HOLDER IN DUE COURSE: AN OVERVIEW

- **Holder in Due Course (HDC):** A holder who:

  (1) acquires a negotiable instrument **for value,**

  (2) in **good faith,** and

  (3) **without notice** that the instrument:

    (a) is overdue (reasonable time for a demand instrument; 90 days for a check),

    (b) has been dishonored,

    (c) is subject to a valid claim or defense by any person,

    (d) contains alterations or unauthorized signatures, or

    (e) is so irregular or incomplete as to call into question its authenticity.

- **Shelter Principle:** A person who does not qualify as an HDC can, nonetheless, acquire the rights and privileges of an HDC if he or she derives his or her title to the instrument through an HDC.
HOLDER IN DUE COURSE: FOR VALUE AND GOOD FAITH

Under the U.C.C., a holder can take an instrument for value in one of the following ways:

1. **Performing the promise** for which the instrument was issued or transferred;

2. Acquiring a security interest or other lien in the instrument, excluding liens obtain by judicial process;

3. Taking an instrument in payment of (or as security for) an preexisting debt;

4. Giving a negotiable instrument as payment; or

5. Giving an irrevocable commitment as payment.

**Good Faith:** Article 3 of the U.C.C. defines “good faith” as “Honesty in fact and the observance of reasonable commercial standards for fair dealing.”
HOLDER IN DUE COURSE: WITHOUT NOTICE

To acquire HDC status a holder must take the instrument without notice.

Notice of a defective instrument is given whenever the holder:

1. has **actual knowledge** of a defect;

2. has received **notice** of the defect (e.g., letter from bank identifying serial number of stolen checks); or

3. has **reason to know** that a defect exists, given all of the facts and circumstances known at the time.
SIGNATURE LIABILITY

- **Primary Liability:** An absolute requirement, unless there are valid defenses, to pay a negotiable instrument upon presentment.

- Only *makers* and *acceptors* (drawees that promise to pay when the instrument is presented) are subject to primary liability.

- Failure by either a maker or acceptor to pay on presentment constitutes *dishonor* of the instrument.

- **Secondary Liability:** A contingent requirement to pay a negotiable instrument triggered by a primarily liable party dishonoring or the failing to pay or accept the instrument.

- Only *drawers* and *indorsers* are subject to secondary liability; and then, only if:

  (i) the instrument is **properly and timely presented**;

  (ii) the instrument is **dishonored or rejected**; and

  (iii) **timely notice** of dishonor or rejection is given to the secondarily liable party.
ACCOMMODATION PARTIES AND AGENTS

Accommodation Party: A person who signs an instrument for the purpose of lending his or her name as credit to another party on the instrument.

Agents’ Signatures: An authorized agent can bind his or her principal on an instrument by signing the instrument in such a way as to clearly show that he or she is signing on behalf of the principal. In such a case, the principal, rather than the agent, will be liable on the instrument.

Agent: A person who agrees to represent or act for a principal (e.g., employee).

Principal: A person who agrees to have an agent act on his or her behalf (e.g., employer).

If an agent signs both on behalf of his or her principal and individually, then both the agent and the principal are liable on the instrument.

If an agent signs on behalf of his or her principal without the authority to do so, the principal will not be liable on the instrument, whereas the agent will be.
UNAUTHORIZED SIGNATURES

- **Unauthorized Drawer/Maker’s Signature:** As a general rule, unauthorized signatures are wholly inoperative and will not bind the person whose name is forged.

- However, an unauthorized signature will bind the person whose name is forged if that person ratifies, or affirms, the obligation.

- **Unauthorized Indorsement:** The first party to take an instrument bearing an unauthorized indorsement will bear the burden of loss, unless the unauthorized indorsement is that of the payee, in which case the loss falls on the drawer or maker.

- **Imposter:** One who, by use of the mails, telephone, or personal appearance, induces a maker or drawer to issue an instrument in the name of the imposter. Indorsements by imposters are treated as being authorized.

- **Fictitious Payee:** A payee whom the maker or drawer does not intend to have an interest in the instrument. For example, where a dishonest employee (i) issues an instrument on his or her employer’s behalf, or (ii) deceives the employer into signing an instrument payable to a party with no right to receive payment.
TRANSFER WARRANTIES

- **Transfer Warranties:** Implied warranties, made by any person who transfers an instrument for consideration to subsequent transferees and holders who take the instrument in good faith, that:

  (1) the transferor is **entitled to enforce** the instrument;

  (2) all signatures are **authorized and authentic**;

  (3) the instrument has **not** been **altered**;

  (4) the instrument is not subject to a **defense or claim** of any party that can be asserted against the transferor; and

  (5) the transferor has no knowledge of any **insolvency** proceedings against the maker, the acceptor, or the drawer of the instrument.

- Transfer Warranties extend to all subsequent holders when there is a transfer of order paper for consideration.

- Transfer Warranties extend only to the immediate transferee when there is delivery of a bearer instrument (no indorsement) for consideration.
PRESENTMENT WARRANTIES

Presentment Warranties: Implied warranties, made by any person who presents an instrument for payment or acceptance, that:

(1) the person seeking payment or acceptance is entitled to enforce the instrument or is authorized to obtain payment or acceptance on behalf of a person who is entitled to enforce the instrument;

(2) the instrument has not been altered; and

(3) the person seeking payment or acceptance has no knowledge that the signature of the drawer is unauthorized.
UNIVERSAL DEFENSES - PART I

■ **Universal Defenses:** Absolute defenses to liability on a negotiable instrument that are *valid against all holders*, including HDCs and other holders with the rights of HDCs.

■ **Forgery:** Forgery of a maker’s or drawer’s signature cannot bind the person whose name is used unless that person *ratifies* the signature or is *precluded* from denying it (e.g., because the forgery was made possible by the maker’s negligence).

■ **Fraud in the Execution:** A person whose signature is obtained while that person believes he is signing something other than a negotiable instrument. This person is generally not liable unless *reasonable inquiry* (in light of, among other things, the signer’s age, experience, and intelligence) would have revealed to the signer the nature and terms of the instrument.

■ **Discharge in Bankruptcy:** Discharge is an absolute defense against the claims of any holder, including an HDC.

UNIVERSAL DEFENSES - PART II
- **Material Alteration:** An alteration that changes the terms of the instrument between any two parties in any way (e.g., adding words or numbers).

- Material alteration is a **complete** defense against claims of an ordinary holder. Material alteration is a **partial** defense against an HDC, only to the extent of the alteration.

- **Minority:** Minority is a defense to liability on an instrument to the same extent that it is a defense under the applicable state law to contract liability.

- **Illegality:** Any illegal act which would render a contract **void** under state law is an **absolute** defense against the claims of **any** holder, including HDCs.

- **Mental Incapacity:** Any instrument made or issued by a person previously adjudged to be mentally incompetent is **void ab initio** and, therefore, unenforceable even by an HDC.

- **Extreme Duress:** Any instrument signed and issued under immediate threat of force or violence is void and unenforceable by any holder, including an HDC.
PERSONAL DEFENSES - PART I

- **Personal Defenses:** Defenses that may be used to avoid payment to an ordinary holder, but not an HDC or a holder with the rights of an HDC.

- **Breach of Contract or Warranty:** When there is a breach of the underlying contract for which the negotiable instrument was issued, the maker of a note can refuse to pay it, or the drawer of a check can order his or her bank to stop payment. Breach of warranty may also be claimed as a defense to liability on an instrument.

- **Lack or Failure of Consideration:** The absence of consideration may constitute a defense in some cases.

- **Fraud in the Inducement:** A person who issues a negotiable instrument based on false statements by another party will be able to avoid payment of the instrument unless the holder presenting the instrument for payment is an HDC.

- **Illegality:** Acts that render a contract voidable create a defense against an ordinary holder, but not against an HDC.
PERSONAL DEFENSES - PART II

- **Mental Incapacity:** A person who has not been adjudged mentally incompetent, nonetheless may claim mental incapacity as a defense against an ordinary holder, but not an HDC.

- **Other Personal Defenses:**
  
  (1) Discharge by **payment or cancellation**;

  (2) **Unauthorized completion** of an incomplete instrument;

  (3) **Nondelivery** of the instrument; and

  (4) **Ordinary duress or undue influence** rendering the contract **voidable**.
DISCHARGE FROM LIABILITY

Discharge from liability on an instrument can occur in several ways:

1. If the **party primarily liable** pays the instrument in full, **all** parties on the instrument are discharged;

2. If a **secondarily liable party** pays the instrument, only that party and subsequent parties are discharged (the primary party [maker or drawer]), as well as any indorsers prior to the paying party, remain(s) liable;

3. **Intentional cancellation** (e.g., writing “PAID” across the face of the instrument, destroying the instrument) discharges the liability of **all** parties;

4. **Material alteration** may discharge the liability of any party(-ies) affected by the alteration; and

5. If a party’s **right of recourse** (i.e., right to seek reimbursement) has been impaired, that party may be discharged from further liability.
FTC RULE 433

The Federal Trade Commission issued Rule 433 requiring that a notice be included in all consumer credit contracts. The notice states that any holder is subject to all claims and defenses of the debtor.

- A consumer is one who purchases for personal, family, household use.

- A credit transaction includes promissory notes but not checks.