RULES AND REGULATIONS

Title 16—Commercial Practices
CHAPTER I—FEDERAL TRADE COMMISSION
PART 433—PREVENTION OF CONSUMERS’ CLAIMS AND DEFENSES

PROCLAMATION OF TRADE REGULATION RULE


Written comments from interested parties have been received by the Commission. Public hearings have been held in New York (June 7–9, 1971); Chicago, Illinois (July 12–14, 1971; May 7–9, 1973); and Washington, D.C. (September 20–23, 1971 and March 15–17, 1973). See 36 F.R. 6595, 7685; and 38 F.R. 8000.

Accordingly, the Commission hereby amends Subchapter D, Trade Regulation Rules, Chapter 1 of 16 CFR by adding a new Part 433 as follows:

Sec. 433.1 Definitions.

433.2 Preservation of consumers’ claims and defenses, unfair or deceptive acts or practices.

AUTHORITY: 38 Stat. 717, as amended; (16 U.S.C. 41, et seq.)

§ 433.1 Definitions.

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

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

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

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

(e) Financing a sale. Extending credit to a consumer in connection with a

“Credit Sale” within the meaning of the Truth in Lending Act and Regulation Z.

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

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

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

(i) Consumer credit contract. Any instrument which evidences or embodies a debt arising from a “Purchase Money Credit Transaction” or a “Service Transaction” as defined in paragraphs (d) and (e).

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

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

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

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

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SALE OF GOODS OR SERVICE OFFERED WITH THE PROCEEDS HEREOF. RECOVERY HEREBY DEPENDS ON THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREBUNDER.

or,

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

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SALE OF GOODS OR SERVICE OFFERED WITH THE PROCEEDS HEREOF. RECOVERY HEREBY DEPENDS ON THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREBUNDER.

Effective: May 14, 1976.


CHARLES A. TOBIN, Secretary.

STATEMENT OF BASIS AND PURPOSE

The Commission’s purpose, in issuing this statement, to review thoroughly the information, data, and testimony which was received in the course of the proceedings on this rule. It is also in the Commission’s purpose to state, with particularity, the purpose of each provision of the rule together with the Commission’s reasons for enforcing or not enforcing the revisions as a result of information elicited during these proceedings.

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

CHAPTER 1: HISTORY OF THE PROCEEDING

On January 21, 1971, the Commission, in the matter of the Preservation Buyers’ Claims and Defenses in Consumer Installment Sales, published a proposed rule in the Federal Register on January 26, 1971. All interested parties were invited to file written data, views or arguments concerning the proposed rule, to testify at public hearings in Washington, D.C., New York City, and Chicago. As a result of the public record developed in the initial round of hearings, the Commission published a revised version of its proposed rule entitled Preservation of Consumers’ Claims and Defenses. On January 15, 1973, the reopened proceeding hearings were held in Washington, D.C., and Chicago. The closing date for written comments and submissions was June 1, 1973.

In the course of two rounds of hearings on this rule, conducted by the Assistant Director for Rulemaking, every person who expressed a desire to present his views had an opportunity to do so. The 3,350 page transcript of the hearings has been included in the public record of these proceedings, together with 7,362 pages of written comment. In this Statement of basis and purpose, references to the transcript of hearings are designated by the prefix “Tr.” References to written submissions on the record are designated by the prefix “Ps.”

Accordingly, pursuant to Section 6(p) of the Federal Trade Commission Act, together with Section 302(c) of the Federal Trade Commission Improvements Act (Public Law 92–637, January 4, 1970), the Commission hereby amends its Trade Regulation Rule pertaining to Preservation of Consumers’ Claims and Defenses in credit-sale transactions, this Statement of Basis and Purpose is published to

See footnotes at end of chapter.
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define, with particularity, the reasons the Commission has decided to take this action, together with the purposes of the rule.

3 26 FR 1211.
5 26 FR 6032 (April 7, 1971). Hearings were held in New York on June 7-9, 1971, at the Federal Building, 20 Federal Plaza (Foley Square).
6 26 FR 7665 (April 27, 1971). Hearings were held in Chicago on July 12-14, 1971 at the Everett, Division B.
7 28 FR 892.
8 28 FR 3044 (April 4, 1973). Hearings were held May 7-9, 1973 at the La Salle Hotel.
11 2 Y.C. File 215-81.

CHAPTER II. BACKGROUND

General introduction. In 1971, the year the proceeding was commenced, aggregate consumer installment debt in the United States amounted to $137.2 billion dollars. This figure represented a two-fold increase in outstanding consumer credit from the year 1950, for a compound annual growth rate, over the 21 years. Forty-eight percent of all U.S. families allocated some 14.7 percent of all U.S. disposable personal income to the repayment of installment obligations. By 1974, aggregate installment indebtedness had increased to $164.8 billion dollars, a large part of which was employed in the acquisition of consumer installment credit. Over the past two decades, banks and credit unions have vigorously pursued emerging opportunities in the consumer credit market. They held $54.4 billion dollars in consumer installment credit as of December 1970, or 53.8% of the market. By December 1976, commercial banks and credit unions held only $63.0 billion dollars in consumer installment credit. Manufacturers of automobiles and other "largely non-durable" in the consumer inventory have created huge consumer finance subsidiaries to meet the needs of both dealers and consumers. At the same time, large independent consumer finance companies have experienced equally prodigious growth in servicing demand from consumers who do not or cannot obtain bank credit. Finally, the larger retail establishments have created credit departments and subsidiaries to service customers at the same location where purchases are made.

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

As of August, 1971, finance companies, retailers, in other financial institutions which are directly subject to the Federal Trade Commission's jurisdiction held in excess of 75 billion dollars in consumer installment debt. This constitutes a major commitment to the retailer market on the part of these institutions. It is this major commitment, together with widespread spread of abuse and injury discussed below in this Statement, which suggests a need for this rule. The rule is the other acts as a Compt, in belief to be an anomaly. To a varying extent, depending on the jurisdiction where a credit sale is completed and the procedure employed, the sale of the party financing the transaction is able to assert rights which are superior to those of the seller. The creditor may assert his right to be paid despite misrepresentation, breach of warranty or contract, or even fraud on the part of the seller, and despite the facts that the seller's credit was generated by the sale.

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

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

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

The definition of "holder in due course" which is more clearly defined in Article Three of the UCC is a recapitulation of principles which were first articulated in Miller v. Race, 97 Eng. Rep. 598 (C.B. 1758). To protect the "true" commercial paper market the court in Miller decided that a bona fide purchaser of an instrument which was negotiable on its face should not be required to look behind the face of the obligation. A promissory note drawn on the bank of England was negotiable. The soundness of the entire commercial system would be threatened. At that time promissory notes drawn on the Bank of England were not negotiable. Like modern day bank drafts, they changed hands frequently and rapidly and served many of the functions served by negotiable instruments. The Uniform Commercial Code superseded the Negotiable Instruments Law. For centuries, the holder in due course doctrine has served the two-fold interest of liquidity and confidence in the commercial paper market. The term "negotiable instrument" has come to encompass a variety of short and long term obligations. Included are checks, banker's acceptances, bills of exchange, letter of credit, and promissory notes. Each of these devices has a variety of commercial applications. Each is technically different from the rest, but has one essential feature in common. They contain an "unconditional promise or order to pay a certain sum certain in money and no other promise, order, obligation, or power. . . ."

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

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to enter this market. The average consumer would hardly expect that his sales agreement would receive the same treatment as a slight draft on the Bank of England, in the event that his seller fails to perform as promised. This result is nonetheless assured. When an acceptance company purchases a consumer's promissory note and sends a payment book in the mail, it can assert rights which are akin to those of the seller. For the consumer to defeat the creditor's right to be paid in the face of gross seller misconduct, he must prove that the creditor holding the note had actual knowledge of seller abuse in the prior transaction. Where a negotiable instrument is employed, measurement falls into two categories: the holder in due course status is always difficult and often impossible. Where law or commercial expediency forbids the use of promissory notes in consumer sales, creditors and sellers still have an indirect procedure for accomplishing the same end. An assignment of a retail installment contract, as distinguished from a note because of the inclusion of mutual promises and obligations, affects the UCC, thereby transferring to the creditor rights analogous to those of a holder in due course if the contract contains an agreement to assert defenses against the seller. Creditors may assert only a waiver of defenses clause in the consumer's sales agreement with the seller. If the same tests of good faith and knowledge of note are met, the creditor who holds the contract is in the same position as a holder in due course.

Some forty jurisdictions have enacted legislation bearing on the use of negotiable instruments in consumer sales. This legislation is intended to prevent the use of discount method. Some forty jurisdictions have enacted legislation bearing on the use of negotiable instruments in consumer sales. Such enactments prevent the use of negotiable instruments in credit sales, but often have no effect on the continuing use of a hold in line of agency. A sale's use of one method of payment, a stated time period during which the consumer is permitted, after receipt of notification that his obligation has been assigned to an acceptance company, to communicate sale-related grievances directly to the creditor. Any claim or defense which is raised during this time may be asserted in a subsequent suit to defeat or diminish a creditor's claim for payment.

The original draft of the Uniform Consumer Credit Code (UCC) reflected both of these approaches. It invalidated the use of negotiable instruments in sale agreements when the same draft was followed by two alternative approaches to waivers of defenses, designated alternative A and alternative B. Under alternative A, which was explicitly prohibited. Under alternative B, a ninety-day complaint period was provided. Enacting states were free to select between the two alternative approaches to waivers of. Seven enacting jurisdictions adopted alternative B, and several reduced the length of the complaint period substantially. Mounting criticism of the complaint period approach appears to have led several enacting states to adopt complaint period jurisdictional laws in the model law to delete alternative B. In addition to legislative enactments, judicial decisions in some jurisdictions have mitigated harsh applications of the law of negotiability in certain specific cases. Creditors have been held to share a sufficient community of interest and to persuade some jurists that "knowledge" should be implied to the creditor or that the creditor should be liable as a primary party to the transaction. The common law doctrine of chancery may also have been used to set aside oppressive instances of boilerplate waivers of defenses on similar grounds.

More recently, certain state courts have undertaken a frontal assault on the law of negotiability as it pertains to sales agreements. These cases suggest mounting expert opinion that commercial banking documents have no place in retail sales. The Georgia Court of Appeals has recently held that a retail installment contract must not be deemed negotiable. The Florida courts have invalidated the use of boilerplate waivers of defenses. And the California Supreme Court has extended application of a recent legislative enactment to an offensive position, permitting the assertion of claims and defenses whether or not a creditor files suit for payment. These decisions had significant impact on the continuing vitality of these principles of law. They reflect widespread public concern about misleading and unfair methods of commercial practice.

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

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

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

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

1 Consumer Credit in the United States, Dept. of the National Commission on Consumer Finance 5 (December, 1972) (hereinafter NCCP Rept.).
2 Id.
3 NCCP Rept. at pages 16-17.
5 NCCP Rept. at page 11.
6 As of December 1970, 61.4 billion dollars in installments credit or 19.0% of the market.
7 In August, 1974, consumer finance companies held 33.8 billion dollars in installment credit. Fed. Reg. Bull., supra note 16, at A-47, A-48. In addition, the proportion of credit that is secured with the 6.3 billion dollars they held in December, 1969, NCCP Rept. at 11. (This figure is derived from subtracting the 19.3 billion in installment credit held by commercial banks which the examiner from 15 U.S.C. 61 et seq. from the 15.6 billion outstanding as of August, 1971. Fed. Reg. Bull., supra note 15.)
9 Uniform Commercial Code Sec. 3-104.
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37 "The following is an example of a typical waiver of defense clause:"
38 "The seller should assign the contract in full faith to a third party, the buyer shall be protected in his interests from attacking the validity of the contract on grounds of fraud, duress, mistake, want of consideration, etc.
39 NCCP Us. at 34-35.
43 CCCH Consumer Credit Guide Paragraph D104: "Local Modifications.
45 E.g., Commercial Credit Corp. v. Chadis, 192 Ark. 1073, 107 V.2d 269 (1949); Commercial Credit Corp. v. Orange County Mach. Works, 24 Cal. 2d 759, 151 p. 2d 819 (1945); Smith v. Fin. Co. v. Martin, 83 So. 2d 65 (Fla. 1953).
48 "But the Chrysler Credit Co., 262 S.W. 2d 453 (1953).
49 Vasquez v. Superior Ct. of San Joaquin County, 22 Cal. 2d 809, 252 P. 2d 894 (1957).
51 See, for example, "Consumer Defenses Against Purchase Money Paper, 68 Colum. L. Rev. 455, 473 (1968).

CHAPTER III COMMISSION FINDINGS WITH RESPECT TO THE PROPOSED INSTRUMENTS AND WAVERS OF DEFENSES IN CONSUMER INSTALLMENT SALES TRANSACTIONS

This chapter discusses the Commission's findings with respect to foreclosure.

See footnotes at end of chapter.

The following discussion suggests that waivers of defenses and promissory notes which result in foreclosures of substantial sums of money and make it impossible for the consumer to transfer money have little or no place in consumer transactions. The insolvency obtained by creditors in consumer transactions is the product of an inappropriate application of legal principles developed by and for merchants and bankers. The following example, drawn from the transcript of the Senate Hearings, is included as an illustration:

"Typical: Mr. Suarez, says my name is Jose Suarez and I live on Westchester Avenue. I don't know how to write or speak English."

On or about December 29, 1970 two salesmen visited my address at my house. Spanish speaking asked me if I knew how to talk English. I answered that I didn't and he asked me to talk to me in Spanish. He showed me a record player. He said that he would and they came into my house. The Spanish speaking salesman told me that his name was Mr. Hernandez and started talking about English language lessons. Mr. Hernandez explained that this was composed of records, lessons and some tapes that I will have to record in my voice and sent to Columbia. The salesman went over. He told me that it would be very easy to learn English with this method.

He also showed me some drawings of the equipment. This looked like big equipment. Mr. Hernandez told me that the price of the course was $482.

Mr. Hernandez gave me a contract to sign, but since this contract was in English I could not read it. He repeated that the price was $482 to be paid in installments of $82. I gave him $82 as a down payment and I signed the contract.

Two or three weeks after this I received the equipment. The salesman said, "It's a tape recorder. It was a tape recorder and I didn't know how to use it. I have not been able to use it."

Shortly after this a friend of mine who knew how to read English saw the contract and told me that I was a victim of fraud. After that I called the telephone number that was printed on the contract. The person with whom I talked told me that Mr. Hernandez had already left and she had the phone number of another man.

I went on the phone and he lied and he told me he was another person.

Meanwhile I stopped payments because this was the only way I would make them bear my case.

Two months ago I started receiving letters from Lincoln Budget telling me that I owed them money. I thought I had to pay to Columbia and I didn't know how to pay to another company.

More or less on the 24th of May a man went to my place of work and asked me why I was not paying. I explained the problem. I explained the problem. I explained the problem. The man said that that was why I wanted to talk to Mr. Hernandez. This person told me that I had to pay and that we would see each other in court.

More or less by April 10th I received another letter from Lincoln Budget telling me that this was going to be in court.

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

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

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

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

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

The magnitude of the problem is made clear through the aggregate statistics supplied by various consumer groups, legal aid agencies and the Office of Economic Opportunity (OEO), and the Office of Economic Opportunity (OEO) is especially noteworthy.

At the request of the Commission, the OEO Office of Legal Services polled its neighborhood legal services projects on the incidence of consumer injury arising from the use of negotiable notes and waiver of defenses agreements. OEO was requested for a survey to be conducted by an outside service, the Bureau of Social Science Research, Inc. The survey resulted in the return of the OEO sample, and a survey of the OEO sample demonstrating the magnitude of consumer injury sustained by the two cut-off devices.

The survey revealed the results of detailed returns from 59 projects in 32 states and territories, and from each of the ten OEO regions. The 59 projects involved a large and varied sample of the total project legal services caseload for the current fiscal year (750,000 cases). The OEO sample is large and varied enough to permit generalization as to the contours of the problem.

The analysis reports:

The same 59 projects, handled a total of 13,781 holder in due course and waiver of defenses cases, or combinations thereof, during the period (May 1, 1970 to April 30, 1971). Thus, these cases comprised 7.9 percent of their aggregate caseload. Of all the cases, one out of every 13 cases involved holder in due course or waiver of defenses. Considering the general variety of types of cases handled by Neighborhood Legal Services Offices, this would appear to be a rather heavy concentration for a single pair of related types.

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

### Table 1: Distribution of types of cases

<table>
<thead>
<tr>
<th>Type of case</th>
<th>Number</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Holder in due course</td>
<td>10,122</td>
<td>75.9</td>
</tr>
<tr>
<td>Waiver of defenses</td>
<td>1,356</td>
<td>10.6</td>
</tr>
<tr>
<td>Combination</td>
<td>2,238</td>
<td>16.5</td>
</tr>
<tr>
<td>Total</td>
<td>13,781</td>
<td>100.0</td>
</tr>
</tbody>
</table>

See footnotes at end of chapter.

Holder in due course is involved in 92.1 percent of all these cases, including the "combination" cases; waiver of defenses is involved in 7.9 percent, again including "combination" cases.

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

Secondly, not all persons, rich or poor, are knowledgeable enough to seek legal aid when confronted with a "holder" or waiver problem. In general, the number of persons seeking the aid of Neighborhood Legal Services agencies is only a fraction of those with legal problems.

Therefore, only a fraction of the low-income consumers wronged by cutoff devices show up in caseload statistics. In short, the magnitude of the problem indicated by the sampling is likely to be understated.

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

From the hearings, for example:

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

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

I remember last year there was quite a surge of health club contract suits.

We had a refrigerator and meat franchises where the meat is standard in quality or not of the type ordered, shortages of the nature. It's a breach of warranty argument. We see it quite often. I again, have not kept statistics on it.

The written record also contains comments of a more general nature. For example, "Though statistics are not available as to the exact percentage of 558 consumer complaints received by the Wisconsin Attorney General's Office of Consumer Protection in 1969) which involved a financing arrangement with an alleged holder in due course, a significant proportion of consumer complaints involved holder in due course agreements.

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

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

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

Having established the magnitude or extent of consumer injury from forfeited claims and defenses in credit sale transactions, the Commission requested and received specific information as to the areas or sectors of retail sales endeavor where such injury appeared to be most prevalent. This inquiry was initiated to determine whether or not a rule could be prepared along narrow lines to delineate those areas where relief was most needed, without unduly affecting sectors of the retail market where foreclosures of equities might have some commercial necessity.

The record is overwhelmingly suggestive of the need for across-the-board relief. While the most serious instances of foreclosure of asserted claims and waivers of defenses appeared to be in the most marginal sales transactions (e.g., inner-city door-to-door-sales), the simple range of transactions brought to the attention of the Commission in actual case histories precludes any effort at narrowing or delineating along the lines discussed above. Creditors and sellers rely heavily on devices to insulate the creditor from consumer claims and defenses in a complex and extensive variety of retail transactions.

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

C o u r s e d, T r a i n i n g o r I n s t r u c t i o n . The most notable development in this category was a large number of cases in which the holder in due course doctrine or waivers of defenses figures in health club or so-called "health spa" deceptions.

One case involves 1,500 families. The holder in due course doctrine is used to establish the right of "health club" or "health spa" to refuse return of goods. The fact that so many of the health spa operations have used negotiable instruments or waivers of defenses is strong evidence that refund from claims to consumer sales. It affords evidence that these techniques are seized upon by those who set out to exploit new fields of consumer fraud and deception.

Other cases brought to our attention include courses of English language instruction, television and modeling school courses, computer schools, flying lessons, karate schools, and other miscellaneous courses of training or instruction.

Furniture and appliances. Many consumer cases indicated that there were attempts to assert defenses (such as the seller's failure to deliver or refusal to honor warranties or service agreements, delivery of goods of inferior quality, or problems other than those picked by the consumer) against third-party finances of pur-
chases in the furniture and appliance category. Cases frequently involved television and stereo sets.18 Other cases concerned furniture, a washing machine,20 sewing machines,21 curtains22 and miscellaneous items.22

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

Nearly every witness at the hearings,23 and many written submissions24 emphasized the degree to which a creditor's unfettered right to payment in these cases contributes to discontent among consumers, particularly the poor and less advantaged consumers.25

There are many examples of creditors using collection efforts in a wide variety of other consumer purchases. Among them: vacuum cleaners,26 kitchen utensils,27 encyclopedias,28 emery boards,29 ashes,30 a hearing aid,31 and an employment placement service.32

Common elements in all the cases on the record. In the cases on this record, operation of the holder in due course doctrine or other cutoff devices reflects a number of common elements: (1) the collection by the consumer of a promissory note or waiver of defenses and subsequent negotiation or assignment of the contract by the seller to a third party assignor; (2) seller's conduct in the transaction between seller and consumer—that is, an infirmity in the original sale—or the development of a fault of the holder in due course; (3) failure of the seller to remedy the defect or otherwise deal with the complaint of the consumer, either directly through contact on the part of the seller or due to the seller's disappearance from the market; (4) interruption in payments by the consumer; (5) the financial condition of the banks and finance companies at the time of the financing of its protected status in order to obtain payment on the obligation. It should be noted that the last element—assumption by the finance company of its protected status—need not occur in the context of a law suit. The protected position of the holder may be made known to the consumer in collection efforts prior to litigation. Thus the record contains numerous instances where consumers were told that the record contained no interest in the original transaction and because the holder in due course status was asserted in the consumer's favor.24

See footnotes at end of chapter.

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

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

The tragedy of this situation is that Mrs. Kessex and her husband are unable to prove themselves with counsel... (As you know, in order to make a case based upon the Unisco doctrine, considerable time would have to be expended in conducting discovery in the form of interrogatories, requests for admissions and possible depositions which might also include motions to be argued before the court concerning the copying of documents which, may be necessary to establish a link between the lender, the manufacturer and the seller of the goods. Most attorneys, especially in a case of this kind where "new ground is being plowed" require a sizable deposit for costs, probably in the neighborhood of $5,000.00. Additionally, the total attorney's fee in a matter such as this may be well over $500.00. When faced with the economic pressures of residents who get into such a situation in the first place are unable to provide themselves with protection in the form of adequate counsel..."

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

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

Support for the waiver ban in the proposed Rule was widespread. Many witnesses emphasized that such agreements were really contracts of adhesion, designed to deprive the consumer of his right to raise defenses. Whether a waiver arises by contract or by law, its effect is analogous to the use of an adhesion contract. The Uniform Commercial Code expressly analogizes waivers to "Holder In Due Course" status.
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three small rooms of carpeting. [After the carpet began to come up] ... Mrs. Collins called to the bank to discover whether the carpet company had gone out of business. She ... was told that Budget was not responsible for any premises "to make repairs free of cost for 25 years" made by the store. She would have to continue making payments."

The history submitted by New York City Department of Consumer Affairs, R. 335-336; R. 2983; T. 112-113 ("Pyramid or chain referral plan...wall-to-wall carpeting at prices ranging from $57 to $60 per square yard...which could be purchased for less for $50...珠江; postal fraud conviction); T. 386 (referral sales).

A particularly alarming case is related in Schrag, "On Her Majesty's Secret Service: Protecting the Consumer in New York City," 80 Yale L.J. 1599, 1595-1598. The case is that of Foolproof Protection, Inc., which sold $4 million in burglary and fire alarm systems door-to-door, exclusively in ghettos of greater New York City.


7. "aa. R. 253-256 (door-to-door); T. 416.

8. R. 1803-1805.


12. R. 1126-1128.

13. R. 1097 ("a").

14. E.g., Keesler, T. 1003; Williams, T. 70; Fidler, T. 64, 69, 74; Scholl, T. 1723; Bluestone, T. 1849; Ryan, T. 1901.


16. "b. Rough she has said...the lady put her name on the paper to the tune of $1,000 for goods and services. When she went to rescind the contract the following day, the [salesman] told her he would forward the paper to a finance company and that it was impossible to rescind the contract." Edwin P. Fujimoto, Rhode Island Consumers Council, R. 104. The consumer signs a contract committing him to pay about twice the fair market value for his furniture. Settlement contracts are immediately sold to a finance company, which refuses to honor buybacks. This is on the ground that the independent representations made by the salesman do not appear on the face of the contract..."Lucy Montana, California Rural Legal Assistance, R. 3426; Furrer, T. 303; Weiner, T. 1103.

17. "a. The examples of your testimony—you will have a locally incorporated vendor and a foreign loan company. In one case, the frozen foods corporation. I believe it was the same company that had to discontinue doing business in Rhode Island because the [finance company] could not assemble [finance company] but they are all interstate in one way or another." Roberts, T. 1426; see also T. 231; John Keller, Office of Superintendent of Public Instructions, State of Illinois ("many" finance companies in "one state"). T. 568; Sims, T. 214, 252, Specific cases, e.g. Fugler, T. 926 (D.C.—Maryland); Roddy, T. 100 (New Jersey—Pennsylvania); Stack, T. 938 (D.C.—Maryland).

18. E.g., Elston, T. 276; Greg, T. 1361; Krupke, T. 459; Mindell, T. 256; Pettus, T. 1362; Sims, T. 223; Williams, T. 62, 70; E.g., R. 5, 22, 31, 393, 529, 1234-35, 1493.

19. E.g., Cain, T. 1166; Charnley (on behalf of Rep. Bella Abzug), T. 458; Rice, T. 75; E.g., E. 3, T. 152; Stack, T. 262.


21. E.g., Orth, T. 458; Judge Arthur Dunn, T. 758, 766; Fritsch, T. 747; Rice, T. 75.

22. Virginia Knauer, Special Assistant to the President for Consumer Affairs, R. 896-897.

23. E.g., Furrer, T. 37; Carpenter, T. 945; Matsen, T. 288; Mullins, T. 1102.

24. T. 758-758.


27. U.C.C. § 1-304, Comment 2.

28. E.g., Colorado, Laws R 1070 1-303; Delaware, Titus, § 4611(a); Hawaii, Rev. Statutes § 476-18(8); Maine, Rev. Statutes. Title II, §§ 2502, 2503 (and § 8(d)); Massachusetts Gen. Laws. ch. 250D. § 16(d); Minnesota. Laws, Ch. 276 § 2(a) and (3); New Mexico, Proc. Law, ch. 41, art. 10, § 403(9)(c). 415(3)(c).

29. Under Section 9-206(1) of the U.C.C. an agreement may be enforceable if in fact the parties...he will not assert against an assignee any claim or defense which he may have against the obligor or his assignee by any...assignee...A buyer who as part of one transaction signs both a negotiable instrument and a finance contract may have such an agreement." (Emphasis added.)

30. E.g., Ezovski, T. 786; Keesler, T. 1057; Mindell, T. 255; Frelotnik, T. 345, R. 924, 1901.


32. C.F. U.C.C. 9-206(1).

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

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

"For the sake of simplicity, the practice varies..."specious cash sales," "interlocking sales/loans," and, more colloquially, "dragging the body"—will be the term used in the following paragraphs."

The practice arises when a merchant, desiring to circumvent restriction upon the holder in due course doctrine, arranges for a consumer purchase to be financed by a cooperating financing agency. The resultant financial transaction has the appearance of a direct cash loan, payment of which can be enforced by the loan company without reference to the underlying transaction. An example, related by a consumer witness and at the 1971 Washington hearings, will illustrate:

John Hatch, a witness, testified as follows:

"Mr. Hatch: Mr. Chairman, my name is John Hatch. I went to buy a used car. They gave me all kinds of guarantees. This was my first car, so I was very much afraid. Mr. Compact says, 'I have some boys to look after you.'

He took me to the American Consumer Discount House...I went into one room and he went into another room. They had the parts off the car. It was a subby loan.

"I received the car and they told me the car was guaranteed for 30 days; anything after 30 days I would have to pay the full cost.

"I like to not got the car off the lot. After that I complained so much that after three days after I received the car I went back to the finance company. They said, 'This is your baby. We didn't finance any car. We gave you a personal loan.'

"They made out the check to Mr. Compact and the only thing I did was to sign the check.

"I could not use the car. The finance company wouldn't make the dealer fix the car. The dealer refused to fix the car."

"My home and all of my possessions were up for a sheriff's sale."

"They repossessed the car. They sold it to me for $1,512, and about a month later they sold the same car for $300 because it wasn't in good shape."

The transcript and record contain additional consumer case histories involving related credit and jurisdictional jurisdictions and in connection with various consumer purchases. Automobile sales seem to predominate, perhaps because in several jurisdictions automobile sales have been the subject of legislation specifically restricting the use of promissory notes and waivers of defenses. Most notable, however, was the experience in New York State. For many years New York had a 10-day "notice" provision, generally regarded as ineffective by consumer representatives. In 1971 the New York legislature enacted a more rigorous, direct restriction upon the availability of cut-offs to third party assignees of consumer paper. Although the law was still, in the view of consumer interest spokesmen, far from comprehensive..."See footnotes at end of chapter.

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hensive, the enactment placed New York among the handful of states with rela-
tive control over the practice.1

A startling development at the New York hearings—held only four months after the effective date of the new law—was the speed and extent to which the vendor related loan abuse had been seized upon by merchants and financiers desirous of circumventing the new law. The record contains several references to the histories concerning New York consumers caught in a "sloppy cash sale," as the practice is termed in New York, familiar with the New York experience expressed alarm at the sudden prevalence of the practice and urged the Commission to broaden the proposed rule to meet the related creditor abuse.2

As a result of the comments received in the first set of hearings, the second published version of the rule included provisions making it applicable to vendor related loans. In the reopened proceeding, this section of the rule received widespread support on the record, both through individual consumers who testified about their own experiences, and from consumer and industry witnesses.3

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Legal aid and community legal services attorneys in particular noted the need for such a provision based on the extensive experience in states which had enacted similar provisions, the boldness of the course, but had not addressed related creditors.

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

(4) Common control or affiliation of creditor and seller. This provision was similar to a feature of the District of Columbia's Creditors' "lender law," and is supported on the record.

"If there is a close relationship * * * I think it puts into effect the rule that the creditors are related parties in the strict sense between the * * * retailer and the finance company. This is the Universal Acceptance Corporation against Russell case that speaks of the situation.* * *"

The director of Universal Acceptance was also director of Wig Fair. They sold their wigs before Christmas with six-month service agreement, which the Consumers Bureau in February, when the Universal director put his own hat and sash on the negotiable instrument. I mean this is something that somehow the court said were two different people * * *.

(5) Joint venture. Recommendation of Professor Fairfax Leary.5

See footnote at end of chapter.

(6) Payment of consideration by creditor to seller. A feature of the District of Columbia's Consumer Protection Act6 and Arizona's related creditor statute.7 Support for the provision was offered by legal services lawyers.8

(7) Consideration for credit. This section derived from a provision of the Maryland "related creditors" law.9

Five provisions were made. This provision was an adaptation of the Massachusetts statute, which deems a sufficient connection with the seller to exist where the lender has made two or more loans in a one-year period the proceeds of which were used in transactions with the same seller and the lender was then recommended by the seller. The Consumer Credit Protection Act contains a similar provision which specifies twenty such referrals.10 This approach was also urged upon the Commission by the office of the United States Attorney for the Southern District of New York.11 Several legal services representatives stressed that in their view under state law, a provision similar to subsection 8 would be particularly useful. They suggested that FTC enforcement efforts to prevent the consumer from meeting their own needs by their own practice and that this subsection would, therefore, be most necessary.12

"We feel that provision is one of the most important, and many times we find that by using one process, we are still unable to find any type of connection between the two. Obviously, most often we have been able to find that the same lender and seller have engaged in the same transactions 10, 15 or 20 times; that we feel that Subsection 8 is important, that it is useful."13

(9) By knowledge of seller misconduct. This subsection was derived from the District of Columbia Consumer Protection Act 14 and was similar to provisions of an analogous Illinois statute.15 The knowledge of adverse claims and defenses and absence of good faith are charges often used to deny holder in due course status to the assignee of a note. The provision received support on the record.16

By the credit relation portion of the rule received widespread support in this proceeding.17 Most opposition to this section was directed to the credit rule; that is, they offered very little opposition on the record directed specifically to a related creditor section. Whatever specific opposition was registered focused on the breadth of the related creditor portion of the rule. Additionally, opponents argued that the several individual provisions in the definition portion of the rule were vague or overly broad.18

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

1 E.g., Farah, Tr. 630; Nelson, Tr. 723; Escoli, Tr. 908; Leary, Tr. 958, 979-980; Kessler, Tr. 1059; Kacz, Tr. 1071; Schree, Tr. 1092; Tr. 1074; Tr. 70, 938, 1242, 1992, 2277-2278.

2 Tr. 1595-1599. See also R. 2198.

3 E.g., Tr. 867-868 (Illinois; used car); Tr. 1214-1216 (Illinois; Schuette; Hines; Schappert; R. 2199)."Illegitimate loan company; consumer referred to a specific official at corporation loan company); Tr. 1562-1563 (Maryland; used car).

4 R. 127-128 (Louisiana; aluminum siding); R. 904-908 (New York; home improvements).

5 T. 1590-1592 (Michigan; camper); R. 1684-1685 (New York: air conditioner); R. 2363-2394 (Illinois; used car).

6 "In other words, it is written up as if it were a loan to the bank first, made a loan, and then came to this automobile dealer to buy the car." This practice is widespread, and I would say it occurs in one-third of all automobile financing transactions in Philadelphia." R. 1717; National Urban League, Community Legal Services, Inc., Tr. 1172.

7 Mindell, Tr. 19-28, R. 682; Felder, R. 971 (1949-1950).

8 N.Y. Proc. Law, § 401 et seq.

9 E.g., Furnace, Tr. 34, Eilers, Tr. 276.

10 E.g., Griffin, Tr. 2-4 (aluminum awnings); R. 354 (clothing peddled door-to-door); R. 357 (furniture); 358 (rug, referral sales); R. 2139-2140.

11 Mindell, Tr. 10-31; Furnace, Tr. 37-38; Spencer, Tr. 114-116; Szymanski, Tr. 346; Hynes, Tr. 1112; Tr. 1121; 2362 (E. Elkins,). R. 482.

12 E.g., School, Tr. 1723; Jefferson, Tr. 1519; Kaufman, Tr. 1567; Chandall, Tr. 1585; Betty Burton, Tr. 1588; Wensczalk, Tr. 2121-12.

13 E.g., Knaur, Tr. 1401; Gutman, Tr. 1523; School, Tr. 1722; Schick, Tr. 1738; Jeffrey, Tr. 1604; Hynan, Tr. 1708; Escoli, Tr. 2163.


15 E.g., Patricia Hynes, Tr. 249; Fairfax Leary, R. 2006.

16 E.g., N.Y. Proc. Law, § 254(b) and (c); Md. Rev. Laws, Art. 11, § 176(a)(5); 28 D.C. Code 3529(a)(1).

17 E.g., Hynes, Tr. 248; Douglas, Tr. 1543; Leary, R. 2087.

18 E.g., Code 3529(a)(3).

19 Code 418; Tr. 214; Prof. Egon Gutman, Tr. 1629; Leary, R. 2087.

20 School, Tr. 1523.

21 Public Interest Research Group, currently University of Pennsylvania Law School, R. 926.


24 Daniel Scholl, Delaware County Legal Services, Tr. 1723-1724; Utah Legal Services, R. 439; Kansas City Legal Aid and Defender Society, Tr. 1543.


27 National Consumer Act § 2407(1907), R. 2858-2859.

28 R. 148-249.

29 E.g., School, Tr. 1729, 1730-1731, Byrd, Tr. 1710.
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The acceptance by merchants of credit cards is an implied warranty by the credit card issuer as to the merchant's reliability.

The credit card industry in general is in a position to control the use of credit cards largely on the following grounds:

The Commission lacks jurisdiction over bank-issued credit cards.

Credit card waivers are not abused.

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

The credit card issuer has no way to control the retail selling practices of the merchant.

Credit card transactions are inherently different, or unique.

In a reopened proceeding, the Commission revised its rule to contain a provision which would prohibit sellers from accepting credit cards issued in return for a waiver of a charge in exchange for agreeing to return the money from the issuer.

In publishing the proposal the Commission was aware of the fact that—without three states had regular laws of waiver of defenses in credit card transactions. The Commission believed that the laws of waiver of defenses in credit card transactions should be included in any final rule on the subject of buyers' claims and defenses.

The thrust of consumer testimony was that credit cards must be covered in any final rule to meet potential abuses.

Use of credit cards is rising and the potential for abuses analogous to that in other credit sales.

The previous few demonstrative cases of consumer injury were cited in general agreement by consumers that the credit card issuer's ability to insulate itself from card-holder claims and defenses does not result in widespread abuse.

The crafty of consumer testimony was that credit cards must be covered in any final rule to meet potential abuses.

(5) The use of cardholders' evaluated as safe. The number of cases involves the possibility of a bar to the cardholder's use of the card.

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

See footnotes at end of chapter.

The Commission concludes that consumer injury from reliance on the standard card industry practice of credit card contracts is infrequent, where the context of millions of transactions. At the same time, the continuing relationship between the issuer of a credit card and the subscriber tends to render abusive reliance on the insulation conferred by the waiver counterproductive. If the unexpectedly that the nature of the credit card company makes the consumer aware of the existence of the card without the consumer's knowledge.

The credit card company investigates both the cardholder to whom it extends credit, and the credit card company from which it obtains that credit card.

The expectations of the purchaser in an installment sale, therefore, can be quite different from the situation with the credit card transaction.

The credit card holder, however, knows when he signed a credit card charge slip that his obligations will extend to the credit card company. Thus, the consumer's expectations in this situation are conditioned by the credit assignment. He, in effect, directs the retail store to assign his note to the credit card company of his choice.

Secondly, consumers in each of these transactions often have different economic advantages, as well.

Installment sales financing is most often used by lower and middle income consumers, while credit card transactions are usually restricted to middle or upper income consumers. Many Americans permitting them to purchase goods and services through this country and many foreign countries without the necessity of paying large amounts of credit or establishing local credit.

In the absence of the credit card industry, many credit cards may be used as a substitute for currency in what is considered by the card holder as essentially a cash purchase.

Prohibiting waivers of, defenses could well compromise a considerable consumer benefit from credit cards, thereby at best augmenting consumer costs.

Finally, there has been substantial evidence that the abuse of the hold harmless clause in the credit card industry is taking place in the area of installment sales.

To some extent, I believe that this is the result of self-policing by credit card companies. Most of them carefully investigate the retailer with whom they deal, and do not hesitate to sever relations with them and with sellers who do not provide satisfactory merchandise or services. This is exactly the sort of voluntary business action that can often provide the best protection for consumers.

In addition to the information discussed above which has suggested that no such defense as a bar to the cardholder's use of the card, the contracts are not abused to the same extent as the "holder in due course" doctrine, the Commission is cognizant of recent
legislative developments, at the federal level, which will alleviate any existing problems in this area. The recently enacted Credit Billing Act invalidates waivers of defenses in credit card contracts where a card is used to make a purchase of more than $50 dollars within this state. Where the user resides or within 100 miles of the place where the card is issued. The Commission has no reason to believe that this legislation will not afford adequate protection to consumers at the present time.

1 Ross, "The Credit Card's Painful Coming-of-Age," Fortune, October, 1971, p. 168. Trade card and entertainment cards, for example, are American Express, Dinners Club and Carte Blanche. Nationally distributed bank cards are Master Charge (Interbank Card Association) and the Bank-Americard (National BankAmericard, Inc.).

2 The cards issued by retail stores of 100 million, the largest category of charge cards outstanding—do not pose this potential difficulty since they are not three party cards. Likewise, the 90 million travel cards currently held do not involve waiver agreements.

3 E.g., Kesler, Tr. 1065; Swankin, Tr. 1396; Weller, Tr. 1399.

4 E.g., Daniel, Tr. 1256; 1254; 1250; Doyle (American Bankers Association), Tr. 109, 1128; Morgan Interbank Card Association (“Master Charge”), Tr. 1259; Serafine (Charge Account Bankers Association), Tr. 1260. See also, the “Richer Sewing Machine Case” cited by Bess Myerson, Tr. 376-377.

5 See, Tr. 1396; Forhame, Tr. 650; Leatherberry, Tr. 1018; Swankin, Tr. 1371.

6 E.g., Flcker, Tr. 404; Kas, Tr. 1209; Myerson, Tr. 363; Eledendrah, Tr. 362-3. See also R. 234, 391, 1369.

E. Egal, Tr. 793; Kas, Tr. 1209; Leatherberry, Tr. 403, 423; Martin-Trigona, Tr. 385; Weller, Tr. 1046.

8 Egal, Tr. 793; Kesler, Tr. 1065; Leary, Tr. 261.

9 E.g., Buxbaum, Tr. 1036; Furness, Tr. 29; Leatherberry, Tr. 1018; Myerson, Tr. 361; Willer, Tr. 1046-1049.

10 E.g., Egal, Tr. 807; Leary, Tr. 981.

11 Kas, Tr. 1239; Martin-Trigona, Tr. 575; Serafine, Tr. 583.

12 E.g., Daniel, Tr. 1249, 1251, 1259; Serafine, Tr. 1276 et seq. (American Bankers Association [ABA]); R. 1277 et seq. (ABA, Interbank, National BankAmericard and two other bank card associations).

13 E.g., Badders, Tr. 1329, 1341; Serafine, Tr. 1036.

14 E.g., Daniel, Tr. 1237; 1242; Doyle, Tr. 1113, 1134; Serafine, Tr. 1089.

15 E.g., R. 1727, 1707 B. 2470-2479 (Charge Card Association) - it is clear that bank charge cards will form the foundation for a nationwide electronic payment system. Submissions included department store clipings in substantiation of this point. To now burden that evolving system... would have intolerable consequences.” Charge Card Association, R. 2477.

16 E.g., Daniel, Tr. 1258, 1245, 1258, 1264; Doyle, Tr. 1110; Serafine, Tr. 1081. One banker, however, after making such an ascertainment, probably mistakenly assumed that bank encouraged a reform in the selling practices of a health spa. Morgan, Tr. 1221, 1225; 1235, 1236; Doyle, Tr. 1109, 1128; Morgan, Tr. 1229; Serafine, Tr. 1072, 1077.

17 Federal Reg. 892. Proposed sections relevant to credit card waivers were:

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

(b) Cardholder. Any consumer who enters into an agreement with a credit card issuer conferring the right to use a credit card in connection with a consumer transaction.

(c) Consumer transaction. Any sale or lease of goods or services unless it constitutes an unfair and deceptive act or practice for a seller to:

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

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

(2) Places any time limitation on the right of a cardholder who is 18 years of age or older to cancel the credit card or to release or cease the date of final delivery of the goods or the completion of the furnishing of the services purchased.

(3) Requires that the card be used only for car lease or credit purchases made within 30 days of the date of final delivery of the goods or the completion of the furnishing of the services purchased.

(f) Any witness cited note 1 supra and Bess Myerson, Tr. 1783; Northern National Bank of North Carolina, R. 3991.

4 E.g., Witnesses cited note 18 supra and Mrs. Virginia A. Knauer, Special Assistant to the President for Consumer Affairs, Tr. 1393; Professor James H. Heilbron, Professor of Law, Duke University, Tr. 1469.

5 E.g., Professor John Guittar, American University Law School, Tr. 1605; Blake, National Consumer Law Center, Tr. 1739; Stuart Bluestone, on behalf of Consumer Federation of America, Tr. 1844 et al.; claims or defenses arising out of consumer transactions.

6 Jeffery, Tr. 1600-10; Dale S. May, Tr. 1600; Samlin, Tr. 2106; E. Thomas Garman, Tr. 2507; Chase, R. 6700; Norris, R. 6803; Sweet, R. 5992.

7 See notes 26 and 27 supra.

8 Estimated at over 300 million transactions per year, Ross, op. cit., supra note 1.

9 Public Law 89-946, October 29, 1974.

CHAPTER VI. OPPOSITION TO THE RULE

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

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

Effect on cost and availability of credit.

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

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

In the past, in the young cases, those dealers feel the banks have become terribly what we call ‘turn down.' The turn downs have increased since the advent of this.

In California... it has cut down sources of financing..." Joseph L. Kaufman, Vice President of Pacemaker Corporation, a boat manufacturer and owner of a retail boat outlet in New York, wrote that the New York Statute which eliminates the holder in due course defenses “has resulted in a material decrease in the sales of our boats at the manufacturers' level, and almost the retail level as well.”

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

Many businessmen predicted that damage to their businesses would result from the increased reserve accounts and re-
tutions did not want the responsibility of policing sellers and that sellers would not bear the risks or survive with additional red tape. Other arguments against the rule included that most mortgage lenders would reduce their credit limits so that certain lenders who lend at a profit would stop paying without cause, and that the rule would interfere with free competition. In particular, it was argued that the rule would result in a unwarranted hardship for honest small businessmen, who cannot survive without readily available financing.

The most particular concern expressed for the individual, especially the minority businessman, just beginning a business without a previously established reputation. This problem was discussed by Professor Homer Kripe:

I must say in all candor that the result of such a rule may be to make it more difficult for young, or get financing when they are just starting business and have no background, or experience to demonstrate that they do and can perform satisfactorily and this is maybe particularly acute in the minority businesses, making every effort to get started with small business, but here the problem is anyway a problem of substantive small business.

That relatively narrow problem should not in my opinion be permitted to obstruct what is a very sound reform having much broader implications than the relatively narrow problem of aiding small business.

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

Eugene Hart, Vice President of Wisconsin Bank, commented on his bank's experience under Wisconsin's administration. Wisconsin is a large consumer credit market and the bank was under severe pressure to reduce the holder in due course doctrine in home improvement contracts.

Our bank, Marine National, had been required to reduce our home improvement paper. That paper had dropped to $50,000 a month and we are making the fifty in direct loans. Our outstanding home improvement paper seven years ago was $7 million. It's now $3 million.

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

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

I think there has been a drying up in the business... no one in the banking business wants any paper that generates problems.

See footnotes at end of chapter.

We look to the sellers, the dealers that give us good paper, and if we see any degree of problems, we destroy our books, I think people have gone out of that business... The home improvement business is a tricky, time-consuming business but now those people that remain are pretty legitimate.

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

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

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

The list, which is kept up to date (names are continually added, and deleted if the contractor reforms), has at present approximately 500 names of companies (and individuals) for which the FHA refuses to insure loans, on the theory that it has a responsibility to protect consumers. The list is part of a larger program that is designed to prevent consumers from being defrauded.

Many finance industry witnesses indicated that their companies always screen new applicants for payment of mortgage paper.

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

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

Not significantly. There are some changes, the changes which have been investigated the merchants with whom we do business. We do a little better job now in the area of our credit investigation, in general.

There's not been any significant changes at this time, but we are taking a closer look at certain types, I'd say, of marginal credit as a result of the new Act.

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

Other steps we feel are important in protecting the consumer are trying to investigate the merchant from whom we purchase contracts.

This is probably a singularly important aspect. In doing this, we make every effort to be sure that people from whom we buy contracts are ethical, responsible businessmen.

We buy paper only from those that we have personally investigated and our personal investigation goes into such matters as ethical, financial ability, financial capacity, business ability, etc., forth.

We especially reject any merchant that has had substantial and substantiated consumer complaints registered with the Better Business Bureau.

It has been our experience that the best time to resolve complaints is early in the game, as we make an effort to maintain a personal investigation and maintain contact with each merchant. This is especially true where there's been misrepresentation, so forth, and we terminate our dealings with this merchant.

We think this program of merchant investigation and inspection is effective.

Once we establish an agreement with a merchant about paper, we conclude a financing agreement. Until this arrangement we require him to repurchase any contract that relates to merchandise that has been unsatisfactory and not properly received.

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

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

The code thus expressly recognizes and mandates imposition of the assurance by creditors in any loan contract between a finance company and a large finance company.

Professor Homer Kripe testified about the use of various recourse arrangements in consumer transactions. His testimony is based on his experiences as counsel for large finance companies.
these arguments rest on purported legal grounds and could be without merit.

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

Similarly, the banks have sometimes publicly argued that if consumer installment obligations purchased from merchants subject to defenses, they would not be legal for investment by banks, because they would not be firm obligations, which is a specious reasoning. In my opinion, banks have always discounted negotiable notes arising in merchandising transactions between the holder in due course doctrine. That doctrine does not give protection against the "real" obligations that are not negotiable. For the bank seller, the factum, infancy, incapacity, duress, illegality including usury, etc. See Uniform Commer-
cial Code, Section 3-810. Agreements are made in nearly every state. This means, therefore, that whenever a bank discounts a note which has not been negotiated away from the factor, or, the bank is subject to all the possibilities of holding an unenforceable note arising from any infirmity of the factor. The fact that the factor may or may not hold obligations which may be unenforceable would prove the bank from the possibility. It is obviously not the law.

This brings us to the second and perhaps more significant aspect of the reliance of the financial institutions, namely, that they cannot afford to hold consumer installment obligations if they are subject to defenses arising out of consumer dissatisfaction. I considered this question for many years when I was counsel for a large consumer finance organization, and in subsequent years of practice specializing in that field. In 1899 I took the position in a case that although the holder in due course doctrine was properly applicable in the situation, the question was really of little practical moment—it was much ado about nothing. *Kripke, Chattel* Paper as a Negotiable Security, 5 Yale J. L. 1209, 1214-1222 (1909). I was then speaking in the context of the business of a company which placed itself on its reputation and the character of the business it was doing, and would have been quick to refuse to do business with a merchant who produced a large amount of customer dissatisfaction. Subsequent-
ly, when the New York statutes (re-
strictions permitting due-course transactions were passed), the question arose in that financial organization whether we should insert in the contracts, as they were negotiated, a clause as to the fact that the proceeds would not be subject to the waiver of the defenses.

See footnote at end of chapter.

**Commission resolution of cost and supply questions.** As noted earlier in this chapter, one of the major points in opposes to the rule concerned anticipated impact of the rule on consumer credit. In considering this issue, the Commission has carefully reviewed the material in the public record, especially the testimony of law enforcement officials and other witnesses from these jurisdictions which have enacted or adopted effective regulatory restrictions and the holder in due course doctrine and other cutoff devices. Additionally, the Commission has reviewed the comprehensive work of the National Commission on Consumer Finance on this specific issue and has noted the testimony of representatives of the NCCFC.

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

In the course of this proceeding the Commission has received considerable testimony concerning the impact of emerging state legislation similar to the rule. Almost without exception it supports the findings and the conclusion that such legislation would be little, if any, negative impact from such legislation. This conclusion was advanced by industry witnesses and was used with support of the impact of laws in states with which they were familiar. For example:

It is fair to say then—it's narrow it to your experience in California. . . . That by a large the consumer in due course is a dead letter, and that as a matter of fact, dual cutoff is not proceeding.

Mr. Smith: They are flourishing.

The bank financing of automobiles is expanding.

. . .

I don't think the Eec-Leering (Act) change has persuaded any banks to get out of the automobile financing business.

Consumer witnesses made similar assertions. Blair Shick, Legislative Coordin-
ator of the National Consumer Law Center, Boston, testified as to the Mass-
achusetts bank regulations in Massachusetts, for example, it was the first state to abolish holder-in-due-course in a comprehensive sense through consumer protection. There is absolutely nothing to indicate that as you compare Massachusetts with, say, Connecticut, a very analogous state, that anything has changed, that there was a need to change the rate structure, that people in Connecticut that is low income people are getting credit that aren't in Massachusetts. There was just no evidence of that.

. . .

. . .

The Massachusetts banks have a—almost a decade of experience. They don't come forward with their internal data. We can only look at the external and say it doesn't happen. It's never happened, that restricting one of these remedies or applying it here against a holder in due course has made any meaningful difference at all in availability of credit or the price of credit.
Finally, these facts were also confirmed by State law enforcement officials based on their experiences.

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

We are very fortunate in Wisconsin in that the problem which is dealt with by your proposal had already been studied in detail by the Wisconsin Consumer Act.

The Wisconsin Consumer Act prohibits negotiable instruments in consumer credit sales transactions as well as installment loans. These interlocking loans are substantially the same by definition as your related provisions.

The Act also provides that waiver of defense clauses are ineffective for the first 30 days after the following assignment.

It is clear that the Wisconsin Consumer Act and yours as well fill an urgent need without unduly burdening the business.3

A nationwide survey conducted by the National Commission on Consumer Finance provides the most authoritative evidence of just how extreme and of expected impact of this rule.4 It supports the assertion that this rule will not unduly burden business or consumers. Douglas F. Greer, Professor of Economics at the University of Maryland, and formerly Economic Consultant to N.C.C.F., discussed his work in this area during hearings in the Senate Committee.

The second major part of my testimony relates to our attempt to... determine the extent to which credit availability would be reduced if interest rates affected by abolishment of these two remedies.5

* * * * * is to attempt to isolate the effect of one variable by holding the influence of all relevant variables constant, and in that way we can estimate the impact of one variable, a dependent variable, such as extension of credit at interest.

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

* * * * it can be concluded that denial of these remedies is likely to reduce credit availability in certain circumstances by reducing installment credit written at the retailer 67

Professor Greer predicted a reduction in the amount of credit extended in connection with certain consumer sales transactions in the neighborhood of 5 to 10 percent.8 This suggests a very slight impact is likely from restrictions on cutoff devices in consumer sales. A finding that this rule may marginally reduce the aggregate amount of sales-related credit which is extended is not a permissive argument against its adoption.

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

An excellent example of such conditions and their adverse impact is afforded by the Monarch Construction case in the District of Columbia. Monarch Construction promised home improvements to owners of rowhouses in lower-income areas of the city. In return they took promissory notes which represented staggering consumer indebtedness—often many times the annual income of the maker.

The promised home improvements were usually never undertaken; if begun, they were not completed. Had the promised work been done, its acknowledged value would have been far less than the indebtedness incurred.

If this rule or a similar state statute had been in effect, Monarch Construction Company would have been an obvious "reduction" in the amount of aggregate credit extended by Monarch and would have been untenable by Monarch. It is reasonable to expect that those of Monarch's customers who really needed home improvement work, and reached this conclusion without the help of the high-pressure sales tactics which characterized the Monarch operation, would have sought financing for legitimate contracts executed with reputable firms. The evidence that a reputable firm would have charged far less than Monarch, for vastly more comprehensive work. It should be clear that the reduction in outstanding credit occasioned by the application of the proposed rule to a Monarch-like seller reflects both social utility and an improvement in the financial situation of individual consumers.

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

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

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

We conclude this discussion with reference to the testimony of Thomas Talhan, Supervisor of Consumer Credit for the Minnesota Department of Commerce. He summarized some of the concerns raised in the course of proceedings on this rule.
RULES AND REGULATIONS

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

The State of Minnesota enacted a law in 1971 similar to the NCCP. The NCCP and this rule dealing with third party collections are not identical.

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

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

The real impact seems to have been on the small finance companies serving the lower middle class and poor areas. Such residents were unable to obtain bank financing—not because it wasn't desirable—they just didn't qualify. So they financed their purchases of car, furniture, and small appliances through local finance companies and banks. Transactions were handled on both a secured and unsecured basis. Large-scale changes recommended by the NCCP.

The Legal Aid Society and Better Business Bureau report that the new law has been very effective. In unsecured deals used car dealers that a $900 used car should have more than a month's income in the city; in furniture dealers that a sofa sits better with four legs; and that the stereo really isn't "cheap" when one has to purchase records albums at $7.93 a piece. Reputable finance companies, out of economic necessity, were forced to carefully select their dealers.

Has the law hurt business?
Is it harder for the poor to obtain sufficient credit?

We don't think so.

Finance companies are out daily beating the pavement looking for good deals; they find that there is never enough.

Legal Aid attorneys attempting to unweave the new law have found that the small dealers that should have been hurt have not hurt.

In Minnesota, both consumers and businesses have benefited from the new law. None have reported adverse impacts on our economy that were feared to have occurred.

We in Minnesota support the adoption of the proposed trade rule.

B. Opposition based on related developments in the field. In the original proposal, many parties urged that the Commission withhold action until the report of the National Commission on Consumer Finance was completed and published.1 That report was released in January, 1973. Among the recommendations are proposals to abolish the holder in due course doctrine and waivers of defenses, and to sharply restrict vendor-related loans.

In the proposed proceeding, the Commission was urged to wait at least four years from the date of the NCCP report, in order that the individual states might have an opportunity to enact the NCCP recommendations.2 Additionally, it was pointed out that the recommendations of the NCCP were considered as a comprehensive proposal which sought not to be acted upon piecemeal.3

The Commission has agreed that the restrictions embodied in this rule cannot be enacted as an independent regulation. A stay separate from the much more comprehensive, large-scale changes recommended by the NCCP. Many states have legislated restrictions similar to this rule without undertaking concurrent changes in other aspects of consumer finance. In addition, the Commission notes that NCCP statistics strongly suggest that alteration of the existing law is necessary only when considering a restriction of third party cutoff devices.4

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

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

(a) Of all the states that have legislated, only a few have enacted a complete measure. Some states have abolished either the holder in due course doctrine or waiver of defenses clause, but have not dealt with the problem of the vendor-related loan. In other states, major exceptions or exclusions are contained in the legislation, or the statute applies to only one type of transaction, e.g., automobile sales, home solicitation sales, home improvement sales, to the exclusion of other.5 These partial limitations do not reach the full extent of the problem.6

(b) Consumer representatives noted on the record that, in states that have not acted, the opponents of consumer credit reform are so strong that no statutory is likely to pass.7

(c) The considerable number of interstate consumer credit transactions which may elude even the most comprehensive state statutory protection will be affected by the Proposed rule.

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

(e) While a growing number of state courts have held application of holder in due course or waiver of defenses to be unenforceable when applied in consumer transactions, such decisions are not comprehensive in effect. Judicial re-

1 Chapter VIII and Appendix.
2 E.g., Robert Doyle, Tr. 116, David Gecon, Tr. 15; Scott Grzes, N.T. Texas Independent Automobile Dealers Association, R. 53; Marvin G. Lovin, President, Professional Reminders Association of Greater Chicago, R. 96.
3 E.g., Ira J. Leaton, Tr. 659; Warren J. McIenney, Tr. 1294; Robert Saratine, Tr. 1120; Leonard M. Cohen, General Counsel, Independent Finance Association of Illinois, R. 1297.
4 E.g., Eugene H. Hart, Tr. 694; James J. Banta, Texas Independent Auto Dealers Association, R. 1297; Michael Lonergan, President, Mis- sissippi Exchange Bank of Milwaukee, R. 88.
5 George Grzes, Tr. 330; David Gecon, Tr. 385; J. Manly Head, Tr. 1166; Warren J. McIenney, Tr. 1283; Leonard Cohen, R. 1377; John M. Proctor, Pennsylvania banker, R. 572.
6 Tr. 1270.
7 R. 310.
8 Tr. 310-311-30.
9 Tr. 1509.
10 Sec. notes 4 and 5, supra. Also, Ira J. Leaton, Tr. 656; E. D. Curtin, Pennsylvania banker, B. 88.
11 David Gecon, Tr. 1277; Ira J. Leaton, Tr. 659; L. A. Beaberry, Pennsylvania banker, R. 97; Leonard Cohen, R. 1377.
12 R. 55.
13 Tr. 1568; George Jones, Tr. 1597-99.
14 E.g., Robert Doyle, Tr. 1137; Helen Nelson, Tr. 720.
15 R. 649-650; sec also Helen Nelson, Tr. 720; Jack Watson, Pennsylvania banker, R. 372.
17 Hart, Tr. 629.
18 Tr. 629.
19 Tr. 705-705. Mr. Hart also attributed some of the declines to the 3-day cooling-off period requirement. Finally, when asked whether National Marine Bank's drop from $450.00 to $50.00 was due primarily to Wisconsin legislation on the holder-in-due course doctrine (proposed one year be- fore the hearings), Mr. Hart responded, "Well, this has been over a period of ten years. There's been a gradual diminution" (Tr. 710).
20 E.g., Tr. 287-290 Louis Grzes, Boulevard Loan Company, New York, Tr. 1272 (David Gecon, Volkswagen American Dealers Association); R. 81 (Cincoma Finance Corp.); R. 1377 (Independent Finance Association of Illinois); R. 1630-41 (Richard P. Schaumann for Indiana Automotive Dealers Association); 1631-63 (Robert Holland, Ohio Na- tional Bank of Columbus); R. 1630-61 (Con- tinental Credit Union League, Inc.); R. 1500-
69 (Keith Nelson for Mercantile Credit Corp.) "The burden of such policing is really on the banks," E.g., R. 16 (The Board for bank of the Southwest, Amarillo, Texas); R. 1707 (Roland Barton, Bell Federal Sav- ing and Loan, R. 1915 (Consumer Bankers Association), R. 2254 (John F. Cline, Minne- apolis).
21 E.g., Tr. 629; Gros, Tr. 322; Doyle, Tr. 1103.
22 Ferguson and Carper, The Dark Side of

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the Marketplace 86 (1969). Information [in bold] by Mr. Fulfill, fully written (1968), the number of firms on the Precautionary Measures List was "over 7,000." The number of firms dropped over the years 1968-72, which period also marked a significant activity in the list with the N.O.C.F. rules creating restrictions upon the holder in due course doctrine. Indeed, many of the statutes are specifically aimed at these improvements.

E.g., Hart, Tr. 705; Robert R. Evans, National Consumer Finance Ass'n., Tr. 1109; Richard P. Mckinney, Household Finance Corp., Tr. 2024; Bill W. Dixon, Wisconsin Installment Bankers Ass'n., Tr. 2194.

Guzo G. Hatt, Vice President, Marine National Exchange Bank, Milwaukee, Tr. 705.

Tr. 2094-308.35.

3 USC § 417 (2) (d). The comment to this provision states: "The purpose is taken by the buyer that the note does not contain a note or mortgage and is intended for consumers to defeat "holder in due course" status."

Tr. 427.

of the Companies assembled by the National Commission on Consumer Finance confirm Prof. Krieger's assessment. See National Commission on Consumer Finance, "Consumer Credit in the United States" 36 (1972.)

E.g., Zung, W. Hart, Tr. 691; Prof. William E. Willer, Tr. 1058; William H. Hux- baum, Attorney General's Office, Commonwealth of Massachusetts, Tr. 1300; Jim Smith, Senior Vice President, Security Pacific National Bank, California, Tr. 1437; Robert E. Evans, Maryland, Tr. 1907; John S. Bingham, National Automobile Dealers Association (Utah), Tr. 1799; Mckinney, Tr. 2040-47; Larson, Tr. 210-40; Bill W. Dixon, Tr. 210-40; Richard Victor, Assistant Attorney General, Wisconsin Department of Justice, Tr. 2173-218.


Schell, General Counsel, Douglas F. Greer, Economic Consultant, NCCP.

"Note, "A Case Study of the Impact of Consumer Legislation: The Elimination of Negligibility and the Cooling-Off Period," 18 Yale L. J. 613 (1959), where, at p. 626, it is concluded from the study that accounting for fraudulent dealers had led credit risks, and thus induced financial institutions to be reluctant to take these notes. The findings of this study sug- gest that financiers impose important new restrictions on dealers which should reduce the number of fraudulent transactions. On the other hand, the conservative reaction by most banks and finance companies to the elimination of negotiability in Connecticut has created a widespread uproar in the trade and is diffusing consumer paper. This apparent overreaction has resulted in higher charges to consumers and damage to legitimate business interests, both of which may more properly be attributed to the benefits from restrictions designed to penalize fraudulent dealers is impossible to estimate exactly," Tr. 1058.

See notes 36-42 (a) infra.

E.g., Hart, Smith, Erans, Hickley, Mc- manus, Lazenby, Tr. 845, 859, 861, 1130.

Jim Smith, Senior Vice President, Secu- rity Pacific National Bank, San Francisco, Tr. 1185.

Tr. 1757-1758.

Tr. 2194-2098.

NCCP Report, pp. 36.

Tr. 1594-95.

Tr. 1596.

It is significant that the N.C.O.F. recommended imposition of restrictions analogous to those contained in this rule, despite the predicted marginal diminution in aggregate credit. See N.C.O.F. Report at pages 34-38. With A. Gen, Jean Carper (NY 1973).

Fairfax Learie, Tr. 5073-5074.

Tr. 1594, 1595.

Wells, Tr. 2102, 2103, 2104.

E.g., Paul Daniel, Tr. 1553; Virginia K. Kneader, Tr. 900; Robert Scharahe, Tr. 1034; Jones, Tr. 1025, 1224.

David C. Todd, Tr. 1180, American Industrial Bankers Association, R. 29.


Id. at 24.

E.g., Milton W. Schober, Tr. 1917.

Schober, Tr. 1618; Morris, Tr. 1701.

See the testimony of Dr. Greer cited in footnote 46.

E.g., Paul Daniel, Tr. 1553; Robert Doyle, Tr. 1109 1128; C. Gross, Tr. 361; Edwards, Hart, Tr. 694, 697; J. Manley, Head, Tr. 1139-40; Warren J. Mclennan, Tr. 1252, 1258; Rob- ert S. O'connor, Tr. 695; James Box, President, Pennsylvania Independent Automobile Dealers- association, R. 56; Michael J. Laxson, President, Exchange Bank, Milwaukee, Wisconsin, R. 59.

E.g., Richard Haney, Tr. 485; Betty Furness, Tr. 34-36; Lester S. Goldblatt, Tr. 409; Virginia Kneader, Tr. 901; Fairfax Learie, Tr. 970; Bess Myerson, Tr. 365; Fred Speaker, Tr. 1037; David Swinkin, Tr. 1973; William F. Willer, Tr. 1034, 1041; Robert Smith, Tr. 100; where the quoted material was included.

E.g., Massachusetts, New York, New Jer- sey, Wisconsin, Interaction between statutory and decisional law probably makes California eligible for this list as well. The limited time that legislation has been effective in other states makes evaluation difficult.

E.g., Connecticut, Mississippi, Nevada, Texas, New Mexico.

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

E.g., In Pennsylvania, the statute with the strongest protection excludes motor vehicle and home improvement sales; Connecticut and Maryland have quite liberal exclusionary policies; Delaware (excludes motor vehicle and home repair sales).

Prof. Homer Kripe, Tr. 439; Robert S. Forre, Tr. 297.

E.g., Wilbur Leatherberry, Tr. 1016; Wag- man, Tr. 609; William Wulff, Tr. 1004.

The following witnesses testified that transactions often involve an out-of-state party. Jack W. Bilson, Tr. 925; Anthony Martin-Trigona, Tr. 916; Dennis J. Roberts, II, Tr. 420; Alan Sims, Tr. 137. See also note 65, supra p. 169.

Dean W. Determan, Tr. 1006; Betsy Fur- nes, Tr. 43; Lester S. Goldblatt, Tr. 460-69; Howard K. Kimson, Tr. 500; Virginia H. Kneader, Tr. 400; Fairfax Learie, Jr., Tr. 970; Bess Myerson, Tr. 365; Lewis Nelson, Tr. 575; New York Times, Tr. 995; Edwin Palumbo, Tr. 413; Fred Speak- er, Tr. 1027; Eve Widows, Tr. 94; William Wulff, Tr. 1006; Views of the Atlanta Legal Aid Society, Tr. 23.


Judge Arthur Dunn, Tr. 770; Benny L. Kass, Tr. 1219; Homer Kripke, Tr. 438; Fal- fair Learie, Jr., Tr. 609; Wilbur Leatherberry, Tr. 1916; Bess Myerson, Tr. 24; Agnes Ryan, Tr. 558; Alan Sims, Tr. 218.

Many witnesses agree that a trade regulation rule would encourage rather than discourage consumer action. E.g., Barbara Fickler, Tr. 607; Betty Furness, Tr. 23; Benny L. Kass, Tr. 1599; Steven Mindell, Tr. 23; Helen Nelson, Tr. 721; Stephen Schlossberg, Tr. 882; David Swinkin, Tr. 1973; Cf. Robert S. O'shea, Tr. 1008; Box Financing, Tr. 818, 852.

CHAPTER VII. WHAT THE REVISED RULE DOES AND WHY

Part One. The purpose of this rule. The Commission believes that it is an unfair practice for a seller to employ procedures in the course of attempting to collect the proceeds of a consumer sale which separate the buyer's duty to pay for goods or services from the seller's right to receive such payment. The rule is framed to achieve this policy. The Commission's rulemaking procedures, which encourage broad participation on the part of interested parties and which result in a final rule, is a fair and appropriate way to an end, where a Trade Regulation rule is found to be necessary and appropriate, any final rule must be concise and straightforward as possible. The final revisions of this rule reflect modifications for clarification and coverage. As revised, the rule will prevent sellers from foreclosure consumer equities in credit sale transactions. It will prevent the use of direct-lean financing to accomplish the same end.

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

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

See footnotes at end of chapter.
price or unpaid balance of a sales-related loan. Seller misconduct occurs in a way that renders many sales finance transactions inherently deceptive and misleading. In addition, the Commission is also compelled to bear the costs occasioned by the misconduct of another, while the "guilty" party avoids all liability. In the absence of contractual foreclosures of equities in consumer transactions constitutes an unfair practice under Section Five of the F.T.C. Act.

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

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

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

We believe that a rule which compels creditors to either absorb seller misconduct costs or return them to sellers, by denying sellers access to cut-off devices, will discourage many of the predatory practices and schemes discussed above in Chapter III. Creditors will simply not accept the risks generated by the truly unscrupulous merchant. The market will be policed in this fashion and all parties will benefit accordingly. Where applicable economies militate against a creditor's efforts to return costs to a particular seller, due to the limited or irregular nature of such costs, the rule would require the creditor to absorb such costs. In short, we believe that the consumer blame for seller misconduct or claim or defense is valid, but limited in amount, a creditor may choose to accept the risks as payment to save the transaction costs associated with pursuing the seller whose conduct gave rise to the claim. The creditor may also look to "reserve" or "recovery" arrangements or account with the seller for reimbursement.

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

The Commission, in adopting this rule, is mindful of the fact that a regulatory requirement which requires creditors to either absorb seller misconduct costs or return them to sellers, may have the effect of imposing some measure of misconduct costs on sellers too. This could occur when a re-purchase contract facilitates the disregard of bad debts by returning them to the seller and to them. It is virtually certain that creditors that are more efficient collectors of bad debts than are sellers. Thus, a system which engenders an increase in the number of bad debt sellers must collect may yield a slight reduction in efficiency with respect to "seller misconduct" costs. We are persuaded that such diseconomies will be substantially outweighed by the benefits which will attend a re-allocation of social costs from the seller to the consumer. Absent seller misconduct costs. Creditors and sellers are in a position to engage in meaningful, arms-length, bargaining over the terms contained in recourse arrangements. The Commission has received substantial evidence that such agreements are routinely employed in sales-finance transactions, and that the provisions contained therein can be made to respond to the needs of both parties. Such recourse contracts between sellers and creditors are constantly refined by the development and modification, based on experience, of recourse agreements to allocate risk and liability between the parties to correspond with actual as- sessments of risk.

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

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

Section Five of the F.T.C. Act and Con- tracts of Adhesion. Furthermore, the Commission concludes that the economic injury to consumers discussed here- tofore results from terms contained in form contracts. Commission inquiries of the many legal services groups who participated in the proceeding indicated that consumers have a pre-contractual assurance that waivers of defenses are inserted as hag- gling points in installment agreements. They also stated that consumers rarely com- pare the significance of the terms when the transaction is con-
therefore persuaded that the reasoning appearing above in this chapter applies equally to loans that are fully paid for and financed, and that our rule must apply to "purchase money" loan transactions.

Part Two. What the revised rule does. With the exception of the Truth in Lending Act, our rule is the first which classifies the consumer as a "Creditor" for the purposes of the rule whenever he executes a retail installment contract. In his capacity of seller and creditor, the seller is enjoined from taking or receiving a consumer credit contract, of any kind, which fails to contain the following provision:

--

ANY HOLDERS OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE SELLER OF GOODS OR SERVICES OBTAINED PERSUANT HERETO OR WITH THIS PROCEEDS HEREUNDER. The debtor shall not exceed amounts paid by the debtor heretofore.

The rule expressly applies to credit contracts arising from sales of services, such as trade or vocational school agreements, and as such is consonant with the purpose of the Truth in Lending Act.

In a new section, we have added a paragraph within each of the substance of the rule to make clear the application of the rule to consumer service contracts.

Our original proposed rule contained two sections providing for the prohibition of transactions. It required inclusion of a similar provision in any promissory note or other negotiable instrument taken as a condition of the transaction to secure consumer service contracts.

Instead of two prohibitions the rule contains only one, namely the requirement that the specified contract provision be inserted in all sale-related consumer credit contracts.

Our definition of "financing a sale" makes it clear that the rule only applies to credit transactions within the meaning of the Truth in Lending laws. Our original prohibition on waivers would have applied to all sales, regardless of whether credit was involved.

Such a prohibition would have affected warranties and other obligations which were not the subject of this proceeding.

Finally, by eliminating references to terms such as "negotiable" or "negotiable in form" we have simplified the rule. We have not avoided them in our discussion of enforcement proceedings by eliminating consideration of the technical nature of a non-conforming contract.

Vendor-related loan transactions. The original rule proposed by the Commission did not look beyond discount or acceptance transactions. The rule was limited to installment sales contracts.

This approach would have permitted widespread evasion of the rule.

As a result, in the new section in Chapter IV herein, we required all loans for additional hearings and comment with respect to the use of vendor-related loan financing. Our revised proposal contained a general definition of "Related Creditor" together with nine enumerations.

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The words "Contract" and "Business Arrangement" are defined to include all arrangements and procedures which, based on this record, would justify imputation of an established and continuing course of dealing between the parties. These definitions will encompass all of the situations enumerated in the rebuttable presumptions and the initial rule with the exception of the ninth which involved knowledge of a seller's reputation. We are not persuaded that knowledge alone is sufficient to raise too many problems of proof.

We have retained the "referral" test originally proposed as one of the rebuttable presumptions. As proposed it specified five or more referrals to a creditor. Based on this record we are persuaded that while the act of referral is sufficient to justify imposition of the rule, provided referrals are made in the course of some routine or arrangement, there is no justification for choosing a specific number. Such a number would be arbitrary and unsupportable. There is no reason why five referrals render a seller's conduct different from that when there are not.

One seller may do business in a small town where the smallest number of referrals justifies imposition of the rule; another may do business in a large city where a larger number would be required to impose the rule. As a general proposition, we believe that this record supports the proposition that referrals by a seller make a creditor "related". The word is stated in the plural in the rule. Any seller who arranges financing for his customers should be prevented from cutting off claims and defenses by means of the financing so arranged.

The four definitions of "Creditor", "Purchase Money Loan", "Contract", and "Business Arrangement" will reach every situation where a seller and a lender may be said to work cooperatively to finance consumer sales. We believe that the record in this proceeding supports application of the rule to all situations where concern as to the conduct between sellers and creditors is employed to facilitate the retail distribution of goods and services to consumers. The term "Finance Charge" is the "type" of credit, loan or discount, which is used. The revised rule goes exactly this far and no further.

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

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

"Notice: Any holder of this consumer credit contract is subject to all claims and defenses which the creditor could assert against the seller of goods or services or the holder of any recovery hereunder by the debtor shall be limited to amounts paid by the debtor hereunder."

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

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

The revised rule will require a consumer notice. Many consumers and consumerists urged the Commission to include a requirement in this rule that a consumer be given a copy of pertinent legal documents employed in credit sales transactions to apprise consumers of their legal rights.3 We received significant evidence that many consumers simply fail to read their contracts.3 There was therefore a continuing concern that the federally protected consumers might forfeit the benefits conferred by the rule, more or less by default.

The industry opposed any detailed consumer notice with strong assertions that the actual text of the document proposed by FTC staff was extremely antibusiness in tone.3 In this respect, certain consumer groups agreed that consumer education notices, prepared

See footnotes at end of chapter.
for comment in the proceedings, were probably too inclusive in scope to be fair to the industry.27

In our view, the most persuasive case for imposing an additional burden on the industry in the form of a mandatory notice to accompany all consumer credit sales contracts used in credit sales was made by the commission in its decisions on the problems of Spanish-speaking Americans in the course of the New York hearings.28 29 These comments and testimony were supported by the testimony of various representatives of the Consumer Federation of America.29 The Commission is persuaded that Spanish-speaking Americans are more readily victimized by unscrupulous merchants and creditors. The Commission agrees that Spanish-speaking Americans have more difficulty in comprehending and vindicating their legal rights.

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

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

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


29 Id.


32 See, e.g., C. Calabret, The Costs of Accidents (1970) which contains a detailed explanation of this kind of analysis.

33 The Commission has received copies of many “speculator” letters from various states of this proceeding and related investigations. See Chapter VI, supra at note 28.

34 See the discussion appearing in F.T.C. v. Curtis Publishing Co. 79 FTC 1472, 1815 (1971) where the anticompetitive impact of permit allocation was held to be a risk to retain an unlawful gain may be a factor in determining that the conduct violates section Five of the Federal Trade Commission Act, 15 U.S.C. 41 (1933); Interstate Home Equip. Co. at 40 FTC 250 (1945); and F.T.C. v. Winsted Rosely, Inc., 368 F.2d 269 (2nd Cir., 1966) where similar theories are discussed.

35 See Sperry and Hutchinson v. FTC, 465 U.S. 239, 244 (1982).

36 Sperry and Hutchinson v. FTC supra note 35.

37 Some courts have already taken steps to impose a duty of care, albeit a limited one, on creditors who willingly finance dubious or fraudulent deals. See W.2 gob v. Gross, 587 F.2d 889 (2nd Cir., 1979).

38 See, e.g., Uniform Credit receipt, 540 U.S.C. 15, 16 (1980).

39 Some courts have already taken steps to impose a duty of care, albeit a limited one, on creditors who willingly finance dubious or fraudulent deals. See W.2 gob v. Gross, 587 F.2d 889 (2nd Cir., 1979).

40 A joint venture is defined as one who seeks a specific profit joint with another in a particular transaction. Ditcher v. Booth, 13 N.J. Super. 668, 671, 36 A.2d 648, 652 (1951). Also see e.g., Uniform Partnership Act, Sec. 13-15. Correpondants or partners are generally liable for each others acts on their behalf. A joint venture may arise with no formal arrangement. It may be imputed inferentially. Cooperstein v. Shapiro, 122 N.J. 284, 287 A.2d 638 (1973).

41 Forham, Tr. 650-66 (represented twenty-five employees who had enrolled in a computer training program and who were under pressure from various financial institutions to continue making payments); John Keller, Office of the Superintendent of Public Instruction, Illinois, Tr. 565 (1971) (high school teacher who was instructed by school district to enroll in a private business and vocational schools in Illinois and he cites two typical student complaints); Mindell, Tr. 19 (recent case where computer operators were lured by casual offer); John C. Neubauer, Consumer Education & Protection Organization, Des Moines, Iowa, Tr. 622; Ronald Fritsch, Chicago Legal Aid Bu-
Professor Gutman went on to say that the right to recover against an assignee is "nothing new in the law . . . Where does the right of a non-corporate assignee arise to make them different from the rest of the people?"

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

The finance companies contend that under this section [of the Unruh Act] plaintiffs may bring an affirmative action against the defendant for breach or for recission but may only assert their defenses in an action by the finance companies to collect on the contracts and then only to the extent of the amount still owing. Upon analysis, however, a number of considerations weigh against such a restrictive interpretation . . .

The purpose of the Unruh Act is to protect consumers from unfair business practices and can be liberally construed to that end. (Morgan v. Resor, 69 Cal. 2d 861, 889.) If we were to adopt the concept of proprietary rights, it would be like stowing upon the seller immunities and privileges against consumers unavailable to them in the ordinary commercial transaction. (Cf. Unico v. Owen (N.J. 1967) 232 A.2d 405, 417-418.)

It is suggested by amicus curiae that Section 17592 was intended to eliminate the possibility that by depriving assignees of any right to take free of the buyer's defenses against the seller despite agreement to the contrary, the section might subject assignees to products liability suits which might involve personal injuries and large damage claims.

It would be ironic indeed if a provision in an act intended to benefit consumers could be invoked to their detriment to such an extent that they would stand in a less advantageous position than others in the commercial area . . . If, despite the allegations of the complaint, assignees were consumer in the true sense—we were to adopt the view of the finance companies, were we going to find the provisions of the statutory language against consumers than they enjoy without reservation all others. Such a result cannot be justified.

At the New York hearings Bess Myerson, Commissioner of the New York City Department of Consumer Affairs, discussed the New York statute which limits the consumer to a defense or setoff and stated, "without the right to initiate suit, . . . consumers are denied a basic weapon of protection against unresponsive third parties to installment credit contracts." 4

Another reason for not limiting consumers to a defensive position is that a stronger potential consumer remedy will encourage greater policing of merchants by finance institutions.

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

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

Finally, it is important to remember that the consumer action and rule will require can only be enforced between the parties in a court of competent jurisdiction. The purpose of this rule is to mandate judicial supervision of consumer installment credit transaction, when a bona fide dispute develops between buyer and seller. The various cut-off devices involved in this statement are a judicial review of the equities in such transactions. Consumers will not be in a position to obtain an affirmative relief from the seller unless they have actually commenced payment and received little or nothing of value from the seller. In a case of non-refund of the deposit, the buyer, unless the seller asserts his right to the deposit, or the like, we believe that the consumer is entitled to a refund of monies paid on account.

A set maximum amount. Some industry representatives suggested that high price sales should be exempted from the rule. First, the consumer who buys a high priced "luxury" item such as an airplane or a boat is generally more sophisticated than the average consumer, and therefore, is likely to read and understand the legal consequences of his contracts. 5

Second, the seller of such items relies on the judgment of the consumer when he enters into installment contracts in order to replenish his costly inventory. If the market for this paper becomes tighter, industry contends that many of these sellers would be driven out of business. 6

This assertion rests on assumptions about the alleged difficulty of assigning notes in the absence of cut-off devices. The weaknesses of these arguments have been examined above. 7

The price of a house full of furniture, an automobile, certain home improvements or other necessity items purchased by average consumers often exceed $5,000 or $10,000 a year ago by industry spokesmen as an upper limit to the rule. The rule should protect the rights of middle income consumers as well as low income consumers.

The basis for the rule is a finding that reliance on various cut-off devices is ar age old. The provisions of Title 5 of the PTC Act. The practice does not cease to be unfair simply because it involves a larger amount of money.

C. Limitation of time in which defenses can be raised. Some witnesses urged the Commission to adopt a rule which would set a limit upon the time in which consumer action could be brought. This would require the consumer to notify the third-party financier of any defenses within the specified period.

The "complaint period" approach, touched upon earlier, requires the assignee of a consumer instrument to give notice to the consumer of the transfer of the consumer's right to raised defenses or make claims within set period—usually 10, 15 or 30 days. It has been suggested that even the most shoddy merchandise will stand up for 15 or 30 days, and that the complaint period will be of little use. 8 More fundamental is the criticism advanced by several commentators and witnesses in this proceeding—that any "complaint period" approach suffers several fatal flaws:

(i) It is reported that the financial "notices" reach consumers buried in the midst of various junk mail 18 and that few, if any, consumers understand the implication of the affirmative act of properly drafting and sending the notice. 19

(ii) The fact of "non-complaint" may just as easily hold the consumer to an even stronger legal position than he occupies under current law. "This kind of statute appears to give . . . an assignee as a preferable legal position as one holding free of defenses by specific statutory mandate." 20

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

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

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

2. That the rule's protection be extended to include small businessmen. Such an extension would undermine a rule which protects that consumer from transactions are essentially different from commercial transactions and the holder in due course doctrine originated and is only appropriate for the latter. The need for such an extension of cov-
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3. That the consumer is required to make written demand upon the seller before stopping payments. In most cases a consumer will attempt to resolve complaints before resorting to stopping payment. Specifying in the rule the manner in which such consumer/seller negotiation must take place would introduce unnecessary formality into the procedure. The format of such efforts should remain flexible. The Commission is also concerned that formalistic requirements upon the consumer would serve to create other problems, especially of proof—e.g., did the seller in fact receive notice?

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

5. E.g., Eugene Hart, Tr. 712; Iris J. Leiton, Tr. 672–73; Robert Olson, Tr. 949–50; Robert Serafine, Tr. 1096; Max Denney, R. 26; Statement of American Bankers Association, et al., R. 1809–10.

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

7. Id. at 399–400.

8. Id. at 397–398.

9. See Notes and Comments, supra. The rules as a whole are designed to provide the consumer with basic protections from default or wrongful conduct of a business. By providing these protections, the rule should not be viewed as a “hold-up” device. See supra, note 4.

10. E.g., Barry Baline, Tr. 1187; Arthur Roddy, New Jersey consumer who describes the problems he had with a contractor to construct a swimming pool, Tr. 100. See also R. 64–65 (swimming pool).

11. Hart, Tr. 120; Finance group, Tr. 672–3; Olson, Tr. 949; Todd, Tr. 1182.


18. Delzer, New Jersey Consumer, Tr. 422; Betty Furness, Tr. 58; Anthony Martin-Trigona, Tr. 907, 914.

19. Robert S. Olson, Tr. 949; contre, Gladys Kessler, Tr. 1064; Ronald Pritsch, Tr. 741.


22. Robert D. Breth, Certified Consumer Credit Executive, R. 4564–47.


APPENDIX: Public Comment on the Proposed Rule

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

Submissions came from a great variety of sources. Support ranged from one-line postcards to lengthy, heavily-documented legal submissions. There are over two hundred submissions and a host of individual comments from individuals not identified with a group or business—which express general support for the rule.4

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

Federal, state and local government officials expressed approval of the rule.

Two judges expressed support.5 The Canadian Minister of Consumer and Corporate Affairs expressed approval of proposed Commission action,6 and the Ministry supplied materials documenting the Canadian experience.7

Support for the rule was expressed by over one hundred complaints and other associations and organizations.8 Over thirty legal aid organizations are on record in favor of the rule. In addition to the trade attorneys who wrote as individuals, not on behalf of a client, in support of the rule.9 Over one dozen educators wrote10 or spoke in favor.

Finally, the rule received strong support from a number of businessmen11 and the backing of two bankers.12

Most opposition to the proposed rule was presented by businessmen, bankers and trade associations. There are also a number of letters opposing the rule submitted by individuals not identified as affiliated with a group or business.13 Two public officials expressed disapproval.14

There are hundreds of letters in opposition from individual retailers, representing a variety of businesses.15 Individual banks and bankers wrote to oppose the rule in fairly large numbers.16 Finance companies are represented by submissions17 including closely related financial service corporations and similar organizations make up the bulk of the remainder of submissions in opposition.18 By number, automobile dealers,19 and bank mortgage loan officers head the list. All commissions were also received from credit card issuers and organizations.

There are several letters expressing disapproval of the rule from attorneys not writing on behalf of a client nor on a corporation,20 and from the academic community.21 Promulgated by the Federal Trade Commission November 14, 1978.

Then, I "strongly believe it is in the public interest to abolish the 'holder-in-due-course doctrine.' Thank you," H. Greensleeves, Jr., R. 3453.


23. E.g., . . . if the seller and note holder both know that the law is on [the consumer's] side, the seller will make a better product that he can stand behind without fear." R. Stevens, R. 16; "Let us cease to legally screw the poor," Tony Scott, R. 78–79.

24. "I realize that lenders will have to learn something about fair value of items . . . don’t you think that since the item is technically collateral that they should know what their collateral is really worth?" Arne Sampe, R. 348; . . . one more thing we might do to help convince our public and people besides really is effective recourse for just grievances in large numbers," Mrs. R. J. Freistein, R. 348. This same rule will give the consumer a little more assurance that the retailer will be as honest in disposing of his product as good bank such as Bank of America, R. 338.

25. "I urge the Commission to abolish this antiquated and unconscionable practice." Riesz Odell, R. 3442.


27. U.S. Representatives:

Hon. John M. Murphy, R. 999–1001.

Federal, operative:


Deputy Assistant Attorney General, Bruce R. Wilson, Antitrust Division, United States Department of Justice, R. 1926–1988.
Thomas E. Kauper, Assistant Attorney General, Antitrust Division, United States Department of Justice, R. 7105–7128.

Sitting with:

Florida: Robert J. Bishop, Director of Consumer Services, Department of Agriculture and Consumer Services, R. 5846. City of Jacksonville, R. 1001–1004.


Indiana: Richard Burgdorff, Administrative Assistant to Director, Department of Financial Institutions, R. 1977–1997.

Kansa: Vern Miller, Attorney General, R. 5644.
PROPOSED RULES

STATEMENT OF REASON FOR THE PROPOSED AMENDMENT

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

The Commission has conducted lengthy public proceedings on the "holder in due course" doctrine and related problems in consumer sales transactions. Extensive testimony, data, and information were elicited in the course of the proceedings. On the basis of information contained in those proceedings, the Commission promulgated TIR relating to the Preservation of Consumer's Claims and Defenses, 16 CFR 423. In that proceeding the Commission determined that it constitutes an unfair or deceptive act or practice for a seller to separate, by means of a form consumer credit contract, a buyer's duty to pay from the seller's duty to perform as promised, and that this practice is injurious to consumers and to the market as a whole.

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

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

INVITATION TO PROPOSE ISSUES OF FACT FOR CONSIDERATION IN PUBLIC HEARINGS

All interested parties are hereby given notice of opportunity to propose disputed issues of fact, in contrast to legislative fact, which are material and necessary to the rule. The Commission or its duly authorized presiding official, shall, after reviewing submissions hereunder, identify any such issues in a Notice which will be published in the Federal Register. Such issues shall be considered in accordance with Section 18(c) of the Federal Trade Commission Act, as amended by Public Law 92-587, and in accordance with rules promulgated thereunder. Proposals shall be accepted until no later than January 15, 1976 by the Special Assistant Director for Rulemaking, Federal Trade Commission, Washington, D.C. 20580, A proposal should be identified as a "Proposal Identifying Issues of Fact-Holder in Due Course," and, when feasible and not burdensome, submitted in five copies. The time and place for public hearings will be set forth in a later Notice which will be published in the Federal Register.

INVITATION TO COMMENT OF THE PROPOSED AMENDMENT TO 16 CFR 433.3

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

Issued: November 14, 1975.

By the Commission.

CHARLES A. TOBIN,
Secretary.

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