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FTC RULE 433 AND THE UNIFORM COMMERCIAL CODE: AN ANALYSIS OF CURRENT LENDER STATUS

DONALD W. GARNER* AND DARRELL W. DUNHAM **

INTRODUCTION

When in 1758 Lord Mansfield declared that an innocent innkeeper could collect a stolen bank note he had taken in payment, the doctrine of holder in due course was launched.¹ Miller v. Race incorporated a large chunk of the law merchant into the common law by recognizing that a "bank note is constantly and universally both at home and abroad treated as money, as cash; and paid and received in cash; and it is necessary, for the purposes of commerce, that their currency should be established and secured."²

Lord Mansfield would probably be surprised at the uses of his holder in due course doctrine in the modern setting.³ As codified in the U.C.C.,⁴ the doctrine authorizes the good faith lender who purchases a negotiable instrument to collect the instrument from the debtor in all except the most compelling circumstances. For instance consider a retail...
furniture store that sells the consumer a sofa on credit by taking a negotiable note from the consumer payable to the furniture store. The store then sells the note signed by the consumer to a finance company. The finance company can demand payment even though the furniture store breached its contract with the consumer by failing to deliver the sofa or by delivering one that is worthless. Only in the most extreme and statistically irrelevant cases will the consumer have a defense against the all-powerful lender. The "real defenses" available in such cases include infancy, duress, illegality, and minority. In the vast majority of cases, the law permits the lender to enforce the breached contract, even though the seller would not be able to do so.

When the consumer started to vigorously participate in the post-World War II credit economy, the doctrine of holder in due course, which was originally intended to aid commerce by treating bank notes as cash, became a burden on commerce, at least from the consumer's

5. U.C.C. § 3-305. See generally Promulgation of Trade Regulation Rule and Statement of Basis and Purpose, 40 Fed. Reg. 53,506, 53,510-11 (1975) [hereinafter cited as Statement of Basis and Purpose]. For cases illustrating the consumer's plight in such situations, see Calbert Credit Corp. v. Williams, 244 A.2d 494 (D.C. 1968); Davis v. Commercial Credit Corp., 87 Ohio App. 311, 94 N.E.2d 710 (1950).


7. U.C.C. § 3-305 provides:

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

(1) all claims to it on the part of any person; and

(2) all defenses of any party to the instrument with whom the holder has not dealt except

(a) infancy, to the extent that it is a defense to a simple contract; and

(b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and

(c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and

(d) discharge in insolvency proceedings; and

(e) any other discharge of which the holder has notice when he takes the instrument.

8. See note 5 infra. See also Bowen, infra note 6, at 595.

9. From 1950 to 1971 aggregate consumer installment debt increased fivefold to $137.2 billion. From 1971 (when rule 433 was first proposed) to 1974 the aggregate debt climbed to $154.5 billion. As of August, 1974, finance companies, retailers, and other institutions subject to FTC jurisdiction held in excess of $75 billion in consumer installment debt. Statement of Basis and Purpose, infra note 5, at 53,507.

viewpoint.11 The holder in due course doctrine places the cost of seller misconduct on the buyer instead of the lender.12 Given the apparent inabilities of consumers to pursue their rights against sellers through costly litigation,13 the guilty seller often was able to keep the proceeds of his misconduct. Meanwhile, the lender could legally enforce the sales contract breached by the seller and could legally demand that the buyer pay for goods which he may never have received or which no longer work.

In response to the changing reality occasioned by massive consumer credit, a majority of states, by both statute and judicial decision, have limited the operation of the holder in due course doctrine with respect to consumers.14 By statute some states have eliminated holder in due course altogether,15 while many court decisions have refused to grant preferential status to what would otherwise be a holder in due course if the lender and the seller are “closely-connected.”16

As a result of this legislative and judicial curtailment of the doctrine of holder in due course, lenders and sellers have resorted to other techniques to avoid defenses on commercial paper generated in consumer transactions. Contractually, by incorporating a “waiver of defense” clause into a non-negotiable instrument, the seller requires the buyer to

11. That the holder in due course doctrine as applied to consumers is a burden on commerce is both the source of jurisdiction for the FTC and the raison d’etre for rule 433. See generally Statement of Basis and Purpose, supra note 5, at 53,526.


13. At the heart of rule 433 is the notion that, without assistance, consumers are incapable of “internalizing” the costs of seller misconduct, i.e., a commercial system which enables sellers and creditors to divorce the consumer’s obligation to pay from the seller’s obligation to perform allocates all the costs of seller misconduct to the consumer. Of all the parties to a consumer sales transaction, the consumer is the least able to negotiate a price which reflects all the costs of the transaction, including the costs of seller misconduct. The stated purpose of rule 433 is to reduce the costs of misconduct to a minimum and to incorporate remaining costs into the price of consumer goods. Thus, goods are to be priced more nearly to reflect actual social costs. It is the FTC’s position that this results in optimum allocation of society’s resources. Statement of Basis and Purpose, supra note 5, at 53,522-23.


15. For examples of state legislation which eliminate the effective use of the holder in due course doctrine in all consumer goods or service transactions, see Ala. Code tit. 5, § 319(a) (1973); Ind. Code § 24-4.5-2-404 (1976); Wyo. Stat. § 40-2-403 (Supp. 1975).

sign away his right to assert personal defenses resulting from the seller's breach of contract against the lender who is attempting to enforce that same contract. Another technique is the direct loan, where the seller directs the buyer to a specific bank or loan company to borrow the money for the purchase. The direct loan gives the appearance that the loan and the sale are separate transactions. The direct lender, therefore, is not forced into the position of having to prove himself a holder in due course or the beneficiary of a waiver of defense clause because he will not be attempting to collect on a contract that has been breached by the seller. The direct lender will be enforcing a contract between himself and the consumer—a contract the direct lender fully performed when he gave the money to the buyer. The direct lender can claim with a straight face that it is no concern of his that the buyer lost the money, gambled it away, spent it on a bad vacation, or purchased a lousy sofa.

In response to the patchwork of state regulation and the clever devices used by lenders and sellers to avoid such regulation, the Federal Trade Commission (FTC) stepped into the fray. On May 14, 1976, FTC rule 433 became effective. The rule's stated purpose is to deny preferred lender status to financiers of consumer goods and services. It attempts to do so by declaring it to be an unfair and deceptive trade practice for the seller to fail to incorporate a legend in his sales contract that will preserve the consumer's claims and defenses against the

17. U.C.C. § 9-206 provides in part: (1) Subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods, an agreement by a buyer or lessee that he will not assert against an assignee any claim or defense which he may have against the seller or lessor is enforceable by an assignee who takes his assignment for value, in good faith and without notice of a claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the Article on Commercial Paper (Article 3). A buyer who as part of one transaction signs both a negotiable instrument and a security agreement makes such an agreement.


19. “[T]he [borrowers] came to the office of the [lender] seeking a loan. They executed the note in question and all the money called for by its terms was delivered. The [borrowers] got full value for the note they signed.” Commercial Credit Plan, Inc. v. Beebe, 187 A.2d 502 (Vt. 1963). See also note 105 infra.


lender. The lender was not directly regulated because at the time the rule was proposed the FTC had no jurisdiction over banks (which are regulated by the Federal Reserve Board). Thus, to avoid regulating a part of the lender community, the rule was written to exempt lenders completely.

In an assignment situation, where the buyer gives the seller a note and the seller in turn discounts the note to a remote lender, the rule requires that the seller include in the loan papers (in ten-point type) the following legend or be subject to FTC sanctions:

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 OB-

23. Id. The FTC's authority to declare unlawful and prohibit unfair practices is found at 15 U.S.C. § 45 (1970). It is doubtful that the commission could have proposed this rule under the original Federal Trade Commission Act of 1914, ch. 311, 38 Stat. 711. A circuit court decision interpreting the original act held that FTC authority did not extend to purely consumer affairs which did not affect competition. Raladam Co. v. FTC, 42 F.2d 430 (6th Cir. 1930). The Raladam decision is criticized in Handler, The Jurisdiction of the Federal Trade Commission Over False Advertising; 31 COLUM. L. REV. 527 (1931).

In any case, the FTC act was amended in 1938 so that the commission could regulate consumer-oriented issues. Rather than speaking in terms of "unfair methods of competition," ch. 311; § 5, 38 Stat. 719 (1914), the 1938 Wheeler-Lea Amendment encompassed "unfair or deceptive acts or practices in commerce." The purpose of this change was to extend protection to consumers where there was no anticompetitive effect from the deceptive act. 83 CONG. REC. 395 (1938); H.R. REP. NO. 1613, 75th Cong., 1st Sess. 3 (1938).


These attacks have been answered by recent amendments which explicitly grant rule-making authority to the FTC and should be interpreted to give FTC regulations the fullest possible commerce power scope. 15 U.S.C. §§ 45(a)(1), 57(a) (Supp. V 1975); [1974] U.S. CODE CONG. & AD. NEWS 7702, 7712-13, 7714-15.

TAIRED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.\textsuperscript{25}

If the consumer borrows money directly from the lender and thus the seller never touches the note, the seller violates the FTC rule if he accepts the proceeds of a direct loan which fails to include a similar legend preserving the consumer’s claims and defenses.\textsuperscript{26}

The problem with the rule is manifest in that it puts the onus of preserving the buyer’s claims or defenses on the seller rather than on the lender. The lender is not directly regulated, and his status is not directly affected.

This half step by the FTC provokes exceptionally complicated legal issues. The rights and liabilities of the consumer and the lender involve detailed legal argument and analysis requiring consideration of numerous factors: whether the lender is attempting to collect or the buyer is attempting to recover the payments already made; whether the loan papers include or fail to include the FTC legend preserving the claims and defenses; and whether the creditor is lending directly to the consumer or indirectly by taking an assignment of the note from the seller. In some cases, the result may even hinge on the nature of the assigned paper, \textit{i.e.}, whether the note is negotiable or non-negotiable.

This article will offer an analysis of the status of the consumer and the lender under the U.C.C. now that the FTC rule is in operation. Although many commentators have written about the new FTC action,\textsuperscript{27} most have either simply assumed that the rule has successfully elimi-

\begin{itemize}
  \item \textsuperscript{25} 16 C.F.R. § 433.2 (1977).
  \item \textsuperscript{26} [I]t is an unfair or deceptive act or practice ... for a seller ... to:
    
    (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:

    \begin{verbatim}
    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 OBTAINED WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.
    \end{verbatim}

  \item \textsuperscript{27} See, \textit{e.g.}, Hansford, \textit{The Holder in Due Course—An Endangered Species?}, 37 ALA. LAWYER 540 (1976); Rohner, \textit{Holder in Due Course In Consumer Transactions: Requiem, Revival or Reformation?}, 60 CORNELL L. REV. 503 (1975); Comment, \textit{The FTC Proposed Rule and the Holder In Due Course}; 18 S.D.L. Rev. 516 (1973).
\end{itemize}
nated preferential lender status, or have engaged in rather bizarre reasoning to arrive at that conclusion. Section I of this paper will deal with the scope of the FTC rule and will point out situations where the seller is in violation of the rule. Section II will deal with the effect rule 433 will have on the lender's status under the U.C.C. The writers' analysis indicates that in an overwhelming majority of cases the FTC rule, in conjunction with the U.C.C., ought to prove successful in preserving both the defenses and claims of the buyer. The FTC rule achieves this result even in cases where the legend is not incorporated into the contract. The organizational approach will be as follows:

I. THE SELLER'S LIABILITY TO FTC SANCTION: SCOPE OF THE NEW RULE

A. Parties

B. Transactions

1. Assignment of the Consumer's Note to a Holder in Due Course
2. Assignment of Paper Containing a Waiver of Defense Clause
3. Direct Loans to the Consumer by a Third-Party Lender
   a. Referrals
   b. Affiliation
4. Excluded Transactions

II. THE RULE'S EFFECT ON THE LENDER'S STATUS

A. Lender Sues Consumer For Payment

1. Legend Paper
2. Paper Not Containing the Required Legend
   a. Holder in Due Course
   b. Waiver of Defense Clause
   c. The Direct Loan

B. Consumer Claims Against the Lender

1. Legend Paper
2. Paper Not Containing the Required Legend
   a. Holder in Due Course
   b. Waiver of Defense Clause
   c. The Direct Loan

III. CONCLUSION


29. See Comment, Implied Consumer Remedy Under FTC Trade Regulation Rule—Coup De Grace Dealt Holder In Due Course?, 125 U. Pa. L. Rev. 876, 886-95 (1977) (suggesting that a cause of action be implied against a lender who has not broken the law).
I. The Seller's Liability to FTC Sanction: Scope of the New Rule

The Magnuson-Moss Warranty—Federal Trade Commission Improvement Act granted the FTC new powers to enforce its rules. Until recently, the FTC was limited to the use of a cease and desist order in preventing unfair and deceptive trade practices. The FTC now can require (by means of rescission, reformation, damages, etc.) the violator to civilly “redress injury” suffered by the party the FTC rule was intended to protect. This section will describe the operation of rule 433 and thereby set forth those situations in which the seller will be subject to these fortified FTC sanctions when he fails to insert the required legend.

A. Parties

As indicated in the introduction, the FTC was concerned primarily with techniques used to cut off the consumer's claims and defenses against the lender. Little concern was expressed for businessmen and corporations who were perceived to be more capable of fending for themselves. Thus, rule 433 protects only a “natural person who seeks to acquire goods and services for personal, family, or household use.”

In addition, the rule applies only to a seller who “in the ordinary course of business sells or leases goods or services to consumers.” Likewise, the sale must be financed by a commercial “creditor,” “[a] person who, in the ordinary course of business, lends purchase money or finances the sale of goods or services on a deferred payment basis.” The rule has no application if the lender is a rich uncle, if the buyer is General Motors, or if the seller is your next door neighbor.

B. Transactions

1. Assignment of the Consumer's Note to a Holder in Due Course

As codified in Article Three of the U.C.C., the consumer is deprived of his defenses to collection by the assignment of a negotiable instrument to a holder in due course. Under the new rule, when the seller of goods or services assigns a negotiable instrument generated by

32. See generally Statement of Basis and Purpose, supra note 5, at 53,507-08.
33. 16 C.F.R. § 433.1(b) (1977).
34. Id. § 433.1(j).
35. Id. § 433.1(c).
36. See note 4 supra.
37. Under U.C.C. § 3-104(1) in order to be negotiable the paper must:
   (a) be signed by the maker or drawer, and
the sale, to a commercial lender the seller commits an unfair and deceptive trade practice if he fails to incorporate the required legend.\textsuperscript{38} Once again, it should be emphasized that the \textit{lender} himself will not be in violation of the rule. Section II \textit{infra} will explore whether holder in due course status will be denied the lender attempting to collect the note.

2. Assignment of Paper Containing a Waiver of Defense Clause

A lender who is assigned non-negotiable paper containing a waiver of defense clause is attempting to acquire the same rights as held by the assignee of a negotiable note under the holder in due course doctrine.\textsuperscript{39} Like the holder in due course situation, a waiver of defense clause enables the lender to collect without regard to the buyer's defenses against the seller.\textsuperscript{40} Under the new FTC rule, the seller would be committing an unfair and deceptive trade practice if he fails to include in the loan papers the FTC legend preserving the consumer’s claims and defenses against the lender.\textsuperscript{41}

3. Direct Loans to the Consumer by a Third-Party Lender

The FTC discovered that the seller and the lender could finesse both state legislation and judicial decisions which limited the doctrine of holder in due course and the use of waiver of defense clauses.\textsuperscript{42} The finesse was achieved by employment of a direct loan whereby the seller would direct the consumer to the lender. These loans (dubbed “dragging

\begin{itemize}
  \item[(b)] contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power as given by the maker or drawer except as authorized by this Article; and
  \item[(c)] be payable on demand or at a definite time; and
  \item[(d)] be payable to order or to bearer.
\end{itemize}

Thus, if the consumer signs a negotiable note in exchange for the sale of services, goods, or even land, Article Three of the U.C.C. will govern his rights and liabilities. Therefore, unlike Article Two of the Uniform Commercial Code which applies only to the sale of goods (U.C.C. § 2-102), a negotiable note given as consideration for the sale of services will be governed by Article Three.

\textsuperscript{38} 16 C.F.R. § 433.2 (1977).
\textsuperscript{39} See note 17 \textit{supra}.
\textsuperscript{40} U.C.C. § 9-206(1) expressly provides that under a waiver of defense clause the assignee takes free from all claims and defenses except “defenses of a type which may be asserted against a holder in due course of a negotiable instrument” under Article Three.
\textsuperscript{41} 16 C.F.R. § 433.2 (1977).
\textsuperscript{42} The original version of the rule did not cover direct loans from the lender to the buyer. During the first set of hearings, however, the FTC elicited testimony from consumer witnesses who related their unfortunate experiences in this area. As a result of these case histories and the testimony of industry witnesses and public interest organizations, the FTC determined that “vendor-related loans should be covered by any Commission rule in this area.” See Statement of Basis and Purpose, \textit{supra} note 5, at 53,514-15.
the body" because they were tantamount to the seller's "dragging" the consumer to the lender's office) gave the appearance that the sale and the loan were separate transactions. There are even documented instances of door-to-door selling where the lender's agents made house calls with the salesmen.

In response to these tactics, the new FTC rule provides that where there is a connection between the lender and a seller, the seller engages in a deceptive and unfair trade practice if he takes the proceeds of a direct loan which does not contain the required legend. Conversely, if a consumer obtains a direct loan from the lender and there is no connection between the lender and the seller, the rule does not apply. The obvious issue is whether there is a sufficient connection. The rule sets forth two types of relationships, "referral" and "affiliation," that trigger operation of rule 433.

a. Referral

If the seller "refers consumers to the creditor," the seller violates federal law if he takes the proceeds of a loan which fails to preserve the consumer's claims and defenses. Thus, the literal language of the rule would place any referral within the rule's scope. However, it appears that occasional referrals are not governed by the rule. Only the systematic and calculated channeling of consumers to a particular credit outlet is regulated; the passing on of information to consumers about potential sources of financing is not regulated. Therefore, there is no violation when a seller provides lists of financing institutions or even occasionally recommends one financing institution over another so long as this is not done on a regular basis. However, according to the FTC

43. Id. at 53,514.
45. 16 C.F.R. § 433.2 (1977).
46. Guidelines, supra note 22, at 20,025.
49. Id. at 20,025. In the words of the commission:
   The word "refers" is intended to reach those situations where a seller, in the ordinary course of business, is sending his buyers to a particular loan outlet, or to particular outlets, for credit which is to be used in the seller's establishment. In such circumstances, the seller is effectively arranging credit for his customers. No specific number of referrals is specified in the Rule. The key distinction is between those instances where a seller is merely passing along information about places where his buyers may obtain credit and those where a seller is acting as a conduit for financing and channeling buyer-borrowers to a particular lender or limited group of lenders. (Emphasis added).
50. The FTC illustrates several situations where the Notice would be required in direct loan transactions in Preservation of Consumers' Claims and Defenses—Statement of Enforcement Policy, 41 Fed. Reg. 34,594, 34,596 (1976).
staff, once a referral relationship exists, all subsequent transactions involving the same seller and lender fall within the scope of the rule even though some of the loans are not the result of a referral.\textsuperscript{51}

b. Affiliation

In addition to referrals, the rule requires that the loan papers contain the FTC legend if an "affiliation" relationship exists between the seller and the lender. Affiliation exists when there is "common control, contract, or business arrangement"\textsuperscript{52} between the seller and lender. The FTC staff guidelines indicate that while the "contract" or "business arrangement" may be informal, an agreement nevertheless must exist.\textsuperscript{53} The Commission considers the following examples of affiliated relationships:

- Maintenance of loan application forms in the office of the seller;
- Joint participation in the processing of loan documents;
- Creditors' referrals of customers to sales outlets;
- Payment of consideration to a seller for furnishing loan customers or to a creditor for furnishing sales prospects;
- Floor-planning or inventory financing arrangements which include or contemplate the assignment of indirect paper or the referral of loan customers;
- Active creditor participation in a sales program;
- Joint advertising efforts;
- An agreement to purchase paper on an indirect basis.\textsuperscript{54}

Thus, the rule requires either a formal or an informal agreement with some lender participation in the selling of the goods or services.\textsuperscript{55}

4. Excluded Transactions

As indicated, the FTC rule protects only consumers and does not extend to nonconsumer transactions. However, not every transaction involving a consumer falls within the scope of the rule. The rule applies only to "consumer credit contract[s]"\textsuperscript{56} and defines this term by reference to the Federal Truth in Lending Act\textsuperscript{57} and Regulation Z.\textsuperscript{58} This

\textsuperscript{51} Id. See also Guidelines, supra note 22, at 20,026.
\textsuperscript{52} 16 C.F.R. § 433.1(d)(2) (1977).
\textsuperscript{53} Guidelines, supra note 22, at 20,026.
\textsuperscript{54} Id.
\textsuperscript{55} Under the original rule, the establishment of facts given in the examples gave rise to a rebuttable presumption that an affiliated relationship existed. 38 Fed. Reg. 892, 893 (1973). The use of rebuttable presumptions was eliminated in the final rule because the FTC felt their application would be both unnecessary and unwise. See Statement of Basis and Purpose, supra note 5, at 53,525.
\textsuperscript{56} 16 C.F.R. § 433.2 (1977).
\textsuperscript{58} 12 C.F.R. § 226 (1977). See generally 16 C.F.R. § 433.1(d), .1(e), .1(i) (1977); Statement of Basis and Purpose, supra note 5, at 53,524-25.
definition excludes consumer purchases of goods if the amount to be financed exceeds $25,000.00.\textsuperscript{59}

Credit card transactions also are exempted.\textsuperscript{60} During the hearings prior to the adoption of the rule, there was substantial debate as to whether it should apply to credit cards.\textsuperscript{61} The FTC eventually decided to exempt credit card transactions. Nevertheless, federal legislation was passed which severely limits the ability of the credit card company to insist upon payment of the credit card bill if the goods or services sold were not as warranted. The Fair Credit Billing Act prevents the credit card issuer from invoking a waiver of defense clause if the amount of the purchase is in excess of $50.00 and if the purchase occurred in the consumer's home state or within 100 miles of his residence.\textsuperscript{62} Thus, for most large, non-vacation purchases, the consumer will have the right not to pay his credit card bill if the goods or services prove to be unsatisfactory.

II. The Rule's Effect on the Lender's Status

The foregoing section outlined the circumstances under which the seller commits an unfair and deceptive trade practice. The following sections will analyze the rule's effect on the rights and liabilities of the lender in two contexts: where the lender sues the consumer for payment, and where the consumer sues the lender to recover payments already made.

A. Lender Sues Consumer For Payment

1. Legend Paper

If the credit contract contains the legend required by rule 433, of course the seller avoids committing a deceptive or unfair trade practice. The question discussed in this section is the effect of inclusion of the legend on the lender's ability to collect. The FTC guidelines state that the legend itself becomes a part of the contract.\textsuperscript{63} When the legend


\textsuperscript{60} 16 C.F.R. § 433.1(c) (1977).

\textsuperscript{61} Statement of Basis and Purpose, supra note 5, at 53,516. The FTC found very little consumer abuse in this area in proportion to the volume of transactions, which in 1971 was estimated at over 300 million per year. Ross, The Credit Card's Painful Coming-of-Age, \textit{FORTUNE}, October, 1971, at 108. The Commission also found that, in order to insure their subscribers continued satisfaction and business, in some cases credit card issuers will intervene on the behalf of consumers in their disputes with sellers.


\textsuperscript{63} Guidelines, supra note 22, at 20,023.
is incorporated into the contract, then at a minimum the lender has waived any right to separate the buyer’s obligation to repay from the seller’s obligation to perform.64 In effect, by successfully threatening the seller with FTC punishment, the seller is compelled to require the lender to “agree” not to assert what would otherwise be his holder in due course status or his rights under an inconsistent waiver of defense clause,65 or his rights to repayment of a direct loan. (Even a shotgun wedding is better than no wedding at all.)

When the lender sues to collect and the FTC legend preserving the consumer’s “claims and defenses” is in the loan papers, the question becomes what sort of defenses can be raised against the lender that will excuse the consumer’s obligation for the unpaid balance of the loan. The FTC staff guidelines state that the incorporated legend protects the consumer’s right “to assert against the creditor any legally sufficient claim or defense against the seller. The creditor stands in the shoes of the seller.”66 The preservation of claims and defenses affected by rule 433 does not confer any new substantive rights on consumers. Rather, the claims and defenses existing under the U.C.C.67 are preserved, but not enlarged.

The extent of the lender’s responsibility for the seller’s conduct is illustrated by an example. Consumer buys a new $7,000 Buick on credit and Seller discounts the paper incorporating the FTC legend to Finance Company. Subsequently, Consumer buys a new Chevrolet for $4,000 cash from Seller. The Chevrolet turns out to be a lemon and Consumer resists paying Finance Company for the Buick. The FTC staff addressed this problem in a common sense manner by announcing a “same transaction” test. “The holder's obligations are limited to those arising from the transaction which he finances.”68 Thus, the lender’s right to payment is not burdened by problems between the seller and consumer that are unrelated to the financed transaction.

64. Id.
65. The FTC staff takes the position that the text of the Notice cannot be qualified by other language which limits the legend’s effect. Therefore, a contract which contains both the FTC legend and a waiver of defense clause would be an unfair and deceptive trade practice. Id.
66. Guidelines, supra note 22, at 20,023.
67. If the seller fails to deliver the goods, the buyer has a remedy under U.C.C. §§ 2-713 and 2-715. If the seller delivers the goods, their quality must meet certain standards. The quality terms for goods imposed by the U.C.C. are as follows: express warranties under U.C.C. § 2-313; implied warranties of merchantability under U.C.C. § 2-314; implied warranties of fitness for a particular purpose under U.C.C. § 2-315. The seller’s failure to conform to these quality terms gives rise to buyer’s remedies under U.C.C. §§ 2-714 and 2-715. Buyers’ remedies, including cover and recovery of identified goods, are treated generally at U.C.C. § 2-711.
68. Guidelines, supra note 22, at 20,024.
2. Paper Not Containing the Required Legend

The problems are more complex when the lender attempts to collect and the loan papers do not contain the legend. As indicated above, the seller may be exposed to FTC sanctions. However, the effect of the seller's violation on the lender's ability to collect is a question that many commentators simply have assumed to be answered in the consumer's favor. The problem must be analyzed in three contexts—holder in due course, waiver of defense clause, and direct loan—each of which in the past would have placed the lender in a preferred collecting status.

a. Holder in Due Course

When the seller assigns the consumer's negotiable note to the lender, the lender becomes a holder in due course if he has complied with the requirements of U.C.C. section 3-302. That section requires that the lender take the paper in good faith, for value, and without notice of a defense to the note's collectibility. Obviously, because the commercial lender almost always will buy the note, the consumer's arguments under section 3-302 will be based upon notice and lack of good faith.

Certainly the lender's knowledge that the loan papers do not contain the FTC legend cannot be considered "notice of a defense" under section 3-302 because that section traditionally has been interpreted to require notice of an existing defense. If the FTC legend is missing, the lender would not be on notice of an existing defense; he only would be on notice that the consumer's defenses have not been preserved. Sec-

69. See note 28 supra.
70. See note 4 supra.
71. U.C.C. § 3-304(6) provides that notice is effective only if received so that the recipient can act on it. Thus, a defense arising after the holder takes the negotiable note gives him no opportunity to act on it. See Crest Fin. Co., Inc. v. First State Bank, 37 Ill. 2d 243, 226 N.E.2d 369 (1967); Branch Banking & Trust Co. v. Gill, 286 N.C. 342, 211 S.E.2d 327 (1975); First Nat'l Bank v. Motors Acceptance Corp., 15 Wis. 2d 44, 112 N.W.2d 381 (1961). See generally 10 C.J.S. Bills and Notes § 332 (1972).
72. If a court did not feel bound to a literal interpretation of the U.C.C. and was willing to decide these cases on policy grounds supporting the notice requirement, the lender's knowledge that the seller should have put the FTC legend in the loan papers should be sufficient notice to deprive the lender of holder in due course status. As U.C.C. § 3-302 now reads, the lender's knowledge that the seller has breached his contractual duties to the consumer permits the consumer to assert his defenses to payment against the lender. Now that the FTC requires the seller to preserve the consumer's defenses, the lender's knowledge that the seller has breached his duty to preserve those defenses should allow the consumer to assert those defenses against the lender. If the lender's knowledge of an existing defense burdens his rights on the negotiable note with respect to that defense, his knowledge that defenses should have been preserved also should burden his rights on the note. In this regard, it is the lender's knowl-
tion 3-304 elaborates on what is meant by taking the instrument "without notice of claim or defense" and declares that the lender does take with notice of a claim or defense if the note is "so incomplete . . . so irregular as to call into question its validity (or) terms...." While the cases have dealt only with missing signatures and the like, an Indiana court declared in dictum that if a federal regulation required certain terms to be incorporated into a note and those terms were excluded, the note would be irregular on its face. It certainly seems persuasive that when federal law requires all consumer paper to contain a clause which preserves the consumer's claims and defenses the note would be incomplete and irregular without it.

Moreover, the lender may not qualify as a holder in due course on the ground that he did not take the paper in good faith. Good faith is defined by section 1-201 (19) as "honesty in fact in the conduct or transaction concerned." This section generally has been interpreted to provide for a "subjective" test of honesty. In the modern setting

edge that he is purchasing a consumer credit contract that should put him on notice because he is presumed to know that the law requires that the legend be placed in such contracts.

75. U.C.C. § 3-304(1)(a).
75. Western State Bank v. First Union Bank & Trust Co., 360 N.E.2d 254 (Ind. Ct. App. 1977). The issuer of certificates of deposits (negotiable instruments) contended that Regulation Q of the Federal Reserve Board required that the certificates indicate a maturity date and interest rate, and that because the certificates in question did not contain a maturity date or an interest rate, they were irregular on their face such that there could be no holder in due course status for the holder of the certificates. The court held that Regulation Q did not require an indication of an interest rate or maturity date and therefore did not decide whether the omission made the certificates irregular. Nevertheless, the court did state in dictum that § 3-304(1)(a) contemplated more than intrinsic irregularities, thereby implying that the certificates would have been irregular if Regulation Q had not been complied with.
76. U.C.C. § 1-201(19).
(where the lender knows the seller's business so well that the FTC now requires the lender to bear the risk of seller misconduct), only in the rarest situations will the lender be heard to claim that he did not know he was taking consumer paper and thus did not know that the absent FTC legend was required to be present. If the lender knowingly aids the seller's violations by purchasing paper without the FTC legend, certainly he can never take the paper in good faith.\textsuperscript{78}

Finally, in addition to the irregularity-incompleteness and good faith arguments, the consumer may find solace in the "real" defense of illegality. As mentioned in the introduction, certain real defenses such as infancy, duress, misrepresentation as to the nature of the instrument, insolvency, etc., are valid even against a holder in due course. Among the real defenses announced in U.C.C. section 3-305 is "illegality of the transaction as renders the obligation of the party a nullity."\textsuperscript{79} The seller's violation of the FTC rule by failing to include the legend in the note may taint the whole credit transaction.\textsuperscript{80} The seller's unlawful trade practice may rationally result in a court's treating the note like a gambling debt—the source of numerous illegality cases.\textsuperscript{81} Many gambling debt cases have held that the innocent holder in due course cannot enforce the note at all.\textsuperscript{82}

If the courts refuse to enforce any part of the debt by declaring a note without the FTC legend to be unlawful, a windfall might go to the debtor who may not have actually been injured by the failure of the seller to incorporate the required legend. The buyer simply may be unable or unwilling to pay and have no meritorious defense against enforcement of the debt.\textsuperscript{83} Still, a court would apparently be empowered to stand back and not lend its aid to the enforcement of this unlawful

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\textsuperscript{78} A lender who knows of the seller's violations cannot be said to have abided by the U.C.C.'s standard of "honesty in fact." U.C.C. § 1-201(19). Even where the holder intentionally keeps himself ignorant of the details surrounding a suspicious transaction, he may not be acting in good faith. See, e.g., Norman v. World Wide Distrib., Inc., 202 Pa. Super. 55, 195 A.2d 115 (1963).

\textsuperscript{79} U.C.C. § 3-305 (2)(b).

\textsuperscript{80} U.C.C. § 3-305 generally is read as a deference to the law of the local jurisdiction. See U.C.C. § 3-305, Comment 5; 2 R. Anderson, U.C.C. § 3-305.18 (1971). If the underlying transaction is considered to be "void ab initio" and not merely "voidable," there can be no holder in due course status. See generally Pacific Nat'l Bank v. Herrreich, 240 Ark. 114, 398 S.W.2d 221 (1966); Middle Georgia Livestock Sales v. Commercial Bank & Trust Co., 123 Ga. App. 733, 182 S.E.2d 533 (1971); Annot., 22 A.L.R.3d 932, § 28 (1969).


\textsuperscript{82} See cases cited note 81 supra.

\textsuperscript{83} Cf. Associate Credit Co. v. Nogic, 327 A.2d 740 (Conn. Cir. Ct. 1974) (the court allowed the consumer a windfall in order to enforce a statutory consumer protection scheme by holding that failure by the seller to include a three
contract. The deterrent effect occasioned by the courts' refusal to enforce nonlegend paper based on an illegality argument would be substantial. A lender simply would refuse to buy nonlegend paper if he knew he could not turn to the courts to enforce his debt. The FTC rule consequently would be served and vindicated by rewarding the undeserving consumer.

The refusal of the courts to enforce a note marred by illegal activity is supported by U.C.C. section 2-302 which governs unconscionable contracts. If it finds a contract unconscionable, "the court may refuse to enforce the contract." While the courts have not so used this draconian power, the comments reaffirm the authority of the court to refuse any enforcement: "Under this section, the court, in its discretion, may refuse to enforce the contract as a whole if it is permeated by the unconscionability...." If the law permits the courts to refuse to enforce an unconscionable contract, the courts also ought to be permitted to refuse enforcement of unlawful contracts.

If a court finds the nonlegend paper to be an unlawful contract but chooses not to grant the consumer a possible windfall, then at a minimum the lender ought to be denied holder in due course status and the consumer's personal defenses should be heard. However, if this restrained use of the defense of illegality is employed, then the requirement of section 3-305 that the "illegality of the transaction [be such] as renders the obligation of a party a nullity" (emphasis added) has not been literally satisfied. If, through one contention or another (e.g., irregularity, incompleteness, good faith, illegality), the negotiable note holder who is attempting to collect paper without the FTC legend is denied holder in due course status, then U.C.C. section 3-306 comes into play. Section 3-306 states that "[u]nless [the lender] has the rights of a holder in due course [the lender] takes the instrument subject to... all day rescission notice required by the state Consumer Protection Act permitted the borrower to completely avoid paying the lender).


85. Cf. Pearlstein v. Scudder & German, 429 F.2d 1136 (2d Cir. 1970), cert. denied, 401 U.S. 1013 (1971) (a highly culpable debtor was awarded damages from a more or less innocent violator of Federal Reserve Board Regulation T; the debtor won, not because he deserved to win, but because the creditor deserved to lose), noted in Note, 49 Tex. L. Rev. 192 (1970).

86. U.C.C. § 2-502(1).

87. Id. Comment 2.

88. See Household Fin. Corp. v. Mowdy, 13 Ill. App. 3d 822, 300 N.E.2d 863 (1973) (the court permitted the consumer to assert a defense to payment even though the notice provision required by the Illinois Consumer Fraud Act had been omitted from the credit contract). Contra, Associate Credit Co. v. Nogic, 327 A.2d 740 (Conn. Cir. Ct. 1974).

defenses of any party which would be available in an action on a simple contract; ..." The cases under this section illuminate the sort of defenses the debtor can assert to reduce his liability. Just as the FTC staff explained that the "claims and defenses" preserved by the FTC legend were those which arose from the financed transaction, a majority of courts under section 3-306 and its precursor, section 58 of the Uniform Negotiable Instruments Law, have limited the debtor to defenses arising out of the financed transaction. A buyer's rights against the seller which arise out of collateral transactions between the buyer and seller are called "set-offs" and are not permitted to be asserted as a defense against the lender.

While set-offs are not permitted, the defense of "failure of consideration" specifically is permitted by section 3-306(c). That section has been interpreted expansively to cover not only cases where the consumer never received the goods, but also cases of breach of warranty. Thus, if the lender is not a holder in due course because the papers fail to bear the FTC legend preserving the consumer's claims and defenses, under U.C.C. section 3-306 the consumer will be able to resist paying the unpaid balance of the note when the seller does not perform at all, sells unmerchantable goods, or renders faulty service. Therefore, the consumer is protected against the collecting assignee of a negotiable note even though the seller failed to incorporate the FTC legend.

90. Guidelines, supra note 22, at 20,024.
91. For cases under NIL § 58 holding that a holder not in due course is not subject to an independent set-off, see, e.g., Manufacturers' Fin. Corp. v. Vye-Neill Co., 62 F.2d 625 (1st Cir. 1933; Stegal v. Union Bank & Fed. Trust Co., 163 Va. 417, 176 S.E. 438 (1935). See generally Annot., 95 A.L.R. 582 (1935).
93. Set-off and recoupment, the common law forerunners of the modern day counterclaims in equity practice, were based on the notion that one should not be forced to pay what he will be able to recover. Recoupment was developed to permit the defendant to demonstrate any facts arising out of the transaction sued upon which might support an independent action in favor of the defendant for the purpose of reducing the plaintiff's recovery. It was imperative that both claims involve the same "subject matter" or arise out of the same "transaction." However, where the defendant's claim arose out of a different transaction than that sued upon by the plaintiff, he was compelled to bring a separate action. The equity courts, in order to relieve this hardship on the defendant, began allowing a "set-off" at an early date. To qualify for a set-off, the demands either had to be liquidated or arise out of contract or judgment, be due the defendant in his own right against the plaintiff or his assignor, and not be barred by the statute of limitations. J. COUND, J. FRIENDENTHAL & A. MILLER, CIVIL PROCEDURE 505-06 (2d ed. 1974).
94. Northern Plumbing Supply, Inc. v. Gates, 196 N.W.2d 70 (N.D. 1972). While the case spoke only of a breach of warranty that caused the consumer to
b. Waiver of Defense Clause

If the seller includes a waiver of defense clause in non-negotiable paper that does not contain the FTC legend preserving the consumer's claims and defenses and the paper is then assigned to the lender, a question arises as to the effect of the seller's violation of the FTC rule on the lender's ability to collect. Section 9-206 of the U.C.C. regulates and sanctions the use of a waiver of defense clause in suits by the assignee-lender to collect from the debtor. However, the sanction is expressly made "[s]ubject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods..." 95 Although the FTC rule is not a statute, violation of rule 433 does violate section 5 of the Federal Trade Commission Act. 96 Assuming that rule 433 is a "statute," the question is whether it is a "statute" contemplated by section 9-206. Because section 9-206 applies only to suits by lenders against debtors (not those by sellers against debtors), and rule 433 does not directly apply to lenders, the courts should conclude that rule 433 is not the type of statute contemplated by section 9-206, and that therefore rule 433 does not of itself preclude enforcement of waiver of defense clauses. If rule 433 did directly regulate lenders, then it would be a statute which protects buyers of consumer goods against lenders.

However, this does not mean that the consumer is now subject to the oppressive waiver of defense clause. Section 9-206 also requires that the lender take the non-negotiable paper given as consideration for goods or services which contains the waiver of defense clause "in good faith" without "notice of a claim or defense" before he can assert the waiver. 97 The comments indicate that this is a reference to the re-

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95. U.C.C. § 9-206(1). See note 17 supra.
97. U.C.C. § 9-206(1). If a non-negotiable instrument containing a waiver of defense clause is given as consideration for the sale of services, the lender who takes the instrument by assignment must meet the good faith arguments of section 9-206 under both the 1962 version of Article Nine as well as the 1972 amendments. Under the 1962 code if the sale of services had not been performed at the time of assignment, it would be classed as a "contract right" because "right to payment under [the] contract [had] not yet [been] earned by performance." U.C.C. § 9-106 (1962 version). If the services had been performed at the time of assignment, the obligation to pay is defined as an "account." U.C.C. § 9-106 (1962 version). If the non-negotiable instrument was accompanied by a security agreement given for the sale of services, then the obligation is defined as...
requirements that must be met in order to become a holder in due course of a negotiable note under section 3-302. Thus, the arguments already made concerning irregularity-incompleteness, good faith, and illegality, all of which deny the assignee of a negotiable note holder in due course status or prevent his enforcement of the contract, are equally applicable to the assignee of non-negotiable paper who is seeking to enforce a waiver of defense clause. If the holder of a negotiable instrument not containing the legend does not qualify as a holder in due course, similarly, the holder of a non-negotiable instrument which does not contain the legend should not be permitted to assert a waiver of defense clause.

Once it is decided that the assignee of non-negotiable paper is not protected by a waiver of defense clause, the consumer will be permitted to assert his defenses to payment by operation of U.C.C. section 9-318. Like section 3-306 which governs the right of an assignee of a chattel paper. U.C.C. § 9-105(1)(b) (1962 version). See also U.C.C. § 9-106 (1962 version). Whether the non-negotiable paper is considered a contract right, an account, or chattel paper, § 9-102(1)(a) and (b) provides that the paper is within the scope of Article Nine. Thus, all three types of paper given for the sale of services containing the waiver of defense clause are subject to the general obligation of § 9-206 which requires the assignee-lender to act in good faith. Under the 1972 code, the definition of a "contract right" is merged into an "account." U.C.C. § 9-106 (1972 version). Thus, an unperformed sale of services is now considered an account. However, if the non-negotiable paper also contains a security interest, the paper is still considered "chattel paper." U.C.C. § 9-105(1)(b). See also U.C.C. § 9-106. Section 9-102(1)(a) and (b) provides that Article Nine governs both the sale of accounts and assignment of chattel paper. Therefore, the assignment of a non-negotiable instrument given as consideration for the sale of services, whether it be considered an account or chattel paper, will be governed by the good faith requirements of § 9-206.

98. U.C.C. § 9-206, Comment 1.


100. Courts confronted with the waiver of defense mechanism have rendered it unenforceable in a number of ways other than as suggested in the text. Among the most far-reaching decisions are those based on a public policy of preserving consumer defenses and giving effect, via the U.C.C., to the doctrine of unconscionability. See San Francisco Sec. Corp. v. Phoenix Motor Co., 25 Ariz. 531, 220 P. 229 (1923); Fairfield Credit Corp. v. Donnelly, 158 Conn. 543, 264 A.2d 547 (1969); Dearborn Motors Credit Corp. v. Neel, 184 Kan. 437, 337 P.2d 992 (1959); Quality Fin. Co. v. Hurley, 337 Mass. 150, 148 N.E.2d 385 (1958). See also Tiger Motor Co. v. McMurtry, 284 Ala. 283, 224 So. 2d 638 (1969) (because the waiver of defense action is at law, the consumer was permitted to sue in equity to rescind a contract due to the seller's breach of warranty).

101. U.C.C. § 9-318(1) provides:

(1) Unless an account debtor has made an enforceable agreement not to assert defenses or claims arising out of a sale as provided in Section 9-206 the rights of an assignee are subject to
negotiable note to collect from the consumer, section 9-318(1)(a) permits the consumer to assert against the assignee of non-negotiable paper any defense arising out of "the contract between the [consumer] and [seller]." Thus, there is also a "same transaction" requirement in a waiver of defense clause case. However, unlike section 3-306, the consumer also is permitted under section 9-318 to assert a "set-off" (a defense to payment arising out of a transaction unrelated to the financed transaction) provided that the set-off "accrues before [the consumer] receives notification of the assignment." 103

(a) all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom; and
(b) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives notification of the assignment.

Section 9-318 of both the original code and the 1972 version governs most of these cases due to the expansive definition of "account" under § 9-106. Section 9-318 governs the rights of the lender and consumer where there has been an assignment of an "account." "Account" means any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance." U.C.C. § 9-106. Thus, § 9-318 will govern all consumer credit transactions except those which involve an "instrument" or "chattel paper." Section 9-105(1)(i) defines instrument as a "negotiable instrument." Therefore, § 3-306 will control those cases. "Chattel paper" is defined as "a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods . . ." U.C.C. § 9-105(1)(b). Thus, § 9-318 does not govern a consumer credit contract which contains both a waiver of defense clause and a security agreement. Since there is no code provision governing the rights of the lender and the consumer over chattel paper, non-code law must determine the consumer's ability to assert a defense. Section 168(2) of the Restatement (Second) of Contracts (Tent. Drafts Nos. 1-7 1973) provides that the consumer can assert any claim or defense which "accrues" before his notification of the assignment to the lender. The term "accrues" has been interpreted to include any defense or claim which arose as a part of the transaction between the consumer and the seller. Thus, the consumer will be permitted to assert all claims and defenses which arise out of the contract which was assigned. As for defenses that did not arise out of the financial transaction, the lender may give the consumer notice of the assignment and thereby cut off defenses which the consumer may assert against the seller and which arise in the future. Since the present wording of § 9-318 is based on § 168(2) of the Restatement (see authorities cited note 146 infra) it is not surprising that the two sections yield identical results.

Section 9-106 under the 1962 code defined "account" in the same way as § 9-106 under the 1972 code, except that a right which had not been "earned by performance" was excluded from this definition and given the separate definition of "a contract right." Thus, an unperformed sale of services was a "contract right" under the 1962 code. If the seller assigns this type of consumer credit contract, the legal relationship between the lender and consumer also will be governed by § 168(2) of the Restatement (Second) of Contracts.

102. See section II(A)(2)(a) supra.

103. U.C.C. § 9-318(1)(b).
c. The Direct Loan

When the consumer goes directly to the lender and negotiates a loan which is thus separate from his sales contract with the seller, it must be determined what rights to defeat collection are possessed by the consumer when the loan papers fail to bear the FTC legend. It is important to remember that the direct lender will not be seeking to enforce a contract that has been breached by either the seller or the lender. By definition, a direct loan means that the lender and the consumer are the only formal parties to the note, and the lender will have performed fully the moment he gave the money to the consumer.\(^{104}\) The truly independent direct lender can honestly claim that whatever the consumer does with the money is the consumer’s business, and if the consumer gets into a bad deal with a merchant who is unrelated to the direct lender, it is of no concern to the lender. Many cases have made the obvious point that the seller’s breach of his sales contract does not put the unrelated direct lender in breach of his loan contract.\(^{105}\)

Unlike the assignee lender, the direct lender does not attempt to enforce the seller’s breached contract and has no need to prove himself a holder in due course or beneficiary of a waiver of defense clause. The direct lender simply has no need to cut off the consumer’s claims and defenses against the seller because those defenses do not exist against

104. See text accompanying note 19 supra; note 105 infra.
105. See United States v. McCulloch, 26 F. Supp. 7 (E.D.N.Y. 1939) where the consumers used the direct loan proceeds to install an oil burner. The court was prompted to say: “The difficulty with the [consumers’] position is that because of some real or fancied defect in the oil burner which they purchased, they desire to avoid payment of the note which they gave to a third party to enable them to buy a burner. The [lender] was not the seller of the oil burner and made no representations in respect to the oil burner.” Id. at 8. Thus, the court permitted the lender to recover on the note. See also United States v. Warshaw, 61 F. Supp. 678 (E.D.N.Y. 1945); Utah State Nat’l Bank v. Stringer, 44 Idaho 599, 258 P. 522 (1927) (loan); Farmer’s Savings Bank v. Grange, 199 Iowa 978, 203 N.W. 37 (1925) (loan); Beneficial Fin. Co. v. Bienemy, 244 So. 2d 275 (La. Ct. App. 1971) (loan); Wood v. Morgan Bros., 135 So. 2d 692, 695 (La. Ct. App. 1961) (note given as consideration for services rendered); Ohio Loan & Discount Co. v. Tyarks, 173 Ohio 564, 184 N.E.2d 374 (1962) (loan); First Nat’l Bank v. Somers, 38 S.D. 96, 160 N.W. 523 (1916) (loan).

In a case decided under the U.C.C., the maker of a note sought to avoid payment on the ground that the lender and the third-party contractor, who allegedly received the proceeds of the loan, were in fact the same party. Thus, the maker argued that he should be able to defend the lender’s action on the note by raising defenses he had against the third-party contractor. The court sent the matter back for further evidence on the question whether the lender and the third-party contractor were the same entity. Thereby, the court impliedly held that if the lender and the third-party contractor were separate entities the maker could not burden the lender’s right to payment with the maker’s claims and defenses against the contractor. See Behrens v. Apessos, 39 Mich. App. 426, 197 N.W.2d 886 (1972).
the direct lender. If the FTC legend is included in the loan papers, the
direct lender will have agreed to make his loan "subject to all claims and
defenses which the debtor could assert against the seller . . . ." However,
what are the consumers' rights when the legend is missing, but should
have been incorporated due to a referral or affiliation connection be-
tween the direct lender and seller?

One excellent source of consumer protection in this situation may be
found in the "overriding and super-eminent principle" of good faith.
Section 1-203 of the U.C.C. with a grand sweep provides that "[e]very
contract or duty within this act imposes an obligation of good faith in its
performance or enforcement." The standard of good faith for lenders is
"honesty in fact in the conduct or transaction concerned." If the di-
rect lender knows, as he certainly will in most cases, that he is dealing
with a customer of a seller with whom the lender has an "affiliation" or
"referral" relationship, then in the authors' view, the direct lender must
incorporate the FTC legend in order to honor his obligation of good
faith.

When a consumer walks into E-Z Finance to get a loan, he certainly
will have to fill out a loan application form. E-Z will inquire into the
purpose of the loan, if for no other reason than to acquire a security
interest if goods are to be purchased. When the consumer tells E-Z's
loan officer that he is going to use the money to buy a sofa from Sticks
Furniture, the loan officer will then know (because he surely knows
whether Sticks and E-Z do business together) whether the loan papers
should contain the FTC legend. If Sticks and E-Z are related to each
other in such a way as to activate rule 433, then E-Z is acting in bad faith
when it aids Sticks' violation of rule 433 by failing to include the legend.
We accept as a matter of faith that if honesty means anything, it means
avoiding the knowing participation in a conspiracy to violate federal
law. Of course, the lender would not violate the FTC rule, but he
would have aided and abetted the seller's violation and thereby would

106. See Farnsworth, Good Faith Performance and Commercial Reasonableness
107. U.C.C. § 1-201(19). See note 77 supra.
108. Cf. Burnett v. H.O.U. Corp. (In re Kalamazoo Steel Process, Inc.) 503 F.2d 1218 (6th Cir. 1974), where a seller of goods was not permitted to assert his
security interest against the debtor's trustee in bankruptcy. Although the seller
had filed his security interest under the debtor's legally correct name at the time
of sale, the seller knew the debtor was about ready to undergo a name change.
Thus, the seller tried to mislead future creditors who would not be able to locate
the security interest by a check under the debtor's new name. The court noted
that "a realization that another is unaware of something or does not understand
it may be considered as not conforming to the good faith standard of the Code."
Id. at 1222, quoting King, Policy Decisions and Security Agreements Under the Uniform

If, in a rule 433 situation, the lender knows he is participating in a trick to
deny the ignorant consumer of his claims and defenses, then it is more than
have violated the obligation of good faith required of direct lenders. When the requisite connection exists between the seller and lender, such that the seller violates the FTC rule by taking the proceeds of a direct loan that did not include the FTC legend, there is a high probability that the lender knows he is participating in a scheme to deprive the consumer of what would otherwise be his preserved rights.  

If the direct lender is declared to have violated his obligation of good faith, what is the sanction to be imposed? A sanction specifically mentioned in the U.C.C. for the assignment situation is that the assignee-lender who does not demonstrate his good faith will be denied holder in due course status and also will not be permitted to claim rights under a waiver of defense clause. Because the direct lender does not need to be a holder in due course or the beneficiary of a waiver of defense clause, this sanction is useless in the direct loan context.

An appropriate sanction for the direct lender’s bad faith in failing to incorporate the FTC legend would be to treat the direct loan as if the FTC legend had been incorporated. If good faith demands the FTC legend’s incorporation, then this remedy corrects the bad faith. With the FTC legend judicially placed in the loan papers, the consumer will be able to assert his defenses to collection, which arose from the seller’s breach of his sales contract against the direct lender in the lender’s suit to recover the unpaid balance.

The net result under this analysis will be to subject all bad faith lenders, both direct and assignee, to the consumer’s defenses even though the FTC legend is missing. If the lender is an assignee, his bad faith will result in denial of holder in due course status or of benefits under a waiver of defense clause, thereby subjecting him to the consumer’s defenses arising from the breached sales contract. If the lender makes the loan directly, his bad faith should allow a court to reform the

arguable that the lender is acting in bad faith. The Kalamzoo case was followed in King v. Williams (In re Conger Printing Co., Inc.), 18 U.C.C. Rep. Serv. 224 (D. Or. 1975).

109. Dictum in Commercial Credit Plan, Inc. v. Beebe, 123 Vt. 317, 321, 187 A.2d 502, 505 (1963) suggests that if the direct lender had known of the seller’s misconduct, then the lender would have been unable to collect from the defrauded customer.

Cf. Restatement of Torts § 876(b) (1939) (“For harm resulting to a third person from tortious conduct of another, a person is liable if he . . . knows that the other’s conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself . . . .”).

110. See sections II(B)(1), II(B)(2) supra.

111. For various theories to hold the direct lender liable in situations not specifically concerned with failure to incorporate the FTC legend, see Note, Direct Loan Financing of Consumer Purchases, 85 Harv. L. Rev. 1409 (1972). See also TPO, Inc. v. FDIC, 487 F.2d 131 (3d Cir. 1973); Ryan v. Ryan, 298 A.2d 343 (Del. Super. Ct. 1972); Lewis v. Citizens & Southern Nat’l Bank, 139 Ga. App. 855, 229 S.E.2d 765 (1976), where the direct lender was unable to collect in his suit on the negotiable note.
contract by constructively placing the FTC legend in the loan papers, thus burdening the loan with the buyer's defenses arising from the seller's breach.\textsuperscript{112}

B. Consumer Claims Against the Lender

The preceding section II (A) supra dealt with the consumer's ability to assert a defense against the lender in order to reduce the consumer's obligation to repay the outstanding balance of the note. This section will deal with the consumer's ability to assert claims against the lender in order to recover payments already made.

1. Legend Paper

The lender who loans money pursuant to a consumer credit contract that contains the FTC clause stating "Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller. . ."\textsuperscript{113} has contractually obligated himself to stand in the shoes of the seller. When the rule works and the legend is included in the consumer credit contract, the lender in effect has agreed to let the buyer assert his claims against him. Mercifully, only in cases discussed infra involving down-payments and trade-ins will it make a difference whether the lender acquires the contract by assignment\textsuperscript{114}

\textsuperscript{112} One court has achieved the results suggested in the direct lender-good faith situation by mistakenly treating the direct lender as an assignee lender. In Slaughter v. Jefferson Fed. Sav. & Loan, 361 F. Supp. 590 (D.D.C. 1973) a seller of home improvements steered his ghetto customers to a number of savings and loan associations who made the loans directly to the customers. Due to the unconscionable prices charged by the seller, the customers sued as a class to rescind the notes held by the direct lenders as well as to recover payments already made. Incredibly, the direct lender claimed that the reason he could enforce the notes was because he was a holder in due course. The trial court snapped up this plea and responded by declaring that the direct lenders were not holders in due course because they had operated in bad faith. The direct lenders, according to the court, intentionally kept themselves ignorant, in the face of very suspicious circumstances, of the unconscionable prices charged by the seller. In turn, the court reformed all the notes so as to have them reflect only the true value of the work performed by the seller. Some got money back, some had reduced payments. On appeal the District of Columbia Circuit reversed on the issue of good faith. 538 F.2d 397 (D.C. Cir. 1976). See also First Nat'l Bank v. Brown, 181 N.W.2d 178 (Iowa 1970), where a direct lender's fraud prevented his collection of the unpaid balance. This very fair and sound result is to be encouraged, but future courts and litigants should recognize that the direct lender is not trying to cut off defenses to the enforcement of his note because there is no defense to be cut off. If courts desire to protect the consumer against the direct lender who is connected with the seller, they can do so by requiring the lender to act in good faith and remedying the direct lender's bad faith by judicially imposing the legend into the loan agreement.

\textsuperscript{113} 16 C.F.R. § 433.2 (1977) (emphasis added).

\textsuperscript{114} Prior sections to this paper have drawn a distinction between a lender who is assigned a negotiable note and is asserting holder in due course status
or makes a direct loan. The FTC legend is essentially the same in both cases, and the contractual rights of the consumer to assert a refund claim against the lender should be identical in most cases. If the FTC legend is in the loan papers, the lender will have more or less consented to return the debtor’s payments if the debtor has a valid claim against the seller.

While liability may be the same in both the assignment and direct loan contexts, there are still perplexing and unanswered questions with respect to the consumer’s ability to recover the payments made. An example may aid the analysis. Consumer buys a new dunebuggy from Seller for a price of $6,000. Consumer trades in his old buggy for a credit of $2,000 on the purchase price and pays an additional $1,000 cash down-payment. Consumer’s negotiable note with a balance due of $3,000, to be repaid in installments over a three-year period, is then assigned by Seller to Lender. The note contained the FTC legend:

Notice. Any holder of this 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.115

Seller warrants the dunebuggy against defects in materials and workmanship for five years, but after only six months, the dunebuggy is completely destroyed by a fire caused by a leaking, defective gas tank. The fire causes no other damage. At the time of the fire, Consumer had paid $500 in installments to Lender with $450 applied to principal and $50 applied to interest.

As previously indicated, Lender will have waived what might have otherwise been his holder in due course status or his ability to rely on a waiver of defense clause if the FTC legend is in the loan papers.116 Consequently, Consumer will be able to assert the defense of Seller’s breach of warranty to defeat Lender’s suit to collect the remaining $2,500 balance. However, Consumer is not satisfied with just the right to cease making payments but also wants to recover the $500 of installment payments, the $1,000 cash down-payment, and the $2,000 trade-in. There is no question whether Consumer will be permitted to recover the $450 that was applied to principal. Seller’s breach is directly related to the financed transaction and Lender will have to give Consumer his money back.117 Because the legend states that the recovery against the

and the lender who is assigned a non-negotiable note which contains a waiver of defense clause. Since the FTC rule requires the same legend be placed in both types of contracts, the contractual rights and obligations of the consumer and lender will be the same and there is no need to treat the cases separately in this section.

116. See notes 95-103 and accompanying text supra.
117. See sections II(A)(1), II(A)(2)(a) supra.
lender "shall not exceed amounts paid by the debtor," there is no problem raised by recovery of the $450. As the $50 interest also was paid under the contract, there should be no hesitation on the part of the courts to allow Consumer to recover it as well.

The FTC staff suggests that recovery of the down-payment and trade-in depends upon whether an assignment or a direct loan is involved. The Staff Guidelines provide that a down-payment should be included in the consumer's potential recovery if the lender acquires the consumer credit contract by assignment from the seller but should be excluded if the consumer credit contract is acquired by a direct loan. Both legends (that for assignments and that for direct loans) contain identical language: "Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder." In the case of an assignment, the down-payment is made to the seller pursuant to the consumer credit contract. Because the assignee-lender later holds that same contract, the down-payment made thereunder can be recovered as part of the consumer's claim against the lender. The consumer will not be able to recover the down-payment made to the seller in the direct loan situation because the down-payment would not have been made pursuant to the direct loan contract with the lender.

This distinction between direct loans and assignments is made all the more significant by realizing that there is no fundamental distinction between trade-ins and down-payments. If a down-payment is "paid" in an assignment situation, then there is no reason to assume that a trade-in should be treated differently. Therefore, in an assignment case the lender will be liable for all that the consumer has given up in purchasing the goods or services, and the lender's potential liability will exceed, in many cases, the amount he has received from the consumer. Caveat cessionarius.

A change in the dunebuggy hypothetical illuminates problems other than with trade-ins and down-payments. Assume that there has been no down-payment or trade-in, but that installment payments in the amount of $500 have been made. The dunebuggy fire on this occasion does $200 damage to the dunebuggy's paint job, causes the consumer's garage to burn down, and results in personal injuries. The garage damage totals $5,000 and the consumer suffers $10,000 in personal injuries. There is little question that the consumer could recover $200 of his payments to

118. 16 C.F.R. § 433.2 (1977).
119. An extended search failed to reveal an official FTC comment on interest. An FTC attorney who handles rule 433 problems said that the reason there is no comment is that because it was so obvious that "paid hereunder" included interest, the staff had never thought to comment. Telephone interview with Walter Diercks (Oct. 11, 1977).
120. Guidelines, supra note 22, at 20,023.
121. 16 C.F.R. § 433.2 (1977).
122. Guidelines, supra note 22, at 20,023.
pay the cost of a new paint job for the dunebuggy. The real issue raised is whether he could recover up to an additional $300 (thereby reaching the limits of the amounts paid under the consumer credit contract) to at least partially compensate him for the damage to his garage and person. The FTC staff has said that the rule “does apply to all claims or defenses connected with the transaction whether in tort or contract.” As there is no indication that consequential damages are not “claims,” the consumer could recover an additional $300 from the lender.

A final question is raised by cases where the warranty period is longer than the repayment period. The FTC legend preserving the consumer’s claims and defenses adds nothing to the substantive law and reference must be made to state law to determine what constitutes a good claim or defense. Consequently, if a statute of limitations has run on the claim, or the period of the warranty has expired, the consumer would have no recognized claim or defense when the goods fail, even though he is still in debt to the lender. The consumer may be unhappy but if he has no recognized claim or defense, inclusion of the FTC legend will not aid his recovery.

But what of the converse situation where the consumer has a good claim, but he has already paid off the lender? In the hypothetical case, if the dunebuggy fire occurred after four years of use by the consumer, i.e., a year after the lender had been totally paid off and the note had been marked paid in full and returned to the consumer, the question is whether the consumer would have any claim for recovery. An astute attorney for the lender might argue that the consumer has no claim to recover payments from the lender because the lender is no longer “a holder of a consumer credit contract.” A holder is defined in the U.C.C. as “a person who is in possession . . . of an instrument.” If

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123. U.C.C. § 2-714(2) sets forth a general rule for determining the damages suffered by a consumer when accepted goods do not live up to their warranty. The general measure of damages is the difference between the value of the goods accepted and their value had they been as warranted. However, where the true damage is the repair cost, § 2-714(1) permits damages to be determined “in any manner which is reasonable” and § 2-714(2) permits damages to be determined in a different manner if there are “special circumstances.” Therefore, the fire loss probably would be determined by the amount of the repair bill instead of by an attempt to determine hypothetically different values.

124. In addition to U.C.C. § 2-715 (which permits recovery for consequential damage to person or property caused by breach of warranty), RESTATEMENT (SECOND) OF TORTS § 402A (1965) permits recovery of damages for physical harm to person or property from one who sells a defective product in an unreasonably dangerous condition.

125. Guidelines, supra note 22, at 20,024.

126. Id. at 20,023. See note 66 supra for a general outline of the claims and defenses that accrue to a consumer of goods.


128. U.C.C. § 1-201(20).
the lender no longer is in possession of the note, as he would not be if the note had been paid off and surrendered to the consumer, then arguably the time has passed for him to respond to the consumer's claims. However, an FTC staff member has stated that the lender's liability is coextensive with the length of the seller's warranty liability.129 The FTC contention is that once the lender touches the consumer credit contract, he obligates himself to return the consumer's payments whenever the seller would be liable to the consumer.130 The wording of the legend does not indicate whether the lender must be a holder at the time of suit or whether he simply must have been a holder any time before suit. Thus the issue cannot be resolved by a reading of the rule.

2. Paper Not Containing the Required Legend

a. Holder In Due Course

As section II(A)(2)(a) supra indicated, the holder of a negotiable instrument may not qualify as a holder in due course when the note fails to bear the FTC legend. This results in the consumer being able to assert his defenses against collection under U.C.C. section 3-306.131 At issue is whether the consumer also will be able to recover payments he has already made from a holder not in due course when the FTC legend is missing. Section 3-306 only permits the assertion of "claims to [the instrument]," i.e., claims to recover the instrument or proceeds that were stolen, forged, or altered.133 In cases where the consumer does not get what he bargained for, the consumer's relief under section 3-306 is limited to asserting a defense to defeat the lender's suit to collect the unpaid balance.134

By only permitting the consumer to raise defenses, section 3-306 may imply that the lender is protected from affirmative liability. A number of knowledgeable commentators have stated that the assignee-lender's exposure is limited to the unpaid balance of the loan.135 The little court authority available supports the notion that the assignee of a

129. Letter from Rachel Shao, Attorney, FTC Division of Compliance, to Darrell Dunham (June 20, 1977).
130. The staff expressed concern that a lender may be able to avoid the rule simply by having the consumer sign a series of term notes. Thus, the consumer would never be able to recover his payments because the lender would surrender each note after the consumer's payment.
131. See section II(A)(2)(a) supra.
132. U.C.C. § 3-306(a).
133. U.C.C., § 3-306, Comment 2 states: "'All valid claims to it on the part of any person' includes not only claims of legal title, but all liens, equities, or other claims of right against the instrument or its proceeds." (Emphasis added).
134. See cases cited note 92 supra.
135. Rohner, Holder in Due Course in Consumer Transactions: Requiem, Revival, or Reformation?, 60 CORNELL L. REV. 503, 554 (1975). Rohner relied on 2 G. Gil-
negotiable note is not affirmatively liable. For instance, in *Standard Insulation & Window Co. v. Dorrell* the assignee of a negotiable note sued to collect and was met with a counterclaim that the maker had made an overpayment to the assignor. The court held that the assignor was not a holder in due course because it took the note with knowledge that it was overdue, and consequently, the assignor was subject to the maker's defenses but was not liable for the overpayment.

However, there appears to be no good reason to deny affirmative liability when the assignee of a negotiable note actively participates in the sale and thus may be in violation of his obligation to act in good faith imposed in the *U.C.C.* There is a case that imposes affirmative liability on the bad faith, closely-connected assignee of a negotiable note. In *Gross v. Appelgren* a referral scheme to sell Tappan ranges was set up by attorneys who also represented Metropolitan Industrial Bank. Negotiable notes were taken by the seller and assigned to the bank. The customers of the seller were defrauded in various ways, and after a number of payments were made to the bank, the customers sued to rescind the notes and recover their payments. The Colorado Supreme Court first held that the bank could not have acted in good faith because it was so closely connected with the seller. Therefore, the bank was denied

*More, Security Interests in Personal Property* 1091-92 (1965), where Professor Gilmore stated:

Between buyer and seller the unsoundness of [the goods and services] would be available both as defenses and as claims. If seller sued for the price, buyer would plead breach of warranty or failure of consideration as a defense, but buyer could also sue seller (or bring a counterclaim in the seller's action) to recover a down payment or any damages that resulted from the breach. Between buyer and seller's assignee, however, the breach of warranty or failure of consideration is available only defensively; if buyer wishes to recover his down payment or his damages, he must go directly against the seller. The assignee, who comes in to finance the transaction, does not thereby become responsible for the assignor's warranties or prospective performance.

Professor Gilmore was referring to non-negotiable notes under Article 9, but there is no suggestion that the idea is not so applied to negotiable notes. See also 80 C.J.S. *Set-Off and Counterclaim* § 61 c (1953) "[J]udgment cannot be rendered against the assignee for the excess. [Borrower] is entitled to use his claim defensively, and not offensively."


137. As discussed in section II(A)(2)(c), all lenders are under the obligation to act in good faith.


139. A number of courts have held that the assignee-lender who is closely connected to the seller cannot as a matter of law be a holder in due course, but none of these cases imposed affirmative liability. See, e.g., *Commercial Credit Co. v. Childs*, 199 Ark. 1073, 137 S.W.2d 260 (1940); *Commercial Credit Corp. v.
holder in due course status. However, the court did not stop there. It also ruled, with no discussion, that the bank would have to return the payments already made.

When the assignee of a negotiable note not containing the required legend knows that he is helping the seller violate rule 493, he ought to be declared to be acting in bad faith.140 Under U.C.C. section 3-302, the bad faith will result in the lender being denied holder in due course status and therefore subject him to the buyer’s defenses via section 3-306. In addition, if the consumer has a justified claim for a refund, the court ought to correct the violation of the lender’s good faith obligation by judicially introducing the FTC legend into the loan. Under the reconstituted loan, the consumer then could assert his claim for recovery of the payments he already made. Nowhere in the U.C.C. does it say that bad faith can serve only as a shield. On the contrary, cases involving bad faith sellers under Article Two have resulted in affirmative liability being imposed.141

b. Waiver of Defense Clause

If the lender purchases non-negotiable paper not containing the FTC legend and attempts to assert a waiver of defense clause, the analysis set forth in section II (A)(2)(b) supra indicated that U.C.C. section 9-206 will not authorize the waiver’s use. If the buyer can therefore raise his defenses under section 9-318,142 can he also assert his claims to recovery of the payments already made when the FTC legend is absent? Unlike section 3-306, which regulates holders not in due course of negotiable instruments and specifically authorizes only the assertion of defenses, section 9-318 appears to permit an affirmative recovery. Section 9-318(1)(a) not only makes the lender’s rights “subject to any claim arising” from the contract between the consumer and the seller, i.e., claims relating to the financed transaction, but also permits a consumer’s unrelated claim against the seller to be asserted against the lender if this unrelated claim arose prior to the consumer receiving notice of the assignment.

However, Professor Gilmore, one of the draftsmen of this section,143 has written that consumers are not authorized under this section to seek


140. See note 109 supra.


142. See note 101 supra for text of § 9-318.

affirmative relief from the lender,¹⁴⁴ and the cases support this assertion.¹⁴⁵ Professor Gilmore states that section 9-318 permits "claims" to be asserted by the consumer only in the limited context of a defense to a suit by the lender and only for the amount of the judgment.¹⁴⁶ Therefore, section 9-318 as glossed by Professor Gilmore and the courts operates like section 3-306.¹⁴⁷

However, just as in the case of a bad faith assignee of a negotiable note,¹⁴⁸ the holder of non-negotiable paper who has violated his obligation of good faith by participating in a scheme to deprive the consumer of his FTC rights ought to be required to return the consumer's payments (assuming, of course, that the consumer has a justified refund claim).

*Massey-Ferguson Credit Corp. v. Brown*¹⁴⁹ illustrates the point that where the lender is not a remote financier but participates in bringing about the harm, he will be made affirmatively liable. A farm implement manufacturer purchased non-negotiable paper from a dealer who sold a combine to a farmer and took in trade the farmer's old combine. The non-negotiable paper contained a waiver of defense clause. The manufacturer-lender's representative had been present at the sale and had assured the farmer that the dealer would honor his promise to service the combine. The combine broke down, the dealer went out of business, and the manufacturer-lender sued to collect the unpaid balance. The farmer counterclaimed to recover the value of his trade-in. The Montana Supreme Court held that the manufacturer-lender was so close to the transaction that he could not be said to have taken the paper without notice of a defense as required by U.C.C. section 9-206. Moreover, the lender's participation not only prevented his collection but also prompted the court to remand the case for a hearing on the counterclaim.¹⁵⁰

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¹⁴⁶ See authorities cited note 144 supra.

¹⁴⁷ There are unique cases which will be governed by non-Code law as illustrated by the Restatement (Second) of Contracts § 168(2) (Tent. Drafts Nos. 1-7, 1971), but the results will be the same as those achieved under U.C.C. § 9-318. See note 101 supra.

¹⁴⁸ See section II(B)(2)(a) supra.

¹⁴⁹ 547 P.2d 846 (Mont. 1976).

¹⁵⁰ The Colorado Supreme Court has provided the only other case that permitted an affirmative recovery by the consumer from an assignee of a non-
The consumer's claim for refund is even stronger when the lender acts in bad faith by purchasing non-negotiable paper without the required legend from a seller who later defaults. There is simply no reason to protect the bad faith lender from the consumer's justified claims for refund. If the lender breaches his duty of good faith by participating in what amounts to a conspiracy to aid the seller's violation of federal law, the lender cannot, in good conscience, claim that he expected to be able to retain the benefits of the conspiracy.

c. The Direct Loan

When the consumer goes directly to the lender and there is thus no note to be assigned, can the buyer get his money back when the goods or services prove to be shoddy? If the direct lender's bad faith in failing to include the FTC legend can render his loan uncollectible as indicated in section II(A)(2)(c) supra, then his bad faith ought to prevent his retention of the consumer's payments if the consumer has a justified claim for refund. When the direct lender knowingly aids the seller's violation of rule 433 and thereby attempts to deprive the consumer of his claims and defenses against the direct lender, the courts should remedy the bad faith exclusion of the legend by treating the loan as if the legend were present. Conversely, when the direct lender does not participate in the seller's violation of the FTC rule, the direct lender ought to be isolated from both the consumer's claims and the consumer's defenses.

Two direct loan cases nicely illustrate the point that the direct lender's degree of participation in injuring the consumer determines his affirmative liability to the consumer.

In Blackwell v. Midland Federal Savings & Loan Association\(^{151}\) home buyers borrowed directly from the savings and loan company and then

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\(^{151}\) 132 Colo. 20, 284 P.2d 1060 (1955).
engaged a contractor to build a house. The lender was not obligated to inspect the house, nor did the court mention any connection at all between the lender and builder. After six years of occupancy, the buyer sued both the lender and contractor for damages occasioned by the faulty construction of the house. The ubiquitous Supreme Court of Colorado denied the buyer's affirmative claims and affirmed the trial court's summary judgment in favor of the lender.

On the other hand, in *Connor v. Great Western Savings & Loan Association*¹⁵² the lender actively participated in a home construction project where many of the homes contained major structural defects. The lender financed the builder's acquisition of the land and construction of the houses and helped plan the entire subdivision development. Great Western also directly loaned the funds to acquire the homes to some of the home purchasers.¹⁵³ When the purchasers sued Great Western for damages, *i.e.*, the imposition of affirmative liability, and recission, Justice Traynor declared that the lender had a duty of reasonable care to protect the purchasers of the homes from damages caused by faulty construction.¹⁵⁴

In a rule 433 situation when the direct lender and seller are connected by a referral or affiliation relationship, the requisite foundation has been laid for lender bad faith liability. If there is no connection between the direct lender and seller, the rule does not apply. Thus, the direct lender would not be aiding and abetting the seller's violation of the rule by failing to incorporate the legend. Simply put, if the lender helps cheat the consumer, good faith provides the authority to make him pay.¹⁵⁵

III. Conclusion

The foregoing analysis demonstrates that when the FTC legend is missing, the consumer's claims and defenses will rest principally on the not too certain foundation of good faith. The seller may be subject to


¹⁵³ From the lower court opinion, it appears that Great Western held almost all the first mortgages on the homes. *Connor v. Conejo Valley Dev. Co.*, 61 Cal. Rptr. 333 (Ct. App. 1967).


¹⁵⁵ See note 141 *supra*. For cases where affirmative liability has been placed on the bad faith insurer, see *The Tort of Bad Faith: A Perspective Look at the Insurer's Expanding Liability*, 8 Cum. L. Rev. 241 (1977).
quite stringent remedies now available to the FTC but the lender will go on his way unregulated unless the courts take the pains to construct a theory of liability.

Of course, an aggressive court could rationally declare that in order to advance the public policy protecting consumers, henceforth lenders will be treated as if the FTC legend were in the loan papers. By judicial fiat, and without a troublesome inquiry into the labyrinth of the U.C.C., all the problems raised in this article could be eliminated. There is a persuasive analogy to suggest such a judicial tour de force. As mentioned before, a number of courts have declared that a lender who is closely connected to the seller cannot ever be a holder in due course even though the formal requirements of section 3-302 (that the lender take for value, in good faith, and without notice of a defense) have been complied with. This judicial amendment to the U.C.C. was made and has been hailed as necessary to protect the hapless consumer.

Another technique that has been suggested to avoid tying the fate of the consumer to the lawfulness of the seller is the creation of an implied right of action. The idea is for a court to imply a cause of action in favor of the consumer against the lender for the seller’s violation of rule 433. Indeed, there is authority for implication of a civil remedy in favor of a consumer injured as a result of violation of an outstanding FTC cease and desist order. However, the implied cause of action ran against the violator of the cease and desist order, not against some third party. In a rule 433 situation, the seller is the violator, but the implied cause of action is to run against the lender who has violated no FTC rule. As the seller is already civilly liable to the consumer for his breach of contract, implication of a cause of action against the seller for his violation of rule 433 does the consumer no good. To advance the

156. See 15 U.S.C. § 57b(b) (Supp. V 1975) which provides remedies of rescission or reformation of contracts, refund of purchase money, return of property, payment of damages and public notification of rule violations.

157. See authorities cited notes 16 and 139 supra.

158. See authorities cited notes 16 and 139 supra.


161. See U.C.C. §§ 2-711,-714,-715.
idea of implying a cause of action against the lender really amounts to nothing more than urging the courts to do for the FTC what the FTC did not do for itself.

The strength of these arguments hopefully lies in pointing out to the courts, litigants, commenters, and the FTC, how rule 433 operates in conjunction with the U.C.C. These arguments can permit a "strict constructionist" judge, in good conscience, to grant the consumer all that he would have gotten had the seller not violated the rule. No broad policy ground need be broken, no blind assumptions need be made; a court only has to require lenders to act in good faith as required by the U.C.C. and thereby arrive at a socially desirable result.

However, these results will be reached on a state-by-state basis; if a jurisdiction does not accept the good faith and related arguments made here, the consumer will be prejudiced by the FTC failure to make the lender liable under rule 433. It is ironic that the FTC rule, which was intended to bring order out of the chaos of state regulation of the holder in due course,162 doubtless will produce its own patchwork of varying judicial interpretation as to its effect.

Rule 433, half step though it may be, already is achieving desired results. Lenders are requiring sellers to recourse the paper they discount,163 thus providing the seller with a strong incentive to stand behind the goods and services he sells. Lenders also are refusing to carry paper from fly-by-night sellers, drying up these sellers' sources of consumer credit164 thus drying up this type of seller. These beneficial results have been achieved without provoking either interest rate increases or substantial market dislocations.165

However, until such time as the FTC and the Federal Reserve Board are moved to adopt rules which directly regulate lenders (such rules are now in the proposal stage),166 the courts will continue to be faced with the problem of the seller failing to place the FTC legend in the loan papers. Unfortunately, the problem will not go away even if the FTC and the Federal Reserve Board act tomorrow. From May 14, 1976, until such time as the proposed regulations are adopted, millions of consumer credit contracts will be negotiated and in those cases where the legend is missing, the consumer may very well be prejudiced by the FTC's failure to go all out to protect him. Hopefully, this article will provide the courts with the U.C.C. analysis to aid them in resolving the perplexing questions occasioned by the FTC's half measure.

164. Id.
165. Id.
166. See note 24 supra.