The Holder in Due Course Doctrine as a Default Rule

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I. INTRODUCTION

The “holder in due course” doctrine, as implemented by Article 3 of the Uniform Commercial Code (U.C.C., or the Code), governs negotiable instruments such as checks and promissory notes. The doctrine says that a party who acquires a negotiable instrument in good faith, for value, and without notice of certain facts, and who also meets some additional requirements, takes the instrument free of competing claims of ownership and most defenses to payment. The doctrine thus may relieve a party acquiring a check or note from worries that anyone else owns the instrument or that its maker will have particular legal grounds for refusing to pay it.

For example, suppose that a person borrows money from a bank to buy a house and makes a note promising to repay the loan. The bank might later sell the note to an investor. If the note meets the formal requisites of a negotiable instrument, and the investor purchases the instrument in good faith and for value and without notice of various potential problems, the investor may qualify as a “holder in due course.” The investor then will have assurance that no one else can claim an interest in the note, even if the bank has purported to sell the note to someone else. In addition, the investor will know that the homeowner has a duty to pay the note.
even if the homeowner might have had a defense to payment against the bank such as fraud or failure of consideration.

The holder in due course doctrine has remained largely unchanged for hundreds of years.\(^8\) Lord Mansfield clarified the holder in due course doctrine in several important common-law cases decided during the late 1700s.\(^9\) His rules were later codified in the Uniform Negotiable Instruments Law (N.I.L.), a model act drafted in 1896 and eventually adopted by forty-eight states.\(^10\) Since the 1950s, every state has replaced the N.I.L. with Article 3 of the U.C.C.\(^11\) Most states now have supplanted the original version of Article 3 with a revised version promulgated in 1990.\(^12\) Both versions of Article 3 have retained the basic features of the doctrine as it existed at common law.\(^13\) As Professor Grant Gilmore said, “[T]ime seems to have been suspended, nothing has changed, the late twentieth century law of negotiable instruments is still a law for clipper ships and their exotic cargoes from the Indies.”\(^14\)


\(^11\) See 4 HAWKLAND & LAWRENCE, supra note 10, § 3-101: 01, at 3 (stating that Article 3 is revision and modernization of N.I.L.).

\(^12\) See [State U.C.C. Variations Binder] U.C.C. Rep. Serv. (CBC), at xix-xx (1997) (listing 47 jurisdictions that now have adopted revised version of Article 3).

\(^13\) See Rubin, supra note 8, at 777 (commenting that negotiable instruments law has retained many principles for 200 years); M.B.W. Sinclair, Codification of Negotiable Instruments Law: A Tale of Reiterated Anachronism, 21 U. TOL. L. REV. 625, 625 (1990) (noting that law of negotiable instruments has changed very little despite “revolutionary developments”).

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Over the course of this long history, a set of conventional policy arguments for the holder in due course doctrine has developed. The standard justification for immunizing a holder in due course from claims and defenses is that the immunity will encourage beneficial commercial transactions.\(^{15}\) For instance, in the example above, the doctrine arguably encourages the investor to buy the note from the bank, and thus makes the bank more willing to lend money to the homeowner. The standard explanation for the various requirements for attaining holder in due course status--good faith, value, lacking notice of certain facts--is that these requirements promote fairness and properly limit the incentives that the doctrine creates.\(^{16}\)

This Article questions the conventional policy arguments. It contends that parties can generally recreate the effects of the holder in due course doctrine by using “waiver of defense” clauses in ordinary contracts. Pursuant to these clauses, parties may specify the precise circumstances under which an assignee of contractual rights takes those rights free from claims and defenses. As a result, this Article argues, a justification for the holder in due course doctrine must do more than show that stripping claims and defenses encourages beneficial transactions; it must explain why maintaining the doctrine as a matter of law is preferable to leaving the rules regarding the transfer of instruments to private contract.

This Article suggests an alternative economic justification for the doctrine that takes into account the possibility of using waiver of defense clauses as an alternative to making negotiable instruments. It asserts that, while parties could replicate the doctrine through waiver of defense clauses, the holder in due course doctrine spares them the effort. In this way, the doctrine serves as a default rule that may reduce transaction costs, and thus may promote efficiency. This Article further asserts that the requirements for attaining holder in due course status should exist because they probably establish limitations that people who use negotiable instruments want, and that they would include in waiver of defense clauses if they could not make negotiable instruments.

*786 II. AN OVERVIEW OF THE HOLDER IN DUE COURSE DOCTRINE

The current official version of Article 3 of the U.C.C. codifies the holder in due course doctrine in sections 3-302, 3-305, and 3-306, all of

\(^{15}\) Discussed infra Part III.A.

\(^{16}\) Discussed infra Part IV.A.
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which are reprinted in the Appendix to this Article.\(^{17}\) Sections 3-305 and 3-306 declare that a holder in due course takes a negotiable instrument free from certain claims and defenses. Section 3-302 states the requirements for obtaining holder in due course status. The following discussion explains these provisions.

A. IMMUNITY FROM CLAIMS AND DEFENSES

Ordinary contract law specifies that, unless otherwise agreed, the assignee of rights under a contract takes the rights subject to any defenses available against the assignor.\(^{18}\) For example, suppose that a business contracts to pay a furniture dealer $1000 for a desk and chair. The furniture dealer may assign its right to receive the $1000 payment to a third party, such as a bank. As an ordinary assignee, the bank would take the right to receive payment subject to any defenses that the business could assert against the furniture dealer. Thus, if the dealer failed to deliver the desk and chair and that failure would excuse the business from paying the dealer, it also would excuse the dealer from paying the bank as an assignee.\(^{19}\)

By contrast, the assignee of a negotiable instrument who has the status of a holder in due course generally takes the instrument free of the maker’s defenses. Section 3-305(b) states, with one exception, that “[t]he right of a holder in due course to enforce the \(^*787\) obligation of a party to pay the instrument ... is not subject to defenses of the obligor ... or claims in recoupment.”\(^{20}\) The sole exception provides that the maker of an instru-

\(^{17}\) *Infra* app., pp. 822-824.

\(^{18}\) See *RESTATEMENT (SECOND) OF CONTRACTS* § 336(1) (1981), which asserts:

> By an assignment the assignee acquires a right against the obligor only to the extent that the obligor is under a duty to the assignor; and if the right of the assignor would be voidable by the obligor or unenforceable against him if no assignment had been made, the right of the assignee is subject to the infirmity.

For a similar expression of the rule, see E. ALLAN FARNSWORTH, CONTRACTS § 11.8, at 810 (2d ed. 1990); 2

\(^{19}\) See *RESTATEMENT (SECOND) OF CONTRACTS* § 336 illus. 6 (1979) (providing similar example); *see also* U.C.C. § 2-210(2) (1995) (authorizing assignments of rights under sales contracts).

\(^{20}\) U.C.C. § 3-305(b) (1995).
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ment may assert so-called real defenses, such as infancy, duress, incapacity, illegality, fraud in the factum, or a discharge in bankruptcy.21

For instance, suppose that the business in the example above issues a negotiable promissory note for $1000 to the furniture dealer and that dealer sells the note to a bank. If the bank qualifies as a holder in due course, then it could enforce the note against the business, and the business could not assert the dealer’s failure to deliver the furniture as a defense to payment. The bank would take the note free of that defense, and the firm’s only means of asserting its claim for nondelivery of the furniture would be to sue the furniture dealer for breach of contract.22

In addition to taking an instrument free of defenses and claims in recoupment, the holder of a negotiable instrument also takes the instrument free of competing claims of ownership. Section 3-306 says that “[a] person taking an instrument, other than a person having rights of a holder in due course, is subject to a claim of a property or possessory right in the instrument....”23 By contrast, a “person having rights of a holder in due course takes free of the claim to the instrument.”24 To understand this rule, suppose in the example above that, after the business issues the note to the furniture dealer but before the dealer sells it to the bank, a thief steals it and sells it to a finance company. Under section 3-306, if the finance company qualifies as a holder in due course—if it purchases the note in good faith, without notice of the theft, and so forth—the finance company will then own the note. The dealer cannot recover it.

*788 The rules stated above have changed very little over time. The prerevision version of Article 3, first promulgated in the 1950s, contained

21 Id. § 3-305(a)(i) (listing real defenses); id. § 3-305(b) (subjecting holder in due course to defenses stated in section 3-305(a)(1), but not other defenses). For an in-depth discussion of real defenses and possible justifications for treating them differently, see Clayton P. Gillette, Rules, Standards, and Precautions in Payment Systems, 82 VA. L. REV. 181, 237-243 (1996).
22 See U.C.C. § 2-711 (stating remedies available to buyer of goods when seller fails to deliver); id. § 3-305 cmt. 3 (explaining how maker of note would retain contractual rights against payee in this situation).
23 Id. § 3-306.
24 Id.
highly similar provisions.25 Before it, the N.I.L. and the common law established largely the same rules.26

B. REQUIREMENTS FOR HOLDER IN DUE COURSE STATUS

To become a holder in due course of a negotiable instrument, a party must first qualify as a “holder” of the instrument. This means that the person must have possession of the instrument, and the instrument must be payable to that person or payable to bearer.27 A party who satisfies the formal requirements of being a holder must then meet eight additional requirements, specified in section 3-302, to qualify as a “holder in due course.”28 Seven of these eight requirements relate to the manner in which the person obtained the instrument. The other requirement concerns the appearance of the instrument. The following discussion briefly describes each of these eight requirements.

First, the holder must give “value” for the instrument.29 Typically, a holder will give value by buying the instrument or taking the instrument as payment for a debt.30 For example, a bank might purchase a mortgage note from another bank, or a *789 merchant might take a cashier’s check in payment for a sale of goods. A holder does not give value by merely

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25 Section 3-305 of the prerevision version of Article 3 stated: “To the extent that a holder is a holder in due course he takes the instrument free from (1) all claims to it on the part of any person; and (2) all defenses of any party to the instrument with whom the holder has not dealt except ... [real defenses, such as infancy, duress, etc.].” U.C.C. § 3-305 (1989).

26 The N.I.L. stated: “A holder in due course holds the instrument free from any defect of title of prior parties, and free from defenses available to prior parties among themselves, and may enforce payment of the instrument for the full amount thereof against all parties liable thereon.” N.I.L. § 57 (1896), reprinted in UNIF. NEGOTIABLE INSTRUMENTS ACT § 57, 5 U.L.A. 13-14 (1943). Decisions under the N.I.L. recognized implied exceptions for real defenses, such as infancy. See generally U.C.C. § 3-305 cmt. 4. (prerevision) (discussing defense of infancy). For a brief description of this common-law history, see Rubin, supra note 8, at 778-86.

27 U.C.C. § 1-201(20) (1995) (“ ‘Holder,’ with respect to a negotiable instrument, means the person in possession if the instrument is payable to bearer or, in the case of an instrument payable to an identified person, if the identified person is in possession.”).

28 Id. § 3-302 (1995). A holder in due course may transfer his or her rights to another party. Id. § 3-203(b). As a result, a party can have the rights of a holder in due course without actually being a holder in due course. Id. § 3-203 cmt. 2.

29 Id. § 3-302(a)(2)(i) (imposing value requirement).

30 Id. § 3-303(a)(1)-(5) (stating ways that holder may give value).
promising to pay for an instrument; a promise constitutes value only “to the extent the promise has been performed.”

Second, the holder must take the instrument “in good faith.” The Code defines good faith as “honesty in fact and the observance of reasonable commercial standards of fair dealing.” A holder who participates in a fraudulent scheme might lack good faith under this standard. For example, a check-cashing service might act in bad faith if it takes an indorsed check from a person whom it suspects stole the instrument.

Third, the holder must take the instrument “without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series.” Instruments payable at a definite time become overdue after the time for payment has passed. Demand instruments become overdue after ninety days in the case of checks, or after an “unreasonably long” period in the case of other instruments.

Fourth, the holder must take the instrument “without notice that the instrument contains an unauthorized signature or has been altered.” Consequently, the holder cannot know or have reason to know that someone has forged the signature of a drawer, maker, or indorser or has altered the terms of the instrument. A person might alter the terms of an instrument by erasing the original terms and substituting new ones.

Fifth, the person must take the instrument “without notice of any claim to the instrument described in [s]ection 3-306.” A claim under section 3-306, as noted above, is a claim of ownership. For example, suppose that the payee loses a bearer instrument and that someone else finds it. The payee has a claim of ownership to the instrument just like the payee would have a claim of ownership to any other lost personal property.

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31 Id. § 3-303(a)(1).
32 Id. § 3-302(a)(2)(ii).
33 Id. § 3-103(a)(4).
34 Id. § 3-302(a)(2)(iii).
35 Id. § 3-304(b)(2).
36 Id. § 3-304(a)(2).
37 Id. § 3-304(a)(3).
38 Id. § 3-302(a)(2)(iv).
39 See id. § 3-407(a) (defining alteration).
40 Id. § 3-302(a)(2)(v).
41 Supra Part II.A.
This provision would thus prevent the finder from becoming a holder in due course.

Sixth, the person must take the instrument “without notice that any party has a defense or claim in recoupment described in [section 3-305(a)].”\textsuperscript{42} Section 3-305(a), in turn, lists all the different kinds of defenses a drawer or maker might have on a check or note, including real and personal contract defenses and other defenses established by Article 3.\textsuperscript{43} For example, the maker of a note might argue that he never received the promised consideration for that note.\textsuperscript{44}

Seventh, the holder cannot have taken the instrument in certain specified ways outside the ordinary course of business. The holder, for instance, cannot have taken the instrument “by legal process or by purchase in an execution, bankruptcy, or creditor’s sale or similar proceeding.”\textsuperscript{45} The holder also cannot have taken the instrument “by purchase as part of a bulk transaction not in [the] ordinary course of business of the transferor.”\textsuperscript{46} Similarly, the holder cannot have taken the instrument “as the successor in interest to an estate or other organization.”\textsuperscript{47}

Eighth, the negotiable instrument must have a proper appearance. When the holder takes the instrument, it must not “bear such apparent evidence of forgery or alteration” or otherwise appear “so irregular or incomplete as to call into question its authenticity.”\textsuperscript{48} An instrument might appear incomplete if it lacks *791 words or numbers that an ordinary instrument

\textsuperscript{42} U.C.C. § 3-302(a)(2)(vi).
\textsuperscript{43} See id. § 3-305(a)(1)-(3) (setting forth possible defenses, including infancy, duress, lack of legal capacity, illegality of transaction under other laws, fraud in the inducement, simple contract defenses, and claims in recoupment).
\textsuperscript{44} Claims in recoupment are claims arising from the transaction that gave rise to the instrument, such as a claim for breach of warranty. See id. § 3-305 cmt. 3 (offering breach of warranty as example of claim in recoupment). For example, if a merchant sells defective goods in exchange for a check, the drawer of the check may have a claim of recoupment based on an express or implied warranty about the quality of the goods. See id. § 2-714 (1995) (providing buyer with remedy for non-conforming goods).
\textsuperscript{45} Id. § 3-302(c).
\textsuperscript{46} Id.
\textsuperscript{47} Id.
\textsuperscript{48} Id. § 3-302(a)(1).
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would include. The Code does not define “irregular,” but the term presumably describes instruments that do not follow ordinary conventions.

Like the rules specifying that a holder takes an instrument free of claims and defenses, the definition of a holder in due course has changed very little over time. Section 3-302 in the revised version of Article 3 differs little from its counterpart in the prerevision version of Article 3. It also closely resembles the comparable provision in the N.I.L.

III. THE POLICY ARGUMENT FOR STRIPPING CLAIMS AND DEFENSES UNDER THE HOLDER IN DUE COURSE DOCTRINE

A policy argument for a legal doctrine should explain how the doctrine benefits society. The following discussion shows that the conventional policy justification given for stripping claims and defenses under the holder in due course doctrine fails to satisfy this requirement. The discussion describes the conventional argument, shows what the argument overlooks, and then suggests a more persuasive alternative.

49 See id. § 3-115(a) (defining incomplete instrument as “a signed writing, whether or not issued by the signer, the contents of which show at the time of signing that it is incomplete but that the signer intended it to be completed by the addition of words or numbers”).
51 See U.C.C. § 3-302(1) (1989) (prerevision version) (“A holder in due course is a holder who takes the instrument (a) for value; and (b) in good faith; and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person.”). The prerevision version further states:

A holder does not become a holder in due course of an instrument: (a) by purchase of it at judicial sale or by taking it under legal process; or (b) by acquiring it in taking over an estate; or (c) by purchasing it as part of a bulk transaction not in regular course of business of the transferor.
Id.
52 A holder in due course is a holder who has taken the instrument under the following conditions: (1) That it is complete and regular upon its face; (2) That he became the holder of it before it was overdue, and without notice that it had been previously dishonored, if such was the fact; (3) That he took it in good faith and for value; (4) That at the time it was negotiated to him he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it.

UNIFORM NEGOTIABLE INSTRUMENTS ACT § 52, 5 U.L.A. 13 (1943).
A. THE CONVENTIONAL POLICY ARGUMENT

The conventional policy argument for the holder in due course doctrine attempts to justify the doctrine’s existence using a two-step syllogism. As the following Sections document, the argument asserts that (1) stripping claims and defenses will encourage transactions in negotiable instruments; and that (2) encouraging transactions in negotiable instruments benefits society.

1. The Argument that Stripping Claims and Defenses Encourages Commercial Transactions. A party contemplating buying a negotiable instrument or taking one in payment from someone other than its maker may have two concerns relating to his or her right to enforce the instrument. One is that the maker will have a legal ground for refusing to pay.53 The other is that someone else will claim ownership of the instrument.54 The party taking the instrument, in theory, could address both these worries by expending time and money to investigate the origin of the negotiable instrument before purchasing it or taking it in payment. The holder in due course doctrine, however, makes that effort largely unnecessary by stripping away claims of ownership and most defenses.55 The doctrine, therefore, arguably encourages parties to take negotiable instruments when they would otherwise hesitate.

Numerous courts have articulated this theory of the function of the holder in due course doctrine. In the landmark case of Unico v. Owen,56 for example, the New Jersey Supreme Court stated: “The basic philosophy of the holder in due course status is to encourage free negotiability of commercial paper by removing certain anxieties of one who takes the paper as an innocent purchaser knowing no reason why the paper is not as sound as its face would indicate.”57 The Indiana Court of Appeals offered a comparable explanation of the policy in Western State Bank v. First Union Bank & Trust Co.58

*793 The purpose of conferring HDC [i.e., holder in due course] status is to encourage and facilitate the circulation of commercial paper. It is sometimes said that the holder in due course doctrine

53 LARY LAWRENCE, AN INTRODUCTION TO PAYMENT SYSTEMS 53 (1997).
54 Id.
55 Id.
57 Id. at 410.
is like oil in the wheels of commerce and that those wheels would grind to a quick halt without such lubrication.” White and Summers, Uniform Commercial Code, p. 457. It permits a specified class of holders to receive negotiable instruments free of the risks of claims or defenses which might be valid against the original recipient. These risks are twofold. First, the HDC is assured that he will not lose any action brought to enforce the instrument due to such claims or defenses. This is the substantive effect of the rule. Second, and perhaps just as important, the holder is assured that should he acquire HDC status he will not incur high transaction costs in the form of protracted litigation when seeking to enforce the contract. This is the procedural effect of the rule.59

Other judicial opinions, both old and new, also state this conventional understanding of how stripping claims and defenses encourages transactions. 60

A variety of academic works reiterate this idea. In perhaps the most frequently cited article on the subject, Professor Grant Gilmore explained that the good faith purchaser “is protected not because of his praiseworthy character, but to the end that commercial transactions may be engaged in without elaborate investigation of property rights.”61 In other words, a party may purchase or pay *794 a negotiable instrument without knowing for sure how the person in possession acquired it. A leading treatise by Professors William Hawkland and Lary Lawrence similarly asserts: “To encourage the purchase of negotiable instruments, it is essential that a good faith purchaser receive his bargained for exchange. The Code establishes the status of holder in due course to help ensure this result.”62 The

59 Id. at 258.
60 E.g., Bankers Trust Co. v. Litton Sys., 599 F.2d 488, 493-94 (2d Cir. 1979) (quoting Gilmore on value of preventing embarrassment in commercial transactions); Barnett Bank v. Regency Highland Condominium Ass’n, 452 So. 2d 587, 591 (Fla. Dist. Ct. App. 1984) (stating underlying policy to promote commercial transactions without “elaborate investigation” of process and “in reliance on the contract rights of one who offers them for sale or to secure a loan”); Sabine v. Paine, 119 N.E. 849, 850 (N.Y. 1918) (discussing prevention of embarrassment in commercial transactions).
62 4 HAWKLAND & LAWRENCE, supra note 10, § 3-302: 01, at 416; see also 5A RONALD A. ANDERSON, ANDERSON ON THE UNIFORM COMMERCIAL CODE § 3-302: 3, at 590 (3d ed. 1995) (paraphrasing policy argument stated in Unico decision).
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document, to put it another way, prevents unknown claims and defenses from diminishing the apparent value of an instrument purchased in good faith. Law school textbooks typically explain the function of the doctrine in the same way.  

Some room for disagreement does exist. Contrary to the sources cited above, this author does not believe that stripping away claims and defenses necessarily encourages transactions. As this Article suggests further below, stripping claims and defenses in some instances simply may raise the price of instruments and may not promote transfers. Yet, as will be shown, even if the doctrine does facilitate transactions, that effect alone cannot justify the existence of the doctrine.

2. The Argument that Increased Transactions May Benefit Society. The conventional policy argument does not merely claim that the holder in due course doctrine encourages third parties to buy negotiable instruments or take them in payment. It also posits that the facilitated transactions benefit society. Discussions of the holder in due course doctrine frequently cite the following three putative examples of benefits.

First, by encouraging third parties to buy notes, the holder in due course doctrine may reduce the price of credit or make credit available when it otherwise would not be. Small banks, for example, can make more

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63 See, e.g., PETER A. ALCES & MARION W. BENFIELD, CASES, PROBLEMS AND MATERIALS ON PAYMENT SYSTEMS 102-03 (1993) (reprinting part of Gilmore’s article); STEVE NICKLES ET AL., MODERN COMMERCIAL PAPER: THE NEW LAW OF NEGOTIABLE INSTRUMENTS (AND RELATED COMMERCIAL PAPER) 231 (1994) (stating that “the protection of purchases ‘in due course’ and other factors ‘reflect a body of law intended to facilitate trade in instruments’”).

64 Infra Part IV.B.1.

65 Infra Part III.B.


67 E. ALLAN FARNSWORTH, CASES AND MATERIALS ON NEGOTIABLE INSTRUMENTS 89 (4th ed. 1993) (“[A] buyer’s ability to relinquish most defenses as against a financing agent when signing a negotiable promissory note, may make credit available when it otherwise would be denied or may make credit available to the buyer at more favorable terms than would otherwise be available.”); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 1-4-1, at 503 (4th ed. 1995) (arguing that holder in due course doctrine “facilitates the flow of capital from large lenders to the seller to an individual consumer. In theory it does that by causing lenders to purchase consumer paper and
home loans if they can resell the promissory notes that they receive from borrowers to larger banks or other investors. The larger banks and investors will be more willing to buy the notes, or will pay a higher price, if they can take them free from claims and defenses.

Second, by encouraging banks to grant credit for deposited checks, the holder in due course doctrine may improve the check collection system. When a bank customer deposits a check, the bank generally does not have to give the customer credit for the check immediately. Many banks, however, advance credit to their customers upon deposit as a courtesy. Although other factors may also influence this decision, the banks know that they will become holders in due course of deposited checks to the extent that the depositors withdraw credit that they give. Holder in due course status affords them a measure of protection because, if a check bounces, they will have the right to enforce it against the drawer free from claims and defenses. The doctrine thus may give depositors quicker access to their money.

Third, by encouraging people to take negotiable instruments in payment, the holder in due course doctrine facilitates the creation of substitutes for cash. In the past century, before the government issued paper currency, banks issued notes in which they promised to pay money to the holder. Merchants would take these notes in payment because they knew that, under the holder in due course doctrine, the banks could not assert a defense to payment. During the twentieth century, the practice of issuing bank notes has died out, but banks still create some cash substitutes. Cashier’s checks, for example, often go from a bank to a remitter and then

thus to use their capital to allow individual lenders and merchants to do business with the consumer”).

68 WHITE & SUMMERS, supra note 67, § 14-1, at 503; Nyquist, supra note 66, at 936.

69 See 12 C.F.R. §§ 229.10(c), .12(b)-(c) (1996) (setting forth schedule for when credit must be given for most types of checks); U.C.C. § 4-215(c) (1995) (stating rule for other checks).

70 To become a holder in due course, a bank--like anyone else--must give value for the instrument. U.C.C. § 3-302(a)(2)(i) (1995). A depositary bank gives value when it acquires a security interest in a deposited check. Id. § 4-211. A bank can acquire a security interest by giving a depositor credit for a deposited check before it clears, if the customer withdraws the credit. Id. § 4-210(a)(1).

71 Id. § 3-305(b).

72 Gilmore, supra note 14, at 452; Sinclair, supra note 13, at 634-35.
to a payee. The payee may be willing to take the check because the payee knows that the bank cannot assert a defense to payment against a holder in due course. For example, the bank cannot assert that the remitter failed to pay for the instrument.

Although the holder in due course doctrine theoretically might have these effects, critics have expressed several reasons for discounting the overall benefit of the doctrine. Many scholars, for example, have argued that the holder in due course doctrine has less value now than it may have had in prior centuries because commercial practices have changed. As discussed more fully below, they argue that despite the theoretical benefits of the holder in due course doctrine, consumers, businesses, and banks now rely on it only in a small percentage of payment transactions. This criticism, if valid, would suggest that legislatures probably have more important topics to worry about than the holder in due course doctrine. The criticism, however, does not undermine the theory behind the conventional policy argument. Even if commercial practices have changed in general, the doctrine still could encourage beneficial transactions in some circumstances.

*797 Other critics have argued that the holder in due course doctrine might sometimes encourage transactions for inappropriate reasons. Most significantly, if applicable, the doctrine might make it easier for unscrupu-

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73 See U.C.C. § 3-103(a)(11) (defining remitter as person who “purchases an instrument from its issuer if the instrument is payable to an identified person other than the purchaser”); id. § 3-302 cmt. 4 (describing this kind of transaction in first case).

74 Gilmore, supra note 14; Ronald J. Mann, Searching for Negotiability in Payment and Credit Systems, 44 UCLA L. REV. 951 passim (1997); James S. Rogers, The Irrelevance of Negotiable Instrument Concepts in the Law of the Check-Based Payment System, 65 TEX. L. REV. 929 (1987); see also James S. Rogers, The Myth of Negotiability, 31 B.C. L. REV. 265, 317-18 (1990); Albert J. Rosenthal, Negotiability--Who Needs It?, 71 COLUM. L. REV. 375, 401 (1971) (concluding that “today, negotiability, and specifically the protections of holders in due course, are not necessary or even helpful in fostering the flow of commerce”); Rubin, supra note 8, at 788 (noting that in many traditional settings, negotiability how has “limited commercial relevance”). But cf. WHITE & SUMMERS, supra note 67, § 14-1, at 503-04 (noting that significant amount of litigation involving holder in due course doctrine continues to occur, which suggests that the doctrine still has some importance in commercial transactions); Nyquist, supra note 66, at 902 (noting many ways in which negotiability remains important).

75 Infra Part V.A.
lous merchants to defraud unsophisticated consumers. For example, merchants might take notes in payment for goods or services, sell the notes to a holder in due course, and then fail to perform to the consumer’s satisfaction. The holder in due course doctrine would strip away the unwary consumer’s defenses, and require the consumer to pay the note.

In response to this criticism, federal and state law now limits the ability of consumers to make negotiable notes. The Federal Trade Commission has promulgated a regulation making it an unfair or deceptive act or practice for a merchant to take an installment sale or lease contract (including a note) from a consumer unless the contract contains a clause stating that the consumer may assert defenses against all subsequent assignees. A number of states have also adopted provisions from a model statute called the Uniform Consumer Credit Code (U.C.C.) that prevents merchants from taking negotiable instruments, other than checks, from consumers. These limitations reduce the harm that the holder in due course doctrine might cause, and thus strengthen the conventional policy argument for preserving the doctrine in other circumstances.

*798 B. WHAT THE CONVENTIONAL POLICY ARGUMENT OVERLOOKS

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See Vern Countryman, *The Holder in Due Course and Other Anachronisms in Consumer Credit*, 52 TEX. L. REV. 1, 2-11 (1973) (explaining how holder in due course doctrine presents obstacle to consumer defrauded by merchant); Ralph J. Rohner, *Holder in Due Course in Consumer Transactions: Requiem, Revival, or Reformation*, 60 CORNELL L. REV. 503, 515 (1975) (noting that holder in due course doctrine has negative consequences for those “victimized by deceptive sales practices, shoddy goods, and inept services”); Rosenthal, *supra* note 74, at 378-85 (comparing holder in due course doctrine’s application when poor consumer pays for inoperable refrigerator with negotiable note or middle class consumer pays with check).


See *U.C.C. § 3-307* (1974) (“With respect to a consumer credit sale or consumer lease, the creditor may not take a negotiable instrument other than a check ....”); *U.C.C. § 3-302(g)* (subordinating holder in due course doctrine to “any law limiting status as a holder in due course in [a] particular class of transactions”). For a list of states that have adopted the U.C.C. or comparable provisions, see 1 CONSUMER CRED. GUIDE (CCH) P 505, at 1083-98 (July 18, 1995-Nov. 18, 1997).
Even if the conventional policy argument for the holder in due course doctrine withstands the criticism described above, it still has a fundamental shortcoming. The conventional argument rests on an unstated assumption that, in the absence of the holder in due course doctrine, assignees of negotiable instruments would have to take them subject to claims and defenses, and they therefore could not obtain the benefits that the holder in due course doctrine provides. This assumption lacks validity.

Contract law, as described above, ordinarily provides that the assignee of contractual rights takes the rights subject to any defenses applicable against the assignor. This general rule, however, has an important exception that the conventional policy argument for the holder in due course doctrine overlooks. In particular, a contract may grant immunity to subsequent assignees through a “waiver of defense” clause. A waiver of defense clause (also known as a “cut off” or “hell or high water” clause) says that the obligor under the contract waives the right to assert defenses against subsequent assignees.

For example, again suppose that a business promises to pay $1000 to a furniture dealer in exchange for a desk and a chair. Ordinarily, as noted above, if the furniture dealer assigned the contract to a third party, the business would not lose its right to assert defenses. If the furniture dealer did not deliver the goods, the business could refuse to pay the assignee.

The result, however, would change if the contract contained a waiver of defense clause saying: “The buyer will not assert against an assignee of this contract any defense that it might have against the furniture dealer.” This clause would ensure that, even if the holder in due course doctrine did not apply, the assignee would take the contractual rights free of defenses. The contract could include a similar clause guaranteeing that the buyer would pay the person possessing the contract even if someone else claimed to have the right to payment.

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79 Supra notes 18-19 and accompanying text.
81 See RESTATEMENT (SECOND) OF CONTRACTS § 336(1) (1981) (explaining that assignee is vulnerable to defenses of obligor).
82 See Frisch & Gabriel, supra note 80, at 770-72 (suggesting ways to effect such rule by contract).
The Holder in Due Course Doctrine as a Default Rule

Nothing in Article 3 prohibits parties from using waiver of defense clauses to replicate the effects of the holder in due course doctrine. Indeed, an official comment to Article 3 even suggests that option:

[T]he immediate parties to an order or promise that is not [a negotiable] instrument may provide by agreement that one or more of the provisions of Article 3 determine their rights and obligations under the writing.... An example of such an agreement is a provision that a transferee of the writing has the rights of a holder in due course stated in Article 3 if the transferee took rights under the writing in good faith, for value, and without notice of a claim or defense.\(^{83}\)

This statement reveals that the Article 3 drafters did not intend the U.C.C. to preempt waiver of defense clauses.

Modern contract law also does not generally forbid waiver of defense clauses. On the contrary, pursuant to these clauses, courts have stripped away a variety of defenses, such as failure of consideration,\(^{84}\) breach of warranty,\(^{85}\) misrepresentation,\(^{86}\) and nonoccurrence of a condition.\(^{87}\) The courts have generally seen no reason to hold that parties to a contract cannot waive their rights in favor of an assignee. For example, in Walter J. Hieb Sand \& Gravel, Inc., the Kentucky Court of Appeals explained:

There is no question but that the seller and buyer here could have executed negotiable indicia of the sale which would have cut off the defense pleaded here. Thus there seems to be no logical reason why they could not impart to their contract limited aspects of negotiability with the purpose of facilitating the financing of their transaction.\(^{88}\)

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\(^{83}\) U.C.C. § 3-104 cmt. 2.
\(^{86}\) E.g., General Elec. Credit Corp. v. Tidenberg, 428 P.2d 33, 36 (N.M. 1967).
\(^{87}\) E.g., Georgia R.R. Bank & Trust Co. v. Doolittle, 252 S.E.2d 556, 558 (S.C. 1979).
\(^{88}\) 332 S.W.2d at 622.
Other courts have justified upholding waiver of defense clauses on similar grounds.\textsuperscript{89}

Despite the general enforceability of waiver of defense clauses, four limitations deserve mention. First, the same laws that limit the ability of consumers to make negotiable instruments also restrict their use of waiver of defense clauses. The Federal Trade Commission regulations, described above,\textsuperscript{90} generally require consumer credit sale or lease contracts, whether or not they qualify as negotiable instruments, to contain a clause preserving defenses.\textsuperscript{91} The U.C.C.C. likewise prohibits waiver of defense clauses in consumer credit sale and lease contracts.\textsuperscript{92}

Second, Article 9 of the U.C.C. regulates waiver clauses in assignments of contracts that involve security interests. Section 9-206(1) makes waiver clauses in such assignments generally enforceable,\textsuperscript{93} and courts have upheld them in numerous cases \textsuperscript{*801 under this provision.\textsuperscript{94} This section, however, contains a few restrictions. For instance, it only permits waiver of defenses in favor of an assignee who has taken the assigned right in good

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\textsuperscript{89} See, e.g., \textit{Troy-Parisian, Inc.}, 115 F.2d at 226 ("[T]here would appear to be no good reason why [parties] may not by agreement impart to [their contract] limited elements of negotiability.").
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\textsuperscript{90} \textit{Supra} note 77 and accompanying text.
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\textsuperscript{91} See 16 C.F.R. § 433.1(i) (1997) (defining consumer credit contract); \textit{id.} § 433.2 (requiring consumer credit contracts to contain provision preserving claims and defenses).
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\textsuperscript{92} See \textit{U.C.C.C.} § 1.301(12) (1974) (defining "consumer credit sale"); \textit{id.} § 1.301(14) (defining "consumer lease"); \textit{id.} § 3.404(1) (1974) (subjecting assignees of rights of seller or lessor in consumer credit sale or consumer lease to all claims and defenses); \textit{id.} § 3.405(4) (prohibiting waiver clauses).
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\textsuperscript{93} Subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods, an agreement by a buyer or lessee that he will not assert against an assignee any claim or defense which he may have against the seller or lessor is enforceable by an assignee who takes his assignment for value, in good faith and without notice of a claim or defense; except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the Article on Negotiable Instruments (Article 3) \textsuperscript{U.C.C.} § 9-206(1) (1995); see also \textit{id.} § 2A-407(1) (1995) (making waiver of defense clause standard term of finance lease).
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THE HOLDER IN DUE COURSE DOCTRINE AS A DEFAULT RULE  

faith, for value, and without notice of defenses.95 In addition, the provision does not permit parties to waive real defenses such as infancy.96 At least one court also has held that the provision only allows buyers and lessors of goods (and not other parties) to waive defenses,97 but commentators have generally criticized this view.98

Third, some secondary authorities indicate that, while waiver of defense clauses may cut off defenses to payment based on breach of warranty, they may not strip away other defenses.99 This *802 position, however, conflicts with decisions, such as those noted above,100 in which courts have stripped away other types of defenses. Section 9-206(1), moreover, overrules any contrary decisions to the extent that they involve security interests; this section permits parties to waive all defenses except the “real” defenses applicable even against a holder in due course.101

95 U.C.C. § 9-206(1).
96 Id.
97 Suburban Trust & Sav. Bank v. University of Del., 910 F. Supp. 1009, 1016-18 (D. Del. 1995). The court reasoned that U.C.C. section 9-318(1) subjects an assignee to all defenses applicable to the assignor and that section 9-206(1) literally creates an exception only for sellers and lessors. Id. at 1016. The court also concluded that in contracts involving security interests, section 9-206(1) supplants any common-law rule generally validating waiver of defense clauses. Id. at 1018.
98 See BARKLEY CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 11.04[4], at 11-23 n.70 (1993) (“The limited scope of the U.C.C. language [in section 9-206(1)] should be treated as a drafting error, and the courts should by analogy extend the rationale to any agreement that may be the subject of an Article 9 assignment.”); GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 41.5, at 1095 (1965) (“The section is written in terms of present sales (and leases) of goods; however, if the language is read in a cheerful spirit, there is no insuperable difficulty in applying it to transactions which are not sales and leases ....”).
99 See RESTATMENT (SECOND) OF CONTRACTS § 331 cmt. f, illus. 10, 11 (1979) (drawing this distinction); U.C.C. § 9-206(1) cmt. 1 (noting that courts have allowed waiver clauses “to operate to cut off at least defenses based on breach of warranty”); Frisch & Gabriel, supra note 80, at 764 (indicating that some courts do not allow waiver of fraud defense); Gilmore, supra note 61, at 1095-96 (asserting that waiver of defense clauses do not preclude defense of failure of consideration). Older cases support this view. See, e.g., American Nat’l Bank v. A.G. Somerville, Inc., 216 P. 376, 379 (Cal. 1923) (waiver of defense clause voidable because maker of contract received no consideration).
100 Supra notes 84-87.
101 See U.C.C. § 9-206(1) (referring to defenses in Article 3); id. § 3-305(a)(1) (1995) (identifying so-called real defenses).
Fourth, courts in some jurisdictions have struck down waiver clauses on grounds that they violated public policy or were unconscionable in the circumstances involved. Many of these cases, however, involved consumer contracts and, thus, do not appear to have general application. Other decisions predate the U.C.C. and rest on a controversial view that the N.I.L. (the U.C.C.’s predecessor) prohibited attempts to effect negotiability by contract. The U.C.C., as noted, contains no such prohibition.

These four limitations show that courts may not uphold waiver of defense clauses in all circumstances. Yet, in most instances in which parties can use a negotiable instrument to allow an assignee to take free of claims and defenses, they can effect a comparable result by inserting a waiver of defense clause in an ordinary contract. To the extent that courts will uphold waiver of defense clauses, the need for the holder in due course doctrine becomes a more complicated issue than the conventional policy argument suggests.

Although the conventional policy argument for the holder in due course doctrine describes the benefits of stripping claims and defenses, it does not explain what the doctrine accomplishes that parties could not achieve with waiver of defense clauses. In other words, the conventional policy

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103 See, e.g., Fairfield Credit Corp., 264 A.2d at 547 (dealing with retail sales installment contract); Unico, 232 A.2d at 407 (dealing with installment contract for purchase of stereo records).

104 See Frederick K. Beutel, Negotiability by Contract: A Problem in Statutory Interpretation, 28 ILL. L. REV. 205, 213-24 (1933) (discussing but rejecting theory that N.I.L. made waiver of defense clauses contrary to public policy). Although some courts initially held that the N.I.L. precluded using waiver of defense clauses, other courts later reached the opposite conclusion. See Frisch & Gabriel, supra note 80, at 764 (discussing general application of courts allowing waiver in simple breach of warranty cases); Gilmore, supra note 61, at 1096-97 (discussing Utah case where waiver was effective in simple breach of warranty claim).
argument does not show how society benefits from having provisions like sections 3-305 and 3-306 on the books.

C. UNDERSTANDING SECTIONS 3-305 AND 3-306 AS DEFAULT RULES

A better policy argument for sections 3-305 and 3-306 is that these sections serve simply as default rules. A review of some basic principles of contract law makes this argument easier to understand. The law enforces promises to pay money in the future--whether in the form of a check, a promissory note, or an ordinary contract--for a widely accepted economic reason. In particular, enforcing promises to take action in the future generally promotes efficiency by allowing parties to enter exchanges in which both parties do not have to perform simultaneously to protect themselves.105

If the law did not enforce promises to pay money in the future, commercial transactions would generally require immediate cash payment. Sellers would hesitate to sell property or services on credit because they would have no legal means of insuring that they would receive payment.106 That result would harm society because the possibility of credit enables the formation of many beneficial bargains that otherwise would not occur.

When the law enforces a promise, it generally gives effect to all the terms of the promise. Absent incapacity, fraud, or duress, parties to a contract presumably set the terms of their promises through a bargaining process.107 Refusing to enforce some terms may deny one party a portion of the benefit expected from the bargain while giving the other a

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105 See RICHARD A. POSNER, ECONOMIC ANALYSIS OF THE LAW § 4.1, at 81 (3d ed. 1986) (“[T]he fundamental function of contract law ... is to deter people from behaving opportunistically toward their contracting parties, in order to encourage the optimal timing of economic activity and make costly self-protective measures unnecessary.”).

106 See O.W. HOLMES JR., THE COMMON LAW 248-50 (1881) (explaining that, if law did not enforce promises to take action in future, parties might resort to socially harmful measures such as hostage taking to persuade others to keep their promises).

107 See RESTATEMENT (SECOND) OF CONTRACTS ch. 7 intro. note (1981) ( “Contract law has traditionally relied in large part on the premise that the parties be able to make legally enforceable agreements on their own terms, freely arrived at by the process of bargaining.”).
windfall.\textsuperscript{108} For this reason, courts generally should and do enforce waiver of defense clauses in a contract to pay money, just as they enforce terms setting the interest rate or the payment date.\textsuperscript{109}

While, in theory, bargaining should produce efficient exchanges, the process has a cost. Parties forming contracts often must dicker for terms they want until they reach agreement. They then must expend resources to express the terms clearly. For example, they may take time and pay attorneys to prepare a carefully drafted written contract.

The law, however, can reduce the cost of bargaining by establishing default rules that reflect terms most people favor in a given context. For example, although parties may insert a clause liquidating damages in the event of a breach,\textsuperscript{110} they do not have to expend this effort. Instead, if they say nothing, the law will supply a term stating that they will receive expectation damages.\textsuperscript{111} Default rules of this nature promote efficiency by giving parties to contracts the terms that they want, while sparing them the transaction costs of setting terms.\textsuperscript{112}


\textsuperscript{109}The need for exceptions to the general enforceability of bargains remains a subject of debate. Compare POSNER, supra note 105, at 104 ("Economic analysis reveals no grounds other than fraud, incapacity, and duress... for allowing a party to repudiate the bargain that he made in entering into the contract."). with Eisenberg, supra note 108, at 748-84 (advocating additional exceptions to address exploitation of distress, transactional incapacity, susceptibility to unfair persuasion, and price ignorance).


\textsuperscript{111}See id. § 347 (stating presumption of expectation damages).

\textsuperscript{112}See Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 VA. L. REV. 757, 826 (1995) ("As default rules are currently understood, their content should mimic the actual contracts that a majority of [[[parties] would adopt in the absence of transaction costs. The social value of default rules is measured in terms of reduced transaction costs.”)); Andrew Kull, Mistake, Frustration, and the Windfall Principle of Contract Remedies, 43 HASTINGS L.J. 1, 43 (1991) ("The standard approach to the choice of default rules recommends that they be those the parties to a typical contract would be most likely to select for themselves."). For a discussion of potential exceptions to this rule designed to limit strategic behavior, see Ian Ayres & Robert Gertner, Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules, 101 YALE L.J. 729 (1992).
THE HOLDER IN DUE COURSE DOCTRINE AS A DEFAULT RULE

*805 This discussion leads to the alternative policy argument for the holder in due course doctrine. In particular, it suggests that the doctrine should exist because it could reduce the cost of bargaining. Although parties could recreate the effects of the doctrine by drafting waiver of defense clauses, the doctrine itself spares them the effort.\(^{113}\) Parties who waive claims and defenses against subsequent assignees merely have to make negotiable instruments within the scope of Article 3.\(^{114}\) The doctrine will then automatically supply the necessary terms.

This alternative policy argument has two distinct advantages over the conventional policy argument. Most significantly, it provides a reason for the doctrine’s continued existence, even though courts generally uphold waiver of defense clauses. In addition, it eliminates the need for speculating about the exact reasons parties may have for wanting to waive claims and defenses. Their particular purposes do not matter. Whatever their reasons, if competent parties choose to waive claims and defenses, the holder in due course doctrine may reduce the cost of accomplishing that result.\(^{115}\)

D. STRENGTH OF THE REVISED POLICY ARGUMENT

The revised policy argument for the holder in due course doctrine, to repeat, claims that the doctrine serves as a default rule that saves parties the expense of drafting waiver of defense clauses. This claim naturally raises the question of how much savings the doctrine produces. Without an empirical study, no one can answer *806 this question with certainty. Two widely different conclusions, however, seem possible.

On the one hand, the doctrine might be saving considerable bargaining costs because the holder in due course doctrine applies in a large number of transactions. Americans, after all, enter billions of transactions annually

\(^{113}\) Although Professor Edward L. Rubin criticizes the present holder in due course doctrine on a variety of grounds, he makes a similar argument for developing a modern law for the transfer of commercial instruments. Rubin, supra note 8, at 796-97. In particular, he recognizes that establishing appropriate default rules can enhance efficiency. Id.

\(^{114}\) See U.C.C. § 3-104 (1995) (stating formal requirements for negotiable instruments such as checks and notes).

\(^{115}\) The policy argument stated here only explains why the holder in due course doctrine should exist given the alternative of waiver of defense clauses. It does not attempt to show that everyone should have capacity to waive defenses, either through a waiver clause or a negotiable instrument. It thus does not address the desirability of consumer protection measures.
that involve checks and notes within the ambit of Article 3.116 Admittedly, many of the participants in these transactions do not care about the holder in due course doctrine because they either do not expect a holder in due course to take the instrument or they do not think that any claims or defenses will arise. 117 An unknown and possibly substantial number, however, may want assignees to take free from claims and defenses. For example, banks generally prefer to take negotiable notes when they lend money. If sections 3-305 and 3-306 did not exist, some banks might insist on contractual terms that would achieve the same result. Sections 3-305 and 3-306 saves them the effort.

On the other hand, despite the large volume of transactions in negotiable instruments, the doctrine might not save very much in terms of bargaining costs because parties can supply their own waiver of defense clauses inexpensively. Even in the absence of sections 3-305 and 3-306, individuals and businesses would not have to draft their own contractual terms each time they wanted to make a note or check. Instead, they could use a standard form agreement that contained appropriate preprinted contractual terms. Alternatively, they simply could attach a legend incorporating by reference a set of standard terms.

In fact, in many payment transactions not involving negotiable instruments, the participants already rely on form agreements to set the terms. For example, banks typically issue letters of credit *807 that include a clause subjecting them to the terms of the Uniform Customs and Practice for Documentary Credits, a privately established protocol published by the International Chamber of Commerce.118 Likewise, when using a credit

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117 See RICHARD E. SPEIDELE ET AL., PAYMENT SYSTEMS 89 (5th ed. 1993) (noting rise of credit extension methods not reliant upon note transfer to third party and doctrine’s unimportance when obligor lacks defenses).

118 See U.C.C. § 5-103 cmt. 2 (1995) (explaining that, because of abbreviated nature of Article 5 and fact that law beyond Article 5 will often determine rights and liabilities in letter-of-credit transactions, parties and courts should look to customs and practice for guidance). Article 5 of the U.C.C., which governs letters of credit, generally permits parties to opt out of statutory rules and establish their own by agreement. Id. § 5-103(c).
card, consumers typically sign a slip that contains a legend (in tiny print) saying: “Customer agrees to perform the obligations set forth in the Cardholder’s agreement with the Issuer.” This legend subjects the transaction to a form agreement established by the credit card industry.¹¹⁹

These competing considerations make the benefit of the holder in due course doctrine difficult to determine. This lack of certainty, however, should not condemn the doctrine. Even if the doctrine saves only a small amount of transaction costs, in theory, little harm can come from the doctrine’s existence. Current regulations and statutes, as noted, generally protect consumers. Other parties may opt out of the doctrine by making non-negotiable instruments, with or without waiver clauses.

IV. THE POLICY ARGUMENT FOR LIMITING HOLDER IN DUE COURSE STATUS

The holder in due course doctrine does not apply every time a person acquires a negotiable instrument by assignment. Instead, as noted above, a person can become a holder in due course—and thus take an instrument free of claims and defenses—only by satisfying the numerous requirements set forth in section 3-302.¹²⁰ For example, a person must take the instrument in good faith, for value, and without notice of claims, defenses, and other problems in order to become a holder in due course.¹²¹

*808 The requirements listed in section 3-302 have two conventional justifications, one based on considerations of fairness and the other on a desire to shape incentives. The following discussion describes and criticizes the standard arguments and then suggests an alternative. It proposes that, like sections 3-305 and 3-306, section 3-302 serves as a default rule and should exist principally for the purpose of reducing transaction costs.

A. THE CONVENTIONAL FAIRNESS AND INCENTIVES POLICY ARGUMENTS

The conventional fairness argument for the requirements in section 3-302 rests on an assumption concerning the distributional effects of the holder in due course doctrine. The argument presumes that stripping away claims and defenses provides a benefit to the person taking the instrument while placing a burden on the person who made the instrument. The

¹¹⁹ See Mary Elizabeth Matthews, Credit Cards--Authorized and Unauthorized Use, 13 ANN. REV. BANKING L. 233, 240-42 (1994) (discussing agreement between cardholder and issuing bank).
¹²¹ See supra Part II.B. (describing these requirements).
argument then justifies the requirements in section 3-302 as appropriate limitations designed to prevent unfairness to the maker of an instrument who may lose his or her defenses.

A simple statement of the conventional fairness argument appears in a leading treatise by Professors Hawkland and Lawrence:

A holder in due course takes free from virtually all claims and defenses of all parties and is protected from other risks which would defeat his expectations. Since these protections are usually at the expense of an innocent party, the Code establishes strict requirements for determining holder in due course status. These requirements attempt to separate those purchasers who are worthy of protection from those purchasers who are not.\textsuperscript{122}

To understand the argument, suppose a homeowner issues a note to a bank, and the bank then negotiates\textsuperscript{123} the note to an investor.\textsuperscript{809} The homeowner may have a defense to payment, such as fraud on the part of the bank. The conventional fairness argument would assume that stripping way that defense would burden the homeowner and benefit the investor. The requirements in section 3-302 arguably restrict the application of the holder in due course doctrine to ensure that no unfairness occurs.

The rule that a person must give value for an instrument to become a holder in due course\textsuperscript{124} provides an example. The conventional fairness argument would say that the homeowner should not suffer the burden of having a defense stripped away when no good reason exists for conferring that benefit on the investor. If the investor has not given value to acquire the instrument, he will not lose anything by being subjected to defenses. Fairness, according to the conventional argument, should preclude stripping away these defenses in such a case.\textsuperscript{125}

\textsuperscript{122} 4 HAWKLAND & LAWRENCE, supra note 10, § 3-302:01, at 416.
\textsuperscript{123} See U.C.C. § 3-201(a) (defining “negotiation” as “a transfer of possession, whether voluntary or involuntary, of an instrument by a person other than the issuer to a person who thereby becomes a holder”).
\textsuperscript{124} U.C.C. § 3-302(a)(2)(i).
\textsuperscript{125} See Barry L. Zaretsky, Contract Liability of Parties to Negotiable Instruments, 42 ALA. L. REV. 627, 673 (1991) (“Perhaps to the extent that the person seeking enforcement is denied holder in due course status because he gave no value, it is fair to deny enforcement. The person seeking enforcement loses only an expectation, which would seem to be outweighed by the representative’s equitable position.”); U.C.C. § 3-303 cmt. 2 (noting that “[h]older in due course status is not necessary to protect” a party who will not suffer “an out-of-pocket loss”).
The Holder in Due Course Doctrine as a Default Rule 27

The conventional fairness argument uses similar reasoning to explain why a holder in due course must take an instrument in good faith and without notice of claims or defenses. A person who acts in bad faith, according to the argument, should not get the benefit of immunity from defenses at the expense of the innocent person who made an instrument. Similarly, in fairness, a person who knows an instrument has a problem should not have the right to take the instrument and impose the problem on its maker.

*810 The conventional incentives argument for the requirements in section 3-302 rests on a different assumption. The incentives argument postulates that stripping defenses will encourage transfers of instruments, and that not stripping defenses will discourage transfers of instruments. In other words, it assumes that an investor would prefer to buy an instrument free of defenses than to buy one that comes subject to defenses. The argument then justifies the limitations on who can become a holder in due course as serving to curb the incentives to take instruments when encouraging transactions would cause harm or serve no societal purpose.

For example, as noted above, section 3-302 says, among other things, that a person cannot become a holder in due course of an instrument that has gaps or irregularities or that has become overdue. The traditional incentives argument supports these restrictions on grounds that no good reason exists for creating an incentive for people to buy such instruments. Professors Robert Jordan and William Warren, who drafted much of the revised version of Article 3, summarized the conventional incentives argument for this rule by asking rhetorically: “If negotiability is a doctrine to promote the free flow of instruments, what social or economic gain is achieved by encouraging the currency of stale, irregular, or incomplete

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127 See Carrie Stradley Lavargna, Government-Sponsored Enterprises Are “Too Big to Fail”: Balancing Public and Private Interests, 44 HASTINGS L.J. 991, 1032 (1993) (arguing that granting holder in due course status to party with prior knowledge of defenses would be “unfair to innocent borrowers”).

128 See U.C.C. § 3-302(a)(1) (stating that person is not holder in due course if there is evidence of forgery or alteration in the instrument, or if it is so irregular or incomplete that its authenticity is called into question); id. § 3-302(a)(2)(iii) (stating that person must take instrument without evidence it is overdue to qualify as holder in due course).
instruments?" In other words, society does not need to create incentives to take such instruments, and thus the holder in due course doctrine should not apply.

The conventional incentives argument attempts to justify other requirements in section 3-302 in a similar way. For example, the argument justifies denying holder in due course status to a person who acquires an instrument by judicial process on grounds that such a person does not need the incentive that stripping away claims and defenses would provide. The requirement of good faith arguably strives to limit the incentive to take instruments in bad faith, which could harm society.

B. CRITICISM OF THE CONVENTIONAL POLICY ARGUMENTS

The conventional fairness and incentives arguments for the requirements in section 3-302, although widely accepted, have two flaws. First, they do not take into account the possibility of compensation for risk. Second, and perhaps more significantly, they see the limitations in section 3-302 as a means of regulating behavior without recognizing that parties generally can achieve negotiability without these limitations by using appropriately drafted waiver of defense clauses.

1. Compensation for Risk. Both the fairness argument and the incentive argument for conditioning holder in due course status rest on assumptions that have questionable economic validity. The fairness argument assumes that stripping away a maker’s defenses may impose risks on the maker in an unjust manner. This assumption, however, ignores the possibility that the maker of the instrument could receive compensation for the increased risk, and thus would suffer no unfairness.


130 See 4 HAWKLAND & LAWRENCE, supra note 10, § 3-302: 05, at 438 ("As to purchasers [at] judicial sales, etc., the drafters believed that the negotiability of instruments in general would not be promoted by granting them holder in due course status.").

131 Although parties who act in bad faith cannot become holders in due course, they still may negotiate instruments to others who thus become holders in due course. The Federal Trade Commission, in part for this reason, decided to prohibit merchants from taking negotiable notes in most consumer transactions. See FTC, Statement of Basis and Purpose, 40 Fed. Reg. 53,506, 53,509 (1975) (asserting that holder in due course rule "enables a merchant who engages in disreputable and unethical sales practices to establish and maintain a source of payment which assures him a place in the market, notwithstanding continuing breaches of contract and warranty").
For example, suppose a buyer wants to purchase goods from a seller by making a note. If the buyer-maker could waive the value requirement, the seller might offer him more favorable terms; the seller might prefer a note not subject to the value requirement because eliminating that requirement might increase the market for the note. The definition of value, as noted above, does not include an unperformed promise. As a result, the nonwaived value requirement prevents a third party who buys a note on credit from becoming a holder in due course until after making payment. Waiving the value requirement, however, would allow a third-party purchaser for credit to become a holder in due course immediately. This, in turn, would make a credit sale more attractive to that third party, and thus might bring the seller more consideration, part of which might pass to the maker as incentive to waive the value requirement. Therefore, although the maker may have no defenses against a third party who did not pay value, the maker might be compensated for this risk and thus would not unfairly be denied his defenses.

The conventional incentives argument has a similar difficulty. As noted above, the incentives argument rests on the idea that the holder in due course doctrine creates incentives for third parties to purchase negotiable instruments but that restrictions are required to prevent those incentives from encouraging certain harmful transactions. This assumption, however, fails to recognize that price adjustments may dilute any incentives that the holder in due course doctrine otherwise might produce. For example, suppose that a borrower issues two notes to a bank. One note is negotiable and the other note is not. Which note would an investor prefer to purchase from the bank? The question, as put, has no clear answer. Although the negotiable note will come free from claims and defenses, the investor almost surely will have to pay more for it than for the non-negotiable note because the purchase involves less risk. The market, indeed, may adjust the prices of negotiable notes and non-negotiable notes such that neither note represents a better overall bargain than the other.

For this reason, the requirements in section 3-302 that prevent a person from becoming a holder in due course in certain circumstances may not limit the incentives for their purchase. Instead, the requirements in some instances simply may alter the price of these instruments. Purchasers may

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132 U.C.C. § 3-303(a)(1).
133 See Mann, supra note 74, at 958 (observing that, all other things being equal, liquid assets will have greater value than illiquid assets).
be just as willing to buy the instruments at a lower price and subject to defenses, as they would at a higher price and free from defenses.

2. **Regulatory Effects.** In addition to overlooking economic considerations, the conventional policy arguments for restricting holder in due course status have another fundamental difficulty. *813 The arguments assume that section 3-302 can regulate conduct to protect innocent parties and promote socially beneficial transactions. This assumption, however, ignores the availability of alternatives to negotiable instruments.

As discussed previously, 134 parties can generally replicate the holder in due course doctrine by including waiver of defense clauses in ordinary contracts. If parties decide that they do not like the restrictions on who can become a holder in due course under section 3-302, they can draft contracts including waiver clauses that state different requirements for when assignees take free from defenses. For example, a waiver of defense clause could state: “The maker of this note will not assert any defenses against an assignee, even if the assignee acquires it after it becomes overdue.” This provision would allow an assignee to avoid one of the holder in due course requirements currently stated in section 3-302, 135 while still enjoying immunity from the maker’s defenses that holder in due course status would confer.

The ability to opt out of the Code and tailor waiver of defense clauses as desired deprives section 3-302 of much of its regulatory effect. The section cannot control conduct effectively because parties have the ability to ignore it. A policy argument for the requirements in section 3-302 must take this alternative into account.

C. UNDERSTANDING SECTION 3-302 AS A DEFAULT RULE

A better policy argument for the eight-requirements qualification as a holder in due course stated in section 3-302 parallels the argument for stripping claims and defenses under sections 3-305 and 3-306. In particular,

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134 Supra Part III.B.
135 See U.C.C. § 3-302(a)(2)(iii) (defining holder in due course as one who takes instrument without notice that it is overdue). Parties may not have the ability to opt out of all of the requirements in section 3-302. As noted above, although section 9-206(1) authorizes parties to use waiver of defenses in contracts involving security interests, it imposes mandatory requirements of good faith, value, and lack of notice of defenses or claims. Id. § 9-206(1) (1992 & Supp. 1997). The section, however, does not impose any of the other requirements stated in section 3-302. Id.
the requirements should exist because they potentially could reduce transaction costs. Although parties can draft their own waiver of defense clauses and can devise their own requirements for when a waiver takes place, section 3-302 acts as a default rule that applies to promises made in the form of negotiable instruments. If parties who wish to waive claims and defenses favor the default requirements in section 3-302, then the section can spare them the effort of drafting alternative requirements themselves. The section serves as a default rule, and thus saves transaction costs and promotes efficiency.

This revised policy argument avoids the problems associated with the conventional fairness and incentives arguments. The revised argument does not ignore the possibility of compensation for risk because it makes no claims about how stripping claims and defenses burdens or benefits either party. The revised argument also takes into account the ability of parties to draft their own waiver clauses; indeed, that possibility serves as part of the justification for having a set of requirements that most people would choose if they had to draft their own clauses.

The revised policy argument raises the question of why users of negotiable instruments would want holders in due course to meet the numerous specific requirements in section 3-302. The answer to this question, although perhaps interesting, has mostly academic value. If section 3-302 exists to save transaction costs, then the reason that people favor the requirements does not make much difference. So long as section 3-302 saves parties the trouble of drafting their own waiver clauses, then the section has value, regardless of what requirements it imposes.

With that caveat in mind, most of the requirements in section 3-302 appear to have straightforward economic explanations. Parties making or purchasing negotiable instruments face several risks. For instance, a person promising to pay money may worry that he or she will not receive the agreed-upon consideration. Meanwhile, a person purchasing a negotiable instrument may worry that the maker will assert a defense to payment. The parties may shift these risks around, but they generally cannot eliminate them. Most of the requirements in section 3-302 appear to reflect a desire to shift the risks to the party who can avoid them at the lowest cost.136

136 For a superb and extensive discussion of this idea, see Marie T. Reilly, The FDIC as Holder in Due Course: Some Law and Economics, 1992 COLUM. BUS. L. REV. 165, 203-13; see also Gillette, supra note 21, at 239 (similarly suggesting that holder in due course doctrine may serve to allocate risks).
*815 For example, suppose that a customer issues a non-negotiable note to a merchant and the merchant then sells it to a bank. There is a risk in this transaction that the merchant has given the customer defective goods. The customer and the bank cannot eliminate this risk. Yet, they can decide who should bear it between the two of them. If the customer does not waive defenses against subsequent assignees, then the bank will bear the risk; by contrast, if the customer does waive defenses, then the customer will bear the risk.137

In many instances, the customer would prefer to assume the risk because he has a better ability to assess it. The customer, for example, generally will know more about the underlying transaction than the bank because he deals directly with the merchant and obtains possession of the goods. Although the bank could assess the underlying transaction, it would incur investigation costs that could result in higher prices for the customer.138 As a result, the customer may prefer to pay less for the goods and bear the risk himself instead of paying more for the goods and placing the risk on the bank.139 The customer, accordingly, will make a negotiable instrument which will give the bank immunity from the risk.

In certain circumstances, however, the customer may not want to assume the risk. For example, if the bank knows that the customer has a defense, then the bank can avoid that risk at very little cost simply by not purchasing the instrument. As a result, the customer may want to place the risk of loss on the bank in that specific situation. Accordingly, although the customer ordinarily *816 will waive claims and defenses, the customer will not waive them when the bank has notice of defenses. Section 3-302, by

137 In either case, the customer and the bank may have rights against the merchant. For example, even if the bank takes the right to receive payment free from defenses, the customer may retain the right to recover from the merchant for breach of warranty. U.C.C. § 3-305 cmt. 3. Similarly, if the bank bears the risk and the customer asserts a defense, the bank may have a right of recourse against the merchant. RESTATEMENT (SECOND) OF CONTRACTS § 333(1) (1973); FARNSWORTH, supra note 18, § 11.8, at 815.

138 This is true because, after expending resources to assess the merchant-customer transaction, the bank might pay the seller less for the non-negotiable note than it would for a negotiable note that is free from investigation costs as well as most risk; if the bank pays the seller less for the non-negotiable note, then the seller may in turn charge the buyer more for the goods.

139 A non-negotiable note that did not contain a waiver clause would put the risk on the bank because the customer would retain the right to assert defenses. See RESTATEMENT (SECOND) OF CONTRACTS § 336(1) (1981) (asserting that assignee acquires only those rights the assignor had with respect to obligor).
denying holder in due course status to one who has notice of defenses,\footnote{U.C.C. § 3-302(a)(2)(vi).} implements this rational preference.

Other factors besides shifting risks may explain why people make negotiable instruments governed by section 3-302, even though they could opt out of the provision. For example, parties who lack legal sophistication simply may not realize that they have a choice. In general, however, the popularity of negotiable instruments suggests that, for whatever reason, people generally favor (or at least do not oppose) the restrictions on who can obtain the status of a holder in due course. If they did not like the requirements, they might draft their own waiver clauses more often.

V. IMPLICATIONS

The foregoing portions of this Article have argued that the holder in due course doctrine should exist, not for the conventional reasons given, but rather because the doctrine may reduce a specific type of transaction cost. If the law did not state that parties may take negotiable instruments free from claims and defenses, some makers of these instruments would want to draft waiver of defense clauses to implement that rule. The holder in due course doctrine has social value to the extent that it spares them this trouble.

This new understanding of the purpose of the holder in due course doctrine has three important implications. First, it contributes to the ongoing debate about the importance of the doctrine. Second, it indicates that efforts to reform the doctrine should focus on insuring that the doctrine reflects popular desires in commercial transactions. Third, it reveals that restrictions on using negotiable instruments will have little effect unless they also apply to waiver of defense clauses.

A. IMPORTANCE OF THE HOLDER IN DUE COURSE DOCTRINE

Over the past several decades, and especially following the recent revision of Article 3 of the Uniform Commercial Code, a number of \footnote{Supra note 74 and accompanying text.} authors have questioned the importance of the holder in due course doctrine. As noted briefly above, some writers contend that the doctrine no longer has much relevance because patterns of commerce have changed.\footnote{Rubin, supra note 8, at 786-95.}

Professor Edward L. Rubin, for example, surveyed all the major uses of negotiable instruments in a recent article.\footnote{Rubin, supra note 8, at 786-95.} He concluded that the holder
in due course doctrine generally does not affect checks and has little impact on promissory notes. Rubin explained that, with respect to checks, the holder in due course doctrine almost exclusively serves to protect check-cashing services that take paychecks from people who do not have bank accounts.\(^{143}\) Rubin also observed that non-U.C.C. law now prohibits using negotiable notes in most consumer transactions,\(^ {144}\) and that short-term commercial paper made by large corporations, although negotiable, does not circulate very much.\(^ {145}\) In addition, he noted that even though banks negotiate mortgage notes, homeowners rarely have defenses against lenders; thus, the holder in due course doctrine does not greatly affect them.\(^ {146}\) Other writers have expressed some reservations about these contentions, although they have not rejected them altogether.\(^ {147}\)

The policy argument developed in this Article has relevance to this debate. It supports the position that the holder in due course doctrine does not have much importance, but not for the reasons usually given. Whether or not the doctrine applies to many transactions, and whether or not courts use it to decide many cases, the doctrine has little significance; eliminating it probably would have little practical effect on commerce. If sections 3-305 and 3-306 *818 of the Code did not exist, parties generally could replicate their effects by adding waiver of defense clauses to their contracts. They could accomplish this task, as noted above, either by drafting the clauses themselves or by incorporating them by reference to predrafted provisions. Their private contracts would then operate in much the same way that negotiable instruments operate today.

For this reason, legislatures probably should not extensively worry about the holder in due course doctrine. Perhaps the doctrine saves parties some time and effort and insures that all businesses follow the same general rules. Yet, so long as commerce can shape ordinary contracts to suit its

\(^{143}\) Id. at 788.
\(^ {144}\) Id. at 789-90.
\(^ {145}\) Id. at 791-92.
\(^ {146}\) Id. at 793.
\(^ {147}\) See WHITE & SUMMERS, supra note 67, § 14-1, at 503-04 (arguing that holder in due course doctrine has been effectively eliminated in area of consumer paper transferred among sellers and lenders, but it has rendered many lenders who make direct loans to consumers subject to defenses that those consumers have against third-party sellers); Nyquist, supra note 66, at 922 (arguing negotiability is vital “whenever a transferee is granted rights to recover property free and clear of claims against that property in the hands of the transferee”).
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needs, it could survive without the holder in due course provisions in Article 3.

B. REFORMING THE DOCTRINE

The new understanding of the holder in due course doctrine also has an implication for future reforms. In particular, it suggests that proposals for significant amendments to sections 3-302, 3-305, and 3-306 should generally produce skepticism. To repeat, a person who wants to waive claims and defenses in favor of subsequent assignees can accomplish that result using either a negotiable instrument or an ordinary contract containing a waiver of defense clause. Yet, most parties who want to waive defenses choose negotiable instruments. This practice suggests that most people favor the current status of the holder in due course doctrine or at least do not see a pressing need to change it.

Even though the doctrine probably does not require revision at present, the new policy argument provides guidance for determining when and how to make future amendments. The argument, again, claims that the doctrine serves to reduce transaction costs by sparing parties the efforts of drafting their own waiver of defense clauses. In the future, if parties cease using negotiable instruments and start using waiver of defense clauses, then the doctrine no longer will provide a savings and will need adjustment so that it reflects more accurately what most people want.

For example, as described above, section 3-302 currently sets forth eight requirements for becoming a holder in due course. Suppose that in the future most parties decide they do not like one of these requirements, and decide to opt out of the doctrine by constructing waiver clauses that impose only the seven requirements that they favor. An amendment deleting the eighth requirement would then improve the doctrine.

Determining what to save and what to change will require detailed empirical study. Some evidence may come from parties that have decided to opt out of the present rules. One commentator, for example, has observed that “[f]inancial institutions often [have] preferred to use waiver-of-defense clauses to avoid some of the cumbersome formalities inherent in negotiable promissory notes.” If substantial evidence shows

148 Supra Part II.B.
149 See Rubin, supra note 8, at 797 (arguing for empirical research into what most people want in commercial transactions as means of developing rules that reduce transaction costs).
150 FARNSWORTH, supra note 18, § 11.8, at 813.
that this practice has continued, then perhaps the U.C.C. should shed some of those formalities and save these institutions the trouble.

C. RESTRICTIONS ON THE USE OF NEGOTIABLE INSTRUMENTS

The new understanding of the function of the holder in due course doctrine has another important implication that concerns restrictions on the use of negotiable instruments. The policy argument suggests that any attempt to regulate the use of negotiable instruments may prove ineffective unless the regulations also apply to waiver of defense clauses in contracts. Although legislative and administrative bodies sometimes have recognized this principle in the past, they have not done so in all instances.

The restrictions on the ability of consumers to make negotiable notes provides a helpful example of the relationship between negotiable instruments and ordinary contracts that contain waiver of defense clauses. As noted above, the U.C.C.C. (in contrast to the U.C.C.) generally prohibits anyone from taking a negotiable instrument, other than a check, in a consumer transaction. This restriction strives to prevent merchants from taking advantage of unsophisticated consumers who may not understand how the holder in due course doctrine works.

*820 The drafters of the U.C.C.C., however, recognized that simply banning merchants from taking negotiable notes from consumers would not guarantee protection from loss of defenses. Merchants could avoid the consequences of the ban by persuading consumers to waive their defenses in ordinary contracts. To prevent this end-run around the prohibition, the U.C.C.C. also bans waiver of defense clauses in certain consumer transactions. If the statute did not contain this restriction, its prohibition on taking negotiable instruments would have had little real effect.

In other situations, however, the drafters of rules designed to restrict the holder in due course doctrine have failed to consider the alternative of using waiver of defense clauses. For example, the drafters of the U.C.C. believed that the assignee of a negotiable instrument should not become a holder in due course simply because the assignee acquired the instrument through judicial process. This restriction, however, has a shortcoming.
Parties can avoid the limitation in most instances by using a waiver of defense clause that does not treat judicial sales differently from other assignments.\textsuperscript{154} If the drafters of the U.C.C. wanted to insure that only assignees who did not obtain instruments through judicial sales could become holders in due course, they would have been required to ban waiver of defense clauses that did not impose that restriction.\textsuperscript{155}

VI. CONCLUSION

This Article has sought to advance a thesis that both attacks and supports tradition. It calls into question the customary policy arguments for the holder in due course doctrine. Yet, at the same time, it suggests another justification for it, and consequently *821 argues that the holder in due course doctrine has a reason for existing, and probably does not need reform.

Policy arguments historically have done little to shape the holder in due course doctrine. The drafters of the U.C.C. for the most part merely sought to replicate the earlier provisions of the N.I.L.,\textsuperscript{156} while the drafters of the predecessor N.I.L. merely sought to replicate the common law.\textsuperscript{157} The judges who first upheld negotiability in common-law cases similarly wanted the law to reflect merchant practices, and generally did not focus on other policy arguments.\textsuperscript{158} The possibility that some policy arguments made for the doctrine after its creation might have flaws, therefore, should come as no surprise. This Article merely has attempted to devise a better rationalization for a doctrine that has long existed, and doubtlessly will continue to exist for some time.

\*822 APPENDIX

U.C.C. § 3-302. Holder in Due Course.

\textsuperscript{154} Nothing in Article 3 prevents this, and Article 9 expressly allows waiver of defense clauses without distinguishing judicial sales from other means of acquisition. \textit{Id.} § 9-206(1) (1995).

\textsuperscript{155} This failure, however, probably makes little difference because most people--again, for whatever reason--continue to make negotiable instruments.


\textsuperscript{157} See BRITTON, \textit{supra} note 8, at 14-17 (describing formulation of N.I.L.).

\textsuperscript{158} See \textit{id.} at 8-9 (noting that bills of exchange originated between merchant traders).
(a) Subject to subsection (c) and Section 3-106(d), “holder in due course” means the holder of an instrument if:

(1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity; and

(2) the holder took the instrument (i) for value, (ii) in good faith, (iii) without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, (iv) without notice that the instrument contains an unauthorized signature or has been altered, (v) without notice of any claim to the instrument described in Section 3-306, and (vi) without notice that any party has a defense or claim in recoupment described in Section 3-305(a).

(b) Notice of discharge of a party, other than discharge in an insolvency proceeding, is not notice of a defense under subsection (a), but discharge is effective against a person who became a holder in due course with notice of the discharge. Public filing or recording of a document does not of itself constitute notice of a defense, claim in recoupment, or claim to the instrument.

(c) Except to the extent a transferor or predecessor in interest has rights as a holder in due course, a person does not acquire rights of a holder in due course of an instrument taken (i) by legal process or by purchase in an execution, bankruptcy, or creditor’s sale or similar proceeding, (ii) by purchase as part of a bulk transaction not in ordinary course of business of the transferor, or (iii) as the successor in interest to an estate or other organization.

(d) If, under Section 3-303(a)(1), the promise of performance that is the consideration for an instrument has been partially performed, the holder may assert rights as a holder in due course of the instrument only to the fraction of the amount payable under the instrument equal to the value of the partial performance divided by the value of the promised performance.

(e) If (i) the person entitled to enforce an instrument has only a *823 security interest in the instrument and (ii) the person obliged to pay the instrument has a defense, claim in recoupment, or claim to the instrument that may be asserted against the person who granted the security interest, the person entitled to enforce the instrument may assert rights as a holder in due course only to an amount payable under the instrument which, at the time of enforcement of the instrument, does not exceed the amount of the unpaid obligation secured.
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(f) To be effective, notice must be received at a time and in a manner that gives a reasonable opportunity to act on it.

(g) This section is subject to any law limiting status as a holder in due course in particular classes of transactions.

U.C.C. § 3-305. Defenses and Claims in Recoupment.

(a) Except as stated in subsection (b), the right to enforce the 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 essential terms, or (iv) discharge of the obligor in insolvency proceedings;

   (2) a defense of the obligor stated in another section of this Article or a defense of the obligor that would be available if the person entitled to enforce the instrument were enforcing a right to payment under a simple contract; and

   (3) a claim in recoupment of the obligor against the original payee of the instrument if the claim arose from the transaction that gave rise to the instrument; but the claim of the obligor may be asserted against a transferee of the instrument only to reduce the amount owing on the instrument at the time the action is brought.

(b) The right of a holder in due course to enforce the obligation of a party to pay the instrument is subject to defenses of the obligor stated in subsection (a)(1), but is not subject to defenses of the obligor stated in subsection (a)(2) or claims in recoupment stated in subsection (a)(3) against a person other than the holder.

*824 (c) Except as stated in subsection (d), in an action to enforce the obligation of a party to pay the instrument, the obligor may not assert against the person entitled to enforce the instrument a defense, claim in recoupment, or claim to the instrument (Section 3-306) of another person, but the other person’s claim to the instrument may be asserted by the obligor if the other person is joined in the action and personally asserts the claim against the person entitled to enforce the instrument. An obligor is not obliged to pay the instrument if the person seeking enforcement of the instrument does not have rights of a holder in due course and the obligor proves that the instrument is a lost or stolen instrument.
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(d) In an action to enforce the obligation of an accommodation party to pay an instrument, the accommodation party may assert against the person entitled to enforce the instrument any defense or claim in recoupment under subsection (a) that the accommodated party could assert against the person entitled to enforce the instrument, except the defenses of discharge in insolvency proceedings, infancy, and lack of legal capacity.

**U.C.C. § 3-306. Claims to an Instrument.**

A person taking an instrument, other than a person having rights of a holder in due course, is subject to a claim of a property or possessory right in the instrument or its proceeds, including a claim to rescind a negotiation and to recover the instrument or its proceeds. A person having rights of a holder in due course takes free of the claim to the instrument.