Holder in Due Course in Consumer Transactions: Requiem, Revival, or Reformation?

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HOLDER IN DUE COURSE IN CONSUMER TRANSACTIONS: REQUIEM, REVIVAL, OR REFORMATION?

Ralph J. Rohnert†

It is hard, and it becomes each year harder, for counsel to explain convincingly why "the law" requires that a hard-pressed wage-earner who has been bilked by a now-insolvent seller into buying junk masquerading as a television set or a washing machine must pay the full price to a bank or finance company whose own relationship with the fraudulent seller has been intimate, long-continued and profitable.1

No area of consumer protection has produced as much near-religious ferment in recent years as that collection of rules which insulate third party financers from product-related claims or defenses of consumer purchasers. Courts,2 legislatures,3 agencies,4

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2 The case law is too plentiful to be collected into a single footnote, but is discussed throughout the balance of this Article. Epitomizing the cases is Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967), in which the New Jersey Supreme Court denied holder in due course status to a finance company on the basis of extensive and close connections between it and the seller. This oft-cited, lengthy opinion is now a departure point for most discussions of holder in due course; it has also become the standard law school casebook vehicle for treating the issue. See, e.g., R. Braucher & A. Sutherland, Commercial Transactions 277 (4th ed. 1968); V. Countryman & A. Kaufman, Commercial Law 383 (1971); H. Kripke, Consumer Credit 239 (1970); A. Maleson, B. Callahan & J. Beard, Cases and Materials on Contemporary Commercial Law 956 (2d ed. 1972); R. Nordstrom & A. Clovis, Commercial Paper 941 (1972); R. Speidel, R. Summers & J. White, Commercial and Consumer Law 606 (2d ed. 1974).
3 Upwards of 35 jurisdictions have restricted holder in due course to some degree, by statute. See Willier, Need for Preservation of Buyers' Defenses—State Statutes Reviewed, 5 UCC L.J. 132 (1972); notes 88-104 and accompanying text infra.
commissions, and commentators have assailed the holder in due course idea from all directions, so far as its application in consumer transactions is concerned. The cloud of rhetoric thus raised has tended to obscure the complexity of the subject, state only imperfectly the significant considerations, and oversimplify the appropriate legal responses. Moreover, the focus of much of this recent discussion has been on traditional notions of holder in due course. There are now important new developments in the form of the recommendations of the National Commission on Consumer Finance, a completely redrafted 1974 Uniform Consumer Credit Code, a new Model Consumer Credit Act drafted by the National Consumer Law Center, the possibly imminent promulgation of a holder in due course Trade Regulation Rule by the Federal Trade Commission, and, most recently, the enactment of a federal statute limiting holder in due course application in credit card transactions. This Article takes up the changing shape of the holder in due course controversy and outlines grounds for consensus as to future legislative policy.

5 National Comm'n on Consumer Finance, Consumer Credit in the United States xvii, 34-38 (1972) [hereinafter cited as NCCF Report].
6 The literature is voluminous. For significant recent contributions see Countryman, The Holder in Due Course and Other Anachronisms in Consumer Credit, 52 Texas L. Rev. 1 (1973); Littlefield, Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test, 39 S. Cal. L. Rev. 48 (1966); Littlefield, Preservation of Consumer Defenses in Interlocking Loans and Credit Card Transactions—Recent Statutes, Policies, and a Proposal, 1973 Wis. L. Rev. 471; Murphy, Another "Assault Upon the Citadel": Limiting the Use of Negotiable Notes and Waiver-of-Defense Clauses in Consumer Sales, 29 Ohio St. L.J. 667 (1968); Rosenthal, Negotiability—Who Needs It?, 71 Colum. L. Rev. 375 (1971).
7 NCCF Report.
9 Model Consumer Credit Act (1973) [hereinafter cited as MCCA]. This Act is not without predecessor. National Consumer Act (1970) [hereinafter cited as NCA].
10 1973 Proposed FTC Rule.

"Holder in due course" used to be a term of art, confined to the law of bills and notes, describing by very precise criteria the special status of certain transferees of negotiable paper. The gist of the holder in due course theory\(^{12}\) was that the bona fide purchaser for value of a note or draft duly negotiated to him in an arm’s-length transaction could enforce the instrument against a maker, drawer, or indorser free of most claims and personal defenses of such a defendant. The desirability of holder in due course status for anyone regularly purchasing commercial paper was obvious: to the extent he took free of claims and defenses he reduced his risks of nonrecovery and shunted to the consumer the risk of the merchant’s default or insolvency. It is hardly surprising, then, that the various institutional financers who underwrite the billions of dollars of consumer credit presently outstanding\(^{13}\) have sought holder in due course status, or its equivalent, for themselves. In the process, “holder in due course” has come to describe an array of techniques—some contractual, some statutory—by which creditors seek to insulate themselves from claims or defenses arising out of the underlying consumer transaction. A brief review of these techniques and their effects on consumer debtors will be useful.


\(^{13}\) By November 1974, the Federal Reserve Board reported that total consumer credit, excluding home mortgages, totalled \$188,084,000,000. It was distributed as follows, rounded to the nearest tenth billion:

<table>
<thead>
<tr>
<th>Installment Credit</th>
<th>Non-Installment Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automobile paper</td>
<td>$52.3</td>
</tr>
<tr>
<td>Other consumer goods</td>
<td>50.4</td>
</tr>
<tr>
<td>Home Improvements</td>
<td>$8.3</td>
</tr>
<tr>
<td>Personal loans</td>
<td>$44.2</td>
</tr>
<tr>
<td>Single-payment loans</td>
<td>$13.0</td>
</tr>
<tr>
<td>Charge accounts</td>
<td>$9.3</td>
</tr>
<tr>
<td>Service credit</td>
<td>$10.7</td>
</tr>
</tbody>
</table>

In terms of the shares of this credit held by various types of lenders, commercial banks held consumer obligations totalling \$84.4 billion, finance companies \$38.8 billion, retail outlets \$18.3 billion, and other financial lenders, such as credit unions, savings and loan associations, and so forth, \$25.2 billion. 61 Fed. Reserve Bull. A 47-48 (Jan. 1975).

The 1974 total of \$188 billion of outstanding consumer credit obligations reflects more than a doubling of such credit in the nine years since 1965. To appreciate further the rate of growth, note that this total was \$21.5 billion in 1950 and a mere \$9.2 billion in 1941. 58 Fed. Reserve Bull. A 56 (May 1972).
A. Consumer Financing Patterns

For analytical purposes, the financing patterns which give rise to holder in due course claims can be categorized—but one must be aware that there are no clear delineations between them and that the patterns may overlap. Nor are they frozen into stereotyped forms. Certainly the credit industry has not exhausted the ingenuity that produced these techniques, and it is to be expected that creditors will continue to seek new ways to protect themselves from consumer defenses.

1. Notes

In many transactions, the consumer is asked to execute a negotiable promissory note separate, or separable, from the underlying sale agreement. This note, with any accompanying mortgage or security instrument, is then sold ("negotiated") to a bank, finance company, or similar third party. The legal rules here are old and straightforward. If the holder takes the instrument for value, in good faith, and without notice, he has taken "in due course" and can claim the special protections of holder in due course status. The note is also deemed to "impart negotiability" to

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14 One of the most striking shifts in purchasing patterns is the rapidly increasing use of bank credit cards. The amount of such credit jumped from $1.3 billion in 1968 to $7.9 billion by November 1974. 61 Fed. Reserve Bull. A 47 (Jan. 1975). It has been ably argued that credit card transactions are not really credit transactions at all in many cases, and that even if they are they involve neither negotiable notes nor assignments of consumer obligations from merchant to issuer in the classic sense. Brandel & Leonard, Bank Charge Cards: New Cash or New Credit, 69 Mich. L. Rev. 1033 (1971).

Banks in particular continue to blur the lines of traditional financing patterns through check credit loans incident to credit card plans and overdraft privileges for regular checking accounts. A bank in the District of Columbia has advertised a "Gold Key Auto Charge Card" by which the bank commits itself in advance to make an auto loan to approved customers who may then simply select their purchase from any of 80 participating dealers. The bank then requires the dealer to assign the executed contracts. See National Bank of Washington, Buying A Car Is As Easy As Saying "Charge It," 1973 (brochure distributed to customers). In the related area of farm credit, a midwest bank has begun offering what it calls "Ag Reserve" plans which amount to an open line of credit for farmers, avoiding the need for a series of separate loans, separately secured. Douglas, Ag Reserve: Welcomed Aid to Farm Financing 58 Burroughs Clearing House 22 (June 1974).

15 UCC § 3-303.
16 Id. §§ 1-201(19), 3-302(1)(b).
17 Id. § 3-304.
18 Id. § 3-305. The operative language protects the holder in due course 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." The balance of the provision excepts five specified "real" defenses which therefore remain available even against a holder in due course. Id.
the collateral security agreement, so that the holder can foreclose the security free of defenses as well.

There does not seem to be any discernible pattern to the use of notes as opposed to contractual waiver clauses. Promissory notes commonly appear in home-improvement cases, automobile installment sales, and other hard-goods financing.

2. Waiver of Defense Clauses

Alternatively, or at times in addition, to using a negotiable note, the form contract signed by the consumer may contain a simple clause by which the consumer agrees to assert any claim or defense only against the merchant-seller and not against any assignee. Despite some early reluctance on the part of courts to give effect to these clauses, they have become commonplace in consumer credit transactions and their effect is to insulate the creditor from most claims and defenses by virtue of contract terms rather than by formal application of the law of negotiable instruments. The Uniform Commercial Code supports the validity of such clauses generally in commercial agreements, "subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods," and subject also to those more serious, or "real," defenses that would be assertable even against a holder in due course.

Where permitted, these clauses are boilerplate inclusions in


20 One clause, from the contract involved in Block v. Ford Motor Credit Co., 286 A.2d 228 (D.C. App. 1972), reads:

\[
\text{Buyer understands and agrees that Buyer will settle directly with the Original Seller all claims, setoffs, counterclaims and other defenses there may be against the Original Seller and that Buyer shall not setup any such claim, setoff, counterclaim or other defense against any such subsequent holder.}
\]

Id. at 230. A standard form book recommends simpler language: "The buyer hereby waives as against any assignee of this contract any claim or defense which he may have against the seller." R. Anderson, Uniform Commercial Code, Legal Forms, Form 9:182, at 886 (1963).


22 UCC § 9-206.

23 See notes 35-39 and accompanying text infra.
every consumer contract which contemplates transfer to a third party financer. A particular bone of contention has been their use in the agreements between credit card holders and issuers to disable the consumer from, in effect, stopping payment for defective goods or services purchased with the card.\textsuperscript{24}

3. \textit{Interlocking Loans}

A consumer is theoretically always free to borrow cash from an independent lender—bank, credit union, loan company—and use that money to pay cash for goods or services. In such a two-step transaction the consumer has no legal basis for refusing to repay the loan if he is dissatisfied with his purchase: the loan and the purchase are in fact and in law separate agreements. But there is evidence that it is becoming increasingly common for a merchant-seller to develop a working arrangement with an independent lender whereby customers desiring credit are referred to a particular lender—or lenders, if the customer needs to borrow the downpayment separately from the balance—for cash loans which are paid directly to the merchant-seller. The "interlock" between seller and lender can take many forms: common ownership, formal agreement, long course of dealing, the lender's providing loan applications to the seller who assists customers in procuring the loan, free transportation from the seller's place of business to the lender's, and so on. The net effect is that the lender is financing retail sales, but in a format which appears to leave him beyond the reach of the customer's defenses from the sale part of the transaction.\textsuperscript{25}

Examples of such ostensibly independent loan-sale transactions range from one reported instance where a door-to-door salesman had a loan company official riding with him on his rounds\textsuperscript{26} to the increasingly common check-credit plans offered by many banks where the consumer "borrows" from the bank by writing overdraft checks on his regular checking account.

4. \textit{Credit Cards}

The entry of banks into the revolving credit business in the early 1960's, and the proliferation of multi-purpose credit card

\textsuperscript{24} See notes 27-29 and accompanying text infra.
\textsuperscript{26} This story has been recounted third-hand. Crandall, \textit{The Wisconsin Consumer Act: Wisconsin Consumer Credit Laws Before and After}, 1973 Wis. L. Rev. 334, 366 n.107.
plans like Carte Blanche and American Express, have created gargantuan regulatory problems in the space of less than a decade.\textsuperscript{27} One of those problems is whether consumers ought to be able to assert defenses arising from the underlying transaction against the card issuer. Without conceding that they are "assignees" of the merchant's contract claim against the consumer cardholder,\textsuperscript{28} the card issuers have nonetheless regularly included waiver of defense clauses in their cardholder agreements. The one major lawsuit that would have presented the question of the validity of these clauses for judicial review aborted before the question could be reached.\textsuperscript{29}

There is, of course, no difficulty with the revolving-charge account operated by the merchant himself. Sears, Montgomery Ward, and J.C. Penney, for example, are clearly subject to their own customers' product defenses. The troublesome patterns are the nationwide or regional multiparty card plans, where the local bank which has issued the card may have no contact with or control over the merchant half a continent away from whom the cardholder buys defective goods, and where the card issuer appears to have committed a line of credit to its customer without any idea of, or control over, what the customer may purchase with it.

5. Cognate Arrangements

While the above-described techniques are expressly designed to cut off consumer defenses, there are any number of other ways for the creditor to produce virtually the same effect. One of these—which is partially contractual and partially evidentiary—is the insistence by third party creditors on "completion certificates" from consumers before purchasing their obligations.\textsuperscript{30} When the

\textsuperscript{27} See Webster, Bank Charge Cards—Recent Developments in Regulation and Operation, 26 Bus. Law. 43 (1970); Weistart, Consumer Protection in the Credit Card Industry: Federal Legislative Controls, 70 Mich. L. Rev. 1475 (1972).


\textsuperscript{29} Payne v. United Cal. Bank, 23 Cal. App. 3d 850, 100 Cal. Rptr. 672 (1972). The court determined that the suit was not properly maintained as a class action and so never reached the merits of the holder in due course issue. Id. at 859, 100 Cal. Rptr. at 678.

\textsuperscript{30} Such certificates were instrumental in protecting the financers in Sullivan v. United Dealers Corp., 486 S.W.2d 699 (Ky. 1972), and Fuller v. American Aluminum Corp., 249 So. 2d 410 (Miss. 1971). By contrast, the New Jersey Supreme Court has cited the financier's failure to insist on a completion certificate as part of its rationale for denying holder in due course protection. General Inv. Corp. v. Angelini, 58 N.J. 396, 401, 278 A.2d 193, 195 (1971).
consumer claims the aluminum siding was shoddy or never completely installed, the creditor brandishes the certificate and in effect asserts an estoppel against the consumer as to defenses relating to the adequacy or completeness of the seller's performance. Another is the use of cognovit notes, confession of judgment clauses, or wage assignments. Where permitted, these devices enable the creditor upon default to reduce his claim to judgment immediately or to begin immediate payroll deductions. If the consumer is to assert his claim he must reopen that judgment or revoke the assignment through whatever procedure the jurisdiction provides. Similarly, the secured creditor who repossesses collateral from a consumer debtor—particularly if he repossesses by self-help without recourse to judicial process—effectively deprives the debtor of a chance to assert his defenses unless that consumer takes the litigation initiative.

To these can be added the myriad procedural devices which either intentionally or accidentally deny the consumer debtor a reasonable opportunity to litigate or negotiate his claim: sewer service of process, inconvenient venue, lack of access to legal counsel, sheer ignorance of the judicial process—all those things that produce the high ratio of default judgments in consumer cases. Still further, but more remotely, an intransigent creditor attitude, harassing collection efforts, threats of destroying credit ratings, or threats of employment discharge all work to undermine

31 Only a handful of states permit confession of judgment clauses in consumer obligations. NCCF Report 26. Such clauses did, however, survive a charge that they were per se unconstitutional in recent companion cases in the Supreme Court. D. H. Overmyer Co. v. Frick Co., 405 U.S. 174 (1972); Swarb v. Lennox, 405 U.S. 191 (1972). The Swarb decision involved a consumer obligation, and the Court acknowledged that entry of judgment pursuant to the clause could be unconstitutional if consent to it by the consumer was not a knowing and voluntary one, supported by consideration and not otherwise unconscionable. 405 U.S. at 201. Wage assignments have been found not to involve state action at all and thus not to be challengeable on due process grounds. Bond v. Dentzer, 494 F.2d 302 (2d Cir.), cert. denied, 95 S. Ct. 65 (1974). Proposed uniform laws would flatly prohibit such arrangements. 1974 UCCC §§ 3.305-306; NCA §§ 2.403-404; MCCA §§ 2.405-409; see 1969 UCCC §§ 2.410-415, 3.403-407.

32 Self-help repossession, if it can be done without a breach of the peace, is valid. UCC § 9-503. Due process challenges to this tactic have been repeatedly beaten back. Adams v. Southern Cal. First Nat'l Bank, 492 F.2d 324 (9th Cir. 1973), cert. denied, 95 S. Ct. 325 (1974).

the consumer's right to assert defenses and claims from the underlying transaction. 34

6. Consumer "Claims and Defenses"

With this arsenal of protective devices facing the consumer, it is worth describing briefly the different kinds of legal claims or defenses the consumer may want to assert.

Initially, there is that group of defenses which are so serious that the law has traditionally permitted the obligor to assert them even against an innocent purchaser for value of the obligation. These are the so-called real defenses: 35 illegal contract, incapacity to contract, duress, infancy, "fraud in the factum," and insolvency discharge. The thrust of these defenses is that they negate the very obligation sought to be enforced either because a basic requisite of a binding contract is lacking, or in order to effectuate public policies of a higher order than merely maintaining the marketability of commercial paper. 36 Case law on these defenses in consumer transactions is scant, 37 and what there is arises in the context of negotiable notes; there is no judicial opinion on the effectiveness of a waiver clause to avoid these defenses. The reason undoubtedly is that since the claimed defense vitiates the obligation entirely no waiver of rights within that same obligation can survive. The


The seller may also try to cut off consumer claims and defenses at the threshold, by disclaiming warranty and other obligations in the original contract. See Dugan, Severance of Buyer's Defenses Against the Seller's Assignee Through Merger-Disclaimer Clauses: Circumvention of UCC Sections 2.403 and 2.404, 19 VILL. L. REV. 555 (1974).

35 These "real" defenses have been defined to be:
(a) infancy, to the extent it is a defense to a simple contract; and
(b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and
(c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and
(d) discharge in insolvency proceedings; and
(e) any other discharge of which the holder has notice when he takes the instrument.

UCC § 3-305(2).

36 W. Britton, supra note 12, at 332.

Uniform Commercial Code confirms that a waiver clause is not effective "as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument." But, curiously, there was no similar language in the original Uniform Consumer Credit Code provision which validated a limited waiver agreement.

Another large grouping of consumer defenses are those characterized as personal defenses, which are effective only against the merchant-seller. In the case of a negotiable note, these would include the fact that the consumer had never delivered the instrument to the creditor, or that delivery was conditional and the condition had not been satisfied. For example, an automobile purchaser might execute a note on the understanding that it would be cancelled if he could not obtain liability insurance coverage. Should this note be negotiated on to an innocent third party he could enforce it free of the consumer's claim of conditional delivery. The many kinds of fraud in the inducement are also mere personal defenses. Here the consumer's position is that he was persuaded to execute the obligation by deception, misrepresentation, or other trickery not amounting to the more egregious real defense of fraud in the factum. High pressure sales tactics, knowingly false product claims, and nondisclosure of material information are examples. Exorbitant prices and other oppressive contract terms which may be held unconscionable under contemporary case law are also probably only personal defenses, lost against a holder in due course.

Most consumer claims and defenses, however, are usually related to the goods or services that were the subject of the

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38 UCC § 9-206(1).
39 1969 UCCC § 2.404, Alternative B.
40 A person who does not have the rights of a holder in due course takes the instrument subject to, inter alia,
(b) all defenses of any party which would be available in an action on a simple contract; and
(c) the defenses of want or failure of consideration, nonperformance of any condition precedent, non-delivery, or delivery for a special purpose . . . .
UCC § 3-306(b), (c).
42 Neither court nor commentator has addressed the question whether unconscionability is a real or a personal defense. A hornbook lists unconscionability among personal defenses (see J. White & R. Summers, supra note 12, at 487), but another commentator has suggested without elaboration that "if a contract is unconscionable under [UCC] section 2-302 an obligation based on it may be a 'nullity,'" for UCC § 3-305 purposes. Countryman, supra note 6, at 6.
transaction. The furniture is never delivered, or only part of it arrives; the health spa goes out of business halfway through the membership term; the home improvement contractor never finishes the installation or he fails to clean up his debris; the used car transmission falls out; the new automobile spends more time in the repair shop than on the road—all of these examples are, unfortunately, familiar. These facts can generate legal claims under various theories: fraud, failure of consideration, breach of warranty, breach of contract, negligence. Whatever the legal ground, these product-based claims frustrate and anger consumers and justifiably lead to withheld payments, defaults, unsuccessful attempts to rescind, and ultimately to the creditor's assertion that he is a holder in due course and entitled to collect notwithstanding the consumer's legitimate complaint against his seller.

Beyond these are an increasing battery of statutory claims consumers may assert against sellers and hence, arguably, against assignees or other third parties who hold consumer obligations. Recovery of usurious interest is one example.\textsuperscript{43} Several proposed uniform acts authorize consumers to recover either damages caused by statutory violations or civil penalties unrelated to actual damages. For instance, the 1969 Uniform Consumer Credit Code authorizes recovery of penalties and specifies that the liability runs to "an assignee . . . who undertakes direct collection of payments or enforcement of rights arising from the debt."\textsuperscript{44} The Uniform Consumer Sales Practices Act\textsuperscript{45} similarly permits recovery of a minimum of one hundred dollars by a consumer who is damaged by a violation of that Act's proscriptions against deceptive and unconscionable practices. In both cases attorney's fees are also recoverable.\textsuperscript{46}

Both the 1969 Uniform Consumer Credit Code\textsuperscript{47} and the federal Truth in Lending Act\textsuperscript{48} provide for civil penalties from one hundred to one thousand dollars for disclosure violations, and both laws recognize that in some instances these claims can be

\textsuperscript{43} Penalties for usury vary across the nation, ranging from forfeitures of only the excess amount to forfeiture of all interest, to a recovery of treble the amount of interest charged, to a voiding of the entire obligation. See Winter & Hirsch, Inc. v. Passarelli, 122 Ill. App. 2d 372, 259 N.E.2d 312 (1970).

\textsuperscript{44} 1969 UCCC § 5.202(1). Similar language appears in the following two subsections, dealing with recovery of payments from unlicensed lenders and recovery of excess charges. See text accompanying notes 267-75 infra.

\textsuperscript{45} Uniform Consumer Sales Practices Act § 11(a).

\textsuperscript{46} 1969 UCCC § 5.202(b); Uniform Consumer Sales Practices Act § 11(c).

\textsuperscript{47} 1969 UCCC § 5.203(1).

pressed against third party financers. Together these statutes constitute a significant effort to strengthen the consumer's hand in policing against unlawful practices; at the same time they represent substantial potential liabilities for financers if holder in due course protection cannot be invoked.

The common feature of the various categories of consumer claims and defenses is that they arise in the first instance in the dealer-consumer transaction. They are all obviously assertable against that merchant if he can be found and if he is solvent. The susceptibility of the third party financer to these claims and defenses is derivative or indirect. This has been the traditional meaning of holder in due course—the insulation of the financer from vicarious liability. But there is now some evidence that in appropriate cases courts may consider the financer directly liable for his own conduct. Whether cast in terms of the financer's obligation to exercise due care, or his fiduciary responsibility, or his duty to avoid defamation of title, the prospect of direct creditor liability adds another significant dimension to the geometry of the holder in due course notion.

As one final observation, it is worth noting that until very recently the universal assumption seems to have been that the most any obligor could hope to achieve by challenging an alleged holder in due course was that, if the challenge succeeded, the creditor's recovery on the principal balance would be diminished or cancelled. It has apparently been unspeakable to suggest that a consumer—or any other debtor, for that matter—might be entitled to an affirmative recovery against the financer over and above any balance then outstanding. Thus, in any enumeration of the kinds of consumer claims and defenses that would be retained if holder in due course is abolished, a subliminal question is the extent of the

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51 Slaughter v. Jefferson Fed. Sav. & Loan Ass'n, 361 F. Supp. 590 (D.D.C. 1973). The court did not explicate a fiduciary responsibility in so many words, but it is implicit in the opinion. The financer, Jefferson, had made first trust loans directly to consumer purchasers, rather than purchasing notes from others. The case is therefore a version of the interlocking loan pattern described above. It is now on appeal to the Court of Appeals for the District of Columbia. Civil No. 74-1179 (D.C. Cir., filed Jan. 28, 1974).
52 Paulson v. Kustom Enterprises, Inc., 157 Mont. 188, 483 P.2d 708 (1971). On review of a summary judgment, the court agreed that the third party financer might be liable for "slander to title" to the consumer's home, which was mortgaged to the seller of defective carpeting. This writer understands from plaintiff's counsel that the case was then settled on the basis of a substantial payment from defendant-financer to plaintiff-consumers.
resulting liability. Can, or should, the financer ever be subject to suit or counterclaim for amounts beyond the contract balance? The answer, it is submitted, is quite unclear despite the fact that most proposals for statutory modification of holder in due course would restrict the financer's exposure to the amount owing at the time he learns of the claim or defense.\footnote{See text accompanying notes 217-41 infra. The new UCCC adopts that limitation in provisions dealing with assignees, credit card issuers, and interlocking lenders. 1974 UCCC §§ 3.403(3)(d), -404(2), -405(2); Compare FCBA § 170(b).}

B. \textit{The Death Watch}

Since holder in due course was originally a judicially created doctrine, it is not surprising that it has been the courts which have led the assault on its use in consumer transactions. Their attacks over at least thirty-five years\footnote{The watershed case is Commercial Credit Corp. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940).} have taken many forms, but the common rationale has been that a financer who works closely with a seller does not merit insulation from consumer defenses. In terms of risk allocation policy, courts have said, the financer is in a better position than the consumer to bear or distribute losses.\footnote{One court put it this way: \textit{It may be that our holding here will require some changes in business methods and will impose a greater burden on the finance companies. We think the buyer—Mr. & Mrs. General Public—should have some protection somewhere along the line. We believe the finance company is better able to bear the risk of the dealer's insolvency than the buyer and in a far better position to protect his interests against unscrupulous and insolvent dealers. Mutual Fin. Co. v. Martin, 63 So. 2d 649, 653 (Fla. 1953).}} It was argued that policies favoring the free marketability of commercial paper were inapplicable in the consumer area because creditors simply did not need holder in due course protection to engage profitably in consumer financing.\footnote{Professor Kripke argues forcefully that there is no cutoff of defenses in the financing of commercial accounts receivable because the contracts giving rise to the accounts are not contracts of adhesion and the commercial buyers-obligors simply would not tolerate efforts to include cutoff terms in those contracts. The commercial financer therefore studies carefully the operations and experience of the seller-assignor and refuses to do business with unreliable merchants. Thus, accounts receivable financing flourishes without concern about cutting off defenses and, says Kripke, "[t]he same type of credit thinking would provide the answer in the consumer field." Kripke, \textit{Consumer Credit Regulation: A Creditor-Oriented Viewpoint}, 68 Colum. L. Rev. 445, 472 (1968).}

Aside from doctrinal analysis, the human effects of permitting holder in due course protection were found intolerable, particularly for the poor and the uneducated, who were most likely to be victimized by deceptive sales practices, shoddy goods, and inept services. Loud voices were raised that holder in due course ought
to be abolished outright in consumer transactions, and several state legislatures had moved in that direction by the early 1960's.\textsuperscript{57} The case law rejecting holder in due course reached a high-water mark when the New Jersey Supreme Court decided \textit{Unico v. Owen}\textsuperscript{58} in 1967. And when the 1969 Uniform Consumer Credit Code fencestraddled the issue, consumer spokesmen launched vehement attacks on the document.\textsuperscript{59}

Holder in due course was described as "hard... to explain,"\textsuperscript{60} an "anachronism,"\textsuperscript{61} and "effectively dead."\textsuperscript{62} In 1972, the prestigious National Commission on Consumer Finance recommended its abolition,\textsuperscript{63} and the National Conference of Commissioners on Uniform State Laws has now promulgated the 1974 Uniform Consumer Credit Code, which would largely accomplish that recommendation. Much of the case law since \textit{Unico} has continued the assault typified in that case.\textsuperscript{64} Under this kind of pressure, and with almost no countering voices\textsuperscript{65} in its defense, holder in due course should have succumbed quietly. But, as the following sections show, it refuses to go away. The same writer who in 1969 declared it "effectively dead"\textsuperscript{66} was writing in 1974 of the "continuing demise"\textsuperscript{67} of the doctrine, apparently without appreciating what a

\textsuperscript{57} See generally B. Curran, TRENDS IN CONSUMER CREDIT LEGISLATION 108 (1965). In 1961, Massachusetts was the first state to enact a broad prohibition against holder in due course, requiring that all consumer obligations carry a legend identifying them as "consumer notes" which are non-negotiable. See MASS. GEN. LAWS ANN. ch. 255, § 12C (1968); id. ch. 255B, § 19A; id. ch. 255D, § 25A.

\textsuperscript{58} 50 N.J. 101, 232 A.2d 405 (1967); see note 2 supra.

\textsuperscript{59} For a collection of papers criticizing the 1969 UCCC see CONSUMER RESEARCH FOUNDATION, CONSUMER VIEWPOINTS: CRITIQUE OF THE UNIFORM CONSUMER CREDIT CODE (1971). Of particular interest are the appraisals of proposed § 2.404 by Benny L. Kass (id. at 313), the National Legal Aid & Defender Association (id. at 231), the New York City Consumers' Advisory Council (id. at 339-43), Neil O. Littlefield & William R. Breetz, Jr. (id. at 360-62), Berlin, Roisman & Kessler—counsel to the Consumer Federation of America (id. at 443-46), and Judge George Brunn (id. at 525-26).

\textsuperscript{60} Gilmore, supra note 1, at 1098.

\textsuperscript{61} Countryman, supra note 6, at 1.

\textsuperscript{62} Littlefield, supra note 25, at 292.

\textsuperscript{63} NCCF REPORT 34-38.

\textsuperscript{64} See cases cited note 68 infra.

\textsuperscript{65} Defenders of holder in due course show up at legislative hearings, but rarely elsewhere in public. One recent article, itself based on testimony before the FTC, appeared to defend the doctrine, but in fact was mostly a challenge to the jurisdiction of the FTC to promulgate a trade regulation rule on the subject. McNeill, The Necessity of Retaining the Holder in Due Course Doctrine, 5 UCC L.J. 149 (1972).

\textsuperscript{66} Littlefield, supra note 25, at 292.

lengthy death watch he was conducting. The thought begins to gnaw that obituaries may be premature and that perhaps the all-out nature of the assault has been disguising some deeper complexities in the three-cornered relationship among consumer, merchant, and the financer of their transactions.

C. Judicial Resurgence

Although the overall judicial attitude toward holder in due course is clearly unsympathetic, the movement against the doctrine continues to be sporadic and uneven. Where anti-holder-in-due-course sentiment is strong, courts have not hesitated to reflect it in their opinions. For example, the New York Appellate Division recently approved sweeping discovery into a finance company’s corporate structure and business practices in support of a consumer’s close-connectedness challenge to his financer’s holder in due course status. A Massachusetts court was quite willing to preserve a debtor’s defenses against a home improvement financer who inadvertently captioned his form “Consumer Note,” even though the court agreed that the transaction was technically one for services and not subject to the statutory ban against holder in due course.

On the other hand, in some states—particularly in the south—courts have ignored the war on holder in due course being waged elsewhere, and continue to recognize it in its traditional form. In other states, the courts simply have not dealt with the


Other decisions denied the financer the status of holder in due course, but did so by applying the traditional formulae without a glimmer of special concern for the consumer litigants. United States Fin. Co. v. Jones, 285 Ala. 105, 229 So. 2d 495 (1969); Tri-D
issue. In still others, there have been in the past two or three years some unexpected holdings from the highest courts in the jurisdictions that reaffirm the protected status of consumer financers. Each of these latter cases is somewhat curious on its facts; each is easily criticized on its merits; none can be read as a total repudiation of anti-holder-in-due-course policy in the jurisdiction. But together they suggest that the case against the doctrine has not been made persuasively in appellate tribunals, or at least that there are some judges who find the doctrine to be acceptable consumer policy on certain facts.

In one of these cases, a divided Minnesota Supreme Court upheld a waiver of defense clause in a consumer's automobile purchase contract against an argument that the Unico rationale should be applied to invalidate it. It found arm's-length dealing between seller and bank on the record in that case, despite the fact that a few years earlier the same court had ruled that a close relationship between seller and financer deprived a lending agency of the protections accorded a holder in due course. The case at bar was unique in that the "defense" asserted was not a defect in the car sold, but the failure of the dealer to pay off a prior lien on the traded-in automobile. Still, the judicial attitude seems to be a clear retreat from an earlier position and is at odds with prospective legislative policy in the state—a Minnesota statute, not yet effective at the time of the subject transaction, flatly bars waiver of defense clauses in consumer credit sales.

Another retreat from an earlier holding occurred in Kentucky in 1972. The Court of Appeals sustained the holder in due course
HOLDER IN DUE COURSE

claim of a finance company which purchased a consumer's note and mortgage from the seller of a defective prefabricated home.76 Although the financer had done five hundred thousand dollars' worth of business with the seller since 1951, and although the financer knew that construction had not begun when it took the instruments, it did not have notice of anything except that there might be defenses. This, said the court, was not enough to deny holder in due course protection. But, as in Minnesota, there was earlier case law from the same court citing a close business association as grounds for stripping protection from an otherwise independent financer.77 The later decision seems to back off from that position.

From Vermont, too, has come a surprising analysis of holder in due course, in a case which, although admittedly unusual, seemed clearly to call for consumer protection. In Randolph National Bank v. Vail,78 the consumer debtor contracted for the construction of a home. After construction was begun, the contractors sought a loan from the bank, which the bank agreed to make if the homeowner would execute a promissory note payable to the contractors which would then be indorsed to the bank. This Mr. Vail did, only to find that construction was never completed and the bank was demanding full payment. The Vermont court approved entry of summary judgment for the bank, and its opinion explicitly rejected a "close connectedness" argument urged by the defendant consumer. In the court's view, this was purely a "one-time encounter" between the bank and the contractors and the lender could not be considered the "moving force" behind the transaction even though it had insisted on having Vail's note.79 What makes the case startling, however, is the fact that there was in effect in Vermont a statute which appeared to deny holder in due course status across the board in consumer transactions.80 The

77 In Massey-Ferguson, Inc. v. Utley, 439 S.W.2d 57 (Ky. 1969), the plaintiff manufacturer had purchased back from the retail dealer the installment sales contract executed by defendant Utley in connection with the purchase of allegedly defective farm equipment. This kind of manufacturer financing is apparently common in that market. The court noted that the manufacturer could be considered the "real vendor" in the transaction, since its representatives assisted the retail seller in making sales and it regularly supplied the dealer with blank contract forms which were routinely assigned as soon as sales were made.
79 Id. at 394-95, 308 A.2d at 590-91.
80 The statute stated:
  The holder of a promissory note or instrument or other evidence of indebtedness of a consumer delivered in connection with a contract shall take or hold that
court took the incredibly narrow position that since Vail executed
the note after the construction agreement the note was not "de-

cluded in connection with a contract" as the statute required. The
decision thus clearly frustrates one of the most sweeping anti-
holder-in-due-course statutes yet enacted, and raises ominous ques-
tions about how other such legislation will fare in the hands of
tradition-minded courts.

The strangest and most troublesome of these resurgent cases is
Block v. Ford Motor Credit Company. The creditor sued in the
District of Columbia for the balance owing on a Ford automobile
purchased by Block in Baltimore, Maryland. The parties agreed
that Maryland law controlled, but the court ruled that even though
Maryland adhered to the "close connectedness" doctrine there was
no evidence here of the requisite closeness between Ford's
affiliated finance company and its franchised Ford dealer. The
court spelled out the factual bases for this conclusion, among which
were the lack of any joint management of the dealer and the
creditor, the absence of any formal discounting agreement between
them, and a high rejection rate for contracts offered to the
financer. On the other hand, the financer had acquired about
2,500 contracts per year from the dealer, supplied the sales con-
tact forms used by him, allowed its name to be used for advertis-
ing purposes at the seller's place of business, and was aware of
other customer complaints. While the District of Columbia court
might have felt reluctant in this choice-of-law context to essay
interpolations of Maryland law, it hardly did justice to the Mary-
land precedent cited. Ultimately the case may be explainable only


Despite the surface simplicity of this language, difficulties in applying it to interlocking
loans have been noted. Littlefield, supra note 6, at 490-91.

81 131 Vt. at 393, 308 A.2d at 590.
83 Id. at 232-33.
84 Id. at 233.
85 The court in Block acknowledged that Maryland recognizes the "close connectedness
case, the Maryland Court of Appeals ruled that where state law forbade the taking of
negotiable notes in consumer transactions, a finance company could not be a holder in due
course if it purchased such a note with knowledge that it arose from a consumer installment
sale. Remanding the case for further proceedings, the court then instructed the trial judge
to consider separately whether the financer knew this was a forbidden note, and "whether
the relationship between Reliance [the financer] and Meadowbrook [the seller] was so close
as to make Reliance not a holder in due course." Id. at 665, 264 A.2d at 837. The court thus

note, instrument or evidence subject to all defenses of such consumer which would
be available to the consumer in an action on a simple contract . . . .
by its relative lily-whiteness: Block was a business executive with a doctorate degree; the seller was still in business and apparently solvent; there had been no other litigation in the past five years involving the finance company and customers of the dealer.

Although these cases are a minority even among recent holder in due course decisions, they distinctly brake the trend of case law in jurisdictions which had begun to discard holder in due course. They therefore raise the question why they were decided as they were. Why wasn't the court in each instance persuaded either to extend prior case law or to reinforce legislative policy in the state? Why were these courts hesitant to join the funeral cortege, when they clearly had the option to do so? The only easy answer is that they felt it unwise or injudicious to declare that holder in due course had outlived its usefulness.

D. Legislative Developments and Impasses

While the courts continue to struggle with holder in due course cases, a number of legislatures have attempted to deal with the issue by statute. As with case law, there has been distinct movement toward legislation prohibiting, or severely restricting, holder in due course in its many forms in consumer credit transactions. The legislative approach, of course, is the “clean” one, for it avoids the vagaries of judicial opinions, provides a basis for uniform practices, and permits comprehensive data-gathering beyond the confines of a single dispute. But the sum of these activities is hardly an unequivocal consensus on what the problems are or how statutes should deal with them.

There is but one pertinent federal statute, and that is limited to credit cards. Controversial provisions and proposals are discussed throughout the balance of this Article, and it will suffice at this point simply to appreciate the disparity of legislative efforts, and their current status.

86 A catalog of the enactments in the various states has been made elsewhere and will not be repeated here. A compilation prepared by the National Consumer Law Center is incorporated into an article by the Center’s first director. Willier, supra note 3. The NCLC study is also excerpted as the fourth and fifth appendices to another article. Crandall, supra note 26, at 386.

87 FCBA § 170 (1974).
1. The State Statutes

Compilations show that as of 1972 some thirty-four jurisdictions had modified holder in due course by banning or limiting the use of negotiable instruments in consumer transactions,\(^8\) while thirty-seven jurisdictions had dealt with waiver of defense clauses.\(^9\) A few states have added provisions since that date.\(^9\) There is little unanimity, however, within these groups. Some prohibit the use of negotiable notes in consumer transactions but leave unimpaired the rights of a person who takes such a note without knowledge that it is in violation of the statute;\(^9\) others require legends on the instruments themselves indicating their origin in a consumer transaction.\(^9\) The ban on negotiability is sometimes applicable to all consumer transactions,\(^9\) and sometimes only to home solicitation sales,\(^9\) or home improvements,\(^9\) motor vehicle sales,\(^9\) or consumer goods and services other than motor vehicles.\(^9\) A handful of jurisdictions give the consumer a limited period of time—ranging from five to ninety days—within which he can assert defenses but after which the creditor is insulated.

For waiver of defense clauses, the same array of variations exists. Some states bar such clauses altogether;\(^9\) others contain

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\(^8\) For a discussion of these statutes see Crandall, supra note 26, at 387-93.
\(^9\) For a discussion of these latter statutes see id. at 394-99.


time-notice provisions;\textsuperscript{100} some retain all consumer defenses,\textsuperscript{101} others retain only an enumerated few.\textsuperscript{102} The scope of these statutes may run to all consumer goods or services, or may be limited to specific transactions.

Only a few jurisdictions\textsuperscript{103} have dealt with the interlocking loan pattern; although they generally agree that consumers ought to retain defenses against lenders who act in concert with retail dealers, there is little consistency in the specific statutory criteria by which this policy is implemented. Another handful of states have legislated specifically with respect to credit card transactions,\textsuperscript{104} but here too there is disparity of treatment.

One might hope that the crazy-quilt of present legislation could be minimized by uniform statutes promulgated by the National Conference of Commissioners on Uniform State Laws, or otherwise. But there is little basis for such optimism. One reason, of course, is that those states which have already acted on holder in due course are unlikely to redraft their statutes solely in the interest of uniformity. More seriously, the draftsmen of the first proposed uniform act in this area, the 1969 Uniform Consumer Credit Code, badly miscalculated anti-holder-in-due-course sentiment when they promulgated that act. The statute barred the use of negotiable instruments,\textsuperscript{105} but offered alternative provisions on waiver of defense clauses: one would effectively prohibit their use,\textsuperscript{106} but the other contained a time-notice provision\textsuperscript{107} reminiscent of earlier ones in several jurisdictions.\textsuperscript{108} This fence-straddling drew the ire of critics, and sent the draftsmen back to the drawing board. The 1974 version now contains much stronger provisions\textsuperscript{109} and treats the interlocking loan and credit card patterns as well. But it may be too late to achieve any real uniformity in state law.\textsuperscript{110}

\begin{thebibliography}{}
\bibitem{101} E.g., Hawaii Rev. Stat. §§ 476-18(b), (d) (1968).
\bibitem{103} E.g., D.C. Code Ann. § 28-3809 (1973). For a discussion of other jurisdictions dealing with this issue see Willier, \textit{supra} note 86, at 139-40.
\bibitem{105} 1969 UCCC § 2.403.
\bibitem{106} 1969 UCCC § 2.404, Alternative A.
\bibitem{107} 1969 UCCC § 2.404, Alternative B.
\bibitem{109} 1974 UCCC §§ 3.307, -.403-.405.
\bibitem{110} Not only did the first six states to adopt the UCCC—Colorado, Idaho, Indiana,
On a parallel track, but in response to felt inadequacies of the Uniform Consumer Credit Code, the National Consumer Law Center offered its National Consumer Act in 1970, and in 1973 a modified version called the Model Consumer Credit Act. With the deftness of a blunt instrument, these proposals would retain consumer defenses and affirmative claims against holders of negotiable instruments, assignees, and interlocking lenders.\(^1\) The overwhelming partisanship of both the National Consumer Act and the Model Consumer Credit Act probably preclude their adoption intact in any state, but the National Consumer Act has served as a provocative burr in the sides of the legislative processes in several jurisdictions.\(^2\)


If uniform legislation on the state level is a wan hope, there is also only a fading prospect that comprehensive national standards for retention of consumer defenses may soon emanate from the Federal Trade Commission.

For five years or so the Federal Trade Commission has given increasing attention to the plight of consumers whose obligations have been transferred to third party financers. First on a case by case basis,\(^3\) and then by general instructions to its staff,\(^4\) the Commission asserted that it is a deceptive or unfair practice under Section 5 of the Federal Trade Commission Act\(^5\) to deprive the consumer of his product defenses in this manner. Then, in 1971,\(^6\) and again in 1973,\(^7\) the Commission served notice of its intent to issue a Trade Regulation Rule making it a prima facie violation of Section 5 for any merchant-seller to enter into any

Oklahoma, Utah, and Wyoming—split on which versions of § 2.404 they included, but the next three—Iowa, Kansas, and Maine—adopted versions only tentatively redrafted by a committee of the National Conference of Commissioners on Uniform State Laws. See 1974 UCCC, Prefatory Note, at viii, xv.

\(^1\) See NCA §§ 2.405-.407; MCCA §§ 2.601-.603.


\(^4\) 4 CCH CONSUMER CREDIT GUIDE ¶ 10,181 (1973).


\(^7\) 1973 Proposed FTC Rule.
consumer transaction which purported to cut off the consumer's defenses as against a third party who took up the obligation. The 1973 proposed rule covered notes, waiver clauses, interlocking loans, and credit card plans, and was a blanket proscription of holder in due course for all transactions involving "[g]oods or services purchased or leased primarily for personal, family or household purposes, including courses of instruction or training."\textsuperscript{118}

Hearings on the revised proposed rule were held in 1971 and 1973, and a massive record assembled,\textsuperscript{119} but it has yet to be officially promulgated by the Commission. This writer understands unofficially that staff work on the rule is completed, including some changes from the published version of the proposal, and that the rule has been forwarded to the full Commission for action.

A sweeping Commission rule on this subject—aside from its inherent merits—is fraught with unique problems, however. Although the Commission's authority to issue such rules having the force of law is now beyond dispute,\textsuperscript{120} there traditionally have been limits both to the intrastate jurisdiction of the Commission\textsuperscript{121} and to its authority to regulate banks.\textsuperscript{122} The proposed rule attempts to sidestep the latter difficulty by addressing its prohibition only to the seller of the goods or services—making it unlawful for him to participate in the outlawed financing arrangement and saying nothing about the legality of the conduct of the bank or other lender. As to the intrastate reach of such a Commission rule one must speculate. Section 5 of the Federal Trade Commission Act has been amended to extend the Commission's authority to ac-

\begin{footnotes}
\item[118] Id.
\item[119] The collection of statements, articles, memoranda, correspondence, and exhibits and the oral testimony from the 1971 and 1973 FTC hearings are paginated consecutively within the same FTC document. FTC Record and Transcript of Hearings on Proposed Trade Regulation Rule, FTC Docket No. 215-31-1 (Jan. 26, 1971) [written material hereinafter cited to FTC Record, oral matter to FTC Transcript].
\item[122] Section 5(a)(6) of the FTC Act excepts banks, common carriers, and others from the sweep of FTC authority to deal with unfair or deceptive acts or practices. 15 U.S.C § 45 (1970).
\end{footnotes}
activities "in or affecting commerce," rather than merely "in commerce;" but there is still the possibility of a layer of purely local financing beyond the effective reach of the Commission.  

Additional problems flow from the notorious inadequacy of the Commission's consumer protection budget, and the present state of the law which holds that violations of the Federal Trade Commission Act do not constitute private wrongs actionable by individual consumers. These factors in combination might tempt unscrupulous sellers to see what they could get away with out of the Commission's view.

While the proposed rule has stalled, Congress miraculously has passed and President Ford has signed a bill limiting the cut-off of defenses in credit card transactions. When Senator Proxmire first introduced his Fair Credit Billing Act in the ninety-second Congress, it contained restrictions on the holder in due course doctrine in bank credit card transactions. Those provisions, however, were rejected by the Senate Committee on Banking, Housing, and Urban Affairs by an eight to seven vote, on the ground that "this is an area of governmental policy which can be effectively dealt with at the State level at this time." Undaunted, Proxmire reintroduced the Fair Credit Billing Act, including its anti-holder-in-due-course provisions, in the ninety-third Congress, and it was ultimately merged with several other consumer credit proposals into an omnibus bill which passed the Senate in July 1973. The bill then languished in the House Committee on Banking and Currency and threatened to expire with the close of the ninety-third Congress. Proxmire, however, was able to have the bill added in conference to uncontroversial amendments to the Federal Deposit Insurance Act, and as Title III of the Depository Institutions Amendments of 1974, it became law.

The contents of Proxmire's bill are discussed in more detail.

125 FCBA § 170; see note 11 supra.
below.\textsuperscript{131} Suffice it to say that it compromises on the question of the card issuer's freedom from consumer claims and defenses, which are retained for the consumer only under certain conditions. The Fair Credit Billing Act becomes a part of the Truth in Lending Act, and pre-empts any state laws which are less protective of consumers. And since Truth in Lending is one of the broadest exercises of Congress' commerce power, the provisions limiting credit card issuers' rights would presumably have plenary application to all such plans.

E. Overview and Agenda

The sum of this review is that although holder in due course may be under broadside attack in courts and legislatures, it is not yet a defunct legal doctrine. No draftsman has been able to assemble provisions meeting with universal approval. Exceptions lace almost every statute purporting to limit or restrain holder in due course. Present law is nonuniform, sometimes inconsistent, and often unclear. The various formulations of rules leave many questions unanswered or produce new questions of great difficulty.

There is apparent agreement on a general proposition that the reasons for holder in due course protection for creditors are often, or even usually, outweighed by the reasons against that status. The reasons against can be variously stated,\textsuperscript{132} but they condense down to the contention that, where the law recognizes holder in due course, many consumers are unknowingly and unavoidably saddled by law with a payment obligation despite legitimate defenses

\textsuperscript{131} See text accompanying notes 191-92 & 202-16 infra.

\textsuperscript{132} Usually two grounds are urged in combination: (1) creditors who are subject to consumer defenses will more carefully police the operations of retail dealers from whom they buy paper, thereby—it is hoped—improving the level of dealer performance, and (2) creditors can more readily distribute the economic losses resulting from defective goods or services through their rate structure or by maintaining automatic charge-back rights, or dealer reserves. Cf. Littlefield, supra note 6, at 492-96. These policy arguments make the most sense, however, only against the backdrop of traditional financing arrangements, where institutional financers buy consumer paper from many dealers, generally within a limited geographical area, and where those institutions are presumed to have the skill, personnel, and time to screen participating dealers and the freedom to adjust their rates to reflect increased risk.

There is an additional and distinct ground for opposition to holder in due course which is rarely articulated in judicial opinions—perhaps because it is so obvious. That ground is, of course, to prevent the successful perpetration of the kind of joint fraud that occurs when dealer and financer are both artificially created to deal exclusively with each other in a concerted scheme to generate defense-free consumer paper. See Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967); Jones v. Approved Bancredit Corp., 256 A.2d 739 (Del. Sup. Ct. 1969); Timeplan Corp. v. Fuxa, 9 UCC REP. SERV. 262 (Okla. Ct. App. 1971).
such as fraud, breach of warranty, failure of consideration, and the like, while a party better able to cope with these risks can be legally unconcerned about them. The argument for retaining the doctrine in some form is the classic theory of economic inducement: that without being able to reduce their risks to finite proportions—through application of the holder in due course doctrine—creditors will not be able or willing to extend credit in the consumer marketplace.\textsuperscript{133} Both lines of argument, and the assumptions underlying them, begin to disintegrate when they are applied to other than prototypical facts. Why, for example, should financiers object to increased risks if the rate ceilings in the jurisdiction permit them to pass on any additional costs? On the other hand, what goals are achieved by permitting a consumer to recover civil penalties for Truth in Lending violations from a third party financer? Still further, how is a local bank to police the operations of thousands of merchants nation- or world-wide who accept the credit card issued by that bank? These are the kinds of questions now emerging, along with such speculative ones as how abolition of holder in due course will really affect the supply and cost of consumer credit, and how that abolition may inhibit the development of new technologies in the credit industry. It is to these questions that this Article will now turn.

II

THE SEARCH FOR CONSENSUS

The judicial and legislative activity concerning holder in due course is proof of discontent with the status quo, but the scattergun nature of the reform efforts indicates tremendous uncertainty as to where and how far the law should go. What follows is a series of inquiries aimed at separating what is known from what is pure

\textsuperscript{133} It is hard to find a clearer expression of the perceived dire consequences of abolishing holder in due course status than the following:

Lenders will be forced to litigate [many] issues which have no relationship to the normal risks of lending money but instead are directly related to the quality of the products or services sold or the performance of warranties by the seller. To date, we know of no financial institution which has included such costs in its rate calculations. However, if enforcing warranties or guaranteeing product performance is to be forced upon financial institutions as a cost factor, you can rest assured that those additional costs will be passed on to the consumers of our products through increased consumer interest rates or through restrictions on the availability of consumer credit or both.

Consumer Bankers Ass'n, Statement Before the FTC in the Matter of Revised Proposed Trade Regulation Rule, March 5, 1973, in FTC Record 6446-7.
speculation, at determining what is feasible and what is not, and at providing a basis for general agreement as to proper and comprehensive policy in this area. One general observation is required at the start: it seems undeniable that successful resolution of holder in due course issues must be by legislation, both to provide certainty to creditors and consumers in the conduct of their affairs and to make meaningful whatever measure of consumer protection is deemed appropriate. Continued reliance on decisional law to protect consumers from loss of defenses is inherently self-defeating, for it requires the consumer to litigate, often extensively and expensively, the threshold question of whether he shall be permitted to assert defenses at all. The varying treatments given by the courts to such concepts as "negotiable," "good faith," "notice," and "close connectedness" at least encourage creditors to seek protection by contract and to litigate challenges to their insulated status. Thus, the rush to legislate concerning holder in due course in consumer transactions is not only a fact but a necessity. What is not so clear is the proper content of that legislation.

A. How Pervasive and How Pernicious Is the Use of Holder in Due Course Protection in the Marketplace?

A considerable body of circumstantial evidence, but little of a scientifically empirical nature, suggests that, when the law allows creditors to do so at all, they will usually claim holder in due course status and will do so most often when financing marginal or high risk dealers and consumers in connection with purchases of relatively expensive items. The National Commission on Consumer Finance put the matter in some perspective when it noted that, although holder in due course devices were among the least essential collection tools, creditors relied on them "to a significant extent in legal actions to collect defaulted obligations."

If one uses as a barometer the body of case law since the Unico decision in 1967, one notes that the underlying transactions range from sales of home improvements—the largest group—to those of automobiles, television sets, furniture, special appliances, burglar alarms, swimming pools, freezer-food plans, and photo albums. In nearly every case the third party creditor is a finance company rather than a bank, credit union, or savings and loan association. Of thirteen automobile cases, for example, only one involved a

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134 NCCF Report at 36.
135 By this writer's rough count of the post-Unico case law, better than 80% of the creditors were finance companies, and less than 10% were banks.
This fact is most curious, because 1973 Federal Reserve Board figures show that banks held nineteen billion dollars in automobile paper, as opposed to only $11.9 billion held by finance companies. Similarly, finance companies were the creditors in fourteen of sixteen home improvement cases despite the fact that banks extended more than four times as much home improvement credit as finance companies. These ratios could be read to mean that commercial banks either do not contract for, or do not assert, holder in due course protection very often. But this may be too generous an assessment, for the bankers, through their trade associations, entered a vigorous defense of the doctrine before the Federal Trade Commission. It may be safer to say that the case law reflects a disproportionate use of holder in due course by non-bank financers.

The cases also reflect a recurring pattern of unsavory sales transactions: door-to-door sales of shoddy home improvements, valueless freezer-food plans, bogus referral sales—all of which have become classic consumer frauds. These cases suggest not only that deceptive and fraudulent sales practices force financers to claim holder in due course status, but also that the ability to market consumer obligations free of defenses may be the enabling element in those unlawful schemes.

Some further inferences can be drawn by looking to see who testifies against proposals which would limit or abolish holder in

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139 60 Fed. Reserve Bull. A 47-48 (July 1974). The precise figures are $3,982,000,000 for banks and $917,000,000 for finance companies, as of December 1973.
140 See American Bankers Ass'n, Consumer Bankers Ass'n, Interbank Card Ass'n & National BankAmericard, Inc., Statement Before the FTC in the Matter of Revised Proposed Trade Regulation Rule, March 7, 1973, in FTC Record 6872-77; Consumer Bankers Ass'n, Statement, supra note 133, in FTC Record 6340.
142 E.g., Vasquez v. Superior Court, 4 Cal. 3d 800, 484 P.2d 964, 94 Cal. Rptr. 796 (1971); Star Credit Corp. v. Molina, 59 Misc. 2d 290, 298 N.Y.S.2d 570 (N.Y. City Civ. Ct. 1969).
due course. Although their approaches differed, opposition to the Federal Trade Commission's proposed trade regulation rule was presented by representatives of commercial banks, finance companies, automobile dealers, and other merchants—in other words, the whole credit industry. Their arguments ranged from concern over Commission rule-making authority, to the need to maintain "stability" in the consumer credit market, to the fear by some small merchants that without readily marketable consumer paper they could not compete with the giants in their trade. Underlying these positions, of course, was the unspoken assumption that they did in fact use holder in due course devices.

Broad waiver of defense clauses were, until recently, universal in multiparty credit card plans, and the presence of these

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144 See notes 133 & 140 supra.
145 National Consumer Finance Ass'n, Position Paper on Revised Proposed FTC Trade Regulation Rule, March 2, 1973, in FTC Record 7085-89.
147 E.g., American Imported Automobile Dealers Ass'n, Statement Before the FTC in the Matter of Revised Proposed Trade Regulation Rule, March 5, 1973, in FTC Record 7009; John Hiatt of the Nat'l Independent Automobile Dealers Ass'n, Testimony, March 15, 1973, in FTC Transcript 1843; Nat'l Automobile Dealers Ass'n, Statement, March 14, 1973, in FTC Record 7067; National Tire Dealers & Retreaders Ass'n, Comments to the FTC on Revised Proposed Rule, March 5, 1973, in FTC Record 5966.
148 Some financers have apparently rejected use of holder in due course as a matter of policy, but are unable to restrain counsel from relying upon it when undertaking collection. Compare Household Fin. Corp. v. Mowdy, 13 Ill. App. 3d 822, 300 N.E.2d 863 (1973), with Richard P. McManus of Household Finance Corp., Statement, May 7, 1973, in FTC Record 7179. In that proud statement Household Finance declared:

Once a financing arrangement is established with a merchant, our agreement requires him to repurchase any contract where the buyer declines payment because of unresolved complaints concerning the purchase.

When purchasing a contract from a merchant, we promptly contact the buyer to ensure that he has actually received what he bargained for and is satisfied with it. Complaint records for each merchant with whom we deal are maintained and regularly reviewed. Our relationship is promptly terminated whenever fraud, misrepresentation, or failure to promptly and honestly rectify customer complaints is found.

Our complete confidence in the effectiveness of this program has caused us to reject reliance upon the Holder-In-Due-Course Doctrine. We do not utilize this doctrine in our business.

149 In the Master Charge Customer Agreement the cardholder agrees [to adjust all claims directly with any merchant Person [sic] or organization honoring his Master Charge credit card, to waive and release Master Charge from all defenses, rights and claims he may have against such persons, and to make all required payments to Master Charge without reference to such claims or defenses. American Bankers Ass'n, Consumer Bankers Ass'n, Interbank Card Ass'n & National BankAmericard, Inc., Statement, supra note 140, in FTC Record 6910. For the comparable BankAmericard agreement see Hale, Holder in Due Course and Bank Cards, 5 UCC L.J. 164, 170 (1972).
waivers may explain the lack of any decisive case law in which cardholders assert defenses against card issuers. Moreover, the array of patterns in which credit cards are used to finance consumer purchases is so wide—one commentator has identified eleven different categories of credit card transactions—that it is impossible to know for certain which are even susceptible to attack. Nevertheless, recent statutes in several states, and now also the Fair Credit Billing Act, have reinstated consumer defenses against card issuers under certain circumstances.

The nature of the "specious interlocking loan arrangement" makes it particularly difficult to judge the extent of its use, since the connection between dealer and financer usually does not appear on the face of the paper. Allegations of cooperative efforts between sellers and lenders have been made, and one study purports to show regular use of this device in one city. Referral of credit customers appears occasionally in the facts of reported cases, but has not been the explicit basis for decision in any of them. This writer has heard, but cannot verify firsthand, that it is common in the District of Columbia, where there are no small loan

150 The validity of such waiver clauses was challenged but not decided in Payne v. United Cal. Bank, 23 Cal. App. 3d 850, 100 Cal. Rptr. 672 (1972).

151 Professor Leary listed these transactions before the Senate Subcommittee on Consumer Credit. His listing included transactions where the card issuer was itself the seller, or affiliated closely with the seller; where the card issuer's mailings also solicited sales of products; where the seller's mailings or advertisements invited use of one or more designated credit cards; where credit cards are accepted in home solicitation sales or at seller's place of business. The categories were set out in what Leary believed to be the decreasing order of the card issuer's alignment with the seller. 1973 Senate Hearings 150.

152 See, e.g., CAL. CIV. CODE § 1747.90 (West 1973).


154 Miller, An Alternative Response to the Supposed Direct Loan Loophole in the UCCC, 24 OKLA. L. REV. 427, 434-37 (1971). The reported study is ambiguous and inconclusive, however. For one thing, the limited survey was conducted by phone. Id. at 434 n.42. For another, the total of dealers who arranged referral credit apparently included those who accepted credit cards. Id. at 435 n.45. Although one might agree that bank credit card transactions resemble interlocking loans, credit cards present their own difficulties and ought not be lumped in with the distinct category of referral credit devices.

companies, for retail merchants to transport credit customers to Maryland lenders clustered along the main streets just outside the District line. The interlocking loan device may inconvenience the seller by bifurcating the sale and loan arrangements and may deny the lender normal recourse rights, but there are strong incentives for its use—freedom from defenses, freedom from the generally lower rate ceilings for sale credit, and freedom from other regulations such as cooling-off periods and collateral limitations. The device is reportedly popular enough to have generated its own jargon.\(^{156}\)

It is one thing to conclude that most creditors insert the necessary holder in due course boilerplate in their consumer obligations wherever the law permits. It is quite another to know how often creditors use that weapon to coerce payment from consumers who have legitimate defenses but no manner of recourse against the insolvent or out-of-business seller. There is evidence that Legal Services attorneys have been able to settle approximately forty-five percent of the holder in due course claims brought against their clients,\(^ {157}\) but the nature of those settlements is unknown, as is the answer to the query whether either the financer or the consumer could shift any of the loss to the original seller. In a number of the post-Unico cases, it is specified that the original dealer was in fact out of business or had fled, and the losing party simply had to bear the loss. It is no doubt more than coincidental that in five of the six reported cases in which the courts expressly noted the impossibility of recovery over against the seller the judgment was in favor of the consumer debtor.\(^ {158}\) But hardly any of the post-Unico cases included the original seller as co-defendant or third party defendant,

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\(^{156}\) It is our experience that this kind of financing seems to be regularly associated with the obtaining of down payments for used cars (known as "side loans"), vocational schools and certain door-to-door selling operations. Small loan companies seem to be particularly involved in operations of this kind. Indeed, the industry has coined the term "dragging the body" to refer to the process whereby the salesman gets the customer to the lender.

National Consumer Law Center, Statement (undated), in FTC Record 7044, 7051.

\(^{157}\) Speaker, *Holder in Due Course—Burden of the Poor*, 5 UCC L.J. 146, 148 (1972). The OEO study reported 14,000 holder in due course cases from 59 Legal Services projects in a single year. Said Mr. Speaker: "The magnitude of the problem indicated by this sample is frightening." Id. at 147.

\(^{158}\) The five consumer victories were: Jones v. Approved Bancredit Corp., 256 A.2d 739 (Del. 1969); Calvert Credit Corp. v. Williams 244 A.2d 494 (D.C. App. 1968); Kennard v. Reliance, Inc., 257 Md. 654, 62 A.2d 832 (1970); General Inv. Corp. v. Angelini, 58 N.J. 396, 278 A.2d 193 (1971); Star Credit Corp. v. Molina, 59 Misc. 2d 90, 298 N.Y.S.2d 570 (1969). In the sixth case, Holt v. First Nat'l Bank, 297 Minn. 457, 214 N.W.2d 698 (1973), the court noted the dealer's insolvency but found for the creditor.
which suggests that the sellers were probably judgment proof or otherwise unavailable in all of those cases. Why else would the issue of third party financer insulation from defenses be so hotly contested? A small canvass of the attorneys in these cases confirms this logical truth.\footnote{Beyond the cases cited (note 158 supra), attorneys in eight others have written the author that recovery from the seller was in fact impossible. These included both losing financers and losing consumers.}

Even after consumers lose in court there may still be opportunities for post-judgment negotiation and settlement,\footnote{If one can gauge from the smattering of informal correspondence this writer received, the ingenuity of counsel is sometimes refreshing, although also ironic. In one case where a woman's homestead was sold to satisfy a judgment for home improvement costs, her attorney was able to arrange for the original vendor to purchase it at the foreclosure sale and sell it again to the woman, who never had to move out. In another, the debtor's obligation was satisfied by furnishing free advertising space to the creditor in the consumer's family-owned newspaper.} but there is little likelihood that victorious creditors will compromise below what the consumer is able to pay. And there is no way to calculate how often assertions of holder in due course status extract payments from consumers without the need to litigate, in circumstances where the original merchant has disappeared.

The incidence of creditor reliance on holder in due course, therefore, seems to rise along a curve paralleling the inherent riskiness of the underlying transactions. Automobile cases are common because of the range of defects, malfunctions, and non-repairs which can prompt refusals to pay. Home improvement cases also flourish because fly-by-night contractors proliferate. Such is the case, too, with fraudulent or unconscionable sales where the consumer victims are poor or gullible. And although there may be ways for the consumer to contest or compromise a holder in due course claim, there are undoubtedly many consumers who are induced or required to pay without having recourse against their sellers.

B. What Effect Does the Abolition of Holder in Due Course Have on the Cost and Availability of Consumer Credit?

\textit{A priori}, the elimination of creditors' freedom from consumer claims and defenses means that those creditors will be unable to collect some obligations they might otherwise collect. Facing such a prospect, financers have several options. They might, for instance, calculate as best they can their prospective lost revenues, adjust their rates—upward—accordingly, and continue financing consumer transactions as before. Or they might decide
that the increased risk makes it unprofitable to deal in consumer paper when there are safer profits to be made investing in, say, pork bellies or soy bean futures. Or they might attempt some combination of these: slightly higher rates with a more discriminating selection of participating dealers. Theoretically, too, they might insist on better quality control and improved sales practices to minimize the instances of consumer dissatisfaction, or larger dealer reserve accounts to shunt losses back to the retailers.

Any one of these responses can produce effects superficially disadvantageous to consumers—higher credit rates, reduced availability of credit, higher prices. Assuming the maintenance of an economic policy that would assure the consuming public maximum credit at minimum cost, the withdrawal of holder in due course protection from financers must entail some compromise with that policy. The proper question, then, is not whether the withdrawal will be cost-free, but whether the costs are, on balance, reasonably tolerable.

Most discussions slough over the possibility of significant counter-effects from the abolition of holder in due course. It is asserted, for example, that automobile financing in Pennsylvania has continued unabated since 1937 without the crutch of holder in due course, and that those states which have enacted such prohibitions have seen little effect on credit costs or availability. One commentator experienced in the credit industry has said that in a "reputable" market the holder in due course rule is "statistically unnecessary." An economist claimed that the effect of the original Uniform Consumer Credit Code provisions on the consumer

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161 The disadvantages are only superficially so because it may be in the best interests of some consumers to make credit more of a luxury. Significant value judgments are involved in determining, for example, that consumers should have access to credit in the future as freely as they have in the past, but no one seems eager either to make those judgments or to propose legislation to implement them. The National Commission on Consumer Finance admitted it could "devise no empirical method for determining who should get credit, how much credit, what kind of credit, and at what price." NCCF Report 2. It also doubted "whether legislators want to begin making the intricate social judgments involved in designing laws to spell out" these matters. Id. One need go back no farther than the late 1960's to find evidence of economic and legal mayhem flowing from an overabundance of credit: the explosion of unsolicited mailings of credit cards and the resulting prohibition of such mailings and the imposition of maximum $50 liability for unauthorized credit card use. See Truth in Lending Act §§ 132, 133, 15 U.S.C. §§ 1642-43 (1970); Hearings on S. 721 Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking and Currency, 91st Cong., 1st Sess. (Dec. 4, 7 & 8, 1969).


163 Willier, *supra* note 3, at 143-44 (citing experience in Massachusetts).

164 Kripke, *supra* note 56, at 473.
credit market was not likely to be substantial. It is difficult to quarrel with these judgments in the face of the obviously continuing growth of consumer credit nationally, at the same time when many states are curtailing use of the holder in due course device. But from other quarters come contrary assertions that the death of holder in due course may spell the death of small merchants, or seriously undercut the utility and acceptability of bank credit cards.

Some less dogmatic voices can be heard. A study on the first year's experience under a Connecticut statute eliminating negotiability in door-to-door sales found a marked reduction in institutional financing of such sales, a shift to repurchase agreements, a cutback in incentive payments to dealers, and increased screening of dealers and inspection of their work. From the dealers' perspective there was some noticeable difficulty in getting financing, some resort to direct lending arrangements, and changes in marketing practices, such as greater reliance on cash sales and wealthier customers.

The National Commission on Consumer Finance conducted a Collection Practices and Creditors' Remedies Survey which, with other data, produced conclusions similar to those just described. Where holder in due course was prohibited there was an "observable reduction" in the availability of credit. This was true not only for finance companies which traditionally deal with high risk credit consumers, but also for the market as a whole. The Commission surmised that this was because the rationing of credit by the finance companies "would probably force out of the market many retailers serving marginal risk consumers unable to obtain credit from general market retailers," thus decreasing the overall sup-

165 Shay, The Impact of the Uniform Consumer Credit Code upon the Market for Consumer Installment Credit, 33 LAW & CONTEMP. PROB. 752, 762 (1968).
166 One plain effect of this [prohibition of holder in due course] is that the small, independent retailer must capitulate to the larger, less credit-dependent retailers. In an industry which already is a bilateral oligopoly, the significance of the Rule is especially threatening: the small retailers must capitulate and competition among all retailers must atrophy. National Tire Dealers & Retreaders Ass'n, Comment, supra note 147, in FTC Record 5966-67.
169 NCCF REPORT 23, 36.
170 Id. at 36.
ply of credit beyond that withdrawn by the finance companies themselves.

The conclusion that abolition of holder in due course has contributed to a constriction of the money market cannot be disproved. Indeed, some confirmation of it has come to this author in correspondence with creditor attorneys who have handled—and lost—recent holder in due course cases, and who note that after the adverse decision either their clients or the originating dealers withdrew from that consumer credit market. This diminished availability may be a temporary adjustment to the onslaught of anti-holder-in-due-course legislation. The National Commission itself doubted whether the repercussions would be as significant as some predicted. But if the consequences to the credit supply are to be kept minimal, it will be because creditors are willing and able to pass on the new risks to dealers in the first instance and ultimately to the consuming public. In this regard, the Commission noted that its recommendations for restrictions on creditor remedies were “inextricably interwoven” with other recommendations it made concerning rates and availability. These recommendations generally called for “realistic” rate ceilings—as proposed in the Uniform Consumer Credit Code—and broad-scale encouragement of entry into the consumer credit market through such means as relaxation of licensing requirements and possible federal chartering of financial institutions.

The most likely prognosis, it seems, is that universal abolition of holder in due course will produce instinctively careful reactions from financers—some initial curtailment of their dealings in consumer paper followed by a gradual reopening of their coffers at higher rates and with more stringent controls over participating merchants.

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171 Id. at 37, citing Cohen, The Uniform Consumer Credit Code—A Design for Disaster, 23 Personal Fin. L.Q. 10 (1968). Mr. Cohen, a Chicago attorney, predicted that the UCCC would lead to “economic chaos,” and emphasized that abolishing creditor remedies like holder in due course would cause “skyrocketing collection costs,” and could drive the less-creditworthy into the “waiting arms of the criminal credit grantor.” Cohen, supra, at 10-12.

172 NCCF REPORT 24. The key recommendation was the following: The Commission recommends that policies designed to promote competition should be given the first priority, with adjustment of rate ceilings used as a complement to expand the availability of credit. As the development of workably competitive markets decreases the need for rate ceilings to combat market power in concentrated markets, such ceilings may be raised or removed. Id. at 149.

173 According to Professor Willier, this is essentially what happened in Massachusetts. Willier, supra note 3, at 142-44.
Whether the impact will be felt more in the cost of credit or in its availability will depend in large measure on whether the additional risks of nonrecovery can be distributed to all consumer debtors. It is, often assumed that increased costs can always be "passed through" to consumers, but the assumption may be unfounded for many retail creditors or financers who find themselves bound by rate ceilings on one side and competitive pressures on the other. So, before presuming too much, one must be satisfied that consumer creditors can fairly be charged not only with the risk of increased losses but also with the resulting burden of distribution.

C. Does Abolition of Holder in Due Course Produce a More Rational Allocation of Marketplace Risks?

American jurisprudence has created a universe of legal responsibilities for sellers of goods or services, and the liabilities that flow from defaults in these responsibilities are intended by the law to rest on the seller as a cost of his business. Abnormal losses therefore occur when either the financer or the consumer is required to pay for defective goods or services. It is the risk of these abnormal losses that calls for attention, under first principles of risk allocation which dictate that they should be borne by the party best able to prevent and distribute them.174

It is doubtless true that when holder in due course theory is used to visit the costs of defective merchandise on the consumer buyer, he has little if any power to distribute that loss. Presumably an accumulation of such "rip-offs," expressed in terms of "cost of living," could underlie a union's demand for a higher pay scale; perhaps a doctor victimized in a credit transaction might reflect the experience indirectly in a revised fee schedule. But the typical wage earner must simply take the blow. Financers, on the other hand, have broader, though not unlimited, opportunities to spread the losses which would result from uncollectible paper.

Theoretically, the financer has several ways of distributing projected losses. For one, he may charge more for his credit directly to consumer borrowers or directly to the merchants whose paper he discounts. This is not always a free option, however, for his rates may already be at the legal ceiling. Open-end credit—

174 Risk allocation underlies much of the developing law in such apparently diverse areas as products liability and securities fraud. A particularly intriguing analogy to financer responsibility is the emerging liability of advertising agencies for deceptive and misleading ads. See Doherty, Clifford, Steers & Shenfield, Inc. v. FTC, 392 F.2d 921 (6th Cir. 1968).
especially in credit card plans—is almost always offered at the highest permissible rate, and creditors who have dared to cross this line have been challenged. Further, increasing his price puts the financer at a distinct competitive disadvantage. For example, direct bank loans for automobile purchases are generally cheaper than financing through third party finance companies. Abolition of holder in due course, if reflected in finance companies' rates, would only increase the disparity between them.

Alternatively, the financer can try to distribute losses by shunting them back to the dealer whose default caused the loss in the first place and who presumably can redistribute them through its price structure. The devices by which this may be accomplished vary, and for some creditors, under some circumstances, may just not be available at all. In typical transactions where the financer purchases consumer paper regularly from a dealer, incentive payments are made to the dealer in the form of a percentage of the finance charge. Many creditors maintain reserve accounts in which accumulate portions of the discounted prices of consumer obligations. These funds are released periodically to the dealers as the obligations are paid off, and thus represent a kind of contingency fund from which the creditor can withhold amounts equal to what it cannot collect from the consumer debtors. Either of these devices can be manipulated to increase the financer's return and lessen the dealer's, and the National Commission found it "logical to assume" that financers would protect themselves in this way. In addition, financers may purchase consumer paper on a pure recourse basis whereby the dealer is a virtual guarantor of uncollectible items.

175 In the Washington, D.C., area Riggs National Bank operates a regional credit card plan called Central Charge. Its monthly carrying charges were the typical 1.5%. When a local attorney challenged these rates as exceeding the 8% usury limit in the District, the court held the rate permissible under the venerable "time-price" doctrine. Kass v. Central Charge Serv., Inc., 304 A.2d 632 (D.C. 1973). This holding required great straining of legal doctrine, for time-price theory has historically been invoked only in transactions between sellers and buyers. Indeed, courts have not hesitated at times to declare that the hypothecation of consumer paper from dealer to financer makes the entire transaction a loan for usury purposes. Dunn Co. v. Mercantile Credit Corp., 275 So. 2d 311 (Fla. App. 1973). While the Kass case was pending, Congress responded to the creditors' pleas by enacting a monthly 1.5% rate ceiling for all revolving credit plans. D.C. CODE ANN. § 28-3702 (1971).

176 At the end of 1973, new car financing was available through commercial banks at rates averaging 10.5% and through finance companies at rates averaging 12.4%; for other consumer goods, bank credit was offered at 12.86% and finance company credit at 18.77%. 60 Fed. Reserve Bull. A 48 (July 1974).

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178 A typical full-recourse agreement for assignment of accounts or chattel paper might read as follows:

We [assignor] warrant the payment when due of each sum payable thereunder and
When negotiable notes are used, the dealer's indorsement leaves him liable to pay the holder on dishonor or liable to the holder for breach-of-warranty damages even if the dealer indorses "without recourse." Thus, on paper there are ample devices through which the financer can throw losses back to the seller, who must then worry about redistribution. All of them, however, depend on the dealer's agreeing to them and such agreement may not be happily tendered. One would think that if recourse rights are so easy to incorporate into financing arrangements creditors would long ago have insisted on them as universal practice—for what financer would not want to supplement his primary, holder in due course reinforced rights against the consumer debtor with secondary rights against the dealer-assignor? Yet the landscape is strewn with creditors who had no usable recourse rights. Were these creditors foolhardy, or is it equally possible that the dealer was the dominant party whose wishes controlled? Moreover, even the clearest of contractual charge-back rights can avail the creditor nothing against the seller who has skipped the state or gone bankrupt.

The interlocking loan pattern presents unique obstacles to the lender who wishes to retain contractual recourse rights against the seller. Since no paper flows from seller to financer, traditional notions of indorser liability or warranty do not apply. Incentive payments and reserve funds are possible, but more difficult to structure. If the formally independent, but in fact related, lender is denied holder in due course status he may be able to negotiate indemnification agreements with his associated dealers. More useful to the lender may be efforts to develop a traditional legal recourse theory such as unjust enrichment or subrogation to the rights of the debtor. Perhaps the safest technique would be to include in all consumer loan agreements a contingent assignment

the payment on demand of the entire unpaid balance in the event of non-payment by the customer . . . without first requiring assignee to proceed against said customer.


179 UCC § 3-414(1).

180 UCC §§ 3-417(2)(d), (3).

181 See text accompanying notes 158-59 supra.

182 See Restatement of Restitution § 162.

183 An analogous statutory right of subrogation already exists in the law of commercial paper: The Uniform Commercial Code permits a bank which has improperly paid a check over a stop-order to subrogate to the rights of the drawer (consumer) against the payee (merchant). UCC § 4-407. The Model Consumer Credit Act posits a right of subrogation in favor of the interlocking lender against the seller. MCCA § 2.604(3).
by the consumer to the lender of his rights against the original seller.

Credit cards are something else again. Precisely because the bank card issuers are operating at the fringe of profitability and at the ceiling rate, they can distribute losses only by charge-back in one form or another. They might increase the discount rate at which they take up the sales slips, forcing participating dealers to raise prices for all credit card transactions. Or they might physically return disputed items through the clearing system and debit an account of the delinquent merchant. Charges incurred in a local area might involve only the issuing bank, while items from consumer transactions at a distance from the issuer could be returned through the regional exchanges.

Card-issuing banks do insert charge-back privileges in their dealer agreements. Indeed, one compilation shows that they return significant numbers of sales slips for various reasons, including a substantial number for missorting, expiration of cards, lack of motor vehicle identification, erroneous amount, and missing signatures. But a large proportion—nine percent of the total—were returned because "customer disputes slip." Thus the machinery exists for returning slips to the banks in which they were deposited, and presumably for then charging them to the accounts of the merchant depositors. These returns, while obviously a bother, are further expedited by the use of Federal Reserve routing symbols on the sales slips so they can be computer read and processed.

To assess fairly the ability of various financers to distribute losses, therefore, one must recognize that there are some limiting

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184 An apparently typical BankAmericard Merchant Agreement contains this covenant: Merchant agrees to pay Bank the total face amount of any Sales Draft, and Bank will have the right at any time to charge Merchant's commercial account therefor without notice, in any situation relating to such Sales Drafts where:

(e) the Cardholder disputes the sale, quality, or delivery of merchandise or the performance or quality of services covered by the Sales Draft. See R. Speidel, R. Summers & J. White, supra note 2, at 436 (BankAmericard Merchant Agreement ¶ 10).

185 In response to a question from Senator Proxmire, the president of the Interbank Card Association submitted information on chargebacks among member banks. 1973 Senate Hearings 262.

186 Id. The proportion of sales drafts returned because of customer complaints nearly doubles, to 17% of all chargebacks, if one excludes the "missort" chargebacks. Id. A "missort" apparently is a sales slip sent to the wrong card-issuing bank.

187 The president of the Interbank Card Association believed that most such chargebacks would be returned to the merchant involved, but also opined that many chargebacks would be absorbed by the banks in the interest of customer relations. Id. at 259.
forces at work in the marketplace: rate ceilings, possible restrictions on reserve funds, uncertain recourse by direct lenders, and competitive pressures. It is then appropriate to allocate the risks of defective products to financers rather than consumers only on the premise that creditors often, or usually, have opportunities to distribute losses—not on the premise that they always do. One can also view the pressure to abolish holder in due course across the board as a technique to put pressure on the rate-makers, and to influence creditors to insist on workable recourse arrangements with the sellers of goods they finance. In this light some proposed statutes may be chargeable with overkill in that they seem to disregard distributability as a criterion for denying holder in due course status. And where distributability is downplayed, the case for abolishing the doctrine must rest on the financer's greater ability to prevent bad merchant practices at the threshold.

The National Commission on Consumer Finance concluded its discussion of holder in due course with the judgment that

the costs of abolishing third party cutoff devices to all consumers in the marketplace would be more than counter-balanced by the protections which the consuming public will receive in the form of better goods and services.\footnote{190}

If the hope is that the physical quality of consumer products will improve, the Commission must be accused of naiveté. It is unrealistic to expect that sellers of goods and services—already subject to a vast array of potential liabilities for intentional, negligent, and faultless conduct—will materially improve their level of performance because banks or finance companies are looking over their shoulders.

How can a financer police his dealers? He can investigate a dealer's general reputation for honesty, integrity, and solvency. He can periodically renew that investigation. He can insert into his dealer agreements language like that in contracts between credit card issuers and participating merchants wherein the dealer promises to "establish a fair policy for the exchange or return of merchandise."\footnote{191} In home improvements, the creditor might insist

\footnote{188 The Fair Credit Billing Act contains a prohibition against any card issuer requiring, as a condition to participation, that member merchants maintain an account with the bank. FCBA § 168. This provision prompted arguments from the bankers that it deprived them of their only effective recourse against member merchants. 1973 Senate Hearings 226-27.}

\footnote{189 For discussion of the MCCA see text accompanying notes 193-99 infra.}

\footnote{190 NCCF REPORT 37.}

\footnote{191 See R. Speidel, R. Summers & J. White, supra note 2, at 435 (BankAmericard Merchant Agreement ¶ 9).}
on completion certificates, or inspect, or otherwise verify completion of the work. But he can hardly run quality tests on all toasters in the dealer's inventory, nor can he easily eavesdrop on the automobile salesman's pitch. Transaction-by-transaction supervision of the dealer's goods and practices by employees of the creditor is impracticable to say the least. The financer's ability even to urge good practices or to influence the quality of goods or services sold is dependent on his relative indispensability to that merchant. Perhaps a large auto financer such as General Motors Acceptance Corporation can indirectly influence these matters through its and the dealer's corporate parent, but it is most doubtful whether local lenders could do the same with respect to area merchants, even where the revised Uniform Consumer Credit Code, for example, would treat them as interlocked.

What financers collectively can do to police the market, however, is withdraw, or threaten to withhold, their credit supply from merchants with bad track records. It is this power to cut off the dealer's essential commodity that is the tangible policing mechanism. In contrast to consumers who have at best the atomistic power to punish merchants who dissatisfy by refusing to trade with them in the future, financers who regularly support the credit operations of given dealers hold weighty economic billy clubs. To the extent, therefore, that abolishing holder in due course is justified on this ground, it carries the clear implication that financers should exercise that clout to freeze out misfeasant and malfeasant sellers even where it is not economically necessary for them to do so—i.e., even where the financer can charge back all disputed obligations. Risk allocation principles, in this context, are instruments of a positive social policy—the starving out of merchants whose products or sales techniques cannot sufficiently and regularly satisfy legal norms.

D. What Degrees of Independence from the Seller Will Justify Freedom from Defenses for Some Financers?

The theoretical answer to this query flows easily from the discussion above: susceptibility to consumer product-related defenses ought not be thrust on a financer who genuinely cannot effect the twin goals of risk distribution and prevention. But how can one measure the varying capabilities of varying lenders in even more varying credit marketing patterns?

At one extreme is the closely related, perhaps even affiliated or jointly controlled, financer who regularly discounts consumer
paper for the retail dealer. To the maximum extent any financer can bear, distribute, and prevent losses, he does. At the other extreme is, for example, the bank which makes an unsecured signature loan directly to a consumer for purposes unknown to the bank, and perhaps even unknown to the consumer beyond a general intention to refurnish his living room. The bank is probably lending at the highest permissible rate, and has absolutely no way to turn the uncollectible loan back onto the distant furniture supplier with whom the consumer ultimately deals.

Hardly anyone would dispute the propriety of abolishing holder in due course in the first pattern; even the most vigorous proponent of consumer protection likely would not argue for retaining defenses in the latter. But where between them is the proper divide? Shadings exist even within the operations of a single creditor: a bank credit card issuer stuffs advertising brochures into its monthly statements inviting direct ordering of products by return mail chargeable to the card account; the same issuer lends its emblem to the media advertisements and storefront windows of thousands of merchant-depositors in its national inter-bank system; it also issues blank checks to its cardholders which are charged as loans to the credit card account but which may be taken in payment by anyone. In the first two instances there is a structured relationship between issuer and seller; in the last there is none. A card issuer might, or could, assure himself of recourse rights against the seller in the first two, but how could he in the third?

A student author has argued that consumers ought to retain defenses against otherwise independent direct lenders whenever the lender knew the specific purchase to be made with the loan. The National Consumer Law Center’s latest proposal similarly hinges the creditor’s liability on whether he knew or had reason to know that the loan would be used in a consumer transaction; it goes on to provide, in section 2.603(4), that the lender will be “deemed to have” such knowledge when

\[(a) \text{ the lender is a person related to the seller; or}
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192 The new Fair Credit Billing Act would apparently treat all three differently. The check-credit transaction would leave the consumer unprotected because his card was not "used as a method of payment." Where the card is used in a retail establishment, the consumer can assert defenses only if the transaction exceeded $50 and occurred within 100 miles of the cardholder’s home. In the combined mailing situation, the consumer could assert all defenses without dollar or location limitation. FCBA § 170(a).

(b) the lender supplies to the seller or the seller prepares documents used to evidence the loan obligation of the consumer; or
(c) the lender has recourse to the seller for nonpayment of the loan through guaranty, reserve account or otherwise; or
(d) the lender directly or indirectly pays to the seller any commission, fee or other consideration based upon the assistance or cooperation of the seller in the obtaining of the loan; or
(e) the lender makes payment of the proceeds of the loan to the seller either individually or jointly with the consumer; or
(f) the lender conditions the extension of the credit upon the purchase of goods or services from the seller; or
(g) the lender knew or should have known that the loan was arranged by the seller or a person acting on behalf of the seller; or
(h) the lender and seller participate in any arrangement, formal or otherwise, in which the seller refers consumers to the lender; or
(i) the lender permits the reference to his services to be used by the seller in connection with the consumer transactions; or
(j) the lender takes a security interest in the property which is the subject of the consumer transaction; or
(k) the lender otherwise participates in or is connected with the consumer transaction.¹⁹⁴

Subsection (c) is the key to this provision, for it stresses the distributability criterion. Other subsections—(a) through (i)—are also justifiable because they imply or assume some pre-arrangement between lender and seller through which recourse rights can be established. Subsection (j) would sweep in any lender who took, as many do,¹⁹⁵ a valid security interest in the debtor's "consumer goods" without knowing or claiming specifically the items purchased with the loan proceeds. Subsection (k) is even more dangerously broad and unspecific.

The difficulty in devising precise criteria can be seen in the facts of a recent case in the District of Columbia. In Slaughter v. Jefferson Federal Savings & Loan Association,¹⁹⁶ the court held that the defendant lender was subject to the claims of a group of consumers who had been victimized by the Monarch Construction Company, a notoriously fraudulent home improvement contractor, even though the Association had made direct loans to the consumers, rather than buying consumer obligations from the seller-contractor. There was no joint ownership, no supplying of docu-

¹⁹⁴ MCCA § 2.603(4).
¹⁹⁵ See, e.g., In re Turnage, 493 F.2d 505 (5th Cir. 1974).
¹⁹⁶ 361 F. Supp. 590 (D.D.C. 1973); see note 51 supra.
ments, no recourse arrangement, no rebate or kickback, no express conditioning of the loan on purchasing from Monarch, no overt "arrangement" of any kind. The lender did, however, take a security interest in the consumers' residences, but these were not even purchase money mortgages. The court stressed that responsible officers of the lender had failed to conduct adequate inspections of work in progress and had generally closed their eyes and ears to the many suspicious circumstances of Monarch's activities. Thus, said the court, the lender had not shown the requisite good faith to be a holder in due course of the mortgage notes payable directly to it.

The result might be the same under subsections (i) and (k) of Model Consumer Credit Act section 2.603(4), but the applicability of these provisions is uncertain. Subsection (j) would drag this transaction in, but the retention of the security interest is the most innocuous aspect of the whole transaction. Even if the current District of Columbia interlocking loan statute applied to home improvements, which it does not, this transaction would slip through because none of the criteria are met. The revised version of the Uniform Consumer Credit Code, however, could produce the same result as the court's because it would retain consumer defenses against a lender where

the lender, before he makes the consumer loan, has knowledge or, from his course of dealing with the particular seller or lessor or his records, notice of substantial complaints by other buyers or lessees of the particular seller's or lessor's failure or refusal to perform his contracts with them and of the particular seller's or lessor's failure to remedy his defaults within a reasonable time after notice to him of the complaints.

Here the emphasis is not so much on the lender's probable ability to secure recourse rights, as on his ability to police the seller by denying financing to its customers. Thus this provision is consistent with the risk allocation goals of distributability and prevention.

197 361 F. Supp. at 599.
198 According to District of Columbia law,
(a) A lender who makes a direct installment loan for the purpose of enabling a consumer to purchase goods or services is subject to all claims and defenses of the consumer against the seller arising out of the purchase of the goods or service if such lender acts at the express request of the seller, and—
(1) the seller participates in the preparation of the loan instruments, or
(2) the lender is a person or organization controlled by or under common control with the seller, or
(3) the seller receives or will receive a fee, compensation, or other consideration from the lender for arranging the loan.
199 1974 UCCC § 3.405(1)(f).
Regrettably, creditors and creditor spokesmen seldom offer constructive criticism of proposals like these, preferring to point out ambiguities in statutory language. Any effort aimed at picking out in legislation the fine points of distinction between legitimately independent loan transactions and truly specious sales can only be less than perfect. No two drafting efforts in this area have matched, but it seems beyond dispute that some lending patterns sufficiently involve the financier in the underlying sale transaction to justify allocating to him the "abnormal" risks of the seller's defaults. Proper legislative policy, therefore, would seem to require, in any statute retaining consumer defenses against lenders, itemization of only those "interlocks" which clearly point to such a course of dealing between lender and seller that the lender could be expected to contract for recourse rights for its own self-protection. This approach might require periodic amendments of the statute as new financing patterns and new cooperative techniques between lenders and sellers emerge. But it seems preferable to the alternative, which is a scattergun listing of every conceivable connection between lender and seller supported perhaps by a statutory right of subrogation which makes lending institutions involuntary policemen of the conduct of merchants with whom they have no regular contact.

A further word is in order here about the successful effort of credit card issuers to keep almost all normal credit card transactions free from consumer defenses. Nearly every recently proposed or enacted statute dealing with consumer defenses against credit card issuers would retain those defenses only if the disputed transaction exceeds some specified dollar amount, usually fifty dollars, and only if the cardholder and his seller are within close geographic proximity of each other. The justifications offered for these limitations refer to risk allocation principles. With respect

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200 See, e.g., American Imported Automobile Dealers Ass'n, Statement, supra note 147, in FTC Record 7025-26.
201 The Model Consumer Credit Act gives the interlocking lender a statutory right of subrogation to the rights of the consumer. MCCA § 2.604(3). But, where the lender and retailer have no regular course of dealing, this only means that once the lender has been denied recovery against the consumer he has the legal right to seek out and sue the defaulting merchant, hopefully with the cooperation of the consumer, whose testimony may be critical. This would force lenders to act as public enforcement agencies. Preferable to this, it seems, is a policy which induces lenders to do what is least burdensome—and least expensive—to them, and which most nearly coincides with their own self interest—i.e., take contractual recourse rights from those merchants with whom they do deal regularly.
202 These statutes include the new Fair Credit Billing Act. FCBA § 170.
203 Id. § 170(a)(2); see 1974 UCCC § 3.403(3)(a).
204 FCBA § 170(a)(3); see 1974 UCCC § 3.403(3)(b).
to the geographic limitation, the bankers argue that the local issuing bank cannot be expected to police the activities of distant merchants in other regions of the interchange system, or could do so only at the risk of engaging in boycotts considered unlawful under the antitrust laws. However, the Chairman of the Federal Trade Commission doubted the possibility of antitrust violations and the bankers themselves concede that the mechanism for charge-backs throughout the interbank system already exists. It is difficult therefore to see any real basis for treating the card issuer as a protected, independent lender on the simple basis of distance. Although one can appreciate that banks would like, as a matter of sheer convenience to themselves and their participating merchants, to keep charge-backs to a minimum, a policy grounded on creditor convenience would reinstate holder in due course in all its glory.

The justification for the dollar limitation is more complex and perhaps more meritorious—although when the average credit card purchase is less than twenty dollars, a fifty-dollar cut-off point for asserting defenses means that the bulk of all such purchases are defense-free as far as the issuer is concerned. The bankers argue primarily that purchases for small amounts simply ought not be treated as credit purchases at all, but should be considered essentially as convenient forms of cash transactions—"check substitutes." There is evidence that many consumers do use their credit cards for convenience in payment, regularly paying off balances at the first billing, without incurring any finance charge. But it is patently self-serving for the banks to argue from this that no consumer ought to be able to assert defenses against the card issuer in small transactions where the seller's

205 1973 Senate Hearings 227 (testimony of D. W. Hock, President of National BankAmericard, Inc.).
206 1973 Senate Hearings 91 (testimony of Lewis A. Engman, FTC Chairman).
207 See text accompanying notes 184-87 supra.
209 At one point the bankers urged a $100 cut-off point, conceding at the same time that no more than 2% of all credit card purchases exceed that figure. 1973 Senate Hearings 228, 242-43, 260.
211 Estimates of the percentage of credit card billings paid in full within the free period range from 33% to 53%. 1973 Senate Hearings 70, 228. Thus from one-half to two-thirds of all credit card debt actually incurs some finance charge. Whatever the intentions of the cardholder, he in fact enjoys "credit" from the time of his purchase.
default, the consumer's dissatisfaction, and the bank's ability to return the item are exactly the same as in larger ones. Other, better ways exist to prevent overburdening card issuers with small complaints.\textsuperscript{212}

In short, one cannot reasonably subject to consumer claims and defenses any otherwise independent lender merely on the ground that he knows or has reason to know the purpose of the loan, without indulging a pure deep-pockets rationale on the consumer's behalf. The crucial and important question, instead, is whether the lender's relationship to the seller presents the lender with reasonable opportunity to charge back consumer obligations where there are proved or apparently meritorious defenses. Traditional credit patterns, where notes or contracts are taken by the seller in the first instance and then transferred on to a financer, clearly meet this test, as, it is submitted, do credit card transactions. The growing concern for the "interlocking loan" ought not be allowed to produce an over-reaction that ignores marketplace reality and that may for that reason increase unnecessarily the marginal cost and unavailability of consumer credit.

E. What Protection Has the Financer Against Large Numbers of Frivolous Claims and Defenses?

Once holder in due course protection is stripped away, third party financers are arguably vulnerable to alleged consumer defenses that in fact are groundless attempts to avoid payment. The creditor has no way of resolving the consumer's grievance, nor can he even judge its validity or speciousness without investigating the underlying transaction. Creditors may legitimately feel, as the bank card issuers do,\textsuperscript{213} that the only real option available to them when a consumer refuses to pay is to charge the item back to the dealer. On reflection, however, the likelihood of wholesale defaults is slim, and the creditor does have other options.

Initially, there has been no hue and cry from jurisdictions which have abolished holder in due course that deadbeat consu-

\textsuperscript{212} One of these is to limit the time for asserting claims against an open-end creditor to the time when the debt is paid off, treating all credit card charges as paid off in the order of purchase. Any cardholder who pays off his full bill each month would thus reduce the issuer's exposure to a very short period, part of which we might assume would be used by the cardholder to seek adjustments from the seller. See FCBA § 170(b); 1974 UCCC § 3.403(4).

ers are taking tactical advantage of their newfound rights. It defies human nature to think that there would be. Certainly consumers can be expected, on the whole, to be no less honest than their creditor counterparts.

Further, holder in due course is law for litigation—that is, it is cranked in only after a consumer has defaulted and the creditor has sued. From a narrow, lawyer's point of view, the viability of holder in due course may make or break that lawsuit. For the consumer whose auto transmission has disintegrated, or whose roofing job is left half-done, it is doubtful that his first concern will be whether he can successfully resist further payment. More likely he will invest his first efforts in pleading, demanding, or negotiating with his seller. Only when these efforts fail, or on discovery of the seller's disappearance or insolvency, is the consumer likely to default. Certainly there is no reason to believe that any more complaints would be taken up with the financer than with the seller, and the good faith cure efforts that can be expected of most sellers should reduce the flow of real claims and defenses to a trickle.

Nor are the financers without defensive measures of their own. They may simply determine that the consumer's position is without merit and proceed to sue or otherwise seek recovery as before, for the abolishing of holder in due course does not create defenses, it merely permits their proof. The secured creditor may proceed to replevy his collateral, forcing the consumer to consider whether he really wants to post bond, retrieve the property, and defend on the merits. If the creditor repossesses by self-help, the consumer must view his claim as worthwhile enough to retain counsel and file suit on his own.

A particularly devastating device available to bank credit card issuers is the right of setoff. If a defaulting cardholder maintains a checking or savings account with the issuer, traditional doctrine would permit the bank, without notice to the cardholder, to deduct from those accounts enough to cover the unpaid credit card balance.214 The ensuing prospect of dishonored checks, extra service charges, and angry creditors is enough not only to chill the consumer's thoughts of frivolous nonpayment, but also to suggest

that this unilateral bank weapon ought to be subject to some reasonable controls.\textsuperscript{215}

In any case of disputed nonpayment there is also no requirement that the bank suspend its accumulation of interest, finance charges, or late fees while the account goes unpaid.\textsuperscript{216} This economic inducement to consumer honesty is augmented by the probable costs of defending a lawsuit, the possibility of legitimately adverse credit references, or the justifiable cancellation of their credit card. Indeed, to say that consumers are now able to assert claims and defenses does not mean they can do so freely. The abolition of holder in due course leaves the consumer—even the consumer with a substantial defense—as open as ever to collection efforts short of litigation. Only his chances for ultimate vindication are improved.

If all this were not enough to reassure creditors against voluminous disputes, recent statutory proposals have added a salutary extra precaution. That is, the consumer retains his defenses against the financer only if he "has made a good faith attempt to obtain satisfaction from the seller or lessor with respect to the claim or defense."\textsuperscript{217} This provision, it seems, makes no assumptions about what is proper satisfaction, nor does it specify what steps the consumer must take. It is no more than a rough marketplace equivalent of the idea of exhausting administrative remedies, and should not in any way inhibit the assertion of genuine defenses.

F. Once the Barriers to Consumer Claims and Defenses are Removed, What Should Be the Extent of the Financer's Liability?

I. Contract-Related Claims and Defenses

In the middle of a twelve-month payment term a consumer's color television set catches fire, destroying itself and the consumer's residence. May the consumer now recover his extensive damages from the third party financer? Can he at least recover the pay-

\textsuperscript{215} The Fair Credit Billing Act limits the bank's power here, but perhaps not by much. It may require nothing more than a boilerplate provision in the parties' agreement that the bank reserves the right to setoff. FCBA § 169.

\textsuperscript{216} The Fair Credit Billing Act is permissively silent on these matters. See FCBA § 161.

\textsuperscript{217} This language appears in virtually the same form in the 1974 Uniform Consumer Credit Code and the Fair Credit Billing Act. 1974 UCCC §§ 3.403(3)(c), .404(2), .405(2); FCBA § 170(a)(1).
ments he has made—and what of the downpayment? Or must he be content not to make any further payments?

Possible answers to some of these questions bring shudders to the finance industry, but virtual silence from the commentators and courts. In Unico v. Owen,218 for example, the New Jersey court specifically reserved the question whether financers would under any circumstances be liable for breach of warranty damages, and it has not returned to the issue in subsequent decisions. The original Uniform Consumer Credit Code not only limited the financer's liability to the amount owing at the time the consumer asserted his defense, but it also insisted that the consumer await the creditor's pleasure in bringing suit for the balance of the debt.219 The 1974 UCCC220 and the new Fair Credit Billing Act221 both limit the creditor's liability to the amount owing when it first learns of the asserted defense or claim.

On the other hand, the Federal Trade Commission's revised proposed Trade Regulation Rule would subject the creditor to liability up to the "full amount" of the instrument, which was interpreted to include all finance charges, insurance premiums, and other fees.222 A District of Columbia statute measures the assignee's liability by "the amount owing . . . at the time of the assignment,"223 or, in the case of interlocking loans, by "the amount of the loan."224 The National Commission on Consumer Finance recommended that any holder's liability "should not exceed the original amount financed."225 The Model Consumer Credit Act begins by making the financer "liable to the full extent

218 50 N.J. 101, 123, 232 A.2d 405, 417 (1967); see note 2 supra.
219 1969 UCCC § 2.404, Alternatives A & B. The suggestion that the consumer had to wait until he was sued by the creditor implied he could not take affirmative action to rescind a contract or remove a lien on his property.
221 FCBA § 170 (b).
222 The FTC would make it an unfair and deceptive practice to fail to give a consumer a statement which said:

It is agreed that any holder of this instrument takes this instrument subject to all claims and defenses which would be available to the maker in an action arising out of the contract which gave rise to the execution of this instrument, notwithstanding any agreement to the contrary. Recovery by the maker under this provision shall not exceed the full amount of this instrument.

1973 Proposed FTC Rule § 433.2(a). In an accompanying "Commission Interpretation" the FTC construed the words "full amount" to include "all finance charges, interest, pre-paid interest, charges for life insurance, and any other fees, charges or costs imposed upon the consumer in connection with the financing of the consumer transaction."

224 Id. § 28-3809(b).
225 NCCF REPORT 35; id. at 36.
of all claims, defenses and equities of the consumer which arise from that transaction."\textsuperscript{226} This apparently is intended to authorize affirmative recoveries for personal injuries and other consequential damages, for the Act goes on to scale down the liability of "good faith" financers to the "transaction total of the original transaction,"\textsuperscript{227} or the "amount of the proceeds of the loan used in the consumer transaction."\textsuperscript{228}

There is obviously some need to reconcile these disparate approaches if creditors are to have any chance to calculate their likely losses and risks. But there is a more important reason to reconcile them, and that is to crystalize exactly what policies are being implemented by the abolition of holder in due course. Where financers are subject to liability for all direct and consequential damages, in contract or tort, flowing from a consumer transaction, those financers are made to act as insurers of sellers' total performance; they are forced to become joint venturers in the economic enterprise of marketing goods or services. Where instead financers are liable to the extent of all monies previously paid, they may be viewed as stakeholders, guaranteeing at most the economic value of that transaction to the consumer. But if the dissatisfied consumer can legally do no more than defeat the creditor's right to future payments, it must be because the creditor is seen as nothing but a limited alter-ego of the original seller—a surrogate only for the purpose of collecting payment. The measure of liability at least ought to be consistent with the identified goals of risk allocation, consumer protection, and marketplace policing, and there is no reason to increase the creditor's exposure beyond what is necessary to accomplish these goals. In fact, overextension of liability would inevitably and needlessly increase the costs and lower the availability of consumer credit.

Under traditional doctrines—whose origins are deep in the history of the law of contract\textsuperscript{229}—when a creditor cannot qualify for holder in due course protection, he stands as a simple assignee of the seller's contractual right to payment. He has not assumed or been assigned the burden of performing the underlying contract, and thus is commonly said to be "subject to . . . all defenses of any party which would be available in an action on a simple con-

\textsuperscript{226} MCCA § 2.602(1); id. § 2.603(1).
\textsuperscript{227} Id. § 2.602(2).
\textsuperscript{228} Id. § 2.603(2).
\textsuperscript{229} See 1 Restatement of Contracts § 167(1) (1932); UCC §§ 3-306, 9.318(1); cf. 2 G. Gilmore, Security Interests in Personal Property ch. 41 (1965).
tract." His maximum loss is the amount yet unpaid on that contract. There are almost no cases in which contract debtors have sought refunds or other affirmative recoveries from third party assignees, although a recent commercial case concluded that an account debtor may recover prior payments on a restitutionary theory.

Yet a legislature can begin with a clean slate, and the question remains open: what should be the extent of financer liability?

In the present state of the market, it is impossible to make the case for full financer liability, as proposed in the Model Consumer Credit Act. Dealers and financers, despite considerable hand-holding, are not yet recognized as partners or joint venturers. They are institutionally separate entities, under separate managements, without identical economic interests. Sophisticated legal—and insurance—structures exist to compensate consumers for consequential personal injury and property damage where the immediate seller is unreachable or judgment proof. Further, the risk of such claims for a financer dealing with many merchants selling a universe of goods and services is probably beyond calculation on any actuarial basis; if it is insurable at all, it is so only at very high rates.

The case might more easily be made for holding financers liable, not as insurers, but to the full extent of their investments in individual consumer transactions. This practice would require

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230 UCC § 3-306(b).

231 According to Professor Gilmore:

Between buyer and seller's assignee, however, the breach of warranty or failure of consideration is available only defensively; if buyer wishes to recover his down payment or his damages, he must go directly against his seller. The assignee, who comes in to finance the transaction, does not thereby become responsible for the assignor's warranties or prospective performance.


234 Such a contention with respect to a real estate financer was rejected by the California Supreme Court in Connor v. Great Western Sav. & Loan Ass'n, 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968).
financing institutions to refund collections received from customers on proof of claims or defenses which justify rescission or revocation of acceptance, or which involve substantial consequential damages. There is some support for this formula in cases which accord a debtor an unjust enrichment claim against an assignee who has received payments under the mistaken belief that the assignor-seller has satisfactorily completed his performance of the underlying transaction. This thought must underlie the Federal Trade Commission's proposal and legislation such as that in the District of Columbia.

But there are problems with this measure of liability, too. Since the financer's liability at any given time would not depend on the amount currently outstanding, consumers would presumably be free to press claims against the lender any time within the pertinent statute of limitations, either in an action brought by the creditor or independently in a suit by the consumer as plaintiff. The passage of time could prejudice the creditor in his defense to such a claim, and his closing of the books on that consumer transaction might cost him any recourse rights he might have had against the dealer.

There is an additional reason why neither of the extended measures of financer liability is appropriate: they go beyond reasonable consumer expectations and beyond what is needed to preserve the credit-buying consumer's position against the original seller. Consider the simple two party credit sale. With no independent financer involved, the consumer dissatisfied with the transaction can refuse to make further payments and force the seller to take the initiative to recover any more. But that same consumer always has the burden of suing the merchant to recover any payments previously made. Should the seller disappear or fail, the consumer must be content with his self-help recoupment. Any exposure for the financer beyond the amount owing at the time the consumer asserts his defense would therefore make the consumer's tactical position against the financer better than that available against the defaulting merchant. This windfall is difficult to justify. If the proclaimed evil of holder in due course is that it denies the consumer the tactical opportunity to withhold payments, the proper response is to restore that balance and no more.

Thus it is not altogether surprising that the relatively moder-

235 See note 233 and accompanying text supra.
236 See note 222 supra.
237 See note 223 supra.
ate 1974 Uniform Consumer Credit Code opts for a measure of liability limited to the amount outstanding at the time the financer learns of the asserted claim or defense. The consumer remains in the identical position he would hold against the original seller. Other observers have reached the same conclusion, for essentially the same reasons.\footnote{238} One estimated that probably ninety-eight percent of the injustice wreaked by holder in due course can be eliminated through this device.\footnote{239} What is surprising, in fact, is that the most vigorous consumer spokesmen should suddenly veer away from their support for limited creditor liability\footnote{240} to propose, in the Model Consumer Credit Act, a greatly expanded liability.

Once the basic extent of creditor exposure is settled, there are still loose ends. Could a court in an appropriate case still order a financer to refund payments received by "mistake"? Arguably it could do so, on the theory that the legislation abolishing holder in due course was not intended to displace equitable doctrines such as unjust enrichment or restitution.\footnote{241} Should the consumer defenses now available be limited to contractual defenses? The Fair Credit Billing Act stipulates that assertable claims do not include "tort claims,"\footnote{242} an obvious concession to creditor fears that they might be subjected to extensive personal injury claims. But the creditors are protected to a considerable degree by the basic rule on maximum liability, and this phrase in the statute arguably prevents a consumer from justifying his default in payment on grounds of fraud, misrepresentation, negligence, or strict tort liability. Legislatures considering similar language ought to avoid this ambiguity. The best way to do so, in the view of this author, is to drop any attempted specification of the kinds of claims and defenses retained. Against the original seller the characterization of the "de-
fense” would make no difference, and the consumer’s position should be the same against the third party creditor.

Another matter of detail is how to compute the balance owing in open-end credit plans. Both the 1974 Uniform Consumer Credit Code\textsuperscript{243} and the Fair Credit Billing Act\textsuperscript{244} have settled on a “first in, first out” rule that is both fair and easily applied. It deems payments applied first to finance charges, then to purchases, both in the order of entries to the account.

Finally, if the creditor’s liability is to be measured at the time he learns of the consumer claim or defense, it is critical that there be workable guidelines to determine when such notice is received. The key language in the 1974 Uniform Consumer Credit Code points to the time when “the assignee has notice of the claim or defense.”\textsuperscript{245} Actual receipt of information is apparently required, but notice has traditionally been broad enough to include constructive notice through suspicious circumstances and “reason to know,” and there is no reason to construe the term more narrowly in this context.\textsuperscript{246} Nor should it be necessary to prove some affirmative act of notification by a consumer, for the requisite “notice” might be acquired through the dealer or independently by the financer.\textsuperscript{247} Clearly, the consumer can fix the financer’s maximum liability by giving notice before he attempts the required good faith resolution of the dispute with the seller. Oral notice is sufficient, but the creditor can insist on written confirmation.

These ground rules seem adequate for consumers who are aware of their legal rights. But it could rationally be argued that some consumers will fail to protect themselves and that there is a need for explicit disclosure to consumer debtors of their right to withhold payments upon notification of the creditor. The proposed Federal Trade Commission rule incorporated such a disclosure requirement,\textsuperscript{248} and the Truth in Lending Act now

\textsuperscript{243} 1974 UCCC §§ 3.403(4), -404(3), -405(3).
\textsuperscript{244} FCBA § 170(b).
\textsuperscript{245} This language, and that supporting the next few sentences, comes from 1974 UCCC §§ 3.403(3)(d), -404(2), -405(2).
\textsuperscript{246} The 1974 Uniform Consumer Credit Code does not define “notice,” but adequate definitions can be borrowed from Uniform Commercial Code §§ 1-201(25) and 3-304.
\textsuperscript{247} The Fair Credit Billing Act can be criticized on this point. It measures the card issuer’s liability only from the time “the cardholder first notifies the card issuer” of his claim or defense, thus apparently requiring some provable notification action, and leaving open the possibility that the card issuer will require written notice. FCBA § 170(b).
\textsuperscript{248} The text of the “Notice” is set out at note 222 supra. In addition, the FTC rule would require delivery to the consumer of a separate, full page statement of his rights. 1973 Proposed FTC Rule § 433.3, -.4.
requires semi-annual notification to debtors of their rights under the new Fair Credit Billing Act.\textsuperscript{249} In truth, the difficulty and probable futility of adding another complicated disclosure to the paperwork of consumer transactions militates against such "protection," at least until such time as there is evidence of significant abuse.

In sum, the objective of abolishing holder in due course is the modest one of retaining defenses to the payment obligation. This goal is attained by limiting creditor liability to the amount owing when the lender learns of the claim and can take steps to protect itself.

2. \textit{Parallel Tracks: Penalities and Direct Liability}

Reducing the creditor's liability for contract-related claims and defenses does not end the creditor's exposure. There are at least two other possible sources of liability, which for purposes of this Article will be merely noted and left for others to prospect more closely. One is the recovery of civil penalties for violation of consumer protection statutes such as the Uniform Consumer Credit Code or the Federal Truth in Lending Act. The second is the possibility—remote at the present time—that courts may find financers directly liable for negligence or other misfeasance of their own.

Numerous state and federal statutes now permit consumers to collect civil penalties, unrelated to actual damages, from creditors who violate protective provisions of those acts. The Federal Truth in Lending Act prescribes penalties ranging from one hundred to one thousand dollars, plus attorney's fees, for disclosure violations and now also for violations of the Fair Credit Billing chapter.\textsuperscript{250} The 1969 and 1974 versions of the Uniform Consumer Credit Code likewise call for varying penalty recoveries.\textsuperscript{251} Can consumers assert claims for these penalties as offsets or counterclaims to reduce or cancel recoveries by third party financers?

In the case of Truth in Lending, Congress intended the penalty provision to draw individual consumers into the policing of creditor practices. Congress was equally aware that consumer obligations would often be assigned, and so provisions dealing with

\textsuperscript{251} 1969 UCCC §§ 5.202(1), (4), -203; 1974 UCCC §§ 5.201, -203.
assignees were inserted into the Act. Where the underlying transac-
tion involves a security interest in real estate, the likely target being 
the home improvement industry, the Act permits a penalty recovery 

against any subsequent assignee of the original creditor where 
the assignee, its subsidiaries, or affiliates were in a continuing 
business relationship with the original creditor . . . unless . . . the 
assignee shows by a preponderance of evidence that it did not 
have reasonable grounds to believe that the original creditor was 
engaged in violations of this part, and that it maintained proce-
dures reasonably adapted to apprise it of the existence of any 
such violations.\textsuperscript{252}

The original Act contained no other affirmative statement of the 
liability of assignees, but a new section added in 1974 declares that 
any action which might have been brought against the original 
creditor "may be maintained against any subsequent assignee . . . 
where the violation from which the alleged liability arose is ap-
parent on the face of the instrument."\textsuperscript{253}

Financers are therefore vulnerable to penalty recoveries, even, 
apparently, in separate actions by consumers against whom the 
financers have no offsetting claims. Some measure of protection is 
afforded the assignee-financer by evidentiary presumptions set out 
in the Act: for creditors required to give consumers special notice 
of a three-day right to rescind, a written acknowledgment of 
receipt "does no more than create a rebuttable presumption of 
delivery thereof."\textsuperscript{254} Otherwise, in actions by or against the as-
signees, "written acknowledgment of receipt by a person to whom a 
statement is required to be given . . . shall be conclusive proof of 
the delivery thereof and, unless the violation is apparent on the 
face of the statement, of compliance with this part."\textsuperscript{255} Thus 
assignees may be insulated from derivative claims for Truth in 
Lending penalties so long as the consumer has executed the 
appropriate "acknowledgment" and the violation is not obvious.\textsuperscript{256}

But troublesome interpretational questions arise from even this

\textsuperscript{253} Pub. L. No. 93-495, § 413 (Oct. 28, 1974) (adding Truth in Lending Act § 115).
\textsuperscript{254} Truth in Lending Act § 125(c), 15 U.S.C. § 1635(c) (1970).
\textsuperscript{256} Some further help for creditors besieged by Truth in Lending requirements comes 
through a 1974 amendment adding a new subsection 130(f), which relieves creditors from 
liability for acts or omissions in good faith reliance on prevailing Federal Reserve Board 
rules, regulations, or interpretations, even though those standards are later withdrawn or 
succinct statutory language. When is a violation “apparent on the face of the statement”? Does “assignee” include the holder of a negotiable instrument? Do these provisions state by negative implication the exclusive grounds for assignee liability and thus preempt applicable state law such as the Uniform Commercial Code or the Uniform Consumer Credit Code? What, for example, would be the position of a finance company holding a negotiable note under circumstances where its holder in due course status would be defeated by its “close connectedness” with the seller, and where there was neither a signed acknowledgment nor a violation apparent on the face of the note?

The exculpatory language of section 131 of the Truth in Lending Act was given literal reading and application in a Georgia case\(^2\) where the auto-buying consumer executed a contract which stated, directly above her signature, “Buyer acknowledges receipt of a completely filled-in copy of this contract.” When the consumer claimed never to have received a copy of the contract containing the required Truth in Lending disclosure, the appellate court directed summary judgment for Chrysler Credit Company on the grounds that the signed acknowledgment satisfied section 131, and that there was no violation apparent on the face of the contract and no evidence that Chrysler knew of any noncompliance. Earlier, a federal district court had read section 131 equally literally, but with the opposite effect, where a furniture contract clearly failed to include certain downpayment information.\(^3\) Here, said the court, “[t]he failure to provide this information is apparent on the face of the paper. Thus, the assignee has notice of the failure to comply with the disclosure requirements.”\(^4\)

The only other reported cases\(^5\) construing the civil penalty liability of third party financers unfortunately lose themselves in a thicket of statutory brambles trying to fashion an elaborate “conduit” theory to justify imposing civil penalties on assignees. That issue is now academic in light of the 1974 amendment to Truth in Lending,\(^6\) which specifies that assignees may be held liable.

\(^4\) Id. at 89, 584.
Since Truth in Lending expressly preempts inconsistent state law,\textsuperscript{262} it is doubtful that any penalty liability can be thrust upon financers other than as the Act itself permits. But many disclosure violations will arguably be "apparent on the face of the instrument assigned," and in these cases financers can be subjected to settlement pressure, to setoffs, and even to affirmative recoveries.\textsuperscript{263} And where the Act permits a consumer to rescind a real estate credit transaction, there is authority that the financer is not only susceptible to the rescission decree but can also be compelled to refund any mortgage payments received.\textsuperscript{264}

Other civil penalty statutes can present variations on the same theme. Penalties recoverable under the Federal Odometer Law, for example, are substantial—thrice actual damages or fifteen hundred dollars, whichever is greater\textsuperscript{265}—but there is no indication in the statute of special protections for financers of used cars sold in violation of the Act.

The 1969 Uniform Consumer Credit Code provided an array of penalty liabilities for creditors who violated its provisions. For some creditor misdeeds, the consumer debtor was released from any obligation to pay the finance charge and entitled as well to recover up to three times that finance charge.\textsuperscript{266} If a lender violates provisions on "supervised loans," the consumer need not repay either principal or interest and can recover any payments made.\textsuperscript{267} Consumers were also entitled to prompt refunds of any charges in excess of those allowed by the Act, failing which the debtor could recover either the full finance charge or ten times the excess charge, whichever is greater.\textsuperscript{268} For each of these penalties the Act specified that they were recoverable either from the original creditor "or from an assignee of that person's rights who undertakes direct collection of payments or enforcement of rights against debtors

\textsuperscript{263} The opinion in a recent case is instructive on these points. Hall v. Sheraton Galleries, 4 CCH CONSUMER CREDIT GUIDE ¶ 98,737 (N.D. Ga. 1974). Without apparent objection, General Electric Credit Corporation was joined as a defendant in an action for civil penalties for disclosure violations by the Galleries. Information concerning collection of attorneys' fees and acceleration of unpaid balances was on the reverse side of the disclosure statement and this, said the court, violated the regulation requiring all Truth in Lending disclosures to be in a meaningful sequence. Id. at 88, 336. For these sins the court recommended awards of $100 against Galleries and $1,100 against the Credit Company. Id. at 88, 338.
\textsuperscript{264} Sosa v. Fite, 498 F.2d 114 (5th Cir. 1974).
\textsuperscript{266} 1969 UCCC § 5.202(1).
\textsuperscript{267} Id. § 5.202(2).
\textsuperscript{268} Id. § 5.202(3).
arising from the debt." Read at face value, these provisions would permit counterclaims or direct suits by consumers against third party financers for the full amount of the specified penalties, regardless of the amount, or even the existence, of an unpaid balance on the underlying debt. The financers' only protections are the "bona fide error" excuse and the statute of limitations.

Against this background, the 1974 Uniform Consumer Credit Code introduces complications. The language expressly permitting penalty claims against assignees is retained only in the section dealing with recovery of excess charges. For violations of twenty-two other provisions the new Act specifies that penalties from one hundred to one thousand dollars may be recovered "from the person violating this Act." There is no mention of assignees, and although presumably the draftsmen intended the lack of symmetry, their comments shed no light at all on the reasons for the differing provisions. Again reading the Act at face value, third party financers are apparently relieved of considerable potential penalty liability in what the draftsmen intended as a more pro-consumer Uniform Consumer Credit Code. But there is more! A subsequent provision of the Act states:

Damages or penalties to which a consumer is entitled pursuant to this Part may be set off against the consumer's obligation, and may be raised as a defense to an action on the obligation without regard to the time limitations prescribed by this Part.

Still there is no mention of assignees, but the language can be construed as more than a waiver of time limitations—it can be read as a general authorization to consumers to use penalty claims to defeat recoveries by financers. This interpretation would fit nicely

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269 This language appears in each of the provisions cited above. Notes 268-69 supra (emphasis added).
270 The 1969 Uniform Consumer Credit Code imposes no liability if the creditor can prove that a violation is unintentional or the result of bona fide error. 1969 UCCC § 5.202(7).
271 Sections 5.202(1) and (2) of the 1969 Uniform Consumer Credit Code set one year limits, while § 5.202(4) allows two years for recovery of excess charges on revolving charge and loan accounts, and one year as to other accounts.
272 1974 UCCC § 5.201(2).
273 Id. § 5.201(1).
274 Id. § 5.209. The grammatical and substantive ambiguity of this sentence defies belief. Is it merely confirming that consumers can assert penalty claims defensively, or is its thrust that whenever a consumer otherwise has a penalty claim against his creditor he is excused from the normal time limitations? Are the time limitations waived only if the penalty is raised as a defense in a lawsuit, or are they also waived if the consumer at any time deducts his claimed penalty from his bill?
with the 1974 Uniform Consumer Credit Code's provisions subjecting financers to "all claims and defenses of the consumer against the seller," but only "to the extent of the amount owing" at the time the creditor receives notice.\textsuperscript{275} Third party financers might be unable to recover balances owing on the consumer obligation, but they would not be subject to affirmative penalty liability beyond that.

Thus there appear to be differing attitudes toward financer liability for penalties in the Truth in Lending Act at the federal level, and in the 1974 Uniform Consumer Credit Code as a model for state enactment. There may be some grain of justification for holding independent financers to stricter account for violations of Truth in Lending rules concerning disclosure of the basic credit terms—which the financer may dictate—than for violations of other protective provisions. In both cases, however, the threat of penalty liability puts additional pressure on the financer to know and to police the contracts and practices of his dealers.\textsuperscript{276}

Finally, a creditor with an eye on the horizon for potential liabilities ought to consider the implications of the decision in \textit{Connor v. Great Western Savings & Loan Association}.\textsuperscript{277} Written by Chief Justice Roger Traynor of the California Supreme Court, this case lays the foundation for imposing on third party lenders a substantial burden of due care in overseeing the activities of the sellers they finance, from which burden an action directly against the financer will lie for all direct and consequential damages caused by his negligence. If the case portends so much, it merits a closer look.

The defendant Association in \textit{Connor} had provided construction loans to the developers, and purchase money mortgages to consumer buyers, during the development of a tract of residences in southern California. The slab foundations of the homes turned out to be unsuited for the adobe soil. When they cracked and shifted, causing extensive structural damage, a number of home buyers sued the developer and the lender for damages.\textsuperscript{278} The

\textsuperscript{275} 1974 amendment to the Truth in Lending Act prevents a consumer from setting off a claimed penalty against his debt until the creditor's liability has been determined in court. Pub. L. No. 93-495, § 408(d) (Oct. 28, 1974) (adding Truth in Lending Act § 130(b)).

\textsuperscript{276} The National Commission on Consumer Finance specifically recommended amendment of the Truth in Lending Act to make clear that assignees were liable for penalties for obvious violations. It saw this device as easing the policing burden and expense of public enforcement agencies. NCCF REPORT 190.

\textsuperscript{277} 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968).

\textsuperscript{278} Id. at 856, 447 P.2d at 611, 73 Cal. Rptr. at 371.
question of negligent construction and resulting damage were conceded by the time the case reached the California Supreme Court, where the issues were whether the Association's involvement with the developer amounted to a joint venture and, if it did not, whether there could be independent liability for the lender.279

The Association's spirit of adventure must have peaked in this case. It committed some three million dollars in loans to a development company called Conejo and run by two individuals, neither of whom had any significant experience in the construction of tract housing. It "warehoused" the real estate itself, purchasing it in its own name and reselling it to the developers at a twenty percent profit. Aware of Conejo's thin capitalization, the Association charged a five percent loan placement fee and a 6.6 percent interest on the construction loans themselves. It reserved a right of first refusal on all first trust loans to home purchasers, and collected an additional one or one and a half percent fee from the developers for every such loan made. It reviewed the borrowed architectural plans and specifications for the homes, but not the foundation plans. "It was preoccupied with selling prices and sales."280 As construction progressed, the Association had its inspectors on the job site weekly, but their attention was given to seeing that the superstructure plans were being followed and that the Association's money was disbursed only for work completed.281

There was in this arrangement no joint venture, said Chief Justice Traynor. Despite the shared risk and shared control, and although both the Association's and the developer's profits were dependent on the overall success of the venture, there was no "joint" interest; neither participant was to share in the profits or losses of the other. Nor was there any contractual underpinning for a joint enterprise.282 But, said the court, even though the lender is not vicariously liable for the developer's negligence, "there remains the question of its liability for its own negligence."283

To answer this question, Traynor turned to California precedents on negligence liability without privity of contract, adopting a six part test the court had developed a decade earlier:

The determination whether in a specific case the defendant

279 Id. at 856, 862-64, 447 P.2d at 611, 615-17, 73 Cal. Rptr. at 371, 375-77.
280 Id. at 860, 447 P.2d at 614, 73 Cal. Rptr. at 374.
281 Id. at 862, 447 P.2d at 615, 73 Cal. Rptr. at 375.
282 Id. at 863, 447 P.2d at 615, 73 Cal. Rptr. at 375.
283 Id. at 864, 447 P.2d at 616, 73 Cal. Rptr. at 376.
will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are (1) the extent to which the transaction was intended to affect the plaintiff, (2) the foreseeability of harm to him, (3) the degree of certainty that the plaintiff suffered injury, (4) the closeness of the connection between the defendant's conduct and the injury suffered, (5) the moral blame attached to the defendant's conduct, and (6) the policy of preventing future harm.  

Applying these criteria to Great Western the court adjudged that the lender was "clearly under a duty to the buyers of the homes to exercise reasonable care" to avoid structural defects. Traynor's response to arguments of the Association that imposing such a duty would increase housing costs, drive marginal builders out of business, and decrease the supply of needed housing was that these burdens were at best "conjectural." He noted that adobe soil conditions could be easily and cheaply identified and remedied. Finally, observing that there were no local ordinances requiring soil analysis prior to construction, the court stated:

If existing sanctions are inadequate, imposition of a duty at the point of effective financial control of tract building will insure responsible building practices. . . . [T]he losses of family savings invested in seriously defective homes would be devastating economic blows if no redress were available.

The considerations underlying direct tort liability for tract financiers, then, are precisely those that pervade holder in due course analyses—risk distribution and policing of merchant practices!

If the court's opinion is presumptively thoughtful and judicious, in the Traynor tradition, it is surprising that its reception has been so unenthusiastic. The majority opinion drew strong dissents. The California legislature rushed to the aid and comfort of the lenders by passing a statute which would exculpate any real or personal property financer from liability for defective products, "unless such loss or damage is a result of an act of the lender outside the scope of the activities of a lender of money." Nor has the decision drawn any judicial following.

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285 Id. at 866, 447 P.2d at 617, 73 Cal. Rptr. at 377.
286 Id. at 867, 447 P.2d at 618, 73 Cal. Rptr. at 378.
287 Id. at 868, 447 P.2d at 618, 73 Cal. Rptr. at 378-79.
288 CAL. CIV. CODE § 3434 (West 1970).
289 Connors has frequently been considered and rejected in cases involving real estate financing. See Bradler v. Craig, 274 Cal. App. 2d 466, 79 Cal. Rptr. 401 (1969); Callaizakis v.
Nevertheless, it is not difficult to superimpose the Connor rationale onto some of the holder in due course cases. When Unico was formed exclusively to finance paper generated by Universal, could not the financer be charged with responsibility to see that the merchant's sales practices were reasonable and that it would not default on executory contracts? Could not the District of Columbia savings and loan association whose officers blithely took first trust deeds from Monarch victims after inspecting the "improved" homes, and knowing the outrageous contract terms, be considered negligent toward the consumers? Was it only "notice" for holder in due course purposes, or might it not be negligence, for the General Investment Company to purchase aluminum siding notes without inspection of the premises and without asking for a completion certificate signed by the consumer?

As a Pennsylvania court noted, Connor might be effectively overruled by statute in its state of origin, but it remains a viable expression of common law principles, available for judicial adoption at a moment's notice. Its lurking presence in the background of holder in due course debate ought to be acknowledged, and its implications understood, for so long as holder in due course is not uniformly abolished across the country, courts are free to bypass it in favor of a direct liability, for negligence or otherwise, that will compensate the injured consumer for all his damages. And even if the provisions of the 1974 Uniform Consumer Credit Code are uniformly adopted, its limitations on financer liability could be disregarded by courts choosing the Connor path.

III

Prognosis

Holder in due course is not dead, even in its historical sense, so long as different jurisdictions treat it differently in their courts and legislatures and so long as it is not abolished root and branch


in all consumer transactions—from home improvements to auto
sales to credit card purchases. In fact, to prolong the metaphor,
holder in due course is not a single organism slayable in a single
blow. It is a collection of legal traditions and rules and commercial
practices which merge into a single result: the insulation of finan-
cers from consumer claims. No assault on the doctrine can there-
fore succeed unless it is both comprehensive and uniform, and the
impetus for such an attack may need to come from the federal
level.\footnote{Momentum for comprehensive federal intervention clearly exists. The Truth in
Lending Act has now been followed in quick succession by the Fair Credit Reporting Act (15
28, 1974)). The National Commission on Consumer Finance has also recommended a
federal watchdog agency to coordinate compliance with existing laws. NCCF REPORT 58-59.
Senator Proxmire has become chairman of the full Senate Banking committee in the
94th Congress, and is likely to introduce legislation to strengthen the Fair Credit Reporting
Act and to regulate credit insurance. A comprehensive National Consumer Credit Act is also
on the drawing boards. Washington Star-News, Dec. 27, 1974, at 1, col. 4.}

Financing patterns will grow and change. As creditor protec-
tions like holder in due course are eliminated, marginal dealers
and financers may go with them. In that case, the share of the
consumer credit market held by the banks and by large institu-
tional lenders will undoubtedly increase, creating a potentially
unhealthy concentration of market power in the hands of a rela-
tively few dominant creditors and merchants.\footnote{Cautions against the danger of a credit oligopoly have been sounded loudly. See
NCCF REPORT 138; id. 219 (separate statement of Senator John Sparkman); Milton Schober,
Former General Counsel to NCCF, Statement, March 13, 1973, in FTC Record 6994, 6996.
See NCCF REPORT 205-12. Title II of the Act of October 28, 1974, established a
National Commission on Electronic Fund Transfers and charged it to study, investigate and
make recommendations for appropriate administrative and legislative action "in connection
with the possible development of public or private electronic fund transfer systems." The
Commission is to take into account the need to preserve and promote competition, the need
to prevent discriminatory practices and to afford confidentiality, and, last on the list, "the
need to protect the legal rights of users and consumers." Pub. L. No. 93-495 (Oct. 28, 1974).}Technology is
developing new fund-transfer systems as a result of which the line
between credit and cash transactions will fade.\footnote{See NCCF REPORT 205-12. Title II of the Act of October 28, 1974, established a
National Commission on Electronic Fund Transfers and charged it to study, investigate and
make recommendations for appropriate administrative and legislative action "in connection
with the possible development of public or private electronic fund transfer systems." The
Commission is to take into account the need to preserve and promote competition, the need
to prevent discriminatory practices and to afford confidentiality, and, last on the list, "the
need to protect the legal rights of users and consumers." Pub. L. No. 93-495 (Oct. 28, 1974).}As this merger
occurs, the fairly safe position of credit card issuers under present
law will probably need to be reexamined.

A proper line for distinguishing independent from interlock-
ing lenders has yet to be drawn. Judicial attitudes from the past will
likely haunt the enforcement of the best legislative efforts, and it
can only be a matter of time before courts, in the face of egregious
facts, will begin extending creditor liability beyond statutory
bounds on theories of restitution or negligence or joint venture.
What is happening to holder in due course is a reformation, a cutting away of old abuses and the hopeful structuring of a new order in the consumer credit market. But, like other reformations, this one cannot be fully implemented without corresponding changes in other areas such as rate regulation, freedom of entry, and consumer education. And like other reformations, this one will undoubtedly produce divisions, schisms, heresies, and upheavals of its own.