

MEMORANDUM

Holder in Due Course Doctrine: Personal and Real Defenses

Jim Smith, Reporter

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The holder in due course doctrine cuts off some, but not all, defenses that a borrower might assert against the original payee of the instrument. A holder in due course is said to take subject to *real defenses* and take free of *personal defenses*. UCC Article 3 codifies the real defenses, listing them as (1) infancy, (2) duress, (3) legal incapacity, (4) illegality of the transaction, (5) fraud that induced the obligor to sign the instrument without knowledge of its character or essential terms (often called “fraud in the factum”), and (5) discharge in insolvency proceedings.¹ Purchasers of residential mortgage loans in the secondary mortgage market have always taken subject to these real defenses.

Article 3 specifies that a holder in due course takes free of other defenses² (the so-called personal defenses). The UCC does not provide a list of personal defenses. The ones frequently identified by courts and commentators are:

- Fraud that did not prevent the obligor from obtaining knowledge of the character of essential terms of the instrument (often called “fraud in the inducement”).
- Misrepresentation. Probably this is the most common claim cut off by the holder in due course doctrine in the context of residential mortgage loan origination. Typical claims are that a lender’s representative or mortgage broker falsely described the characteristics of the loan, such as interest rate, other costs and fees, balloon payments, or prepayment terms; or made collateral promises, such as a promise to refinance at a better rate at a particular time in the future, which were not honored. Such alleged misrepresentations would often be characterized as fraudulent misrepresentation.
- Failure or lack of consideration. The starkest example is the borrower’s failure to receive the loan proceeds.
- Unconscionability.

¹ Revised UCC § 3-305(a):

[T]he obligation of a party to pay an instrument is subject to the following:

(1) A defense of the obligor based on (i) infancy of the obligor to the extent it is a defense to a simple contract, (ii) duress, lack of legal capacity, or illegality of the transaction which, under other law, nullifies the obligation of the obligor, (iii) fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms, or (iv) discharge of the obligor in insolvency proceedings . . .

The list of real defenses in pre-revision Article 3 is substantially the same. UCC § 3-305(2).

² Revised UCC § 3-305(b).

- Undue influence.
- Breach of warranty.
- Discharge by payment to someone other than the holder of the instrument.³
- Statutory violations (to the extent that the statute does not expressly make transferees liable for violations by the originating lender).

³ Although payment to the wrong person is a personal defense, residential borrowers appear to be largely protected from this risk by federal law that requires the sending of a notice to the borrower when there is a new loan servicer to whom payments are to be made. 12 U.S.C. § 2605, *Servicing of mortgage loans and administration of escrow accounts*, provides:

(b) *Notice by transferor of loan servicing at time of transfer*

(1) *Notice requirement*

Each servicer of any federally related mortgage loan shall notify the borrower in writing of any assignment, sale, or transfer of the servicing of the loan to any other person. . . .

(3) *Contents of notice*

The notice required under paragraph (1) shall include the following information: . . .

(E) The date on which the transferor servicer who is servicing the mortgage loan before the assignment, sale, or transfer will cease to accept payments relating to the loan and the date on which the transferee servicer will begin to accept such payments. . . .

This provision, enacted in 1990, is part of the Real Estate Settlement Procedures Act (RESPA).