



1950

Illegality as a Real Defense Against a Holder in Due Course

Fred Charles
University of Kentucky

Follow this and additional works at: <https://uknowledge.uky.edu/klj>

 Part of the [Contracts Commons](#)

Right click to open a feedback form in a new tab to let us know how this document benefits you.

Recommended Citation

Charles, Fred (1950) "Illegality as a Real Defense Against a Holder in Due Course," *Kentucky Law Journal*: Vol. 38 : Iss. 3 , Article 12.
Available at: <https://uknowledge.uky.edu/klj/vol38/iss3/12>

This Note is brought to you for free and open access by the Law Journals at UKnowledge. It has been accepted for inclusion in Kentucky Law Journal by an authorized editor of UKnowledge. For more information, please contact UKnowledge@sv.uky.edu.

ILLEGALITY AS A REAL DEFENSE AGAINST A HOLDER IN DUE COURSE

As a general rule illegality of consideration is not recognized as a defense against a holder in due course.¹ However, in most jurisdictions there is an exception to this rule when the instrument arises from an illegal transaction which is declared void by statute. The Kentucky Court of Appeals has adopted this exception.²

A situation which may give rise to such a problem is this: A and B are involved in a gaming transaction, as a consequence of which A gives to B either his promissory note or, more commonly, a check. Subsequently, B negotiates the instrument to C, a holder in due course. On proper presentment of the instrument, payment is refused. C then seeks recourse against B, the payee-indorser, and to his surprise he finds that B is either insolvent or has absconded. C is therefore unable to secure satisfaction of the instrument if no recovery is allowed against A.

In this hypothetical situation C will be given no relief under the Kentucky holdings. He has become a financier of an illegal transaction. Kentucky, by statute, makes every wagering or gaming contract void.³ A check or promissory note comes under the effect of this statute, those instruments being construed under the Negotiable Instruments Law as formal contracts.⁴

It is unquestioned that the enactment of such a statute reflects a wholesome public policy. But, one the other hand, it is also in the public interest that a holder in due course should be allowed to recover on the instrument he holds even though it arose from an illegal transaction.

The Negotiable Instruments Law is very thorough and concise in specifying what constitutes a holder in due course and what position he holds as a result of that status. To be a holder in due course, one must take 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.⁵

There is only one specific reference to illegal consideration set forth in the NIL. That reference states that a person's title to an instrument is defective when such instrument was acquired for an illegal consideration.⁶ However, if the holder has no notice of the defect in the title of the person negotiating the instrument, and if he meets the other requisites for a holder in due course, he then holds the instrument free from any defect of title of prior parties among themselves and may enforce payment of the instrument for the full amount against all parties liable thereon.⁷ Thus, under the Uniform Negotiable Instruments Law it takes

¹ 3 WILLISTON, CONTRACTS, sec. 1676 (3rd ed. 1922).

² Whitaker v. Smith, 255 Ky. 339, 73 S.W. 2d 1105 (1934); Levy v. Doerhoefer s Ex'r., 188 Ky. 413, 222 S.W. 515 (1920); Alexander & Co. v. Hazelrigg, 123 Ky. 677, 97 S.W. 353 (1906).

³ KY. R. S. sec. 372.010 (1948). KY. R. S. sec. 360.020 (1948) is a similar statute declaring void usurious rates of interest.

⁴ 1 WILLISTON, CONTRACTS, sec. 7 (1926).

⁵ KY. R. S. sec. 356.052 (1948).

⁶ KY. R. S. sec. 356.055 (1948).

⁷ KY. R. S. sec. 356.057 (1948).

no strained construction to conclude that illegal consideration is merely a personal defense and is not to be invoked when the tainted instrument finds its way into the hands of a holder in due course.

Did the adoption of the Negotiable Instruments Law operate as a repeal by implication of those particular statutes repugnant to its provisions? A majority of the courts have held that where, prior to the NIL, a statute made a contract void, even as against a holder in due course, such statute remains in force after the enactment of the NIL.¹⁰ One of the few cases expressing a contrary rationalization was decided shortly after the passage of the NIL. The opinion in that action very prominently states:

“ we know, moreover, that the great and leading object of the act, not only with Congress, but with the large number of the principal commercial States of the Union that have adopted it, has been to establish a uniform system of law to govern negotiable instruments wherever they might circulate or be negotiated. It was not only uniformity of rules and principles that was designed, but to embody in a codified form, as fully as possible, all the law upon the subject, to avoid conflict of decisions, and the effect of mere local laws and usages that have heretofore prevailed. The great object sought to be accomplished by the enactment of the statute was, to free the negotiable instrument, as far as possible, from all latent or local infirmities that would otherwise inhere in it, to the prejudice and disappointment of innocent holders, as against all the parties to the instrument professedly bound thereby. This clearly could not be effected so long as the instrument was rendered absolutely null and void by local statute ”

In states where a statute does not expressly or by necessary implication make the instrument void, but merely declares the instrument illegal or the transaction out of which it arose illegal, a holder in due course may recover notwithstanding the illegality.¹¹ The same result is reached in those jurisdictions which give a “voidable” interpretation to the word “void.”¹²

Those rulings which declare the instrument void *ab initio*, due to the illegality in the inception of the instrument, are of one mind in stating that such a construction is essential to a wholesome public policy. They seem to take the attitude that the prevention of crime is of more importance than the fostering of commerce. If it were necessary to make a choice between these two alternative policies then those particular holdings denying the innocent holder a remedy would be justified.

¹⁰ *Plank v. Swift*, 187 Iowa 293, 174 N.W. 236 (1919); *Levy v. Doerhoefer's Ex'r.*, 188 Ky. 413, 222 S.W. 515 (1920); *Elkin Henson Grain Co. v. White*, 134 Miss. 203, 98 So. 531 (1924); *Fisher v. Brehm*, 100 N.J. 341, 126 Atl. 444 (1924); *Sabine v. Paine*, 223 N.Y. 401, 119 N.E. 849 (1918); *Larschen v. Lantzes*, 115 Misc. 616, 189 N.Y. Supp. 137 (1921); *Farmers' State Bank v. Clayton Nat. Bank*, 31 N.M. 344, 245 Pac. 543 (1926); *Hall v. Mortgage Security Corp. of America*, 119 W. Va. 140, 192 S.E. 145 (1937).

¹¹ *Wirt v. Stubblefield*, 17 App. D.C. 283, 287 (1900). *Accord*, *Sakon v. Santini*, 257 Mich. 91, 241 N.W. 160 (1932); *Wolford v. Martinez*, 28 N.M. 622, 216 Pac. 499 (1923).

¹² *City Nat. Bank v. De Baum*, 166 Ark. 18, 265 S. W. 648 (1924); *First Nat. Bank v. Combs*, 237 Ky. 834, 36 S. W. 2d 644 (1931); *Whitman v. Fourier*, 233 Mass. 154, 125 N. E. 303 (1919); *Winecoff Operating Co. v. Pioneer Bank*, 179 Tenn. 306, 165 S. W. 2d 285 (1942).

¹³ *J. Furman Evans Co. v. Bryson*, 146 Ga. 278, 91 S. E. 71 (1916); *Ranier v. La Rue*, 83 Ind. App. 28, 147 N. E. 312 (1928); *Modern Industrial Bank v. Hegeman*, 54 N. Y. S. 2d 251 (1945); *McCardell v. Davis*, 49 S. D. 554, 207 N. W. 662 (1926); *Rosenblum v. Gomall*, 52 Utah 206, 173 Pac. 243 (1918).

Little concern, however, is given to the fact that not only could the prevention of crime continue to be fostered, but at the same time a cloud could be removed from the world of commercial paper. This passive attitude is very apparent from the frequently quoted phrase, "the disappointment now and then of an innocent holder of a negotiable instrument would not be as hurtful and injurious to the best interests of the states as the removal of the ban from gaming contracts."¹² Does this construction of such a statute¹³ reflect the true legislative intention by doing such a gross injustice to an innocent party? By declaring the instrument void *ab initio*, the courts may well be giving protection to that which the legislatures have prohibited. Not only is the holder in due course without a remedy, but the obligor to the illegal transaction is relieved of all liability on the instrument. An Oklahoma court used apt phraseology in stating, "The penalty of one's folly in engaging in a losing and illegal enterprise at cards cannot under the present state of law be visited on an innocent holder in due course of commercial papers."¹⁴ It has been pointed out that every restriction put upon negotiable paper in an injury to the state for it tends to derange trade and hinder the transaction of business.¹⁵

In determining if such a construction of these statutes is conducive toward a sound public policy, consideration must be given to another phase of this problem. By declaring the illegal transaction absolutely void, a very tempting stage is set for the perpetration of a fraud without an illegal transaction ever occurring. Thus, in the hypothetical situation A and B could connive to put C in such a position with both sharing in the resulting proceeds.

The only exception to the rule which denies a holder in due course relief on an instrument which arises from a transaction expressly declared void by statute is accomplished by way of estoppel. Thus, if the maker or drawer of the illegal instrument induces the innocent holder to purchase the instrument on the assurance that it is valid and subsisting, the maker or drawer is later estopped from invoking the defense that it was given for an illegal consideration.¹⁶ Even here an Illinois case held that where by statute a note given for a gambling transaction was void, it was void for all purposes, and what the law makes void, estoppel cannot make valid.¹⁷ However, such a holding is decidedly contrary to the weight of authority and is not in accord with the theme of the NIL which allows an estoppel to be invoked where the instrument would otherwise be void.¹⁸

One of the prime objectives sought to be achieved under the Law Merchant and later under the NIL was the free circulation of commercial paper as a substitute for money. As long as negotiable instruments are subjected to laws foreign to the Uniform Negotiable Instruments Law the purpose of the act is to some extent frustrated. Not only are laws which set up illegalities as defenses against a holder in due course unjust, but such a practice makes for a destabilizing effect on commercial paper.

The outstanding objection to giving the holder in due course relief is that such a holding would tend to remove the ban from the illegality sought to be prohibited. However, will relieving the violator of his obligation on the illegal

¹² Alexander & Co. v. Hazelrigg, 123 Ky. 677 97 S. W. 353 (1906).

¹³ See notes 3 and 4, *supra*.

¹⁴ Huffman v. Kohn, 167 Okla. 389, 29 P. 2d 767 768 (1934).

¹⁵ Chemical National Bank v. Kellogg, 183 N. Y. 92, 75 N. E. 1103 (1905).

¹⁶ Pritchett v. Ahrens, 26 Ind. App. 56, 59 N. E. 42 (1901); Blades v. Newman, 19 Ky. L. Rep. 1062, 43 S. W. 176 (1897); See Holzbog v. Bakrow, 156 Ky. 161, 160 S. W. 792, 794 (1913).

¹⁷ Kyser v. Miller, 144 Ill. App. 316 (1908).

¹⁸ Ky. R. S. sec. 356.023 (1948); Ky. R. S. sec. 356.124 (1948).

instrument have a deterrent effect on that which is sought to be prohibited? This can hardly be answered in the affirmative. The obligor on the illegal instrument is probably more apt to continue his illegal practices once his immune status is established. Also, these holdings have a tendency to throw suspicion on negotiable paper and retard its free circulation. These objections coupled with the fact that it results in hardship and individual injustice to the holder in due course should be sufficient basis for enforcing the illegal instrument against the maker or drawer.

It is therefore submitted that the statutes declaring the illegal transaction void, should be reconciled with the provisions in the NIL to allow a more harmonious and equitable result. Such a conclusion could be attained by construing those particular statutes declaring certain contracts void as only applicable to the original parties to the transaction and their assigns with notice. The manifest purpose of the NIL to give protection to the holder in due course could then be carried into full effect. Such a construction would in no manner promote the illegalities sought to be prohibited, and at the same time the courts would no longer be giving protection to that which the legislatures have prohibited.

FRED CHARLES