The F.T.C. Does Lord Mansfield In

Ralph J. Rohner
The Catholic University of America, Columbus School of Law

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AFTER YEARS of writhing agony at the hands of courts and legislatures, one of the most venerable of legal rules has bitten the dust, and it happened right here in Washington, D.C. The victim is the holder in due course rule as it applies to consumer credit transactions. The slayer is neither the Supreme Court nor the Congress but the oft-maligned Federal Trade Commission.

The seismic event occurred just before Thanksgiving of 1975 when the commission issued its final version of a trade regulation rule entitled "Preservation of Consumers' Claims and Defenses." The rule was officially promulgated on November 14, 1975, and may be found beginning on page 53505 of the Federal Register for November 18. Its effective date will be May 14, 1976.

Holder in Due Course Abolished

What the rule does, in a nutshell, is declare it to be an "unfair or deceptive act or practice" under the Federal Trade Commission Act for any retail seller to take any consumer obligation which purports to cut off the consumer's defenses against the seller when that obligation is transferred on to a third-party financier. For anyone whose memory can't recall exactly the holder in due course idea, look no further. It was said, in its simplest formulation, was that the holder in due course was indispensable in the widespread availability of the credit consumer.

Thus far—at least in this city—the reaction has been much like that which followed Lincoln's Gettysburg address: a silence, both stunned and awed. Elsewhere, one newspaper columnist has declared that "consumers have finally hit the jackpot" and has called May 14, 1976, "the effective date of the consumers' declaration of independence from that infamous, outrageous, and oppressive rule of law." While most creditors apparently are taking a resigned view that the abolition of holder in due course was inevitable, one Midwest banker has written the F.T.C. in outrage, indicating he will promptly withdraw his bank from all consumer financing and consumer lending unless the commission reverses its ruling.

Precedent for Financer Protection

In order to appreciate the significance of this new rule, one needs to understand its background. The holder in due course concept was first articulated in opinions of Lord Mansfield for the King's Bench in the mid-eighteenth century. What it said, in its simplest formulation, was that the good-faith purchaser for value of an instrument held it free from the most common defenses the maker might have against the original creditor. Transposed to the consumer marketplace in this country in the years following World War II, the rule has helped banks and finance companies to invest in consumer obligations, or buy them outright, with very little risk that those obligations would be uncollectible because of mal-performance by the seller. Holder in due course, the credit industry argued, was an essential enabling element in the widespread availability of the credit consumers wanted to be able to enjoy the good life.

The doctrine had its effects when consumers had to pay for defective or undelivered goods or services, and the legal gimmickry that protected the financiers was always almost always included in the boilerplate terms of the contract—rarely read and rarely understood by the consumer. Assaults on the doctrine were frequent, persistent, and often vitriolic. When the original 1969 version of the Uniform Consumer Credit Code took an equivocal position on holder in due course, consumer spokesmen unloaded on it. The F.T.C. itself that same year began finding in individual cases that the use of cut-off devices was an unfair or deceptive practice.

Thus it was not altogether surprising in 1971 when the commission first proposed a trade regulation rule on the subject. The proceeding dragged on, with huge amounts of testimony and materials being accumulated, but with no consensus as to what the rule should include. The proceeding was reopened with a revised proposal in early 1973, and more hearings were held in Washington and other cities. For two years the entire matter lay dormant. In late 1974 Congress enacted a limited measure dealing with holder in due course problems in credit card transactions, but still there was no indication of imminent final action from the commission on its much more comprehensive rule.
In the meantime many states had taken the initiative to deal with holder in due course in legislation. More than forty states have statutes curtailting the doctrine to some extent. A new 1974 version of the Uniform Consumer Credit Code took a much harder line against holder in due course protections, including the so-called related lender pattern of dealing. I have reviewed the entire history in some detail in an article, "Holder in Due Course in Consumer Transactions," in the April, 1975, issue of the Cornell Law Review.

Objections to the Rule

By midsummer 1975 rumors spread that the commission and its staff had not given up on the rule but, in fact, were polishing it up for final issuance. No one could claim surprise when it did appear. And now, months later, reflective reactions and assessments are just beginning to surface.

The commission, accompanied the final rule with a 150-page statement of basis and purpose, which is well worth reading for those who want to explore the commission's own reasoning. Amply documented with citations to its own four-and-a-half year record, the statement lays out the commission's findings with respect to the uses of negotiable notes, waiver-of-defense clauses, and sale-related loans. Objections to the rule are analyzed and critiqued, and the commission's own purposes and justifications are explained.

According to the commission: "Our primary concern, in the course of these proceedings, has been the distribution or allocation of costs occasioned by seller misconduct in credit sale transactions. These costs arise from breaches of contract, breaches of warranty, misrepresentation, and even fraud. The current commercial system, which enables sellers and creditors to divorce a consumer's obligation to pay for goods and services from the seller's obligation to perform as promised, allocates all of these costs to the consumer/buyer. Consumers are generally not in a position to evaluate the likelihood of seller misconduct in a particular transaction. Misconduct costs are not incorporated in the price of the goods or services, nor are they reflected in any deferred payment price or unpaid balance of a sales-related loan. Seller misconduct costs are thus externalized in a way that renders many sales finance transactions inherently deceptive and misleading.

In addition, to the extent that consumers are also compelled to bear the costs occasioned by the misconduct of another, while the 'guilty' party avoids all liability, we believe that reliance on contractual foreclosures of equities in consumer transactions constitutes an unfair practice under Section Five of the F.T.C. Act." To this, I say "Amen." There are so many bogeymen invoked in debates over consumer credit regulation—the most common is that restrictions on unconscionable creditor practices will dry up sources of credit or price it beyond the reach of most consumers—that it is to the credit of the commission and its staff that they took the time to separate the wheat from the chaff and produce a rule both simple and comprehensive. The argument that creditors need holder in due course protection to keep costs down and to make credit available was deflated by the commission, which noted also that it might be distinctly good to dry up the sources of credit for the food-freezer rackets, the home improvement swindlers, and the vanishing health spa operators.

The best quoted remark in the record to me is this, by Prof. Homer Kripke of the New York University Law School, himself a longtime finance company lawyer: "The banks ought to be ashamed of arguing that they are serving merchants whose injuries to their customers are so substantial as to constitute a significant impairment of the collectibility of the obligations."

Recoveries Allowed

The critical paragraph that must appear on every credit obligation is deceptively simple, but there are some careful and judicious decisions underlying it. For example, the commission avoided the mistake of the original U.C.C. of limiting the consumer to a defense or set-off against a claim by the creditor, thus apparently denying the consumer a right to seek reformation or rescission. The rule expressly allows affirmative recoveries up to the amount paid to the creditor. The commission also declined to have the disclosure statement spell out time limits for asserting rights and refused to put into the definition of purchase money loan a laundry list of presumptive connections between a seller and a lender. The first of these would necessarily have been arbitrary, to some consumers' disadvantage, and the second would tend to hamstring enforcement efforts with endless factual disputes about the extent and nature of the relationship.

Somewhat surprisingly the rule does not touch credit card transactions. The commission says that is because they simply found no evidence of a problem with credit cards, but this is hard to reconcile with the F.T.C. Act's express directive to prevent future abuses. More likely the commission was shying away from any possible conflict with the Fair Credit Billing Act, which does put some limits on holder in due course in credit card plans.

At the same time there are some gaps, loopholes, and other potential stumbling blocks to the full implementation of the rule, and they should be noted.

The rule may be challenged in court by creditor interests on the allegation that it exceeds the commission's authority. Although doomed to fail, this tactic could delay the rule's full effectiveness. And a reactionary Congress conceivably could overturn it by statute, but this is even more unlikely.

Some litigation will be needed to flesh out the meaning of parts of the rule, such as the definition of a "purchase money loan." When, for example, does a seller "refer customers to the creditor"? When exactly are a seller and a creditor "affiliated . . . by common control, contract or business arrangement"?

By its terms the rule proscribes only conduct by "sellers." This means that a fly-by-night operator who may be willing to risk F.T.C. prosecution might generate quantities of consumer paper without the required legend and discount it to unsuspecting financiers. Since violations of the F.T.C. Act do not constitute per se actionable private wrongs, those creditors might invoke holder-in-due-course swords against those consumers. In any case in which a third-party creditor is a knowing collaborator in violations of the rule, he is for the moment beyond reach of the enforcement authorities. The commission, however, simultaneously with the issuance of this rule, has issued a proposed revision of the rule to extend its
Section Membership Dues Raised

At the 1975 annual meeting in Montreal, the House of Delegates approved the recommendation of the Section of Insurance, Negligence, and Compensation Law to increase its membership dues from $12.00 to $17.50 a year. The dues increase will apply to the Association year 1976-77 and will be reflected in the first billing for that year.

Scope to creditors as well as sellers. Comments on this proposal and proposed issues of fact were due by January 15, 1976, and we may only hope that this logical extension of the rule is not deferred another four and a half years.

Since the F.T.C.'s jurisdiction does not include banks, there is a potential loophole for credit transactions other than sales. Lenders conceivably could still do a brisk business in notes that are discounted to old-fashioned holders in due course. Although apparently not required to do so by the recent Federal Trade Commission Improvements Act, which calls for parallel regulations, the Federal Reserve Board probably will issue soon a companion regulation binding on banks. This will not only close down this loophole but bring the enforcement authority of the banking regulatory agencies to bear on creditors who might be inclined to skirt the F.T.C. rule.

The most frustrating aspect of the rule is that its enforcement is left almost completely in the hands of the commission itself. This, of course, is the nature of trade regulation rules. Even with the expanded powers given it in the Federal Trade Commission Improvements Act (Public Law 93-637), the commission is still notoriously short of the resources needed to be a vigilant policeman of its own rules throughout the country. Although the commission's jurisdiction now runs to activities both "in" and "affecting" commerce and it now has statutory authority to seek restitution for injured consumers, the public will have to keep its fingers crossed that the commission can adequately detect, investigate, and move against serious violators. What could and ought to happen is that the state legislatures or Congress will see the advantage of and need to convert the rule to statutes enforceable by the affected individuals themselves.

And so, without great fanfare, the burden of holder in due course has been lifted from the American consuming public. Or soon will be. And the "good guys" in the piece are the folks at the tip of the Federal Triangle in Washington.

1976 ROSS ESSAY CONTEST

The following information is furnished for contestants in the 1976 Ross Essay Contest, which is conducted by the American Bar Association pursuant to the terms of the bequest of Judge Erskine M. Ross.

**Time for Submission:** On or before April 1, 1976

**Amount of Prize:** $5,000

**Subject:** "Should the Code of Professional Responsibility be amended to make better known to the public the availability of legal services?"

**Eligibility:** The contest will be open to all members of the Association in good standing, including new members elected prior to March 1, 1976 (except previous winners, members of the Board of Governors, officers and employees of the Association), who have paid their annual dues to the Association for the fiscal year in which the essay is to be submitted.

**Essay Requirements:** No essay will be accepted unless prepared for this contest and not previously published. Each entrant will be required to assign to the Association all right, title, and interest in the essay submitted. It is the policy of the Association to return all the winning manuscript after the judges have made their decision and to release the assignment of rights.

**Instructions:** All necessary instructions and complete information with respect to the number of words, number of copies, footnotes, citations, and means of identification may be secured on request to the Ross Essay Contest, American Bar Association, 1155 East Sixtieth Street, Chicago, Illinois 60637.

Notice by the Secretary of the American Bar Association Regarding Election of Assembly Delegates

- Five Assembly delegates to the House of Delegates will be elected at the 1976 annual meeting for three-year terms beginning with the adjournment of the meeting and ending with the adjournment of the 1979 annual meeting. Candidates for election as Assembly delegates are to be nominated by written petition. For the 1976 election in Atlanta, Georgia, the deadline for filing nominating petitions is May 28, 1976.

  If more than one resident of the same district submits nominating petitions, each will be notified within ten days of the fact that there is more than one nominee from that district. Under the constitution, no more than one nominee from a particular district may be elected in the annual election. Districts are defined in Section 2.1 of the constitution.

  Voting, by I.B.M. ballot, will be in the registration area of the headquarters hotel. The polls will be open during the same hours as the registration area, except on the last day the polls will close at 11:00 A.M. The votes will be tallied and the five nominees with the highest number of votes (taking into account that no more than one may be elected from the same district) will be declared elected as Assembly delegates. In the event of a tie vote, the secretary will determine the winner by lot. Rules which restrict campaigning for the position of Assembly delegate will be mailed to all nominees upon receipt of their petitions.

  Nominating petition forms may be obtained from the Office of the Secretary, American Bar Center, 1155 East Sixtieth Street, Chicago, Illinois 60637. The petition must be signed by twenty-five members of the American Bar Association. The signing by any member of one petition will not disqualify him as the signer of other petitions. Each petition must be filed with the secretary at the above address before the close of business at 4:45 P.M., Chicago time, May 28, 1976, together with the written consent of the nominee and the biographical sketch of the nominee in the form approved by the nominee and consisting of not more than fifty words. All biographical sketches will be printed and distributed to Association members as they register or collect their credentials at the registration desk at the annual meeting.

  Any questions regarding the foregoing should be sent promptly to the Office of the Secretary at the American Bar Center.

  Herbert D. Sledd, Secretary