Negotiability in Consumer Sales: The Need for Further Study

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I. INTRODUCTION

Because few people can afford to pay cash for consumer goods and services, and because most dealers in such goods and services are not in the business of lending money, the typical consumer-dealer transaction involves a third-party financer. The most common method of financing the purchase of goods and services is the three-party installment credit sale. Under this arrangement, when the consumer purchases goods from the dealer, he obligates himself to pay the dealer in a series of monthly installments by signing an installment sales contract. Pursuant to a clause in the contract, the dealer may assign to a financer the right to receive the monthly payments. In substance, what this amounts to is an indirect loan from the financer to the consumer. In contrast to the indirect loan transaction, the consumer may borrow money directly from the financer; the consumer can then pay cash for his goods and services. A third type of financing is available through the use of a lender credit card. The cardholder may use the card

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2. For discussions of the emergence of the lender credit card in consumer transactions and the legal issues which it presents, see Brandel & Leonard, Bank Credit Cards: New Cash or New Credit, 69 Mich. L. Rev. 1033 (1971); Davenport, Bank Credit Cards and the Uniform Commercial Code, 85 Banking L.J. 941 (1968); Comment, Waiver of Defense Clauses in Three Party Consumer Credit Transactions, 11 B.C. Ind. & Com. L. Rev. 90 (1969); Comment, The Tripartite Credit Card Transaction: A Legal Infant, 48 Calif. L. Rev. 459 (1960); Comment, The Applicability of the Law of Letters of Credit to Modern Bank Card Systems, 18 Kan. L. Rev. 871 (1970); Comment, Commer-
just like cash to purchase goods and services from participating dealers.³ Participating dealers have an agreement with the issuer of the card, the lender, whereby the issuer has agreed to pay the dealer for goods sold to cardholders. The issuer is then responsible for collection from the cardholder.⁴

Traditionally, financers, in each of the three transactions described above, have insulated themselves from consumer defenses against the dealer. That is, the consumer's obligation to satisfy the financer is independent of the dealer's obligation to satisfy the consumer; the financer may proceed against the consumer despite any defenses the consumer may have against the dealer, such as failure of consideration or breach of warranty. In the three-party installment sale transactions, financers have typically used either the promissory note or the contractual waiver of defense clause, or both to facilitate cutting off the buyer's defenses against the financer. The same result is achieved in credit card financing by inserting a waiver clause in the agreement between cardholder and issuer, whereby the cardholder agrees that he will not assert against the issuer any defenses which arise out of any sales transactions with a dealer.⁵

Preservation of consumer defenses has been and continues to be one of the most hotly debated issues in the consumer credit industry. Consumer advocates argue that the only real protection a consumer has against dealer misconduct is the power to withhold payment. Furthermore, if the consumer may withhold payment, he has the procedural advantage of placing the burden of initiating litigation on the dealer or financer.⁶ On the other hand, many banking and financial institutions argue that if they were subject


⁴ Other notes include:

1. Since the lender's responsibility is not limited to the purchase price, the lender may charge a discount on the sales price. The discount ranges from 2 to 7%.

2. The lenders normal procedure is to issue the cardholder with a monthly statement. The statement includes all card purchases and the total amount due. The cardholder has the option of paying the entire bill or paying a minimum percentage of the total. If the cardholder pays the entire bill, there is no interest charge. If the card is used in this manner, it may be a convenient way to consolidate many monthly expenses into one check payment at no cost. On the other hand, if the cardholder pays the bill in installments, he pays interest on the unpaid balance.

5. A typical clause in the agreement provides:

Issuer has no responsibility for merchandise or services purchased by Customer with Credit Card and Customer agrees to pay issuer for all credit purchases even though a dispute may exist.

to consumer defenses, consumer credit might vanish or become so expensive as to be prohibitive. The debate has prompted judicial and legislative response. The primary thrust of this response has been directed against the use of promissory notes and waiver of defense clauses in installment sales transactions. To a lesser extent, there have been some legislative measures preserving defenses in the direct loan and the lender credit card transaction.

At present, the impact of preserving consumer defenses on the consumer credit industry is an unknown quantity. Statistical data on the subject is virtually non-existent. Much of the debate over the extent if any, to which financers should be subject to consumer defenses, would seem to turn on the determination of factual issues. Is protection for the consumer, in the form of allowing him to assert his defenses against the financer, needed in all segments of the consumer sales industry or just certain ones such as home solicitation sales or sales of motor vehicles? Has there been a general shift from the indirect loan transaction to direct loans so as to necessitate preservation of defenses in the latter transaction as well as the former? Will the cost of credit increase if defenses are preserved? Will preservation of defenses force some dealers out of business? Despite the lack of empirical evidence to answer these questions, many legislatures have enacted statutes which preserve consumer defenses in a variety of transactions. The legislation has been justified largely on the basis of its “theorized” impact, and not by any factual data.

Two consumer credit bills were introduced in the first session of the 1974 Nebraska Legislature. The original draft of L.B. 325 was concerned with the problem of preserving consumer defenses. Provisions in L.B. 325 which eliminated negotiability of all “consumer credit sales” and “consumer leases” were deleted from the bill by the standing committee amendments. A later part of this article will discuss these original provisions of the bill. The other bill, L.B. 327, enacted by the Legislature with an emergency

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10. 1974 Neb. Leg. Jnl. 771 (Feb. 25, 1974). L.B. 325's original language was struck and replaced with the provisions of Senator Waldron's original L.B. 327, which earlier had been amended by Senator Murphy. See note 14 infra.
11. See notes 53-56 and accompanying text infra.
clause on March 21, 1974,\textsuperscript{13} was only indirectly related to the preservation of consumer defenses.\textsuperscript{14} Although the original draft of L.B. 325 never reached the floor of the Legislature, and L.B. 327, even in its original form, only indirectly touched the problem, debate over preservation of consumer defenses is likely to be a recurring one in the Nebraska Legislature as the interest in consumer legislation increases. This article will survey the variety of legislation that has developed in other states and it will suggest how empirical study in certain areas might shape future legislation.

II. LEGISLATIVE, JUDICIAL BACKGROUND

Much has been written about the problem of preservation of consumer defenses.\textsuperscript{15} There is no need to duplicate extensive

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\item \textsuperscript{13} 1974 \textit{Neb. Leg. Jnl.} 1239 (March 21, 1974).
\item \textsuperscript{14} As introduced by Senator Waldron, L.B. 327 would have provided consumers with a cause of action against “suppliers” who commit deceptive and unconscionable sales practices, in connection with consumer transactions. A “supplier” was to be defined as a “seller, lessor, assignor, or other person who regularly solicits, engages in, or enforces consumer transactions, whether or not he deals directly with the consumer.” Under Waldron’s form of the bill, a financer was certainly one who “enforces consumer transactions” and if the consumer could have established that the financer had engaged in a deceptive or unconscionable practice, he could have pursued an action directly against the financer.
\item After reaching the floor of the Unicameral, L.B. 327 was substantially amended upon motion of Senator Murphy, 1974 \textit{Neb. Leg. Jnl.} 649 (Feb. 14, 1974), to delete the provisions described in the preceding paragraph. In its amended form, L.B. 327 contained some additions to the Uniform Deceptive Trade Practices Act, \textit{Neb. Rev. Stat.} §§ 87-301 to -306 (Reissue 1971). During debate of L.B. 327 on the floor of the Legislature, Senator Murphy said he thought
\begin{quote}
[r]equiring that a consumer sign a contract waiver and all this defense . . . come under the definition of unconscionable.
I’ll grant you unconscionable is not a clearly defined word.
The courts are left with the interpretation of it which the courts are left with the interpretation of anyhow.
\end{quote}
Record of floor debate on L.B. 327 at 5606 (Feb. 25, 1974). This comment would suggest that Senator Murphy felt his bill did not need to consider the waiver of defense problem because Nebraska courts might find such clauses unconscionable. See note 27 and accompanying text infra.
works on the plight of the consumer and the analysis of the alternative proposals to remedy the problem. However, a survey of the problem and a summary of the judicial and legislative responses to it will serve as a framework for further discussion.

A. Judicial Response

If the consumer signs a promissory note, and the dealer then negotiates the note to a financer, the financer becomes a holder in due course if he took the note for value, in good faith and without notice of any defenses to it.\(^{16}\) A holder in due course takes the instrument free from any "personal" defenses of any party to the instrument with whom the holder has not dealt.\(^ {17}\)

\[\text{Upon the Citadel}:\] 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); Shay, The Impact of the Uniform Consumer Credit Code Upon the Market for Consumer Installment Credit, 33 La. & Con-temp. Prov. 752, 761-63 (1968); Comment, Consumer Defenses and Financers as Holders in Due Course, 4 Conn. L. Rev. 83 (1971).

\[\text{Uniform Commercial Code} \S 3-302(1) \text{ (1962 Official Text) [hereinafter cited as UCC]}\]

A holder in due course is a holder who takes the instrument

- for value; and
- in good faith; and
- without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person.

17. \text{UCC } \S 3-305 provides for the rights of a holder in due course:

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 person; 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.

Defenses referred to in \text{UCC } \S 3-305(2) are personal defenses; they are good only against non-holders-in-due course and the original parties to the instrument. Defenses referred to in \text{UCC } \S 3-305(2) (a) to (e) are real defenses; they are good against anyone, even holders-in-due course. As an example of the distinction between real and personal defenses as it relates to a consumer credit transaction, con-
this means to the consumer is that the financer can enforce the note even though the consumer has a personal defense against the dealer which would prevent the dealer from enforcing the note himself. The same result obtains if the consumer procures a direct loan from a financer, and then purchases consumer goods from a dealer for cash. The consumer is a party to two separate and independent transactions—one a purchase from the dealer, and the other a loan from the financer.

While a majority of jurisdictions still honor the holder in due course status of the financer, the courts have developed a number of theories to deny him that privileged treatment. Most of the theories are dependent upon the consumer establishing a close relationship between the dealer and the financer; the “close connectedness” doctrine holds that the purchaser of a negotiable instrument is not a holder in due course if he is too closely connected to his transferor. It has been held that where the financer and dealer were intimately connected, the financer could not have taken the note in good faith and without notice of a defense to it. Some other courts have reasoned that to allow the financer

18. For extensive reviews of the judicial development in the holder-in due course cases, see J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 14-8 at 479-84 (1972) [hereinafter cited as WHITE & SUMMERS]; Littlefield, supra note 1, at 275-77; Murphy, supra note 15, at 675-78; Comment, supra note 15, at 91-97.

19. WHITE & SUMMERS, supra note 18, at 479, refers to the recent development as the “close connectedness” doctrine.

20. The earliest leading case for this proposition was Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940). In Childs, the consumer signed a document which included an installment sales contract, a promissory note, and on the back of the instrument was a form for the assignment of the note. The forms were supplied to the dealer by the financer; the note was executed and assigned the same day. The court stated:

We think appellant was so closely connected with the entire transaction or with the deal that it can not be heard to say that it, in good faith, was an innocent purchaser of the instrument for value before maturity. It financed the deal, pre-
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who has close ties with the dealer to claim the holder in due course status would be unconscionable. A close relation between the dealer and financer has been held sufficient to make the dealer an agent of the financer. The dealer's knowledge of defenses is therefore imputed to the financer. This brief listing of theories is by no means complete, nor are the categories of cases referred to intended to be precise. Any one case may have based its decision on one or more of the listed theories. The common factor in the cases, however, is the close relation between the financer and the dealer. Some authorities have suggested that rather than try to categorize cases under one theory or another, it is more important to identify those circumstances in a case which constitute a "close connection." Five factors have been so identified:

(1) Drafting by the lender of forms for the seller.

(2) Approval or establishment or both of the seller's procedures by the lender (e.g., setting of the interest rate, approval of a referral sales plan).

(3) An independent check by the lender on the credit of the debtor.

(4) Heavy reliance by the seller upon the lender (e.g., transfer by seller of all or a substantial part of his paper to one lender).

pared the instrument, and on the day it was executed took an assignment of it from the Arkansas Motors, Inc. 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. Id. at 1077, 137 S.W.2d at 262. See Calvert Credit Corp. v. Williams, 244 A.2d 494 (D.C. App. 1968); Universal C.I.T. Credit Corp. v. Ingel, 347 Mass. 119, 196 N.E.2d 847 (1964); Norman v. World Wide Distributors, Inc., 202 Pa. Super. 53, 195 A.2d 115 (1963); Jaeger & Branch, Inc. v. Pappas, 20 Utah 2d 100, 433 P.2d 605 (1967).


23. One other theory, the "identity of parties" theory, denies the financer holder in due course status where he is really the moving party to the transaction. Even though the financer may not have been present during the negotiations between the consumer and the dealer, he may be deemed to be a party to the instrument and to have knowledge of the consumer claims and defenses. Comment, supra note 15, at 95 cites Commercial Credit Corp. v. Orange County Mach. Works, 34 Cal. 2d 766, 214 P.2d 819 (1950), as a clear illustration of the "identity of parties" theory. Wims & Summers, supra note 18, at 460, refers to a theory that the "oneness" of the parties is tantamount to no transfer between them.
(5) Common or connected ownership or management of seller and lender.24

The holder in due course doctrine still prevails in most jurisdictions; nevertheless, recent case developments, as described above, have made the financer's preferred status less certain. Consumers, at least, have decisional authority from which to formulate a close connectedness case from a variety of transactions.25

The waiver of defense clause, as the name indicates, is simply a clause in the contract between the dealer and the consumer whereby the consumer agrees that if the contract is assigned to a third party, the consumer shall be precluded from attacking the contract on the grounds of fraud, mistake or want of consideration.26 The clause, sometimes referred to as an attempt to create "negotiability by contract," gives to the financer essentially the same rights as if he were a holder in due course, i.e., the right to proceed against the consumer, free from the consumer's claims and defenses against the dealer.

According to the weight of authority, the waiver of defense clause is valid.27 The Uniform Commercial Code specifically authorizes waiver clauses, but the Code provision is expressly made subject to any other statute or court decision which may restrict

24. White & Summers, supra note 18, at 481. Other more intangible factors include how badly the consumer was treated by the dealer and the nature of the financer's business. White & Summers notes, "In each of the four recent cases of close connectedness, the defendant was a consumer who had been 'reamed, steamed and dry cleaned' by his seller." Id. at 483. The authors further state:

In addition to the egregiousness of the seller's behavior in these cases, one should note that the plaintiff in each of them was a finance company; none involved a bank. A court may be willing to conclude that paper handled by a finance company is more smelly than that transferred to a bank, and may be quicker to infer unproven interrelationships between seller and finance company than between seller and bank. Id.

25. White & Summers, supra note 18, at 484.

26. A typical waiver of defense clause might read as follows: "If seller should assign the contract in good faith to a third party, the buyer shall be precluded against such third party from attacking the validity of the contract on the grounds of fraud, mistake or want of consideration."

27. Gilmore, The Commercial Doctrine of Good Faith Purchase, 63 Yale L.J. 1057, 1096 (1954); Murphy, Lawyers for the Poor View the UCCC, 44 N.Y.U.L. Rev. 298, 318 (1969). For cases which have enforced the waiver of defense clause, see Jones v. Universal C.I.T. Credit Corp., 88 Ga. App. 24, 75 S.E.2d 822 (1953); Anglo-California Trust Co. v. Hall, 61 Utah 223, 211 P. 991 (1922). See comment of Senator Murphy in note 14 supra indicating that he felt waiver of defense clauses might be found unconscionable in Nebraska.
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the waiver's effectiveness in the case of a buyer of consumer goods. There have been a few courts which have held the clauses unenforceable as void attempts to create negotiability outside the framework of the Uniform Commercial Code. In addition to these public policy theories, some courts have refused to enforce waivers of the defense of fraud.

There are very few reported cases dealing with the preservation of consumer defenses against a direct loan financer. In at least two cases, however, it has been held that defenses which a consumer may assert against a dealer are not good as against a financer from whom the consumer obtained a direct loan.

28. UCC § 9-206(1) provides:

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

29. Littlefield, supra note 1, at 278. See, e.g., Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967); C.I.T. Corp. v. Hetland, 143 N.W.2d 94 (N.D. 1966). In Geiger Fin. Co. v. Graham, 123 Ga. App. 771, 182 S.E.2d 521 (1971), the sales contract and promissory note were all printed on the same document. The court denied the financer holder in due course status because the paper was not a negotiable instrument. The waiver-of-defense clause was therefore invalidated; the court would not enforce the clause if the effect was to render a writing negotiable which was otherwise non-negotiable. The Geiger Finance case is the subject of a casenote at 23Mercer L. Rev. 673 (1972).


31. Beneficial Fin. Co. v. Bienemy, 244 So. 2d 275 (La. Ct. App. 1971); Commercial Credit Plan, Inc. v. Beebe, 123 Vt. 317, 187 A.2d 502 (1963). In Note, 85 Harv. L. Rev. 1409, 1423-32 (1972), the author analyzes the use of three existing legal theories to justify preservation of defenses in the direct loan case. Each of the three theories is predicated to a certain extent on a close connection between the seller and the lender. First, the author discusses judicial precedent for arguing that the lender is a party to the sales transaction either as the seller's principal or as the seller's partner or co-venturer. Second, the author discusses the possibility of a judicial establishment of a direct duty of the lender to the borrower to disclose his knowledge of a related sale when he is or should be aware that the borrower is likely to be cheated. Breach of such a duty could amount to fraud in the solicitation of the loan. Finally, the author suggests there may be precedent for an action by the consumer for the lender's negligence in failing to exercise reasonable care that he is not financing seller misconduct.
B. Legislative Response

A number of state legislatures have enacted measures restricting or prohibiting the use of negotiable notes or waiver-of-defense clauses in consumer transactions. The legislative response has taken a variety of approaches and there is very little uniformity among the states. Some states have restricted the use of or prohibited altogether both negotiable instruments and waiver clauses, while other states have barred one but not the other. Waiver clauses are enforceable under some statutes if notice of the assignment is given to the consumer, and if within a prescribed period he fails to notify the assignee (financer) of facts giving rise to any claim or defense he may have. The types of transactions in which either waiver clauses or negotiable instruments, or both, have been prohibited range from all retail installment sales to such specific ones as home improvement transactions and motor vehicle sales.

32. For a discussion of the variety of legislative measures, and citations to many of the state statutes, see Navin, Waiver of Defense Clauses in Consumer Contracts, 48 N.C. L. Rev. 505, 531-32 (1970).

33. CAL. Civ. Code § 1804.2 (West 1973) (invalidating waiver clause in retail installment contracts); CAL. Civ. Code § 1810.7 (West 1973) (barring negotiability of retail installment accounts); HAWAII Rev. Laws § 476-18 (1968) (prohibits negotiability and waiver clauses in retail installment sales); N.Y. Pers. Prop. Law § 403(1) (McKinney 1962) (prohibiting negotiability in situation involving retail installment contracts and obligations); § 403(3)(g) (McKinney 1962) (making waivers ineffective when contract is executory and is for services); WASH. Rev. Code Ann. § 63.14.020 (Supp. 1972) (prohibiting negotiability in retail-installment transactions); § 63.14.150 (Supp. 1972) (prohibiting waivers in retail installment contracts). If L.B. 325, 83d Neb. Leg. Sess. had been enacted, as introduced, it would have fallen in this category of statutes.


36. The parenthetical notations in notes 33, 34 and 35 supra indicate the transactions to which the statutes apply.
Some authorities perceive a shift from the three-party indirect loan transaction to direct loan or lender credit card financing.\textsuperscript{37} This may be partially attributable to legislation in several of the states which eliminates negotiability in some or all consumer transactions. Most of the statutes apply only to consumer credit "sales" and not to "loans."\textsuperscript{38} The lender credit card transaction is generally classified as a loan from the financer.\textsuperscript{39} By switching to direct loan financing, financers can still insulate themselves from consumer defenses. Some states, however, have enacted legislation to preserve consumer defenses in the direct loan and the lender credit card cases. At least five jurisdictions, Arizona,\textsuperscript{40} Massachusetts,\textsuperscript{41} New York,\textsuperscript{42} Rhode Island\textsuperscript{43} and Wisconsin,\textsuperscript{44} have statutes

\begin{itemize}

\item \textsuperscript{37} Littlefield, supra note 1, at 293.
\item \textsuperscript{38} For the Uniform Consumer Credit Code provisions, see note 66 infra, and for the treatment of this issue by L.B. 325, 33d Neb. Leg. Sess. (1974), see note 56 infra.
\item \textsuperscript{39} Id.
\item \textsuperscript{40} Ariz. Rev. Stat. Ann. § 44-145 (Supp. 1973-1974). This statute permits the consumer to assert defenses against a holder or an assignee of an instrument "which evidences the obligation of a natural person as buyer, lessee, or borrower in connection with the purchase or lease of consumer goods." (emphasis added). The consumer must send notice of his defense by certified mail to the seller within 90 days of receiving the goods or services. Section 44-145B(3) provides that the statute is inapplicable to transactions where the note evidences a loan "which was not arranged by the seller or lessor." "Arranged" is defined as follows: "Arranged" means to provide or offer to provide a loan which is or will be extended to another person under a business or other relationship pursuant to which the person arranging such loan receives or will receive a fee, compensation, or other consideration for such service or has knowledge of the terms of the loan and participates in the preparation of the instruments required in connection with the extension of the loan.
\item \textsuperscript{42} N.Y. Gen. Bus. Law §§ 253-54 (McKinney Supp. 1973-1974). This statute is also patterned after the NCA provision, but there are significant differences. The lender must have "knowingly participated in or was directly connected with" the sale before the statute applies to the direct loan transaction. The New York statute lists three fact situations (the NCA lists seven) which create a rebuttable presumption that the creditor shall have knowingly participated in or shall have been directly connected with a consumer sale—(1) lender related to the seller, (2) seller prepared the loan documents, (3) lender supplied forms used by the consumer. Under the NCA model, any of these three fact situations, plus the four others in § 2.407 conclusively establishes that the creditor participated in or was connected

\end{itemize}
designed to preserve defenses in the direct loan transaction. Each of the statutes require some connection between the dealer and the direct lender. Arizona, California, Massachusetts, Vermont with the consumer sale. The New York statute does not apply to transactions involving the purchase of an automobile.

43. R.I. Gen. Laws Ann. § 6-27-5 (Supp. 1972), provides that if any contract requires or involves the execution of a promissory note by a retail buyer in connection with an extension of credit by the retail seller, or by a creditor to whom the retail buyer was referred by the retail seller and to whom the retail seller regularly, as part of the ordinary conduct of its business, and with the actual knowledge of such creditor, refers retail buyers for credit, the words “non-negotiable consumer note” shall be placed prominently thereon, and an assignee of such note with the words “non-negotiable consumer note” appearing prominently thereon shall take such note subject to the claims and defenses permitted under section 6A-3-306 of the general laws irrespective of whether or not the assignee qualifies as a “holder in due course” as defined in section 6A-3-302 of the general laws.

For an analysis of the knotty problems of interpretation that this statute might produce, see Littlefield, supra note 8, at 482-83.

44. Wis. Stat. § 422.408 (1971). The Wisconsin legislation integrates regulation of consumer sales and loans. The relevant sections apply to a “consumer credit transaction” defined as a “consumer transaction between a merchant and a customer in which real or personal property, services or money is acquired on credit...”. The term includes consumer credit sales, consumer loans, consumer leases and transactions pursuant to open-end credit plans. Wis. Stat. § 422.301(10) (1971). The Wisconsin statute is patterned after NCA § 2.407, infra note 61. Wis. Stat. § 422.408(1) (1971) provides that “the lender in an interlocking consumer loan is subject to the claims and defenses the consumer may have against the seller or lessor in the consumer transaction for which the proceeds of the loan are used.” An “interlocking loan” is defined in Wis. Stat. § 422.408(3) (1971).

For an analysis of the scope and potential problems of interpretation of each of these statutes, see Littlefield, supra note 8, at 478-92. Littlefield suggests that perhaps Vt. Stat. Ann. tit. 9, § 2455 (1971), fits into this category. It provides:

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 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, and all rights available to him under this chapter.

46. For the various requirements of the degree of connection required, see notes 40-44 supra.

47. Ariz. Rev. Stat. Ann. § 44-145 (Supp. 1973). For a discussion of the Arizona statute, see note 40 supra. Section 44-145B(1) provides that the statute is inapplicable to lender credit card sales of perishable consumer goods or consumer services. Furthermore, the statute does not apply to credit card transactions made out of the state as provided in § 44-145B(2).

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mont\textsuperscript{50} and Wisconsin\textsuperscript{51} have statutes preserving defenses in lender credit card transactions.\textsuperscript{52} All of the credit card statutes, except that of Massachusetts, are applicable only to intrastate transactions.

The Nebraska Legislature's L.B. 325\textsuperscript{53} would have eliminated negotiability in all consumer credit sales and consumer leases. Any promissory note, instrument, or other evidence of indebtedness of the buyer issued pursuant to a contract for a consumer credit sale between a retail buyer and a retail seller would not have been a negotiable instrument.\textsuperscript{54} Furthermore, waiver of defenses clauses would have been of no force or effect.\textsuperscript{55} A special definition of lender credit card was provided; but apparently, the lender would not have been subject to consumer defenses because a lender credit card transaction was not included in the definition of consumer credit sale, or consumer lease.\textsuperscript{56}

for credit card transactions, but its statute does not affect direct loans. The California statute, although similar to the NCA § 2.407, infra note 71, contains three important limitations on the assertability of defenses. (1) Defenses are assertable only if the purchase price of the item exceeds $50. (2) The statute applies only to purchases made in the state. (3) The amount to which a defense may be asserted is limited to that amount of the purchase price which is still, at the time of notice of the defense outstanding on the balance.

49. See note 41 supra.
50. VT. STAT. ANN. tit. 8, § 1305 (1971) provides:

With respect to transactions in Vermont charged to a bank credit card account established by a Vermont bank, the defenses preserved by section 2455 of Title 9, shall be available to the cardholder as against the bank in any action or proceeding to enforce collection of said account by a Vermont bank.

VT. STAT. ANN. tit. 9, § 2455 (1971), is quoted at note 45 supra. The applicability of tit. 8, § 1305 is somewhat in question because of its relation to tit. 9, § 2455. See Littlefield, supra note 8, at 490-91.

51. Wis. STAT. § 422.408(3) (f) (1971), supra note 44. The credit card transaction is defined as a consumer loan transaction by Wis. STAT. § 422.408(2).

52. See note 45 supra.
53. See note 9 and accompanying text supra.
55. Id. § 3.
56. Id. § 1(6) defined a “lender credit card:”

Lender credit card shall mean an arrangement or loan agreement, other than a seller credit card, pursuant to which a lender gives a buyer the privilege of using a credit card, letter of credit, or other credit confirmation, or identification in transactions out of which debt arises by the lender's payment or agreement to pay the buyer's obligations;

The lender credit card transaction was specifically excluded from the definition of “consumer credit sale” and “consumer lease.” Id. § 1(4) defined a “consumer credit sale:”
(1) Uniform Consumer Credit Code

One attempt at uniformity in legislative response to the issue of preservation of consumer defenses is the Uniform Consumer Credit Code (hereinafter the "UCCC"), adopted in 1968 by the National Conference of Commissioners on Uniform State Laws. At the date of this writing, seven states have enacted the UCCC, and it is under some phase of consideration in the legislature of nearly every state.58

UCCC section 2.403 prohibits the use of negotiable instruments in consumer credit sales.59 The only limitation on the prohibition

Consumer credit sale shall mean, except for a sale in which the seller allows the buyer to purchase goods or services pursuant to a lender credit card or similar arrangement, a sale of goods or services in which: (a) Credit is granted by a seller who regularly engages as a seller in credit transactions of the same kind, (b) the buyer is a natural person other than an organization, (c) the goods or services purchased are primarily for a personal, family, household, or agricultural purpose, (d) either the debt is payable in installments or a credit service charge is made, and (e) the amount financed does not exceed twenty-five thousand dollars;

"Consumer lease" was defined at id. § 1(11):

Consumer lease shall mean a lease of goods (a) which a lessor regularly engaged in the business of leasing makes a natural person who takes under the lease primarily for a personal, family, household, or agricultural purpose, (b) in which the amount payable under the lease does not exceed twenty-five thousand dollars, and (c) which is for a term exceeding four months, but shall not include a lease made pursuant to a lender credit card or similar arrangement.


58. For the current status of UCCC legislation in any state, see CCH CONSUMER CREDIT GUIDE ¶ 4771.

59. UCCC § 2.403 (1969 Official Text) [hereinafter cited as UCCC] provides:

In a consumer credit sale or consumer lease, other than a sale or lease primarily for an agricultural purpose, the seller or lessor may not take a negotiable instrument other than a check as evidence of the obligation of the buyer or lessee. A holder is not in good faith if he takes a negotiable instrument with notice that it is issued in violation of this section. A holder in due course is not subject to the liabilities set forth in the provisions on the effect of violations on rights of parties (Section 5.202) and the provisions on civil actions by
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is that a person who has no knowledge that the note has been issued in violation of section 2.403, and is otherwise a holder in due course, may enforce the obligation free of consumer defenses.

The original version of the UCCC provided two alternative sections concerning the enforceability of waiver of defense clauses.

Administrator (Section 6.113).

Among the states that have adopted the UCCC, there are certain local variations. COLO. REV. STAT. ANN. § 73-2-403 (Cum. Supp. 1971) provides:

(1) If a consumer credit sale or consumer lease, other than a sale or lease primarily for an agricultural purpose, involves the execution of a promissory note or instrument or other evidence of indebtedness of the buyer, or lessee, such note, instrument, or evidence of indebtedness shall have printed on the face thereof the words 'consumer paper', and such note, instrument, or evidence of indebtedness with the words 'consumer paper' printed thereon shall be a negotiable instrument within the meaning of article 3 of chapter 155, C.R.S. 1963, ninety days after the date of such instrument.

(2) Notwithstanding the absence of such notice on a note, instrument, or evidence of indebtedness arising out of a consumer credit sale or consumer lease, and notwithstanding an agreement to the contrary, 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, up to and including the amount owing to the assignee at the time the claim or defense is asserted against the assignee.

(3) Failure to imprint the words 'consumer paper' on such note, instrument, or evidence of indebtedness shall subject the seller, lessor, or other responsible person to the liabilities set forth in the provisions on the effect of violations on rights of parties (section 73-5-202) and the provisions on civil actions by the administrator (section 73-6-113).

IDAHO CODE ANN. § 28-32-403 (Cum. Supp. 1973) provides:

With respect to a consumer credit sale or consumer lease, other than a sale or lease primarily for an agricultural purpose, the seller or lessor may not take a negotiable instrument other than a currently dated check as evidence of the obligation of the buyer or lessee.

The Kansas version of the UCCC does not contain § 2.403.

The official comment to UCCC § 2.403 states:

Since the prohibition against certain negotiable instruments in consumer financing will be well known in the financial community after enactment of this Act, professional financers buying consumer paper will normally not qualify as holders in due course with respect to instruments taken by dealers in violation of this section and negotiated to them. To qualify as a holder in due course all requirements of UCC Section 3-302 must be satisfied. However, it is possible that in rare cases a second or third taker may not know of an instrument’s consumer origin; in this unusual situation the policy favoring negotiability is upheld in order not to cast a cloud over negotiable instruments generally. A person who takes a negotiable instrument in violation of this section is subject to Sections 5.202 and 6.113. Compare Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967).

For a discussion of Alternatives A and B, see Hogan, supra note 15,
Section 2.404, Alternative A rendered waiver clauses unenforceable altogether,^62 while under Alternative B, waiver clauses were enforceable, provided the financer notified the consumer of the assignment, and within three months thereafter, the consumer did not notify the financer of any claim or defense.^63 Many consumer ad-

at 686-91; Jordan & Warren, supra note 15, at 436-37; Littlefield, supra note 1, at 288-92; Murphy, supra note 15, at 682-85.

62. UCCC § 2.404, Alternative A provides:
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.

Idaho adopted Alternative A with extensive modification to read:
When assignee not subject to defenses.
(1) With respect to a consumer credit sale or consumer lease, (other than one 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 that
(a) there is an agreement to the contrary, or
(b) the assignee is a holder in due course of a negotiable instrument issued in violation of the provisions on prohibition of certain negotiable instruments (section 2.403).
(2) The assignee's liability under subsection (1) may not exceed the amount owing to the assignee with respect to the sale or lease at the time the assignee has notice of a claim or defense of the buyer or lessee. If debts arising from two or more consumer credit sales, other than pursuant to a revolving charge account, or consumer leases are consolidated, payments received after the consolidation are deemed, for the purpose of determining the amount owing the assignee with respect to a sale or lease, to have been first applied to the payment of debts arising from the sales or leases first made; if the debts consolidated arose from sales or leases made on the same day, payments are deemed to have been first applied to the smallest debt. Payments received upon a revolving charge account are deemed, for the purpose of determining the amount owing the assignee with respect to a sale, to have been first applied to the payment of credit service charges in the order of their entry to the account and then to the payment of debts in the order in which the entries to the account showing the debts were made.
(3) An agreement may not provide for greater rights for an assignee than this section permits.


63. UCCC § 2.404, Alternative B provides:
(1) With respect to a consumer credit sale or consumer lease, other than a sale or lease primarily for an agricultural purpose, an agreement by the buyer or lessee not to assert
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vocates were disturbed that the UCCC had not taken a stronger position against the waiver clause; consequently, the alternative provisions have been the subject of much controversy. In the latest redraft of the UCCC, Alternative B was rejected.\(^6^4\)

Under both Alternative A and Alternative B of UCCC section 2.404, there are two limitations on the financer's liability. First, the financer's liability may not exceed the amount owing to him at the time the consumer brings his claim against the financer.

Against an assignee a claim or defense arising out of the sale or lease is enforceable only by an assignee not related to the seller or lessee who acquires the buyer's or lessee's contract in good faith and for value, who gives the buyer or lessee notice of the assignment as provided in this section and who, within 3 months after the mailing of the notice of assignment, receives no written notice of the facts giving rise to the buyer's or lessee's claim or defense. This agreement is enforceable only with respect to claims or defenses which have arisen before the end of the 3-month period after notice was mailed. The notice of assignment shall be in writing and addressed to the buyer or lessee at his address as stated in the contract, identify the contract, describe the goods or services, state the names of the seller or lessor and buyer or lessee, the amount payable by the buyer or lessee and the number, amounts and due dates of the instalments, and contain a conspicuous notice to the buyer or lessee that he has 3 months within which to notify the assignee in writing of any complaints, claims or defenses he may have against the seller or lessor and that if written notification of the complaints, claims or defenses is not received by the assignee within the 3-month period, the assignee will have the right to enforce the contract free of any claims or defenses the buyer or lessee may have against the seller or lessor which have arisen before the end of the 3-month period after notice was mailed.

(2) An assignee does not acquire a buyer's or lessee's contract in good faith within the meaning of subsection (1) if the assignee has knowledge or, from his course of dealing with the seller or lessor or his records, notice of substantial complaints by other buyers or lessees of the seller's or lessor's failure or refusal to perform his contracts with them and of the seller's or lessor's failure to remedy his defaults within a reasonable time after the assignee notifies him of the complaints.

(3) To the extent that under this section an assignee is subject to claims or defenses of the buyer or lessee against the seller or lessor, 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 and 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.

Indiana, Oklahoma and Wyoming adopted Alternative B, but amended the three-month periods to 60 days, 30 days and 45 days respectively. Colorado reserved § 2.404 for future use, and Kansas did not enact either Alternative A or B of § 2.404.

\(^6^4\) UCCC WORKING REDRAF\(T\) NO. 4 § 3.404.
In other words, the consumer may not recover the payments he made to the financer prior to the assertion of his defense. In addition to the finality of payment rule, the consumer's claim may be asserted only as a matter of defense to or set-off against a claim by the financer. In the most recent version of the UCCC, the "defense or set-off" language was deleted while the limitation of financer liability to the amount owing to the assignee at the time the assignee has notice of the defense was retained.65

Because UCCC sections 2.403 and 2.404 apply only to "consumer credit sales" they do not preserve consumer defenses in the direct loan or the lender credit card cases.66 However, another change in the new draft of the UCCC is to allow the consumer to assert his defenses against a direct lender in certain enumerated situations—(a) the consumer is referred by the dealer to a lender for a commission, (b) the dealer and the lender are related, (c) the dealer guarantees the loan, (d) the lender directly supplies the dealer with the contract documents, or (e) the loan is conditioned upon the consumer's purchase of the goods or services from a particular dealer.67

65. UCCC WORKING REDRAFT No. 4 § 3.404(2). L.B. 325 § 3, 83d Neb. Leg. Sess. (1974), incorporated the finality of payment rule. It provided:

An assignee's liability under this act shall not exceed the amount owing to the assignee at the time the claim or defense is asserted against such assignee.

66. UCCC § 2.104 defines "consumer credit sale:"

"[C]onsumer credit sale" is a sale of goods, services, or an interest in land in which

(a) credit is granted by a person who regularly engages as a seller in credit transactions of the same kind,
(b) the buyer is a person other than an organization,
(c) the goods, services, or interest in land are purchased primarily for a personal, family, household, or agricultural purpose,
(d) either the debt is payable in installments or a credit service charge is made, and
(e) with respect to a sale of goods or services, the amount financed does not exceed $25,000.

There are two provisions in the UCCC which remove the credit card transaction from the scope of the prohibition against negotiability and the prohibition against waiver clauses. UCCC § 2.104(2)(a) provides:

Unless the sale is made subject to this Act by agreement (Section 2.601), "consumer credit sale" does not include a sale in which the seller allows the buyer to purchase goods or services pursuant to a lender credit card or similar arrangement.

UCCC § 3.106:

"Loan" includes

(3) the creation of debt pursuant to a lender credit card or similar arrangement.

67. UCCC WORKING REDRAFT No. 4 § 3.405 provides:
(2) National Consumer Act

The National Consumer Act (hereinafter the "NCA"), 68 undoubtedly the most determinedly pro-consumer of all recent statutory proposals, completely abrogates the holder in due course doctrine by providing that no creditor may have a consumer sign a note payable "to order" or "to bearer." 69 The NCA subjects an

(1) A lender, other than the issuer of a lender credit card, who, with respect to a particular transaction, makes a consumer loan for the purpose of enabling a consumer to buy or lease from a particular seller or lessee goods or services [other than primarily for an agricultural purpose,] is subject to all claims and defenses of the consumer against the seller or lessor arising from that sale or lease of the goods and and services if

(a) the lender knows that the seller or lessor arranged, for a commission, brokerage, or referral fee, for the extension of credit by the lender;

(b) the lender is a person related to the seller or lessor unless the relationship is remote or is not a factor in the transaction;

(c) the seller or lessor guarantees the loan or otherwise assumes the risk of loss by the lender upon the loan;

(d) the lender directly supplies the seller or lessor with the contract document used by the consumer to evidence the loan, and the seller or lessor significantly participates in the preparation of the document; or

(e) the loan is conditioned upon the consumer's purchase or lease of the goods or services from the particular seller or lessor, but the lender's payment of proceeds of loan to the seller or lessor does not in itself establish that the loan was not conditioned.

(2) A claim or defense of a buyer or lessee specified in subsection (1) may be asserted against the lender only to the extent of the amount owing to the lender with respect to the sale or lease at the time the lender has notice of the claim or defense.

(3) For the purpose of determining the amount owing to the lender with respect to the sale or lease

(a) payments received by the lender after the consolidation of two or more consumer loans, other than pursuant to open end credit, are deemed to have been first applied to the payment of the loans first made; if the loans consolidated arose from loans made on the same day, payments are deemed to have been first applied to the smaller or smallest loan or loans; and

(b) payments received upon an open end credit account are deemed to have been first applied to the payment of finance charges in the order of their entry to the account and then to the payment of debts in the order in which the entries of the debts are made to the account.

(4) An agreement may not limit or waive the claims or defenses of a consumer under this section.

68. For a discussion of the NCA and the original UCCC, see Moo, New Consumer Credit Legislation: Which Approach—the UCCC or the NCA?, 2 URBAN L. 439 (1970).

69. NCA § 2.405 provides:
assignee of an installment contract to all the claims and defenses of the consumer arising out of a consumer credit transaction in spite of a waiver clause.\textsuperscript{70} The NCA preserves consumer defenses in many direct loan transactions by providing in section 2.407(1) that the lender is subject to such defenses if he "participated in or was connected with the consumer sale or lease transaction."\textsuperscript{71} In order

\begin{enumerate}
\item No lender, seller or lessor shall take or otherwise arrange for the consumer to sign an instrument payable "to order or to bearer" as evidence of the credit obligation of the consumer in a consumer credit transaction or a consumer lease.
\item Any holder of an instrument, contract or other writing evidencing an obligation of the consumer takes it subject to all claims and defenses of the consumer up to and including the amount of the transaction total arising out of the transaction whether or not it is payable "to order or to bearer." \textsuperscript{7}
\item Taking or otherwise arranging for the consumer to sign an instrument in violation of this Section shall be subject to the provisions of Section 5.304.
\end{enumerate}

The official comment to NCA § 2.406 explains its significant difference from UCCC § 2.403:

\begin{enumerate}
\item In order to avoid the doctrine of "holder in due course," the Uniform Consumer Credit Code pretends to prohibit the use of negotiable instruments in consumer credit sales. It acknowledges that such instruments can still be used in violation and that there can be holders in due course. Further, it does not apply even this restriction to consumer loans.
\item This section prohibits the taking of instruments payable "to order or to bearer." Under Article 3 of the Uniform Commercial Code this destroys the negotiability of such instruments, although they are still subject to other provisions of Article 3. This gives some certainty to the law of transfer of such instruments, even though there can be no holder in due course under Section 3-805 of that statute. Subsection (2) of this section subjects a holder taking an instrument in violation to all defenses of the consumer. Such holder is liable up to the "transaction total," which is the total amount of the transaction at its inception. Thus, this Act destroys once and for all the doctrine of "holder in due course."
\end{enumerate}

\textsuperscript{70} NCA § 2.406 provides:
"Notwithstanding any term or agreement to the contrary, an assignee of the rights of the creditor is subject to all claims and defenses of the consumer arising out of a consumer credit transaction or consumer lease."

\textsuperscript{71} NCA § 2.407 provides:
\begin{enumerate}
\item The creditor in consumer loan transactions shall be subject to all of the claims and defenses of the consumer up to the total amount financed, arising from the consumer sale or lease for which the proceeds of the loan are used, if the creditor participated in or was connected with the consumer sale or lease transaction.
\item Without limiting the scope of subsection (1), the creditor participates in or is connected with a consumer sale or lease transaction when:
   \begin{enumerate}
   \item the creditor is a person related to the seller or lessor; or
   \end{enumerate}
\end{enumerate}
to determine when the lender "participated in or was connected with" the sales transaction, NCA section 2.407(2) sets out a number of situations in which the connection is conclusively established, including where the creditor was the issuer of a credit card.\footnote{72} The Massachusetts legislation, referred to above, was substantially patterned after the NCA.\footnote{73}

III. EFFECT OF LEGISLATION

It is quite obvious that legislatures have responded to the problem of preservation of consumer defenses with a variety of measures. Despite the large volume of commentary on this issue, there is a dearth of empirical data which a legislature might look to in drafting a statute. There are no statistics which identify the need for the legislation or more specifically in which segments of the consumer credit industry such a need might exist. Furthermore, there is little available information which analyzes the impact of the "protective" legislation on the financer, the dealer or the consumer. While the controversy over the legislation has centered on the balance between the need for consumer protection on the one hand and the fear of a detrimental effect on the dealer's ability to market consumer paper on the other, neither side has statistical information to support its respective position.

A. Commentators Discuss Impact

Nonetheless, the commentators have not necessarily been silent on the issue of the impact of the legislation. In the early 1950s, it was argued by at least one authority that the consumer's inability to assert his defenses against a third party financer was an in-

\begin{itemize}
  \item[(b)] the seller or lessor prepares documents used in connection with the loan; or
  \item[(c)] the creditor supplies forms to the seller or lessor used by the consumer in obtaining the loan; or
  \item[(d)] the creditor makes 20 or more loans in any calendar year, the proceeds of which are used in transactions with the same seller or lessor, or with a person related to the same seller or lessor; or
  \item[(e)] the consumer is referred to the creditor by the seller or lessor; or
  \item[(f)] the creditor, directly or indirectly pays the seller or lessor any consideration whether or not it is in connection with the particular transaction; or
  \item[(g)] the creditor is the issuer of a credit card which may be used by the consumer in the consumer sale or lease as a result of a prior agreement between the issuer and the seller or lessor.
\end{itemize}

\footnote{72}{Id.}
\footnote{73}{Note 41 supra.}
teresting theoretical problem but not a very large problem factually.\textsuperscript{74} This was based on the feeling that there was only an infinitesimal number of installment sales transactions where the consumer was harmed by not being able to assert his defenses against the financer.\textsuperscript{75} Most sales, it was argued, satisfied the consumer and most deficiencies were cured by responsible sellers.\textsuperscript{76} Some authorities, more recently, have used this same major premise to argue that there is no difference in the availability of financing nor the profits of sellers or financers among those states which allow negotiable instruments and waiver clauses and those states which do not.\textsuperscript{77} These same authorities, however, generally favor preservation of consumer defenses. Even if no protection is needed in the vast majority of cases, there are a significant number of consumers, particularly the low income segment, who do need the protection.\textsuperscript{78}

\textsuperscript{74} Kripke, \textit{supra} note 15, 59 \textsc{Yale} L.J. at 1215-16 (1950) stated:

This problem is indeed an interesting one, theoretically, but the intriguing theoretical situation makes the problem loom larger than it is factually. The purchaser on time is no more likely to be dissatisfied with his purchase than any other purchaser. In the whole vast range of consumer purchase transactions, the cases of customer complaint, justified or unjustified, are infinitesimal. Even in the case of justified dissatisfaction, the seller is ordinarily able and willing to make adjustment. If he is not willing, he is, of course, legally responsible either in a direct suit by the purchaser or at the insistence of the third party holder of the obligation if the latter has been unable to collect because of the successful assertion of defenses based on dissatisfaction with the merchandise. Therefore, the question is merely procedural, except in the comparatively few cases where the seller is unavailable or insolvent.

Kripke more recently has written in favor of the preservation of consumer defenses, see Kripke, \textit{supra} note 15, 68 \textsc{Columbia} L. \textsc{Rev.} at 470-73 (1968).

\textsuperscript{75} Kripke, \textit{supra} note 15, 59 \textsc{Yale} L.J. at 470-73.

\textsuperscript{76} Id.

\textsuperscript{77} Felsenfeld, \textit{supra} note 6, at 551-52; Hartman & Walker, \textit{The Holder in Due Course Doctrine and the Consumer}, 77 \textsc{Com. L.J.} 116, 123-24 (1972).

\textsuperscript{78} Id. \textit{Project—Legislative Regulation of Retail Installment Financing}, 7 \textsc{U.C.L.A. L. Rev.} 623, 750 (1960), states:

It has been suggested that from both the buyer's and financing agency's point of view, the issues of negotiability and waiver of defense have been greatly exaggerated in importance. It is said that the financing agency, prior to asserting its rights against the buyer, will attempt to settle honest claims by having the dealer make appropriate adjustments, thereby preserving the latter's reputation in the community. Failing this, resort will be had to the dealer's reserve account or his recourse indorsement. Only in cases where the dealer is insolvent, or where the financing agency and he are united in interest, will the buyer be called upon
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Probably the most widely accepted prediction of the impact of the preservation of consumer defenses is that financers will be more careful about the paper that they purchase, and as a result financers will screen out those marginal sellers with whom consumers have had problems in the past.\textsuperscript{79} Added screening procedures, it is predicted, will increase the cost of purchasing and servicing installment paper originated by dealers.\textsuperscript{80} Commercial banks will have a tendency to loan money directly to consumers and will have a disincentive to purchase dealer paper,\textsuperscript{81} while independent finance companies may diversify away from consumer paper.\textsuperscript{82} All of this, it is thought, will add up to some curtailment in the availability of credit and some increase in the cost of credit to the consumer.\textsuperscript{83}

Despite the acknowledgement that credit may be more difficult to obtain and that it may become more expensive, "the complete weight of academic thinking" is in favor of preserving consumer defenses.\textsuperscript{84} The legislation has been justified on the basis of two theories. First, as between the financer and the consumer, the financer is in a better position to prevent losses to the consumer by screening out thinly capitalized or fraudulent dealers.\textsuperscript{85} The financer can simply refuse to purchase the paper from these dealers, and the end result will be that the only sources of installment credit will be from adequately capitalized or reputable dealers. A second and independent justification is that of the financers ability to allocate the risk of consumer loss back to the dealers and con-

\begin{itemize}
  \item to make good his promise even though the seller has not performed his part of the bargain. Thus, it is argued, only in an infinitesimal number of retail installment sale transactions is the buyer harmed by his agreement to waive his defenses or by having given a negotiable instrument.
  \item Conceding that no protection is needed in the vast majority of cases, protection in the remaining ones must come from the legislature, for it is also agreed that the buyer is unable to provide it for himself. Moreover, to say that the problem is not substantial is to look only to the reported decisions, few in number. It is to overlook the larger number of cases which either never reach an appellate level or never go to trial. The buyer who is being protected by retail installment legislation is normally one who cannot afford the luxury of a lawsuit and may, therefore, be forced as a practical matter to submit to the demands of the financing agency though he has an otherwise valid claim.
\end{itemize}

\textsuperscript{79}. Shay, \textit{supra} note 15, at 761-62.
\textsuperscript{80}. Id. at 762.
\textsuperscript{81}. Id.
\textsuperscript{82}. Id.
\textsuperscript{83}. Id.
\textsuperscript{84}. Kripke, \textit{supra} note 15, 68 \textit{COLUM. L. REV.} at 470.
\textsuperscript{85}. Id. at 472. Littlefield, \textit{supra} note 1, at 280-83.
sequently assure that the costs of doing business are carried by those engaged in the enterprise. Furthermore, the financer can spread the cost of risk allocation over several transactions. The individual consumer has no ability to shift risks or allocate costs, and he must absorb all his own losses. It is strenuously argued by some commentators that these theories also justify the preservation of consumer defenses in the direct loan and the credit card transactions.

B. The Yale Project

In 1969 a group of Yale law students, recognizing the lack of empirical data by which to determine the impact of the restriction on negotiability on the consumer credit industry, conducted a study of the home improvement business in Connecticut and the effects of certain provisions of the Connecticut Home Solicitation Sales Act of 1967 (hereinafter "the Act"). Among other things, the Act contained a provision that the obligation to pay, arising from a home solicitation sale, cannot be evidenced by a negotiable instrument. The study analyzed separately the impact of that provision on the financer, the dealer and the consumer.

(1) The Financer

The study reported "the clearest consequence of the Act has been a marked reduction in institutional financing of business engaged in door-to-door sales." The reduction was explained by analyzing the financer's criteria for dealer selection and the terms of the financing arrangements. Screening of dealers by financers became more regular and more intensive after the Act became effective. The decrease in institutional financing was partially explained by the difficulty that dealers had in complying with the

89. CONN. GEN. STAT. ANN. § 42-134 to -143 (Supp. 1968).
90. Note 88 supra, at 637.
91. Id. at 638. Financers reported that they had screening procedures prior to the Act. Financers inquired into such information as the number of customer complaints about a dealer and the number of past defaults by a dealer's customers. Financial statements were often required. After the Act became effective, the screening procedures became more intensive and more regular. Financers now reported checking several possible references such as suppliers or other banks and businesses that might be acquainted with the dealer. Some were even checking the dealer's work.
generally more rigorous standards set by financers. An additional factor in the decrease was the new obligations which financers required of dealers. \(^{92}\) Foremost among the new terms of financing agreements was the repurchase agreement whereby the dealer promised to repurchase the consumer’s note from the financer should the consumer for any reason refuse payment. \(^{93}\)

A second major consequence of the Act was that credit became generally more expensive. The increase in cost was not manifested by higher interest rates but in less direct ways. \(^{94}\) The study indicated one way in which financers were “regularly” taking a greater return on home improvement transactions than they did prior to the Act. Traditionally, upon taking an assignment from a dealer, financers would give the dealer incentive payments, a supplement to the amount of the sales price. The use of incentive payments declined. \(^{95}\) Some financers discontinued the practice and others either reduced the percentage of the payment or the number of dealers to whom the payment was available. \(^{96}\)

Under the Connecticut Act, financers who loan money directly to consumers, who, in turn, purchase goods from the dealer for cash, are not affected by the elimination of negotiability in installment credit transactions. Because the direct loan transaction offered financers insulation from consumer defenses, many financers shifted their emphasis to seeking direct loan customers rather than soliciting dealers for financing. \(^{97}\)

(2) The Dealer

“Almost half of the dealers reported that it had become more

\(^{92}\) Id. at 640.

\(^{93}\) Id. Repurchase agreements provide much the same insulation for financers to consumer defenses as did the holder in due course doctrine. However, if the dealer is either absent or insolvent so that he cannot honor the repurchase agreement, the consumer can still present his defenses against the financer. For this reason, even with repurchase agreements, financers are unlikely to purchase a dealer’s paper, unless the dealer is in a relatively stable financial condition.

\(^{94}\) One method is the reserve account. When the financer purchases the note from the financer, typically he does not pay the dealer the full face amount of the note. Rather, the financer retains a small percentage of the total—from 1 to 2½%—in an account under the dealer’s name. The financer could increase the cost of credit by increasing the reserve account percentage. However, the study found that reserve account requirements generally have not increased since the Act went into effect. Note 88 supra, at 641.

\(^{95}\) Id. at 642.

\(^{96}\) Id.

\(^{97}\) Id.
difficult to obtain financing since the Act.\textsuperscript{98} Several dealers found it impossible to secure financing and were either severely damaged in their business or were forced out of business altogether.\textsuperscript{99} These results were explained by the changes in the screening procedures required by financers.\textsuperscript{100}

Dealers reacted to the difficulty of obtaining financing in one of three ways. A very few dealers ceased door-to-door operations and worked instead from a permanent location.\textsuperscript{101} Some dealers chose to finance consumer sales themselves.\textsuperscript{102} The most common reaction to the new situation was to decrease the percentage of credit sales.\textsuperscript{103} This might be brought about by encouraging consumers to seek direct loans from financers; in some cases the dealer might even attempt to establish relations with a financer to whom he could refer his customers for direct loans.\textsuperscript{104}

Despite the difficulty that dealers had in obtaining financing and their decision to reduce credit transactions, most dealers reported an increase in sales volume since the Act.\textsuperscript{105} This result, the study indicated, might be explained by the fact that dealers were avoiding the financer screening procedures by requiring cash sales; some dealers were working harder to find cash buyers and many had shifted their sales to higher income consumers who could more easily purchase for cash and whose credit rating would enable them to obtain direct loans.\textsuperscript{106}

(3) \textit{The Consumer}

The study attempted to measure the impact of the Act in terms of its effectiveness in protection and advancement of consumer interests.

Of course, the major direct benefit to consumers was the avail-

\textsuperscript{98} Id. at 643.
\textsuperscript{99} Id. at 644.
\textsuperscript{100} Many of the problems that dealers encountered were related to their inability to comply with the substantive requirements of the financer's new screening procedures, \textit{e.g.}, certain capital requirements, accepting repurchase agreements and taking smaller "incentive payments" or losing them altogether. Also there was an added burden of increased paperwork imposed by the new screening techniques.
\textsuperscript{101} Id. at 644. The Connecticut Act applied only to home solicitation sales. Therefore, if the dealer were to work from a permanent location, he could finance with negotiable notes.
\textsuperscript{102} Id.
\textsuperscript{103} Id.
\textsuperscript{104} Id. at 645.
\textsuperscript{105} Id. at 645-46.
\textsuperscript{106} Id.
ability of defenses in a suit brought by the financer. 107

One of the principle arguments of those in favor of preserving consumer defenses is that financers will be encouraged to more carefully screen dealers and thereby rid the market of fraudulent and insolvent dealers. Although the study did indicate that screening procedures of financers had intensified, it also indicated that the new procedures were not entirely successful in putting fraudulent dealers out of business. 108 To the extent that the screening techniques were concerned with the quality of the dealer's work, the consumers' interests in receiving a better product were furthered. However, many other considerations influence a financer's decision whether to do business with a dealer. It was thought that the repurchase agreement, in many cases, allowed the financer to be unconcerned with the quality of the dealers work. 109 This agreement affords the financer much the same protection as did the holder in due course status. It was not always the fraudulent dealer who was eliminated by the requirement of a repurchase agreement. The financers often refused to take the notes of small legitimate dealers with few fixed assets and a weak credit position; the repurchase agreement was worthless to the financer if, as a practical matter, it could not be enforced against the dealer. 110

Second, in addition to the quality of the dealers work product, the size of his business and the amount of business he did with the financer were important factors in the decision whether to finance a dealer. 111 Financers were reportedly reluctant to cut the volume dealer off; he brought in a substantial credit business and, equally important, he may have meant business to the financer in other respects, e.g., mortgages, savings and checking accounts. 112 These factors again may have the effect of damaging the small legitimate dealer.

Because of the methods utilized by the financer to spread the risk, particularly repurchase agreements and the discontinued use of incentive payments, credit was more costly to dealers. 113 Dealers, in turn, passed this increased cost to the consumer. 114 Because

107. Id. at 650-51.
108. Id.
109. Id. at 652-53.
110. Id.
111. Id. at 639.
112. Id.
113. See notes 98-106 and accompanying text supra.
114. Note 88 supra, at 653.
of this increased cost of installment credit, the study reported a general switch to direct loans.\textsuperscript{115}

The Yale study is the only major empirical test of the theories that have been advanced to justify legislation preserving consumer defenses. There definitely was a difference in Connecticut in the home solicitation sales industry before and after the Act. The study reported "widespread difficulty in marketing consumer paper" and a general tendency of dealers to reduce their credit sales and to concentrate on cash-paying customers.

Many people who theorize that preservation of consumer defenses will cause financers to more carefully screen the dealers with whom they do business are correct, but the effect appears to be more subtle than some have explained it. The crucial question is, given more thorough screening, on what basis do financers decide whether to finance a dealer. To the extent that it is quality of work, the fraudulent or fly-by-night operator may be forced out of the market. To the extent that it is volume of business, many large, fraudulent dealers, or if not fraudulent, dealers who sell substandard products or perform shoddy services, may still be able to obtain financing. Many small legitimate dealers may be severely damaged.

As was predicted, financers have utilized their powers to shift the increased risk of being subject to consumer defenses back to the dealer. The dealer, of course, has passed his increased cost to the consumer. The increased cost, however, is spread throughout the consumer credit industry, and it is justified if the "product," i.e., consumer credit, is worth more to the consumer. The product is better in that the individual consumer may not be forced to absorb his entire loss resulting from dealer misconduct himself; if the errant dealer is absent or insolvent, the consumer's defenses are good against the financer.

The study suggested that elimination of negotiability may have prompted a general shift away from the three-party installment sales transaction. This traditional method of financing consumer purchases was replaced either by direct loan financing or by a reduction in credit sales. Many dealers placed a greater emphasis than before on seeking cash customers. There is some fear that the trend toward direct loans and cash sales may make consumer credit worthless to low-income consumers. It is highly unlikely that the low income will be among the cash-paying consumers. Furthermore, while many low income consumers were able to ob-

\textsuperscript{115} Id. at 654-55.
tain indirect-loan financing, it is probable that some of these same consumers cannot obtain direct financing, or, at least, can do so only at high interest rates.  

IV. CONCLUSION

There are two broad choices open to the Legislature as it debates the preservation of consumer defenses issue. It can jump on the bandwagon and join the growing number of states that have eliminated negotiability in some or all consumer transactions. In the alternative, it might hold off on legislation until it can gather empirical data, in an attempt to determine the extent to which, if any, consumer defenses should be preserved. The choice is not a clear one. Obviously, many states have taken legislative action without benefit of empirical study. Data would not be easy to gather nor to analyze. Very little statistical information exists now, and its validity is subject to some question. The Yale project was concerned with a very limited segment of the consumer credit industry—home solicitation sales of home improvements. The financers involved were predominantly commercial banks as opposed to independent financing agencies. Another caveat is that information was obtained primarily from financers and dealers; that these parties may have had an interest in the conclusion of the study should be considered in measuring its reliability.

116. Id.
117. L.B. 327, 83d Neb. Leg. Sess. (1974), as introduced, would have provided for a consumer protection agency under the Attorney General. L.B. 327 § 8, would have provided that the director of such an agency, "may conduct research, hold public hearings, make inquiries and publish studies relating to consumer sales acts or practices." Amendments to the bill deleted these provisions, see note 14 supra.
118. Note 88 supra, at 625 n.34. "Banks handle most of the home improvement financing in Connecticut."
119. In Shuchman, Empirical Studies in Commercial Law, 23 J. Leg. Educ. 181 (1971), the author questions the methodology of the Yale project. His first criticism was that the students depended on the subjects of their study—financers and dealers—to do the research. Most questionnaires simply were sent through the mail and there were few follow-up interviews. The author further pointed out:

Moreover, the Yale students needed and received help from the co-counsel for the Connecticut Bankers Association (said to be its chief lobbyist) and from the chairman of the Connecticut Home Improvement Association. The Yale students conceded that their respondents were probably different than the general population of those groups. The reader appreciates their candor. But, then, having advised their readers of probable bias in advice and of lack of representatives in the completed questionnaires they proceed as if the mere
On the other hand, whether or not the specific conclusions of the Yale study are accepted as being accurate, the study did indicate the kind of subtle effects that this legislation may have, perhaps more subtle than some theories advanced to support the legislation have suggested. One has only to look at the variety of legislative approaches to this problem to know that there is no consensus among the states concerning the extent to which, if any, negotiability in consumer transactions should be prohibited. A partial explanation for the variety in legislative response is that in the absence of adequate empirical data, legislatures have been unable to clearly identify the problem.

There are two basic questions that need empirical study. First, what is the need for legislation? This question is directed at identifying those segments of the consumer credit industry where there is a need to preserve consumer defenses. A study may be able to isolate those consumer transactions where abuse does occur and where the consumer is really at a disadvantage by not being able to assert his defenses against the financers. Such an inquiry may reveal that the need exists in all retail installment credit sales; on the other hand, the information may identify a specific segment of the industry, such as motor vehicle sales, home-solicitation transactions or the consumer service industry. The second question is directed at ascertaining the impact on the consumer credit industry of preserving defenses; it is perhaps the more difficult question. One relevant concern might be the impact on the cost of credit. In addition, the Yale study raised some questions about potential adverse effects on small legitimate dealers and low-income consumers. Whether a state decides to protect consumers at the possible expense of forcing some small dealers out of business is a question of public policy for the legislature. Similarly, the extent to which legislation might adversely affect the low-income consumer's participation in consumer credit transactions is a policy question. It is suggested that a legislature cannot fairly deal with these policy questions without some statistical basis for even knowing that they exist.

To a certain extent the inquiries as to need and impact may overlap. For instance, if negotiability were eliminated in all retail installment sales, an impact of this legislation may very well be a shift to direct loan financing. The determination of this impact

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warning was enough. Perhaps, they should have stopped there rather than going on to ask the wolves how they tend the sheep and what has been the effect of the new anti-wolf device.

*Id.* at 183-84.
might then indicate a need for preserving defenses in the direct loan transaction. Consequently, a legislative study should consider as an integrated problem the three-party installment credit sale, the direct loan and the lender credit card transaction.

For some, the proposition that negotiability should be eliminated in all consumer credit transactions is a foregone conclusion. This article suggests that there are still some legislative choices to be made, and that those choices can best be made if based on results of the proposed empirical studies.

120. CLARK & FONSECA, supra note 1, § 12 at 14 (Supp. 1973), notes that the "holder in due course doctrine appears to be dead." This is not an entirely accurate statement. In the absence of a statute, most courts continue to observe the doctrine, and even under many statutes negotiability has not been completely eliminated.