**Being a Holder in Due Course: Personal Defenses**

Welcome to this podcast on Being a Holder in Due Course: Personal Defenses brought to you by CALI. I am Professor Jennifer S. Martin. The topic of this podcast is to introduce you to the protection afforded a holder in due course from defenses to payment arising from personal defenses. Some of the benefits accruing to holders in due course can be confusing so it’s worth the time to sort this out. As holder in due course doctrine arises under Article 3 of the Uniform Commercial Code, this topic deals with instruments, typically paper checks and promissory notes. Importantly, holders in due course doctrine, especially the benefits, are tested by a number of states on the bar examination. This podcast primarily addresses defenses set forth in § 3-305, which you should read carefully.

Recall that a holder in due course under § 3-302 is simply a holder of an instrument that takes for value, in good faith and without notice of problems with the instrument. The particular requirements to be a holder in due course are covered in another podcast. Additionally, under the shelter rule, in § 3-203, if a holder in due course transfers an instrument, the transferee has the same rights as a holder in due course even if the transferee cannot qualify as a holder in due course in their own right. So, if the shelter rule applies, then the transferee is entitled to the benefits in the same way as any other holder in due course.

Being a holder of an instrument makes the holder a person entitled to enforce the instrument (sometimes called a PETE) under § 3-301. Ordinarily, this means that the holder is entitled to present the instrument for payment pursuant to § 3-501. However, the presentment by a holder is subject to any defenses or counterclaims the issuer can assert against the PETE. The primary benefit of being a holder in due course under § 3-305(b) is that a holder in due course takes the instrument free of personal defenses to payment. On the other hand, real defenses can be asserted even against a holder in due course. Real defenses are covered in another podcast. The result is that a holder in due course will take an instrument free of many of the significant defenses that could be asserted to payment.

Simply stated, as provided in § 3-305(b), an obligor on an instrument cannot use personal defenses or claims in recoupment as defenses to payment against a holder in due course. Most importantly, personal defenses and claims in recoupment include any defense that an obligor can raise to performance on an obligation with a simple contract, including claims involving nonconforming goods whether accepted by the buyer or not. In case you are wondering what a claim in recoupment really is, it is simply a contract claim whereby an obligor on an instrument would have a defense, such as a warranty claim, to reduce the amount owed on a note (perhaps because accepted goods were defective). While contract claims are probably the most common scenario for personal defenses, personal defenses also include, though, defenses of the obligor under another section of Article 3, such as claims for possession of the instrument and claims to rescind the negotiation.

Let’s look at an example. Hypo #1. I write a check for $2000 to the order of a handyman, Steve, believing he had finished agreed-upon services for the repairing of a ceiling in my garage that had water damage. As it turns out, I later discover the work was half done. I would have a contract defense to payment against Steve for breach of contract. Suppose that Steve negotiates my check to Southern Check Cashing, which pays value, in good faith, and without notice of the problems with Steve’s performance on the contract. Southern Check Cashing is probably a holder in due course and would take the instrument free of my personal defense of breach of contract by Steve. This means that I would have to pay on the instrument presented by Southern Check Cashing. As to my unfinished repairs, I would need to assert my breach of contract claim against Steve.

Hypo #2. The personal defenses would also be ineffective against a holder in due course even if Steve obtains the check by fraud. For instance, rather than repairing the ceiling, he simply painted over the water damage in an effort to make it appear as though he had done the repair. Basic fraud that induced me to write the check is a defense under contract law. As such, simple fraud is a personal defense. Southern Check Cashing could demand payment on the instrument and be free of any claims regarding the fraud by Steve. Again, I will have to pay on the instrument and would need to assert my contract claim for fraud against Steve. Holder in due course status means that I have no defense that’s good against Southern Check Cashing.

Remember that fraud is a defense in common law contracts. Most types of fraud cannot be asserted against a holder in due course. Where fraud relates to the underlying transaction, rather than the signing of the instrument itself, you may hear this fraud referred to as fraud in the inducement. Fraud in the inducement is not assertable as a defense to payment against a holder in due course. However, there is another type of fraud, sometimes called real or essential fraud or fraud in the factum, which is assertable as a real defense against a holder in due course, but this type of fraud relates to tricks to get someone to sign a document that they didn’t know was an instrument, rather than relating to the underlying transaction. Because there are two types of fraud, bar examiners like to test fraud along with holders in due course. The regular ordinary fraud that you probably learned in your first year contract class is typically fraud in the inducement, a personal defense.

Let’s move on. While less common, personal defenses also include defenses specifically arising under Article 3, including the non-issuance of the instrument; conditional issuance and issuance for a special purpose; and failure to countersign a traveler’s check; modification of the obligation by separate agreement; payments that violate a restrictive endorsement; instrument issued without consideration or which promised performance has not been given and breach of warranty when a draft is accepted.

Let’s look at hypo #3. Suppose a bank took a $1000 check made out to cash from the thief, giving value, in good faith and without notice of the nature of the stolen instrument. The bank would be immune from claims to the instrument arising under § 3-306 due to its holder in due course status.

Basically, the protection from personal defenses makes the holder in due course a privileged sort of holder which is immune from a wide variety of defenses that could be asserted upon demand for payment. A holder in due course, though, must take the instrument for value. An important limitation on the power of a holder in due course is where it has only paid part of the promised value for the instrument. In such situations the holder is still a holder in due course but only to the extent that the value was actually given. Meaning, holder in due course protections are pro-rated.

For example, suppose Sam, a car repairman, sold Beverly a promissory note with a face value of $1200 with Beverly promising to pay $800 cash today and $200 next month. Beverly pays the $800 and seeks to enforce the note against the issuer, Ingrid. Ingrid refuses to pay on the grounds that Sam had not adequately repaired her car. Ingrid’s defense of breach of contract by Sam would be a personal defense. Being a personal defense, Ingrid cannot assert it against a holder in due course. However, Beverly has not paid the entire value promised, so her holder in due course protection is pro-rated. Beverly would be a holder in due course to the extent of 80% of the value of the note. In this case, Beverly has paid $800 of the $1000 promised, which is 80%. As such, Beverly will be treated as having 80% of a holder in due course status. Note that the proration here is based upon the amount of value Beverly promised, here $1000, and the amount of value she has actually given, here $800 bucks. The proration is not based upon the face value of the note, here $1200.

At this point, you should be able to describe the benefits of being a holder in due course, in particular, protection from personal defenses. You should be able to distinguish the types of fraud and particularly where fraud in the inducement is simply a personal defense. Additionally, you should be able to describe how holder in due course benefits may be prorated in the event that the full value promised has not been paid. .

I hope you’ve enjoyed this podcast on Being a Holder in Due Course: Personal Defenses.

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