**Who is a Holder in Due Course**

Welcome to this podcast on Who is a Holder in Due Course brought to you by CALI. I am Professor Jennifer S. Martin. The topic of this podcast is who is a holder in due course, how someone becomes a holder in due course, and why it’s important. I find that students often get confused about the process of becoming a holder and a holder in due course, so it’s worth the time to sort this out. Yes, again, this deals with instruments, typically paper checks and promissory notes. While we might not use instruments frequently, checks and promissory notes are still used in many transactions, particularly larger ones. Not only is this a practice issue, but holders in due course are covered in Article 3 of the Uniform Commercial Code, which is tested by a number of states on the bar examination. Holders, particularly when coupled with holders in due course doctrine, are favorites on bar examinations. It is important to try and use the correct terminology so be on the lookout for the following: holder, negotiation, holder in due course, value, good faith, and notice.

Recall that being a holder is important to the negotiation of an instrument. Negotiation is simply the transfer of possession of an instrument to a person who becomes its holder and thereby a person entitled to enforce the instrument. We sometimes call the person entitled to enforce the instrument a PETE. When an instrument is payable to an identified person the process of negotiation requires not only transfer of possession of the instrument, but also the indorsement of the identified person. So if we want to be a PETE and obtain the money on the instrument, in most cases we need to be a holder.

There are two types of holders. First, a person in possession of an instrument, if the instrument is payable to bearer, often this means the instrument is payable to the order of cash or the like. Second, the person in possession of an instrument that is payable to an identified person that happens to be the person in possession of the instrument. A simple example of this would be if I write a $100 check payable to the order of my daughter Emma and I give it to her then she would be a holder. In this case, Emma would be a holder because she is a person in possession of the instrument and she is the person identified as payee.

But what about being a holder in due course? As you might guess, in order to be a holder in due course a person must be a holder of the instrument. But that is not all, there are other requirements to be a holder in due course. Holder in due course doctrine will ultimately provide some important protections to holders against defenses of the obligor or claims of prior owners. As such, there are restrictions on who will qualify.

So what type of person warrants this extra protection against some defenses and claims? First, when the instrument is issued or negotiated to a holder, it cannot bear apparent evidence of forgery, or alteration, or otherwise be irregular so as to call into question its authenticity. Second, a holder in due course must meet three other requirements when taking the instrument: (i) for value, (ii) in good faith; and (iii) without notice of problems with the instrument.

Let’s look at each of these requirements. Holders who take an instrument that are so incomplete or irregular as to call into question its authenticity should naturally be on notice that the instrument might not be what it purports to be. That is, Comment 1 to section 3-302 explains that these type of purchasers should do so at their own risk and should not expect extra protection from defenses. An example of this would be a $200 check I write payable to the order of the electrician, Steve. Suppose that I wrote the check in blue ink but Steve altered the amount to $2,000 using red ink. If he negotiates this check to Southern Check Cashing, it might be a holder, but it will have difficulty claiming status as holder in due course due to the irregularity of the ink on the check.

A holder in due course must also take the instrument for value. Notice that we’ve use the word value here not consideration such that more explanation is required when looking at holder in due course status. Section 3-303 provides five specific, separate ways to satisfy the value requirement. First, if an instrument is issued or transferred for a promise of performance, if the promise has been performed. Second, if the transferee acquires a security interest or other lien in the instrument, except if it is a judicial lien. Third, if the instrument is issued or transferred as payment of or security for an antecedent claim of any person, whether or not the claim is due. Fourth, if the instrument is issued or transferred in exchange for a negotiable instrument. Fifth, and finally, if the instrument is issued or transferred in exchange for the incurring of any irrevocable obligation to a third party by the person taking the instrument. Some examples are in order here.

Hypo #1. Sam owes Jessica $1000. The debt is not represented by a note. Later, Sam issues a note to Jessica for the debt. At contract law, this would be past consideration. It would not qualify to support a contractual obligation. However, an instrument issued as payment of an antecedent claim does constitute value for purposes of Article 3.

Hypo #2. Sam hires Heather to clean his house next week and writes a check for $150 to her. While a promise to do something in the future could be consideration under contract law, the executory promise is only value for purposes of Article 3 to the extent the promise is performed. There would be value to the extent that Heather performs the housekeeping services as promised. If at the time the check is cashed Heather’s performance is due but has not been performed then Sam has a defense.

In order to qualify as a holder in due course the holder must also take the instrument in good faith. Pursuant to section 1-201(20) of the U.C.C. good faith means honesty in fact and the observance of reasonable commercial standards of fair dealing. For instance, if Ingrid Imposter takes an unusually large check written by Esther Elderly to City Check Cashers and obtains payment, City Check Cashers might have difficulty arguing that it took the instrument in good faith. Good faith might be lacking, for instance, if Ingrid was not a normal client of theirs, the amount was larger than they typically accept, and they made no attempt to verify the check with Esther Elderly. Whether a party has acted in good faith, though, will be a factual inquiry.

The final qualification for holder in due course status relates to notice of problems with the instrument. There are several problems with instruments that will disqualify a holder from being a holder in due course. First, the holder must be without notice that the instrument is overdue, has been dishonored, or that there is an uncured default with respect to payment of another instrument issued as part of the same series. Second, the holder must be without notice that the instrument contains an unauthorized signature or has been altered. Third, the holder must be without notice of any claim to the instrument under section 3-306, such as claims of ownership, property or possessory interests. Fourth, the holder must be without notice that any party has a defense or claim in recoupment described in section 3-305(a), including some of the traditional contract defenses.

Let’s look at some examples where notice might be at issue.

Hypo #3. Debt Collectors Inc. purchases on January 1, 2018 a promissory note where payment was due by the maker on June 30, 2017. Debt Collectors Inc. could not be a holder in due course for this promissory note because it would have notice that the instrument is overdue in light of the stated due date.

Hypo #4. Tom writes a check for $200 to the order of the plumber, Paul. Paul, in the presence of his roommate, Terry, alters the check to the amount of $2000. Paul then negotiates the note to Terry. Terry could not be a holder in due course because he had notice of the alteration.

Hypo #5. Beverly purchases a car from Stan by giving Stan a cashier’s check bought from First Bank. First Bank has a defense to its obligation to pay the check because Beverly bought the check from bank with a check known to be drawn on an account with insufficient funds to cover the check. If First Bank issued the check to Beverly as payee and Beverly endorsed it over to Stan, Stan could be a holder in due course if he had no notice of the defense of First Bank.

At this point, you should be able to describe who is a holder, how a person becomes a holder in due course, and why it’s important.

I hope you’ve enjoyed this podcast on Who is a Holder in Due Course.

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