Title 16—Commercial Practices

CHAPTER I—FEDERAL TRADE COMMISSION

PART 433—PRESERVATION OF CONSUMERS' CLAIMS AND DEFENSES

Promulgation of Trade Regulation Rule and Statement of Basis and Purpose

Notice is hereby given that the Federal Trade Commission, pursuant to the Federal Trade Commission Act, as amended, 15 U.S.C. 41, *et seq.*, the provisions of Part I, Subpart B, of the Commission's Procedures and Rules of Practice, 16 CFR 1.7, *et seq.*, and Section 553 of Subchapter II, Chapter 5, Title 5 of the U.S. Code (Administrative Procedure) has conducted a proceeding for the promulgation of a Trade Regulation Rule concerning Preservation of Consumers' Claims and Defenses. The proposed rule was published in the FEDERAL REGISTER for comments and hearings thereon on January 26, 1971 (36 F.R. 1211). A revised version thereof was published in the FEDERAL REGISTER for comments and hearings thereon on January 5, 1973 (38 F.R. 892).

Written comments from interested parties have been received by the Commission. Public hearings have been held in New York, New York (June 7–9, 1971); Chicago, Illinois (July 12–14, 1971; May 7–9, 1973); and Washington, D.C. (September 20–23, 1971 and March 12–15, 1973). See 36 FR 6592, 7865; and 38 FR 8600.

Accordingly, the Commission hereby amends Subchapter D, Trade Regulation Rules, Chapter I of 16 CFR by adding a new Part 433 as follows:

Sec.
433.1 Definitions.
433.2 Preservation of consumers' claims and defenses, unfair or deceptive acts or practices.

AUTHORITY: 38 Stat. 717, as amended; (15 U.S.C. 41, *et seq.*)

§ 433.1 Definitions.

(a) *Person.* An individual, corporation, or any other business organization.

(b) *Consumer.* A natural person who seeks or acquires goods or services for personal, family, or household use.

(c) *Creditor.* A person who, in the ordinary course of business, lends purchase money or finances the sale of goods or services to consumers on a deferred payment basis; *Provided,* such person is not acting, for the purposes of a particular transaction, in the capacity of a credit card issuer.

(d) *Purchase money loan.* A cash advance which is received by a consumer in return for a "Finance Charge" within the meaning of the Truth in Lending Act and Regulation Z, which is applied, in whole or substantial part, to a purchase of goods or services from a seller who (1) refers consumers to the creditor or (2) is affiliated with the creditor by common control, contract, or business arrangement.

(e) *Financing a sale.* Extending credit to a consumer in connection with a "Credit Sale" within the meaning of the Truth in Lending Act and Regulation Z.

(f) *Contract.* Any oral or written agreement, formal or informal, between a creditor and a seller, which contemplates or provides for cooperative or concerted activity in connection with the sale of goods or services to consumers or the financing thereof.

(g) *Business arrangement.* Any understanding, procedure, course of dealing, or arrangement, formal or informal, between a creditor and a seller, in connection with the sale of goods or services to consumers or the financing thereof.

(h) *Credit card issuer.* A person who extends to cardholders the right to use a credit card in connection with purchases of goods or services.

(i) *Consumer credit contract.* Any instrument which evidences or embodies a debt arising from a "Purchase Money Loan" transaction or a "financed sale" as defined in paragraphs (d) and (e).

(j) *Seller.* A person who, in the ordinary course of business, sells or leases goods or services to consumers.

§ 433.2 Preservation of Consumers' Claims and Defenses, Unfair or Deceptive Acts or Practices.

In connection with any sale or lease of goods or services to consumers, in or affecting commerce as "commerce" is defined in the Federal Trade Commission Act, it is an unfair or deceptive act or practice within the meaning of Section 5 of that Act for a seller, directly or indirectly, to:

(a) Take or receive a consumer credit contract which fails to contain the following provision in at least ten point, bold face, type:

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

or, (b) Accept, as full or partial payment for such sale or lease, the proceeds of any purchase money loan (as purchase money loan is defined herein), unless any consumer credit contract made in connection with such purchase money loan contains the following provision in at least ten point, bold face, type:

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICE OBTAINED WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

Effective: May 14, 1976.

Promulgated by the Federal Trade Commission November 14, 1975.

CHARLES A. TOBIN,
Secretary.

STATEMENT OF BASIS AND PURPOSE

PREFACE

It is the Commission's purpose, in issuing this statement, to review thoroughly the information, data, and testimony which was received in the course of proceedings on this rule. It is also the Commission's purpose to state, with particularity, the purpose of each provision of the rule together with the Commission's reasons for adopting certain revisions as a result of information elicited during these proceedings.

The precise format of such statements may change from rule to rule, as a function of the complexity of the issues involved and the nature and extent of information received and evaluated.

CHAPTER I. HISTORY OF THE PROCEEDING

On January 21, 1971, the Commission announced a Trade Regulation Rule to Preserve Buyers' Claims and Defenses in Consumer Installment Sales.[1] The proposed rule was published in the FEDERAL REGISTER on January 26, 1971.[2] All interested parties were invited to file written data, views, or arguments concerning the proposed rule or to testify at public hearings in Washington, D.C.,[3] New York City,[4] and Chicago.[5]

As a result of the public record developed in the initial round of hearings, the Commission published a revised version of its proposed rule entitled Preservation of Consumers' Claims and Defenses on January 5, 1973.[6] In the reopened proceeding hearings were held in Washington, D.C.[7] and Chicago.[8] The closing date for written comments and submissions was June 11, 1973.[9]

In the course of two rounds of hearings on this rule, conducted by the Assistant Director for Rulemaking,[10] every person who expressed a desire to present his views had an opportunity to do so. The 2,250 page transcript of the hearings has been included in the public record of these proceedings, together with 7,362 pages of written comment.[11] In this *Statement* references to the transcript of hearings are designated by the prefix "Tr." References to written submissions on the record are designated by the prefix "R".

As a result of the information, testimony, and data elicited in the course of proceedings on this rule, the Commission has concluded that final enactment of a revised version of the rule would be in the public interest. The final revisions are fully explained herein below and supported by substantial evidence on the record of this proceeding.

Accordingly, pursuant to Section 6(g) of the Federal Trade Commission Act together with Section 202 (c) of the Federal Trade Commission Improvements Act (Public Law 93–637, January 4, 1970), the Commission herewith announces final adoption of its Trade Regulation Rule pertaining to Preservation of Consumers' Claims and Defenses in credit-sale transactions. *This Statement of Basis and Purpose* is published to

See footnotes at end of chapter.

define, with particularity, the reasons the Commission has decided to take this action together with the purposes of the rule.

[1] FTC News Release of January 21, 1971.

[2] 36 FR 1211.

[3] 36 FR 7865 (April 27, 1971). Washington hearings were originally scheduled to begin May 10, 1971, but were rescheduled and held September 20-23, 1971.

[4] 36 FR 6592 (April 7, 1971). Hearings were held in New York on June 7-9, 1971 at the Federal Building, 26 Federal Plaza (Foley Square).

[5] 36 FR 7865 (April 27, 1971). Hearings were held in Chicago on July 12-14, 1971 at the Everett Dirksen Building.

[6] 38 FR 892.

[7] March 12-15, 1973.

[8] 38 FR 8600 (April 4, 1973). Hearings were held May 7-9, 1973 at the La Salle Hotel.

[9] 38 FR 8600 (April 4, 1973).

[10] Pursuant to Commission Directive, 35 FR 15164.

[11] F.T.C. File 215-31.

CHAPTER II. BACKGROUND

General introduction. In 1971, the year this proceeding was commenced, aggregate consumer installment debt in the United States amounted to 137.2 billion dollars.[1] This figure represented a five-fold increase in outstanding consumer credit from the year 1950, for a compound annual growth rate, over the 21 year period of 9 percent.[2] Forty-eight percent of all U.S. families allocated some 14.7 percent of all U.S. disposable personal income to the repayment of installment obligations.[3] By 1974, aggregate installment indebtedness had increased to 154.5 billion dollars, a large part of which was employed in the acquisition of consumer goods and services.[4]

Over the past two decades, banks and credit unions have vigorously pursued emerging opportunities in the consumer credit market. They held 54.4 billion dollars in consumer installment credit as of December 1970, or 53.8% of the market. In December 1950, commercial banks and credit unions held only 6.3 billion dollars in consumer installment credit.[5] Manufacturers of automobiles and other "large ticket" items in the consumer inventory have created huge consumer finance subsidiaries to meet the needs of both dealers and consumers. At the same time, large independent consumer finance companies have experienced equally prodigious growth in servicing demand from consumers who do not or cannot obtain bank credit. Finally, the larger retail establishments have created credit departments and subsidiaries to service customers at the same location where purchases are made.[6]

Credit institutions have thus become active, and frequently dominant, partners in the retail distribution of consumer goods and services. In many instances, they finance dealers and consumers alike, extending credit for the acquisition of inventory and receiving increased "acceptance" or "discount" business from the dealer as his business grows.[7] Where smaller retailers lack the resources or volume to justify a credit subsidiary or a continuing relationship with an acceptance company, it is not uncommon for them to enter into one or more formal or informal arrangements with consumer finance outlets serving their community. Buyers may be referred for loans to a cooperative consumer finance company on a more periodic basis.

See footnotes at end of chapter.

As of August, 1974, finance companies, retailers, and other financial institutions which are directly subject to the Federal Trade Commission's jurisdiction held in excess of 75 billion dollars in consumer installment debt.[8] This constitutes a major commitment to the retailer market on the part of these institutions. It is this major commitment, together with widespread evidence of abuse and injury discussed below in this *Statement*, which suggests a need for this rule. The rule is directed at what the Commission believes to be an anomaly. To a varying extent, depending on the jurisdiction where a credit sale is completed and the procedure employed to execute the sale, the party financing the transaction is able to assert rights which are superior to those of the seller. The creditor may assert his right to be paid by the consumer despite misrepresentation, breach of warranty or contract, or even fraud on the part of the seller, and despite the fact that the consumer's debt was generated by the sale.

How sellers separate the consumer's duty to pay from the seller's duty to perform. There are two methods of eliminating creditor exposure to consumer claims or defenses arising from a credit sale. In the first case the seller is the initial creditor. He executes a retail installment sales agreement with his buyer, together with a promissory note where this is permitted, and he then sells (discounts) the contract and/or note to a sales finance company or a bank. In the second case the seller acts as a conduit, referring his buyers to local consumer finance outlets for personal loans, the proceeds of which are then applied to cash purchases. Where the arranged loan is used, the goods purchased are usually collateral for the debt.

Installment sales transactions: The discount method. Sellers and creditors may succeed in insulating the creditor's claim to repayment from any and all seller misconduct in the underlying transaction by compelling the consumer buyer to enter the commercial paper market. This is accomplished by the use of promissory notes, in the sales finance component of the transaction, or by the incorporation of a waiver of defenses clause in a retail installment sales contract.

The use of a promissory note entails the execution and subsequent assignment of what commercial law calls a "negotiable instrument." Under Article Three of the Uniform Commercial Code, preexisting equities are foreclosed when a negotiable instrument is purchased by a third party in good faith and without notice of claims, defenses, or infirmities arising from the transaction between the makers. When a third party purchases a consumer's promissory note, he will receive the note as a "holder in due course" free and clear of any claim or grievance that the consumer may have with respect to the seller. He may claim and receive payment notwithstanding anything that may have been done or said by the seller in the prior transaction which spawned the note, provided he has no knowledge of seller misconduct.

The definition of "holder in due course" which appears in Article Three of the UCC is a recapitulation of principles which were first articulated in *Miller v. Race*, 97 Eng. Rep. 398 (K.B. 1758). To protect the burgeoning commercial paper market the court in *Miller* decided that a bona fide purchaser of an instrument which was negotiable on its face should not be required to look behind the face of the obligation. A promissory note drawn on the bank of England was stolen and subsequently sold to a legitimate merchant. The court determined that the draft should be treated as money, and that the bona fide purchaser who had no notice of the history of the note would prevail over all other claimants. The rationale behind this decision was the social utility to be obtained from a system which encouraged and protected commercial transactions. If businessmen were required to look behind an instrument which on its face was negotiable, the soundness of the entire commercial system would be threatened. At that time promissory notes drawn on the bank of England were not "legal tender." Like modern day bank drafts, they changed hands frequently and rapidly and served many of the functions served by specie. These same principles underpinned the English Bills of Exchange Act of 1882 and the Uniform Negotiable Instruments Law enacted in this country in 1896. The Uniform Commercial Code superseded the Negotiable Instruments Law.

Over two centuries, the holder in due course doctrine has served the two-fold interest of liquidity and confidence in the commercial paper market.[9] The term negotiable instrument has come to encompass a variety of short and long term obligations. Included are checks, banker's acceptances, bills of exchange, letters of credit, bills of lading, and promissory notes. Each of these devices has a variety of commercial applications. Each is technically different from the rest, but all have one essential feature in common. They contain an "unconditional promise or order to pay a sum certain in money and no other promise, order, obligation, or power. . . ."[10]

While the principles articulated in *Miller v. Race* have validity in commercial exchanges and transfers, their application to consumer credit sales is anomalous. Consumers are not in the same position as banks, bond issuers, or shippers of freight; nor are they in an equivalent position to vindicate their rights against a payee. The considerations which underpin the laws of negotiability have little or no application in consumer transactions where the integrity of the commercial paper market is not a concern. Unfortunately, where promissory notes are employed in connection with credit sales, consumers are forced

to enter this market. The average consumer would hardly expect that his sales agreement will receive the same treatment as a sight draft on the Bank of England, in the event that his seller fails to perform as promised. This result is nonetheless assured. When an acceptance company purchases a consumer's promissory note and sends a payment book in the mail, it can assert rights which are superior to those of the seller. For the consumer to defeat the creditor's right to be paid in the face of gross seller misconduct, he must prove that the creditor holding the note had actual knowledge of seller abuse in the prior transaction. Where a negotiable instrument is employed in a consumer transaction, defeating holder in due course status is always difficult and often impossible.[11]

Where law or commercial expediency forbid the use of promissory notes in consumer sales, creditors and sellers still have an indirect procedure for accomplishing the same end. An assignee of a retail installment contract, as distinguished from a note because of the inclusion of mutual promises and obligations, may, under UCC 9-206, assert rights analogous to those of a holder in due course if the contract contains an "agreement not to assert defenses against an assignee."[12] Creditor and seller need only insert a waiver of defenses clause in the consumer's sales agreement with the seller. If the same tests of good faith and lack of notice are met, the creditor who buys the contract is in the same position as a holder in due course.

State law affecting the discount method. Some forty jurisdictions have enacted legislation bearing on foreclosures of equities in installment sales. Existing enactments fall into two categories. The first category consists of statutes which render "holder in due course" principles inapplicable in consumer sales transactions.[13] Such enactments prevent the use of negotiable instruments in credit sales, but often have no effect on the continuing use of a waiver of defenses to achieve the same result. The second category consists of "complaint period" statutes which restrict cut-offs of consumer rights for a stated time period during which the consumer is permitted, after receipt of notification that his obligation has been assigned to an acceptance company, to communicate sale-related grievances directly to the creditor.[14] Any claim or defense which is raised during this time may be asserted in a subsequent suit to defeat or diminish a creditor's claim for payment.

The original draft of the Uniform Consumer Credit Code (UCC) reflected both of these approaches. It invalidated the use of negotiable instruments in sales transactions. This prohibition was followed by two alternative approaches to waivers of defenses, designated alternative A and alternative B. Under alternative A, waivers of defenses were flatly prohibited. Under alternative B, a ninety-day complaint period was provided. Enacting states were free to select between the two alternative approaches to waivers. Of seven enacting jurisdictions all selected alternative B, and several reduced the length of the complaint period substantially.[15] Mounting criticism of the complaint period approach and unsatisfactory experiences in complaint period jurisdictions have induced the draftsmen of the revised UCC to delete alternative B.[16]

In addition to legislative enactments, judicial decisions in some jurisdictions have mitigated harsh applications of the law of negotiability in certain specific cases. Creditors have been held to share a sufficient community of interest and endeavor to persuade some jurists that "knowledge" should be imputed to the creditor or that the creditor should be liable as a primary party to the transaction.[17] The common law doctrine of unconscionability has also been used to set aside oppressive instances of boilerplate waivers of defenses on similar grounds.[18]

More recently, certain state courts have undertaken a frontal assult on the law of negotiability as it pertains to consumer transactions. These decisions suggest mounting expert opinion that commercial banking doctrines have no place in retail sales. The Georgia Court of Appeals recently held that retail installment contracts will no longer be treated as negotiable instruments.[19] The Florida courts have invalidated the use of boilerplate waivers of defenses;[20] and the California Supreme Court has extended application of a recent legislative enactment to place consumers in an offensive position, permitting the assertion of claims and defenses whether or not a creditor files suit for payment.[21]

These developments have had significant impact on the continuing vitality of these principles of law. They reflect widespread public concern about mechanical abrogations of consumer rights.[22] Unfortunately, holder in due course principles still affect consumers in many jurisdictions. As detailed below, the hearings and written submissions received in the course of this three-year proceeding reveal a continuing need for meaningful Federal intervention.

Vendor-related loans. The second alternative which is available to sellers and creditors is the direct personal loan. After a buyer selects an item for purchase and requests credit terms, the seller may refer the buyer to a local loan outlet. Referral can and does include accompanying the buyer to the loan office, remaining present while applications are processed and accepting a loan proceeds check endorsed to both seller and buyer. For this reason, this practice has been referred to as body-dragging.

The law continues to regard a prearranged loan of this kind as indistinguishable from a spontaneous transaction solicited by a borrower. The existence of a formal or informal business relationship between seller and lender does not alter this fact. Despite continuing referrals, affiliation, or even actual knowledge on the lender's part that the seller engages in questionable sales practices, the loan and sale transactions continue to receive discrete treatment. The lender's claim for repayment remains wholly independent of any sales agreement between borrower and seller. The vendor-related loan thus presents a convenient alternative to discount financing. Issues such as knowledge, community of interest, or bad faith never arise. The hearings and written submissions received in the course of this proceeding indicate that substantial increases in body-dragging have been spawned by state enactments abrogating holder-in-due-course law. This fact is directly reflected in the recent Massachusetts enactment which was drafted to cover related-lender financing.[23]

Direct loan financing is discussed in detail below, at Chapter IV. Suffice it to say at this point that this type of financing offers a viable alternative to the discount method, one which has proved increasingly attractive in jurisdictions where the discount method has been restricted.

The balance of this statement. The remainder of this Statement of Basis and Purpose is devoted to a discussion of the information obtained in the course of proceedings on this rule, the conclusions drawn by the Commission after review of the record, and an exegesis of the nature and purpose of the rule which we have prepared to deal with a nationwide problem. Our reasons for selecting a particular approach in lieu of others which were suggested in the course of these proceedings are fully explained.

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[1] *Consumer Credit in the United States*, Rept. of the National Commission on Consumer Finance 5 (December, 1972) (hereinafter *NCCF Rept.*).

[2] *Id.*

[3] NCCF Rept. at pages 16–17.

[4] Fed. Res. Bull., Vol. 60, No. 10 at A–47 Oct. 1974.

[5] NCCF Rept. at page 11.

[6] As of December 1970, retailers held 14.1 billion dollars in installment credit or 13.9% of the market.

[7] In August, 1974, consumer finance companies held 38.9 billion dollars in installment credit. Fed. Res. Bull. *supra* note 15, at A–47, A–48. This prodigious sum may be contrasted with the 5.3 billion dollars they held in December, 1950. *NCCF Rept.* at 11.

[8] This figure is derived from subtracting the 73.3 billion in installment credit held by commercial banks which are exempt from 15 U.S.C. 41 *et seq.* from the 154.5 billion outstanding as of August, 1974. Fed. Res. Bull., *supra* note 15.

[9] *See* Littlefield, Good Faith Purchase of Consumer Paper, 39 *Southern Cal. L. Rev.* 48 (1966).

[10] Uniform Commercial Code Sec. 3–104.

[11] Note, "Consumer Financing, Negotiable Instruments, and the Uniform Commercial Code: A solution to the Judicial Dilemma", 55 *Cornell L. Rev.* 611 (1970); Comment, "Judicial and Statutory Limitations on the Rights of a "Holder in Due Course"; in Consumer Transactions, "11 *B.C. Ind. & Comm. L. Rev.* 90 (1969); Comment, "The Role of Cut-Off Devices in Consumer Financing", 1968 Wisc. L. Rev. 505; Comment, "Financing Consumer Goods Under the Uniform Commercial Code: Installment Buyers

and Defaulting Sellers", 37 *U. Chi. L. Rev.* 513 (1970).

[12] "The following is an example of a typical waiver of defense clause:

"If the seller should assign the contract in good faith to a third party, the buyer shall be precluded as against such third party from attacking the validity of the contract on grounds of fraud, duress, mistake, want of consideration. . . ."

NCCF Rept. at 34–35.

[13] *E.g.*, Md. Ann. Code art. 83, § 147 (1968); Mass. Gen. Laws Ann. ch. 225, § 12C (1968); Vt. Stat. Ann. tit. 9, § 2455 (Supp. 1968); Rev. Code Wash. Ann. tit. 63, § 14.020 (Supp. 1968).

[14] *E.g.*, Del. Code Ann. tit. 6, § 4312 (Supp. 1966) (15 days); Ill. Rev. Stat. Ch. 121 ½, § 262D (Smith-Hurd Supp. 1968) (5 days). *See* also Murphy, "The Consumer and the Code: A Cross-sectional view", 23 Univ. of Miami L. Rev. 11, 65 (1968); C. Katz, ed., *The Law and the Low Income Consumer* 249–51 (1968).

[15] CCH Consumer Credit Guide Paragraph 5104: "Local Modifications".

[16] Murphy, "Lawyers for the Poor View the UCC", 44 N.Y.U. Rev. 298, 310 (1969).

[17] *E.g.*, Commercial Credit Corp. v. Childs, 199 Ark. 1073, 137 S.W. 2d 260 (1949); Commercial Credit Corp. v. Orange County Mach. Works, 34 Cal. 2d 766, 214 p. 2d 819 (1950) Mutual Fin. Co. v. Martin, 63 So. 2d 65 (Fla. 1953).

[18] Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967).

[19] Geiger Finance Co. v. Graham, 123 Ga. App. 771, 182 S.E.2d 521 (1971). This case is discussed in a *Georgia State Bar Journal* 400 (Feb. 1972).

[20] Rehurek v. Chrysler Credit Co., 262 so. 2d 452 (1972).

[21] Vasquez v. Superior Ct. of San Joaquin County, 4 Cal. 3d 800, 823; 484 P. 2d 964, 979 (1971).

[22] *See, e.g.*, Wallace, "The Logic of Consumer Credit Reform," 82 *Yale L.J.* 461 (1973); Note, "Direct Loan Financing of Consumer Purchases," 85 *Harv. L. Rev.* 1409 (1972); Note "Consumer Financing, Negotiable Instruments, and the Uniform Commercial Code: A Solution to the Judicial Dilemma," 55 *Cornell L. Rev.* 611 (1970); Comment, "Financing Consumer Goods Under the Uniform Commercial Code: Installment Buyers and Defaulting Sellers," 37 *U. Chi. L. Rev.* 513 (1970); Comment, "Judicial and Statutory Limitations on the Rights of A Holder in Due Course; in Consumer Transactions," 11 *B.C. Ind. & Comm. L.Rev.* 90 (1969); Littlefield, "Preserving Consumer Defenses: Plugging the Loophole in the New U.C.C.C.," 44 *N.Y.U.L. Rev.* 272 (1969); Kripke, "Consumer Credit Regulation: A Creditor-Oriented Viewpoint, 68 *Colum. L. Rev.* 455, 459–473 (1968); Comment, "Consumer Protection—The Role of Cut-Off Devices in Consumer Financing," 1968 *Wisc. L. Rev.* 505; Symposium on Consumer Credit "Developments in the Law: Finance Companies and Banks as Holders in Due Course of Consumer Installment Credit Paper," 55 *Nw. U. L. Rev.* 389 (1961); Gilmore, "The Commercial Doctrine of Good Faith Purchase," 63 *Yale L.J.* 1057, 1097–1100 (1954); Kripke, "Chattel Paper as a Negotiable Specialty Under the Uniform Commercial Code," 59 *Yale L.J.* 1209, 1215–1216 (1950).

[23] Gen. Laws Mass. Ch. 255D, § 22A.

CHAPTER III. COMMISSION FINDINGS WITH RESPECT TO THE USE OF NEGOTIABLE INSTRUMENTS AND WAIVERS OF DEFENSES IN CONSUMER INSTALLMENT SALES TRANSACTIONS

This chapter discusses the Commission's findings with respect to foreclosures of consumer claims and defenses in sale transactions. We will concentrate on installment sales, where a promissory note or a waiver of defenses insulates the creditor from seller misconduct. Arranged loans will be discussed in Chapter IV.

See footnotes at end of chapter.

Criticism of application of the holder in due course doctrine to consumer transactions has concentrated on the fact that it places the risk of a seller's misconduct on the party least able to bear the burden—the individual consumer. It also enables a merchant who engages in disreputable and unethical sales practices to establish and maintain a source of payment which assures him a place in the market, notwithstanding continuing breaches of contract and warranty. The relatively equal bargaining power which characterizes dealings between merchants is absent in consumer transactions, which are consummated by the use of standard form contracts which the customer must sign as a condition of purchase. Consumers without sufficient resources or business sophistication are frequently unable to press their claims effectively against dishonest sellers;[1] moreover, the seller may be beyond the reach of an effective remedy.[2] Because he is prevented from asserting the seller's breach of warranty or failure to perform against the assignee of the consumer's instrument, the consumer loses his most effective weapon—nonpayment.

Between an innocent consumer, whose dealings with an unrealiable seller are, at most, episodic, and a finance institution qualifying as "a holder in due course," the financer is in a better position both to protect itself and to assume the risk of a seller's reliability. The financer may have recourse against the seller based on the seller's endorsement of the instrument, or it may have a full recourse agreement with the seller and withhold part of the payments to the seller as a reserve.[3] In addition, financial institutions usually protect themselves by warranties from the merchant as to freedom of the obligation from customer defenses.[4] As the National Commission on Consumer Finance recognized, financial institutions which purchase consumer paper are in a better position to control the credit practices of retail merchants:

> They can choose the retailers and suppliers with whom they will do business. If a financial institution is subject to consumers' defenses against payment, such as failure of consideration, nondelivery, etc., it will discontinue purchase of paper from those merchants who cause trouble thereby forcing the many merchants who desire to stay in business but need financial institutions to buy their consumer credit paper to "now react responsibly to consumer complaints in order to keep the avenue of credit open."[5]

The foregoing discussion suggests that waivers of defenses and promissory notes which result in foreclosures of substantial pre-existing equities between parties to a transfer of money have little or no place in consumer transactions. The insulation obtained by creditors in consumer transactions is the product of an inappropriate application of legal principles developed by and for merchants and bankers. The following example, drawn from the transcript of the New York Hearings, is included as an illustration:

> *Interpreter:* Mr. Suarez says, my name is Jose Suarez and I live on Westchester Avenue, the Bronx. I don't know how to write or speak English.
>
> On or about December 29, 1970 two salesmen visited at my home; one of them Spanish speaking asked me if I knew how to talk English. I answered that I didn't and he asked me would I like to learn. I answered that I would and they came into my house. The Spanish speaking salesman told me that his name was Mr. Hernandez and started talking about English language lessons. Mr. Hernandez explained that this course was composed of records, lessons and some tapes that I will have to record in my voice and send to Columbia Institute for some teachers to go over. He told me that it would be very easy to learn English with this method.
>
> He also showed to me some drawings of the equipment. This looked like big equipment. Mr. Hernandez told me that the price of the course was $483.
>
> Mr. Hernandez gave me a contract to sign, but since this contract was in English I could not read it. He repeated that the price was $483 to be paid in installments of $24. I gave him $15 as a down payment and I signed the contract.
>
> Two or three weeks after this I received the same equipment. This was not what I expected. It was a small tape recorder and I didn't know how to use it. I have not been able to use it.
>
> Shortly after this a friend of mine who knows how to read English saw the contract and told me that I was owing them almost $600. When I learned that I tried immediately to get in touch with Mr. Hernandez. I called the telephone number that was printed on the contract. The person with whom I talked told me that Mr. Hernandez had another telephone number and she gave it to me. I have been calling there several times and Mr. Hernandez is never available. I think that once Mr. Hernandez answered the phone but he lied and he told me he was another person.
>
> Meanwhile I stopped payments because this was the only way I would make them hear my case.
>
> Two months ago I started receiving letters from Lincoln Budget telling me that I owed them money. I thought I had to pay to Columbia and I didn't know I had to pay to another company.
>
> More or less at the time a person went to my place of work and asked me why I was not Paying. I explained the problem. I explained why I stopped payments and I told him that I wanted to talk to Mr. Hernandez. This person told me that I had to pay and that we would see each other in court.
>
> More or less by April 10th I received another letter from Lincoln Budget telling me that this was going to be in court.[6]

The experience related above contains many of the problems arising from application of the holder in due course doctrine to consumer transactions. From analysis of the record, the Commission finds:

(1) That sellers and creditors frequently subject consumers to foreclosures of sale-related equities in the course of effectuating credit sales.

In the proceedings conducted pursuant to the proposed rule no witnesses—not even industry spokesmen—suggested that application of the holder in due course doctrine to consumer sales never results in the loss of legitimate consumer

claims, although some maintained that the problem was insignificant.[7] The major issue, therefore, is whether the frequency of such occurrences indicates that action is desirable.

The record contains over fourteen thousand indications of foreclosures of asserted claims and defenses in credit sale transactions. There are over one hundred cases represented by consumer histories provided spontaneously for this proceeding—both in written submissions[8] and in oral testimony at public hearings.[9]

The magnitude of the problem is made clear through the aggregate statistics supplied by various consumer groups,[10] legal aid agencies[11] and the Office of Economic Opportunity.[12] Statistics compiled by the Office of Economic Opportunity (OEO) are especially noteworthy.

At the request of the Commission, the OEO Office of Legal Services polled its neighborhood legal services projects on the incidence of consumer injury arising from the use of negotiable notes and waiver of defense agreements. OEO arranged for a survey to be conducted by an outside service, the Bureau of Social Science Research, Inc. The survey results from the backbone of the record demonstrating the magnitude of consumer injury spawned by the two cut-off devices.[13]

The survey reflected the results of detailed returns from 59 projects in 32 states and territories, and from each of the ten OEO regions. The 59 projects "include very large and very small projects operating in both urban and rural areas [and] . . . during the year closed, in the aggregate, 179,314 cases. This number is nearly one-fourth (23.9 percent) of the total projected Legal Services Projects caseload for the current fiscal year (750,-000 cases)."[14] Thus, the OEO sample is large and varied enough to permit generalization as to the contours of the problem.

The analysis reports:

The same 59 projects, handled a total of 13,781 holder in due course and waiver of defenses cases, or combinations thereof, during the period [May 1, 1970 to April 30, 1971]. Thus, these cases comprised 7.7 percent of their aggregate caseloads. Or, to put it in another way, one out of every 13 cases involved holder in due course or waivers of defenses. Considering the great variety of types of civil cases handled by Neighborhood Legal Services Offices, this would appear to be a rather heavy concentration for a single pair of related types.

Of the three possibilities—holder in due course, waiver of defenses and the combination of the two—cases involving holder in due course are by far the most common . . . :

TABLE 1.—*Distribution of types of cases*

Type of case	Number	Percent
Holder in due course	10,122	73.5
Waiver of defense	1,094	7.9
Combination	2,565	18.6
Total	13,781	100.0

See footnotes at end of chapter.

Holder in due course is involved in 92.1 percent of all these cases, including the "combination" cases; waiver of defenses is involved in . . . 26.5 percent, again including "combination" cases.[15]

In assessing the OEO figures it is important to keep several points in mind. First, although the problems associated with the holder in due course doctrine are most keenly felt by the poor in our society, the OEO statistics—which are drawn from the legal projects' lower income clientele—do not represent their full extent. Such problems are not limited to the poor.

Secondly, not all persons, rich or poor, are knowledgeable enough to seek legal aid when confronted with a "holder" or waiver problem. In general, the number of persons seeking the aid of Neighborhood Legal Services agencies is only a fraction of those with legal problems.[16] Therefore, only a fraction of the low-income consumers wronged by cutoff devices show up in caseload statistics. In short, "[the] magnitude of the problem indicated by this sample is frightening."[17]

In addition to the statistics just summarized, the record contains testimony and written comment of a more general nature, yet from authoritative sources. Individals, state agencies and legal aid groups submitted comments which contained information concerning consumer injury from foreclosures of rights in generalized or summary fashion. Much of this information was submitted by persons highly qualified to draw just such generalizations.[18]

From the hearings, for example:

I am an associate judge of the Circuit Court of Cook County. From September [1970] through April, 1971 I heard and disposed of over 3,000 cases involving . . . creditors actions.

I use the words "vast majority." I keep statistics on dispositions but I don't keep statistics on what proportion are plaintiffs and who they are, but I would say a very, very large number are brought on behalf of finance institutions [as holders in due course] . . . Many of the businesses are no longer available . . . They have their money so they are not interested in pursuing it any further . . .

I remember last year we had quite a surge of health club contract suits . . .

We had many of these refrigerator and meat franchises where the meat is substandard in quality or not of the type ordered, things of that nature. It's a breach of warranty argument. We see it quite often. I, again, have not kept statistics on it.[19]

The written record also contains comments of a more general nature. For example, "Though statistics are not available as to the exact percentage [of 585 consumer complaints received by the Wisconsin Attorney General's Office of Consumer Protection in 1969] which involved a financing arrangement with an alleged holder in due course, a significant proportion did."[20]

Similarly, "of the hundreds of consumer cases handled yearly by our offices a very significant majority involve installment sales transactions out of which develop a number of defenses which could be raised against the seller, but which are effectively lost through the negotiation or assignment of the instrument evidencing the sale to a so-called holder-in-due-course."[21]

Thus, in both specific cases and generalized yet authoritative testimony, the record solidly establishes the magnitude of consumer injury arising from the use of promissory notes and waivers of defenses in credit sale transactions.

(2) That sellers and creditors rely on such cutoff devices in a wide variety of consumer transactions.

Having established the magnitude or extent of consumer injury from forfeited claims and defenses in credit sale transactions, the Commission requested and received specific information as to the areas or sectors of retail sales endeavor where such injury appeared to be most prominent. This inquiry was initiated to determine whether or not a rule could be prepared along narrow lines to delineate those areas where relief was most needed, without unduly affecting sectors of the retail market where foreclosures of equities might have some commercial utility. The record is overwhelmingly suggestive of the need for across-the-board relief. While the most serious instances of foreclosure of asserted claims would appear to be found in the most marginal sales transactions (e.g., inner-city door-to-door-sales), the simple range of transactions brought to the attention of the Commission in actual case histories precludes any effort at narrowing or delineation along the lines discussed above. Creditors and sellers rely on devices to insulate the creditor from consumer claims and defenses in a complex and extensive variety of retail transactions.

Among the types of consumer goods or services involved in the case histories on the record are:

Courses of training or instruction. The most notable development in this category was a large number of cases in which the holder in due course doctrine or waivers of defenses figured in health club or so-called "health spa" deceptions.[22]

One case involves 1,500 families.[23] The Missouri, Tr. 600-610 R. 1243-1258. fact that so many of the health spa operations have used negotiable instruments or waivers of defenses is strong reason to refrain from limiting the scope of the rule to specified consumer sales. It affords evidence that these techniques are seized upon by those who set out to exploit new fields of consumer fraud and deception.

Other cases brought to our attention include courses of English language instruction,[24] television and modeling school courses[25], computer schools,[26] flying lessons,[27] a karate school,[28] and other miscellaneous courses of training or instructions.[29]

Furniture and appliances. Many consumers indicated they were unable to assert defenses (such as the seller's failure to deliver or refusal to honor warranties or service agreements, delivery of shoddy or inferior goods or items other than those picked by the consumer) against third-party finances of pur-

chases in the furniture and appliance category. Cases frequently involved televisions and stereo sets.[30] Other cases concerned furniture,[31] a washing machine,[32] sewing machines,[33] curtains[34] and miscellaneous items.[35]

Home improvements. Home improvements have long been an area subject to considerable deception and outright fraud.[36] In one especially outrageous scheme, which cost hundreds of homeowners millions of dollars, a few homeowners' suits are finally being heard in the courts. Because the contractor has become bankrupt, however, and because consumers cannot maintain claims or defenses against holders in due course of their negotiable instruments, consumers who are fortunate enough to obtain favorable judgments in court will receive only about five cents on the dollar when the remaining meager assets of the contractor are distributed to satisfy debts and judgments.[37]

A related field of deception is the sale of aluminum siding.[38] The record reflects numerous cases of abuse in siding sales and subsequent collection efforts by third party holders of promissory notes.[39] Such sales occur nationwide, often involve a referral scheme or "model home" ploy and invariably produce substantial indebtedness for the consumer.[40]

Freezer meats and other food plans. This is an area of longstanding abuse.[41] Typically, the consumer is led to believe that a food or meat supply plan is being purchased.

In fact, the consumer is buying a freezer, often at grossly inflated cost,[42] and with no assurance that food will continue to be supplied. Frequently the consumer finds that the quality of food actually received is inferior, that the monthly shipments soon cease, and that his contract has been negotiated to a third party who insists on payment.[43]

Automobiles. Automobile sales often resulted in cases on the record in which the promissory notes or other cut-off devices were invoked to defeat assertion of seller-related defenses by the purchaser of the car.[44] Several state statutes restricting this practice are expressly limited to auto sales.[45] The abuses arise about twice as often with used cars as with new.[46] One of the most egregious cases on the record, however, concerns an expensive, brand-new specialty car.[47]

Carpeting. Carpet sales are another area in which substantial consumer injury has been documented. Sellers of carpeting, especially wall-to-wall "specials" of various kinds, often rely on quickly discounted notes obtained through deceptive sales tactics.[48] In addition carpet companies seem especially prone to mercurial tenure in the marketplace.[49] The record for this proceeding contains substantial evidence of reliance on cut off devices subsequent to deceptive carpet sales.[50]

Alarm Systems. As with "health spas," discussed above, sales of fire and burglar alarm systems appear to be an especially fertile field for consumer fraud and abuse of the privileged status the law confers third party holders of promissory notes.[52] The record contains several case histories, one involving a number of individual consumers.[53] Dubious referral sales techniques and amounts of indebtedness which grossly exceed the actual value of the goods sold are common features of these cases.[54]

Swimming pools. Consumer frauds are most often associated with the poor and less advantaged of the community. Certainly this is correct to some extent,[55] but the same procedures used by the predatory inner city merchant can and do permit consumer fraud in certain commodity lines generally regarded as the province of the more well-to-do. Swimming pools are one such commodity. A swimming pool may cost no more than many of the home improvement projects mentioned earlier. However, swimming pools are a luxury item. For this reason, the fact that cases are related on the record is of interest.[56] It shows, together with other examples of expensive purchases, that more privileged consumers are victimized by similar practices and is further justification for across the board relief.

Miscellaneous. Holder in due course and other cut-off devices operated to foreclose consumer defenses in a wide variety of other consumer purchases. Among them: vacuum cleaners,[57] kitchen utensils,[58] encyclopedias,[59] cemetery plots,[60] clothing,[61] a hearing aid,[62] and an employment placement service.[63]

Common elements in all the cases on the record. In the cases on this record, operation of the holder in due course doctrine or other cutoff devices reflects a number of common elements; (1) the execution by the consumer of a promissory note or waiver of defenses and subsequent negotiation or assignment of the contract by the seller to a third party financer; (2) seller misconduct in the transaction between seller and consumer—that is, an infirmity in the original sale—or the development of a fault or defect following the sale; (3) failure of the seller to remedy the defect or otherwise deal with the complaint of the consumer, either through absolute unwillingness on the part of the seller or due to the seller's disappearance from the market; (4) interruption in payments by the consumer to the financer; and (5) assertion by the financer of its protected status in order to obtain payment on the obligation.

It should be noted that the last element—assertion by the financer of its protected status—need not occur in the context of a law suit. The protected position of the holder may be made known to the consumer in collection efforts prior to litigation. Thus the record contains numerous instances where consumers were told that the financer "has no interest" in the original transaction and because the financer is not connected with the seller, payments must be maintained.[64] Frequently such an approach is sufficient and the financer need not assert "holder in due course" status in the formal context of a court suit.[65]

All of the elements outlined above are contained in the many case histories summarized above. In addition, the record shows that in cases where holder in due course status was asserted in collection efforts, a promissory note had often been negotiated hastily,[66] frequently across state lines.[67] These factors suggest a deliberate effort to take unfair advantage of protections afforded by law to third party creditors.

Nearly every witness at the hearings,[68] and many written submissions,[69] emphasized the degree to which a creditor's unfettered right to payment in these cases contributes to discontent among consumers, particularly the poor and less advantaged consumer.[70]

> Oftentimes we have found a client sending a letter to a finance company explaining defects in the merchandise that they have purchased and they explain the reason for not making payments.
>
> The finance company totally ignores that and they say you will have to talk to the person who sold it to you, and that person has gone, and the corporation explains the warranty is invalid or some other b.s.—excuse me. I have felt their frustration and their quiet outrage that they can't talk to the person that they owe money to about the problems of the piece of merchandise that they have purchased.[71]

Witnesses pointed out that the consumer has no opportunity or ability to bargain and often has no alternative to dealing with certain merchants.[72] All proponents of the rule stressed that the proposed rule would help restore confidence in the law and in the legal system, including the courts.

Mrs. Knauer, the President's Special Assistant for Consumer Affairs observed:

> What is involved here is the fundamental idea of fairness and equity, the individual consumer's belief that the "system" serves him fairly; and the right of the people to have their economic and governmental institutions work for their benefit and protection. The "holder-in-due-course" doctrine contributes materially to the affected consumer's feeling of helplessness—and the feeling that the "system" does not serve him fairly.
>
> In effect, the consumer caught in the "holder-in-due-course" game feels he is batted back and forth like a tennis ball—never turning up on the winning side.[73]

(3) Affirmative suits by consumers are not an adequate remedy.

The Commission further finds that aggrieved consumers are often not in a position to take advantage of the legal system. Where seller misconduct in a credit sale transaction has given rise to consumer injury, the consumer is theoretically in a position to seek damages or other relief from the seller in court. This would be the case even where a creditor financing the sale has a valid "holder in due course" defense which will insulate his claim for repayment. However, in such cases the consumer must pay the creditor holding his note or contract whether or not he ultimately receives a judgment against the seller. The amount of a consumer's damages in such a case may be substantial in real terms, hundreds of dollars or more, but such damages are rarely enough to at-

See footnotes at end of chapter.

tract competent representation. The sheer costs of recourse to the legal system to vindicate a small claim, together with the days of work that must be missed in order to prosecute such a claim to judgment, render recourse to the legal system uneconomic. In addition, the worst sellers are likely to be the most volatile entities where market tenure is concerned. They prove difficult to locate and serve, and the marginal liquidity which characterizes their operations makes collection of a judgment difficult or impossible even if they are successfully served. Bankruptcy or insolvency becomes a final barrier to recovery.

The evidence supporting this finding is substantial.[74] For example, Judge Arthur Dunn of Chicago testified as follows:

It's [a] terribly cumbersome device, necessitates the expense of discovery, difficulty of service of summons or proper service, difficulty of a defendant becoming a plaintiff, but one of the most disappointing areas of this is the area of the result which might be reached and receiving or the taking by the consumer of a judgment which is, for all intents and purposes, unenforceable. [Because] a corporation, that is defunct or just unable—unsusceptible of being located.[75]

And Ronald Fritsch, of the Chicago Legal Aid Bureau:

Now, many people ask, "Well, why is a holder-in-due-course rule such a problem for a consumer? The consumer can always sue the seller or he can bring the seller in as a third-party defendant." . . . [B]ut this right of the consumer to file a suit against the seller or bring him in as a third-party defendant is clearly [illusory. It is illusory] because it forces him to become a plaintiff and the plaintiff has many, many problems. He's got to effect good service of summons on the defendant.

The plaintiff usually has the burden of proof in his case. The plaintiff must obtain the evidence for his case through costly discovery procedures; and, if the plaintiff is fortunate enough to have a judgment entered for him, he must go through lengthy and expensive post-judgment proceedings to discover, attach, and/or garnish the assets of the defendant.

I have represented defendants in quite a few cases such as this, either on behalf of a buyer or against a seller or a third-party action against a seller, and I have found that, by and large, the buyers in these cases are more solvent than the sellers.

The seller is either an individual proprietorship or, if the seller happened to have been a corporation, the corporation [is in existence] only a couple years, and by the time the buyer gets around to suing or bringing the seller in as a third-party defendant, the seller is gone. Either the corporation is defunct or, if it's not a corporation, if it's an individual seller, the individual seller is self-employed, he has no wages to attach.

The credit consumer also has a very difficult row to hoe when it comes to seeking legal representation. If he is eligible for a Legal Aid attorney from one of the legal aid organizations, that legal aid attorney usually has many, many more clients to represent than he can possibly represent to the full in court.

If he gets a private attorney, if he has to seek a private attorney to represent him, that private attorney usually doesn't have the resources to bring in a seller as a third-party defendant.[76]

See footnotes at end of chapter.

These problems are compounded where a consumer tries to defeat "holder in due course status" in defending a proceeding brought by the creditor to compel payment. To show that a creditor is not entitled to superior rights which render the debt independent of seller misconduct, the consumer must prove that the creditor had "knowledge" of the seller's misconduct and/or that the instrument relied on by the creditor was obtained in "bad faith". Periodically, a continuing close relationship between a seller a creditor has enabled an aggrieved consumer to meet these tests.[77] But success depends on obtaining skilled counsel; and heavy expenses must be incurred to obtain the discovery and documentation needed to show concerted efforts on the part of the seller and creditor. There is also a significant likelihood, whenever a consumer undertakes to defend a creditor's suit for non-payment, that such efforts will fail. Major consumer finance companies continue to rely on operating procedures which may be asserted to contest any subsequent effort on a consumer's part to show "bad faith" or "knowledge". In this connection, warranties of delivery and satisfaction are customarily obtained by the finance company from merchants whose paper is purchased. Whether or not a finance company elects to pursue a merchant under such a warranty after a deal goes sour, the warranty may always be produced in court to persuade the trier of fact that the finance company could not possibly have had knowledge of seller misconduct in the underlying transaction.

A specific example of the problems confronted by consumers who are victimized by unfair or abusive sales practices and seek to assert seller misconduct as a defense to a creditor's suit for payment is provided by the following letter, submitted for the record by a private attorney. The sale in question involved a swimimng pool to a Northern Virginia family.

The tragedy of this situation is that Mrs. Keatts and her husband are unable to provide themselves with counsel. . . . [A]s you know, in order to make a case based upon the Unico doctrine, considerable time would have to be expended in conducting discovery in the form of interrogatories, requests for admissions and possible depositions which might also include motions to be argued before the court concerning the copying of documents which, may be necessary to establish a link between the lender, the financier and the seller of the goods. Most attorneys, especially in a case of this kind where "new ground is being plowed" require a sizable deposit for costs, probably in the neighborhood of $200.00. Additionally, the total attorney's fee in a matter such as this may be well over $500.00. When faced with this set of realistic facts most clients who get into such a situation in the first place are unable to provide themselves with protection in the form of adequate counsel.[78]

Where waivers of defenses are permitted, the aggrieved consumer may have special problems. Inasmuch as the waiver relied on by the creditor is contained in the consumer's installment contract, the consumer may be said to have had constructive, if not actual, notice of its presence and significance. This may be the case, even though consumers are seldom aware of the existence or meaning of such boilerplate, and even though the waiver appears in a form instrument which is certainly not the product of bargaining between the parties to the sale.

For these reasons a number of state courts have held that boilerplate waivers in installment contracts violate public policy.[79] Such clauses invoke the harsh consequences of negotiability by mere stipulation of the parties. Negotiability by stipulation or agreement was not countenanced by the Uniform Negotiable Instruments Law,[80] nor is it sanctioned by the Uniform Commercial Code.[81] Moreover, many states have banned the use of waivers outright or curtailed their use in consumer transactions.[82] It must also be noted that a waiver of defenses may arise in a manner legally identical to holder-in-due course status.[83] That is, the waiver of rights can arise by operation of law, without the knowledge of the consumer.

Support for the waiver ban in the proposed Rule was widespread.[84] Many witnesses emphasized that such agreements were really contracts of adhesion, designed to deprive the consumer of his right to raise defenses.[85] Whether a waiver arises by contract or by law, its effect is analogous to the use of a promissory note. In this connection the Uniform Commercial Code expressly analogizes waivers to "Holder in Due Course" status.[86]

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[1] *See* Countryman, "The Holder in Due Course and Other Anachronisms in Consumer Credit," 52 *Texas L. Rev.* 1, 2–11 (1973).

[2] *E.g.*, Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967) (seller insolvent); Norman v. World Wide Distrib., Inc., 202 Pa. Super. 53 195 A.2d 115 (1963) (seller disappeared).

[3] *Country man supra*, note 1 pages 10–11.

[4] Kripke, "Consumer Credit Regulation: A Creditor-Oriented Viewpoint," 68 *Colum. L. Rev.* 445, 472 (1968).

[5] *Consumer Credit in the United States*, Report of the Natl. Commission on Consumer Finance (1972) page 36.

[6] Tr. 47–49.

[7] E.g., Robert Doyle, American Bankers Association, Tr. 1108; David Gezon, Volkswagon American Dealers Association, Tr. 1271; "There is no doubt that some limitations should be placed upon the applicability of the holder in due course doctrine and the enforceability of waiver of defenses clauses as they relate to certain consumer transactions." Michael Larson, Marine National Exchange Bank, R. 60; "I will readily concede that there are and have been abuses in the Seller-Holder-in-Due-Course relationship." R. E. Dean, President, Security Mutual Finance Corp., R. 95; "I have seen many abuses of the consumer by unscrupulous businessmen." Joseph L. Kaufman, Vice President, Pacemaker Corp. [boat manufacturer], R. 371; "There can be no question that there have been numerous abuses of the holder-in-due-course concept whereby retail sellers have, by immediately discounting their retail paper deprived a retail buyer of a practical means of asserting wholly valid defenses. . . ." Arthur B. Locke, Esq., on behalf of Connecticut Credit Union League, R. 166–1; see also R. 81, 83, 372, 1272, 1363, 1649, 1656, 1670, 1703, 1729, 1990, 2028. " . . . [T]he abuses are

a . . . very small percentage." H. W. Klockow, Vice President, First Wisconsin letter, R. 1701, 1704, 1705, 1706, 3383, 3384; "[T]his [proposed rule] is tantamount to amputating a leg because of an ingrown toenail." Stephen B. Friedman, General Counsel, Carte Blanche Corp., R. 3404.

[8] *E.g.*, R. 62–63, 338–344, 581, 1297, 1590–92, 2487–95, 3428–31, 3587.

[9] *E.g.*, Tr. 43, 109, 287, 422, 617, 874, 928, 1153, 1346.

[10] *E.g.*, Sandon Members United To Act, Tr. 600–610; R. 1243–1258. Presentation by Robert Wagmen, Assistant Dean, St. Louis University Law School, on behalf of members of "Norm Sandon's Health Club." "This health club chain came to a quick demise in March [1971] when Internal Revenue seized the assets of the clubs for back taxes. At the time of the closing there were an estimated ten thousand or more [St. Louis area] families who had purchased membership in the clubs and as many as fifteen hundred who still were making payments on the notes." R. 1246. See individual cases at R. 2515 (Burns) and 2516 (Carrera), as well.

[11] E.g., Memphis and Shelby County Legal Services Association (100 cases), R. 1626–27; Legal Aid Society of St. Joseph County, South Bend, Ind., R. 1308–1310 (21 clients left with notes to pay when computer training school closed. "One day . . . the student arrived at the school to find that it had closed and that the building had been vacated during the previous night." R. 1308. "The . . . twenty-one students . . . represent only part of the class . . . [T]he ex-students will pay about $2000 each for a training program which they did not receive." R. 1309).

[12] R. 2116–2141, see especially R. 2120.

[13] Legal Action Support Project, Analysis of the Response to the Questionnaire for Legal Services Projects (Leonard H. Goode, Project Director, Bureau of Social Science Research, Inc., Washington, D.C., September 14, 1971) R. 2117–2145.

[14] *Id.* at R. 2119–2120.

[15] *Id.* at R. 2120.

[16] ". . . [I]f all of the millions of poor with legal problems utilized legal services, it would be impossible to handle them." Fred Speaker, Director of Legal Services, Office of Economic Opportunity, Tr. 1026, R. 2112.

[17] *Id.* at Tr. 1027, R. 2112.

[18] *E.g.*, Howard I. Kaufman, Chief, Consumer Fraud and Protection, Office of Attorney General, Illinois, Tr. 497; Virginia H. Knauer, Special Assistant to the President for Consumer Affairs, Tr. 894; Steven Mindell, Assistant Attorney General, Bureau of Consumer Frauds, State of New York, Tr. 9; Alan Sims, New Haven Legal Assistance, Tr. 212.

[19] Hon. Arthur Dunn, Tr. 757, 762, 765, 768. See also, *e.g.*, Mindell, Assistant Attorney General, New York State, Chief of Bureau of Consumer Frauds, Tr. 23: "We don't keep statistical records, but [abuse of the holder in due course doctrine and waivers of defense] was the greatest single problem affecting the low income consumer." Fritsch, Tr. 756 (75% of Chicago Legal Aid cases involve HDC or W/D abuses); Groups, Tr. 886; Leatherberry, Tr. 1011; Myerson, Tr. 367.

[20] Memorandum Brief of the Wisconsin Department of Justice in support of the Proposed Trade Regulation Rule, R. 1756–1762.

[21] Richard F. Halliburton, Legal Aid and Defender Society of Greater Kansas City, Inc., R. 2009. See also, *e.g.*, R. 20, Atlanta Legal Aid Society; R. 31, Omaha Legal Aid Society ("our files are full of hdc abuses"); R. 1497, Civil Rights-Civil Liberties Research Committee, Harvard Law School. "We are confronted almost daily with the harsh and inequitable effects of the holder in due course doctrine. Legal Aid Society of Metropolitan Denver R. 3446.

[22] *E.g.*, R. 1218; 2515–16; 3437–40; 3491–95; Tr. 414–416; Patricia Ahearn (Figure-Tone Spa of Staten Island, N.Y.) Tr. 55–61, documentation at R. 919–944; Lynn Burgess (Chicago Health Clubs; Inc.), R. 2569–2589. See also Federal Trade Commission cases in same subject area, e.g., Dkt. C–1851, Holiday Health Spas, Inc.; C–2134, Plaza Club, Inc.—European Health Spa, Inc.

[23] Norm Sandon's Health Club, St. Louis.

[24] Tr. 47–51; Tr. 210–212; Tr. 474–475.

[25] R. 101; R. 2511–2512; Tr. 563.

[26] R. 102, Tr. 626–628.

[27] Tr. 556–557.

[28] Tr. 638–639.

[29] Dale Carnegie course, R. 112–123; medical receptionist training, Tr. 51–55; "sales academy," Tr. 617–619.

[30] *Televisions:* R. 2055–2056, 2197, 2380, 2381–2382, 3428–3431; Tr. 110–112, 219–221, 300–301, 942–945, 1351, 1353–1356, 1387–1388. See also R. 101 (Stereophonic Phonograph set); R. 378–380 ($1,000 color television-stereo combination); R. 1712–1715 (hi-fi set, referral sales technique).

[31] R. 70–72; Tr. 287–290, Tr. 744–747.

[32] R. 2050–2052.

[33] Tr. 243–244; Tr. 376–378.

[34] Tr. 428–431.

[35] R. 73 (Piano); Tr. 110–112 ("quartz broilers, central vacuum cleaner systems"; referral sales plan; postal fraud conviction); Tr. 301–302 (refrigerator-freezer); Tr. 744–747 (Sofa covers).

[36] See Comment, "A Case Study of the Impact of Consumer Legislation: The Elimination of Negotiability and the Cooling Off Period," 78 *Yale L.J.* 618, 619–621; Note, "The Pennsylvania Home Improvement Finance Act," 10 *Villanova L. Rev.* 309 (1965); Symposium, "Consumer Protection," 64 *Mich. L. Rev.* 1197 (1966). See also Magnuson and Carper, *The Dark Side of the Marketplace* 3–9, 24–25, 31, 39, 46, 68–69, 79, 105, 112–112 (1968). See also Federal Trade Commission cases on the subject, *e.g.*, Dkt. 882, Southern States Distributing Co.; C–2218, Four States Enterprises, Inc.; file 692 3051, Arlen Realty and Development Corp., E.J. Korvette, Inc.

[37] R. 1542. "District Couple Wins Suit in 1965 Home Fraud Case", *Wahsington Evening Star*, March 4, 1971, § B, p. 4. Plaintiffs received a $22,000 award but Atlas Financial Corporation, the Philadelphia holder of the note, successfully defended against judgment being entered against them as holders in due course. A "restitution fund" established by the principals of the defunct Monarch Construction Company contained a grant total of $5,800 for restitution of *all* 700 inner-city families which the U.S. Attorney's Office states were victimized by Monarch. See Jean Carper, *Not With A Gun*, (1973).

[38] See, *e.g.*, Federal Trade Commission cases: Dkt. C–1920, Midwestern Construction and Supply Co.; Dkt. C–2217, Brolan Manufacturing Co.; Dkt. 8875, Certified Building Products, Inc.

[39] Aluminum siding: R. 124, Louisiana* ("over $10,000") R. 125, Louisiana* ("over $25,000" note, including siding "never completed," and debt consolidation); R. 125–126, Louisiana; R. 332, Kansas*; R. 1362, Illinois ($,162; "I have no redress against Mastercraft.") Tr. 204–208 and R. 670–674, New York (over $2,900) Tr. 821–821 Illinois* (over $5,000); Tr. 856–857, Michigan.

Other home improvements: R. 100 (Bridge City, Louisiana); Tr. 465–466, R. 382–384 and R. 582–584 (Toms River, N. J.; $4,897 kitchen remodeling; shoddy workmanship, never completed), R. 566–568 Englewood, N. J.; heating system; R. 581–582 (West New York, N. J.) R. 904–908 (Elmont, New County, Georgia); R. 1684–1685 (Bayshore, N. Y., central air conditioning; over $1,700); R. 2196 (Philadelphia, Pa., $1,863 furnace*); R. 2609–2622 (Ridgefield, N. J.); R. 3425–3426 (Modesto, California); Tr. 113 (N.Y. furnace repair/replacement scheme); Tr. 296–297 (New Jersey); Tr. 408–411 (Elmont, N. Y.) Tr. 639–640, 661–662 Tr. 874–882, R. 1340–1356 (Chicago, Illinois).

[40] *Id.* Referral technique indicated above by asterisk (*).

[41] *E.g.*, Magnuson and Carper, *supra* note 36, at 14, 17, 51. See also Federal Trade Commission cases, *e.g.*, Dkt. C–2211, Cattlemen's Quality Meat, Inc.; Dkt. 8880, Seekonk Freezer Meats, Inc.

[42] Payment of well over $1,000 for a freezer which could be purchased for $250 at most stores is not unusual. See note 43 infra.

[43] Royal Foods of East Providence, Rhode Island: "Induced by advertisements . . . promising reduced prices and increased convenience and the *use* of a food freezer, accompanied by the give-away of a dinnerware set, people contracted for the offered monthly food service. The predominant consumer complaints . . . were that the food supplied by Royal was inadequate . . . that reference to 'use' of a freezer meant, in fact, that the consumer was required to purchase the freezer. The freezers . . . were often sold . . . at unconscionable prices, frequently in the range of $1,000." R. 953–955, documentation at R. 957–962. "Mr. Allen . . . realized that he had agreed to buy, rather than rent, a freezer for $1,087 . . . Mr. Allen went to see his union's lawyer and was told there was no way he could get out of the contract since it was sold to a finance company. The lawyer told him that if he stopped payments he would be sued, have his wages garnisheed, and probably be fired from his job." Case history submitted by New York City Department of Consumer Affairs, R. 1024–1026; see also R. 1517–1518; 2195; 2197; 3517; Tr. 236–237; Tr. 413–414; Tr. 498–499; Tr. 543–544.

[44] Note 46 *infra*. See also FTC cases, *e.g.*, Dkt. C–2129, Town and Country Auto Sales, Inc.; Dkt. C–2195, Jordan Motor Company.

[45] *E.G.*, Illinois, Massachusetts, Michigan, Oregon, Pennsylvania, Mississippi and Texas (waivers only). But note that some states specifically exclude automobile sales from statutes restricting the holder doctrine or similar creditor remedies; *e.g.*, District of Columbia (related creditors provision), Illinois.

[46] *New Cars:* Kirkland, R. 92–93, 2529; Cochario, R. 569; Fuller, R. 2053–2054, Tr. 928–930; Heitzman, R. 2198; Block, R. 2314–2349.

Used Cars: Lusas, R. 375–377; Hatch, R. 2193, Tr. 1159–1162 (related creditor); Gant, R. 2383–2384, Tr. 1356–1359 (related creditor); Combs, R. 3433–3434; R. 3516–3517; Washington, Tr. 43–46 Oswin, Tr. 66–69; Schlossberg, Tr. 857.

[47] The Block case, related by Benny Kass, Commissioner, National Conference of Commissioners on Uniform State Laws, at R. 1199–1202, R. 2314–2349. See Block v. Ford Motor Credit Co., 286 A.2d 228 (D.C. 1972). See also "Moves Gain to Halt Some Credit Practices Assailed by Consumers," *Wall Street Journal*, June 7, 1971, p. 1, col. 1.

[48] Note, "Translating Sympathy for Deceived Consumers into Effective Programs for Protection," 114 *U. Pa. L. Rev.* 395, 398–403 (1966). See also FTC Dkt. 8846, Kustom Enterprises, Inc.

[49] See note 50 *infra*.

[50] *E.g.*, "I have had no satisfactory results from G.E. . . . who financed the carpet. In fact, they feel that they have no responsibility to me whatever and so stated." Mrs. Sophia Bell, Washington, D.C. (carpet firm out of business), R. 62; Dominick Fiorenza, testimony at Tr. 461–464, statement at R. 894, documentation at R. 587–593; "Mrs. Collins received a payment book from Budget Finance requiring her to pay . . . $1,202.68, more than half of her yearly income, for

three small rooms of carpeting. [After the carpet began to come up] . . . Mrs. Collins called Budget Finance to discover that the carpet company had gone out of business. She . . . was told that Budget was not responsible for any promises [to 'make repairs free of cost for 25 years'] made by the store. She would have to continue making payments, rug or no rug." Case history submitted by New York City Department of Consumer Affairs, R. 1026–1028; R. 2196; Tr. 112–113 ("Pyramid or chain referral plan ... wall-to-wall carpeting at prices ranging from $27 to $30 per square yard . . . which could be purchased retail locally for approximately $7 a square yard"; postal fraud conviction); Tr. 358 (referral sales).

[51] A particularly alarming case is related in Schrag, "On Her Majesty's Secret Service: Protecting the Consumer in New York City," 80 *Yale L.J.* 1529, 1553–1585. The case is that of Foolproof Protection, Inc., which sold $4 million in burglar and fire alarm systems door-to-door, exclusively in ghetto areas of greater New York City.

[52] R. 2195–2196 (fire alarms: Consumers "Emma Jackson, Ada Brewington and others. Merchants: Protect-A-Life Corp., R&S Fire Security Co. Holders in due course: 1st Pennsylvania Bank; Beneficial Finance Corp., Mercantile Banking Corp." Referral scheme in some cases. Amounts of indebtedness ranged from $862.20 to $1,031.40); R. 3400 (Fire alarm; referral technique); Tr. 83–85 (burglar alarm); Tr. 612–616 (fire alarm; $556).

[53] The New York City Fire Department certified to the Department of Consumer Affairs that the retail value of the fire alarm systems being sold by Foolproof for $750 was no more than $75. Shrag, *supra* note 50.

[54] See generally, Katz, *The Law and the Low Income Consumer* 215–250, 330–339 (1968).

[55] R. 64–65 (Virginia); Arthur Roddey (Englishtown, N.J.), testimony at R. 100–109; statement and documentation at R. 909–918 but see Walter G. Bellaris, Vice President, Industrial Valley Bank and Trust Co., Jenkintown, Pa., R. 562–563; R. 2197 (Philadelphia, Pennsylvania; $4,985).

[56] R. 101.

[57] R. 338–344.

[58] R. 952–953 (door-to-door); Tr. 416.

[59] R. 1618–1623.

[60] R. 1686.

[61] R. 2198–2199.

[62] R. 3516.

[63] R. 1153–1158.

[64] *E.g.*, Kessler, Tr. 1063; Williams, Tr. 70–73; Huffman, Tr. 84; Douglas, Tr. 1543; Scholl, Tr. 1723; Bluestone, Tr. 1849; Ryan, Tr. 1981.

[65] Weiner, Tr. 1153; Roberts, Tr. 420; Crandal, Tr. 1906; Nelson, Tr. 2117; Tahnk, Tr. 2199; Latturner, Tr. 229; Williams, R. 395; see also R. 20, 544, 1647, 5973, 7395.

[66] "[O]ut of sheer exhaustion . . . the lady put her name on the paper to the tune of $1,000 [for pots and pans]. When she went to rescind the contract the following day, the [salesman] told her he forwarded the paper to a finance company and that it was impossible to rescind the contract." Edwin P. Palumbo, Rhode Island Consumers Council, R. 416; "The consumer signs a contract committing him to pay about twice the fair market value for the freezer . . . These installment contracts are immediately sold to a finance company, which refuses to honor buyers' defenses on the ground that the misrepresentations made by the salesman do not appear on the face of the contract . . ." Lucy McCabe, Attorney California Rural Legal Assistance, R. 3426; Furness, Tr. 33; Weiner, Tr. 1153.

[67] "All the examples of our testimony—you will have a locally incorporated vendor and a foreign loan company. In one case, the frozen foods corporation, I believe it was the reverse, a freight vendor and a Rhode Island incorporated [finance] company, but they are all interstate in one way or another." Roberts, Tr. 420. See also, *e.g.*, Eisendrath, Tr. 831; John Keller, Office of Superintendent of Public Instruction, State of Illinois ("many" finance agencies are outside the state), Tr. 568; Sims, Tr. 214, 224. Specific cases, *e.g.*, Fuller, Tr. 928 (D.C.—Maryland); Roddey, Tr. 100 (New Jersey—Pennsylvania); Scates, Tr. 938 (D.C.—Maryland).

[68] *E.g.*, Elberson, Tr. 275; Gregg, Tr. 1361; Kripke, Tr. 450; Mindell, Tr. 22; Pettus, Tr. 1352; Sims, Tr. 223; Williams, Tr. 62, 70.

[69] *E.g.*, R. 9, 32, 111, 388, 889, 1286–87, 1486.

[70] *E.g.*, Cain, Tr. 1164; Charney (on behalf of Rep. Bella Abzug), Tr. 458; Rice, Tr. 75; Speaker, Tr. 1030.

[71] Allan Sims, New Haven Legal Assistance Association, Tr. 223.

[72] *Eg.*, Charney, Tr. 458; Judge Arthur Dunn, Tr. 758, 768; Fritsch, Tr. 749; Rice, Tr. 75.

[73] Virginia Knauer, Special Assistant to the President for Consumer Affairs, Tr. 896, 897–898.

[74] *E.g.*, Furness, Tr. 37; Carpenter, Tr. 845; Matsen, Tr. 285; Mullins, Tr. 1192.

[75] Tr. 760.

[76] Tr. 735–738.

[77] *E.g.*, Unico v. Owen, 50 N.J. 101, 232 A. 2d 405 (1967); Rehurek v. Chrysler Credit Corp., 262 So. 2d 452 (Fla. 1972); Westfield Ind. Co. v. Fellers 74 N. J. Super 575 181 A. 2d 809 (1962); Commercial Credit Company v. Childs, 199 Ark. 1073, 137 S.W. 2d 260 (1940).

[78] Patrick D. Molinari, Esq., R. 64.

[79] American National Bank v. A. G. Sommerville, 191 Cal. 364, 216 P. 376 (1923). See also Fairfield Credit Corp. v. Donnelly, 158 Conn. 543, 264 A. 2d 547 (1969); Quality Finance Co. v. Hurley, 337 Mass. 150, 148 N.E. 2d 385 (1958).

[80] Warren, "Comments on Vasquez v. Superior Court," 18 *U.C.L.A.L. Rev.* 1065, 1067 (1971).

[81] U.C.C. § 3–104, Comment 2.

[82] *E.g.*, Colorado, Laws H. 1076 § 2–303; Delaware, Title 6, § 4311(a); Hawaii, Rev. Stats. § 476–18(d); Maine, Rev. Stats. Title II, §§ 3–302 5(c) and 5(d); Massachusetts Gen. Laws. ch. 255D, § 10(d); Minnesota, Laws. Ch. 276 §§ 2(a) and 3(a); New Mexico, Pers. Prop. Law, ch. 41, art. 10, §§ 403(3)(a), 413(10)(e).

[83] Under Section 9–206(1) of the U.C.C. . . . 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 enforceable by an assignee. . . . A buyer who as part of one transaction signs both a negotiable instrument and a security agreement *makes such an agreement.*" (Emphasis added.)

[84] *E.g.*, Eovaldi, Tr. 796; Kessler, Tr. 1057; Mindell, Tr. 25; Preloznik, Tr. 543, R. 924, 1201.

[85] *E.g.*, Martin-Trigona, Tr. 584; Newman, Tr. 997.

[86] C.F. U.C.C. 9–206(1).

CHAPTER IV. COMMISSION FINDINGS WITH RESPECT TO THE USE OF SALE RELATED LOANS IN CONSUMER TRANSACTIONS.

A concern that the intended effect of the original proposed rule might be circumvented by merchant-arranged "direct loans" proved to be a significant issue as the proceedings on the proposed rule developed. Many spokesmen addressed this subject in general terms and urged the Commission to broaden the proposal by covering spurious "direct loans."[1]

For the sake of simplicity, the practice—variously referred to as "vendor-related loans," "specious cash sales," "interlocking sales/loans" and, more colloquially, "dragging the body"—will be termed "vendor related loans" in this Statement. The practice arises when a merchant, desiring to circumvent restriction upon the holder in due course doctrine, arranges for a consumer purchase to be financed by a cooperating financing agency. The resultant financial transaction has the appearance of a direct cash loan, payment of which can be enforced by the loan company without reference to the underlying transaction. An example, related by a consumer witness at the 1971 Washington hearings, will illustrate:

John Hatch, a witness, testified as follows:

> "*Mr. Hatch:* Mr. Chairman, my name is John Hatch. I went to buy a used car. They gave me all kinds of guarantees. This was my first car, so I was very much excited. Mr. Compact says, 'I have some boys to take care of you.'
>
> "He took me to the American Consumer Discount House . . . I went into one room and he went into another room. They had the papers set up for me.
>
> "This car wasn't financed under the Pennsylvania Motor Vehicle Law. They tried to say after I got the car it was a personal loan.
>
> "I received the car and they told me the car was guaranteed for 30 days; anything after 30 days I would have to pay half the cost.
>
> "I like to not got the car off the lot. After that I complained so much that after three days after I received the car I went back to the finance company. They said, 'This is your baby. We didn't finance any car. We gave you a personal loan'.
>
> "They made out the check to Mr. Compact and me. The only thing I did was to sign the check.
>
> "I could not use the car. The finance company wouldn't make the dealer fix the car. The dealer refused to fix the car.
>
> "My home and all of my possessions were up for a sheriff's sale.
>
> "They repossessed the car. They sold it to me for $1,512, and about a month later they sold the same car for $300 because it wasn't in good shape.[2]

The transcript[3] and record[4] contain additional consumer case histories involving related creditor sales in several jurisdictions and in connection with various consumer purchases. Automobile sales seem to predominate, perhaps because in several jurisdictions automobile sales have been the subject of legislation specifically restricting the use of promissory notes and waivers of defenses.[5]

Most notable, however, was the experience in New York State. For many years New York had a 10-day "notice" provision, generally regarded as ineffective by consumer representatives.[6] In 1971 the New York legislature enacted a more rigorous, direct restriction upon the availability of cut-offs to third party assignees of consumer paper.[7] Although the law was still, in the view of consumer interest spokesmen, far from compre-

See footnotes at end of chapter.

hensive,[8] the enactment placed New York among the handful of states with relatively effective legislation on the subject.

A startling development at the New York hearings—held only four months after the effective date of the new law—was the speed and extent to which the vendor related loan abuse had been seized upon by merchants and financers desirous of circumventing the new law. The record contains several case histories concerning New York consumers caught in a "specious cash sale," as the practice is termed in New York.[9] Numerous witnesses familiar with the New York experience expressed alarm at the sudden prevalence of the practice and urged the Commission to broaden the proposed rule to meet the related creditor abuse.[10]

As a result of the comments received in the first set of hearings, the second published version of the rule included provisions making it applicable to vendor related loans. In the reopened proceeding, this section of the rule received widespread support on the record, both through individual consumers who testified about their own experiences,[11] and from consumer and industry witnesses who approved of such a provision and urged its adoption.[12] Legal aid and community legal services attorneys in particular stressed the need for such a provision based upon the extensive experience in states which had enacted restrictions upon the holder in due course doctrine but had not addressed related creditors.

The second published version of the rule specified a number of situations indicative of a cooperative arrangement between seller and creditor. The specified situations included the following:

(1) Relation between creditor and seller by blood or marriage.[13] This definition was supported by testimony on the record.[14]

(2) and (3) Relation due to the preparation of forms used in processing credit applications.[15] This definition was supported by both comment and testimony.[16]

(4) Common control or affiliation of creditor and seller. This provision was similar to a feature of the District of Columbia "related lenders" law [17], and is supported on the record.[18]

"If there is a close relationship * * * I think it puts into [the] Rule what the courts have long held the close relationship between the * * * retailer and the finance company.

"It is the Universal Acceptance Corporation against Russell case that speaks of item 4.

"The director of Universal Acceptance was also director of wig Fair. They sold their wigs before Christmas with six-month servicing, only to go out of business in February, whereupon the Universal director put on his other hat and sued on the negotiable instrument. I mean this is something that somehow the court said were two different people * * *." [19]

(5) Joint venture. Recommendation of Professor Fairfax Leary.[20]

See footnotes at end of chapter.

(6) Payment of consideration by creditor to seller. A feature of the District of Columbia Consumer Credit Protection Act [21] and Arizona's related creditor statute.[22] Support for the provision was offered by legal services lawyers.[23]

(7) Guarantee of loan by seller. This section derived from a provision of the Maryland "related creditors" law.[24]

(8) Five or more loans. This provision was an adaptation of the Massachusetts statute, which deems a sufficient connection with the seller to exist where the lender has made two or more loans in a one-year period the proceeds of which were used in transactions with the same seller and the lender was recommended by the seller.[25] The National Consumer Act contains a similar provision which specifies twenty such referrals.[26] This approach was also urged upon the Commission by the office of the United States Attorney for the Southern District of New York.[27] Several legal services representatives stressed that in their work under state law a provision similar to subsection 8 would be particularly useful. They suggested that FTC enforcement experience would parallel their own practice and that this subsection would, therefore, be most necessary.[28]

"We feel that provision is one of the most important in that in many cases we find again that by using discovery processes, we are still unable to find any type of connection between the lender and the seller.

"Most often we have been able to find that the same lender and seller have engaged in the same transactions 10, 15 or 20 times; that we feel that Subsection 8 is important, that it is useful." [29]

(9) Relation by knowledge of seller misconduct. This subsection was derived from the Wisconsin Consumer Act and was similar to provisions of an analogous Illinois statute.[30] The knowledge of adverse claims and defenses and absence of good faith are classic tests used to deny holder in due course status to the assignee of a note. The provision received support on the record.[31]

As a whole, the related creditor portion of the rule received widespread support in this proceeding.[32] Most opposition to this rule was directed to the entire rule; that is, there is relatively little opposition on the record directed specifically to a related creditor section. Whatever specific opposition was registered focused on the alleged overbreadth of the related creditor portion of the rule. Additionally, opponents argued that the several individual provisions in the definition portion of the rule were vague or overly broad.[33]

From the record, and particularly from comments elicited in response to the nine cases of concerted conduct between sellers and creditors which were explored on the record, the Commission concludes that vendor related loans should be covered by any Commission rule in this area. Sellers should not be permitted to evade the rule by diverting business from the discount window to the loan booth. Many of the largest acceptance or discount financers in the country are equally active in the "small loan" industry. The prearranged loan is an efficient method of sales finance, since the costs involved to creditor and seller are comparable to those borne in a discount transaction. The revised version of the rule which we now promulgate has been designed to eliminate the related creditor problem, by treating all credit sales the same way. The final revisions of this important section will be discussed below, in Chapter VII.

[1] *E.g.*, Forham, Tr. 630; Nelson, Tr. 725; Eovaldi, Tr. 806; Leary, Tr. 968, 979–930; Kessler, Tr. 1059; Kass, Tr. 1027; Gregg, Tr. 1364. R. 47, 70, 904, 1294, 1369, 2377–2378.

[2] Tr. 1159–1161. See also R. 2198.

[3] *E.g.*, Tr. 887–888 (Illinois; used cars); Tr. 1153–1156 (Pennsylvania; employment placement service; consumer referred to a specific official at cooperating loan company); Tr. 1356–1359 (Maryland; used car).

[4] *E.g.*, R. 125–126 (Louisiana; aluminum siding); R. 904–908 (New York; home improvements); R. 1590–1592 (Michigan; camper); R. 1684–1685 (New York; air conditioner); R. 2383–2384 (Maryland; used car).

[5] "In other words, it is written up as if the consumer went to the bank first, made a loan, and then came to this automobile dealer to buy the car."

". . . this practice is so widespread, I would say it occurs in one-third of all automobile financing transactions in Philadelphia." Scholl, Community Legal Services, Inc. Tr. 1172.

[6] Mindell, Tr. 10–28, R. 682; Flicker, R. 971; Huffman, Tr. 87–90.

[7] N.Y. Pers. Prop. Law § 401 *et seq.*

[8] *E.g.*, Furness, Tr. 34, Elberson, Tr. 276.

[9] *E.g.*, Givens, Tr. 3–4 (aluminum awnings), 354 (clothing peddled door-to-door), 357 (furniture), 358 (rug, referral sales); Spence, Tr. 114–115.

[10] Mindell, Tr. 18–21; Furness, Tr. 37–38; Spence, Tr. 114–115; Seymour, Tr. 246; Hynes, Tr. 247–249; Elberson, Tr. 403; Schnapper, Tr. 482.

[11] *E.g.*, School, Tr. 1723; Jeffrey, Tr. 1805; Kaufman, Tr. 1937; Crandall, Tr. 1906; Betty Burton, Tr. 1938; Wenclawski, Tr. 2213–19.

[12] *E.g.*, Knauer, Tr. 1403; Guttman, Tr. 1523; School, Tr. 1722; Schick, Tr. 1738; Jeffrey, Tr. 1804; Ryan, Tr. 1978; Eovaldi, Tr. 2183.

[13] *E.g.*, N.Y. Pers. Prop. Laws § 254(a); Md. Rev. Stats. Art. 11, § 197A(b) (1), Art. 58A, § 24(b) (1).

[14] *E.g.* Patricia Hynes, Tr. 249; Fairfax Leary, R. 2086.

[15] *E.g.* N.Y. Pers. Prop. Law § 254 (b) and (c); Md. Rev. Stats. Art. 11, § 196A(b) (5); 28 D.C. Code 3809(a) (1).

[16] *E.g.*, Hynes, Tr. 249; Douglas, Tr. 1543; Leary, R. 2087.

[17] 28 D.C. Code 3309(a) (2).

[18] Hynes, Tr. 248; Prof. Egon Guttman, Tr. 1529; Leary, R. 2087.

[19] Guttman, Tr. 1529.

[20] Public Interest Research Group, currently University of Pennsylvania Law School, R. 2037.

[21] 28 D.C. Code 3809(a) (3).

[22] ARIZ. Rev. Stat. Ann. § 44–145(b)

[23] David Scholl, Delaware County Legal Services, Tr. 1729–1730; Utah Legal Services, R. 4391; Kansas City Legal Aid and Defender Society, R. 4717.

[24] Md. Rev. Stats. Art. 11, § 196A(b) (4); Art. 58A, § 24(b) (4).

[25] Mass. Gen. Laws Ann. Ch. 255, § 12F.

[26] National Consumer Act § 2.407 (1970), R. 2689–2690.

[27] Tr. 248–249.

[28] *E.g.* Scholl, Tr. 1729, 1730–1731, Byrd, Tr. 1770.

[29] Jerry Byrd, United Planning Organization, Washington, D.C. Tr. 1770.

[30] Ill. Rev. Stats., 1969, Chap. 121 ½, §§ 517, 576.

[31] *E.g.*, Byrd, Tr. 1770.

[32] *E.g.*, Prof. Egon Guttman, Tr. 1529; Blair Shick, National Consumer Law Center, Tr. 1738-39; Jerry Byrd, United Planning Organization, Tr. 1769-70; Mildred Jeffery, UAW, Tr. 1805; Stuart Bluestone, Consumer Federation of America, Tr. 1849; Agnes Ryan, Chicago Legal Aid Society, Tr. 1980; Helen Nelson, Tr. 2114-15; Prof. Thos. Eovaldi, Northwestern Univ. Law School, Chicago Council of Lawyers, Tr. 2186; Thos. Tahnk, Supervisor of Consumer Credit, Minnesota, Tr. 2202.

[33] *E.g.*; Pray, Tr. 1641-42; Morris, Tr. 1701; Alabama Independent Auto Dealers, R. 5307; See also R. 3472, 4660, 5140.

CHAPTER V. COMMISSION FINDINGS WITH RESPECT TO THE USE OF WAIVERS OF DEFENSES IN CREDIT CARD CONTRACTS

Americans carry over 275 million credit cards of all types including 55 million bank-issued cards and 5 million travel and entertainment cards.[1] All are issued by means of a master contract which contains a waiver of defenses analogous to that used in installment sales. If a controversy arises over the underlying consumer purchase, the cardholder cannot withhold payment from the issuer.[2] The effect for the consumer is much the same as the financing arrangements discussed above. The method—the charge card procedure—is, of course, different.

In the initial proceeding on the proposed rule, the possibility of the use of credit cards as a method of avoiding the consequences of restrictions on other cut-off devices received considerable attention. Proponents of the rule maintained that credit cards should be included in any final rule on the subject of buyers' claims and defenses.[3]

Opponents felt that credit cards should be excluded, largely because the procedure involved in a credit card transaction differed from that in other credit sales.[4]

In the original proceeding few demonstrated cases of consumer injury were cited.[5] There was general agreement by consumer witnesses that the credit card issuer's ability to insulate itself from card-holder claims and defenses does not result in widespread abuse.[6] The thrust of consumer testimony was that credit cards must be covered in any final rule to meet potential abuses.[7] This position was premised on several assertions.

(1) Use of credit cards is rising and the potential for abuses analogous to holder in due course is great.

(2) Reasons similar to those advanced in the case against contractual waivers of defenses; that is, that such waivers are contracts of adhesion and against public policy.[9]

(3) That credit card issuers are similar to "related creditors" in that they are aware of the business practices of the merchant.[10]

(4) Such waivers are unfair in an absolute sense.[11]

See footnotes at end of chapter.

(5) The acceptance by merchants of credit cards, and the display of credit card seals or "logos," gives rise to an implied warranty by the credit card issuer as to the merchant's reliability.[12]

Adverse witnesses at the original proceeding based their opposition to inclusion of credit cards largely on the following grounds.

(1) The Commission lacks jurisdiction over bank-issued credit cards.[13]

(2) Credit card waivers are not abused.[14]

(3) A ban on waiver agreements in credit card contracts would (a) make it impossible for credit card issuers to operate[15] and (b) hamper development of modern automated electronic banking improvements.[16]

(4) The credit card issuer has no way to control the retail selling practices of the merchant.[17]

(5) Credit card transactions are inherently different, or unique.[18]

In a reopened proceeding, the Commission revised its rule to contain a provision which would prohibit sellers from accepting credit cards issued in return for a waiver of defenses effective against the issuer.[19] In publishing the proposal the Commission was aware of the fact that—at the time—three states had regulated the use of waiver of defenses clauses in credit card transactions.[20] The Commission believed that both consumers and industry should have an opportunity to comment on the subject, in the context of a specific proposal, and that the degree to which credit card waivers might be productive of consumer injury should be explored on the record.

In the reopened proceeding many of the same arguments, both pro and con, were heard with respect to restriction of credit card waivers. Opponents, in addition to renewing their previous objections, noted that the Commission proposed to regulate such waivers indirectly through a requirement on retail sellers.[21] Banking interests maintained that the Commission could not indirectly control the activities of credit card issuers.[22] Industry representatives and other witnesses further noted the unique aspects of credit card transactions and the manner in which they differ from the other three-party financing arrangements addressed in the rule.[23]

Industry representatives again stressed the degree to which their operations are leading to sophisticated electronic transfer mechanisms which will greatly relieve an over-burdened funds transfer system. Opponents of credit card regulation maintained that to place restrictions upon such a system in its early stages of development would hamper the perfection of a system intended to bring long-term benefits to the public.

Consumer representatives repeated their requests that restrictions on credit card waivers be included in the final rule to close a substantial loop-hole in the protections afforded by the rule.[24] A few witnesses testified as to actual cases of consumer injury,[25] and a number of case histories were placed in the written record.[26] The majority of these involve billing errors or other practices unrelated to the existence of the credit card waiver.[27]

The Commission concludes that consumer injury from reliance on the standard form waiver in credit card contracts is infrequent, when viewed in the context of millions of transactions.[28] At the same time, the continuing relationship between the issuer of a credit card and the subscriber tends to render abusive reliance on the insulation conferred by the waiver counterproductive. If the issuer wishes to retain a subscriber's business, he must seek to insure customer satisfaction in most cases. Credit card issuers can and do undertake to intervene in consumer disputes with sellers.[29]

Mrs. Knauer, Special Assistant to the President for Consumer Affairs, summarized the relationship between issuers and users of credit cards thusly:

> "The credit card company investigates both the card holder to whom it extends credit, and the retail credit company from which it buys the card holder's debt obligation.
>
> "The expectations of the purchaser in an installment sale, therefore, can be quite different from those in a credit card transaction.
>
> "The credit card holder, however, knows when he signed a credit card charge slip that his obligation to the retail store will be paid by the credit card company. Thus, the consumer, in a credit card situation, makes the credit assignment himself. He, in effect, directs the retail store to assign his note to the credit card company of his, the consumer's choice.
>
> "Secondly, consumers in each of these transactions often have different economic advantages, as well.
>
> "Installment sales financing is most often used by lower and middle income consumers, while credit card transactions are usually restricted to middle or upper income consumers, people who are presumably better equipped to defend their economic interest.
>
> "Moreover, some credit cards, such as bank credit cards, have become a new medium of exchange for many Americans permitting them to purchase goods and services throughout this country and many foreign countries without the necessity of carrying large amounts of cash or establishing local credit. In this respect, credit cards may be used as a substitute for currency in what is considered by the card holder as essentially a cash purchase.
>
> "Prohibiting waiver, of defenses could well compromise a considerable consumer benefit from bank cards, with their far-flung acceptability as a cash equivalent.
>
> "Finally, there has been substantial evidence of abuse of the holder in due course doctrine in the area of installment sales. I am sure that is one statement we could all agree upon. But I am not aware of similar abuse in credit card transactions.
>
> "To some extent, I believe that is the result of self-policing by credit card companies. Most of them carefully investigate the retailers with whom they deal, and do not hesitate to sever relations with them and with sellers who do not provide satisfactory merchandise or services. This is exactly the sort of voluntary business action that can often provide the best protection for consumers."[30]

In addition to the information discussed above which has suggested that waivers of defenses in credit card contracts are not abused to the same extent as the "holder in due course" doctrine, the Commission is cognizant of recent

legislative developments, at the federal level, which will alleviate any existing problems in this area. The recently enacted Fair Credit Billing Act invalidates waivers of defenses in credit card contracts where a card is used to make a purchase of more than 50 dollars within the state where the user resides or within 100 miles of the place where the card is issued.[31] The Commission has no reason to believe that this legislation will not afford adequate protection to consumers at the present time.

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[1] Ross, "The Credit Card's Painful Coming-of-Age," *Fortune*, October, 1971. p. 108. Travel and entertainment cards ("T and E") are American Express, Diners Club and Carte Blanche. Nationally distributed bank cards are Master Charge (Interbank Card Association) and the Bank-Americard (National BankAmericard, Inc.).

[2] The cards issued by retail stores—at 120 million, the largest category of charge cards outstanding—do not pose this potential difficulty since they are not three party cards. Likewise, the 90 million travel cards currently held do not involve waiver agreements.

[3] *E.g.*, Kessler, Tr. 1066; Swankin, Tr. 1365; Willier, Tr. 1038.

[4] *E.g.*, Daniel (BankAmericard), Tr. 1235, 1254–5; Doyle (American Bankers Association), Tr. 109, 1128; Morgan Interbank Card Association ["Master Charge"], Tr. 1229; Serafine (Charge Account Bankers Association), Tr. 1073.

[5] *E.g.*, the "Richter Sewing Machine Case" cited by Bess Myerson, Tr. 376–377.

[6] *E.g.*, Eovaldi, Tr. 792; Forham, Tr. 630; Leatherberry, Tr. 1018; Swankin, Tr. 1371.

[7] *E.g.*, Flicker, Tr. 404; Kass, Tr. 1209; Myerson, Tr. 368; Eisdendrath, Tr. 382–3. See also R. 334, 891, 1369.

[8] Eovaldi, Tr. 792; Kass Tr. 1209; Leary, Tr. 986; Martin-Trigona, Tr. 583; Willier, Tr. 1046.

[9] Eovaldi, Tr. 796; Kessler, Tr. 1066; Leary, Tr. 981.

[10] *E.g.*, Buxbaum, Tr. 1306; Furness, Tr. 36; Leatherberry, Tr. 1018; Myerson, Tr. 368; Willier, Tr. 1046–1049.

[11] *E.g.*, Eovaldi, Tr. 807; Leary, Tr. 981.

[12] Kass, Tr. 1209; Martin-Trigona, Tr. 575, 583.

[13] *E.g.*, Daniel, Tr. 1249, 1251, 1259; Serafine, Tr. 1074. R. 1737 *et seq.* (American Bankers Association [ABA]); R. 1767 *et seq.* (ABA, Interbank, National BankAmericard and two other bank card associations).

[14] *E.g.*, Badders, Tr. 1334, 1339; Serafine, Tr. 1086.

[15] *E.g.*, Daniel, Tr. 1237; 1242; Doyle, Tr. 1113, 1134; Serafine, Tr. 1089.

[16] *E.g.*, R. 1737, 1767 R. 2476–2479 (Charge Card Association). "It is clear that bank charge cards will form the foundation for a nationwide electronic payment system. [Submission included newspaper clippings in substantiation of this point]. To now burden that evolving system . . . would have intolerable consequences." Charge Card Association, R. 2477.

[17] *E.g.*, Daniel, Tr. 1238, 1245, 1258, 1264; Doyle, Tr. 110; Serafine, Tr. 1081. One banker, however, after making such an assertion, proceeded to relate precisely how a member bank encouraged a reform in the selling practices of a health spa. Morgan, Tr. 1221.

[18] *E.g.*, Daniel, Tr. 1235, 1254; Doyle, Tr. 1109, 1128; Morgan, Tr. 1229; Serafine, Tr. 1073, 1077.

[19] 38 Fed. Reg. 892. Proposed sections relevant to credit card waivers were:

(f) *Credit card issuer.* Any person, partnership, corporation or association, including a bank, which by agreement extends to a cardholder the right to use a credit card in connection with a consumer transaction.

(g) *Cardholder.* Any consumer who enters into an agreement with a credit card issuer extending to such consumer the right to use a credit card in connection with a consumer transaction.

In any consumer transaction it constitutes an unfair and deceptive act or practice for a seller to:

* * * * *

(d) Enter into any agreement, contract or other obligation for participation in a credit card plan with any credit card issuer who:

(1) Takes or receives from a cardholder any agreement, contract or other obligation, except one conforming to Section II(b) of this rule, which contains any provision whereby the cardholder agrees not to assert against the issuer claims or defenses arising out of consumer transactions arranged with the issuer's credit card, up to the full amount financed with the credit card in that transaction.

(2) Places any time limitation on the rights of a credit card holder to assert claims or defenses arising out of a consumer transaction which is shorter than the period in which payments are to be made for the sale or lease or the date of final delivery of the goods or the completion of the furnishing of the services, whichever is longest.

[20] *Ariz. Rev. Stat. Ann.* § 44–145(A) (Supp. 1971); Ch. 1019 § 4 [1971] Cal. Acts. 2152–55 (adding Cal. Civ. Code § 1747.90); Mass. Ann. Laws Ch. 225, § 12F (Supp. 1971).

[21] *E.g.*, Michael J. Larson, Vice-President, Marine National Exchange Bank, Milwaukee, Wisc., Tr. 2123; Ronald E. Brandel, representing Western States Bankcard Association, Tr. 1652; Joint Bankers Statement, R. 6392.

[22] *E.g.*, Witnesses cited note 17, *supra* and Hinckley, Tr. 1783; North American National Bank, R. 5891.

[23] *E.g.*, Witnesses cited note 18, *supra* and Mrs. Virginia Knauer, Special Assistant to the President for Consumer Affairs, Tr. 1393; Prof. John C. Weistart, Assoc. Professor of Law, Duke University, Tr. 1469.

[24] *E.g.*, Professor Egon Guttman, American University Law School, Tr. 1509; Blair Shick, National Consumer Law Center, Tr. 1736; Stuart Bluestone, on behalf of Consumer Federation of America, Tr. 1844–48.

[25] Jeffery, Tr. 1809–10; Dale S. May, Tr. 1930; Samiany, Tr. 2105; E. Thos. Garman, Tr. 2207; Edie Rosenfels, Tr. 2233.

[26] Chase, R. 5760; Norris, R. 5663; Sweet, R. 5592.

[27] See notes 25 and 26, *supra*.

[28] Estimated at over 300 million transactions per year. Ross, op. cit. *supra*. note 1.

[29] Tr. 1221; Tr. 1930; R. 7670.

[30] Tr. 1403–1405.

[31] Public Law 93–495, October 28, 1974.

CHAPTER VI. OPPOSITION TO THE RULE

A. Opposition to the abolition of the holder in due course doctrine. Much of the support for the proposed Trade Regulation Rule concerning Preservation of Consumers' Claims and Defenses has been discussed above in previous chapters. Other, more generalized expressions of support for the proposal are discussed below.[1] This chapter will evaluate the opposition to the rule which was elicited in the course of public proceedings thereon.

For the most part, opponents of the rule directed their comments and testimony to the proposal as a whole. They did not emphasize particular provisions of the rule or focus on individual components of the proposal. Comments with respect to the proposed provisions relating to waivers of defenses in credit card transactions were the major exception. Our credit card proposal elicited the largest volume of specific commentary in opposition.

Effect on cost and availability of credit. In the course of rulemaking proceedings, industry representatives maintained that a Trade Regulation rule which restricted the use of promissory notes and waivers of defenses in consumer transactions would cause an increase in the cost of credit[2] and/or a decrease in the availability of consumer credit.[3] A negative impact on the operations of retail merchants was also predicted. It was argued that financial institutions would become unduly restrictive about the sellers from whom they purchased consumer paper[4] and they might even stop purchasing consumer paper altogether.[5] On the basis of these arguments, some businessmen suggested that their retail operations would be severely curtailed and that some among their ranks would be driven out of business due to a lack of financing.

David Gezon, President of the Volkswagen American Dealers Association testified that California and Pennsylvania legislation removing holder in due course status for assignees of contracts taken in connection with an automobile sale had "worked as a disadvantage to [dealers in those states]."

> "Particularly in the young cases, they [the dealers] feel the banks have become terribly what we call 'turn downsy.' The turn downs have increased since the advent of this.
>
> "In California * * * it has cut down sources of financing."[6]

Joseph L. Kaufman, Vice President of Pacemaker Corporation, a boat manufacturer and owner of a retail boat outlet in New York, wrote that the New York Statute which eliminates the holder in due course defenses "has resulted in a material decrease in the sales of our boats at the manufacturers' level, and also at the retail level in New York."[7]

Mr. George Jones of the Alabama Independent Automobile Dealers Association submitted a survey of the Association's membership which indicated that the practical impact of the Alabama "Mini-Credit Code" was adverse to both the Association membership and to Alabama consumers.[8] The survey, in Mr. Jones' estimation, tended to show that (i) consumers find it harder to get credit, (ii) there are more frequent credit rejections by banks since enactment of the code and (iii) many of those being rejected are worthy of credit. Mr. Jones concludes, therefore, that such restrictions will deprive "thousands of basically honest and decent" consumers of access to credit.[9]

Many businessmen predicted that damage to their businesses would result from the increased reserve accounts and recourse agreements that banks would require when buying consumer paper from sellers.[10] They argued that financial insti-

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See footnotes at end of chapter.

tutions did not want the responsibility of policing sellers and that sellers would not bear the risks or survive with additional red tape. Other arguments against the rule included the claim that many consumers would stop paying without cause,[11] and that the rule would interfere with free competition.[12] In particular, it was argued that the rule would result in unwarranted hardship for honest small businessmen, who cannot survive without readily available financing.[13]

There was also particular concern expressed for the individual, especially the minority businessman, just beginning a business without a previously established reputation.[14] This problem was discussed by Professor Homer Kripke:

> I must say in all candor that the result of such a rule may be to make it more difficult for dealers to get financing when they are just starting business and have no background or experience to demonstrate that they do and can perform satisfactorily and this is maybe particularly acute in the minority areas where we are making every effort to get started with small business, but here the problem is anyway a problem of subsidization of small business * * *
>
> That relatively narrow problem should not in my opinion be permitted to obstruct what is a very sound reform having much broader implications than the relatively narrow problem of aiding small business.[15]

Representatives of financial institutions made many of these same arguments. They contended that certain banks and finance companies would be forced to leave the consumer credit field; that those who remained would require larger reserve accounts and more stringent recourse agreements; and that these policies would mean increased costs for sellers which would be passed on to consumers. Financial institutions also asserted that they would have to switch to direct consumer loans. This, they argued, would work further hardship on sellers. Finally, in order to meet anticipated demands of consumers, financial institutions suggested that they would have to enter the repair business.

Eugene Hart, Vice President of a Wisconsin Bank, commented on his bank's experience under Wisconsin's administrative rule which eliminates the holder in due course doctrine in home improvement contracts.[17]

> Our main bank, Marine National, had been buying $400,000 a month home-improvement paper. That paper had dropped to $50,000 a month and we are making the fifty in direct loans. Our outstanding home improvement paper seven years ago was $7 million. It's now $3 million.[18]

Mr. Hart felt that banks will have to require large reserves which will decrease working capital and ". . . many will be forced out of business."[19]

Later in his testimony Mr. Hart was asked to elaborate on why there was such a great decline in the amount of home improvement paper accepted. He responded,

> I think there has been a drying up in the business . . . no one in the banking business wants any paper that generates problems. We look to the sellers, the dealers that give us good paper, and if we see any degree of problem, we just don't want them on our books, I think people have gone out of that business. . . . The home improvement business used to be strictly a time-selling business but now those people that remain are pretty legitimate.[20]

See footnotes at end of chapter.

Creditor obligation to police the market. Industry members also asserted that they are in no position to know the status and reputation of retail merchants; that they cannot, realistically, be expected to police retail sellers.[21] This assertion is invalidated by other industry testimony which confirms that the volume of consumer sales-finance transactions is such that creditors have a full opportunity to detect and predict the incidence of consumer sales abuse on a statistically reliable scale.[22]

Additionally, this record reflects the fact that financial institutions have access to a variety of information which yields an accurate and reliable picture of a merchant's reputation. Creditors who finance consumer transactions can and do conduct through background investigations of any merchant negotiating consumer paper. This is true despite the fact that where a creditor occupies the protected status of a "holder in due course", he may look to the consumer debtor for payment notwithstanding seller misconduct.

In this connection, the record contains references to a variety of industry tools. For example, all lenders approved by the Federal Housing Administration to grant home-improvement loans automatically receive a list of individuals and firms which have failed to perform satisfactorily on FHA-insured home-improvement jobs. The list, maintained by HUD-FHA, is called the "Precautionary Measures List".

> The list, which is kept up to date (names are continually added, and deleted if the contractor reforms), has at present [approximately 5000] names of companies [and individuals] for which the FHA refuses to insure loans, on the theory that it has a responsibility to the public not to be a party to deceit. Thus, every lender handing out FHA-insured home-improvement loans knows which home-improvement companies have acted in an unreliable manner and has guideline for its judgments in this area.[23]

Many finance industry witnesses indicated that their companies always screen the paper they purchase.[24]

> We look to the sellers, the dealers that give us good paper; and, if we see any degree of problems, we just don't want them on our books.[25]

With reference to the Wisconsin Consumer Act, Mr. Bill W. Dixon, Vice President of the Wisconsin Installment Bankers Association, responded to the question, "has the Wisconsin law changed your operation in any way?" as follows:

> Not significantly. There are some changes. Quite frankly we always investigated the merchants with whom we do business. We do a little better job now in the area of our credit approval.
>
> There's not been any significant changes at this time, but we are taking a closer look at certain types, I'd say, of marginal credit as a result of the new Act * * *[26]

Richard P. McManus, Assistant Director, Law Department, Household Finance Corporation, testified,

> Other steps we feel [are important] in protecting the consumer are trying to investigate the merchant from whom we purchase contracts.
>
> This is probably a singularly most important aspect. In doing this, we make every effort to be sure that people from whom we buy contracts are ethical, responsible businessmen.
>
> We buy paper only from those that we have personally investigated and our personal investigation goes into such matters as ethics, financial ability, financial capacity, business ability, so forth.
>
> We catagorically reject any merchant that has had substantial and substantiated consumer complaints registered with the Better Business Bureau.
>
> * * * * *
>
> It has been our experience that the best time to resolve complaints is early in the game. After that we maintain complaint records on each merchant with whom we deal and when we find that a merchant has a number of complaints that go unresolved, where there's been misrepresentation, so forth, we terminate our dealing with this merchant.
>
> We think this program of merchant investigation and inspection is effective.
>
> * * * * *
>
> Once we establish an agreement with a merchant about paper, we conclude a financing agreement. United this arrangement we require him to repurchase any contract that relates to merchandise that has been unsatisfactory and not properly resolved.[27]

Alternatives available to creditors. Mr. McManus' final point adverts to a variety of contractual arrangements between creditors and retailers which operate to protect the financial institution in consumer transactions. One such arrangement is a "repurchase" or "recourse" provision in a contract between a retailer and a finance company. Such provisions obligate the retailer to assume full or partial liability for a consumer default on a related credit obligation. While it may be true that even the most conscientious program of screening sellers will not eliminate all risk of seller misconduct, a repurchase agreement of the use of a "reserve" account can protect the financial institution against any risk that remains. In this connection, the Uniform Commercial Code provides:

> any person who transfers an instrument and receives consideration warrants to his transferee . . . that . . . no defense of any party is good against him.[28]

The code thus expressly recognizes and mandates imposition of the assurances Mr. McManus' firm routinely obtains from sellers.

Professor Homer Kripke testified about the use of various recourse arrangements in consumer transactions. His testimony is based on his experiences as counsel for large finance companies.[29]

> Banks and financial companies have frequently urged that freedom from merchandise-related defense is essential for a financial institution, in order that it can service the merchants by acquiring from them the obligations of their customers. In so far as

these arguments rest on purported legal grounds, they seem to be without substance.

Thus, it is publicly argued by a finance company that if consumer installment obligations acquired by it from sellers were subject to consumer defenses, the obligations could not be carried on its balance sheet as assets and this disadvantage would make it impossible for the company to engage in the financing of consumer obligations for dealers. The same company, however, is heavily engaged in factoring, which likewise consists of holding obligations of buyers purchased from sellers (usually in a commercial context). No effort is made in the factoring business to protect the third party from defenses between the original parties by a waiver of defense clause or use of negotiable note, and yet the factoring receivables always appear on the balance sheet of the financing institutions handling them.

Similarly, the banks have sometimes publicly argued that if consumer installment obligations purchased from merchants were subject to defenses, they would not be legal for investment by banks, because they would not be firm obligations. This is specious reasoning, in my opinion. Banks have always discounted negotiable notes arising in merchandise transactions, and have relied on the holder in due course doctrine. That doctrine does not give protection against the "real" defenses of the maker, namely fraud in the factum, infancy, incapacity, duress, illegality including usury, etc. See Uniform Commercial Code Section 3–305 which is in force in nearly every state. This means, therefore, that whenever a bank discounts a note which had its inception between a buyer and a seller, the bank is subject to all the possibilities of holding an unenforceable note arising from usury, fraud in the factum, infancy, etc. Thus, there may be complete legal defenses to the obligation held by the bank, and the proposition asserted that banks may not hold obligations which may be unenforceable would preclude the bank from ever holding notes created by other parties. It obviously is not the law.

Thus the question of additional customer defenses arising from merchandise misrepresentations or breaches of warranty does not involve a basic change in the legal position of the banks, but merely a substantive change in the possible extent of the risks of uncollectibility which they provide for by their reserves for losses.

This brings us to the second and perhaps more significant aspect of the claims of the financial institutions, namely, that they cannot *afford* to handle consumer installment obligations if they are subject to the risks of customer dissatisfaction. I considered this question for many years when I was counsel for a large consumer finance organization and in subsequent years of practice specializing in that field. In 1950 I took the position in the Yale Law Journal that although the holder in due course doctrine was properly applicable in this situation, the question was really of little practical moment—it was much ado about nothing. *Kripke, Chattel Paper* as a Negotiable Specialty, 59 Yale L. J. 1209, 1214–1222 (1950). I was then speaking in the context of the business of a company which prided itself on its reputability and the character of the business it was doing, and would have been quick to refuse to do business with dealers who produced a significant amount of customer dissatisfaction. Subsequently, when the New York statutes [restricting the holder-in-due-course doctrine] were passed, the question arose in that financial organization whether we should insert in our contracts the clause authorized by statute that would invoke the waiver of defense argument. The Vice President then in charge of operations decided, with my advice and concurrence, that the nature of our operations was such that we would not need the protection. That company had long since voluntarily abandoned the negotiable note as a means of obtaining that kind of protection.

I cannot believe that banks do or should do a lesser quality of business than this or are in any greater need for protection from the customers of banking clients. It would be interesting to see whether any bank would so denigrate the quality of its own operations as to submit figures showing that this issue is important in its collections. I have a hunch that the issue will prove to be statistically meaningless for the banks, and rests more on a yearning for clear lawyers' opinions about enforceability than on facts.[20] A bank ought to do no less than a factoring company, namely, to investigate its client's experience with customer claims for adjustment and returns, and to refuse to do business with a merchant whose percentage thereof is too great.

It may be useful to clarify a point here. Some endorsements of negotiable notes by merchants for the sale of customer obligations to banks are 'without recourse'. Likewise, in the factoring business, which involves the sale of non-customers' obligations to the factor is done 'without recourse'. These terms do not mean that as between the financing institution and the merchant, the financing institution assumes the risk of customer dissatisfaction. The underlying agreements always contain a warranty by the merchant to the institution that the customer has received and has accepted the goods and has no claim with respect thereto; therefore if the customer does have a claim that a warranty was breached, the financing institution does have recourse against the merchant. This problem, therefore, can arise as ultimately significant only in cases where the merchant has become insolvent and the question is whether the customer or the financing institution must take the loss. Even with an insolvent merchant the financing institution frequently need not take the losses, because many financing arrangements involve the withholding from the merchant, exactly for this purpose, of a portion of the purchase price paid by the financing institution to the merchant for the customer obligation. In any event, the bank is in a far better position than the customer to determine whether a merchant is insolvent and is likely to be in a position where he cannot honor his warranties and representations as to the merchandise sold.

This problem has become acute as the installment credit system has moved from reputable merchants and financing institutions serving middle-class customers into the poverty areas where needy and ignorant customers are preyed on by disreputable merchants. In this context my assertion of 1950 that the problem is unimportant factually no longer holds true.

The question is whether banks and other financial institutions are going to make available an immunity in a third-party position to support business operations which inflict severe monetary damage and other distress on ignorant weak people by disreputable means. The only effective means of control of these merchants is by making it the interest of the financing institutions to deal only with reputable merchants. This can be done only by abolishing the financing institutions' opportunity to get free of merchandise defences. The banks ought to be ashamed of arguing that they are serving merchants whose injuries to their customers are so substantial as to constitute a significant impairment of the collectibility of the obligations."

Commission resolution of cost and supply questions. As noted earlier in this chapter, one of the major points in opposition to the rule concerned anticipated adverse effects on the cost of supply of consumer credit. In considering this issue, the Commission has carefully reviewed the material in the public record, especially the testimony of law enforcement officials and other witnesses from those jurisdictions which have enacted or adopted effective statutory restrictions upon the holder in due course doctrine and other cutoff devices.[21] Additionally, the Commission has reviewed the comprehensive work of the National Commission on Consumer Finance on this specific issue[22] and has noted the testimony of representatives of the NCCF staff on the record for this proceeding.[23]

When the initial proposal in this proceeding was published, relatively little "hard evidence" or economic data was available concerning the demonstrated impact of legislative efforts aimed at restriction of the holder doctrine and other cutoff devices. The only evidence available at the time was ambiguous data drawn from the State of Connecticut.[24]

In the course of this proceeding the Commission has received considerable testimony concerning the impact of emerging state legislation similar to the rule. Almost without exception it supports the finding that there has been little, if any, negative impact from such legislation.[25] This conclusion was advanced by industry witnesses and was implicit in their assessment of the impact of laws in states with which they were familiar.[26] For example:

> It is fair to say then—let's narrow it to your experience in California . . . —that by and large the holder in due course doctrine is a dead letter, and that as a matter of fact financial institutions are still flourishing?
>
> Mr. Smith: They are flourishing . . .
>
> The bank financing of automobiles is expanding.
>
> * * * * *
>
> I don't think the Rees-Levering [Act] change has persuaded any banks to get out of the automobile financing business.[27]

Consumer witnesses made similar assertions. Blair Shick, Legislative Coordinator of the National Consumer Law Center, Boston, testified as to the Massachusetts experience.

> In Massachusetts, for example, it was the first state to abolish holder-in-due-course in a comprehensive sense through consumer transactions. There is absolutely nothing to indicate that as you compare Massachusetts with, say, Connecticut, a very analogous state, that anything has changed, that there was a need to change the rate structure, that people in Connecticut that are low income people are getting credit that aren't in Massachusetts. There was just no evidence of that.
>
> * * * * *
>
> The Massachusetts banks have a—almost a decade of experience. They don't come forward with their internal data. We can only look at the external and say it doesn't happen, it's never happened, that restricting one of these remedies or applying it here against a holder in due course has made any meaningful difference at all in availability of credit or the price of credit.[28]

See footnotes at end of chapter.

Finally, these facts were also confirmed by State law enforcement officials based on their experiences.

Richard Victor, Assistant Attorney General, Wisconsin Department of Justice, said:

We are very fortunate in Wisconsin in that the problem which is dealt with by your proposed rule has been covered in depth by the Wisconsin Consumer Act.

The Wisconsin Consumer Act prohibits negotiable instruments in consumer credit sales transactions as well as interlocking loan.

These interlocking loans are substantially the same by definition as your related provisions.

The Act also provides that waiver of defense clauses are ineffective for the first 12 months following assignment ...

It is clear that in the Wisconsin Consumer Act and yours as well fills an urgent need without unduly burdening the businessman.[39]

A nationwide survey conducted by the National Commission on Consumer Finance provides the most authoritative evaluation and prediction of expected impact of this rule.[40] It supports the assertion that this rule will not unduly burden business or consumers. Douglas F. Greer, Professor of Economics at the University of Maryland, and formerly Economic Consultant to N.C.C.F., discussed his work in this area during hearings on the rule.

The second major part of my testimony relates to our attempt to ... determine the extent to which credit availability would be reduced or interest rates affected by abolishment of these two remedies.

* * * what we do with the econometrics * * * is to attempt to isolate the effect of one variable by holding the influence of all relevant variables constant, and in that way we can estimate the impact of one variable, a dependent variable, such as extensions of credit or interest rates.

And this is basically the way we attempted to treat the matter here.

* * * the observations in terms of denial of these remedies was in terms of those states that have prohibited both waiver and holder * * *

* * * it can be concluded that denial of these remedies is likely to reduce credit availability of one particular type . . . That is: installment credit written at the retailer * * *[41]

Professor Greer predicted a reduction in the amount of credit extended in connection with certain consumer sales transactions in the neighborhood of 5 to 10 percent.[42] This suggests a very slight impact is likely from restrictions on cutoff devices in consumer sales. A finding that this rule may marginally reduce the aggregate amount of sales-related credit which is extended is not a persuasive argument against its adoption.[43]

Elimination of cutoff devices in consumer transactions should have the effect of causing creditors to be reluctant to finance transactions with merchants who engage in disreputable or unethical sales practices. Predatory merchants will thus find it more difficult to obtain a line of credit. At present, sellers are in a position to unload paper rapidly to willing acceptance creditors, leaving the creditor to worry about collection. The creditor, in turn, need not concern himself about abusive sales practices. He may rely on his statutory or contractual insulation from the seller in the event that a dispute arises in the process of collection.

An excellent example of such conditions and their adverse impact is afforded by the Monarch Construction case in the District of Columbia. Monarch Construction promised home improvements to owners of rowhouses in lower-middle income and lower income areas of the city. In return they took promissory notes which represented staggering consumer indebtedness—often many times the annual income of the maker. The promised home improvements were usually never undertaken; if begun, they were not completed. Had the promised work been done, its acknowledged value would have been far less than the indebtedness incurred.

Had this rule or a similar state statute been in effect, Monarch Construction Company would have been an obvious "reduction" in the amount of aggregate consumer credit outstanding in the District of Columbia. However, this reduction would not necessarily have included all of the potential demand for home improvement work that was ultimately absorbed by Monarch. It is reasonable to expect that those of Monarch's customers who really needed home improvement work, and reached this conclusion without the help of the high-pressure sales tactics which characterized the Monarch operation,[44] could and would have sought financing for legitimate contracts executed with reputable firms. The evidence that a reputable firm would have charged far less than Monarch, for vastly more comprehensive work. It should be clear that the reduction in outstanding credit occasioned by the application of the proposed rule to a Monarch-like seller reflects both social utility and an improvement in the financial situation of individual consumers.

Let's suppose that abolition of the rule dries up the credit to the "food-freezer-racket" operator. This is the fellow who unloads freezers having a retail value of not more than $300 at a price of $900 to which he adds interest, insurance, and other charges. I think we should ask "Who needs that kind of credit?" We should ask the same question if we should find that the rule dries up credit to the seller of shoddily made sewing machines at outrageously high prices. We can also do without the credit that enables the home improvement swindler to move with the good weather up and down the East Coast.[45]

During these proceedings proponents from many of the jurisdictions which have enacted legislation similar to the rule indicated that no significant increases in cost or decreases in availability had been observed. They also pointed out that consumers in all economic classes have been harmed by application of the cutoff devices the rule will prohibit. We believe that the benefits to consumers occasioned by this rule vastly outweigh predicted impact on credit or supply.

Readily available credit from a fly-by-night salesman who does not deliver the goods or perform as promised does not benefit consumers. The record contains hundreds of examples of this type of transaction. We agree with the many proponents of the rule who stated that honest merchants, financial institutions and consumers alike will benefit by state and federal regulation which restricts the operation of predatory sellers.

The record of this proceeding shows that the inequities of the present system will be eliminated if a greater responsibility is placed upon the financial institutions to police the merchants with whom they deal. The costs associated with this rule will be shared by banks, other financial institutions, sellers, and ultimately consumers. Witnesses in support of the rule frequently likened increased costs to "insurance premiums" paid to obtain a general improvement in retail sales practices.

The industry argument that credit should be made available to marginal risks by retention of cutoff devices was uniformly rejected by proponents of the rule. If methods to extend availability of credit need to be found, they should be undertaken as an affirmative effort to develop innovative new programs, such as establishing incentives for reputable "general market" retailers to extend credit to the working poor or to open branches in low-income neighborhoods so that the poor might have access to quality goods at competitive prices. The solution to the problem does not lie in continuing a credit practice which has been shown to be injurious to all consumers.

Finally, the record reflects little likelihood of any significant impact on interest rates. This fact is confirmed by witnesses from reform states. It is also confirmed by the work of Dr. Greer and the NCCF, as Dr. Greer testified:

The second major part of my testimony relates to our attempt to * * * determine the extent to which credit availability would be reduced or interest rates affected by abolishment of these two remedies * * *

Finally, we attempted to estimate the effect of denial for the interest rate on such credit; that is, credit extended at the retailer's and we find that the interest rate is reduced slightly as a result of abolishment of these remedies, the interest rate charged to the consumer and also the net interest rate earned by financial institutions buying this credit paper.

The retailer's participation does not seem to be affected; it is only the net rate earned by the financial institution and the consumer rate.

Now, I think that this result is due to the fact that with abolishment of these provisions there is a change in the quality of the credit and also the risk burden borne by the financial institution, such that with the lower risk burden borne by the financial institution the rates of charge are going to be lower.[46]

We conclude this discussion with reference to the testimony of Thomas Tahnk, Supervisor of Consumer Credit for the Minnesota Department of Commerce. It summarizes many of the concerns raised in the course of proceedings on this rule.

See footnotes at end of chapter.

Information for this statement was gathered from a cross section of all licensed financial institutions and from consumer protection groups both in and outside of government.

The State of Minnesota enacted a law in 1971 similar to the proposed trade rule dealing with intra-state transactions.

To the extent that our two years of experience under the Act might provide some indication of its probable impact on the nation as a whole we would like to summarize the Act, its impact on our economy and its shortcomings.

We feel that the proposed trade rule will address itself on a national level to basically the same problems that our law deals with on the local level. We view the proposed trade rule as a companion to rather than a substitute for our law.

* * * * *

The real impact seems to have been on the smaller finance companies serving the lower middle class and poor areas. Such residents were unable to obtain bank financing—not because it wasn't desirable—they just didn't qualify. So they financed their purchases from car jockeys, bait and switch sewing machine companies and secondhand appliance dealers through local finance companies. Transactions were handled on both conditional sales contracts and loans through related creditors. These companies did employ the holder in due course doctrine on a regular basis.

The Legal Aid Society and Better Business Bureaus report that the new law has been very effective in persuading used car dealers that a $900 used car should have more than a five minute warranty; in convincing used furniture dealers that a sofa sits better with four legs; and that the stereo really isn't "free" when one has to purchase 50 record albums at $7.95 a piece. Reputable finance companies, out of economic necessity, were forced to carefully select their dealers.

Has the law hurt business?

Is it harder for the poor to obtain sufficient credit?

We don't think so.

Finance companies are out daily beating the pavement searching for good dealers; they find that there's never enough.

Legal Aid attorneys attempting to unweave the financial messes of their clients report that there is more than adequate credit available.

We conclude that the new law has helped those it was intended to help and has not, as was first feared, acted as a damper on the economy.

Minnesotans have lived under the Act for almost two years. From our vantage point, we feel that the Act has been good for the state, both its consumers and its businesses. None of the dampening effects on our economy that were feared have occurred.

We in Minnesota support the adoption of the proposed trade rule.[47]

B. Opposition based on related developments in the field. In the original proceeding, many parties urged that the Commission withhold action until the report of the National Commission on Consumer Finance was completed and published.[48] That report was released in January, 1973.[49] Among the recommendations are proposals to abolish the holder in due course doctrine and waivers of defenses, and to sharply restrict vendor-related loans.[50]

In the reopened proceeding, the Commission was urged to wait at least four years from the date of the NCCF report, in order that the individual states might have an opportunity to enact the NCCF recommendations.[51] Additionally, it was pointed out that the recommendations of the NCCF were intended to be considered as a comprehensive proposal which ought not to be acted upon piecemeal.[52]

See footnotes at end of chapter.

The Commission does not agree that the restrictions embodied in this rule cannot be enacted as an independent regulation, separate and apart from the comprehensive, large-scale changes recommended by the NCCF. Many states have legislated restrictions similar to this rule without undertaking concurrent changes in the interest rate ceiling or other aspects of consumer finance. In addition, the Commission notes that NCCF statistics strongly suggest that alteration of rate ceilings is *not* necessary when considering a restriction of third party cutoff devices.[53]

The Commission has therefore determined that further delay in restriction of devices which serve to cut off consumers' defenses against third party financers is not warranted.

State action: Many states have acted in some manner to alter or eliminate the traditional holder in due course and waiver of defense doctrines as applied to consumer installment sales. The question thus arises whether state action has made Commission action unnecessary. In general, industry representatives said yes[53] and consumer representatives said no.[54] After careful review of the statements in the record and existing state legislation the following observations can be made.

(a) Of all the states that have legislated, only a few have enacted a comprehensive measure.[55] Some states have abolished either the holder in due course doctrine or waiver of defense clauses, but not both.[56] Many states have not dealt with the problem of the vendor-related loan.[57] In other states, major exceptions or exclusions are contained in the legislation, or the statute applies to only one type of transaction, e.g., automobile sales, home solicitation sales, home improvement sales, to the exclusion of others.[58] These partial limitations do not reach the full extent of the problem.[59] (b) Consumer representatives noted on the record, that in states that have not acted, the opponents of consumer credit reform are so strong that no statute is likely to pass.[60]

(c) The considerable number of interstate consumer credit transactions which may elude even the most comprehensive state statutory protection[61] will be affected by this Rule.

(d) Proponents of the rule emphasized a need for uniformity of protection. They believe that a comprehensive trade regulation rule, uninfluenced by local pressure, would be a major step in achieving this goal.[62]

(e) While a growing number of state courts have held application of holder in due course or waiver of defenses to be unconscionable when applied in consumer transaction,[63] such decisions are not comprehensive in effect. Judicial relief requires more time and money than most consumers can afford and it is only available in the most extreme cases.[64]

For these reasons the Commission concludes that this Rule will serve as a model for further state legislation and give states which lack legislation impetus to act.[65] The argument that the Commission must always "wait for others to act" is not a persuasive one. Further delay of this measure would be inappropriate and unjustified.

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[1] Chapter VIII and Appendix.

[2] *E.G.*, Robert Doyle, Tr. 116, David Gezon, Tr. 1273; Louis Gross, II, Jr., Texas Independent Automobile Dealers Association, R. 53; Marvin G. Levin, President, Professional Remodelers Association of Greater Chicago, R. 1364.

[3] *E.g.*, Ira J. Lefton, Tr. 668; Warren J. McEleney, Tr. 1284; Robert Serafine, Tr. 1089; Leonard M. Cohen, General Counsel, Independent Finance Association of Illinois, R. 1376.

[4] E.g., Eugene W. Hart, Tr. 694; James J. Schintz, Texas Independent Auto. Dealers, R. 55; Michael Larson, Marine National Exchange Bank of Milwaukee, R. 58.

[5] E.g., David Gezon, Tr. 1274; Louis Gross, Tr. 385; J. Manly Head, Tr. 1140; Warren J. McEleney, Tr. 1288; Leonard Cohen, R. 1377; Jack S. Watson, Pennsylvania banker, R. 372.

[6] Tr. 1279.

[7] R. 370.

[8] R. 6011–6048.

[9] Tr. 1502.

[10] See notes 4 and 5, *supra*. Also, Ira J. Lefton, Tr. 668; E. D. Cartwright, Pennsylvania banker, R. 88.

[11] David Gezon, Tr. 1277; Ira J. Lefton, Tr. 685; L. A. Roseberry, Tennessee banker, R. 67; Leonard Cohen, R. 1377.

[12] R. 55.

[13] *E.g.*, George Jones, Tr. 1507–09.

[14] *E.g.*, Robert Doyle, Tr. 1137; Helen Nelson, Tr. 720.

[15] Tr. 549–50; see also Helen Nelson, Tr. 720.

[16] Jack Watson, Pennsylvania banker, R. 372.

[17] Wisc. Ann. Code 110.3 (1970).

[18] Hart, Tr. 695.

[19] Tr. 696.

[20] Tr. 705–706. Mr. Hart also attributed some of the decline to the 3-day cooling-off period requirement. Finally, when asked whether National Marine Bank's drop from $400,000 to $50,000 was due primarily to Wisconsin's restriction on the holder-in-due-course doctrine (promulgated one year before the hearings), Mr. Hart responded, "Well, this has been over a period of ten years. There's been a gradual diminution" (Tr. 710).

[21] *E.g.*, Tr. 387–390 Louis Gross, Boulevard Loan Company, New Jersey: Tr. 1272 (David Gezon, Volkswagen American Dealers Association); R. 81 (Cessna Finance Corp.); R. 1377 (Independent Finance Association of Illinois); R. 1640–41 (Richard P. Schaumann for Indiana Automobile Dealers Association); 1651–53 (Robert Holland, Ohio National Bank of Columbus); R. 1660–61 (Connecticut Credit Union League, Inc.); R. 1667–69 (Keith Nelson for Mercantile Credit Corp.) "The burden of such policing is really tremendous * * *;" R. 1703 (Don H. Reavis for bank of the Southwest, Amarillo, Texas); R. 1707 (Roland Bartson, Bell Federal Savings, Chicago); R. 1912 (Consumer Bankers Association), R. 2524 (John F. Cline, Minneapolis).

[22] *E.g.*, Hart, Tr. 691; Gross, Tr. 382; Doyle, Tr. 1108.

[23] Magnuson and Carper, *The Dark Side of*

the Marketplace 86 (1968). Information [in brackets] updated to June, 1972, by interview with Mr. Stansbury of the Property Improvement Office of FHA, by telephone, June 28, 1972. At the time the quoted material was written (1968), the number of firms on the Precautionary Measures List was "over 7,000". The number declined by approximately 30% over the years 1968-72, which period also marked a time of significant activity in the legislatures of about twenty states in enacting restrictions upon the holder in due course doctrine. Indeed, many of the statutes are specifically aimed at home improvements.

[24] *E.g.*, Hart, Tr. 705; Robert B. Evans, National Consumer Finance Ass'n., Tr., 1709; Richard P. McManus, Household Finance Corp., Tr. 2024; Bill W. Dixon, Wisconsin Installment Bankers Ass'n., Tr. 2154.

[25] Eugene W. Hart, Vice President, Marine National Exchange Bank, Milwaukee, Tr. 705.

[26] Tr. 2154-55.

[27] Tr. 2024-2025.

[28] UCC 3-417 (2) (d). The comment to this provision states: "The position is taken that the buyer does not undertake to buy an instrument incapable of enforcement, and that in the absence of contrary understanding the warranty is implied. Even where a buyer takes as a holder in due course who will cut off the defense, he still does not undertake to buy a lawsuit with the necessity of proving his status." Of course, the mere existence of this warranty makes it harder for consumers to defeat "holder" status.

[29] Tr. 427.

[30] [Statistics assembled by the National Commission on Consumer Finance confirm Prof. Kripke's assessment. See National Commission on Consumer Finance, "Consumer Credit in the United States" 36 (1972).]

[31] *E.g.*, Eugene W. Hart, Tr. 691; Prof. William F. Willier, Tr. 1033; Lawrence R. Buxbaum, Attorney General's Office, Commonwealth of Massachusetts, Tr. 1300; Jim Smith, Senior Vice President, Security Pacific National Bank, California, Tr. 1437; Robert B. Evans, Maryland, Tr. 1707; John S. Hinckley, National Automobile Dealers Association (Utah), Tr. 1794; McManus, Tr. 2023-47; Larson, Tr. 2123-45; Bill W. Dixon, Tr. 2145-60; Richard Victor, Assistant Attorney General, Wisconsin Department of Justice, Tr. 2173-2181.

[32] Alan R. Feldman and Douglas Greer, "Creditors' Remedies and Contractual Provisions: A Legal and Economic Analysis of Consumer Credit Collections", Volume V of the National Commission on Consumer Finance Studies, summarized in Consumer Credit in the United States, Report of the National Commission on Consumer Finance, pp. 34-38 (Washington, 1972), hereafter cited "NCCF Report".

[33] Milton W. Schober, General Counsel, Douglas F. Greer, Economic Consultant, NCCF.

[34] Note, "A Case Study of the Impact of Consumer Legislation: The Elimination of Negotiability and the Cooling-Off Period," 78 *Yale L. J.* 613 (1969), where, at p. 655, it is concluded from the study that

"Eliminating negotiability makes fraudulent dealers bad credit risks, and thus induces financial institutions to be reluctant to take their notes. The findings of this study suggest that financiers impose important new restrictions on dealers which should reduce the extent of fraud in sales. On the other hand, the conservative reaction by most banks and finance companies to the elimination of negotiability in Connecticut has created another cost—widespread difficulty in marketing consumer paper. This apparent overreaction has resulted in higher charges to consumers and damage to legitimate businessmen. Whether these costs more than offset the benefits from restrictions designed to penalize fraudulent dealers is impossible to calculate exactly."

[35] See notes 36-42(a) *Infra.*

[36] *E.g.*, Hart, Smith, Evans, Hickley, McManus, Larson, Dixon, note 31, *supra.*

[37] Jim Smith, Senior Vice President, Security Pacific National Bank, San Francisco, Tr. 1465-6.

[38] Tr. 1757-1758.

[39] Tr. 2174-756.

[40] NCCF Report, p. 36.

[41] Tr. 1594-95.

[42] Tr. 1595.

[43] It is significant that the N.C.C.F. recommended imposition of restrictions analogous to those contained in this rule, despite the predicted marginal diminution in aggregate credit. See N.C.C.F. *Report* at pages 34-38.

[44] *Not With A Gun*, Jean Carper (NY 1973).

[45] Fairfax Leary; R. 2073-2074.

[46] Tr. 1594, 1596.

[47] Tr. 2197-2200, 2203.

[48] *E.g.*, Paul Daniel, Tr. 1252; Virginia H. Knauer, Tr. 900; Robert Serafine, Tr. 1034; Jim Smith, Tr. 1105; David C. Todd, Tr. 1180, American Industrial Bankers Association, R. 29.

[49] National Commission on Consumer Finance, "Consumer Credit in the United States" (Washington, 1972).

[50] *Id.* at 34-38.

[51] *E.g.*, Milton W. Schober, Tr. 1617.

[52] Schober, Tr. 1616; Morris, Tr. 1701.

[53] See the testimony of Dr. Greer cited in footnote 46.

[53a] E.g., Paul Daniel, Tr. 1253; Robert Doyle, Tr. 1109 1124; Louis Gross, Tr. 383; Eugene Hart, Tr. 694, 697; J. Manley Head, Tr. 1139-40; Warren J. McEleney, Tr. 1282, 1286; Robert S. Olson, Tr. 954, 960; James Schintz, Pennsylvania Independent Automobile Dealers Association, R. 55; Michael J. Larson, Marine Nat'l. Exchange Bank, Milwaukee, Wisconsin, R. 59.

[54] E.g., Ruth Charney, Tr. 459; Betty Furness, Tr. 34-35; Lester S. Goldblatt, Tr. 469; Virginia Knauer, Tr. 901; Fairfax Leary, Jr., Tr. 970; Bess Myerson, Tr. 365; Fred Speaker, Tr. 1027; David Swankin, Tr. 1372; William F. Willier, Tr. 1034, 1041; Robert Wagman, Chairman, Sandon Members United to Act, St. Louis, R. 1250; Robert Hadler, Legal Assistance Foundation of Champaign County, Illinois, R. 1294.

[55] E.g., Massachusetts, New York, New Jersey, Wisconsin. Interaction between statutory and decisional law probably makes California eligible for this list as well. The limited time that legislation has been effective in other jurisdictions makes evaluation difficult.

[56] E.g., Connecticut, Mississippi, Nevada, Texas, New Mexico.

[57] Massachusetts, New York, Maryland and the District of Columbia have explicitly closed this loophole.

[58] E.g., In California, the statute with the strongest protection excludes motor vehicle and home improvement sales; Connecticut (statute applied only to home solicitation sales); Delaware (excludes motor vehicle and home repair sales).

[59] Prof. Homer Kripke, Tr. 439; Robert S. Powell, Tr. 297.

[60] *E.g.*, Wilbur Leatherberry, Tr. 1016; Wagman, Tr. 609; William Willier, Tr. 1034.

[61] The following witnesses testified that transactions often involve an out-of-state party; Jack Eisendrath, Tr. 831; Julia Fuller, Tr. 929; Anthony Martin-Trigona, Tr. 910; Dennis J. Roberts, II, Tr. 420; Alan Sims, Tr. 214. See also note 67, *supra* p. 49.

[62] Dean W. Determan, Tr. 1006; Betty Furness, Tr. 42; Lester S. Goldblatt, Tr. 468-69; Howard I. Kaufman, Tr. 505; Virginia H. Knauer, Tr. 900; Homer Kripke, Tr. 440; Fairfax Leary, Jr., Tr. 970; Bess Myerson, Tr. 365; Helen Nelson, Tr. 721; Sarah H. Newman, Tr. 998; Edwin Palumbo, Tr. 413; Fred Speaker, Tr. 1027; Eve Widows, Tr. 94; William Willier, Tr. 1035; Views of the Atlanta Legal Aid Society, Tr. 23.

[63] E.g., Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967); Commercial Credit Corp. v. Childs, 199 Ark., 1073, 137 S.W. 2d 160 (1940); Commercial Credit Corp. v. Orange County Mach. Works, 34 Cal. 2d 766, 214 P. 2d 819 (1950); Mutual Fin. Co. v. Martin, 63 So. 2d 65 (fla. 1953). Fairfield Credit Corp. v. Donnelly, 264 A.2d 547 (1969); Geiger Finance Co. v. Graham, 123 Ga. App. 771, 182 S.E. 2d 521 (1971).

[64] Judge Arthur Dunn, Tr. 770; Benny L. Kass, Tr. 1219; Homer Kripke, Tr. 438; Fairfax Leary, Jr., Tr. 969; Wilbur Leatherberry, Tr. 1016; Steven Mindell, Tr. 24; Agnes Ryan, Tr. 558; Alan Sims, Tr. 218.

[65] Many witnesses agree that a trade regulation rule would encourage rather than discourage further state action. E.g., Barbara Flicker, Tr. 407; Betty Furness, Tr. 32; Benny L. Kass, Tr. 1206; Steven Mindell, Tr. 29; Helen Nelson, Tr. 721; Stephen Schlossberg, Tr. 862; David Swankin, Tr. 1372; Cf. Robert S. Olson, Tr. 952; Rex Carpenter, Tr. 848, 852.

CHAPTER VII. WHAT THE REVISED RULE DOES AND WHY

Part One. *The purpose of this rule.* The Commission believes that it is an unfair practice for a seller to employ procedures in the course of arranging the financing of a consumer sale which separate the buyer's duty to pay for goods or services from the seller's reciprocal duty to perform as promised. The Commission's rulemaking procedures, which encourage broad participation on the part of interested parties and which result in a bright-line standard of conduct in appropriate cases, serve the three-fold interest of clarity, uniformity, and fairness to the regulated industry.[1] For this reason, where a Trade Regulation is found to be necessary and appropriate, any final rule must be as concise and straightforward as possible.

The final revisions of this rule reflect modifications for concision and coverage. As revised, the rule will prevent sellers from foreclosing consumer equities in credit sale transactions. It will prevent the use of direct-loan financing to accomplish the same end.

Policy considerations. In promulgating this rule for enactment the Commission has considered and resolved a variety of policy considerations. We will discuss these considerations here to place this rule in perspective.

Our primary concern, in the course of these proceedings, has been the distribution or allocation of costs occasioned by seller misconduct in credit sale transactions. These costs arise from breaches of contract, breaches of warranty, misrepresentation, and even fraud. The current commercial system which enables sellers and creditors to divorce a consumer's obligation to pay for goods and services from the seller's obligation to perform as promised, allocates all of these costs to the consumer/buyer. Consumers are generally not in a position to evaluate the likelihood of seller misconduct in a particular transaction. Misconduct costs are not incorporated in the price of the goods or services, nor are they reflected in any deferred payment

See footnotes at end of chapter.

price or unpaid balance of a sales-related loan. Seller misconduct costs are thus externalized in a way that renders many sales finance transactions inherently deceptive and misleading. In addition, to the extent that consumers are also compelled to bear the costs occasioned by the misconduct of another, while the "guilty" party avoids all liability, we believe that reliance on contractual foreclosures of equities in consumer transactions constitutes an unfair practice under Section Five of the F.T.C. Act.

The Commission believes that only when prices approach or approximate real social costs do consumer choices in the market tend towards an optimal allocation of society's resources.[2] Our objective then, in this rule, is two fold. First we would employ our remedial authority to modify existing commercial behavior such that the costs occasioned by seller misconduct in the consumer market are reduced to the lowest possible level in the retail distribution system. Second, where certain seller misconduct costs cannot be eliminated from the market we would require that such costs be internalized, so that the prices paid by consumers more accurately reflect the true social costs of engaging in a credit sale transaction.[3]

In the preceding chapters, we have discussed the nature and extent of seller misconduct costs which are allocated in all or part to consumers by means of discount financing and direct loan financing. We have also discussed the reasons why the current commercial system has these effects. Consumers are not in a position to police the market, exert leverage over sellers, or vindicate their legal rights in cases of clear abuse. The sheer expense of obtaining an accurate assessment of the likelihood of seller misconduct in a particular case are prohibitive. High-pressure sales tactics combined with documented misrepresentations in many lines of retail endeavor further reduce the likelihood that an individual buyer can successfully weigh the probability that a given transaction will spawn a claim or defense. Redress via the legal system is seldom a viable alternative for consumers where problems occur. Delays combine with the unpredictable results produced by the legal system to often result in increased harm for the consumer litigant.[4] Where a seller is sued, the consumer must undertake the further risk that his defendant will prove insolvent or unavailable on the day of legal reckoning.[5]

This rule approaches these problems by reallocating the costs of seller misconduct in the consumer market. It would, we believe, reduce these costs to the minimum level obtainable in an imperfect system and internalize those that remain.[6] As a practical matter, the creditor is always in a better position than the buyer to return seller misconduct costs to sellers, the guilty party. This is the reallocation desired, a return of costs to the party who generates them. The creditor financing the transaction is in a better position to do this than the consumer, because (1) he engages in many transactions where consumers deal infrequently; (2) he has access to a variety of information systems which are unavailable to consumers; (3) he has recourse to contractual devices which render the routine return of seller misconduct costs to sellers relatively cheap and automatic; and (4) the creditor possesses the means to initiate a lawsuit and prosecute it to judgement where recourse to the legal system is necessary.

We believe that a rule which compels creditors to either absorb seller misconduct costs or return them to sellers, by denying sellers access to cut-off devices, will discourage many of the predatory practices and schemes discussed above in Chapter III. Creditors will simply not accept the risks generated by the truly unscrupulous merchant. The market will be policed in this fashion and all parties will benefit accordingly. Where applicable economies militate against a creditor effort to return misconduct costs to a particular seller, due to the limited or irregular nature of such costs, the rule would require the creditor to absorb such costs himself. That is, where a consumer claim or defense is valid, but limited in amount, a creditor may choose to accept less payment from the consumer to save transaction costs associated with pursuing the seller whose conduct gave rise to the claim. The creditor may also look to a "reserve" or "recourse" arrangement or account with the seller for reimbursement. In such cases, the price of financing will more accurately reflect the actual costs of sales finance.

In cases where "repurchase" or "reserve" contracts, or other recourse devices available to creditors, facilitate the return of an account to a seller, or whenever serious harm is occasioned by seller misconduct, the creditor will compel the seller to carry the costs so occasioned. Again, the result will be a more accurate price for consumer goods.

The Commission, in adopting this rule, is mindful of the fact that a regulation which requires creditors to either absorb seller misconduct costs or return them to sellers, may have the effect of imposing some buyer misconduct costs on sellers too. This could occur where a repurchase contract facilitates the discarding of bad debts by returning them to the seller who generated them. It is probably true that creditors are more efficient collectors of bad debts than are sellers. Thus, a system which engenders an increase in the number of bad debts sellers must collect may yield a slight reduction in efficiency with respect to "consumer misconduct" costs.

We are persuaded that such diseconomies will be substantially outweighed by the benefits which will attend a reorientation which causes the market to absorb seller misconduct costs. Creditors and sellers are in a position to engage in meaningful, arms-length, bargaining over the terms contained in recourse arrangements. The Commission has received substantial evidence that such agreements are routinely employed in sales-finance transactions, and that the provisions contained therein can be tailor-made to the needs of both parties. Such recourse contracts between sellers and creditors are constantly refined by the development and modification, based on experience, of reserve accounts which allocate risk and liability between the parties to correspond with actuarial assessments of risks.[7]

Section five of the F.T.C. act and the externalization of seller misconduct costs. The policy considerations discussed immediately above underpin our conclusion that the use of promissory notes, waivers of defenses, and vendor-related loan financing to foreclose consumer claims and defenses in credit sale transactions constitutes an unfair practice under 15 U.S.C. 45, as amended. It is unfair to subject an innocent party to costs and harm occasioned by a guilty party. Consumers are clearly injured by a system which forces them to bear the full risk and burden of sales related abuses. There can be little commercial justification for such a system. The desired reallocation of cost and risk will both reduce the costs of seller misconduct in the marketplace and return the residuum to the guilty parties. Consumers and honest merchants will benefit, as prices come to reflect actual transaction costs and honest merchants no longer need compete with those who rely on abusive sales practices.[8]

In announcing this rule, we are pursuing our statutory mandate to identify and prevent unfair or deceptive practices in the marketplace. This authority has been analogized by the United States Supreme Court to the jurisdiction of a commercial equity court.[9] We have thus weighed competing equities in the market in reaching our conclusion that the mechanical abrogation of consumer claims and defenses is unfair to consumers. We conclude that a consumer's duty to pay for goods or services must not be separated from a seller's duty to perform as promised, regardless of the manner in which payment is made. In reaching this conclusion we note thousands of instances, documented in the record of this proceeding, where the separation of what are normally regarded as reciprocal duties caused substantial injury to consumers. The common sense shock articulated by many of the consumer witnesses upon learning that their duty to repay a creditor was totally unrelated to their seller's promises is perhaps the clearest and most direct evidence of the injurious and distorted impact of the challenged practices.

Section Five of the FTC Act and Contracts of Adhesion. Furthermore, the Commission concludes that the economic injury to consumers discussed herein above results from terms contained in form contracts. Consumer witnesses and the many legal services groups who participated in the proceeding indicated repeatedly that promissory notes and waivers of defenses are inserted as boilerplate in installment agreements. They also stated that consumers rarely comprehend the significance of these devices at the time when the transaction is con-

See footnotes at end of chapter.

summated. Our detailed findings in this connection are set forth in Chapter III.

It is clear from the poll conducted by the Office of Economic Opportunity, and from statistics submitted by consumer groups and legal services offices, that the externalization of seller misconduct costs which causes substantial consumer injury is a function of an adhesive bargaining process. Promissory notes and waivers of defenses are presented to consumers on a take it or leave it basis. These contracts are drafted by sellers and creditors and they are not susceptible to modification at the point of sale.

The Commission believes that relief under Section five of the FTC Act is appropriate where sellers or creditors impose adhesive contracts upon consumers, where such contracts contain terms which injure consumers, and where consumer injury is not off-set by a reasonable measure of value received in return. In this connection, the Commission's authority to examine and prohibit unfair practices in or affecting commerce in the manner of a commercial equity court is appropriately applied to this problem.[9a] Where one party to a transaction enjoys substantial advantages with respect to the consumers with whom he deals, it is appropriate for the Commission to conduct an inquiry to determine whether the dominant party is using an overabundance of market power, or commercial advantage, in an inequitable manner.

We have conducted the contemplated inquiry in this case. We have reached a determination that it constitutes an unfair and deceptive practice to use contractual boilerplate to separate a buyer's duty to pay from a seller's duty to perform. We are persuaded that this bifurcation of duties with its attendant externalization of costs injures both consumers and the market. We know of no substantial benefits which may be received by consumers in return for the valuable legal rights they are compelled to relinquish. We can imagine no reasonable measure of value which could justify requiring consumers to assume all risk of seller misconduct, particularly where creditors who profit from consumer sales have access to superior information combined with the means and capacity to deal with seller misconduct costs expeditiously and economically.

Our findings with respect to the use of vendor related loans to separate a consumer's duty to pay from his seller's duty to perform are detailed in Chapter IV. We are of the view that the use of direct loan agreements is no less adhesive than the use of installment sales contracts which incorporate waivers or promissory notes. We have received substantial evidence that sellers work cooperatively with lenders to foreclose consumer equities, and that such cooperation involves high-pressure sales tactics and deceptive and misleading statements. We have received substantial evidence that this rule would be seriously weakened by a failure to address the vendor related loan problem. We are therefore persuaded that the reasoning appearing above in this chapter applies with equal force to direct loan financing, and that our rule must apply to "purchase money" loan transactions.

See footnotes at end of chapter.

Part Two. *What the revised rule does. What is meant by eliminating foreclosures of equities.* This rule is directed at the preservation of consumer claims and defenses. It will require that all consumer credit contracts generated by consumer sales include a provision which allows the consumer to assert his sale-related claims and defenses against any holder of the credit obligation. From the consumer's standpoint, this means that a consumer can (1) defend a creditor suit for payment of an obligation by raising a valid claim against the seller as a set-off, and (2) maintain an affirmative action against a creditor who has received payments for a return of monies paid on account. The latter alternative will only be available where a seller's breach is so substantial that a court is persuaded that rescission and restitution are justified. The most typical example of such a case would involve non-delivery, where delivery was scheduled after the date payments to a creditor commenced.

Thus, the rule will give the courts the authority to examine the equities in an underlying sale, and it will prevent sellers from foreclosing judicial review of their conduct. Sellers and creditors will be responsible for seller misconduct. The courts will remain the final arbiters of equities between a seller and a consumer. However, the liability occasioned by the contract modification imposed by this rule should have two effects. First, it will impel creditors to exercise reasonable care in financing certain sales transactions.[10] Second, it will induce credit outlets to take certain mechanical steps to facilitate the process whereby a contract is returned to a seller for cause.

Transactions to which this rule applies. The Commission has carefully weighed the commercial circumstances which justify imposition of this rule. We have concluded that consumer credit obligations should be subject to claims and defenses whenever credit is arranged or secured in connection with a continuing relationship between a seller and a creditor. In such cases, for the purposes of Section Five of the FTC Act, seller and creditor may properly be viewed as joint venturers.[11] The basic rationale for the rule, namely that sellers should not avoid the costs occasioned by their misconduct and creditors are always in a better position than consumers to return misconduct costs, applies in any situation where sellers and creditors work cooperatively to finance consumer sales.

Discount transactions. The revised rule applies to all consumer discount transactions. Such transactions contemplate the routine assignment of consumer credit obligations to acceptance creditors. In many cases the creditor who purchases this paper also finances the seller's acquisition of inventory. A close and continuing relationship is thus the norm. The revised rule defines "Creditor" as a person who "finances the sale of goods or services to consumers on a deferred payment basis". The words "Financing a Sale" are specifically tied to the Truth in Lending definition of "Credit Sale". The rule thus applies to all retail installment obligations affected by the Truth in Lending Act. A seller is a "Creditor" for the purposes of the rule whenever he executes a retail installment contract. In his capacity of seller and creditor, the seller is enjoined from taking or receiving a consumer credit contract, of any kind, which fails to contain the following provision:

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

The rule expressly applies to credit contracts arising from sales of services, such as trade or vocational school agreements as well as sales of consumer tangibles. The record fully supports application of this rule to consumer service contracts.[12]

Our original proposed rule contained two distinct prohibitions in discount transactions. It required inclusion of a similar provision in any promissory note or other negotiable instrument taken in connection with a credit sale. It prohibited the use of waivers of defenses, rights, remedies, claims . . . etc. in connection with credit sales. The final version of the rule no longer draws a distinction between promissory notes and waivers. Instead of two prohibitions the rule contains only one, namely the requirement that the specified contract provision be inserted in all sale-related consumer credit contracts. Our definition of "Financing a Sale" makes it clear that the rule only applies to credit transactions within the meaning of the Truth in Lending laws. Our original prohibition on waivers would have applied to all sales, regardless of whether credit was involved. Such a prohibition would have affected warranties and other obligations which were not the subject of this proceeding.

Finally, by eliminating references to terms such as "negotiable" or "negotiable in form" we have simplified the rule. We have also avoided potential litigation in enforcement proceedings by eliminating consideration of the technical nature of a non-conforming contract.

Vendor-related loan transactions. The original rule proposed by the Commission did not look beyond discount or acceptance transactions. The rule was limited to installment sales contracts. This approach would have permitted widespread evasion of the rule.

Accordingly, as detailed in Chapter IV herein, we republished our proposed rule for additional hearings and comment with respect to the use of vendor-related loan financing. Our revised proposal contained a general definition of "Related Creditor" together with nine enumer-

ated fact situations which were to create a rebuttable presumption that a creditor was sufficiently close to a seller to justify imposition of the rule. Our original definition of "Related Creditor" was broadly formulated. It read as follows:

Any person, partnership, corporation, or association, except a credit card issuer with respect to his credit card operations, which is engaged in making loans to consumers to enable payment to be made for consumer goods or services, and which either participates in or is directly connected with the consumer transaction.

The nine specific fact situations which followed this definition are discussed in Chapter IV at pages 62–65. These specific criteria did not limit the scope of the above definition, but they were most useful in eliciting testimony on the myriad of different arrangements and relationships between consumer loan outlets and retail sellers which involve some continuing business relationship between the parties. Each of the criteria received specific support and documentation on the record.[14]

In preparing our final version of this rule the Commission has simplified and clarified its vendor-related loan provisions, taking full account of the information elicited during the second round of proceedings on the rule. The final version will afford the coverage which the record justifies with greater clarity and uniformity than our original proposal would have engendered. It will provide the Commission with a small degree of flexibility, in the same manner as the original proposal, while announcing a clear policy which is readily understood and easily followed.

To the extent that a lender is related to a seller by operation of the definition of "Purchase Money Loan", such a lender occupies a position which is functionally similar to that occupied by a discount creditor who purchases the seller's paper. Such lenders have the same access to information as discount creditors The record strongly suggests that they may also obtain equivalent guarantees and endorsements from sellers which embody a "repurchase" obligation.

The final version of this rule contains no rebuttable presumptions. Operation of the rule, in this context, turns on the three related definitions of "Purchase Money Loan", "Contract", and "Business Arrangement", a creditor being defined as a "person who lends purchase money".

The words "Purchase Money Loan" are defined as "a cash advance which is received by a consumer in return for a 'Finance Charge' within the meaning of the Truth in Lending Act and Regulation Z, and which is applied, in whole or substantial part, to a purchase of goods or services from a seller who:

"(a) refers consumers to the creditor, or

"(b) is affiliated with the creditor by common control, contract, or business arrangement."

See footnotes at end of chapter.

The words "Contract" and "Business Arrangement" are defined to include all formal or informal arrangements and procedures which, based on this record, would justify imputation of an established and continuing course of dealing between a lender and a seller. These definitions will encompass all of the situations enumerated in the rebuttable presumption segment of our original rule, with the exception of the ninth which involved knowledge of a seller's reputation. We are not persuaded that knowledge alone suggests a course of dealing, even though questions of a creditor's knowledge are relevant to a determination of his relationship with a seller. Such a test should not be dispositive. It raises too many problems of proof.

We have retained the "referral" test originally proposed as one of the rebuttable presumptions. As proposed it specified five or more referrals to a creditor. Based on this record we are persuaded that while the act of referral is sufficient to justify imposition of the rule, provided referrals are made in the course of some routine or arrangement, there is no justification for choosing a specific number. Such a number would be arbitrary and unsupportable. There is no reason why five referrals render a seller's conduct intrinsically unfair where four do not. One seller may do business in a small town where the smallest number of referrals justifies imposition of the rule; another may do business in a large city where a larger number would be required to impose the rule. As a general proposition, we believe that this record supports the proposition that referrals by a seller make a creditor "related". The word is stated in the plural in the rule. Any seller who arranges financing for his customers should be prevented from cutting off claims and defenses by means of the financing so arranged.

The four definitions of "Creditor", "Purchase Money Loan", "Contract", and "Business Arrangement" will reach every situation where a seller and a lender may be said to work cooperatively to finance consumer sales. We believe that the record in this proceeding supports application of the rule to all situations where concerted or cooperative conduct between sellers and creditors is employed to facilitate the retail distribution of goods and services to consumers. This is true without regard to the "type" of credit, loan or discount, which is used. The revised rule goes exactly this far and no further.

We have eliminated the "rebuttable presumption" mechanism because it is unnecessary. The Commission, after review of the comments and testimony received during this proceeding, has defined the situations it desires to reach. Presumptions may be appropriate absent adequate information; however, a presumption in this rule would work to encourage continuing litigation when enforcement efforts were made. A presumption would thereby engraft many of the undesirable features of adjudication onto a Trade Regulation Rule. It would encourage inconsistent results in successive enforcement proceedings, where one party extinguished the presumption and another failed to do so. It would contribute to continuing uncertainty and unjustified costs and delay in enforcement. As we noted at the outset of this Chapter, a Trade Regulation Rule should serve the threefold interest of uniformity, fairness and clarity.

Finally, in revising the provisions of the rule which are aimed at vendor-related loan transactions we have clarified the practice which is prohibited. The revised rule declares it an unfair practice within the meaning of Section Five for a seller to accept, as full or partial payment for any sale or lease of goods or services, the proceeds of a "Purchase Money Loan", *unless* any consumer credit contract which is made or taken in connection with the loan contains the following provision:

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL BE LIMITED TO AMOUNTS PAID BY THE DEBTOR HEREUNDER.

Sellers will thus be prevented from relying on vendor-related loan financing to avoid the other prohibitions contained in this rule. The most logical and concise way of accomplishing this end, in the text of a rule, is to prohibit the specific conduct which is challenged. For this reason we have focused this provision of the rule by applying a direct prohibition on the acceptance of loan proceeds as payment for a sale. Our original proposal did not specify what was to constitute the unfair practice beyond the act of "engaging in a sale".

By simplifying the definitions, focusing our operative language, and eliminating the broad general definition of "related creditor", we have narrowed our vendor-related loan proposal to correspond with what was learned in this proceeding. We have also revised our vendor-related loan provision so that it functions in a manner analogous to the balance of the rule.

The revised rule will require no consumer notice. Many consumers and consumerists urged the Commission to include a requirement in this rule that a notice be attached to pertinent legal documents employed in credit sales transactions to apprise consumers of their legal rights.[15] We received significant evidence that many consumers simply fail to read their contracts.[16] There was therefore a continuing concern expressed that consumers might forfeit the benefits conferred by the rule, more or less by default.

The industry opposed any detailed consumer notice with vigorous assertions that the actual text of the document proposed by FTC staff was extremely antibusiness in tone.[17] In this respect, certain consumer groups agreed that consumer education notices, prepared

for comment in the proceedings, were probably too inclusive in scope to be fair to the industry.[18]

In our view, the most persuasive case for imposing an additional burden on the industry in the form of a mandatory notice to accompany all consumer credit contracts used in credit sales was made by witnesses who discussed the problems of Spanish-speaking Americans in the course of the New York hearings.[19,20,21] These comments and testimony were supported by the testimony of various representatives of the Consumer Federation of America.[22] The Commission is persuaded that Spanish speaking Americans are more readily victimized by unscrupulous merchants and creditors. The Commission agrees that Spanish speaking Americans have more difficulty in comprehending and vindicating their legal rights.

However, despite the unique problems of Spanish speaking Americans, we are not prepared to impose a consumer notice requirement on sellers and creditors at this time. Any such requirement would involve duplication and attachment of a complex, two-page, document to all related sales contracts and forms. The contents of such a document could be construed as incorporated by reference in a sales agreement, where this was not the Commission's intention. Conversely, the contents of such a document might mislead consumers into relying on apparent legal rights which were ultimately not vindicated by the courts. The purpose of the rule is to permit courts of competent jurisdiction to examine the equities where a consumer has a claim against a seller. The rule thus prevents foreclosures of equities by various means of financing a sale, but it does not impose any other requirements on the parties. Finally, the simple duplication and annexation of a notice similar to the one proposed would involve considerable expense for sellers and creditors.

The rule requires sellers and creditors to include a simple "notice" in the text of every consumer credit contract which is connected with a sale of goods or services. The notice must appear in ten point bold face type. While the wording of the notice is legalistic, we believe that it will be understood by most consumers.

The Commission also anticipates a substantial consumer education effort on the part of its staff after enactment of this rule. We will direct our staff to take reasonable action via the media to publicize the existence of the rule and what it means to consumer buyers. Announcements directed at the Spanish community will appear in the Spanish language. As legal services offices, consumer groups, and individual consumers test the rule by periodic lawsuits against creditors and sellers, and as the courts thus become more receptive and accustomed to considering competing equities in consumer sale transactions, the rule will enjoy increasing knowledge and use on the part of all consumers. We will monitor developments in this regard, and we will take further action if special problems develop.

[1] Natl. Petroleum Refiners Assoc., et al. v. F.T.C., 482 F.2d 672 (DC Cir. 1973). Also see 1 Davis, *Administrative Law Treatise* 6.15 (1970).

[2] C. Ferguson, *MicroEconomic Theory*, 391–92 (1966).

[3] *Id.*

[4] Littlefield, "The Plight of the Consumer in the Uniform Consumer Credit Code," 48 *Denver L. J.* 18 (1971); and "Preserving Consumer Defenses in Credit Card Transactions," 81 *Yale L. J.* 1 (1971).

[5] Commercial Credit Plan v. Beebe, 123 Vt. 317, 187 A.2d 502 (1963); Gross v. Appelgren, 467 P.2d 789 (Colo. 1970); Norman v. World Wide Distributors, 202 Pa. Super. 53, 195 A.2d 115 (1963); also see cases cited in Reply Brief for Appelants at 22 and 23, Payne v. United California Bank, 100 Cal. Rptr. 672 (1972).

[6] See, *e.g.*, G. Calabresi, *The Costs of Accidents* (1970) which contains a detailed explanation of this kind of analysis.

[7] The Commission has received copies of many such agreements in the course of this proceeding and related investigations. See Chapter VI, *supra* at note 29.

[8] See the discussion appearing in F.T.C. v. Curtis Publishing 78 FTC 1472, 1515 (1971) where the anticompetitive impact of permitting an unscrupulous merchant to retain unlawful gains may be a factor in determining that his conduct violates Section Five. Also see, FTC v. Algoma Lumber, 291 U.S. 67 (1934); Interstate Home Equip. Co. at 40 FTC 260 (1945); and FTC v. Winsted Hosiery, 258 U.S. 483 (1922) where similar theories are discussed.

[9] See Sperry and Hutchinson v. FTC, 405 U.S. 233, 244 (1972).

[9a] Sperry and Huchinson v. FTC *supra* note 9.

[10] Some courts have already taken steps to impose a duty of care, albeit a limited one, on creditors who willingly finance dubious sales transactions. See *e.g.* Connor v. Great Western Savings & Loan Assoc., 69 Cal. 2d 850, 447 P. 2d 609 (1968). While the S & L in this case took an active role in the financing of a residential development, and while this role included actively participating in the project, many consumer lenders are active and willing participants in sales transactions, offering "specials" for favored customers and suggesting borrowings for summer sales and Christmas gift needs. In such cases, the duty of care imposed in *Connor* seems highly appropriate.

[11] A joint venturer is defined as one who seeks a sepecific profit jointly with another, in a particular transaction. Ditscher v. Booth, 13 N.J. Super. 568, 571, 80 A.2d 648, 650 (1951). Also see *e.g.* Uniform Partnership Act, Sec. 13–15. Coventurers or partners are generally liable for each others' acts on their behalf. A joint venture may arise with no formal arrangement. It may be imputed inferentially. Cooperstein v. Shapiro, 122 N.J. Eq. 238, 192 A. 826 (1937).

[12] Forham, Tr. 626–28 (represented twenty-one students who had enrolled in a computer training school that went out of business and who were under pressure from various financial institutions to continue making payments); John Keller, Office of the Superintendent of Public Instruction, Illinois, Tr. 562–70 (his office has jurisdiction over 300 private business and vocational schools in Illinois and he cites two typical student complaints); Mindell, Tr. 19 (recent case where computer school went out of business); John C. Neubauer, Consumer Education & Protection Organization, Des Moines, Iowa. Tr. 622; Ronald Fritsch, Chicago Legal Aid Bureau, Tr. 743–44 (modeling-school case in Cook County); John F. Preloznik, Director, Wisconsin Judicare, Tr. 553; Phyllis Senegal, Legal Aid Society of Gary, Indiana, Tr. 638–39 (two cases involving a karate school); Scholl, Tr. 1177; Ryan, Tr. 556–57; Ralph S. Stone, Chief Attorney, Consumer Law Unit, Legal Aid Society of St. Louis, R–1327. Examples of consumer's experiences: Tr. 51–55, 617–19; R. 100, 101, 111, 1672, 1679, 1684, 1686, 1712. Ryan, Tr. 557. Patricia Hynes, Tr. 250, suggested that the definition "include a specific reference to services purchased by an individual to aid him or her in earning a livelihood". Such language has the advantage of encompassing fees charged by employment agencies (R. 1153–58), but the Commission considers the language overly broad for the purposes of this Rule.

[14] See footnotes 13–31 in Chapter IV, supra.

[15] Lawrence R. Buxbaum, Tr. 1313; Teresa Clark, Tr. 925; Barbara Flicker, Tr. 406; Richard Huffman, Tr. 89–90; Patricia Hynes, Tr. 252; Benny L. Kass, Tr. 1203; Gladys Kessler, Tr. 1059; Fairfax Leary, Jr., Tr. 981; Suzane Matsen, R. 284, 291; Bess Myerson, Tr. 369; Dennis J. Roberts II, Tr. 417.

[16] *E.g.*, Benny L. Kass, Tr. 1203; Gladys Kessler, Tr. 1059; Suzane Matsen, Tr. 284, 291; Wilbur Leatherberry, Tr. 1022; Bess Myerson, Tr. 369.

[17] *E.g.*, Hinckley, Tr. 1803; Bernard Davis, R. 5984–85.

[18] *E.g.*, James Latturner, Legal Aid Society, Chicago, Tr. 2226.

[19] Sarah Negron, Tr. 51–55, R. 895–897; Jose Suarez, Tr. 47–51, R. 900–901; Victor Tico, Tr. 210–212, R. 898–899.

[20] Rose Ferreira, R. 585–586; Amada Ortiz, R. 594–596; Aida Luz Nieves, R. 597–599.

[21] *E.g.*, Huffman, Tr. 82; ". . . T/he Spanish-speaking [clients] I had in the South Bronx were at a much greater disadvantage than other minority groups. The Spanish-speaking clients were generally easily swayed by interpretations of what the written English [on a contract] says." Lester S. Goldblatt, Legal Aid Society of New York, Tr. 474; Thos. Eovaldi, Chicago Council of Lawyers, Tr. 2186.

[22] *E.g.*, Williams, Tr. 70–71; Huffman, Tr. 90; Kessler, Tr. 1060 (Consumer Federation of America).

CHAPTER VIII. DISCUSSION AND DISPOSITION OF SUGGESTED ALTERNATIVES AMENDMENTS OR REVISIONS TO THE RULE

A. Limit consumer to defense or setoff. Many industry representatives suggested that the rule be amended so that the consumer may assert his rights only as a matter of defense or setoff against a claim by the assignee or holder.[1] Industry representatives argued that such a limitation would prevent the financer from becoming a guarantor and that any limitation in the extent of a third party's liability was desirable.[2]

The practical and policy considerations which militate against such a limitation on affirmative actions by consumers are far more persuasive. For example, Professor Egon Guttman, Professor of Law at American University and a member of the District of Columbia Ad Hoc Committee on Consumer Protection, stated at the hearings that such a limitation:

> May affect the credit rating of the consumer who, although he is under recent legislation entitled to demand the erasure of improperly determined credit ratings, may still find that his present needs for credit could have been affected by his refusal to pay a debt arising under a retail installment sales transaction.[3]

See footnotes at end of chapter.

Professor Guttman went on to say that the right to recover against an assignee "is nothing new in the law . . . Where does the right of financial institutions arise to make them different from the rest of the people?" [4]

California's Unruh Act which makes an assignee "subject to all claims and defenses of the buyer against the seller" but provides that the buyer may assert his rights only "as a matter of defense to a claim by the assignee," [5] has recently been interpreted by the California Supreme Court.[6] In a consumer class action seeking rescission of the plaintiffs' installment contracts, the assignee-finance companies claimed that the plaintiffs could not bring an affirmative action against them. The California Supreme Court disagreed, stating:

The finance companies contend that under this section [of the Unruh Act] plaintiffs may not bring an affirmative action against them for recission but may only assert their defense of fraud in an action by the finance companies to collect on the contracts and then only to the extent of the amount still owing. Upon analysis, however, a number of considerations militate against such a restrictive interpretation. . . .

The purpose of the Unruh Act is to protect consumers, and it should be liberally construed to that end. (Morgan v. Reasor, 69 Cal. 2d 881, 889.) If we were to adopt the concept of the finance companies it would . . . bestow upon them immunities and privileges against consumers unavailable to them in the ordinary commercial transaction. (Cf. Unico v. Owen (N.J. 1967) 232 A.2d 405, 417-418.)

It is suggested by amicus curiae that Section 1804.2 was intended to eliminate the possibility that by depriving assignees of any right to take free of the buyer's defenses against the seller despite an agreement to the contrary, the section might subject assignees to products liability suits which might involve personal injuries and large damage claims.

It would be ironic indeed if a provision in an act intended to benefit consumers could be invoked to their detriment to such an extent that they would stand in a less advantageous position than others in the commercial arena. . . . If, despite the allegations of the complaint—admittedly true on demurrer—we were to adopt the view of the finance companies, we would be according to financial institutions greater commercial advantage against consumers than they enjoy with reference to all others. Such a result cannot be justified.[7]

At the New York hearings Bess Myerson, Commissioner of the New York City Department of Consumer Affairs, discussed the New York statute which limits the consumer to a defense or setoff and stated, "without the right to initiate suit, . . . consumers are denied a basic weapon of protection against unresponsive third parties to installment credit contracts." [8] Another reason for not limiting consumers to a defensive position is that a stronger potential consumer remedy will encourage greater policing of merchants by finance institutions.[9]

The most persuasive reason for not limiting a consumer to a wholly defensive position is the situation referred to in Professor Guttman's testimony. A consumer may stop payment after unsuccessfully attempting resolution of a complaint with the seller, or he may have finally discovered that the seller has moved, gone out of business or reincorporated as a different entity. During this period the consumer may have been making payments to the financer in good faith, notwithstanding the prior existence of defenses against the seller.

If the consumer stops payment, he may be sued for the balance due by the third party financer. The financer may, however, elect not to bring suit, especially if he knows that he would be unable to implead the seller and he knows the consumer's defenses may be meritorious. Under such circumstances the financer may elect to not sue, in the hopes that the threat of an unfavorable credit report may move the consumer to pay.

Finally, it is important to remember that the contract provision this rule will require can only be enforced between the parties in a court of competent jurisdiction. The purpose of this rule is to mandate judicial scrutiny of a credit sale transaction, when a bona fide dispute develops between buyer and seller. The various cut-off devices discussed in this statement foreclose judicial review of the equities in such transactions. Consumers will not be in a position to obtain an affirmative recovery from a creditor, unless they have actually commenced payments and received little or nothing of value from the seller. In a case of nondelivery, total failure of performance, or the like, we believe that the consumer is entitled to a refund of monies paid on account.

B. *Set maximum amount.* Some industry representatives suggested that high price sales should be exempted from the rule for two reasons. First, the consumer who buys a high priced "luxury" item such as an airplane or a boat is generally more sophisticated than the average consumer and, therefore, is likely to read and understand the legal consequences of his contracts.[10] Second, the seller of such items relies on immediate sale of consumer installment contracts in order to replenish his costly inventory. If the market for this paper becomes tighter industry contends that many of these sellers would be driven out of business.[11] This assertion rests on assumptions about the alleged difficulty of assigning notes in the absence of cut-off devices. The weaknesses of these arguments have been examined above.[12] The price of a house full of furniture, an automobile, certain home improvements or other necessity items purchased by average consumers often exceeds the $2,500 or even the $5,000 urged by industry spokesmen as an upper limit to the rule. The rule should protect the rights of middle income consumers as well as low income consumers.[13]

The basis for the rule is a finding that reliance on various cut-off devices is an unfair practice under Section 5 of the FTC Act. The practice does not cease to be unfair simply because it involves a larger amount of money.

C. *Limitation upon the time in which defenses can be raised.* Some witnesses urged the Commission to adopt a rule which would set a limit upon the time in which a consumer could raise defenses and which would require the consumer to notify the third-party financer of any defenses within the specified period.[14] The suggestion is similar to the "complaint period" approach adopted in several state laws.[15]

The "complaint period" approach, touched upon earlier, requires the assignee of a consumer instrument to give notice to the consumer of the transfer and of the consumer's right to raise defenses or make claims within a set period—usually 10, 15 or 30 days. It has been suggested that even the most shoddy merchandise will stand up for 15 or 30 days, and that the complaint period will be of little use.[16] More fundamental is the criticism advanced by several commentators and witnesses in this proceeding—that any "complaint period" approach suffers several fatal flaws:

(i) It is reported that the financers' "notices" reach consumers buried in the midst of various junk mail [17] and that few, if any, consumers understand the requirement of the affirmative act of properly drafting and sending the notice.[18]

(ii) The fact of "non-complaint" may put the assignee holder in an even stronger legal position than he occupies under current law. "This kind of statute appears to give . . . an assignee as impregnable a legal position as one holding free of defenses by specific statutory mandate." [19]

Thus, for the uninformed, unsophisticated, or uneducated consumer—the person most in need of aid—the "complaint period" approach is unacceptable. The simple expedient of a delaying mechanism does not make a fundamentally unfair practice any less objectionable. The basic unfairness of the use of cut-off devices in consumer transactions remains after the expiration of the complaint period—be it five days or ninety.

D. *Miscellaneous suggestions.* The following revisions were suggested but found no substantial support in the record:

1. That consumer goods covered by an adequate warranty be excluded from the coverage of the rule.[20] The problem with this suggestion is two fold. It would be difficult to identify "adequate warranties in this context." In addition, the worst retailers go to great extremes to conclude sales. Frequently they misrepresent the actual warranty a consumer receives, in the course of getting the consumer to close the deal. This suggestion would leave the consumer with a substantial debt to a creditor and uncertain redress pursuant to a warranty.

2. That the rule's protection be extended to include small businessmen.[21] Such an extension would undermine a basic premise of the rule—that consumer transactions are essentially different from commercial transactions and the holder in due course doctrine originated in and is only appropriate for the latter. The need for such an extension of cov-

See footnotes at end of chapter.

erage is not demonstrated on the record for this proceeding.

3. That the consumer be required to make a written demand upon the seller before stopping payments.[22] In most cases a consumer will attempt to resolve complaints with the seller before stopping payment. Specifying in the rule the manner in which such consumer/seller negotiation must take place would introduce unnecessary formality into the procedure. The format of such efforts should remain flexible. The Commission is also concerned that formalistic requirements upon the consumer would serve to create other problems, especially of proof—*e.g.*, did the seller in fact receive notice?

4. Other miscellaneous suggestions and recommendations included: (i) expanding the rule to provide a comprehensive regulatory provision covering product warranties;[23] (ii) expand the rule to include a ban on confessions of judgment or cognovit notes;[24] (iii) proposals for a "Federal Credit Loss Insurance Corporation" and a "Consumer Credit Arbitration Service";[25] and (iv) a proposal to ban "sewer service" of court papers.[26] In each case the Commission has rejected these proposals as being outside the scope of the instant rule. The Commission takes no position on the merits of these suggestions. They are more appropriate for separate consideration.

[1] *E.g.*, Eugene Hart, Tr. 712; Ira J. Lefton, Tr. 672–73; Robert Olson, Tr. 949–50; Robert Serafine, Tr. 1095; Max Denney, R. 28; Statement of American Bankers Association, et al., R. 1809–10.

[2] For example, Robert Olson stated that the rule "should not . . . provide the consumer with a new remedy, affirmative relief against an innocent third party assignee. A financial institution may be quite willing to accept the risk that the receivable it purchased from the seller is uncollectable because of some defect in the sale transaction. That same financial institution, however, would be most unwilling to become a guarantor of the seller's performance." Tr. 950.

[3] Tr. 1320.

[4] Tr. 1321.

[5] Cal. Civ. Code § 1804.2 (West Supp. 1971).

[6] Vasquez v. Superior Court of San Joaquin County, 94 Cal. Rptr. 796, 484 P.2d 964 (1971).

[7] *Id.* at 823–24, 484, p.2d at 979–80, 94 Cal. Rptr. at 811–12 [footnotes omitted].

[8] Tr. 363. Steven Mindel, Assistant Attorney General wih the Bureau of Consumer Frauds and Protection in New York also criticized the New York statute on this point.

"So the statute, in effect, on the one hand gives him rights and on the other hand says, you can't use these rights as a sword; you have to use them as a shield. It seems to me there is absolutely no justification for this second limitation. It puts the consumer in the guise of defendant. It doesn't permit him to go forward effectively when he feels that he may justifiably do so." Tr. 14.

[9] Frank Cochoran, Tr. 238–39.

[10] *E.g.*, David C. Todd, National Association of Engine and Boat Manufacturers, Tr. 1180; E. D. Chase, President, Cessna Finance Corporation, R. 81–82.

[11] *E.g.*, Jim Smith, Tr. 1136; David C. Todd, Tr. 1181.

[12] Pages 78–92, *supra*.

[13] *E.g.*, Barry Baime, Tr. 1187; Arthur Roddey, New Jersey consumer who describes the problems he had with a contractor to construct a swimming pool, Tr. 100. See also R. 64–65 (swimming pool).

[14] Hart, Tr. 698; Lefton, Tr. 672–3; Olson, Tr. 949; Todd, Tr. 1182.

[15] Murray, "The Consumer and the Code: A Cross-sectional View", 23 Univ. of Miami L. Rev. 11, 65 (1968). See also C. Katz, ed., *The Law and the Low Income Consumer* 249–51 (1968).

[16] Jordan and Warren, "The Uniform Consumer Credit Code", 68 *Columbia L. Rev.* 387, 434–435.

[17] Kripke, "Consumer Credit Regulation: A Creditor-Oriented Viewpoint", 68 *Colum. L. Rev.* 455, 473 n. 75 (1968).

[18] Murphy, "Lawyers for the Poor View the UCCC", 44 N.Y.U. Rev. 298, at 310 (1969).

[19] Jordan and Warren, *supra* n. 16, at 435.

[20] David Gezon, Tr. 1276–77; Warren J. McEleney, Tr. 1291.

[21] Delzer, New Jersey Consumer, Tr. 422; Betty Furness, Tr. 38; Anthony Martin-Trigona, Tr. 907, 914.

[22] Robert S. Olson, Tr. 949; *contra*, Gladys Kessler, Tr. 1064; Ronald Fritsch, Tr. 741.

[23] Wendy Larson, Editor in Chief, St. Paul University Law Review, Tr. 1971–78, R. 6701–41.

[24] McCulloch, R. 3750.

[25] Robert D. Breth, Certified Consumer Credit Executive, R. 5945–47.

[26] Hartnell, R. 2877.

APPENDIX: PUBLIC COMMENT ON THE PROPOSED RULE

Specific submissions in the public record have been discussed or footnoted in the appropriate topic sections above. A few general remarks about the scope of the record are included here.

Submissions came from a great variety of sources. *Support* ranged from one-line postcards[1] to lengthy, heavily-documented legal submissions.[2] There are over two hundred submissions on the record from individuals—not identified with a group or business—which express general support for the rule.[3]

A number of individuals (in addition to those submitting personal case histories) wrote longer, more detailed letters in support of the rule.[4]

Federal, state and local government officials expressed approval of the Rule.[5]

Two judges expressed support.[6] The Canadian Minister of Consumer and Corporate Affairs expressed approval of proposed Commission action,[7] and the Ministry supplied materials documenting the Canadian experience.[8]

Support for the rule was expressed by over one hundred consumer, labor and other associations and organizations.[9] Over thirty legal aid organizations are on record in favor of the rule.[10] A number of attorneys wrote as individuals, not on behalf of a client, in support of the rule.[11] Over one dozen educators wrote[12] or testified.[13]

Finally, the rule received strong support from a number of businessmen[14] and the backing of two bankers.[15]

Most *opposition* to the proposed rule was presented by businessmen, bankers and trade associations. There are also a number of letters opposing the rule submitted by individuals not identified as affiliated with a group or business.[16] Two public officials expressed disapproval.[17]

There are many letters in opposition from individual retailers, representing a variety of businesses.[18] Individual banks and bankers wrote to oppose the rule in fairly large numbers.[19] Finance companies are represented by submissions[20] including closely related finance companies.[21] Trade associations and similar organizations make up the bulk of the remainder of submissions in opposition.[22] By number, automobile dealers,[23] and banking or finance groups[24] predominate. Submissions were also received from credit card issuers and credit card associations.[25]

There are several letters expressing disapproval of the rule from attorneys not writing on behalf of a client bank or association,[26] and from the academic community.[27]

Promulgated by the Federal Trade Commission November 14, 1975.

See footnotes at end of appendix.

[1] *E.g.*, "I strongly believe it is in the public interest to abolish the 'holder-in-due-course doctrine.' Thank you." H. Greenlee, Jr., R. 3453.

[2] *E.g.*, Statement of Civil Rights—Civil Liberties Research Committee, Harvard Law School, R. 1482–1515.

[3] *E.g.*, ". . . [I]f the seller and note holder both know that the law is on [the consumer's] side, the seller will make a better product that he can stand behind without fear." R. Stevens, R. 16; "Let us cease to legally screw the poor." Tony Scott, R. 78–79; "I realize that lenders will have to learn something about fair value of items, but don't you think that since the item is technically collateral that they should know what their collateral is really worth?" Arne Sampe, R. 348: ". . . one more thing we might do to help convince our young people there *really* is effective recourse for just grievances in America." Mrs. B. J. Parsons, R. 1587; "This ruling will give the consumer a little more assurance that the retailer will be as honest as he claims his product is good." Kenneth R. Parr, R. 2566; "I urge the Commission to abolish this antiquated and unconscionable practice." Rice Odell, R. 3442.

[4] *E.g.*, Bycer, R. 1602–1604; Marcellino, R. 2535–2538; DiBiaso, R. 3390–3392.

[5] *U.S. Representatives:*

Hon. Henry B. Gonzales, R. 361–362.

Hon. John M. Murphy, R. 998–1001.

Hon. Abner J. Mikva, R. 2032–2034.

Hon. Bella Abzug, Tr. 458–461.

Federal, appointive:

Virginia H. Knauer, Special Assistant to the President for Consumer Affairs, Tr. 894–906, 1395–1413; R. 2040–2048, R. 6830–6842. See also R. 3386–3387.

Richard W. McLaren, Assistant Attorney General, Antitrust Division, United States Department of Justice, R. 1925–1988.

Deputy Assistant Attorney General, Bruce B. Wilson, Antitrust Division, United States Department of Justice, R. 1925–1988.

Thomas E. Kauper, Assistant Attorney General, Antitrust Division, United States Department of Justice, R. 7105–7128.

Whitney North Seymour, Jr., United States Attorney for the Southern District of New York, Tr. 242–272, R. 1006–1011.

State and local:

Florida: Robert J. Bishop, Director of Consumer Services, Department of Agriculture and Consumer Services, R. 5646. City of Jacksonville: Thatcher Walt, Consumer Affairs Officer, Division of Consumer Affairs, Department of Human Resources, R. 5671.

Georgia: James Mason, Office of Comptroller General, State of Georgia, R. 1720–1723.

Illinois: Howard I. Kaufman, Chief, Consumer Fraud Division, for Attorney General, State of Illinois, Tr. 497–512, 1885–1902. Michael K. Bakalis, Superintendent of Public Instruction, State of Illinois, by John Keller, Assistant, Tr. 562–570, R. 2510–2514. Milton Hirsch, Acting Supervisor, Consumer Credit Division, Department of Financial Institutions, Tr. 2052–2063.

Indiana: Richard Burdge, Administrative Assistant to Director, Department of Financial Institutions, Tr. 1997–2019.

Kansas: Vern Miller, Attorney General, R. 5644.

Louisiana: R. Collins Vallee, Special Counsel, Consumer Protection Unit, Department of Justice, R. 5475–76.

Massachusetts: Lawrence R. Buxbaum, Assistant Attorney General, Chief, Consumer Protection Division, Department of the Attorney General, Commonwealth of Massachusetts, Tr. 1300–1314.

Minnesota: Thomas J. Tahnk, Supervisor of Consumer Credit, Banking Division, Department of Commerce, Tr. 2196–2207, R. 7145–49.

New Jersey: Carl F. Fianchi, Department of Community Affairs, State of New Jersey, R. 1639.

New York: Louis J. Lefkowitz, Attorney General, State of New York, R. 1004–1005; see also Tr. 9–31. Betty Furness, Chairman and Executive Director, New York State Consumer Protection Board, Tr. 31–43, R. 1216–1219. Thomas J. Mackell, District Attorneys, Queens County, R. 1012–1016. Bess Myerson, Commissioner, New York City Department of Consumer Affairs, Tr. 360–382, R. 1017–1023. Anita De Gregorio, Administrative Assistant, Office of Consumer Affairs, County of Onondaga, R. 5483–5594, 5676.

Oregon: Roger Rook, District Attorney, Oregon City, R. 5333–34.

Pennsylvania: Joel Weisberg, Director, Division of Consumer Affairs, Commonwealth of Pennsylvania, R. 5255–56.

Puerto Rico: Maximiliano Trujillo, Assistant Secretary, Department of Consumer Affairs, Consumer Services Administration, R. 5272–73.

South Dakota: John S. DeVany, Commissioner of Consumer Affairs, Office of Attorney General, State of South Dakota, R. 3505–3506.

Utah: W. S. Brimhall, Commissioner of Financial Institutions, State of Utah, R. 57.

Virginia: William T. Lehner, Assistant Attorney General, Division of Consumer Counsel, Office of Attorney General, Commonwealth of Virginia, R. 5262–63. Carl A. S. Coan, Jr., Chairman, Consumer Protection and Public Utility Commission, Fairfax County, R. 5605–07.

Wisconsin: Robert W. Warren, Attorney General, State of Wisconsin, R. 1755–1766, 5458–59. Hon. Harout O. Sanasarian, Wisconsin State Assemblyman, Tr. 510–526, R. 1224–1236. Daniel A. Milan, Director, Bureau of Consumer Protection, State of Wisconsin, Tr. 526–540. Richard Victor, Assistant Attorney General, Office of Consumer Protection, Department of Justice, State of Wisconsin, Tr. 2173–2181.

[6] Hon. Edward Thompson, J.S.C., Administrative Judge, Civil Court of the City of New York ("collective approval" of the proposed rule expressed "on behalf of the 120 judges" of the Civil Court), R. 560–561 and 1654–1655. Hon. Arthur Dunn, Associate Judge, Circuit Court of Cook County, Illinois, Tr. 757–775.

[7] Hon. Ron Basford, R. 1719.

[8] R. 137–325 and R. 3528–3580.

[9] *E.g.*, Local 320, Office and Professional Employees International Union, R. 14; North Carolina Consumers Council, Inc., R. 328; Rhode Island Consumers' Council, R. 945–969; NAACP Legal Defense and Education Fund, National Office for the Rights of the Indigent, R. 978–986; Center for Analysis of Public Issues, Princeton, N.J., R. 987–997; United Auto Workers, R. 1301–1307; Leland Bisbee Broadcasting Company, Tucson, Arizona, R. 2526–2527; consumer Advisory Council, Office of Consumer Affairs, Executive Office of the President, R. 3386–3387; Arizona Consumers Council, R. 3515–3520; Minnehaha County Farmers Union, Sioux Falls, South Dakota, R. 2468.

[10] *E.g.*, Atlanta Legal Aid Society, Atlanta, Georgia, "Each year the Society's attorneys handle approximately 17,000 cases, of which about 35% are consumer problems . . . [M]any of these cases eventually involve litigation in which the holder in due course concept is an important factor." R. 20, plus two case histories, R. 21–23; "An analysis . . . makes one thing abundantly clear: the holder in due course concept is the very heart of these operations. For it is essential to the disreputable seller that he be able to realize payment and then flee (either by actually leaving the jurisdiction or by ceasing operation) before this deception becomes apparent." R. 23. "This office is prepared to deliver . . . over one hundred case histories involving unfair consumer notes with which we have come in contact within the last six months." Memphis and Shelby County Legal Services Association, *Memphis*, Tennessee, R. 1626–1627. "We are confronted almost daily with the harsh and inequitable effects of the holder in due course doctrine." Legal Aid Society of Metropolitan *Denver*, Colorado, R. 3344–3447.

[11] *E.g.*, R. 15, 91, 390, 1365, 1368, 1678.

[12] *E.g.*, ". . . [T]hese will be additional steps to help clean up the inequities of the market place. There is no reason why the holder-in-due-course should assume no responsibility for performance." Stewart Lee, Chairman, Department of Economics and Business Administration, Geneva College, R. 17; John F. Disterhof, California Institute of Technology, R. 1595; Prof. William Seeman, University of Cincinnati, R. 1680; Prof. Phoebe Harris, Mississippi State University, R. 2528.

[13] Law professors Eovaldi (Tr. 784), Guttman (Tr. 1314), Kripke (Tr. 437), Leary (Tr. 967), Wagman (Tr. 600) and Willier (Tr. 1033).

[14] *E.g.*, "[Y]our proposed rule . . . is both excellent and long overdue. I have worked with a great many retailers and I speak from very intimate knowledge." Donald Von Rase, R. 7; "I have no personal axe to grind, but I have seen many of my employees and fellow workers gravely hurt by these contracts and feel that this protection is essential for the consumer." A. Kazanow, Treasurer, Long Transportation Co., R. 13; "As manager of a Credit Union I have seen many of our members 'taken in' . . ." Donn Ashcroft, R. 352; "[L]egal technicalities of this kind . . . are certainly doing a disservice to the free enterprise system." F. Kavli, President, Kavlico Electronics, Inc., R. 1683.

[15] Alvin F. Friedman, Vice President, Amalgamated Trust and Savings Bank, Chicago, R. 1357–1361; R. L. Mullins, Chairman, The Wolfe City National Bank, Wolfe City, Texas, R. 3398–3399.

[16] *E.g.*, R. 1521; "I feel the . . . regulation would be harmful to the consumer rather than help them." Diana M. Bird, R. 2547, R. 2565.

[17] Hon. John R. Rarick, United States House of Representatives, R. 2455–2456. Hon. Willard J. Moody, State Senator, Commonwealth of Virginia, R. 1645.

[18] *E.g.*, Hughes Motor Co., R. 51; Western Auto Associate Store, Farrant, Alabama, R. 61; O'Fallon Frozen Food Lockers, R. 389; Horace Terry Pontiac Co., R. 393; Lou Backrodt Chevrolet, R. 1380–1381; Bill Hull's Appliances, Inc., R. 1519; Sid's Appliance Centers, R. 1529; Carl's TV Sales and Service, R. 3423; Fiore Brothers, Inc., General Contractors, R. 3486.

[19] *E.g.*, First National Bank, Elkhart, Indiana, R. 52; First National Bank of McMinn County, Athens, Tennessee, R. 66–67; Farmers National Bank of Lititz, Pennsylvania, R. 69; Northwest Pennsylvania Bank & Trust Co., Oil City, Pennsylvania, R. 83; The Citizens Bank of South Hill, Virginia, R. 85; The Citizens Bank, Farmington, New Mexico, R. 96; First Bank of Immokalee, Florida, R. 1674; Citizens National Bank, Ennis, Texas, R. 2522; Webster Groves Trust Co., Webster Groves, Missouri, R. 3502, Marine National Exchange Bank, Milwaukee, R. 58–60; National Bank of Detroit, Michigan, R. 2496–2498.

[20] *E.g.*, Cessna Finance Corp., R. 81–82; Security Mutual Finance Corp., Decatur, Alabama, R. 95; Transamerica Financial Corp., R. 1648–1650; Household Finance Corp., R. 1728–1734; Budget Finance Plan, Los Angeles, R. 2026–2031.

[21] *E.g.*, General Electric Credit Corporation, R. 1989–1993; Ford Motor Credit Company, R. 2057–2070; General Motors Acceptance Corp., R. 2457.

[22] *E.g.*, Professional Remodelers Association of Greater Chicago, R. 1363–1364; National Institute of Locker and Freezer Provisioners, R. 1670–1671; National Association of Engine and Boat Manufacturers, R. 2296–2313; Georgia Tire Dealers and Retreaders Association, R. 3581–3582.

[23] *E.g.*, National Independent Automobile Dealers Association (R. 2189–2190) and Independent Automobile Dealers Associations of: Texas, R. 53–54; Pennsylvania, R. 55–56; Florida, R. 2544; Lubbock, Texas, R. 3478; Alabama, R. 3478; Alabama, R. 3526–3527. National Automobile Dealers Association (R. 2356–2366) and Automobile Dealers Associations of: Texas, R. 53–54; Pennsylvania, R. 55–56; Florida, R. 2544; Lubbock, Texas, R. 3478; Alabama, R. 3526–3527. National Automobile Dealers Associations of: Indiana, R. 1640–1644 and Dayton, Ohio, R. 2463–2464; Volkswagen American Dealers Association, R. 2350–2355.

[24] *E.g.*, Banking: American Industrial Bankers Association, R. 27–30; Illinois Bankers Association, R. 1690–1691; American Bankers Association, R. 1861–1862; Consumer Bankers Association, R. 1907–1924; District of Columbia Bankers Association, R. 2480–2485.

Finance: Independent Finance Association of Illinois, R. 1372–1379; National Consumer Finance Association (1,200 member finance companies), R. 1994–1937; Illinois Consumer Finance Association, R. 2021–2025.

Other: Connecticut Credit Union League, R. 1660–1661; United States Savings and Loan League, R. 1735–1736.

[25] *E.g.*, American Express Company, R. 1212–1215; Western States Bankcard Association, R. 1863–1906; Texaco, Inc., R. 2004–2005; Charge Card Association, R. 2476–2479; Carte Blanche Corp., R. 3404–3405.

[26] *E.g.*, "[W]hat you would be doing if you adopt this kind of regulation would be 'kill the goose that lays the golden egg'. . .", Tom Sealy, Esq., Stubbeman, McRae, Sealy, Laughlin & Browder, Midland, Texas, R. 87–90; Ugo F. Ippolito, Esq., Birmingham, Michigan, R. 97–98; Philip Dale Segrest, Esq., Montgomery, Alabama, R. 367–369; "I strongly urge you to curb and restrain this curious fascination for changing society by administrative ruling." Jon Oden, Esq., Amarillo, Texas, R. 1681.

[27] *E.g.*, Edward A. Dauer, Assistant Professor of Law, University of Toledo, Ohio, R. 3396–3397.

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FEDERAL TRADE COMMISSION

[16 CFR Part 433]

PRESERVATION OF CONSUMERS' CLAIMS AND DEFENSES

Notice of Proceeding, Proposed Amendment to Trade Regulation Rule, Statement of Reason for Proposed Amendment, Invitation To Propose Issues of Fact for Consideration in Public Hearings, Invitation To Comment on Proposed Amendment

Notice is hereby given that the Federal Trade Commission, pursuant to the Federal Trade Commission Act, as amended, 15 U.S.C. Section 41, *et seq.*, the provisions of Part I, Subpart B of the Commission's Procedures and Rules of Practice, 16 CFR § 1.11 *et seq.*, and Section 553 of Subchapter II, Chapter 5, Title 5 of the U.S. Code, (Administrative Procedure) has initiated a proceeding for the promulgation of an amendment to the above referenced Trade Regulation Rule.

In accordance with the above notice, the Commission proposes to revise § 433.2:

§ 433.2 Preservation of Consumers' Claims and Defenses, Unfair or Deceptive Acts or Practices.

In connection with any Purchase Money Loan (as that term is defined in § 433.1) or any sale or lease of goods or services, in or affecting commerce as "commerce" is defined in the Federal Trade Commission Act, it constitutes an unfair or deceptive act or practice within the meaning of Section 5 of that Act, for a seller or a creditor, directly or indirectly, to take or receive a consumer credit contract which fails to contain the following provision in at least ten point, boldface type:

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL BE LIMITED TO AMOUNTS PAID BY THE DEBTOR HEREUNDER.

(38 Stat. 717, as amended, 15 U.S.C. sec. 41 et seq.)

STATEMENT OF REASON FOR THE PROPOSED AMENDMENT

It is the Commission's purpose, in issuing this statement, to set forth its reason for the proposed amendment with sufficient particularity to allow and encourage informed comment. While this statement adverts to issues of fact, law, and policy, it should not be interpreted as designating disputed issues of fact. Such designations shall be made by the Commission or its duly authorized Presiding Official in accordance with the Commission's Procedures and Rules of Practice.

The Commission has conducted lengthy public proceedings on the "holder in due course" doctrine and related problems in consumer sales transactions. Extensive testimony, data, and information were elicited in the course of the proceedings. On the basis of information contained in those proceedings, the Commission promulgated a TRR relating to the Preservation of Consumer's Claims and Defenses, 16 CFR 433. In that proceeding the Commission determined that it constitutes an unfair or deceptive act or practice for a seller to separate, by means of a form consumer credit contract, a buyer's duty to pay from the seller's duty to perform as promised, and that this practice is injurious to consumers and to the market as a whole.

While the proceedings on 16 CFR 433 were primarily concerned with the commercial conduct of sellers, the record contains detailed information about related commercial practices of creditors which causes the Commission to have reason to believe that many creditors are participants in the aforesaid practice, that it is unfair and deceptive for them to engage in the practice and that the proscriptions of the rule can more effectively be enforced if creditors are subject to its provisions. Therefore, in the interest of (1) encompassing within the rule all participants in the aforesaid practice whose participation is unfair or deceptive and (2) facilitating enforcement of the rule, the Commission hereby proposes the aforesaid amendment.

At issue in the instant proceeding are simply the questions of whether creditors participate in the aforesaid practice, whether it is unfair or deceptive for them to do so, and whether the rule could be more readily enforced if creditors were made subject to it. The Commission is not, in this proceeding, reopening the question of the applicability of the rule to sellers.

INVITATION TO PROPOSE ISSUES OF FACT FOR CONSIDERATION IN PUBLIC HEARINGS

All interested parties are hereby given notice of opportunity to propose disputed issues of fact, in contrast to legislative fact, which are material and necessary to resolve. The Commission, or its duly authorized presiding official, shall, after reviewing submissions hereunder, identify any such issues in a Notice which will be published in the FEDERAL REGISTER. Such issues shall be considered in accordance with Section 18(c) of the Federal Trade Commission Act, as amended by Public Law 93-637, and in accordance with rules promulgated thereunder. Proposals shall be accepted until no later than January 15, 1976 by the Special Assistant Director for Rulemaking, Federal Trade Commission, Washington, D.C. 20580. A proposal should be identified as a "Proposal Identifying Issues of Fact-Holder in Due Course," and, when feasible and not burdensome, submitted in five copies. The time and place for public hearings will be set forth in a later Notice which will be published in the FEDERAL REGISTER.

INVITATION TO COMMENT OF THE PROPOSED AMENDMENT TO 16 CFR 433.2

All interested parties are hereby notified that they may also submit, to the Assistant Director for Rulemaking, Federal Trade Commission, Washington, D.C. 20580, such data, views, or arguments on any issues of fact, law, or policy, which may have some bearing on the proposed amendment. Written comments, other than proposals identifying issues of fact, will be accepted until forty-five days before commencement of public hearings, but at least until January 15, 1976. To assure prompt consideration of a comment, it should be identified as a "Holder in Due Course Comment" and, when feasible and not burdensome, submitted in five copies.

Issued: November 14, 1975.

By the Commission.

CHARLES A. TOBIN,
Secretary.

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