

UNIFORM COMMERCIAL CODE COMMENTARY

JUDICIAL AND STATUTORY LIMITATIONS ON THE RIGHTS OF A "HOLDER IN DUE COURSE" IN CONSUMER TRANSACTIONS

The application of the "holder in due course"¹ doctrine of the Uniform Commercial Code (hereinafter U.C.C.) to consumer transactions often results in serious inequities for the small consumer. The typical credit purchase of consumer goods entails a down payment and the execution by the buyer of a promissory note,² evidencing his obligation to pay the balance of the purchase price to the seller. In addition, the buyer usually signs a security instrument such as a chattel mortgage, bailment lease, or a conditional sales contract which gives the payee of the note a security interest in the item sold.³ The promissory note and the security instrument are frequently assigned by the seller to a finance company or similar institution. If the financier acquires the instruments "for value," "in good faith," and "without notice" of any irregularities or any claims or defenses to them, it acquires the legal status of a "holder in due course" as defined by Section 3-302 of the U.C.C. As such, under Section 3-305 of the Code, it takes the instruments free from "all defenses of any party . . . with whom the holder has not dealt."⁴ Accordingly, as a holder in due

¹ U.C.C. §§ 3-302, 3-305.

² B. Curran, Trends in Consumer Credit Legislation 91 (1965); Jones, Finance Companies as Holders in Due Course of Consumer Paper, 1958 Wash. U.L.Q. 177, 178. See also *Implement Credit Corp. v. Elsinger*, 268 Wis. 143, 160, 66 N.W.2d 657, 666 (1954) (judicial notice taken of the prevalence of credit sales involving negotiable notes).

³ B. Curran, *supra* note 2; Jones, *supra* note 2.

⁴ U.C.C. § 3-305, Rights of a Holder in Due Course, provides:

To the extent that a holder is a holder in due course, he takes the instrument free from

- (1) all claims to it on the part of any persons; and
- (2) all defenses of any party to the instrument with whom the holder has not dealt except
 - (a) infancy, to the extent that 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.

Thus, the holder in due course is not insulated from the so-called "real" defenses enumerated in subsection 2; however, so-called "personal defenses," e.g., misrepresentation, failure of consideration and breach of express or implied warranty, may not be raised against a holder in due course.

course, the financier is entitled to payment in full on the instrument in his possession, but at the same time assumes no responsibility for "claims or defenses" arising out of the transaction in which the obligation was incurred.⁵

This relative insulation of the holder in due course from the buyer's defenses can pose considerable difficulties if a consumer discovers that he has been defrauded by the seller or if the merchandise purchased proves defective and the seller refuses to rectify the problem. This difficulty is presented in its extreme form if the seller becomes insolvent or cannot be found. If the consumer decides not to pay for the unsatisfactory purchase, he discovers that the finance company holding his note will insist upon payment in full despite his justifiable complaint against the seller.⁶ If the buyer persists in withholding payment, the finance company may ultimately sue and he may discover that, because of the holder in due course doctrine, the court is no more receptive to his difficulties with the seller than the finance company was. The problem has increased greatly with the large upsurge in consumer installment credit sales during the past two decades.⁷

Since finance companies are in a much better position than the average consumer to investigate and evaluate the reliability of their seller-assignors, they are better able to protect their interests. A system which so favors the financier over the relatively more vulnerable consumer seems inherently harsh. The specific requirements of the holder in due course doctrine have provided some sympathetic courts with a basis for affording relief to consumers in particular fact situations. The inequities have also led some legislatures to limit the applicability of the doctrine in consumer transactions. This comment will survey a number of judicial decisions which have refused to recognize assignees of consumer paper as holders in due course and will examine

⁵ With the exception of the "real" defenses as enumerated in U.S.C. § 3-305(2), note 4 *supra*.

⁶ Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 S. Cal. L. Rev. 48, 60 (1966); McEwen, *Economic Issues in State Regulation of Consumer Credit*, 8 B.C. Ind. & Com. L. Rev. 387, 401 (1967) (intentional abuse of the holder in due course principle by "unscrupulous businessmen"); P. Wald, *Report to the National Conference on Law and Poverty* 24 (June 1965) (victimization of the poor through abuses of holder in due course); Note, *Translating Sympathy for Deceived Consumers into Effective Programs for Protection*, 114 U. Pa. L. Rev. 395, 397-403 (1966) (extended hypothetical dealing with holder in due course in a consumer transaction).

⁷ As of December 31, 1950, the total amount of consumer installment credit outstanding was \$14,703,000,000. 1967 Statistical Abstract of the United States 465, Chart 649. As of September 1969, this total had risen to \$95,356,000,000. 55 Fed. Reserve Bull. A-54 (Nov. 1969). See generally J. Chapman and R. Shay, *The Consumer Finance Industry, Its Costs and Regulation* 2 (1967); B. Curran, *supra* note 2, 1-2 (1965); Jones, *supra* note 2; Introduction—*Consumer Credit Symposium*, 55 Nw. U.L. Rev. 301 (1960).

The burgeoning demand by consumers for installment credit has been attributed largely to "the growth in population, earlier family formation, rising incomes, and the increasing availability of sources for consumer credit." J. Chapman and R. Shay, *supra*, at 3.

the various theories upon which these decisions have proceeded. In addition, a number of state statutes limiting the applicability of holder in due course in consumer transactions will be discussed, including the pertinent provisions of the recently promulgated Uniform Consumer Credit Code. The conclusion will suggest that neither of these approaches currently affords the consumer adequate protection against a holder in due course and will propose minimum requisites for effective statutory protection.

I. JUDICIAL LIMITATIONS

A number of courts faced with suits against consumers by financing assignees of sellers have manifested a discernible reluctance to mechanically apply the holder in due course doctrine. This reluctance might be expected when the facts of the case suggest probable fraud by the seller, or when such an application will result in obvious injustice to the consumer. However, the overall judicial response to compelling fact situations and victimized consumers has been characterized as both uncertain and unpredictable.⁸ The unpredictable aspect of the decisions is due primarily to the variety of theories which have been employed by the courts in finding for the consumer. Section 3-305 of the U.C.C. renders the finance company, once it has qualified as a holder in due course, immune to "personal"⁹ defenses. This immunity has been transferred from the Uniform Negotiable Instruments Law,¹⁰ (hereinafter U.N.I.L.) which was initially approved by the National Conference of Commissioners on Uniform State Laws in 1896. Consequently, courts which desire to rule in favor of the consumer in controversies involving a holder of the consumer's note must somehow reconcile their decisions with a legal principle that has existed in statutory form for over 70 years.¹¹

Nevertheless, a number of courts faced with cases involving consumer paper under both the U.N.I.L. and the U.C.C. have ruled for the consumer. These decisions have proceeded upon several distinguishable but overlapping theories: (1) finding the financier-assignee to have been, in essence, a "co-participant" with the seller in the original transaction; (2) finding the relationship between the original seller and the financier-assignee to have been one of "agency"; and (3) finding that the financier acted in "bad faith" or had knowledge imputing notice to him, thus disqualifying him as a holder in due course.

⁸ Littlefield, *supra* note 6, at 65.

⁹ See note 4 *supra*.

¹⁰ Section 57 of the U.N.I.L. provides:

Rights of a Holder in Due Course.—A holder in due course holds the instrument free from any defect of title of prior parties, and free from defenses available to prior parties among themselves, and may enforce payment of the instrument for the full amount thereof against all parties liable thereon.

¹¹ The states of Colorado, Connecticut, Florida and New York adopted the law in 1897, the year following its approval by the Commissioners. 5 Uniform Laws Ann. XIII, Table III (1943).

A. *The Financing Agency as a "Co-participant" in the Original Transaction*

A common basis upon which courts have circumvented the necessity of disallowing consumer defenses in a suit by a financing assignee has been that of finding the financing company to have been too intimately involved with the assignor-seller's business transactions to claim holder in due course status as a "detached" third party. Theoretically, the financing agency which obtains a negotiable instrument in the course of business does so purely in the pursuit of its own commercial endeavors and completely without knowledge of the transaction which gave rise to the instrument. Notwithstanding this theoretical ideal, the practicalities of modern financing have resulted in considerably more direct participation on the part of financing agencies in the transactions of their prospective assignors.¹² An early case denying an assignee's claim that he was an innocent purchaser of a note and not subject to the buyer's defenses in a consumer transaction on the grounds that it was too intimately involved in the business affairs of the seller was *Commercial Credit Co. v. Childs*.¹³ In that case a finance company sued a consumer on a note executed in connection with an automobile sale. When the consumer sought to defend on the grounds that the vehicle was defective and that he had been falsely induced to sign the contract, the finance company disclaimed responsibility for these circumstances as an "innocent purchaser" of the note. In refusing to recognize the finance company's status as such, the court observed that the note being sued upon was attached to the dealer's contract and bore on its back a printed form for assignment to the finance company. Moreover, these instruments had been supplied to the automobile dealer by the finance company and the note, contract and assignment were all executed on the same day. On the basis of these facts the court concluded:

We think appellant [finance company] was so closely connected with the entire transaction or with the deal that it

¹² 1 Board of Governors of the Federal Reserve System, *Consumer Installment Credit*, pt. 2, at 427 (1957); Jones, *supra* note 2, at 179; Littlefield, *supra* note 6, at 63-64; 75 Harv. L. Rev. 437, 438 (1961).

¹³ 199 Ark. 1073, 137 S.W.2d 260 (1940). See 53 Harv. L. Rev. 1200 (1940) (approving the holding as "abandoning the test of the 'white heart and the empty head' in the case of the transferee who is more like an original party to the transaction than a subsequent purchaser. . . ."); *Contra*, *Implement Credit Corp. v. Elsinger*, 268 Wis. 143, 161, 66 N.W.2d 657, 666 (1954):

We can perceive of no reason based upon either logic or public policy why a finance company or a bank which supplied such blank printed forms should be held thereby to have constituted the dealers their agents, or should be deemed to have participated in the sale by the dealer to the customer, including the execution of any contract, mortgage, or note which the customer may have executed to the dealer. For these reasons, this court does not consider the cases of *Commercial Credit Co. v. Childs* . . . and *Mutual Finance Co. v. Martin* . . . holding to the contrary on this point should be followed as precedents in this state for we believe them to be based upon an unsound premise.

cannot be heard to say that it, in good faith, was an innocent purchaser of the instrument for value before maturity. It financed the deal, prepared the instrument, and on the day it was executed took an assignment of it from the Arkansas Motors, Incorporated. Even before it was executed it prepared the written assignment thereon to itself. Rather than being a purchaser of the instrument after its execution it was to all intents and purposes a party to the agreement and instrument from the beginning.¹⁴

The reasoning of *Commercial Credit Co.* was adopted by the Supreme Court of California in *Commercial Credit Corp. v. Orange County Machine Works*,¹⁵ a case involving a commercial rather than a consumer transaction. In *Orange County Machine Works*, the finance company had also supplied the seller with forms and had twice consulted by telephone with the seller regarding the impending transaction. It approved the details of the transaction and had advanced money to the seller with the understanding that the contract and note would be assigned or endorsed to the finance company immediately upon consummation of the sale. The court observed:

In a very real sense, the finance company was a moving force in the transaction from its very inception, and acted as a party to it.

When a finance company actively participates in a transaction of this type from its inception, counselling and aiding the future vendor-payee, it cannot be regarded as a holder in due course of the note given in the transaction and the defense of failure of consideration may properly be maintained.¹⁶

In the later case of *Mutual Finance Co. v. Martin*,¹⁷ the court, citing both *Commercial Credit Co.* and *Orange County Machine Works*, refused to recognize a finance company as a holder in due course in a transaction for the purchase of a deep freezer. In the stipulated statement of facts the finance company admitted that it had prepared and furnished to the seller printed forms for the conditional sales agreement with a promissory note attached. The printed forms designated the finance company as the specific assignee of both the conditional sales contract and note. It was further stipulated that the contract and note designated the finance company's office as the place of payment, that the finance company had investigated the buyer's credit standing, had approved the terms of the purchase in advance, and had taken assignment of both contract and note the day after

¹⁴ 199 Ark. at 1077, 137 S.W.2d at 262.

¹⁵ 34 Cal. 2d 766, 214 P.2d 819 (1950).

¹⁶ *Id.* at 771, 214 P.2d at 822.

¹⁷ 63 So. 2d 649 (Fla. 1953). An annotation on *Mutual Finance*, dealing with transferees of commercial paper as subject to defenses which the buyer could assert against the seller, appears at 44 A.L.R.2d 8 (1955).

their execution. The deep freezer in *Mutual Finance* was stipulated to have been faulty and wholly valueless for its intended purpose. On the basis of these facts, the court declared:

We think, so far as the admitted facts in this case are concerned, that the better rule is that approved in *Commercial Credit Co. v. Childs*. . . .¹⁸

The court then quoted that portion of *Commercial Credit Co.* which held the finance company to have been "to all intents and purposes a party to the agreement and instrument from the beginning."¹⁹

A classic example of an attempt to exploit the holder in due course doctrine is presented in *Westfield Inv. Co. v. Fellers*.²⁰ In *Westfield*, the defendants were victims of a bogus freezer "food plan." A salesman from Ideal Home Food Service represented to them that if they agreed to purchase \$70 worth of food monthly for three years, Ideal would supply them with a freezer and that at the end of the three year period they would obtain title to the freezer absolutely free of charge. On the strength of these representations the defendants signed Ideal's "sales contract" and a promissory note. The instrument, which had been supplied to Ideal by the finance company, contained a printed assignment form designating the plaintiff finance company as exclusive assignee. The forms signed by the defendants contained numerous blanks, and the defendants subsequently discovered that the blanks had been filled in to reflect purported obligations on their part to purchase a freezer for \$825, food for \$111 and to pay finance charges of \$354.72. Thereafter, the defendants refused to make any payments. The finance company, which had taken assignment of the note, repossessed the freezer and food, sold them, and then sued the defendants for a deficiency judgment of \$1,420.75. Noting the prevalence of such "freezer plan" frauds, the court declined to allow the finance company to claim holder in due course status as a bar to the buyer's defenses. After a review of *Commercial Credit Co.*, *Orange County Machine Works*, and *Mutual Finance*, the court concluded:

[T]his court is of the opinion that Westfield Investment Company, not only by its actions and knowledge of the situation prevailing here and in similar freezer deal transactions but also in delivery to its selected dealer of an instrument which, for all practical purposes could be negotiated only to it, became so inextricably a part of the original transaction with the purchaser that it could not thereafter stand aloof in the role of a holder in due course *in good faith*.²¹

¹⁸ 63 So. 2d at 652.

¹⁹ Id. at 653.

²⁰ 74 N.J. Super. 575, 181 A.2d 809 (L. Div. 1962).

²¹ Id. at 590-91, 181 A.2d at 818. But see *Waterbury Sav. Bank v. Jaroszewski*, 4 Conn. Cir. 620, 238 A.2d 446 (Cir. Ct. 1967) (bank found to be holder in due course of

The judicial trend of denying holder in due course status to finance companies which are too intimately involved with the assignor-seller was contained in a recent case, *Unico v. Owen*.²² *Unico* involved another consumer "bargain" in which the buyer, in return for his agreement to purchase 140 stereo albums over an extended period of time, was to have received, "without separate charge," a new stereo player. The contract and note signed by the defendants stated that the payments should be made to Universal Stereo Corporation, the seller. However, on the reverse side of the note appeared an elaborate printed form of endorsement which provided for assignment of the note to Unico, a financing company. The purchasers defaulted on their payments when they failed to receive any more albums after initial delivery of 12 albums. The court observed that Unico was a partnership formed expressly for the purpose of financing Universal Stereo, and that by the terms of the contract between Unico and Universal, Unico agreed to lend Universal up to 35 percent of the value of all contracts assigned to Unico. In return for this agreement Universal submitted to a substantial degree of control of its entire business operation by Unico. The court commented:

This general outline of the Universal-Unico financing agreement serves as evidence that Unico not only had a thorough knowledge of the nature and method of operation of Universal's business, but also exercised extensive control over it. Moreover, obviously it had a large, if not decisive, hand in the fashioning and supplying of the form of contract and note used by Universal, and particularly in setting the terms of the record album sales agreement, which were designed to put the buyer-consumer in an unfair and burdensome legal straight jacket and to bar any escape no matter what the default of the seller, while permitting the note-holder, contract-assignee to force payment from him by enveloping itself in the formal status of holder in due course. To say the relationship between Unico and the business operations of Universal was close, and that Unico was involved therein, is to put it mildly.²³

After a discussion of *Orange County Machine Works* and the subsequent cases holding similarly, the court concluded:

In our judgment the views expressed in the cited cases provide the sound solution to the problem under consideration.

note executed in connection with freezer food plan when evidence disclosed that out of 500 to 600 similar financing transactions only 3 or 4 complaints had been received from customers); *James Talcott, Inc. v. Schulman*, 82 N.J. Super. 438, 198 A.2d 98 (App. Div. 1964) (distinguishing *Westfield* on the grounds that in addition to supplying the seller with forms there were many other circumstances in *Westfield* to indicate actual knowledge on the part of the finance company of the activities of the seller).

²² 50 N.J. 101, 232 A.2d 405 (1967).

²³ *Id.* at 115, 232 A.2d at 413.

Under the facts of our case the relationship between Unico and Universal, and the nature of Unico's participation in Universal's contractual arrangements with its customers, if anything are closer and more active than in any of those cases, and in justice Unico could not be deemed a holder in due course of the Owen note.²⁴

In *American Plan Corp. v. Woods*,²⁵ a fast-talking salesman induced the consumer to purchase a water softener for her home. The sales arrangement involved a "referral scheme" whereby the consumer would be paid \$50 for the name of each prospective customer supplied to the seller, Crystal Clear Incorporated. The consumer mailed form letters to her friends and supplied Crystal Clear with the names of 40 people, many of whom subsequently purchased water softeners, but she received only \$100 for her efforts. The finance company involved in the case had approved of the referral plan in advance, had supplied Crystal Clear with notes and other forms, had established a carrying charge of \$215 for each note, had reserved the right to refuse any note it felt was risky, and personally investigated the credit of each purchaser whose note was offered to it. The consumer had executed one of these notes and the finance company had purchased it. The evidence indicated that she had been given to understand that the machine was being *given* to her for "advertising" and that she did not intend to *buy* a water softener. In permitting the buyer to raise her defenses the court adopted the holding in Unico:

As that court stated, we are impelled to "join those courts which deny the holder in due course status in consumer goods sales cases to those financiers whose involvement with the seller's business is as close, and whose knowledge of the extrinsic factors—*i.e.*, the terms of the underlying sale agreement—is as pervasive, as it is in the present case."²⁶

A very recent decision of the Supreme Court of Delaware has followed the foregoing line of precedents in refusing to recognize a finance company affiliated with a seller of precut homes as a holder in due course under the U.N.I.L.²⁷ In *Jones v. Approved Bancredit Corp.*,²⁸ a salesman representing the seller presented the consumer with a jumble of forms for signing. When she requested time to consult an attorney, he asserted that this would be a waste of time, and that if the forms were not signed immediately, construction of her home would be substantially delayed. The consumer finally acquiesced and signed a mortgage, a judgment bond and warrant, a promissory note, a construction con-

²⁴ *Id.* at 122, 232 A.2d at 416.

²⁵ 16 Ohio App. 2d 1, 240 N.E.2d 886 (1968).

²⁶ *Id.* at 6, 240 N.E.2d at 889.

²⁷ The promissory note was executed before the effective date of the U.C.C. in Delaware.

²⁸ — Del. —, 256 A.2d 739 (1969).

tract, a request for insurance, an affidavit that the masonry work and foundation were completed and paid for (when in fact none of the work had been commenced) and an affidavit that no materials were delivered or work started as of the date of the mortgage. The promissory note in the amount of \$3,250 (\$2,500 principal plus \$750 in "charges") was immediately assigned to Bancredit Corporation which paid the seller \$2,250 for the \$3,250 obligation. During construction an employee of the builder drove a bulldozer into the side of the partially-completed structure and knocked it off its foundation. The seller disclaimed any responsibility for this occurrence deeming it "a work of God," and the builder refused to proceed further with construction. County authorities declared the building site unsafe and the consumer was required to raze the remnants of the building and fill the basement at considerable personal expense. Later, the seller terminated its business and closed its offices.

Thereafter Bancredit foreclosed on the mortgage and sued the consumer for an unpaid balance of \$2,560.23 plus interest. The lower court directed a verdict for Bancredit on the ground that it was a holder in due course, and that the consumer's defenses of fraud could not be raised against it. The depositions of the parties established that the original seller and Bancredit were wholly-owned subsidiaries of Albee Homes Inc. Bancredit was described as a "finance department" of Albee which obtained 99 percent of its business from the seller and similar sales subsidiaries of Albee. Bancredit and Albee had the same officers and directors and Albee named the directors and officers of the seller. Moreover, Bancredit had exclusive power of approval over any transaction tendered by the seller and had the power to impose special conditions on any purchase. The Supreme Court of Delaware, after a review of many of the authorities discussed above, reversed the lower court, observing:

Under the totality of facts and circumstances of this case, we hold that the rule of balance should be adopted and applied; that it should operate in favor of the installment buyer for the reason that, in our opinion, Bancredit was so involved in the transaction that it may not be treated as a subsequent purchaser for value. By reason of its sister corporation relationship to Dell [the seller] and the established course of dealing between them, Bancredit was more nearly an original party to the transaction than a subsequent purchaser of the paper; and, for the reasons of fairness and balance stated in the foregoing authorities, Bancredit should be denied the protected status of holder in due course which would prevent Mrs. Jones from having her day in court on the defenses she would have otherwise had against Dell.²⁹

Generally, these cases have proceeded largely upon the theory

²⁹ *Id.* at ___, 256 A.2d at 743.

that the finance company had become, in effect, a partner in the transactions of the dealer. One recurring feature in the fact patterns of many of the cases is the supplying of forms to the dealer by the finance company. It is apparent, however, that no clear rule has been established. In the *Unico* case the court employed a "transactional" approach in determining whether the relationship between the finance company and the dealer was too "pervasive":

For purposes of consumer goods transactions, we hold that where the seller's performance is executory in character and *when it appears from the totality of the arrangements between dealer and financier* that the financier has had a substantial voice in setting standards for the underlying transaction, or has approved the standards established by the dealer, and has agreed to take all or a predetermined or substantial quantity of the negotiable paper which is backed by such standards, the financier should be considered a participant in the original transaction and therefore not entitled to holder in due course status.³⁰ (Emphasis added.)

The approach in *Westfield* was similar. There the court qualified its holding in the following language:

This court is not about to hold that the *mere* supplying of negotiable forms in blank by the financing company to a vendor is sufficient to strip the financing company of its holder in due course status. However, this court is saying that the supplying of such forms is one of the factors to be looked at in defining the relationship existing between the parties, namely, the vendor, the financing company and the maker.³¹

The *Jones* court also considered "the totality of the facts and circumstances"³² in making its findings.

It would appear that the degree of involvement in the seller's business on the part of the financier, previous course of dealings between the seller and the financier, the degree of control exercised by the financier over the transaction in question, the corporate relationship, if any, between the seller and financier and the details of the assignment itself have all been factors considered by the courts in reaching the conclusion that a given financier participated too closely with the seller to avail himself of the status of a holder in due course. This transactional approach to the problem also appears in the "agency" theory under which some courts have avoided the necessity of allowing holder in due course to preclude a consumer's defenses.

B. *Financer-Seller Agency Relationship*

Some courts have determined that the degree of control exer-

³⁰ 50 N.J. at 122-23, 232 A.2d at 417.

³¹ 74 N.J. Super. at 585, 181 A.2d at 815.

³² — Del. —, 256 A.2d at 743.

cised by a finance company over a given seller's business transactions was sufficient to justify considering the seller as the agent of the finance company, thereby making the finance company, as principal, the true party to the original transaction. Thus, "personal" defenses arising out of the original transaction could be raised directly against the finance company. This implied agency theory appeared in *Westfield* when the court observed:

In the case at bar this court believes that when Rosen [the salesman] approached the defendants and induced them to sign the sales contract with Ideal and the single page conditional sales contract and promissory note containing in bold type the name of Westfield Investment Company as the specific assignee . . . he was to this extent at least *acting as the agent of Westfield*.³³ (Emphasis added.)

In the recent case of *Calvert Credit Corp. v. Williams*,³⁴ a number of customers were defrauded through a "referral plan" involving the purchase of television sets. When the television sets proved to be defective, the consumers defaulted in their payments and the finance company, holder of the notes they had executed in connection with their purchases, brought suit. In refusing to recognize the finance company as a holder in due course, the court stated:

Appellant [finance company] prearranged finance charges and approved the "Referral Plan." It also approved each customer. Without that approval, even a customer who had signed a sales contract was unable to get a television from Interstate [seller]. A jury could properly have concluded that appellant was so intimately involved in every step of the sales process that Interstate was, in fact, appellant's agent.³⁵

An earlier case, *Palmer v. Associates Discount Corp.*³⁶ applied an intriguing variation of the "agency" theory. In that case a finance company sought to interpose the defense of holder in due course to bar claims by the purchaser of an automobile that the condition of the car had been misrepresented to him and that the vehicle was unsafe. As in many of the cases examined, the finance company had supplied to the seller printed forms bearing an assignment to itself on the back. However, the promissory note used in this transaction also designated *on its face* the finance company, Associates Discount Corporation, as the party to receive payments. The court interpreted this as an ap-

³³ 74 N.J. Super. at 589, 181 A.2d at 817.

³⁴ 244 A.2d 494 (D.C. Mun. Ct. App. 1968).

³⁵ *Id.* at 496. See also, *Morgan v. Reasor Corp.*, 69 Cal. 2d 881, 894, 407, 447 P.2d 638, 647, 73 Cal. Rptr. 398 (1968) (dictum):

As has been suggested by other courts, the gravamen of the *Commercial Credit* rule is that the seller accepts the buyer's note and extends credit, not on his own behalf, but *as an agent for the finance company*. (Emphasis added.)

³⁶ 124 F.2d 225 (D.C. Cir. 1941).

pointment of the finance company as the *dealer's agent* to receive payment, observing:

As appellee was named on the face of the note as the dealer's agent to receive payment, it is reasonable to infer that it was in possession of the note and demanded payment in that capacity. . . . The circumstance that an agent to receive payment suddenly assumes the new role of holder in due course after refusal of payment, is itself enough to cast doubt on the good faith of its holding.³⁷

The obvious similarities between this "implied agency" approach of linking the finance company with the original seller and other cases simply holding that the finance company was too intimately involved in the transaction have prompted the observation that fact patterns of this nature should be treated simply as identity of parties situations.³⁸

C. *Financing Agency's "Bad Faith" or "Notice"*

A number of courts, particularly when faced with consumer credit transactions suggestive of fraud or other deceptive business practices, have thoroughly scrutinized the entire transaction in an effort to discover evidence that the holder of the note did not meet the requirements of having obtained the note "in good faith" or "without notice" of irregularities or of claims and defenses.³⁹ Actual bad faith has been found when the assignee is shown to have had knowledge of the poor business reputation of his assignor.

In *Financial Credit Corp. v. Williams*,⁴⁰ the plaintiffs had been fraudulently induced by a salesman for a home improvement firm to sign a mortgage and a negotiable note in the amount of \$6,399.60 for an improvement job they had understood would cost only \$3,200. The plaintiffs brought suit to have the note and mortgage declared void. The court noted that the note and mortgage were purchased by the defendant finance company as part of a "package deal" involving some 480 such instruments, and that the notes were discounted by over 80 percent. Moreover, the finance company was shown to have been aware of the fact that the home improvement concern from which it obtained the notes had a notorious reputation throughout the state for fraud and deceptive business practices. On these facts, the court concluded that the finance company had taken the note in bad faith and could not claim holder in due course status.⁴¹

In a second type of situation, the courts have been able to deny the finance company holder in due course status on grounds of imputed or implied bad faith. Typically these fact situations involve circumstances sufficiently suspicious as to compel some sort of inquiry on

³⁷ Id. at 228.

³⁸ Littlefield, *supra* note 6, at 67.

³⁹ U.C.C. §§ 3-302, 3-304.

⁴⁰ 246 Md. 575, 229 A.2d 712 (1967).

⁴¹ Id. at 585, 229 A.2d at 716-17.

the part of the financing agency prior to taking the note. When financing agencies faced with such circumstances fail to make inquiry, the courts have, on occasion, held that this constitutes sufficient evidence of bad faith to justify disallowing their claim to holder in due course status. The defendants in *Norman v. Worldwide Distribs, Inc.*,⁴² were the victims of a fraudulent "chain referral scheme," involving the purchase of a breakfront, and were being sued by the finance company which had purchased their promissory note. The finance company in question was shown to have dealt with the seller of the breakfront under three different trade names within a year. The vice president of the finance company admitted that he was aware of the referral plan but claimed that he was "not familiar with the details" of that plan. In striking down the finance company's contention that it was a holder in due course, the court declared:

Under all the circumstances, Peoples [finance company] was bound to inquire further into the operation of the seller of these notes, and having made no inquiry, it is held as though it had knowledge of all that inquiry would have revealed.⁴³

In *Local Acceptance Co. v. Kinkade*,⁴⁴ the court stated that claims of "knowledge" or "bad faith" on the part of the plaintiff finance company were available to the defendants to defeat the plaintiff's claim of holder in due course status.⁴⁵ The defendants had chosen the "knowledge" theory. They had purchased a sewing machine under an arrangement whereby payments would be made "in kind" by sewing pre-cut garments which the seller agreed to furnish each month. The transaction, however, involved the execution of a promissory note which the seller subsequently assigned to the plaintiff, a finance company. When, after several months, the seller stopped providing the pre-cut garments to the defendants, the finance company brought suit on the note. The evidence adduced at trial indicated that the finance company, through its manager, knew that *all* sales transacted by the sewing machine company were to be arranged on this "sewing plan" basis. Thus, the finance company had sufficient knowledge to suspect that something was wrong when the sewing machine company offered to assign a note supposedly obtained through the outright sale of a sewing machine. The court affirmed a verdict for the defendants and held that there was no error in the trial court's instruction that if the finance company obtained the note with "knowledge" of the "sewing plan" employed by the seller, it stood in the position of the seller and was therefore not a holder in due course.⁴⁶

A very typical holder in due course issue appeared in *Nationwide*

⁴² 202 Pa. Super. 53, 195 A.2d 115 (1963).

⁴³ *Id.* at 59, 195 A.2d at 118.

⁴⁴ 361 S.W.2d 830 (Mo. 1962).

⁴⁵ *Id.* at 834.

⁴⁶ *Id.* at 835.

Acceptance Corp. v. Henne.⁴⁷ There the promissory note which the defendants signed in connection with a food plan purchase was subsequently altered. The figure \$100 as the amount due on the note had been erased and replaced with the figure \$843.48. In addition, the number of monthly installments had been changed from four to thirty-six. Since the alterations and erasures on the note were "obvious to the naked eye," the instrument acquired by the plaintiff was not "complete and regular upon its face," as required by Section 52 of the U.N.I.L. Such irregularity constituted notice to the finance company of the defendant's defenses, thereby disqualifying the plaintiff as a holder in due course.⁴⁸

The cases discussed disclose that in a number of circumstances consumers can be protected by the requirements of the holder in due course doctrine itself. Frequently consumer transactions entail extensive involvement in the seller's business, or circumstances amounting to bad faith or notice, on the part of the financier. But these cases have little impact in transactions involving more legitimate financing arrangements between sellers and financiers. The difficult question remains who ought to bear the burden of a seller's voluntary or involuntary default, the relatively defenseless consumer or the financier with the resources to protect himself before or after the default? Even in appropriate circumstances the consumer faces difficult evidentiary problems. And where such evidence might be available, the bulk of consumers needing relief may be financially unable or psychologically unprepared to mount a protracted defense in which ultimate success, more often than not, will depend upon the uncertain hope of prevailing on appeal. Thus, while affording relief to the aggressive consumer, whose case presents facts analogous to those reviewed above, such ad hoc decisions by appellate courts fall considerably short of providing satisfactory remedies for most aggrieved consumers in holder in due course situations.

Nor did the enactment of the U.C.C., which has supplanted the U.N.I.L., significantly better this situation, for the rule that the holder in due course is immune to defenses on the underlying contract has been transmitted to the Code from the U.N.I.L. In the drafting of Article 9 of the U.C.C., dealing with secured transactions, the question of the consumer-buyer and his defenses reportedly "led to violent controversy."⁴⁹ Professor Grant Gilmore, who served as Associate Reporter for the drafting of Article 9 from 1946 to 1952, recounts that in the early stages of drafting, "a comprehensive treatment of the problem of consumer finance had been contemplated."⁵⁰ However, due to the ensuing controversy, the plan was eventually abandoned and the pro-

⁴⁷ 194 So. 2d 434 (La. 1967).

⁴⁸ *Id.* at 435.

⁴⁹ Gilmore, *The Assignee of Contract Rights and His Precarious Security*, 74 *Yale L.J.* 217, 232 (1964).

⁵⁰ *Id.* See also Gilmore, *The Secured Transactions Article of the Commercial Code*, 16 *Law & Contemp. Prob.* 27, 45 (1951).

tection of consumers was left to the courts or to the legislative enactments of individual states.⁵¹ A number of states have, in varying degree, acted to cover this area left open by the authors of the U.C.C. and have passed a variety of statutes regulating consumer transactions.

II. *Present Statutory Solutions*

Some state statutes are specifically intended to preserve consumer defenses against the seller's assignees. Essentially these statutes take one of two basic approaches. They either (1) prohibit the use of negotiable notes in consumer transactions, or (2) provide that subsequent assignees of consumer notes are subject to any defenses which the buyer may have against the seller.⁵² Within these two categories there are, of course, numerous variations in specific approach, as the following survey of the statutes in each category will demonstrate.⁵³

A. *Prohibitions Against the Use of Negotiable Notes in Consumer Transactions.*

Six jurisdictions have enacted statutes prohibiting the use of negotiable notes in consumer transactions.⁵⁴ Some of these statutes are limited in scope to installment sales of "goods"⁵⁵ and some are more general in coverage, applying to installment sales of "services" as

⁵¹ Indicative of this final resolution of the conflict is the wording of U.C.C. § 9-206 (1) which states:

Subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods, an agreement by a buyer or lessee that he will not assert against an assignee any claim or defense which he may have against the seller or lessor is enforceable by an assignee who takes his assignment for value, in good faith and without notice of a claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the Article on Commercial Paper (Article 3). (Emphasis added.)

⁵² 75 Harv. L. Rev. 437, 438 (1961).

⁵³ Some states have enacted "home solicitation sales" acts which, as their title suggests, are designed primarily for the regulation of door-to-door sales. Due to their limited applicability, these acts will not be treated here; however, the following are worthy of note, for comparison of the indicated provisions with corresponding provisions of the statutes discussed *infra*: Conn. Gen. Stat. Ann. §§ 42-134 to -143 (Supp. 1969) (notes or "other evidence of indebtedness" taken in connection with a home solicitation sale declared non-negotiable; holder in due course of illegal note may enforce it. § 42-136); N.H. Rev. Stat. Ann. §§ 320:1 to :22 (1966), as amended, (Supp. 1969) (negotiable instruments, except checks, prohibited in sales by "hawkers or peddlers"; no waivers of defenses by buyer permitted. §§ 320:21-a, 320:21-b); R.I. Gen. Laws Ann. §§ 6-28-1 to -8 (Spec. Supp. 1968) (notes must be marked "Non-negotiable consumer note"; assignees of such notes are subject to buyer's defenses. § 6-28-6).

⁵⁴ Cal. Civ. Code § 1810.9 (West Supp. 1968) (recently renumbered § 1810.7, effective Nov. 10, 1969; see 1 CCH Consumer Credit Guide ¶ 6071 at 11,624 (1969)); Del. Code Ann. tit. 6, § 4342 (Supp. 1968); Hawaii Rev. Stat. § 476-18(c) (1968); Mass. Gen. Laws Ann. ch. 255, § 12C (Supp. 1969); N.Y. Pers. Prop. Law § 403(1) (McKinney 1962); P.R. Laws Ann. tit. 10, § 748 (Supp. 1968).

⁵⁵ Hawaii Rev. Stat. §§ 476-18, 476-1 (1968); Mass. Gen. Laws Ann. ch. 255, § 12C (Supp. 1969).

well.⁵⁶ Those covering services resolve in advance such questions as whether contracts to install aluminum siding, fire detection systems, carpeting, and the like are excluded from the coverage of the statute on the grounds that they are installment "service contracts" rather than "installment sales" of goods.⁵⁷ Essentially, statutes of this nature attempt to solve the problem of holder in due course in consumer transactions by eliminating the source of the problem, the theory being that if there are no notes to assign, there will be no assignees to claim holder in due course status. Unfortunately, the statutes do not always attain this result.

In jurisdictions which permit waivers of defenses against assignees of consumer paper under Section 9-206(1)⁵⁸ of the U.C.C., sellers are afforded a potential means of avoiding the intended effect of statutes prohibiting the use of negotiable notes. By simply including in the buyer's sales contract a clause waiving his defenses against assignees, a seller may endow the contract with virtually the same aspects of negotiability as a promissory note. Thus, unless a given jurisdiction also has a statute prohibiting waivers of defenses against assignees in *consumer* installment contracts, sellers may be provided with a ready-made "loophole."

It is arguable that this should not be the result under these circumstances, however, since a statute prohibiting negotiable instruments in consumer transactions evidences an obvious legislative policy adverse to devices which would serve to cut off consumer defenses against assignees. The policy thus established should evidence "a different rule" for consumer transactions, within the meaning of the qualifying introductory language of U.C.C. Section 9-206. A contrary rule would obviously allow facile circumvention of the consumer protection statutes. Public policy alone should militate against such a result.

Several of the jurisdictions which prohibit negotiable notes in consumer transactions have also banned clauses in installment contracts which purport to waive the buyer's defenses against assignees, thereby precluding sellers from utilizing this device as a means of avoiding the intended effect of the consumer protection statutes. In some statutory schemes the prohibition of such waivers is unqualified,⁵⁹ but in several others an assignee may enforce a waiver of defenses

⁵⁶ Cal. Civ. Code, § 1802.5 (West Supp. 1968); Del. Code Ann. tit. 6, § 4301 (Supp. 1968); N.Y. Pers. Prop. Law §§ 403(1), 401(7) (McKinney 1962); P.R. Laws Ann. tit. 10, § 731(5) (Supp. 1968).

⁵⁷ But see the New York statute which prohibits the use of negotiable notes in other retail installment transactions but makes an exception in the case of "the furnishing of goods or services for repairs, alterations or improvements upon or in connection with real property." The note must bear a conspicuous statement to the effect that it arose out of a transaction involving real property but, given compliance with the statute, a subsequent holder of the note can be a holder in due course. N.Y. Pers. Prop. Law, § 403(2) (McKinney 1962).

⁵⁸ See note 51 *supra*.

⁵⁹ Cal. Civ. Code § 1804.1(a) (West Supp. 1968); Hawaii Rev. Stat. § 476-18(b) (1968); Mass. Gen. Laws Ann. ch. 255D, § 10(6) (Supp. 1969).

in the buyer's contract provided he gives the buyer notice of the assignment in writing and informs him that he must notify the assignee, in writing and within a prescribed period, of any claims or defenses which he may have.⁶⁰ If the buyer fails to give such notice to the assignee within the specified time period, the waiver clause may then be enforced.

Generally, the statutory time period within which the buyer must notify the assignee of his defenses is relatively short.⁶¹ This point has received a certain amount of criticism,⁶² the main objection being that many of the buyer's defenses may not become known to him in a short period of time. Thus, under statutes permitting this procedure for validation of waivers of defenses, buyers would lose the right to raise defenses such as subsequent malfunctioning of the item purchased, non-performance by the seller under a protracted service or warranty agreement, or non-performance of any other obligations of the seller which are still executory when the buyer receives notice of the assignment. Moreover, in placing upon the buyer the burden of providing an assignee with prompt, written notice of claims or defenses, these statutes work to the detriment of consumers who are illiterate, blind, unable to comprehend the meaning of the assignee's "notice" soliciting defenses,⁶³ or are simply careless about reading and answering their mail. Perhaps in response to such objections, some statutes now provide that if, by the terms of a contract for services, the seller's performance will not be completed within the established statutory period after the assignee mails notice of assignment to the buyer, the assignee takes the contract or obligation subject to any defenses predicated upon subsequent events.⁶⁴

The State of Delaware provides one other exception under which

⁶⁰ Del. Code Ann. tit. 6, § 4312 (Supp. 1968); N.Y. Pers. Prop. Law § 403(3)(a) (McKinney Supp. 1968); P.R. Laws Ann. tit. 10, § 749(a) (Supp. 1968).

⁶¹ New York and Puerto Rico allow 10 days from the date upon which the assignee mails his notice of assignment to the buyer; Delaware allows 15 days.

⁶² See, e.g., 75 Harv. L. Rev. 437, 439-40 (1961).

⁶³ The statutes often specify the wording of the notice to be used. The New York statute, for example, requires this wording in bold type:

Notice:

1. If the written statement of your transaction with the seller is not correct in every respect; or
2. If the vehicle or goods described in or in an enclosure with this notice have not been delivered to you by the seller or are not now in your possession; or
3. If the seller has not fully performed all his agreements with you; you must notify the assignee in writing at the address indicated in or in an enclosure with this notice within ten days from the date of the mailing of this notice; otherwise, you will have no right to assert against the assignee any right of action or defense arising out of the sale which you might otherwise have against the seller.

N.Y. Pers. Prop. Law § 403(3)(a) (McKinney Supp. 1968). It seems apparent that such a form of "notice" with its reference to "your transaction," "assignee," and "right of action or defense," will not prove very informative to the poor, the uneducated or the unintelligent.

⁶⁴ N.Y. Pers. Prop. Law § 403(3)(a) (McKinney Supp. 1968); P.R. Laws Ann., tit. 10, § 749(f) (Supp. 1968).

waivers of defenses against assignees may be enforced. If the assignee acquired the contract or evidence of indebtedness "relying in good faith" upon a certificate of completion or certificate of satisfaction signed by the buyer, the buyer will be foreclosed from asserting defenses against the assignee.⁶⁵ The statute requires that such a certificate of completion or satisfaction bear a conspicuous warning to the buyer not to sign the certificate until the seller's performance is fully and satisfactorily completed.⁶⁶ However, if an unscrupulous seller were to include such a certificate amid the jumble of confusing forms confronting the buyer in the typical credit transaction, there is at least the possibility that the buyer would unwittingly sign the certificate, notwithstanding the "conspicuous" warning. If he does and the installment contract contains a waiver of defenses against assignees, a good faith assignee of the contract would be able to enforce the obligation regardless of the buyer's defenses.

Finally, it must be emphasized that statutes prohibiting the use of negotiable notes implicitly allow the good faith holder of a note illegally obtained by the seller to enforce the note, since under U.C.C. Section 3-305(1) a holder in due course takes an instrument free from *all* defenses. Presumably this would include the defense that the note was illegally obtained, and a holder would be free to enforce the obligation represented by such a note. It should be noted in this connection that the exception for illegality of the transaction contained in U.C.C. Section 3-305(2)(b) refers only to such illegality "as renders the obligation of the party a nullity." None of the statutes discussed above relieve the buyer of his obligation to pay when the seller obtains from the buyer a negotiable instrument in violation of the statute. It would seem, however, that a provision to this effect would provide an effective sanction in such circumstances. Although some statutes require that promissory notes taken from consumers be labelled "consumer note,"⁶⁷ and expressly declare them to be non-negotiable, it is arguable that this requirement actually enhances the position of a subsequent holder of an unmarked and illegally procured note. The holder, in addition to claiming good faith, could argue that the requirements of the statute entitle him to assume that an unmarked note did not originate in a consumer transaction.

Generally, there are criminal penalties which may be imposed upon sellers who violate the statutes by taking unmarked negotiable notes from consumers.⁶⁸ Moreover, some jurisdictions prohibit the

⁶⁵ Del. Code Ann. tit. 6, § 4312 (Supp. 1968).

⁶⁶ *Id.*

⁶⁷ Hawaii Rev. Stat. § 476-36 (1968); Mass. Gen. Laws Ann. ch. 255, § 12C, (Supp. 1969).

⁶⁸ Cal. Civ. Code § 1812.6 (West Supp. 1968); Del. Code Ann. tit. 6, § 4347 (Supp. 1968) (subject to misdemeanor penalties); Hawaii Rev. Stat. § 476-36 (1968) (fines from \$100 to \$500); Mass. Gen. Laws Ann. ch. 255, § 12C (Supp. 1969) (fines from \$100 to \$500); N.Y. Pers. Prop. Law, § 414(1) (McKinney 1962) (fines up to \$500); P.R. Laws Ann. tit. 10, § 792 (Supp. 1968) (administrative fines from \$100 to \$1000; or

collection of any finance, service, delinquency, penalty or related charge by a seller or assignee who knowingly takes an illegal note, and the buyer is allowed to recover from the seller any such charges which have already been imposed.⁶⁹ This sort of "civil" sanction has received favorable comment since, theoretically, it gives the buyer a personal pecuniary interest in the enforcement of installment sales laws and thereby encourages consumers to play an active role in ferreting out violations by sellers.⁷⁰ However, since a holder in due course, by definition, has taken the note in good faith and without knowledge of its illegal origin, he is therefore free to enforce it against the consumer. The existence of sanctions against culpable parties affords meager consolation to the deceived consumer who discovers that in this situation, despite the statute's purported effect of preventing holders in due course from precluding his defenses, he is still barred from raising them.

Hawaii has eliminated this result by combining the prohibition against negotiable instruments in consumer sales with a general provision to the effect that no rights of action or defenses which the buyer has against the seller shall be cut off by assignment.⁷¹ The statute further provides that, if the buyer has valid defenses arising out of the transaction with the seller, the assignee has recourse against the seller to recoup any losses suffered as a result of the buyer's defenses.⁷² This preservation of the buyer's defenses against assignees constitutes the nucleus of the statutory schemes in those states which have adopted the second technique of limiting the application of holder in due course in consumer situations. Hawaii's statute, by combining the two elements, eliminates some of the problems of both, and thus is probably the most effective of the state statutes.

B. Statutes Providing That Subsequent Holders Take Subject to the Buyer's Defenses

Four states, Maryland, Rhode Island, Vermont and Washington, have enacted statutes providing that subsequent holders of a negotiable note taken in connection with a consumer transaction are subject to any defenses the buyer may have arising out of the original transaction.⁷³ One of those statutes applies only to transactions involving goods,⁷⁴ while the rest apply to transactions involving both goods and

prosecution for misdemeanor with possible fines to \$1000 or up to 2 years imprisonment or both).

⁶⁹ Cal. Civ. Code § 1812.7 (West Supp. 1968); Del. Code Ann. tit. 6, § 4348 (Supp. 1968); Hawaii Rev. Stat. §§ 476-22, -36 (1968); Mass. Gen. Laws Ann. ch. 255, § 12C (Supp. 1969); N.Y. Pers. Prop. Law § 414(2) (McKinney 1962).

⁷⁰ 75 Harv. L. Rev. 437, 438-39 (1961).

⁷¹ Hawaii Rev. Stat. § 476-18(d) (1968).

⁷² Id.

⁷³ Md. Ann. Code art. 83, § 147 (1965); R.I. Gen. Laws Ann. § 6-27-6 (Spec. Supp. 1968); Vt. Stat. Ann. tit. 9, § 2455 (Supp. 1969); Wash. Rev. Code Ann. § 63.14.020 (Supp. 1968).

⁷⁴ Md. Ann. Code art. 83, § 152(b) (1965).

services.⁷⁶ One statute is also restricted in its coverage to secured transactions,⁷⁶ whereas the others contain no such restriction. Two of the statutes refer specifically to "installment sales,"⁷⁷ while the others employ much broader language and appear to cover all types of credit sales.⁷⁸ In Rhode Island a note taken in connection with a consumer transaction is required by law to bear the legend "non-negotiable consumer note,"⁷⁹ and in Washington the note must contain a statement to the effect that assignment will not cut off as to third parties any right of action or defense which the buyer may have against the seller.⁸⁰ Maryland requires that the note specifically mention the installment agreement from which it issued,⁸¹ while the Vermont statute simply provides that a subsequent holder of a promissory note or instrument or other evidence of indebtedness of a consumer takes subject to all defenses which would be available to the consumer in an action on a simple contract, and to all rights available to him under the Consumer Fraud statute.⁸²

Apparently three of the states which provide that holders of consumer instruments are subject to the buyer's defenses arising out of the sale do not expressly prohibit waivers of defenses against assignees in sales contracts.⁸³ As in the case of statutes prohibiting the use of negotiable notes, unless the jurisdiction prohibits such waivers of defenses in the sales contract itself, it would seem that sellers might be able to utilize such waivers to endow sales contracts with the basic attributes of a negotiable instrument. This problem is somewhat compounded by U.C.C. Section 9-206 which, in addition to authorizing express agreements to waive defenses against assignees of the contract, contains the following provision:

A buyer who as part of one transaction signs both a negotiable instrument and a security agreement makes such an agreement.

Thus, in jurisdictions which permit negotiable instruments to be used but provide that subsequent holders take subject to the buyer's defenses, the execution of a negotiable note in conjunction with a retail installment contract containing a security agreement would give rise to an "implied in law" agreement not to assert claims or defenses

⁷⁵ R.I. Gen. Laws § 6-27-6 (Spec. Supp. 1968); Vt. Stat. Ann. tit. 9, §§ 2454, 2455 (Supp. 1969); Wash. Rev. Code Ann. § 63.14.010(5) (1966).

⁷⁶ Md. Ann. Code art. 83, § 152(b) (1965).

⁷⁷ Md. Ann. Code art. 83, § 147 (1965); Wash. Rev. Code Ann. § 63.14.020 (1966).

⁷⁸ R.I. Gen. Laws § 6-27-6 (Spec. Supp. 1968); Vt. Stat. Ann. tit. 9, §§ 2454, 2455 (Supp. 1969).

⁷⁹ R.I. Gen. Laws § 6-27-6 (Spec. Supp. 1968).

⁸⁰ Wash. Rev. Code Ann. § 63.14.020 (Supp. 1968).

⁸¹ Md. Ann. Code art. 83, § 147 (1965).

⁸² Vt. Stat. Ann. tit. 9, § 2455 (Supp. 1969).

⁸³ A check of both statutory and decisional law in Rhode Island, Maryland and Vermont has failed to reveal any express prohibition against waivers of defenses against assignees in consumer contracts in these states.

against an assignee of the contract.⁸⁴ The question then arises whether a subsequent assignee of the *contract* could invoke an actual or "implied in law" waiver to defeat the effect of the statute providing that subsequent holders of a *negotiable instrument* take subject to defenses. Such a result, of course, would all but eviscerate the statute preserving the buyer's defenses. It is arguable that the quoted provision of U.C.C. Section 9-206(1) refers to circumstances involving a negotiable instrument which *would*, when negotiated, insulate a holder in due course from the buyer's defenses. As indicated earlier, the enactment of a statute removing this insulation with respect to consumer paper should suffice to establish "a different rule" for consumers within the meaning of the qualifying language which introduces U.C.C. Section 9-206(1).⁸⁶ The word "rule" as used in that language lends itself to interpretation in a broad sense as meaning "policy." Thus, as in the case of statutes prohibiting negotiable instruments in consumer transactions, this manifest policy against precluding consumer defenses should, by necessary implication, proscribe waivers of defenses, either actual or implied in law. The State of Washington has avoided the whole problem by flatly declaring that waivers of defenses in retail installment or retail charge agreements are invalid.⁸⁶

As indicated earlier, several states require that consumer notes be labelled as such, or require that an instrument taken in a consumer transaction state on its face that transferees take subject to the buyer's defenses. Thus, transferees of such instruments are forewarned of the fact that the defense of holder in due course is not available to them in any controversy involving these instruments. However, it is possible that an illegally obtained or unmarked note may be transferred to a good faith assignee. In this circumstance, three of the states presently under discussion would allow the transferee to enforce the note as a holder in due course, since their statutes preserving the buyer's defenses appear to apply only to instruments which are properly marked in compliance with the law.⁸⁷ The Vermont statute, however, imposes no such labelling requirement and simply provides that the holder of a consumer's instrument is subject to the consumer's defenses.

For several decades states have wrestled individually with the consumer protection problem inherited by them when the Commissioners on Uniform State Laws excluded this area from the U.C.C. In the interim, however, the Commissioners mounted an effort to solve the problem by means of a uniform law, specifically designed to reg-

⁸⁴ See U.C.C. § 9-206, Comment 1, which states in part:

The execution of a negotiable note in connection with a security agreement is given like effect as the execution of an agreement containing a waiver of defense clause.

⁸⁵ See p. 105 *supra*.

⁸⁶ Wash. Rev. Code Ann. § 63.14.150 (Supp. 1968).

⁸⁷ Md. Ann. Code art. 83, § 147 (1965); R.I. Gen. Laws § 6-27-6 (Spec. Supp. 1968); Wash. Rev. Code Ann. § 63.14.020 (Supp. 1968).

ulate consumer credit. This effort ultimately produced the Uniform Consumer Credit Code (hereinafter U.C.C.C.) which received final approval from the National Conference of Commissioners on Uniform State Laws on July 30, 1968. Two states, Oklahoma and Utah, have adopted the U.C.C.C.⁸⁸ and it is a reasonable expectation that other states will follow their lead. The U.C.C.C. includes provisions applicable to holder in due course in consumer transactions.

III. THE U.C.C.C.

The U.C.C.C. bans the use of negotiable notes in consumer credit transactions. Section 2-403 of the Code prohibits a seller or lessor in a consumer credit sale or a consumer lease from taking any negotiable instrument other than a check. The definition of "consumer credit sale," contained in Section 2-104 of the Code, includes credit sales of both goods and services by a seller who regularly engages in such credit transactions.⁸⁹ In addition, the definition provides that the buyer must be a person other than an organization,⁹⁰ and that the goods or services must be purchased primarily for personal, family, household or agricultural purposes.⁹¹ Credit card sales are expressly excluded.⁹² However, there is no provision restricting the applicability of the U.C.C.C. to sales involving a security interest. Consequently, the prohibition against negotiable instruments is applicable to a broad range of consumer sales. The Code also contains no requirement that instruments used in connection with a consumer transaction be distinguished by any particular labelling. Section 2-403 makes it clear that if a seller takes a negotiable instrument in violation of the Code, a subsequent "good faith" holder is entitled to enforce the instrument as a holder in due course with the traditional insulation from the buyer's defenses.

The Official Comment to section 2-403 suggests that the holder in due course concept has been retained in situations involving a good faith holder of an illegally obtained note for two reasons. First, it was assumed that after enactment of the Code the prohibition against negotiable instruments in consumer transactions would be "well-known" in the financial community and that, consequently, situations involving a bona fide holder of an illegally obtained consumer instrument would be "rare." Secondly, it was felt that whenever such a situation did arise, the policy favoring negotiability ought to be upheld "in order not to cast a cloud over negotiable instruments generally."⁹³

The draftsmen of the U.C.C.C. have offered two alternative ver-

⁸⁸ Okla. Stat. Ann. tit. 14A, §§ 1-101 to 9-103 (Supp. 1969); Utah Code Ann. tit. 70B, §§ 1-101 to 9-103 (Supp. 1969). Both jurisdictions adopted the U.C.C.C., effective July 1, 1969.

⁸⁹ U.C.C.C. § 2-104(1)(a).

⁹⁰ U.C.C.C. § 2-104(1)(b).

⁹¹ U.C.C.C. § 2-104(1)(c).

⁹² U.C.C.C. § 2-104(2)(a).

⁹³ U.C.C.C. § 2-403, comment.

sions of Section 2-404 of the Code governing waivers of defenses against assignees. Alternative A is the more effective version and is that adopted by the state of Utah. The provision states:

With respect to a consumer credit sale or consumer lease, other than a sale or lease primarily for an agricultural purpose, an assignee of the rights of the seller or lessor is subject to all claims and defenses of the buyer or lessee against the seller or lessor arising out of the sale or lease notwithstanding an agreement to the contrary, but the assignee's liability under this section may not exceed the amount owing to the assignee at the time the claim or defense is asserted against the assignee. Rights of the buyer or lessee under this section can only be asserted as a matter of defense to or set-off against a claim by the assignee.

Thus, Alternative A, in permitting the buyer to raise any defenses he might have "notwithstanding any agreement to the contrary," effectively invalidates contract provisions purporting to waive the buyer's defenses against assignees. The assignee is protected from affirmative suits through the proviso that the buyer's objections to the contract can only be raised defensively.

Alternative B, which was adopted by the state of Oklahoma, provides that waivers of defenses against assignees may be enforced provided the assignee is not "related to" the seller and has acquired the contract for value and in good faith. Such waivers cannot be enforced, however, unless the assignee notifies the buyer of the assignment in writing and within thirty days⁹⁴ receives no written notice of the facts giving rise to any claim or defense on the part of the buyer. This version further provides that the agreement to waive defenses is only valid with respect to claims or defenses arising within the 30 day period following the date of notification by the assignee. Claims or defenses arising after that time could validly be raised by the buyer against the assignee.⁹⁵ Under a statute patterned after Alternative B, the consumer would risk losing only those defenses which arise during the period covered by the assignee's notice. Thus, a shorter statutory period for reply to the assignee would actually benefit the consumer, since his period of "vulnerability" would be reduced. If defenses arising after the assignee's notice to the buyer has expired were not preserved, a *longer* period for response would be more advantageous to the buyer, so that potential defenses as yet unknown to him would not be prematurely foreclosed upon expiration of the notification period.

The U.C.C.C., while incorporating several desirable principles in the holder in due course area, falls short of affording the consumer full protection. The holder in due course doctrine continues with re-

⁹⁴ The Official Text of U.C.C.C. provides for a three-month period but Oklahoma has changed this to thirty days. Okla. Stat. Ann. tit. 14A, § 2-404(1) (Supp. 1969).

⁹⁵ U.C.C.C. § 2-404, Alternative B, comment.

spect to "good faith" assignees of instruments illegally obtained from consumers, and in jurisdictions adopting Alternative B of section 2-404, the consumer may still, in some instances, forfeit his defenses under a waiver of defenses against assignees. However, since the Code has substantially limited the effectiveness of the "standard techniques" for precluding the buyer's defenses against assignees, financiers and sellers still desiring to accomplish this result must cast about for some alternative method.

It has been suggested that the Code, and indeed the statutory schemes of many states, afford such an alternative method by retaining the distinction between a "consumer loan" and a "consumer credit sale."⁹⁶ Since the "Credit Sales" Article of the U.C.C.C. regulates situations in which the *seller* initially extends the credit,⁹⁷ sellers might adopt the procedure of presenting any buyer who desires credit with a loan application from a cooperating finance company. In addition to signing a retail sales contract, the consumer would sign the loan application and perhaps an authorization for the finance company to pay the money directly to the seller. Essentially the result would be the same as under the present forms of financing. The seller would receive his money immediately and, notwithstanding any subsequent difficulties the buyer might have with the seller, the finance company would insist upon full repayment of the loan. Should the consumer become dissatisfied with his purchase and cease making payments, the finance company would quickly point out that it is not responsible for the fact that the consumer obtained a bad bargain with the money he borrowed. Any note involved in the transaction would apply to the loan and would not be a consumer note executed in connection with the purchase. In order to find for the consumer, the courts would again have to find sufficient connections between the finance company and the seller to justify treating the finance company as a "co-participant" in the sale. To avoid such retrogression, it has been suggested that U.C.C.C. Section 2-404, Alternative A, also be made applicable to "a lender subject to this Act who loans money to the debtor knowing it will be used as the purchase price of specific consumer goods."⁹⁸ As yet, however, there has been no such amendment and it remains to be seen whether sellers and financiers will shift to the "direct loan" approach in consumer transactions.

IV. CONCLUSION

In the final analysis the decisions and statutes surveyed in this comment, including the U.C.C.C., do not afford the consumer comprehensive protection in holder in due course situations. In states which

⁹⁶ See generally Littlefield, *Parties and Transactions Covered by Consumer-Credit Legislation*, 8 B.C. Ind. & Com. L. Rev. 463, 466-69 (1967). Compare U.C.C.C. § 2-104 (definition of a "Consumer Credit Sale") with U.C.C.C. § 3-104 (definition of a "Consumer Loan").

⁹⁷ See U.C.C.C. § 2-104(1)(a).

⁹⁸ Littlefield, *supra* note 96, at 468-69.

do not prohibit waiver of defense clauses, the statutes prohibiting negotiable notes or preserving consumer defenses against holders of such notes are susceptible to circumvention by the use of waiver of defense clauses to endow sales contracts with the essential attributes of negotiable notes. The statutes making waivers of defenses enforceable if the buyer fails to notify the assignee of his defenses when requested to do so are of little benefit to disadvantaged consumers who most need protection. Moreover, the statutes in most instances allow a "good faith" assignee to enforce a negotiable note or instrument taken illegally by the seller. Since it is reasonable to assume that few reputable sellers will be taking illegal instruments, this exception serves to divest the consumer of protection where, theoretically, his need for such protection is greatest. A number of cases have suggested that the risk of the seller's dishonesty should be placed upon the financiers, who are more able to bear the risk of loss, who are in a better position to investigate the reputation of the assignor, and who ultimately stand to gain profits from the transaction.⁹⁹ In order to accomplish this result, the statutes seeking to prevent interposition of holder in due course against consumers should, at the minimum, include:

- 1) An unqualified provision to the effect that all subsequent holders of consumer instruments take subject to the consumer's defenses;
- 2) An unqualified prohibition against waivers of defenses against assignees; and
- 3) A provision that any lender who loans money knowing that it will be used as the purchase price of specific consumer goods is subject to all claims or defenses which the debtor has against the seller.

The scope of these provisions should be as broad as possible, covering secured and unsecured transactions, and sales of services as well as goods. A civil sanction could be included giving "good faith" assignees a right of action for treble damages against any seller who transfers an illegally obtained consumer note on which the assignee incurs a loss as a result of the buyer's defenses.

The objection might be raised that such provisions would "cripple" the consumer financing industry. This objection has already been shown to be spurious,¹⁰⁰ and constitutes nothing more than a complaint that financiers would then be required to ascertain the honesty and reliability of their assignors before accepting their paper. This complaint was ably countered by Justice Drew, speaking for the court in *Mutual Finance*, more than a decade ago:

It may be that our holding here will require some changes in business methods and will impose a greater burden on the

⁹⁹ *Unico v. Owen*, 50 N.J. 101, 110, 232 A.2d 405, 410 (1967); *Mutual Fin. Co. v. Martin*, 63 So. 2d 649, 653 (Fla. 1953).

¹⁰⁰ Note, *Translating Sympathy for Deceived Consumers into Effective Programs for Protection*, 114 U. Pa. L. Rev. 395, 418 (1966).

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. . . .

If this opinion imposes great burdens on finance companies it is a potent argument in favor of a rule which will afford protection to the general buying public against unscrupulous dealers in personal property.¹⁰¹

F. ANTHONY MOONEY

¹⁰¹ 63 So. 2d at 653.