Holders in Due Course: Considerations for Purchasers of Promissory Notes and the Borrowers Who Made Them

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The financial turmoil of the past few years resulted in frequent sales of promissory notes from one party to another. Often these transfers took place through structured loan sales, business acquisitions or even bank closures. Invariably, questions or conflicts may arise as between the borrowers under such notes and the purchasers thereof. Specifically, the borrower (and sometimes guarantors) may assert that the purchaser is not entitled to certain rights under the subject promissory note, including the right to enforce payment of sums due there-under. This article is in-tended to address the rights, or lack thereof, that such a purchaser of a promissory note may possess.

Section 4-1-201(20) of the Colorado Revised Statutes ("C.R.S.") provides that a purchaser of a promissory note becomes the "holder" thereof. C.R.S. § 4-3-301 further provides that, as the holder of the promissory note, the purchaser is generally entitled to enforce said instrument. Unless evidence indicates that the signature of the borrower on the promissory note is invalid, Colorado courts have ruled that the mere production of the promissory note would ordinarily entitle the purchaser to enforce the borrower's obligations there-under. (See Reed v. First Nat. Bank, 48 P. 507 (Colo. 1897); Smith v. Weindrop, 833 P.2d 856, 858 (Colo.App. 1992)). However, where a borrower asserts certain affirmative defenses, further analysis may be necessary before the purchaser's rights can be determined.

Whether or not an affirmative defense can preclude the purchaser's enforcement of the promissory note against the borrower depends on two things: (A) whether the holder is a "holder in due course," and (B) the nature of the defense being asserted. A holder is typically considered a "holder in due course" ac-cording to C.R.S. § 4-3-302 (a) if:

> "(1) The instrument when … 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 a 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 4-3-306, and (vi) without notice that any party has a defense or claim in recoupment described in section 4-3-305(a)."

However, C.R.S. § 4-3-302(c) states that a person normally 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."

Typically, if a holder can satisfy all of the conditions set forth in § 4-3-302(a) and show that none of the circumstances set forth in § 4-3-302(c) apply to it, then it will be considered a holder in due course and will be protected against all defenses that might be asserted by a borrower except the following defenses set forth in C.R.S. § 4-3-305(b): (i) infancy of the obligor … (ii) duress, lack of legal capacity, or illegality of the transaction which, under other law, nullifies the obligation of the obligor, (iii) fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms, or (iv) discharge of the obligor in insolvency proceedings." Colorado case law provides that the burden of establishing an affirmative defense is on the borrower because note holders are deemed prima facie to be holders in due course.

In contested litigation, a borrower will make every reasonable effort to argue that the purchaser has failed to satisfy all those conditions set forth in C.R.S. § 4-3-302(a) or that certain circumstances such as those set forth in C.R.S. § 4-3-302(c) exist, thereby overcoming the presumption in favor of the purchaser. However, when a borrower adduces sufficient evidence to overcome said prima facie presumption, Colorado case law states that the purchaser is afforded an opportunity to prove that it (or its predecessor in interest) acquired the title as a holder in due course. In the event the purchaser can show that it is a holder in due course, only those defenses expressly set forth in C.R.S. § 4-3-305(a)(1) can be asserted against it (i.e., infancy, duress, lack of capacity, illegality, actual fraud and bankruptcy discharge).

An important consideration regarding the "fraud" exception set forth in C.R.S. § 4-3- 305(a)(1)(iii) is that said exception is applicable only to defenses founded upon "fraud in the factum," and not to defenses founded upon allegations of fraudulent misrepresentation or fraudulent inducement. Pursuant to Colorado law, such defenses are "unavailable against a holder in

due course.” (See Stotler v. Geibank Industrial Bank, 827 P.2d 608, 610 (Colo.App. 1992)). A common illustration of “fraud in the factum” is that of the maker who is tricked into signing a note in the belief that it is merely a receipt or some other document. The theory of the defense is that the signature on the instrument is ineffective because the signer did not intend to sign such an instrument at all.

Simply put, the ultimate determination of the rights and obligations of a borrower and a purchaser of a promissory note are highly fact-dependent and may require the opinion of a judge or other arbiter. Nevertheless, the law cited above should provide such a borrower or purchaser with a framework to achieve a preliminary evaluation of the merits of its position and its ability to avoid and/or enforce obligations under a promissory note.