

SECURED TRANSACTIONS / COMMERCIAL PAPER

Secured transactions = Article 9 of the UCC

Introduction

- What is the scope of Art 9?
 - o Applies to consensual security interest in personalty and fixtures
- How does creditor create an enforceable security interest in debtor's collateral – how does creditor attach?
 - o VCR – Value, Contract, Rights in the collateral
- Once attached, how does creditor attain perfection?
 - o By placing the world on record of its existence
- What are rules of priority when more than 1 creditor has stake in same collateral?
 - o Generally, first to perfect takes first
- What if debtor defaults on the debt?
 - o Art 9 creditor has statutory and judicial remedies

1) Scope of Art 9 of UCC

- a) Art 9 applies to consensual security interests in personalty (goods) or fixtures.
 - i) When collateral is real estate, apply law of *mortgages*.
 - ii) Does not apply to statutory or mechanics liens.
 - iii) Example: G borrows \$2mil from the bank and grants bank security interest in his business equipment.
 - (1) Are we in scope of Art 9?
 - (a) Yes
 - (2) Why?
 - (a) This is a voluntary transfer of a security interest in debtor's goods.
- b) Def:
 - i) Debtor: one who owes the money.
 - ii) Secured party or secured creditor: entity who lends the money.
 - iii) Security agreement: contract or record (writing).
 - iv) Security interest: right creditor has in debtor's personalty or fixtures.
 - v) Collateral: the personalty or fixtures creditor can look to for satisfaction.
 - (1) Could be:
 - (a) Tangible, such as:
 - (i) Consumer goods (furniture, appliances, car, etc.)
 - (ii) Equipment (used in business)
 - (iii) Inventory (held for sale)
 - (iv) Farm products (crops, livestock, supplies, etc.)
 - (v) Fixtures (lighting, sprinkler systems, furnaces, etc.)

(vi) For classifying tangible collateral, **look to primary use in the hands of debtor.**

1. I.e., golf clubs in hands of hobbyist are consumer goods. In retailer's hand, inventory. In Tiger's hands, equipment.
2. Classification is important on exam.

(b) Intangibles, such as:

- (i) Patents, trademarks, copyrights, stocks, bonds, mutual funds, proceeds from the sale of collateral, accounts, promissory notes (Art 3 – commercial paper)

2) **Attachment - creation of an enforceable security interest**

a) Attachment: security interest is enforceable.

b) Requirements for attachment: [VCR]

i) **Value** must be given by creditor.

- (1) I.e., bank lends \$50k to debtor, so bank has extended value.

ii) **Contract** (called security agreement) must evidence the secured transaction unless:

- (1) The secured party has taken possession of the collateral.

(a) If secured party is in possession of the collateral, there is no need for a record. But if debtor is in possession of the collateral, a security agreement is needed.

- (2) The record must:

(a) Be authenticated by debtor, and

- (i) Signed or electronically marked.

(b) Reasonably identify the collateral.

iii) **Rights** in collateral.

- (1) Debtor must have rights in the collateral.

(2) Example: M lends \$20k to K, who gives M a security interest in the Brooklyn Bridge. Can M look to the Brooklyn Bridge for satisfaction of the debt when K fails to pay?

- (a) No. Debtor does not have rights in the collateral.

c) After-acquired collateral clauses **are** enforceable

i) Example: secured party lends \$500k to Staples, taking a security interest in “all of Staples’ inventory, whether now held or after acquired.”

- (1) This is an after-acquired collateral clause (“floating lien”)

(2) It is enforceable.

3) **Perfection of security interests**

- a) Perfection is about publicity. It is something the secured party does to put the world on record or constructive notice of the secured party's existence.
 - i) Proper perfection helps protect the secured party from competing creditors.
 - ii) Example: D lends \$300k to S, taking a security interest in S's vintage album collection. D attaches (meaning that she has complied with VCR – she extended value, executed a valid contract and S has rights in the album collection). To protect herself from subsequent creditors who might stake a claim to the album collection, D promptly and properly perfects.
 - (1) Later, suppose that S, in need of quick cash, borrows \$100k from T, granting the same security interest in the albums. If S defaults:
 - (a) D defeats T – D has first priority in the album collection.
- b) How to attain perfection:
 - i) Taking possession of the collateral
 - (1) Example: S and R borrow \$5k from C with a security interest in their famous pig. C properly attaches and takes possession of the pig until the debt is repaid. What must C do to perfect?
 - (a) Nothing. Taking possession *is* perfection.
 - ii) Automatic perfection for purchase money security interests (PMSIs) in consumer goods.
 - (1) PMSI = security interest that enables the debtor to purchase the goods.
 - (a) To encourage retailers to extend credit.
 - (2) Example: Ethan Allen extends \$6k in value to enable Debtor to acquire a new bedroom set. Ethan Allen takes as collateral a security interest in the bedroom set.
 - (a) EA has a PMSI in a consumer good. Upon attachment, perfection is automatic.
 - iii) Secured party files notice of the interest in the public records.
 - (1) Proper filing puts competing creditors on record and constructive notice.
 - (2) UCC-1 is the document filed – a financing statement.
 - (a) Has just enough info to make follow-up inquiries.
 - (b) Contents: need only
 - (i) Debtor's name and address;
 - (ii) Creditor's name and address; and
 - (iii) Description of the collateral
 - (iv) Generic is ok – “all of debtor's assets”

- (3) Filing is with the state Secretary of State where the debtor is located.
 - (a) If debtor is individual, in state of principal residence.
 - (b) If debtor is registered organization, in state under whose laws it is organized.
 - (c) Exception:
 - (i) If collateral is timber, minerals or fixtures, file in the county (not centrally) where the realty is located.

4) **Priority**

- a) The secured party seeks to subordinate, not share.
 - i) Each claimant is entitled to full satisfaction before a subordinate can take.
- b) Def: [need to memorize!]
 - i) **BIOC – buyer in ordinary course**
 - (1) Someone who purchase the collateral from merchant's store.
 - ii) **PAC – perfected attached creditor**
 - (1) Art 9 creditor who succeeds in attaining perfection.
 - iii) **LC – lien creditor**
 - (1) General unsecured creditor who goes to court to get a judicial lien on the collateral.
 - iv) **NOCie – non-ordinary course buyer**
 - (1) Someone who purchases collateral from outside the ordinary stream of commerce.
 - (a) I.e., Steven Tyler buys a guitar from his auto mechanic.
 - v) **AUPie – attached unperfected creditor**
 - (1) Art 9 creditor who creates an enforceable security interest – it attaches but he either never bothers to perfect or tries to perfect but not properly.
 - vi) **GUC – general unsecured creditor**
 - (1) Lender never bothered to take collateral at all.
 - vii) This is the order, from first priority to last:
 - (1) **BIOC→PAC→LC→NOCie→AUPie→GUC**
- c) AUPie v. the world
 - i) AUPie will lose to any buyer without knowledge of the security interest.
 - ii) AUPie defeats any subsequent AUPie.

- d) PAC v. the world
 - i) **PAC defeats all except:**
 - (1) **The PAC who filed first**
 - (a) First in time, first in right
 - (i) Art 9 allows for **early filing** – even at onset of loan negotiations. If early filer subsequently attaches, priority will relate back to the early filing date.
 - 1. Example: on 1/1, C begins negotiating with R about lending him \$10k. On 1/1, C files a financing statement covering R's watch. Later, B lends R \$10k and on 2/1, B perfects a security interest in the watch. On 3/1, C and R finally reach an agreement and C lends him the \$10k with a security interest in the watch. Who has first priority?
 - a. C – she filed first and did later attach. Relates back to early filing date.
 - (2) **Certain PMSI holders**
 - (a) AACF (after-acquired collateral financier) and PMSI
 - (i) AACF = a secured creditor who takes as collateral a security interest “in all of debtor's..., whether now held or hereafter acquired.”
 - (ii) PMSI's are UCC favorites. They fuel consumption and are entitled to special treatment.
 - (b) AACF v. PMSI when collateral is equipment
 - (i) PMSI defeats AACF-PAC if PMSI files properly within 20 days of taking possession.
 - 1. Example: on 3/1, Macy's borrows \$2mil from bank granting bank a security interest in all of Macy's business equipment whether now held or hereafter acquired. Bank properly perfects its interest.
 - a. Bank is AACF PAC
 - 2. Example: later, on 8/1, Macy's buys 10 new registers on credit from Office Depot, granting it a security interest in the registers.
 - a. Office Depot is PMSI.
 - b. Registers are equipment.
 - 3. How can Office Depot get priority on the registers?
 - a. They must file properly within 20 days after Macy's takes possession of the registers.

- (c) ACF v. PMSI when collateral is inventory
 - (i) PMSI defeats ACF-PAC if PMSI files properly before debtor takes possession and notifies the PAC before debtor takes possession.
 - (ii) Example: on 10/1, same as above except Macy's purchases inventory.
 - 1. Bank is ACF PAC.
 - (iii) Later, on 1/1, Macy's gets a line from Armani on credit granting a security interest.
 - 1. Armani is PMSI
 - 2. Line of clothing is inventory.
 - (iv) How can Armani get priority on the clothes?
 - 1. They must file properly before debtor takes possession, and
 - 2. They must notify bank before debtor takes possession.
- 3. These requirements, for the PMSI to get priority, are to prevent debtor fraud, by getting value on extent of inventory when the inventory is already encumbered to someone else.

(3) **The BIOC**

- (a) PAC loses to BIOC
 - (i) Example: Bank has perfected security interest in Nordstrom's inventory. When Ms. Jones buys a handbag from Nordstrom's, she has good title to the merchandise. The bank can't come after it.

5) **Default**

- a) When debtor has breached.
 - i) This is not defined by Art 9 because a breach is what the security agreement says it is.
- b) Art 9 secured creditor can:
 - i) **Self-help repossession**
 - (1) Allowed as long as the creditor does not breach the peace (when party's actions are likely to cause violence).
 - (a) So the question is not whether a fight broke out but whether the secured party did something provocative or likely to cause violence.
 - (2) Repossession made over **any** protest by debtor, however mild, is a breach of the peace.
 - (a) Even debtor just saying "please stop" is enough.
 - (b) Misuse of the color of law (i.e., impersonating a police officer) is using constructive force and has breached the peace.
 - (3) Creditor's misconduct
 - (a) Civil and criminal penalties attach.

- (4) Repossession of collateral in the home
 - (a) May not enter debtor's home without voluntary and contemporaneous consent.
- (5) Repossession of collateral outside of home
 - (a) May take the collateral so long as there is not debtor objection.

ii) **Repossession by judicial action**

- (1) Get a judicial writ – writ of replevin - if no self-help.
- (2) Orders sheriff to obtain possession of the collateral and deliver it to the secured party.

iii) **Strict foreclosure**

- (1) Occurs when the secured party retains the collateral in full satisfaction of the debt.
 - (a) Creditor keeps collateral and the debt is discharged.
 - (b) Example: J borrows \$50k from bank, granting security interest in yacht. J defaults, still owing bank \$44k. Bank lawfully repossesses the yacht and properly accomplishes strict foreclosure.
 - (i) So bank retains the yacht and the debt is discharged.
- (2) To do it, secured party must send a written proposal to retain the collateral in satisfaction of the debt.
 - (a) When collateral is consumer goods, proposal sent to debtor and secondary obligors.
 - (i) Obligors – co-signers on loan.
 - (b) When collateral is not consumer goods, notice is sent to debtor, other secured parties who have told the foreclosing creditor of their security interest, perfected creditors, and secondary obligors.
 - (c) If any notified party objects within 20 days after notice sent, strict foreclosure is not allowed.
 - (i) Collateral must then be disposed of by sale.
 - (ii) Can object for any reason, or no reason.
- (3) Consumer goods and 60% rule
 - (a) If collateral is consumer goods and debtor has paid 60% of loan or cash price, strict foreclosure is not allowed.
 - (i) Collateral must then be sold within 90 days or be liable in conversion.

iv) **Sale**

- (1) Secured party may sell the collateral and apply proceeds to the debt.
 - (a) Every aspect of the sale must be commercially reasonable.
 - (b) Prior to sale, reasonable notice must be sent.
 - (i) Art 9 standard forms are presumptively commercially reasonable.
 - (ii) Who to send to:
 1. When collateral is consumer goods, proposal sent to debtor and secondary obligors.
 2. When collateral is not consumer goods, notice is sent to debtor, other secured parties who have told the foreclosing creditor of their security interest, perfected creditors, and secondary obligors.
 - (iii) Content of notice:
 1. If by public sale, must state time and place of sale.
 2. If by private sale, must state the time after which the sale will be made.
 - a. I.e., "please be advised that after 2/1/2006, secured party will sell the following collateral..."
 - (iv) Advance notice
 1. No standard but commercial reasonableness.
 2. In nonconsumer transaction, notice sent 10 days or more is reasonable.

- (2) Secured party may buy at a public sale but not at private sale (absent external market checks).

v) Action for a deficiency judgment

- (1) Example: if debt is \$100k and sale of collateral nets only \$60k, what can secured party do?
 - (a) Proceed against debtor for a deficiency judgment.
- (2) If secured party sells collateral at a low price to an inside buyer, the price that an independent 3rd party would have paid, rather than the actual amount paid, is the price used in calculating the deficiency.

c) Debtor's limited right of redemption

- i) Right to redeem is cut off once secured party has resold or completed a strict foreclosure.
- ii) To redeem, must pay amount owed + interest + creditor's reasonable expenses including atty fees.
 - (1) If security agreement contains an acceleration clause (allows creditor to say full balance of debt is due in event of default), to redeem, debtor must pay off entire debt + interest + expenses.

Commercial Paper = Article 3 of UCC

Bright line rule to know: when a negotiating instrument is duly negotiated to a holder in due course, the holder in due course takes the instrument free of all claims to it, free of personal defenses and subject only to real defenses.

Must determine:

- When is given writing a negotiable instrument as opposed to a mere contract?
- In these fact patterns, on what theories might def get sued?
 - o Only 2:
 - Contract or signature liability
 - Warranty or transfer liability
- How is a negotiable instrument duly negotiated – what makes the transfer proper?
- How does a transferee qualify as a holder in due course (HDC)?
- What are claims and personal defenses and what are real defenses?

1) **Types of negotiable instruments** – writings called for the payment of money

a) **Promissory note**

- i) “I promise to pay to the order of C \$50k” signed T.
- ii) It is a promise to the maker – containing an affirmative promise to pay and not just a mere IOU.
- iii) Parties:
 - (1) Promisor = maker
 - (2) Promisee = payee

b) **Draft** (it’s a check)

- i) The draft contains an order, an order to pay
 - (1) “Pay to the order of...”
- ii) Parties:
 - (1) Drawer gives the order
 - (2) Drawee is ordered to do the paying
 - (3) Payee is the beneficiary of order

c) **Indorser**

- i) Person who signs on the back

- d) How to tell whether a writing is a negotiable instrument (Art 3 promissor note or draft) or just a contract:
- i) **Negotiable instruments needs: “WOSSUPP”**
- (1) **Writing:**
- (2) **Payable to Order or bearer:**
- (a) Payable to order
- (i) To be negotiable, note or draft must:
1. Use the word “order” or
 2. Use word “assigns” in connection with the payee’s name.
 - a. Example: “pay to order of A,” “pay to the assigns of A,” or “pay to A or his order” are all ok.
- (b) Payable to bearer
- (i) If not payable to order, then to be negotiable, it must be payable to bearer, meaning that it is payable to anyone who has it.
 1. Example: “pay to bearer,” “pay to order of bearer” are ok.
- (ii) Statutory abnormalities provided by Art 3 that are ok:
 1. “Pay to cash”
 2. “Pay to the order of cash”
- (c) Trick – “Pay to A”
- (i) Nonnegotiable!! Just a contract because it doesn’t have the magic words.
- (3) **Signed by the maker or drawer:**
- (a) Note = signed by maker
- (b) Draft = signed by drawer
- (c) Can be anywhere on instrument, can be initials. Not a formal standard
- (4) **Reciting a certain Sum:**
- (a) You must be able to calculate how much is to be paid either from what the writing says or reference to an outside source.
- (i) Example: “\$75k principal amount + interest from date at 10%.”
 1. Negotiable – you can calculate from face of note.
- (ii) Example: “\$75k principal amount + interest.”
 1. Negotiable – when it does not state the rate of interest, the judgment rate will be applied.
- (iii) Example: “\$75k principal amount + interest at 3% above the prime rate charged by Bank as published on date of closing of loan.”
 1. Negotiable – ok to reference rate to outside sources.

(5) **Containing an Unconditional promise or order and no additional promises or orders:**

- (a) Note must have unconditional promise
- (b) Draft must have unconditional order
- (c) Conditional = contract
 - (i) Example: “I promise to pay if the Mets win the World Series.”
 - 1. Writing is a contract, not a negotiable instrument, because of the condition.
- (d) “Governed by” or “subject to” = contract
 - (i) But merely referring to another writing does not make the promise or order conditional.
 - (ii) Also not conditional to refer to another writing for a statement of rights with respect to collateral, prepayment, or acceleration.
 - 1. Example: “this note is secured by a security interest in collateral described in a security agreement between payee and maker. Rights and duties with respect to the collateral are stated in the security agreement”
 - a. This is negotiable.
- (e) Conditional if limits payment to a particular source or fund.
 - (i) Example: “I promise to pay from the funds I realize from my next wheat crop.”
 - 1. This is negotiable.
- (f) Example: “I promise to pay \$5k and give you my vintage Beatles collection.”
 - (i) This is nonnegotiable – no additional promises.

(6) **Payable on demand or at a definite time; and**

- (a) On demand:
 - (i) “on demand”, “at sight”, or “on presentation”
 - (ii) If silent as to time of payment, still negotiable and payable on demand.
- (b) Definite time
 - (i) Payable on or before a stated date or at a fixed period after a stated date.
 - 1. Example: “on or before 2/1/2010” is negotiable.
 - 2. Example: “90 days after 2/1/2010” is negotiable.
 - (ii) Acceleration clauses are ok.
 - 1. Example: “on 2/1/2010 but this becomes immediately due and payable if prior to that time the Giants win the Superbowl” is negotiable.
 - 2. Example: “payable when my first grandchild is born” is nonnegotiable because it is a future event not linked to a date certain.

(7) **Payable in currency**

- (a) Money, foreign currency
- (b) Not goods.
 - (i) Example: "I promise to pay by remitting my business equip."
 - 1. Nonnegotiable – contract.
 - (ii) Example: "I promise to pay by remitting an ounce of gold."
 - 1. Nonnegotiable
 - (iii) Example: "I promise to pay by \$5k or a rolex watch."
 - 1. Nonnegotiable

2) **Theories of liability** in commercial paper hypos

a) **Contract or signature liability**

- i) Def signed the negotiable instrument.
 - (1) When you sign it, you promise to pay it and that's how you get sued.
- ii) Def can be:
 - (1) Maker or promisor of the promissory note.
 - (a) Maker, by signing his name on the instrument, enters into a contract to pay the instrument.
 - (2) Indorser who signs his name on the back of the instrument.
 - (a) Example: E uses his Food Channel paycheck to purchase a meal at a restaurant. Restaurant requires E's indorsement on the back of the check. By doing so, E promises that if the check bounces and he is notified, he will pay.
 - (3) Drawer who signs the check.
 - (a) Example: you buy groceries and write a check. You are the drawer, who promises to pay.
- iii) Drawee who pays the draft, the bank, is not liable.
 - (1) The bank did not sign and this is signature liability.
- iv) If signature has words "without recourse" it is a disclaimer of liability. Used by indorsers and drawers.
 - (1) Example: J indorses his paycheck by signing "without recourse J"
 - (a) J passes title but assumes no signature liability.

b) Warranty or transfer liability

i) Seller's liability for selling a defective instrument.

ii) Def can be:

(1) Any transferor who sells the negotiable instrument.

(a) Not a donor.

iii) Plaintiff can be:

(1) If def indorsed the instrument, anyone in possession of it may sue.

(a) **When def indorses, warranties run with the instrument**

(b) Example: G indorses her paycheck from Paramount and remits her check to her agent for services rendered. Agent in turn remits check to stylist for services. Check bounces. May stylist sue G?

(i) Yes. G was not a donor and she indorsed the check.

(2) If def did not indorse the instrument, then only the def's immediate transferee may sue.

(a) Example: W, who never indorses his paycheck from NBC, remits the check to his agent for services. His agent remits to stylist. Check bounces. May stylist sue W?

(i) No. W did not endorse the check.

iv) Warranties made by def:

(1) That plaintiff has good title to the instrument.

(2) All signatures are genuine and authorized.

(a) So forgery is a breach of warranty.

(3) The instrument has not been materially altered.

(a) If facts tell you instrument has been tampered with, it is defective.

(4) There is no defense or claim good against def.

(a) This means that the instrument is enforceable.

(5) Def has no knowledge of any bankruptcy or insolvency action against maker or drawer.

3) Transferring a negotiable instrument

a) "Due negotiation" means there has been a proper transfer of the instrument.

i) Transferee is a holder and may be eligible to be a holder in due course.

(1) If improper transfer, then transferee cannot be a holder in due course.

b) Payable to order

i) When instrument is payable to order of a specific payee, negotiated by delivery of the instrument to that payee.

ii) Any further negotiation requires that payee indorse the instrument and deliver it to the transferee.

(a) Indorsement must be authorized and valid.

- (2) Example: P loses her paycheck, payable to her order. S finds it, signs P's name and cashes it at R's music shop. Is R a holder?
(a) No. Bad transfer. Instrument was payable to order, so the payee P had to indorse it.

c) Payable to bearer

- i) Indorsement is not required.

(1) Example: P loses her paycheck, payable to bearer. S finds it and cashes it at R's shop. Is R holder?

- (a) Yes.

d) Types of indorsements

- i) Every indorsement must be either special or blank, and restrictive or unrestrictive.

ii) **Special indorsement**

(1) One that names a particular person as indorsee. Indorsee must sign in order for the instrument to be further negotiated.

(a) Example: B indorses his paycheck "pay to H, signed B." H is the indorsee. H loses the check. J finds it, signs H's name, cashes at the shop. Is shop the holder?

- (i) No. Bad transfer because H never indorsed the check.

iii) **Blank indorsement**

(1) Does not name a specific indorsee. May be negotiated by delivery alone.

(a) Example: B indorses his paycheck by signing his name on back and delivers it to E, who loses it. J finds it and cashes it at store. Is store a holder?

- (i) Yes. This is a good transfer.

iv) **Restrictive indorsement**

(1) Contains a condition.

(a) Example: B indorses his check "for deposit only, B." L steals the check from B and cashed it at bank. Is bank holder?

- (i) No.

(ii) Bobby can recover from the bank for conversion.

4) **Holder in due course (HDC)**

a) HDC is a holder who takes the instrument:

i) For value; and

(1) This is not giving consideration.

(2) A promise is not value.

(a) Example: M indorses and delivers his paycheck to R. In return, R promises not to pitch at M's head for a year.

(i) This is not value – a promise is not enough. So R cannot qualify as HDC

(3) Old value is good value.

(a) Example: C indorses and delivers her paycheck to A, to pay him for furniture that he made her last year.

(i) A has given value and could qualify as HDC.

ii) In good faith; and

(1) Subjective test.

(2) Means honesty in fact.

iii) Without notice that it is overdue or has been dishonored or is subject to any defense or claim.

(1) Objective test.

(2) Did holder know or have reason to know of the problem?

(a) Notice that instrument is overdue – should have already been paid.

(i) If person has this notice, then they cannot be HDC.

1. If payment of principal is in arrears, it is overdue and no HDC.

2. If payment of interest is in arrears, then can be a HDC.

(b) Notice of defense or claim

(i) If instrument says VOID on face, cannot be HDC.

(ii) Example: A sells a chair to C. He misrepresents to C that it is an antique. C signs and delivers to A a negotiable note for \$4k for the chair. A indorses the note and sells note to S.

1. Between A and C, C's obligation to pay is voidable.

a. She has a defense to enforcement of promise to pay because A defrauded C.

2. Could S qualify as a HDC?

a. Yes if she did not have notice or reason to know of C's defense.

- (c) Notice of a competing claim to the negotiable instrument
 - (i) If instrument is lost or stolen from true owner, transferee could still be HDC if instrument has been duly negotiated and transferee did not have any knowledge or reason to know of theft or loss.
 - 1. Example: L steals check payable to cash from C and sells it to D. C discovers theft and confronts D. Who gets the check?
 - a. D, if it was properly transferred and D had no notice of theft.
 - (d) Notice that fiduciary negotiated instrument in breach of his fiduciary duty
 - (i) Example: B buys speedboat for his personal use. He pays dealer by indorsing and delivering to dealer a check payable to B's Fan Club.
 - 1. Dealer could be HDC if dealer did not actually know of the breach.
 - b) HDC and **Shelter rule**
 - i) Transferee acquires whatever rights her transferor had.
 - (1) Transferee takes shelter in the status of her transferor. So transferee has all rights of HDC even though they may be a donee or otherwise fail to qualify as HDC.
- 5) **Benefits of HDC**
- a) **HDC** (and those who take shelter in the status) **takes free from claims and personal defenses but subject to real defenses.**
 - b) A claim is a right to the instrument because of superior ownership.
 - i) If negotiable instrument is duly negotiated to a HDC, the HDC defeats the superior owner.
 - c) Personal defenses include every defense available in contract actions:
 - i) Lack of consideration
 - ii) Unconscionability
 - iii) Waiver
 - iv) Estoppel
 - v) Fraud in the inducement
 - d) Real defenses "MAD FIFI4"
 - i) **Material Alteration**
 - (1) Change in the terms of the instrument
 - ii) **Duress**
 - iii) **Fraud In the Factum**
 - iv) **Incapacity**
 - v) **Illegality**
 - vi) **Infancy**
 - vii) **Insolvency**

- viii) Example: Maker writes a check for \$100. Payee changes the amount to \$2,100. Then sells it to a HDC. Maker is liable for only \$100.
 - (1) But if maker was negligent, he is estopped from raising material alteration as a defense.
 - (a) Negligence includes leaving blanks or leaving wide spaces on the check.
- e) Real fraud – fraud in the factum
 - i) Means there is a lie about the instrument.
 - ii) Assertable against HDC.
 - iii) Example: L, who cannot read English, signs a promissory note after atty tells him it is a credit application. Even in hands of HDC, note is not enforceable.
- f) Personal fraud – fraud in the inducement
 - i) Personal defense, so ineffective against HDC.
 - ii) Example: F sells A a ring, telling her diamonds are antique. After paying for ring by check, A discovers it is fake. If check is now held by an HDC, A's defense cannot be asserted.
 - (1) This fraud is personal.
 - (2) Unlike the real fraud example, A knew that she was signing a negotiable instrument.