not effective in preventing the bank from becoming a holder in due course.

In Case 35.2, the court was asked to dismiss a complaint filed in the United States District Court in favor of filing the same action in a Philippines court. To make this decision, the court analyzed the similarity of United States law and Philippine law in the application of the holder-in-due-course doctrine, along with the proof necessary to establish notice.



CASE 35.2

Carl W. Henderson, Jr., Administrator of the Estate of David M. Henderson, Francisco Solis, Trustee of Messenger Trust One, and Michael S. Henderson, Successor Trustee of Messenger Trust One v. Metropolitan Bank & Trust Company

470 F. Supp. 2d 294 (2006)

United States District Court for the Southern District of New York

Shira A. Scheindlin, Presiding Judge

On February 9, 2006, Carl W. Henderson, Jr., of Tennessee, Administrator of the Estate of David M. Henderson; Francisco Solis, of California, Trustee of Messenger Trust One ("the Trust"); and Michael S. Henderson, of New Mexico, Successor Trustee of the Trust (collectively "Plaintiffs"), filed suit against Metropolitan Bank and Trust Co. ("Metrobank"), a corporation headquartered in Makati City, Philippines, in seeking to enforce a "Manager's Check" allegedly issued by Metrobank, with a face value of twelve billion pesos. Plaintiffs also seek damages of \$75 million, representing interest accrued since the instrument was issued.

A manager's check is a negotiable instrument akin to a cashier's check, which is "drawn by the cashier of a bank upon the bank itself." The Manager's Check in dispute here was issued as interest payments on accounts at Metrobank "established by confidential benefactors for humanitarian and sociopolitical purposes in the Philippines." Although the accounts in question were held at Metrobank, the "assets which gave rise to the Manager's Check" originated as cash transfers from Citibank in New York. Jocelyn C. Duran was an "arranged signatory" on the Metrobank accounts, one of which was Account No. 00701-5500691-8. The Manager's

Check was issued on this account to Duran as payee, on March 21, 2000.

At some point subsequent to the check's issuance, Duran "attempted to convert the instrument into cash funds" at Metrobank, and it was dishonored. Duran "sought the assistance of a high-placed government official," and "hereafter, [Metrobank], through its President and Director, Antonio S. Abacon, Jr., offered to convert the instrument into cash equivalent to one-half its [face] value ... if [Duran] would execute a release of any and all claims against accounts held in her name, at that time, in Metrobank." Duran refused this offer. Plaintiffs allege that as a result, Duran "experienced threats to the physical safety of herself and her family." Duran thereupon "transferred her authority to negotiate the Manager's Check ... via a Special Power of Attorney ... to Janito C. Perez." The Complaint does not state whether Duran ever endorsed or negotiated the check to Perez.

Perez met with Metrobank representatives in October 2002, and Metrobank once again refused to honor the check. In order to safeguard the instrument, and to facilitate

(continues)

(CASE 35.2 continued)

“further efforts to resolve any issues that were preventing the check from being honored,” Perez arranged for another transfer of the instrument. Perez delivered the check to David M. Henderson, and executed “a formal assignment [of the check] and Special Power of Attorney, individually and as Trustee of Messenger Trust One.” The Trust was formed “under the laws of Nevada” on August 7, 2002, shortly before Perez’ meeting with Metrobank representatives. Plaintiffs allege that the check was endorsed to the Trust sometime thereafter, but do not state who endorsed it or when.

On April 2, 2003, David Henderson brought the Manager’s Check into the United States. He died on September 11, 2003. David Henderson’s “interest in the check is now an asset of his estate, administered by his brother ... Carl W. Henderson.” Henderson’s son, Michael Henderson, is identified as successor trustee to the Trust.

Neither party disputes that Plaintiff’s right to enforce the instrument will be determined, to a great extent, by The Negotiable Instruments Law of the Philippines (“Act 2031”). Act 2031 has much in common with Articles 3 and 4 of the Uniform Commercial Code (“U.C.C.”), including use of the concepts of negotiation, holder, and holder in due course. Under Philippine law, a holder in due course holds the instrument “free from defenses available to prior parties among themselves, and may enforce the payment of the instrument thereon.” However, “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.” A holder is one who possesses an instrument payable to bearer, or is the named payee or endorsee of an instrument and is in possession of that instrument. A holder in due course is one who:

has taken the instrument under the following conditions: (a) That it is complete and regular on its face; (b) That he became the holder before it was overdue, and without notice that it has previously been dishonored, if such was the fact; (c) That he took it in good faith and for value; and (d) 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.

Metrobank has moved to dismiss the complaint on the ground that the action should be heard in the Philippines.

The degree to which Plaintiffs may be able to step into the shoes of Duran, the payee, and insist on payment will be determined by the manner in which the instrument passed from Duran, to Perez, to David Henderson and the Trust, and finally to Michael Henderson and the Trust. Plaintiffs contend that they are holders in due course of the Manager’s Check, and there is a rebuttable presumption under Philippine law that any holder is a holder in due course. However, the Complaint suggests that Perez took the instrument from Duran with notice that it had been dishonored,

and that David Henderson also had notice that the check had been dishonored. Under Philippine law, a person who takes an instrument with notice that it has been dishonored is not a holder in due course. Thus, it may be that Perez, David Henderson, or Plaintiffs are not or were not holders in due course. Indeed, it is unclear whether Duran ever endorsed or negotiated the check to Perez. Plaintiffs’ right to enforce the instrument, if any, will almost certainly require testimony concerning the transfer of the instrument from Duran to Perez, and then to David Henderson.

The testimony of Perez and Duran, both of whom are presumed to be in the Philippines, will be necessary to resolve these questions. Plaintiffs listed both as witnesses. Plaintiffs also list three witnesses from the Philippines who “are or were Metrobank employees,” including Rafael Ayuste and two others, and state that these individuals attended the October 2002 meeting between Metrobank officials and Perez. Plaintiffs list three other individuals with knowledge of this meeting. One of these, Lilia C. Pastoral, is a trustee of the Trust and a Philippine resident. The other two, Arturo Balbastro and Dr. Ambu Moraka, worked with Plaintiffs or their predecessors to resolve issues relating to the check and are residents of the Philippines and India, respectively. What occurred at this meeting is relevant to determining Plaintiffs’ right to enforce the instrument. Metrobank also lists Ayuste in its initial disclosures as a person possessing information concerning the dishonor of the check at the October 2002 meeting.

Because Plaintiffs may not be holders in due course of the instrument, Metrobank may be able to assert defenses arising from the underlying obligation. Metrobank discloses one witness, Jovencio R. Capulong, Jr., a Metrobank employee whose knowledge of the cash transfers from Citibank would be relevant to such defenses. Capulong is a Philippine resident. Plaintiffs list three managers and executives of Metrobank’s headquarters in Makati City and unnamed managers of Citibank’s offices in Makati City, whom they claim have information relevant to the transactions. Plaintiffs also intend to seek testimony from unnamed managers at Citibank’s New York offices.

Plaintiffs disclose that they may testify, although the subject matter of their testimony is not specified. It appears, however, that the only matters of which Plaintiffs have direct knowledge relate to the existence and management of the Trust. These issues are incidental to the outcome of the case, especially by comparison to the far more critical questions discussed above.

Finally, both sides intend to offer documentary evidence. Metrobank specifies six documents or categories of documents that relate to the issue of the authenticity of the Manager’s Check and one data compilation relating to the transactions underlying the check’s issuance. All of these documents are located in the Philippines. Plaintiffs intend to offer documents relating to the underlying transaction and the issuance of the check. They further intend to offer correspondence of David Henderson and a deposition of Henderson taken by Plaintiffs’ attorney

(CASE 35.2 continued)

before Henderson's death. Although the location of these documents is not specified, it is presumably in the United States. Finally, Plaintiffs will offer the Manager's Check itself, which is in a safe deposit box at a PNC bank branch in Louisville, Kentucky. It is apparent that the Negotiable Instruments Law of the Philippines, like the U.C.C., is a legal framework whose integrity is of vital importance to the Philippine economy. In contrast, to the extent that United States law is implicated here, the issues are minor. Thus, the Philippines' interest in

adjudicating this dispute is much greater than that of the United States.

Motion to dismiss granted.

Case Concepts Review

1. Briefly, what evidence supports Plaintiffs' view that they are a holder in due course?
2. What evidence supports the view that Metrobank has a defense?

35.2e Before Overdue

To be a holder in due course, a purchaser of an instrument must take it without notice that it is overdue [3-304(a)]. A purchaser of overdue paper is charged with knowledge that some defense may exist. A purchaser has notice that an instrument is overdue if he/she has reason to know that any part of the principal amount is overdue. Past-due interest does not impart notice to the holder. The instrument itself will usually indicate if it is past due.

With respect to the holder having notice that the instrument is overdue, demand paper poses a special problem. This type of instrument does not have a fixed date of maturity. Purchasers of demand paper cannot be holders in due course if they have reason to know that they are taking it after a demand has been made, or if they take it more than a reasonable length of time after its issue. What is a reasonable or an unreasonable time is determined on the basis

of a number of factors—the kind of instrument, the customs and usages of the trade or business, and the particular facts and circumstances involved. In the case of a check, a reasonable time is presumed to be ninety days [3-304(a)(2)].



Notification is given when an instrument of purchase is overdue. (Shutterstock)

35.2f Holder from a Holder in Due Course

A transferee may have the rights of a holder in due course, even though he/she personally does not meet all the requirements. Because a transferee obtains all the rights that the transferor had, a person who derives title through a holder in due course also has those rights. Code Section 3-203(b) states this principle, the shelter provision, which advances the marketability of commercial paper.

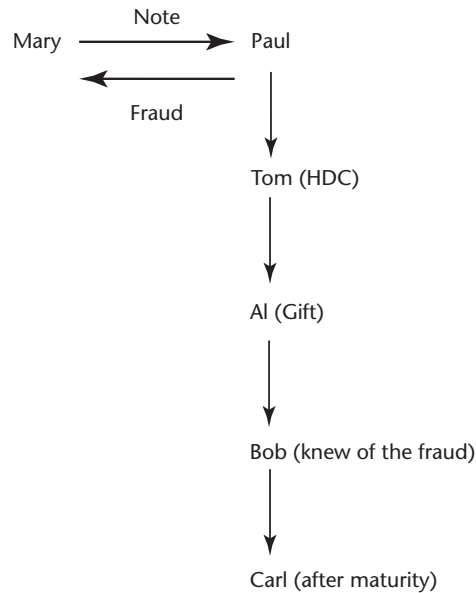
The main significance of the shelter provision is that it permits one who is not a holder in due course to share the shelter from claims and defenses enjoyed by the holder in due course from whom he/she got the instrument.

Example: Paul fraudulently induces Mary to execute and deliver a note to him. Paul then negotiates the note to Tom, who qualifies as a holder in due course. Tom makes a gift of the note to Al, who sells it to Bob, a friend of Paul's, who knew of Paul's fraud. Bob sells it to Carl after maturity. Is Carl a holder in due course? No. Were Bob and Al holders in due course when they owned the instrument? No. Is Carl subject to Mary's defense? No. While Al, Bob, and Carl are not and were not holders in due course, they have the rights of a holder in due course. They have Tom's rights and are free of the personal defense. Mary's defense was cut off by Tom's status as a holder in due course. (See Exhibit 35-1.)

The shelter provision is subject to a limitation. A person who formerly held the paper cannot improve his/her position by later reacquiring it from a holder in due course. If a former holder was a party to any fraud or illegality affecting the instrument, or had notice of a defense or claim against it as a prior holder, he/she cannot claim the rights of a holder in due course by taking from a later holder in due course.

BVTLab

Visit www.BVTLab.com to explore the student resources available for this chapter.

EXHIBIT 35-1
Example for Shelter Provision

35.3 Defenses

35.3a Classifications

As discussed above, the status of being a holder or a holder in due course has a significant impact on the rights of the parties. Defenses can be successfully asserted that prevents collection from a party that could otherwise be responsible for payment.

A holder in due course takes commercial paper free from the *personal defenses* of the parties to the paper [3-305]. One who is not a holder in due course or who does not have the rights of one under the shelter provision is subject to such defenses. All transferees, including holders in due course, are subject to what are referred to as *real defenses*.



STRATEGIC FOCAL POINT

MAY I COLLECT ON THE DEBT OWED UNDER A DEBT INSTRUMENT?

Facts:

Lamb Enterprises contracts with Kaznyk Companies to purchase from Kaznyk a reconstructed train car (including seats and other furnishings) that Lamb wishes to use as the front for a new diner called "Lillian's Place." Lamb gives Kaznyk a ninety-day promissory note (fully compliant with the requirements to be termed a negotiable instrument) for \$19,790 for the train car. The contract between Lamb and Kaznyk warrants that the train car has been restored to the quality of the car at the time of original manufacture in 1958. Upon receiving the train car, Lamb quickly discovers that the exterior paint is chipping, seat covers are coming apart, and other problems exist with the quality of the work performed by Kaznyk. Under the law of negotiable instruments, must Lamb honor the promissory note and make the required payment to Kaznyk at the due date? Also, if Kaznyk negotiated the promissory note to Spielberg and Abrams Loan Company soon after transferring the train car to Lamb, would Lamb have to honor the note?

Law:

Regarding Kaznyk, he is not a holder in due course and therefore is subject to the personal defense of a failure of consideration. That is, Lamb's defense is a recognized reason for not paying Kaznyk. The importance of the holder-in-due-course doctrine is illustrated, however, regarding the Loan Company. The Loan Company is a holder in due course and therefore not subject to personal defenses. Lamb cannot use the failure of the warranty to provide appropriate quality in the workmanship provided by Kaznyk as a legally recognized reason for not honoring the terms of the promissory note. (Lamb may pursue its claim against Kaznyk for the breach of contract for the sale of the train car.)

(continues)

(STRATEGIC FOCAL POINT continued)

Strategy:

Business interests must fully recognize the possibility of being liable for debts that flow from a negotiable instrument. In essence, the debt instrument becomes a form of obligation that, in some sense, is separate from the underlying contract. While the liquidity associated with negotiable instruments is a feature that both parties to an initial contract may find attractive, care must be exercised in order to avoid finding oneself in a precarious position if both consideration for the contract fails and an obligation on a negotiable instrument becomes due.

In general, real defenses relate to the existence of any obligation on the part of the person who asserts them. The most obvious real defense is forgery of the signature of the maker of a note or the drawer of a check. The person whose signature was forged has not entered into any contract, and he/she has an absolute defense even against a holder in due course. Case 35.3 presents a situation where a defense to payment is asserted.

The Code generally specifies which defenses are real and which are personal. A few defenses—infancy being one—are real in some states and personal in others. Table 35-1 groups defenses according to their usual status. The basic aspects of most personal defenses are discussed in the materials on contracts in Chapters 13 through 20.

TABLE 35-1 Commercial Paper: Typical Defenses

Personal Defenses	Real Defenses
Lack or failure of consideration	Unauthorized signature
Nonperformance of a condition precedent	Material alteration
Nondelivery, conditional delivery, or delivery for a special purpose	Infancy, if it is a defense to a simple contract
Payment	Lack of capacity
Slight duress	Illegality
Fraud in the inducement	Illegality
Theft by the holder or one through whom the holder has taken	Extreme duress
Violation of a restrictive endorsement	Fraud in the execution
Unauthorized completion	Discharge in bankruptcy
Other defenses to a simple contract	Discharge of which the holder has notice
Any real defense where the party was negligent	

**CASE 35.3****The Cadle Company v. Barbara E. Shearer and Barbara J. Couvion****69 S.W. 3d 122 (2002)**

Court of Appeals of Missouri

Opinion by Judge Harold L. Lowenstein

Appellant, The Cadle Company (Cadle), the holder of a note, appeals from the grant of a directed verdict in a court-tried case in favor of the makers of the note, Barbara Shearer and Barbara Couvion. Because this court finds that Cadle made a prima facie case, the trial court's grant of a directed

verdict to the defendants after plaintiff's case was against the weight of the evidence. The judgment of the trial court is reversed and remanded for further proceedings.

(continues)

(CASE 35.3 continued)

This case involves a suit by Cadle, as holder, on an unpaid balance of a promissory note dated September 13, 1979. The original amount of the note was \$22,500, with interest at 11 percent, and was executed by Barbara Shearer and Barbara Couvion. The note was payable, in monthly installments of \$232.25, to Edgar House (House) and Paul Cook (Cook) (Couvion-Shearer note). The note was used to secure a loan on a home. On September 20, 1979, House and Cook assigned the Couvion-Shearer note to Southside Bank. On January 30, 1997, the Federal Deposit Insurance Corporation (FDIC), in its corporate capacity as a successor in interest to Republic Bank of Kansas City F/K/A South Side Bank, assigned the Couvion-Shearer note to Midstates Resources Corporation (Midstates). On March 16, 2000, Midstates assigned the Couvion-Shearer note to Cadle.

Another promissory note that was eventually assigned to Cadle was executed by House and Cook on February 23, 1984, payable to Republic Bank (formerly Southside Bank) (House-Cook note). This note was secured by the Couvion-Shearer note, which had already been assigned to Southside bank in September of 1979. The FDIC also assigned the House-Cook note to Midstates, and Midstates assigned the note to Cadle. This note is mentioned because the respondents made reference to it in their brief to cast doubt upon Cadle's evidence concerning how it arrived at a balance due on the Couvion-Shearer note.

In July 2000, Cadle filed a petition seeking payment on the Couvion-Shearer note. Cadle claimed that despite its demands for payment, payments were not made in accordance with the terms of the note and that the note was considered in default. Cadle prayed for judgment in the amount of \$12,716.05 with accrued interest at the rate of 11 percent. Couvion and Shearer alleged in their answer that they had made timely payments on the note and that Cadle and previous holders of the note failed and refused to timely and accurately apply the payments to the reduction of principal and interest due on the note. In fact, their answer states that the note, "is either paid in full and satisfied or very close to being paid in full and satisfied."

After Cadle presented its case, Couvion's and Shearer's counsel moved for a directed verdict, which was granted. No timely motion was made for findings or conclusions. Cadle appeals.

Cadle argues, in its sole point on appeal, that the trial court erred in granting defendant's motion for directed verdict at the close of Cadle's evidence because Cadle had established that it was entitled to payment on the note. Cadle claims that it made a prima facie case—in that the note, the signatures of the makers, and the balance due on the note were received in evidence.

In a suit on a promissory note, the holder makes a prima facie case by producing a note admittedly signed by the maker and showing the balance due. "Where signatures are admitted or established, production of the note entitles the holder of the note to recover on it unless the defendant establishes a defense."

In this case, the Couvion-Shearer note was received in evidence. Couvion's and Shearer's signatures appeared on the note as makers; and both parties admitted in their answer that they executed the note on September 13, 1979, and promised to pay \$22,500, at 11 percent interest. All of the subsequent assignments of the note were also admitted in evidence.

Jeffrey Joseph (Joseph), an account officer for Cadle, testified that he was responsible for verifying the information that Cadle received regarding the Couvion-Shearer note and was also responsible for collection of payment. Joseph obtained from Midstates (the company that assigned the note to Cadle) a recap of their payment history of the Couvion-Shearer note. The Midstates' recap, however, indicated that the starting principal balance when it acquired the note was \$13,509.46, the interest rate was 12 percent; the unpaid interest was \$6,736.41 as of May 18, 1992, and the monthly payment was \$232.25. The principal balance due on the note on March 16, 2000, the date it was transferred from Midstates to Cadle, was \$12,716.05. Joseph prepared a summary for Cadle of the amount due on the note.

While preparing the summary, Joseph reviewed the file and the note and noticed that Midstates had been making its calculations using a 12 percent interest rate. Because the note reflected an 11 percent interest rate, Joseph recalculated the Midstates payments using an 11 percent interest rate. Joseph testified that based on his recalculations, as of trial, the amount of principal due on the note was \$12,594.17, the accrued interest was \$2,708.92, and the late fees were \$870.75. Joseph testified that the total amount owed on the note at the time of trial was \$16,173.85. The transcript of Cadle's evidence was brief. However, there seems to be no dispute that the note was held by Cadle and there was a default by the makers. The amount of the note balance was arrived at with difficulty, but the evidence did show that the note had not been paid in full. Difficulty in determining the exact amount of Cadle's damages should not have resulted in a directed verdict in favor of the makers.

Based upon the foregoing evidence, this court finds that Cadle made a prima facie case, and therefore the trial court's grant of a directed verdict was against the weight of the evidence. The trial court should have overruled the defendants' motion for directed verdict at the close of their case and requested that the defendants put on their evidence. The judgment of the trial court is reversed, and the cause remanded to the trial court for further proceedings.

Reversed and remanded.

Case Concepts Review

1. Why does Cadle make a convincing argument?
2. What impact do the different means of calculating the amount due have on the decision? Why?

35.3b Personal Defenses

A distinction exists between *fraud in the inducement* and *fraud in the execution*. Inducement pertains to the consideration for which an instrument is given. The primary party intended to create an instrument but was fraudulently induced to do so. Such a *defense is personal* and is not available against a holder in due course. *Fraud in the execution* exists where a negotiable instrument is procured from a party when circumstances are such that the party does not know that he/she is giving a negotiable instrument. Fraud in the execution is a real defense [3-305(a)]. The theory is that since the party primarily to be bound has no intention of creating an instrument, none is created. Such fraud is rare because persons are usually charged with knowledge of what they sign.

Another personal defense, acquisition of title by or through a thief, is easily preventable. Conversion of bearer paper to order paper precludes its negotiation by a thief or finder.

A holder in due course is not subject to the defense of unauthorized completion of an instrument. The defense is personal. The person who left the blank space must bear the risk of wrongful completion.

Negligence of a party, frequently present in situations of fraud and material alteration, will reduce a real defense to a personal defense. A check written with a wide, blank space preceding the amount offers a wrongdoer an easy place to raise that amount. The negligent check writer reduces the defense of material alteration to a personal one. This negligence by the drawer typically means that the payor bank (drawee) does not have to recredit the drawer's account for the amount of the alteration. This bank, as a holder in due course, is free from the personal defense that resulted from the drawer's negligence.

35.3c Real Defenses

The *real defense* of unauthorized signature includes signatures by agents without authority and forgeries [3-401, 3-403]. It applies to endorsements as well as to the signature creating the instrument.

The most common example of a material alteration is the "raising" of a check [3-407]. A check drawn in the amount of \$50 might be raised by alteration to \$500. This creates a real defense to the extent of the alteration. A subsequent holder in due course could enforce the check only in the amount of its original \$50.

The defense of lack of capacity is a real defense if the state law so provides. If it is a defense to a simple contract, it is a real defense [3-305]. The same is true for all forms of illegality. If a contract is merely voidable, the defense is personal; if the contract is void or unenforceable, the defense is a real one. If state law provides that usurious contracts are null and void, usury is a real defense.

35.4 Exceptions to Holder-in-Due-Course Status

35.4a Introduction

The holder-in-due-course concept was predicated on the need for commercial paper to move quickly, freely, and as "a courier without luggage" in the financial community. Negotiable instruments were intended to be the equivalent of money. Use of commercial paper was encouraged by freeing it of personal defenses if its holder is a holder in due course. Today, consumer advocates argue that protection of the consumer in credit transactions is more important than the reasons for the holder-in-due-course concept, and that all defenses should always be available to the consumer-debtor. They feel that the best protection for a consumer is the right to withhold payment if goods are defective or not delivered. The logic of this argument also has been extended to commercial credit transactions when there is a close business relationship between an original contracting party and the transferee that receives the negotiable instrument.

A number of states have enacted statutes prohibiting the use or enforcement of clauses that cut off defenses in contracts such as leases. Courts in many states have held that a holder was not a holder in due course when the finance company was closely connected with the seller. Courts have also strictly construed the application of the holder-in-due-course rule. Doubts about the negotiability of instruments have been resolved against negotiability. Several states have achieved this result by the enactment of the Uniform Consumer Credit Code, whose provisions are applicable to instruments other than checks. This code offers two alternative approaches to the problem. A state legislature can select the one it considers best suited to the needs of the state.

One alternative simply gives maximum protection to the consumer by allowing him/her to assert all claims and defenses against the assignee of any paper that he/she signed. The other alternative provides that the assignee can give written notice of the assignment to the debtor. The consumer is then given the right to assert defenses for three months. After the three-month period, the assignee is free of any defense, and the debtor's only remedy is against the seller.

35.4b FTC Rule

Since states were not universal in formulating exceptions to holder-in-due-course status, the Federal Trade Commission (FTC), acting under its authority to prohibit unfair or deceptive methods of competition, adopted a rule that prohibits the use of the holder-in-due-course concept against consumers in credit transactions. It also provides that a clause purporting to cut off defenses is an unfair method of competition and illegal.

The FTC rule is designed to eliminate substantial abuses often inflicted on the purchaser of consumer goods. For example, assume that Carter purchases stereo equipment on credit from The Stereo Company. Carter intends to use this equipment in a personal, noncommercial manner. Carter signs a negotiable promissory note promising to pay the purchase price over a thirty-six month period. The Stereo Company then sells this note to the First National Bank. The note is properly negotiated to the Bank. Now, what would happen if the equipment did not perform as Carter expected and The Stereo Company refuses or is unable to fix the equipment? Carter likely would refuse to make further payments on the note. The First National Bank might assert its right to payment against Carter. When Carter explains that the equipment is defective, the Bank argues that it is free from this personal defense since it is holder in due course. The impact of the Bank's status is that Carter would be liable to pay for merchandise that is defective. Carter's only recourse is against The Stereo Company, which already has indicated its unwillingness to correct the defective equipment. Carter, the consumer-debtor, is caught between the uncooperative seller and the protected holder in due course.

The FTC rule is applicable to any sale or lease of goods or services to consumers in commerce. In such a transaction, it is an unfair or deceptive act or practice for a seller to receive a credit contract that does not contain the following provision in at least 10-point bold type:

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT

IS SUBJECT TO ALL CLAIMS AND DEFENSES

WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER

OF GOODS OR SERVICES OBTAINED PURSUANT HERETO

OR WITH THE PROCEEDS HEREOF.

Thus the holder could not be a holder in due course because the holder agrees to be subject to all defenses.

To prevent sellers from sending buyers directly to the lender and thus circumventing the law, the rule has a special provision relating to lending institutions. It declares that it is an unfair or deceptive practice for a seller to accept in payment the proceeds of a purchase-money loan unless a similar notice is included in the loan agreement in 10-point bold type.

For the purpose of the foregoing rule, a purchase-money loan exists if the seller refers the consumer to the creditor or is affiliated with the creditor by common control, contract, or business arrangement. This means that if the lending institution regularly does business with the seller or has an understanding that its customers may obtain financing, the provision must be included in the loan contract. Again, it provides that all defenses are available to the consumer.

As a result of the FTC rule, if a consumer-purchaser has any defense against the seller, it may assert that defense against the bank or other financial institution that seeks to collect the debt. Thus, banks and other financial institutions must make sure that the seller stands behind the products sold. In addition, they must deal only with responsible parties on a recourse basis if losses are to be avoided.



TOUCHSTONE

In 1975, the Federal Trade Commission promulgated a final Trade Regulation Rule concerning the Preservation of Consumers' Claims and Defenses. The Rule, sometimes called the Holder-in-Due-Course Rule, became effective in 1976. The Rule preserves the consumers' right to assert the same legal claims and defenses against anyone who purchases the credit contract, just as they would against the seller who originally provided the credit.

The federal government recently affirmed the FTC's Holder-in-Due-Course Rule, which protects the rights of consumers who make a purchase using credit obtained through the merchant. The 2012 Opinion Letter affirms that the language of the Rule is unambiguous and that the Rule places no limits on a consumer's right to an affirmative recovery of payments already made. Over the years since the Rule came into existence, some courts have imposed limitations on a consumer's ability to obtain an affirmative recovery. The Opinion Letter affirms that the Rule does not limit a consumer's rights to recover money he/she has already paid under a contract to circumstances where the consumer can legally rescind the transaction, or where the goods or services sold to the consumer are worthless.

[See Federal Trade Commission website, "FTC Opinion Letter Affirms Consumers' Rights under the Holder Rule," released May 10, 2010]

35.4c Close-Connectedness Doctrine

While the FTC rule applies only to consumer credit transactions, many arguments have been made that a similar result should occur in some commercial credit transactions. Continuing the preceding example, suppose that Carter purchased the stereo equipment for use in the reception area of a business. Are there situations when Carter, as a commercial debtor, should be free from the claims of the bank as a holder in due course?

Under a doctrine known as *close connectedness*, a transferee does not take an instrument in good faith when the transferee is so closely connected with the transferor that the transferee may be charged with knowledge of an infirmity in the underlying transaction. The rationale for the close-connectedness doctrine is the basic philosophy of the holder-in-due-course concept: to encourage free negotiability of commercial paper by removing certain anxieties from one who takes the paper as an innocent purchaser, knowing no reason why the paper is not sound as its face would indicate. Therefore, the more the holder knows about the underlying transaction, and particularly the more he/she controls or participates or becomes involved in it, the less he/she fits the role of a good-faith purchaser for value. The closer the holder's relationship to the underlying agreement that is the source of the note, the less need there is for giving him/her tension-free rights.

The factors that tend to establish the close connection are among the following: (1) the drafting by the transferee of forms for the transferor; (2) the approval of the transferor's procedures by the transferee (e.g., setting the interest rate); (3) an independent check by the transferee on the credit of the debtor; (4) the heavy reliance by the transferor on the transferee (e.g., transfer by the transferor of all or substantial part of his/her paper to the transferee); and (5) a common or connected ownership or management of the transferor and transferee.

Close connectedness exists also (1) when the transferee or assignee has substantial voice in, or control of, a vested interest in the underlying transaction; or (2) when the transferee has knowledge of the particular transaction or of the way the seller does business, so he/she knows of claims the buyer has against the seller. The basic question is whether the holder of the instrument is actually a party to the transaction.

As a result of the close-connectedness doctrine, many courts have held that a transferee of a negotiable note does not take in "good faith" and is not a holder in due course of a note given in the sale of goods where the transferee is a finance company involved with the seller of the goods and has a pervasive knowledge of factors relating to the terms of the sale.

Chapter Summary:

Holders in Due Course and Defenses

Status of Third Parties

Status Possibilities

1. A transferee of commercial paper may be an assignee, a holder, or a holder in due course.
2. An assignee is a transferee of a simple contract, or one to whom a negotiable instrument has not been properly negotiated.
3. A holder has a negotiable instrument that has been properly negotiated.
4. A holder that meets certain requirements is a holder in due course and takes instruments free of personal defenses.

Contract Provisions

1. Contracts often contain clauses that waive defenses in the event the contract is assigned.
2. Such clauses are illegal in some states and legal in others.
3. If legal, most states require that the assignee meet the same requirements as a holder in due course, and these states waive only personal defenses.

Holder in Due Course

Value

1. A holder in due course must take the instrument for value and not as a gift. A mere promise is not value, but a preexisting debt is value.

Good Faith

1. A holder in due course must take in good faith. Good faith is honesty in fact. If the holder knows that there is a defense, he/she is not a good-faith taker.

Without Notice

1. A holder in due course must take without notice that it is overdue, has been dishonored, or that there is a claim or defense to the instrument. A person has notice if he/she has actual knowledge or reason to know the fact.

Before Overdue

1. An instrument is overdue if it is demand paper and more than a reasonable length of time has passed. In the case of a check, this time period is ninety days.

Holder from a Holder in Due Course

1. A transferee from a holder in due course has the rights of a holder in due course and thus is free of personal defenses. A person may take by gift, with knowledge of a defense, or after maturity, and still be able to collect on an instrument if it has passed through the hands of a holder in due course.
2. The shelter provision is not applicable to persons who reacquire the paper from a holder in due course.

Defenses

Personal Defenses

1. A personal defense is one that arises out of the transaction that created the instrument. It is generally based on the law of contracts.
2. Payment is a very important personal defense.
3. Negligence reduces a real defense to a personal defense.

Real Defenses

1. A real defense may be asserted against any party, including a holder in due course.
2. Real defenses go to the essence of the instrument. The most important real defense is forgery.

Exceptions to Holder-in-Due-Course Status

FTC Rule

1. The FTC rule prevents the use of the holder-in-due-course concept in a consumer credit transaction.
2. In such transactions involving consumers, the contract must contain a notice in 10-point bold type informing all holders that any defense available against the seller of goods can be asserted against the holder.
3. The same notice must be contained in purchase-money loan documents.

Close Connectedness

1. To provide nonconsumer debtors similar protection to that given to Doctrine consumers under the FTC rule, some courts conclude that a transferee lacks good faith if it is closely connected to the transferor.
2. Lacking good faith, this transferee cannot qualify as a holder in due course and thus is subject to the defenses the debtor has against the original seller-transferor.

Review Questions and Problems

1. Match each term in Column A with the appropriate statement in Column B.

A

B

- | | |
|----------------------------|---|
| (1) Shelter provision | (a) May be a real defense or a personal one, depending on state law |
| (2) Value | (b) Prohibits consumers from holder-in-due-course status |
| (3) Good faith | (c) Always a real defense |
| (4) Holder | (d) Eliminates real defenses |
| (5) FTC rule | (e) Allows a transferee to have the rights of a holder in due course |
| (6) Fraud in the execution | (f) A mere promise does not qualify as this |
| (7) Infancy | (g) Has possession of a negotiable instrument that has been properly negotiated |
| (8) Negligence | (h) Honesty in fact |
| (9) Assignee | (i) Holder who takes for value, in good faith and without notice of defenses |
| (10) Holder in due course | (j) A third person who receives the right to have a contract performed |
- Siegman, a diamond merchant, issued a note for diamonds purchased. The seller endorsed the note to a bank "as collateral for his pre existing obligations to the banks and as collateral for the diamonds shipped to defendants." Did the bank give value so as to qualify as a holder in due course? Explain.
 - A bank received a check to deposit in Seve's account. Seve subsequently wrote checks withdrawing most of the proceeds of the deposited check. The bank paid these checks before receiving notice that the deposited check was dishonored. Does the bank qualify as a holder in due course? Explain.
 - Andrews owed Martin, his accountant, a fee for services rendered. Andrews drew a check on his bank payable to "Cash" and signed it. He left the amount blank because he was not sure of the exact amount owed. On his way to Martin's office, Andrews lost the check. Oliver found the check, filled it in for \$500, and handed it to Ernest to satisfy a \$500 debt that Oliver owed to Ernest. Ernest accepted the check in good faith as payment for the debt and immediately presented it to the drawee bank. The drawee bank refused to cash it because of a stop payment order. Is Andrews liable to Ernest for the \$500? Why?
 - C&S Bank sued Johnson to collect a \$50,000 note. Johnson had signed the note payable to Peek. Peek had transferred the note to the bank as security for a \$20,000 loan. Johnson seeks to assert a defense of fraud and lack of consideration. Is the bank a holder in due course? Why or why not?
 - Nevers executed a note payable to the order of Young due on January 1, 2013. On March 1, 2013, Young negotiated the note to Glassen. Will Glassen be subject to the personal defenses of Nevers? Why?
 - Wells issued a check on its account at First National Bank payable to the order of Tayman in the amount of \$4,200. Wells stopped payment on the check early the next banking day. Later that day, Tayman attempted to cash the check at First National, and when payment was refused, he took the check to his own bank, Second National, which cashed it. Is Second National a holder in due course? Why or why not?
 - Arthur purchased securities from William, giving William his check payable to William's order and drawn on Produce Bank in payment. William immediately endorsed the check to the order of Robert; Robert accepted it in payment of a debt owed him by William. Robert endorsed the check in blank and delivered it to his son, Charles, as a birthday gift. Meanwhile, Arthur discovered that the securities sold him by William were worthless and directed Produce Bank to stop payment. When Produce Bank refuses to pay Charles on the check and Charles sues Arthur, may Arthur assert the defense of failure of consideration against Charles? Explain.
 - Hilda executed a note payable to Home Improvements, Inc., for various improvements to her house. The company negotiated the note to a bank, which sued Hilda. If the bank is a holder in due course, can Hilda raise the defense that Home Improvements made several material misrepresentations in inducing her to sign the note? Explain.
 - Smith delivered to Janett his check drawn on National Bank payable to Janett. Janett had the check certified and delivered it to Cook as payment on account. The certification was stamped on the face of the check. It said "Certified payable as originally drawn." The original check was for \$1,000. Janett had raised the amount to \$4,000 prior to the certification. No one but an expert would have realized that the check had been raised. How much can Cook collect on the check? How much can the bank charge to Smith's account? Explain.

