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

Welcome to this podcast on Being a Holder in Due Course: Real Defenses brought to you by CALI. I am Professor Jennifer S. Martin. The topic of this podcast is to introduce you to the real defenses that can be asserted by an obligor against a holder in due course seeking payment on an instrument. At times, the real defenses can be confusing so it’s worth 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 its benefits and limitations, 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 of § 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.

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. Under § 3-305(b), though, a holder in due course enjoys the benefit of taking the instrument free of *personal* defenses to payment or claims in recoupment. Personal defenses and claims in recoupment are covered in another podcast. On the other hand, the so called *real defenses* can be asserted even against a holder in due course. The result is that while a holder in due course will take an instrument free of many of the significant defenses that could be asserted to payment, the real defenses still apply.

So, what are the real defenses to which a holder in due course is still subject? The real defenses are found in § 3-305(a)(1) and include: (1) infancy that is a defense with simple contract; (2) duress, lack of capacity, and illegality of the transaction, but only to the extent that the defense would render the contract void; (3) fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms; and (4) discharge of the obligor in insolvency proceedings. Let’s look at each of these in turn.

The first real defense good against a holder in due course is infancy to the extent it’s a defense to simple contract. This requires you to remember the defenses you learned in first year contracts. Suppose Leeland is 12 years old and purchases a new gaming system on Craigslist from Simon for $400, paying $100 in cash from his savings and signing a promissory note for the $300 balance. Simon negotiates the note to Hilda, a holder in due course. When Hilda demands payment on the note, Leeland can assert the defense of infancy and refuse to pay the same as he would if it were an ordinary contract cause of action. It does not matter whether the contract was void or voidable when it comes to infants. Leeland is an infant because he is 12 years old.

The second real defense good against a holder in due course is that of duress, lack of legal capacity or the legality of the transaction, but only if they make the obligation void. If the obligation is simply voidable, then the real defense does not apply and cannot be asserted against a holder in due course. You may recall that under some circumstances these defenses make a contract voidable by the other party, but the contract is void where there are extreme circumstances. For instance, when it comes to illegality, some contracts are avoidable because they run afoul of some public policy (sometimes referred to as *malum prohibitum*), but other contracts are wholly void because they deal with a legal prohibition that makes the conduct bad in itself (sometimes referred to as *malum in se*). Suppose Victoria signed a promissory note payable to the order of Peter for $5000 under a threat of having nude pictures published on the Internet that would destroy her career if she did not pay. Peter negotiates the note to Heather, a holder in due course. When Heather presents the note for payment to Victoria, Victoria will likely argue that this type of duress is a real defense, rather than a personal one. As such, Victoria will argue that the defense is good even against a holder in due course. Whether Victoria will prevail will turn on whether a court agrees with her that this type of duress makes the contract void.

The third defense good against a holder in due course is that of fraud but only if the fraud induced the obligor to sign the instrument without knowledge nor reasonable opportunity to learn of the character or its essential terms. This is sometimes called real or essential fraud or fraud in the factum. Since this is a real defense you might want to just call it real fraud. What is more important is that you can identify when it applies. This type of fraud only occurs when the person signing the contract is deceived about the nature of the document being signed.

Other types of fraud related to the transaction as a whole are personal defenses and cannot be asserted against a holder in due course. This type of fraud is sometimes called fraud in the inducement and relates to the underlying transaction, not the signing itself. An example of personal fraud would be where Steve induced me to issue a check to him where we contracted for garage repair work but he disguised his progress on the project. This type of simple fraud is not assertable as a defense to payment against a holder in due course. Because there are two types of fraud, bar examiners like to test this topic to see if you know the difference. Only real fraud is assertable as a defense to payment against a holder in due course.

Let’s look at an example. I receive quarterly shipments of wine for my favorite vineyard, Kings Estate. Because the wine can only be consumed by persons over 21 years of age I always sign a receipt upon delivery. One morning a deliveryman, Dan, rings my doorbell and hands me the box containing the bottles of wine. The deliveryman instructs me to sign the receipt, which I do. In fact, Dan had handed me a negotiable note for $10,000, which I sign. Dan quickly sold the note to Henry, a holder in due course with no notice of the fraud. Even though Henry is a holder in due course, I can assert my defense of real fraud against him because I thought I was signing a receipt and never intended to sign a note. Of course, I will have to prove that I did not have knowledge of the nature of the paper I was signing nor reasonable opportunity to learn of its character or its essential terms. If the situation was one where the signing was rushed at the door where an ordinary person might not investigate further upon the delivery of the wine, a court might find the defense good even against a holder in due course.

The classic example of a claim for real fraud that was not successful was the 1884 case of *Ort v. Fowler* where the court rejected a claim of real fraud by a farmer who did not understand he was signing a promissory note where he could have gotten his glasses to read the document. Basically, the farmer did not know the character of the note, but he did have an opportunity to learn of its character if he would have gotten his glasses.

Finally, the fourth real defense good against a holder in due course is that of discharge of the obligor in insolvency proceedings. Here we are referring to a federal bankruptcy or state insolvency proceeding. Any other type of discharge would not be a real defense so holder in due course would take free of it.

Let’s look at an example. Olga was the obligor on a $4000 promissory note given to Paula the payee. Olga repaid the promissory note in full and Paula sent her an email saying Thank you for the payment. We are square and your note is discharged. Olga is happy to be out of debt but later Paula sells the note to Hanover Bank, a holder in due course. Hanover Bank presents the note to Olga for payment. Olga will not be able to defend on the grounds of discharge because it was not obtained in an insolvency proceeding. Unfortunately, Olga should have insisted that Paula give her the note in exchange for the repayment. The email was not sufficient to cut off the rights of Hanover Bank.

At this point, you should be able to describe the benefits of being a holder in due course and the real defenses that are assertable against a holder in due course. You should also be able to distinguish between void and voidable defenses and between real fraud and fraud in the inducement.

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

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