

NOTES

JUDICIAL AND LEGISLATIVE PROTECTION OF THE CONSUMER NOTEMAKER

Commonly, consumers elect to purchase goods on an installment basis rather than wait until cash can be paid. Because the seller of consumer goods typically lacks sufficient resources to finance long term credit arrangements, he will seek to discount the consumer's promissory note to a financial institution. Under certain circumstances, the finance company acquires a more protected status with respect to the rights of the consumer notemaker than the seller possessed. Theoretically, this allows the seller to obtain a better price for the note¹ and pass the savings on to the consumer in the form of more favorable credit terms. In practice, however, the consumer seldom so benefits.²

The most serious problem created by this pattern of dealings arises when the seller fails to perform his obligations under the sales contract, and then becomes insolvent or skips town. The consumer will then exercise what he considers to be his right to withhold payment until performance resumes whereupon the financier informs him that continuation of payments is expected regardless of the seller's default. Persistent refusal to pay impels the financier to bring an action against the consumer and, since the seller is outside the process of the court or without funds, he is not available as an indemnitor.³ Faced with the choice of placing such a loss on one of two innocent parties, the consumer or the financier, courts usually choose the former on the basis of insuring the free negotiability of negotiable instruments.

As long as there have been negotiable instruments, legal theorists

1. C. PHELPS, *INSTALLMENT SALES FINANCING: ITS SERVICES TO THE DEALER* 62-65 (1953); Note, *Protecting the Installment Buyer*, 49 HARV. L. REV. 128, 130 (1935); 114 U. PA. L. REV. 395 (1966). See generally B. CURRAN, *TRENDS IN CONSUMER CREDIT LEGISLATION* 8-14 (1965) [hereinafter cited as CURRAN].

2. W. PLUMMER & R. YOUNG, *SALES FINANCING COMPANIES AND THEIR CREDIT PRACTICES* (1940).

3. Much of this fact pattern is derived from similar ones described in 75 HARV. L. REV. 437 (1961) and 54 VA. L. REV. 279 (1968). For actual cases resembling this fact pattern see *Calvert Credit Corp. v. Williams*, 244 A.2d 494 (D.C. Ct. App. 1968); *Davis v. Commercial Credit Corp.*, 87 Ohio App. 311, 94 N.E.2d 710 (1950); *Norman v. World Wide Distribs., Inc.*, 202 Pa. Super. 53, 195 A.2d 115 (1963).

have battled over proper policies for their regulation.⁴ The majority position has traditionally been to maintain free negotiability and thereby foster commercial, business, and industrial growth.⁵ Courts have reflected this sentiment more often than not in their holdings. Nevertheless, a growing minority of legislators and jurists are seeking to protect the consumer from the sharp practices of his creditors.⁶ This note will examine the devices utilized to achieve that protection.

The Common Law of negotiable instruments has traditionally provided financiers with virtual immunity from the claims of duped consumers. It is a rather sad commentary on the American judicial system to note the frequency of cases in which the innocent consumer suffers the loss caused by the dishonesty of a defaulting seller. A remedy, until about 1923, was decidedly lacking.⁷ From that point forward, however, a marked trend of rebellion can be observed against the Common Law of Negotiable Instruments (or Law Merchant) as it was embodied first in the Uniform Negotiable Instruments Law (hereinafter NIL) and, subsequently, in the Uniform Commercial Code (hereinafter UCC). At first the remedial spirit was purely judicial, and a distinctly minority sentiment. The spirit then carried into the state legislatures, and legislation on the subject was enacted in many states, although, in terms of total consumer protection, most enactments were merely half-way measures. Today some courts have substantially varied pre-existing negotiable instruments law as to good faith and notice and a few legislatures have structured full-scale, all-encompassing consumer codes.

4. For a detailed account of the conflict and confusion over this matter in the early federal period see BEUTEL'S BRANNON NEGOTIABLE INSTRUMENTS LAW 89, ch. 3 (7th ed. 1948) [hereinafter cited as BEUTEL'S BRANNON]. See also Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 SO. CAL. L. REV. 48 (1966) for a reflection of this conflict upon the early U.S. and British Courts.

5. BEUTEL'S BRANNON 56-61.

6. See, e.g., Jones, *Finance Companies as Holders in Due Course of Consumer Paper*, 1958 WASH. U.L.Q. 117.

7. In 1923, there began a significant trend of pro-consumer decisions with the leading case of *Taylor v. Atlas Security Co.*, 213 Mo. App. 282, 249 S.W.2d 746 (1923). These decisions were handed down in spite of widespread judicial and legislative protection of a holder in due course of a negotiable instrument from the personal defenses of its maker. For a concise discussion of the difference between "real" and "personal" defenses to actions on negotiable instruments see W. HAWKLAND, *COMMERCIAL PAPER* ch. 4 (1959). For a discussion of holders in due course under the Uniform Negotiable Instruments Act and its successor, the Uniform Commercial Code, see Britton, *Holder in Due Course—A Comparison of the Provision of the Negotiable Instruments Law with those of Article 3 of the Proposed Commercial Code*, 49 N.W.U. L. REV. 417 (1954).

I. JUDICIAL ATTACKS

A. *The Good Faith Standard*

The financier, in the typical situation described above, is protected⁸ because of his status as a Holder in Due Course under the NIL and the UCC. The requisites for such status are that the holder take the paper (1) in good faith, (2) for value, and (3) without notice of defect therein.⁹ Although these criteria seem unambiguous, in fact they are not. Courts have never been able to agree upon a single workable definition of a Holder in Due Course under either the NIL or the UCC.¹⁰ Absent this functional ambiguity, courts seeking to protect the consumer would have been unable to do so, without running afoul of NIL or UCC doctrine.

In applying Holder in Due Course criteria, few courts have toiled over the distinction between taking in "good faith" and taking "without notice of defect".¹¹ Therefore, this note will similarly treat them as one, under the larger concept of "Good Faith".

Much of the on-going controversy surrounding the criteria for a Holder in Due Course focuses on whether good faith is a subjective or an objective requirement. Early British decisions adhered to the latter view.¹² Under "objective" doctrine, the question was whether

8. For difficulties of attacking this status in court, see generally Beutel, *Interpretation, Construction, and Revision of the Commercial Code: The Presumption of Holding in Due Course*, 1966 WASH. U.L.Q. 381, 392.

9. The complete requisites for holder in due course status are set out in NIL § 52 and UCC § 3-302. The NIL section reads:

A holder in due course is a holder who has taken the instrument under the following conditions: (1) That it is complete and regular on its face; (2) That he became a holder of it before it was overdue, and without notice that it had been previously dishonored, if such was the fact; (3) That he took it in good faith and for value; (4) That at the time it was negotiated to him he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it.

Section 3-302 of the UCC reads (in part):

(1) A holder in due course is a holder who takes the instrument (a) for value; and (b) in good faith; and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person

10. Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 So CAL. L. REV. 48, 56 (1966) states: "The state of affairs as it existed under the NIL must be described as undesirable. Even the thoughtful commentators cannot agree as to whether the [judicial] results were consistent." Nor was consistency achieved under the Code. See *id.* 77; see also Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1098-99 (1954).

11. Littlefield states: "Almost universally, courts and writers have treated the requirements of good faith and no notice as part and parcel of the same requirement." Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 So. CAL. L. REV. 48, 54 (1966).

12. See, e.g., landmark case of *Gill v. Cubitt*, 3 B.& C. 466, 107 Eng. Rep. 806 (1824), where the test of a holder's good faith was whether he took "under circumstances which ought to have excited the suspicion of a prudent . . . man"

circumstances underlying the note's transfer from seller to financier would generate suspicion in the mind of a reasonable man such that he would investigate further into the original transaction before purchasing the note. The doctrine created an affirmative duty in suspicious would-be purchasers to ascertain further whether the note, or the contract which accompanied it in the original sales transaction, might have been the subject of a claim or defense against the seller. If he found this to be so, but still purchased the note, he became vulnerable to those existing defenses and claims.

The objective doctrine was soon overruled and replaced with what became known as the subjective standard.¹³ This test, which quickly became the majority position in England and the United States, required, before denying the purchaser holder in due course status, proof of his "Actual Knowledge" of the note's defect.¹⁴

When the NIL was promulgated in this country, most courts paid it little heed.¹⁵ They continued to follow the case law precedent of their own jurisdiction, apparently unmoved by any desire to achieve a consistent pattern of results. Most decisions were rendered, as they had been previously, in the context of the split between objective and subjective, with the majority still following the latter line.¹⁶ The few courts that chose to make explicit reference to the NIL were no more limited in their freedom of interpretation than the many that did not; this because the NIL is almost completely devoid of definition of terms relating to holder in due course qualifications. Furthermore, the only definition in the Act pertaining to notice or good faith—section 56—is sufficiently ambiguous as to admit equally well of either subjective or objective interpretation.¹⁷ The task of definition under the NIL devolved, therefore, to the courts.

13. See *Crook v. Jadis*, 5 B.&Ad. 909, 110 Eng. Rep. 1028 (1834), a milestone on the way to a complete Subjective Test. *Crook v. Jadis* modified the simple negligence test of *Gill v. Cubitt* to the extent that a holder's good faith could, after *Crook*, be impeached by no less than gross negligence. But this, too, was soon replaced, in *Goodman v. Harvey*, 4 Ad&E. 870, 111 Eng. Rep. 1011 (1836) which required proof of a holder's actual knowledge of a note's defect.

14. *Goodman v. Simonds*, 61 U.S. 343 (1857) instituted the objective test, which soon became the majority position in the United States. The minority, objective position in this country is best illustrated by *Mee v. Carlson*, 22 S.D. 365, 117 N.W. 1033 (1908).

15. BEUTEL'S BRANNON 80.

16. Littlefield notes that this judicial disregard was in fact the intended result: "It must be remembered that the NIL was drafted to restate, not remake, the Common Law." Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 SO. CALIF. L. REV. 48, 56 (1966).

17. NIL Section 56 reads (In part):

To constitute notice of an infirmity in the instrument . . . the person to whom it is

The drafters of the UCC enjoyed no greater success than their NIL predecessors in achieving a workable definition of good faith which could be consistently applied.¹⁸ They were, in fact, less successful. Unlike the drafters of the NIL, who were little concerned with the matter of defining terms, the drafters of the UCC were obsessed with it.¹⁹ This might have been good in itself had they intended the sections of the Code to function together as a unit. But they did not,²⁰ and as a result failed to foresee inconsistency arising, for example, from defining good faith one way in the "Sales" section and another way in the "Negotiable Instruments" section. In simple fact patterns, little difficulty ensues (as when disposition requires only that the court decide whether the fact pattern involves sales or negotiable instruments). However, as the pattern increases in complexity, it becomes more difficult to draw that line. In fact, few cases today could be classified as either exclusively sales cases or negotiable instrument cases. The result is that in most cases courts are forced to consult not just one section of the Code, but many.

negotiated must have had actual knowledge of the infirmity . . . or knowledge of such facts that his action in taking the instrument amounted to bad faith.

A close look at this section reveals that it contains both tests. "Actual knowledge" is clearly language of the subjective test. If "Knowledge of such facts, etc." were construed to be mere repetition of the above, then the section would yield a subjective result. However, if construed to mean knowledge of such facts as to arouse suspicion in the mind of the reasonable man, then the section would render an objective result, since the latter by definition included the subjective test. This latter position, perhaps the soundest, is argued by Professor Beutel. See Beutel, *Comparison of the Proposed Uniform Commercial Code, Article 3, and the Negotiable Instruments Law*, 30 N.E. L. REV. 531, 545-6 (1951). See also 81 PA. L. REV. 617 (1933).

18. Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 SO CAL. L. REV. 48, 59 (1966).

19. To illustrate, a court attempting to resolve a complex fact pattern containing matters relating to both sales and negotiable instruments law, would have quite a task under the 1957 Draft. He would have to consult no less than four definitions—two of notice and two of good faith. See Notice, §§ 1-201(25), 3-304, and good faith, §§ 1-201 (19), 2-103 (b).

20. See, e.g., Kripke, *The Principles Underlying the Drafting of the Uniform Commercial Code*, 1962 ILL. L. FORUM 321, 331: "It is fair to say that the draftsmen of the Code had an anticodification or antistatute predilection. They did not want to codify the law, in the continental sense of codification." See also Beutel, *Interpretation, Constructions, and Revision of the Commercial Code: The Presumption of Holding in Due Course*, 1966 WASH. U.L.Q. 381, 389-91: "In many instances these [articles of the Commercial Code] are still narrower in scope, subject matter, and language than were the uniform laws they repeal. It is fair to say that, in some of its parts [the Code is] . . . only a collection of special statutes." Professor Beutel believes that the Drafters avowed purpose, if one accepts Kripke's assertion, was in fact realized. *Contra*, Hawkland, *Uniform Commercial "Code" Methodology*, 1962 ILL. L. FORUM 291, 293: "Usually, not much stock should be placed in the fact that a legislative enactment is denominated a code, because, as we have seen, the term is used loosely and can describe a mere statute as well as a genuine codification. Some significance should be given this terminology, however, in its employment in the Uniform Commercial Code, because American legal history indicates that a true code is needed in this area of law, a fact well known to the draftsmen of the Code."

Internal inconsistency was more abundant in the early Code Drafts, published during the decade of the fifties than in the current Draft, published in 1962.²¹ Fortunately, only two states were (both have now revised their Codes) relying on early versions.²² Yet, while the current Draft is an improvement, it too fails of consistency. Moreover, it may have come too late to effectuate the Drafters' professed intention of ruling out the objective test. On the one hand, the Drafters have finally glued together a Code almost internally consistent as to the definitions of good faith and notice, which all but rules out the objective test;²³ on the

21. Fagan, *Notice and Good Faith in Article 3 of the UCC*, 17 U. PITT. L. REV. 176 (1956). Although one is compelled to disregard the general definitions, provided in § 1-201 and applicable to the entire Code, when the particular article to which one is referring also defines the term, some scholars argue that both definitions must be consulted. Professor Beutel argues: "[notice in 1-201] although it clearly applies to Article 3, is limited as follows: 'Subject to additional definitions . . . and unless the context otherwise requires.'" Beutel, *Comparison of the Proposed Commercial Code, Article 3, and the Negotiable Instruments Law*, 30 NEB. L. REV. 531, 546 (1951). As to internal inconsistencies in each of the UCC Drafts, the following illustrates how abundant they were (May, 1949 Draft):

Notice to Purchaser (3-304): (1) Notice means that upon all the facts and circumstances known to the purchaser he has reasonable grounds to believe that there is an infirmity in the instrument or a claim against it or that it is overdue or dishonored.

The accompanying comment makes clear the Drafters' intent to rule out by this section the subjective test:

He is on notice when he has information which would induce a reasonable man in his position to reject the instrument or to refuse to take it without further investigation. (Comment 2, 1949 Draft § 3-304.)

In the same Code, good faith [§ 1-201(16)] is constituted by the observance of "reasonable commercial standards". Whether this is subjective or objective is a matter for debate. See Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 So. CAL. L. REV. 48, 52 (1966). The Spring, 1950 Draft made no significant changes in either of these two sections. See UCC, Spring, 1950 Draft, §§ 1-201(18), 3-304(2)&(4). However, the 1952 Draft was laden with substantial internal inconsistencies. Section 3-304(2)&(4) retain the objective test: "The purchaser has notice . . . when he has reasonable grounds to believe . . ." But § 1-201(19) seems to repudiate the objective test in favor of the subjective—or honesty in fact—doctrine: "Good faith means honest in fact in the conduct or transaction concerned." In 1957, the Drafters further added confusion to the test of notice by denying holder in due course status to a purchaser who "Has reason to know" of a defect, etc., thus replacing with this dubious language the more clearly objective "reasonable grounds to believe" of prior drafts. See 1957 Draft § 3-304(3). The good faith provision of the 1957 Draft [§ 1-201(19)] retains the subjective "honest in fact" test. The current (1962) Draft retains the 1957 language which more clearly seems to set out a subjective test. See UNIFORM COMMERCIAL CODE 1962 OFFICIAL TEXT §§ 1-201(19), 3-304(3).

22. Pennsylvania, 1954 and Massachusetts, 1958.

23. Littlefield points out that by 1958, the Drafters were professing the intention to remove all language which could be construed to call for the objective test. Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 So. CAL. L. REV. 48, 59 (1966). He cites the 1956 RECOMMENDATIONS OF THE EDITORIAL BOARD 103: "The removal of the offending language was intended 'to make clear that the doctrine of an objective standard of good faith, exemplified by

other, a growing body of case law, described in the following sections, has evolved which not only vindicates the consumer-maker, but frequently does so on the strength of the objective test.

B. *The Close-Connectedness Doctrine*

As indicated above, neither the NIL nor UCC afforded courts much guidance in devising a uniform standard of good faith which could be consistently applied. The first breakthroughs in judicial protection of the consumer occurred under the NIL. Forced by ambiguity to "follow their noses", judges were able to vary their holdings according to the exigencies of particular situations and, in their search for more equitable solutions to consumer problems,²⁴ they arrived at the Close-Connectedness Doctrine.²⁵

*Commercial Credit Corp. v. Childs*²⁶ was probably the first case to use the words "closely connected" to describe the relationship between seller and financier which would deprive the latter of holder in due course status. In *Childs*, the plaintiff finance company brought a replevin action against defendant consumer to recover an automobile allegedly purchased under an installment sales contract. The finance company purchased the secured note from the seller. Claiming the automobile to be worthless, Childs defaulted payment. Accordingly, the financier sued on the theory that it was immune from the consumer's personal defenses against the seller because of its status as a holder in due course. At trial, Childs introduced evidence that plaintiff was a moving force behind the sales transaction between itself and seller Arkansas Motors; that the financier had scrutiny over the terms of the sales contract; that it had prepared the instrument; and that the instrument contained on its face a printed endorsement-over clause to appellant.²⁷ The trial court found for

the case of *Gill v. Cubitt* . . . is not intended to be incorporated in Article 3". Whether the Drafters realized their professed intention is a matter for debate.

24. Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 SO. CAL. L. REV. 48, 77 (1966).

25. For another discussion of this doctrine, see Jones, *Finance Companies as Holders in Due Course of Consumer Paper*, 1958 WASH. U.L.Q. 177 (This is an exhaustive state by state statistical analysis of the early cases applying this doctrine). See also Axelord & Barry, *Holder in Due Course—A Memo to Poverty Lawyers*, 22 RUTGERS L. REV. 281 (1968); Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 SO. CAL. L. REV. 48 (1966); Note, *Consumer Financing, Negotiable Instruments, and the Uniform Commercial Code: A Solution to the Judicial Dilemma*, 55 CORNELL L. REV. 611 (1970); 11 U. FLA. L. REV. 558 (1953).

26. 199 Ark. 1073, 137 S.W.2d 260 (1940).

27. *Id.* at 1077, 137 S.W.2d at 262.

the defendant and plaintiff appealed. The Supreme Court of Arkansas affirmed, stating:

We think appellant was so closely connected with the entire transaction or with the deal that it can not be heard to say that it, in good faith, was an innocent purchaser of the instrument for value before maturity. It financed the deal, prepared the instrument, and on the day it was executed took an assignment of it from the Arkansas Motors, Inc. Even before it was executed it prepared the written assignment thereon to itself. Rather than being a purchaser of the instrument after its execution it was to all intents and purposes a party to the agreement and instrument from the beginning.²⁸

* * *

Under the facts detailed above we think it was appellant's duty before taking an assignment of the instrument to inquire whether appellee's signature thereto had been obtained through fraud and misrepresentation.²⁹

Thus, with the close-connectedness doctrine, the *Childs* court provides an important tool for courts seeking to protect the consumer. But, if the doctrine is to continue to withstand the vigorous attacks of finance company plaintiffs, it must be rid of certain weaknesses. Chief among these weaknesses is its lack of precision. The close-connectedness doctrine was not precisely defined by the *Childs* court, and subsequent decisions invoking the doctrine reveal a morass of dissimilar reasoning created by uncertainty on the part of judges as to the issues properly provable and the evidence probative of those issues. The cases are examined below and can be categorized into no less than six types of arguments. As a common ground, all six draw from two classes of evidence and two legal theories.

The first type of evidence is that of a close seller-financer relationship existing prior to the sales transaction under litigation. For example, the seller and financer may frequently do business together,³⁰ there may be a family relationship between personnel of seller and financer,³¹ or they may occupy the same office building.³² The second type of evidence is that of a close relationship between seller and financer during the sales transaction at issue, frequently referred to by courts as the financer's

28. *Id.*

29. *Id.* at 1078, 137 S.W.2d at 262.

30. *See, e.g.*, Taylor v. Atlas Security Co., 213 Mo. App. 282, 249 S.W. 746 (1923).

31. *Id.*

32. *See, e.g.*, Rein v. Merriell, 150 So. 2d 73 (La. 1963).

“active participation”³³ in the original sales agreement. For example, the financier may furnish a blank sales contract and note forms to the seller for use in negotiation with his customers;³⁴ the finance company’s name may be printed on the note in an “endorsement-over” clause;³⁵ the financier may “okay” all sales agreements of seller before they are concluded;³⁶ or the seller may use the financier’s time-price differential charts in the setting interest rates for his customers.³⁷

Courts invoking close-connectedness use either—or sometimes both—of these types of evidence in support of either or both of the following legal theories: the first theory is an expanded objective test, best illustrated by two syllogisms. Using the first type of evidence, the major premise is that all finance companies enjoying an intimate business relationship with a seller should know the nature of his business practices; the minor premise is that seller “S”—with whom financier “F” enjoys an intimate business relationship—frequently defaults on obligations under his consumer contracts; and the conclusion is that, therefore, financier “F” should know that seller “S” has a record of default on consumer contract obligations. Applying the objective test, this would put “F” on notice that, absent further investigation proving otherwise, paper purchased from “S” is marred with defect. Besides default, the syllogism functions as well in situations of fraud or misrepresentation.

Applying the second type of evidence to objective theory, all financiers who actively participate in a sales transaction must have knowledge of its character and that of the seller. Seller “S” misrepresents his merchandise in a transaction in which Financier “F” actively participates; therefore, “F” is charged with notice of defect, applying the objective test as above.

The second legal theory applied in close-connectedness cases abandons the objective test, and functions only with the second type of evidence. From the evidence that the financier actively participated in the original sales agreement, courts using this theory treat the financier and the seller whose interests he represented as one legal entity.³⁸ From this base, they

33. See, e.g., *Commercial Credit Corp. v. Orange County Machine Works*, 34 Cal. 2d 766, 214 P 2d 819 (1950).

34. *Id.*

35. See, e.g., *Buffalo Indus. Bank v. DeMarzio*, 162 Misc. 742, 296 N.Y.S. 783 (Buffalo City Ct.), *rev'd on other grounds*, 6 N.Y.S.2d 568 (Sup. Ct. 1937).

36. See, e.g., *Swanson v. Commercial Acceptance Corp.*, 381 F.2d 296 (9th Cir. 1967).

37. See, e.g., *Associates Discount Corp. v. Goetzinger*, 62 N.W.2d 191 (Iowa 1954).

38. Three theories supporting this proposition can be argued. The first is derived from the NIL.

rely on a great body of law prohibiting an original participant in a sales agreement giving rise to a negotiable instrument from becoming a holder in due course of that same instrument.

A recent case, *Jones v. Approved Bancredit*,³⁹ illustrates a unique factual situation combining all four of the close-connectedness elements. *Jones* was an action by a finance company as a holder in due course of a buyer's note, where the latter withheld payment for the seller's failure to continue performance. At the trial level, the consumer introduced evidence that seller and financier were: (1) both wholly owned subsidiaries of the same parent corporation; (2) that seller discounted 99% of its notes with financier; (3) that financier prescribed the forms of

Section 52 requires that a holder in due course "have no notice of any infirmity in the instrument or defect in the title of the person negotiating it . . . at the time it was negotiated to him" Section 30 defines a negotiated instrument as one "transferred from one person to another". If one were to read "negotiated" in § 52 to require formal transfer from one party to another, it would seem that if a subsequent holder were also an original party to the transaction, he could not qualify as a holder in due course. Furthermore, § 57 grants a holder in due course immunity from defenses "available to prior parties among themselves." With reference to the consumer paper cases, one could argue from these three sections that a financier who was present or constructively present at the original sales transaction, and who represented the same interests as the seller, must be treated as the same legal entity as the seller in all litigation arising out of that transaction. Thus the financier would be unable to become a holder in due course of a note arising out of such a sales transaction because there could be no effective transfer under these sections.

Secondly, one can argue that point under the UCC. Here section 3-305(2) makes it clear that a subsequent holder is not free from consumer defenses if the consumer notemaker is a party with whom he has already dealt: ". . . a holder in due course takes the instrument free from . . . all defenses of any party to the instrument with whom the holder has not dealt" (Emphasis added)

In addition to the holder in due course sections of the codes, consumer-minded courts have drawn from the law of agency and the theory of joint venture. See Note, *Consumer Financing, Negotiable Instruments, and the Uniform Commercial Code: A Solution to the Judicial Dilemma*, 55 CORNELL L. REV. 611, 617 n. 44 (1970). According to the law of agency, holder in due course status is withheld from a financier when the seller is his agent. See, e.g., *Calvert Credit Corp. v. Williams*, 244 A.2d 494 (D.C. Ct. App. 1968); *Associate Discount Corp. v. Goetzinger*, 62 N.W.2d 191 (Iowa 1954); *International Finance Corp. v. Rieger*, 272 Minn. 192, 137 N.W.2d 172 (1965); The theory of joint venture is merely a variation of the law of agency. See, e.g., *Buffalo Indus. Bank v. DeMarzio*, 162 Misc. 742, 296 N.Y.S. 783 (Buffalo City Ct. 1937), *rev'd on other grounds*, 6 N.Y.S.2d 568 (1937). One obstacle immediately presents itself to counsel pursuing the "unity of person theory" on the strength of UCC § 3-315 (2). If he attempts to include indirect as well as direct dealings in the meaning of "dealt" as it is used in that section, he may well run into conflict with UCC § 3-304(2) which provides that a payee may be a holder in due course. For a discussion of this problem, see Note, *The Concept of Holder in Due Course in Article 3 of the Uniform Commercial Code*, 68 COLUM. L. REV. 1573, 1575-77 (1968). See also Baird, *Let the "Seller" Beware—Another Approach to the Referral Sales Scheme*, 22 U. MIAMI L. REV. 861 (1968). For a discussion of the unity of person theory, see Note, *Financing Consumer Goods under the Uniform Commercial Code: Installment Buyers and Defaulting Sellers*, 37 U. CHI. L. REV. 513, 527 (1970) (theory referred to here as the "Party to the transaction rule").

39. 256 A.2d 739 (Del. 1969).

contracts and financing documents to be used; and (4) that each of the seller's transactions was approved in advance by the financier. The trial court found for the plaintiff and defendant appealed.⁴⁰

In reversing the court below, the Delaware Supreme Court seemed to be relying on two distinct arguments. The first will be recognized as the expanded objective test: "The more the holder knows about the underlying transaction which is the source of the paper . . . the less he fits the role of good faith purchaser for value."⁴¹ The second sets down the legal unity of person theory: ". . . in our opinion Bancredit was so involved in the transaction that it may not be treated as a subsequent purchaser for value. . . . Bancredit was more nearly an original party to the transaction than a subsequent purchaser of the paper."⁴²

Although the court stated that its holding is based upon the evidence showing how "closely involved [the finance company was] in the original sales transaction",⁴³ this is not all that the evidence shows. Rather, that numbered 1 & 2 above shows how closely related seller and financier were prior to the original sales transaction. That labelled 3 & 4 could properly be described as showing how closely involved financier was at the original sales agreement. Thus, the *Jones* case contains all four elements. In addition, it illustrates why "close-connectedness" has eluded precise definition. Like all other courts invoking the doctrine, the *Jones* court fails to state which evidence it relies upon in support of which theory. Evidence is cited, theories are invoked, and the reader is left to match them up.

Other courts have used close-connectedness to signify yet other arrangements of evidence and theory. In each, however, the evidence is either that of a close seller-financier relationship prior to the sales transaction, or that of such a relationship at the sales transaction, or both. And the legal theory invoked is either the expanded objective test, or the legal unity of person theory, or both. The following describes the six possible combinations.

The first type, in which all four elements are present, has been discussed above, the *Jones* case being a typical example. A second group of cases use only the first type of evidence, that seller and financier enjoyed a close business relationship prior to the sales transaction under

40. *Id*

41. *Id* at 742.

42. *Id* at 743.

43. *Id* at 739.

litigation, to infer bad faith under the expanded objective test.⁴⁴ In *Rein v. Merriell*,⁴⁵ an example of this technique, financier and seller were classmates at law school, shared office space at one time, often did business together and were close personal friends. There was evidence that financier knew how desperately the seller needed money. The court concludes: "We are of the opinion that the facts and circumstances were sufficient to put the plaintiff [financier] on inquiry."⁴⁶

The third grouping employs evidence which shows the financier's active participation at the original sales transaction to derive an expanded objective test conclusion.⁴⁷ *Swanson v. Fuline* illustrates this argument: ". . . in order to show a lack of 'good faith' on the part of an endorsee, there must be facts showing actual and direct participation by the endorsee in the original transaction between the maker and the original payee of the note"⁴⁸

A fourth group of cases uses evidence of close relationship at the sales transaction to support a legal unity of person theory.⁴⁹ In *Swanson v. Commercial Acceptance Corp.*,⁵⁰ this argument is made: the evidence

44. See, e.g., *Imperial Gypsum & Oil Corp. v. Chaplin*, 4 Cal. App. 2d 700, 40 P.2d 596 (1970); *Bethea v. Investors Loan Corp.*, 197 A.2d 448 (D.C. Mun. Ct. App. 1964); *Financial Credit Corp. v. Williams*, 246 Md. 575, 229 A.2d 712 (1967); *Davis v. Commercial Credit Corp.*, 870 Ohio App. 311, 94 N.E.2d 710 (1950); *Taylor v. Brookline Savings & Trust Co.*, 405 S.W.2d 590 (Tenn. App. 1964); cf. *Kennard v. Reliance, Inc.*, 264 A.2d 832 (Md. 1970) (a UCC case which may present this argument when it returns from a remand for factual determination).

45. 150 So. 2d 73 (La. 1963).

46. The court further states:

It is well settled that express notice of any defect or infirmity in a negotiable note is not indispensable to destroy the good faith of a holder but it will be sufficient if the circumstances are of such a character as necessarily to put a holder on inquiry, and he is bound by what his inquiries would have revealed.

Id. at 75.

47. See, e.g., *Swanson v. Fuline*, 248 F. Supp. 364 (D. Ore. 1965). Here the court rejects the plaintiff notemaker's case based on an argument similar to that in *Rein v. Merriell*, *supra* note 46. At the same time it sets down in dictum:

I am satisfied that in order to show a lack of "good faith" on the part of an endorsee, there must be facts showing actual and direct participation by the endorsee in the original transaction between the maker and the original payee of the note, as distinguished from an endorsee's mere furnishing of forms of notes and mortgages

248 F. Supp. at 371. See also *Beatty v. Franklin Investment Co.*, 319 F.2d 712 (D.C. Cir. 1963).

48. 248 F. Supp. at 371.

49. See, e.g., *United States v. Klatt*, 135 F. Supp. 648 (S.D. Cal. 1955) (this case is decided under FHA regulations, but it gives passing approval to the argument in point); *Commercial Credit Corp. v. Orange County Machine Works*, 34 Cal. 2d 766, 214 P.2d 819 (1950) (A Warning: In this case the notemaker is not a consumer, but a business. However, this makes the decision against the finance company more compelling); *Associates Discount Corp., v. Goetzinger*, 62 N.W.2d 191 (Iowa 1954); *Buffalo Indus. Bank v. DeMarzio*, 162 Misc. 742, 296 N.Y.S. 783 (Buffalo City Ct.), *rev'd on other grounds*, 6 N.Y.S.2d 568 (Sup. Ct. 1937).

50. 381 F.2d 296 (9th Cir. 1967).

showed that the seller “. . . tendered the credit application [of the consumer] and accompanying papers to Commercial [the financier] . . . together with information as to the sales price, down payment, finance charges, and proposed monthly payments. Commercial approved the application”⁵¹ The Court of Appeals for the Ninth Circuit affirmed the district court’s ruling for the consumer notemaker, because the financier “was a moving party in [the] sales transaction itself and thus in substance an original party to [the] note which [the] sale produced”⁵²

A fifth group uses both types of evidence, but only the expanded objective test.⁵³ In *Taylor v. Atlas Security Co.*,⁵⁴ one of the first close-connectedness cases, seller and financier were related by blood. Furthermore, financier bought all of seller’s commercial paper, and had done so for years.⁵⁵ As for evidence of a close relationship at the sales transaction, financier furnished blank forms to seller which contained a printed endorsement-over clause in the financier’s name on their face.⁵⁶ After carefully acknowledging the judicially popular subjective test as the only proper standard, the court indulges in semantical contortions to reach the objective test: “. . . such actual knowledge may be inferred from the facts and circumstances surrounding the purchase of the note by the holder”⁵⁷

The sixth and last close-connectedness group uses evidence of the active participation of financier at the original sales transaction in support of both legal theories.⁵⁸ *Mutual Finance v. Martin*⁵⁹ is illustrative. In *Mutual Finance* evidence disclosed that financier furnished printed forms to the seller designating itself as the specific assignee. On the basis of this, the court concluded (quoting *Commercial Credit v. Childs*): “Rather than being a purchaser of the instrument after its execution it was to all intents and purposes a party to the agreement and instrument from the beginning.”⁶⁰ With this, a

51. *Id.* at 298.

52. *Id.* at 296.

53. *See, e.g.*, *Westfield Investment v. Fellers*, 181 A.2d 809 (N.J. Super. 1962); *Whitfield v. Carolina Housing & Mortgage Corp.* 243 N.C. 658, 92 S.E.2d 78 (1956); *contra*, *Ford Motor Credit Co. v. Williams*, 225 So. 2d 717 (La. 1969).

54. 213 Mo. App. 282, 249 S.W.2d 746 (1923).

55. *Id.* at 285, 249 S.W.2d at 748.

56. *Id.* at 287, 249 S.W.2d at 749.

57. *Id.*

58. *See, e.g.*, *Commercial Credit Co. v. Childs*, 199 Ark. 1073, 137 S.W.2d 260 (1940); *Calvert Credit Corp. v. Williams*, 244 A.2d 494 (D.C. Ct. App. 1968); *International Finance v. Rieger*, 272 Minn. 192, 137 N.W.2d 172 (1965).

59. 63 So. 2d 649 (Fla. 1953).

60. *Id.* at 653.

restatement of the legal unity of person theory, is joined the following (also quoting *Childs*): “. . . [the financier] cannot be heard to say that it, in good faith, was an innocent purchaser of the instrument for value before maturity.”⁶¹ Since the evidence presented would not support a conclusion of actual knowledge of financier regarding the seller’s dubious practices, the court must be referring to constructive knowledge, the essence of the objective test. This conclusion is borne out by citation to *Taylor v. Atlas Security Co.*⁶² later in the opinion.

In order to obtain a complete understanding of the six close-connectedness variations the following factors require consideration: First, evidence showing a close seller-financier relationship prior to the sales transaction under litigation would not logically support the application of the legal unity of person theory unless that evidence showed family ties between personnel of seller and financier, or unless seller and financier were wholly-owned subsidiaries of the same parent company, or were in fact parent and subsidiary.⁶³ Such an argument has, however, apparently never been successfully made. In a case involving a seller who was a major stockholder of financier and used financier’s office facilities to transact some of his business, the court nevertheless rejected defendant notemaker’s claim that the seller was the financier’s agent.⁶⁴

Secondly, one should also be aware that the majority of cases involving finance companies as holders in due course of consumer paper reject the objective test whenever it is argued.⁶⁵ These courts dwell on the

61. *Id.*

62. *Id.*

63. See Note, *Financing Consumer Goods under the Uniform Commercial Code: Installment Buyers and Defaulting Sellers*, 37 U. CHI. L. REV. 513, 528 (1970). This note must be read with the fact in mind that it does not distinguish between the two types of close-connectedness evidence. Furthermore, it comes dangerously near inaccuracy in describing *Jones v. Approved Bancredit*, 256 A.2d 739 (Del. 1969). As illustrated above (see note 39 *supra* and accompanying text), the *Jones* case is composed of all four component parts, two types of evidence and two legal theories, of the close-connectedness doctrine. The Chicago note, however, uses it as an example of the unity of person theory (or in its words, “The party to the transaction rule”). According to the author of that note: “The application of this rule does not require an analysis of either the good faith of the taker or whether there was notice of any defects.” One must question this conclusion in light of an often-quoted sentence in their model case, “. . . the more the holder knows about the underlying transaction which is the source of the paper . . . the less he fits the role of good faith purchaser for value . . .” *Id.* at 742.

64. *Holt v. Queen City Loan & Investment, Inc.*, 377 S.W.2d 393 (Mo. 1964).

65. See leading case of *Implement Credit Corp. v. Elsinger*, 268 Wis. 143 66 N.W.2d 657 (1954) and cases cited therein. See also *Kaplan v. First Trust & Savings Bank of Riverdale*, 48 Ill. App. 2d 373, 199 N.E.2d 243 (1964); *Rice v. Barrington*, 75 N.J.L. 806, 70 A. 169 (1908); cf. *Cook v. Southern Credit Corp.*, 448 S.W. 2d 634 (Ark. 1970); *Factors and Note Buyers, Inc. v. Green Lane, Inc.*, 102 N.J. Super. 43, 245 A.2d 223 (1968) (latter two cases are UCC cases).

popular misconception that the objective test is inconsistent with the UCC and the NIL.⁶⁶ In addition, there is a large body of case law rejecting both the objective test and the use of evidence of a close seller-financer relationship prior to the sales transaction under litigation.⁶⁷ In contrast, several courts, some of them very recently, still argue a pure objective test.⁶⁸ These differ from the above cited cases in that they make no mention of any close seller-financer relationship, and none can be implied.

C. *The Unconscionability Doctrine*

The Close-Connectedness arguments, begun under the NIL and carried over to the UCC, are the most successful means, but no longer the only means, of protecting the consumer-notemaker. Operating under the UCC, courts have added another approach — unconscionability — exemplified by the case of *Unico v. Owen*.⁶⁹ In *Unico*, the consumer bought a stereo set agreeing by a sales contract to a thirty-six month installment term payment plan. In addition to the stereo, the terms provided for periodic delivery of record albums to the consumer. A promissory note for payment was signed. The sales contract provided that the accompanying note be a negotiable instrument separate and apart from the contract even though at the time of transfer it might be attached thereto. On the note was a printed indorsement over to the financer. The consumer, Owen, signed both note and contract. Some weeks later, the seller became insolvent and defaulted on his obligation to deliver records. The consumer withheld payments and the financer, having taken possession of the note, brought action against the consumer for collection. At trial, evidence was presented relating to the close business arrangement between the financer and the seller, the constructive presence of the financer at the original sales transaction, and to show that the financer must have known of the seller's weak financial position. *Held*: The financer was not a holder in due course and thus was not immune to the consumer's personal defenses.⁷⁰

Although the evidence would have supported the same verdict under

66. See, e.g., *Baraban v. Manatee National Bank of Bradenton*, 212 So. 2d 341 (Fla. App. 1968); *Nichols v. Yandre*, 151 Fla. 87, 9 So. 2d 157 (1938).

67. See, e.g., *Norman v. World Wide Distribs.*, 195 A.2d 115 (Pa. 1963).

68. *First Nat'l Bank v. Christian Foundation Life Ins. Co.*, 242 Ark. 177, 420 S.W.2d 912 (1967); *Greenburg v. Morris*, 436 S.W.2d 734 (Mo. App. 1968); *Citizens Bridge v. Guerra*, 258 S.W.2d 64 (Tex. 1953).

69. 50 N.J. 101, 232 A.2d 405 (1967).

70 *Id.*

several of the Close-Connectedness variations, the court paid only lip service to them. The thrust of its reasoning turns on another theory, namely, that the entire transaction was void under the Unconscionability Clause of the UCC.⁷¹ The court began by asserting that the contract which accompanied the note was unconscionable.⁷² This is orthodox procedure under the UCC.⁷³ Next, the judge declared that the note and contract should be read as one document. This too has solid precedent.⁷⁴ But then the judge embarks upon pure innovation: Since the note and the contract are to be read as one, then, like the contract, the note is void as unconscionable.⁷⁵

This approach to the problem of protecting the consumer-notemaker may well be an effective alternative to the Close-Connectedness arguments. Indeed, if one accepts the court's conclusion that the contract is unconscionable and that the note and contract may be treated as one, it logically follows that the note too is subject to revision by the

71. UCC § 2-302(1) reads as follows:

If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

The defendant's note was executed before New Jersey adopted the UCC, thus it fell under the NIL. Nevertheless, Judge Francis makes it very clear that the case is being decided so as to accord with the UCC.

72. The court reaches its conclusion through the following reasoning:

In consumer goods transactions there is almost always a substantial differential in bargaining power between the seller and his financier, on the one side, and the householder on the other. That difference exists because generally there is a substantial inequality of economic resources between them.

50 N.J. at 110, 232 A.2d at 410.

73. The unconscionability clause is invoked in the following leading cases: *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965); *Henningson v. Bloomfield Motors, Inc.*, 32 N.J. 358, 161 A.2d 69 (1960). See also *Leff, Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485 (1967); *Baird, Let the "Seller" Beware—Another Approach to the Referral Sales Scheme*, 22 U. MIAMI L. REV. 861, 868 (1968); 49 NEB. L. REV. 808 (1970).

74. The Court cites four leading cases which lay a solid foundation for this procedure. They are: *Commercial Credit Corp. v. Orange County Machine Works*, 34 Cal.2d 766, 214 P.2d 819 (1950); *Mutual Finance Co. v. Martin*, 63 So. 2d 649 (Fla. 1953); *International Finance Corp. v. Rieger*, 272 Minn. 192, 137 N.W.2d 172 (1965); *Local Acceptance v. Kinkade*, 361 S.W.2d 830 (Mo. 1962). For additional cases treating a note and concurrently executed contract as one document see *First & Lumberman's National Bank of Chippewa Falls v. Buckholz*, 220 Minn. 97, 18 N.W.2d 771 (1945); *Federal Credit Bureau v. Zelkor Dining Car Corp.*, 238 App. Div. 379, 264 N.Y.S. 723 (1933). Generally, these cases refuse to limit the assignment of a sales contract to an assignment of rights accruing to the seller therein only. Rather, they treat the assignment as a transfer of seller's rights and responsibilities as well, thus defeating the intention of both seller and financier that the contract only serve as a security device on the notemaker's credit.

75. "We hold that [the note and contract] are so opposed to [public policy] as to require condemnation." 50 N.J. at 125, 232 A.2d at 418.

court. The approach requires an unprecedented interpretation of the language of the UCC, there being no express provision allowing the judge to rescind unconscionable negotiable instruments. Some believe the Code simply cannot be stretched that far:

Nevertheless, the failure of the *Unico* court to make a subjective inquiry [into the question of the holder's good faith] may be justified if the Code permits courts to adopt a different approach in a context characterized by a lack of arms length bargaining and by inequality of bargaining power between the parties to a transaction. The Code does not grant this power in the negotiable instruments context.⁷⁶

This conclusion, however, is unimaginative, if not inaccurate. UCC § 1-203 states: "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." What is unconscionability if not the absence of one person's good faith in dealing with another? To further illustrate that the Code's unconscionability clause is applicable to negotiate instruments as well as simple contracts, § 1-208 states (applicable to all contracts and obligations):⁷⁷

A term providing that one party or his successor in interest may accelerate payment or performance or require collateral . . . shall be construed to mean that he shall have the power to do so only if he in good faith believes that the prospect of payment or performance is impaired

Whether or not the Unconscionability Doctrine will become popular with the courts remains to be seen. At any rate, it is doubtful that judges will feel any more constrained by the letter of the Code than they did in applying the Close-Connectedness Doctrine to first the NIL, then the UCC.

III. LEGISLATIVE ATTACKS

Although the first significant retail installment sales legislation was passed in 1935,⁷⁸ most states did not offer the consumer any significant legislative protection until after 1950.⁷⁹ The development of these early codes was piecemeal. As needs were recognized, *ad hoc* measures were enacted, each law with a specific and limited purpose, and each unrelated

⁷⁶ 54 VA. L. REV. 279, 287 (1968).

⁷⁷ See also 49 NEB. L. REV. 808, 821-22 (1970); 114 U. PA. L. REV. 395 (1966).

⁷⁸ Indiana, 1935. By 1950, 9 other states had enacted consumer credit legislation: Calif., 1945; Conn., 1947; Hawaii, 1941; Md., 1941; Mass., 1939; N.J., 1948; Pa., 1947; Ohio, 1949; Wis., 1938. See CURRAN 2 n. 7.

⁷⁹ *Id.* 2.

to the other.⁸⁰ The result of this unplanned and undirected growth was ambiguity, contradiction between the separate provisions of a single code and, most significantly, a proliferation of legal loopholes through which a clever supplier of consumer credit could escape.⁸¹

Today, laws regulating consumer credit arrangements are pending or have been enacted in every state.⁸² The ultimate ends of these enactments are similar:

Any statute specialized to consumer credit regulates one or more of the four following aspects: (1) the access of creditors to the market; (2) the information the creditor must give to the consumer; (3) the terms and conditions of the consumer-credit arrangement; and (4) the remedies of consumer and creditor when either has not satisfactorily performed his obligations under the consumer-credit arrangement.⁸³

However, the means adopted vary considerably.

Generally, the contract must be labelled with a descriptive title, such as 'Installment Sales Contract'. In addition, in a number of states, a series of notices to the purchaser, informing him of rights he may possess and obligations he has incurred under the contract, are required. Such notices tell the purchaser that he is not to sign the contract until he has read it or if it has any blank spaces [or] that he has a right to pay the contract in full in advance. . . . Most acts require that the parties to the contract be clearly identified by name and address and that the goods or services covered by the contract be described The seller is generally required to itemize the cost for the buyer . . . [denote] the date due . . . [provide] a copy of the contract . . . [to the buyer].⁸⁴

Many of these acts are unclear, lacking in uniformity, and verbose.⁸⁵ Although procedural safeguards in these statutes protect the consumer against some of the more flagrant abuses to which he was once vulnerable, only a few states have come forth with much substantive protection.

The adoption by every state except Louisiana of the Uniform

80. Various pieces of legislation were initially restricted in their application to particular institutions (e.g., industrial loans laws) to specific arrangements offered by particular institutions (e.g., installment loans to banks), or the characteristics (e.g., of the customer serviced (e.g., small loan laws). *Id.* 3.

81. Curran, *Legislative Controls as a Response to Consumer-Credit Problems*, 4 B.C. IND. & COM. L. REV. 409, 409-10, 416-17 (1967).

82. *Id.* at 418; CURRAN 140-43, 254-555.

83. Curran, *Legislative Controls as a Response to Consumer-Credit Problems*, 8 B.C. IND. & COM. L. REV. 409, 420 (1967).

84. See CURRAN 95-98.

85. Curran, *Legislative Controls as a Response to Consumer Credit Problems*, 8 B.C. IND. & COM. L. REV. 409 (1967). For example, see N.Y. PERS. PROP. LAW § 403 (1962).

Commercial Code has not resulted in greater consumer protection.⁸⁶ When combined, the Code and the procedural safeguards described above all but eliminate the many inequitable devices used by a slick retail seller to take undue advantage of an unwitting consumer.⁸⁷ However, only a few state legislatures have extended this protection to withstand the claims and immunities which may accrue to the seller's transferee.⁸⁸ In most states, courts have only the UCC from which to determine if the transferee is a holder in due course. Under the guise of preserving free negotiability, the 1962 Code seems to require proof of a subsequent holder's *actual knowledge* of a note's defect before denying him holder in due course status.⁸⁹ This requirement, which most courts believe to call for the subjective test,⁹⁰ makes it virtually impossible when so interpreted to find for the consumer in the typical fact pattern. The problem becomes crucial when courts of a given jurisdiction do not subscribe to close-connectedness reasoning. Even when they do, the necessary evidence of close connection between seller and finance company may be lacking. Some states have enacted statutory devices to remedy this problem but only a few go beyond the often ineffective procedural schema characteristic of the other states.⁹¹ Two of these afford the consumer almost complete protection.⁹²

Regrettably, the greater number of state retail installment sales acts

86. Skilton & Helstad, *Protection of the Installment Buyer of Goods under the Uniform Commercial Code*, 65 MICH. L. REV. 1465, 1484 (1967).

87. See, e.g., UCC § 2-302 quoted note 9 *supra*. See also 49 NEB. L. REV. 808, 823 (1970).

88. Skilton & Helstad, *Protection of the Installment Buyer of Goods under the Uniform Commercial Code*, 65 MICH. L. REV. 1465, 1484 (1967).

89. See notes 21 & 23 *supra*. Professor Littlefield calls this requirement a "myth." Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 SO. CAL. L. REV. 48, 59 n. 48 (1966). But myth or not, most courts interpret the present UCC section on good faith to call for a subjective test. *Id.* Most scholars agree. See Professor Sutherland's letter and memorandum in 1 N.Y. LAW REVISION COMMISSION REPORT 240-245 (1954).

90. *Id.* See also 1965 RECOMMENDATIONS OF THE EDITORIAL BOARD 103. This purports to explain why the UCC Drafters removed the phrase "reasonable commercial standards" from the 1958 Code:

. . . removal of the offending language was intended to make clear that the doctrine of an objective standard of good faith, exemplified by the case of *Gill v. Cubitt* . . . is not intended to be incorporated in Article 3. . . .

Id.

91. See, e.g., Alaska Laws of 1970, Sen. Bill no. 352, approved June 27, 1970 repealing §§ 45.50.470-45.50.510; CAL. CIV. CODE § 1803.2 (Unruh Act); DEL. CODE ANN. tit. 6, § 4342 (1960); MD. CODE ANN. art. 83, §§ 147-150 (1957); MASS. ANN. LAWS ch. 255, § 122 (1968); N.Y. PERS. PROP. LAW § 403 (McKinney 1962); OKLA. STAT. ANN. tit. 14a, §§ 1-101, 9-103 (Supp. 1969); ORE. REV. STAT. § 83.650 (1959); PA. STAT. ANN. tit. 69, § 615 (1965), VT. STAT. ANN. § 2455 (amended 1969).

92. Alaska Laws of 1970, Senate Bill No. 352, approved June 27, 1970 repealing §§ 45.50.470-45.50.510; VT. STAT. ANN. § 2455 (amended 1969).

have provisions like the following: Sellers are allowed to transfer consumer paper. As for holders, so long as they meet UCC requirements, they may become holders in due course. Moreover, under these types of consumer codes, the seller is not required to transfer along with the note the concurrently executed sales contract, permitting the subsequent holder to escape any "notice" which the contract might have provided.⁹³

The states which have come forward with more comprehensive laws prohibiting sharp practices of consumer credit houses effectuate their purposes in different ways.⁹⁴ One is to prohibit a seller from transferring a consumer note unless it is duly marked "consumer note", or has similar words indicating on its face its consumer origin.⁹⁵ Subsequent holders of such notes are then not immune to the consumer's personal defenses. Such statutes usually make it quite clear that "notes otherwise negotiable which are not marked as required remain negotiable"⁹⁶ so that a holder who would otherwise qualify for holder in due course status takes free of any defenses of the buyer. Maryland's statute, however, is void of any such clarification, thus, leaving it to the courts to decide how to treat the subsequent holder of an illegally transferred note.⁹⁷ The most

93. See, e.g., MO. REV. STAT. ANN. § 408.260 (Vernon 1965). The relevant sections of this law are as follows: "1. . . . In addition to such retail time contract, the seller may require the buyer to execute and deliver a negotiable promissory note to evidence the obligation created by the retail time contract and the seller may require security for the payment of such obligations. . . . 2. . . . The contract shall contain the following notice . . . (1) Do not sign this contract before you read it or if it contains any blank spaces." The statute contains several other similar procedural guarantees.

94. All statutory devices hereinafter discussed clearly distinguish between consumer transactions, and transactions between merchants or businessmen, the latter being excluded from regulation therein.

95. See, e.g., MASS. ANN. LAWS ch. 255, § 122 (1968); MD. ANN. CODE art. 83, § 147 (1957) which states:

. . . [consumer] note[s] shall refer to the installment agreement out of which [they] arise and in the hands of any subsequent holder, such note shall be subject to all defenses which the buyer might have asserted against the seller.

96. 75 HARV. L. REV. 437, 438 (1961).

97. This is the situation in Maryland, where the State Supreme Court recently remanded for further factual determination *Kennard v. Reliance, Inc.*, 264 A.2d 832 (1970). In this case the consumer bought a retail item from a seller who took a note on the unpaid balance of the purchase price. The seller then transferred the note, in violation of § 147 (see note 95 *supra*) to a finance company which was innocent of knowledge of the note's consumer origin. Seller then failed to perform his obligation, buyer withheld payment, and the finance company sued on the note. One of the issues on appeal was whether this section of the Maryland Code places the burden of ascertaining, in advance of purchase, the origin of the note. If the case is again appealed, the Maryland Court might be confronted with the task of filling in the gaps of § 147 left by the legislature:

A third basis for preserving the Kennard defenses would be if, notwithstanding the enactment of the UCC, § 147 of the Retail Installment Sales Act were held applicable to a

significant drawback of these statutes is that they regulate only the seller's conduct. That is, in a situation similar to the one described in the introduction to this note, if a seller knowingly transfers an unmarked consumer note, representing it to a good faith purchaser as paper arising out of a transaction between merchants, legal sanctions could be imposed only against the seller. No relief, except possibly indemnification, would be available to the consumer as against the subsequent holder's right of payment on the note. Even this fails when the nonperforming seller has quietly and quickly left town.

Other statutory attempts to protect the consumer derive from the recently promulgated Uniform Consumer Credit Code § 2.403 (UCCC).⁹⁸ In effect, these statutes prohibit the taking of a negotiable instrument other than a check as "evidence of the obligation of the buyer or lessee".⁹⁹ These are limited, like the statutes described above, in that they punish only the seller who transfers a note of the proscribed type. As long as a subsequent holder meets standard requirements of good faith, he may enforce the obligations promised in the note free of the consumer's personal defenses, and the court is again confronted with a controversy involving two innocent parties, the guilty party being in absence. Most courts, as previously pointed out, prefer the assignee over

note given in connection with an installment sales agreement when the note, as here, fails to make reference to that agreement and the note is held by one without knowledge of that agreement. We leave that question open at this time.

Id. at 837.

98. UNIFORM CONSUMER CREDIT CODE § 2-403:

In a consumer credit sale or consumer lease, other than a sale or lease primarily for an agricultural purpose, the seller or lessor may not take a negotiable instrument other than a check as evidence of the obligation of the buyer or lessee. A holder is not in good faith if he takes a negotiable instrument with notice that it is issued in violation of this section. A holder in due course is not subject to the liabilities set forth in the provisions on the effect of violations of the rights of parties (§ 5.202) and the provisions on civil actions by administrators (§ 6.113).

Official Comment: Professional financiers buying consumer paper will normally not qualify as holders in due course with respect to instruments taken by dealers in violation of this section and negotiated to them. However, it is possible that in rare cases second or third takers may not know of an instrument's consumer origin. In this unusual situation, the policy favoring negotiability is upheld in order not to cast a cloud over negotiable instruments generally.

99. States explicitly adopting the UCCC are Oklahoma, OKLA. STAT. ANN. tit. 14a, §§ 1-101, 9-103 and Utah, UTAH CODE ANN. 70B-2-403 (Supp. 1969). For an analysis of the extent to which the UCCC overrules prior Utah consumer law see Note, *The UCCC in Utah*, 76 UTAH L. REV. 91 (1970) See also PA. STAT. ANN. tit. 69 § 615 (1965) (applies only to motor vehicles) which is similar to the UCCC language and effect. For a discussion of the problem of consumer financing in the area of automobile sales, see Murphey, *Cars, Creditors, and the Code: The Diverse Interpretations of Section 9-310*, 1970 WASH. U.L.Q. 135.

the obligor. That is to say, they are more willing to slight the interests of an individual wronged by the system, than slight the system itself, the latter being dependent upon maintenance of free flow of commercial paper and the stimulation of investment.¹⁰⁰ Recent opposition to this policy was expressed at the 1967 UCCC Drafting Conference. One can ascertain the intense debate and difference of opinion from a reading of UCCC Working Draft No.6.¹⁰¹ Although those in favor of imposing sanctions on the subsequent holder of illegally transferred paper—regardless of questions of his good faith—were able to wrest some concessions out of their opponents,¹⁰² their successes are not reflected in the state legislatures. States which have adopted the UCCC have codified the majority position and, in so doing, have come no further towards consumer protection than states following the patterns discussed above.¹⁰³

A third type of statute prohibits the separation of a promissory note from the sales contract out of which it arises.¹⁰⁴ The effectiveness of such

100. Jordan & Warren, *The Uniform Consumer Credit Code*, 68 COLUM. L. REV. 387, 436 (1968).

101. Uniform Consumer Credit Code, Working Draft No. 6, National Conference of Commissioners on Uniform State Laws, August, 1967 (Annual Meeting). With reference to the holder in due course of consumer paper problem, this draft made the following concession to the minority opinion expressed at this drafting conference. Two alternative provisions were drafted for § 2.404 (Alternative A):

(1) With respect to a consumer credit sale or lease, other than a sale or lease primarily for an agricultural purpose, an agreement by the buyer or lessee not to assert against a transferee not related to the seller or lessor who acquires the buyer's or lessee's contract on good faith and for value, who gives the buyer or lessee's contract on good faith and for value, who gives the buyer or lessee notice of the transfer as provided in this section and who, within 6 months after the making of the notice of transfer receives no written notice of the facts giving rise to the buyer's or lessee's claim or defense

(Alternative B):

(1) With respect to a consumer credit sale or consumer lease, other than a sale or lease primarily for an agricultural purpose, a transferee of the rights of the seller or lessor is subject to all claims and defenses of the buyer or lessee against the seller or lessor arising out of the sale or lease notwithstanding an agreement to the contrary, but the transferee's liability under this section may not exceed the amount owing to the transferee at the time the claim or defense is asserted

It seems that the latter alternative would place the burden of inquiry on the potential taker to investigate as to a note's origin before purchase, with the penalties of failure to investigate being vulnerability to any consumer claims and defenses which the consumer might have against the seller. By contrast, Alternative A would still permit an innocent purchaser to obtain holder in due course status.

102. *Id.* Alternative B.

103. *Contra*, Curran & Fand, *An Analysis of the Uniform Consumer Credit Code* 49 NEB. L. REV. 727, 741, 743 (1970).

104. *See, e.g.*, CAL. CIVIL CODE § 1803.2 (Unruh Act); N.Y. PERS. PROP. LAW § 403

measures is a function of the extent to which the law further burdens a subsequent holder who has seen the attendant sales contract with the "Notice" required in UCC § 3-304. Strictly speaking, the Code does not divest one of the protected status on an instrument which "states its consideration, whether performed or promised, or the transaction which gave rise to the instrument. . . ." ¹⁰⁵ One state has surmounted this obstacle by enacting a comprehensive modification of traditional negotiable instruments law as applied to the consumer. ¹⁰⁶

Besides containing a provision of the above type, New York's retail consumer laws are riddled with another flaw. In certain transactions giving rise to a consumer credit obligation, the statutory ban on separate negotiation of promissory notes of consumer origin is lifted. ¹⁰⁷

(McKinney 1965); ORE. REV. STAT. § 83.650 (1959); 3 DEL. CODE ANN. tit. 6 § 4342. The Delaware Statute reads:

No retail installment account shall require or entail the execution of any note or series of notes by the buyer which, when separately negotiated, will cut off as to third parties, any right of action or defense which the buyer may have against the seller.

105. UCC § 3-105 (1): "A promise or order otherwise unconditional is not made conditional by the fact that the instrument . . . (b) states its consideration, whether performed or promised, or the transaction which gave rise to the instrument or that the promise or order is made or the instrument matures in accordance with or "as per" such transaction"

106 CAL. CIV. CODE § 1803.2: ". . . every retail installment contract shall be contained in a single document which shall contain: (a) Retail Installment Contract . . . (b) a warning not to sign if there are blanks on the document[s] . . . face" Section 1804.2 states: ". . . an assignee of the seller's rights is subject to all claims and defenses of the buyer against the seller arising out of the sale notwithstanding an agreement to the contrary" Assignment, as it is used here, would include negotiable instruments attached to conditional sales contracts. California is the only state to adopt Alternative B of UCCC § 2.404, which is paraphrased in § 1803.2 above. For the text of Alternative B see note 103 *supra*. It will be noted that these statutes (part of the Unruh Act) would only impute holder in due course status to one who has knowledge of a note's consumer origin, whether explicit notice from the face of the conditional sales contract, with which the consumer note must be transferred, or by implicit notice. This latter fact, which amounts to an application of the objective test, is set down in *Morgan v. Reasor Corp.*, ___ Cal. App. 2d ___, 67 Cal. Rptr. 577 (1968). Here the seller illegally separated the note from the conditional sales contract out of which it arose. The maker was a consumer, and the finance company to which the note and contract were separately negotiated purported to be innocent of this knowledge. The court said:

A holder of a note with constructive knowledge of noncompliance with the Unruh Act is barred from recovery of any time price differential or service charge [The financier] knew of facts which would have put a reasonable man on inquiry as to whether the note and contract were originally contained in a single document, a cursory inquiry would have revealed the violation. These factors constitute sufficient "knowledge" under § 1812.7

. . . Effective implementation of the Unruh Act requires that the standards of knowledge not be set so high as to permit the easy avoidance of § 1812.7 We recognize that stringent enforcement of [this section] will tend to compel such a retailer to sell his paper at a greater discount and to charge a proportionally higher price for his goods. In all likelihood, these increases in retail sales will deter customers from dealing with such a dealer.

107 N.Y. PERS. PROP. LAW § 403 (2) (McKinney 1962).

(2) (1962).

Subsequent holders of this paper need only mail the consumer an interrogatory as to whether the seller's obligation has been fully performed. If he receives no reply within 15 days, he becomes a holder in due course. If the consumer replies that the obligation has been discharged, then the holder is thereafter immune to consumer claims if the goods turn out to possess latent defects.¹⁰⁸

The above three types of statutory devices are, at best, halfway measures in terms of overall consumer protection. No statute protects him from the rights of payment accruing to a holder in due course of a note transferred in violation of law by a seller who has escaped the court's jurisdiction through flight. At least three things can be done by the courts to shore up this hole in the law. First, in jurisdictions like Maryland, where the legislature has been silent on the question of what to do with an innocent holder who takes an illegally transferred note, the courts may add the missing provisions, which may soon occur in that jurisdiction.¹⁰⁹ A second device would require both a statute prohibiting the transfer of consumer paper and that the court applying the statute impute bad faith (using UCC criteria) from the close relationship between seller and transferee.¹¹⁰ Close relationship could be any of the type discussed in the close-connectedness section *supra*. The third avenue open to courts operating under such statutes is strict application of the objective test in determining whether a subsequent holder took with

108. Skilton & Helstad, *Protection of the Installment Buyer of Goods Under the Uniform Commercial Code*, 65 MICH. L. REV. 1465, 1484 (1967). This article also presents excellent documentation of these latent-defect problems.

109. See notes 95, 97 *supra* and accompanying text.

110. Another determination which the Maryland Supreme Court has instructed the lower court to make on remand in *Kennard* is whether the plaintiff's holder in due course status was destroyed through bad faith (UCC 3-302). Defendant notemaker had alleged that knowledge of the note's consumer origin could be imputed to plaintiff because of his close business relationship with the seller. Consumer notes, it will be recalled, are non-negotiable in Maryland (See MD. ANN. CODE art. 83 § 147 set out in note 95 *supra*). Specifically the *Kennard* court said:

There is a second basis upon which defenses Mr. and Mrs. Kennard might have against Meadowbrook might be held preserved. Therefore, if the trial judge determines Reliance did not have knowledge of the fact that this was a transaction coming within the purview of the Retail Installment Sales Act, then he will wish to give careful consideration to the intimacy of the contacts between Reliance and Meadowbrook for the purpose of determining whether the Reliance knowledge of the Meadowbrook operation was such as to make Reliance not a holder in due course under the "good faith" provisions of § 3-302 of the UCC. Although he previously determined Reliance to be a holder in due course, he does not appear to have considered whether the relationship between Reliance and Meadowbrook was so close as to make Reliance not a holder in due course.

264 A.2d at 837.

notice or in bad faith. Assume, for example, that the finance company is aware of the exclusively retail nature of seller's business. Surely it could not be said that, after purchasing a note from that dealer, the finance company had no notice of the note's consumer origin. Indeed, under the objective test, proof of such knowledge could be inferred from evidence showing the nature of that seller's business to be a matter of common knowledge among other finance companies of the community. Courts adopting this doctrine could virtually close the door on the legendary feigned ignorance of finance companies. Finance companies are in the business of discounting commercial paper. They are undoubtedly quite aware of the origin of a negotiable instrument simply by bare inspection. One author feels that this is generally the case.¹¹¹ Assume that such ability to recognize a consumer note by bare inspection could be statistically measured. It would seem that defense counsel armed with such evidence would be in a strong position to attack his adversary's good faith before a judge willing to apply the objective test.

IV. TOWARD COMPLETE PROTECTION OF THE CONSUMER

The efficacy of judicial applications of the objective test by way of supplement to the above described statutes is dependant upon two fundamental assumptions: first, that the financier is aware of the retail or commercial nature of the businesses of most sellers in his community;

¹¹¹ King, *The Unprotected Consumer-Maker Under the Uniform Commercial Code*, 65 DICK. L. REV. 207 (1961). Professor King steps abruptly away from traditional negotiable instruments law. He proposes that Art. 3 of the UCC be amended to provide the consumer-notemaker with an unequivocal right to assert against all subsequent holders any defenses or claims he might have had against an original party to the sales agreement. Such subsequent holders would in no case have holder in due course immunity with respect to these claims or defenses regardless of how innocently they came into possession of the notes. This proposal rests on three premises: First, the financier is better able to ascertain the reliability of the payee with whom he deals; second, he is able to tell by the face of the note if it is indeed of consumer origin; third, in a situation where either the financier or the consumer must absorb an economic loss, the financier is usually in a far better position to do so:

The institutional holder is in the business of discounting paper. It has the resources and facilities to ascertain the reliability of those from whom it purchases the paper. It can restrict its purchases to payees or holders who are reliable. Also, in many cases the institution is able to telephone, telegraph or write the maker to inform him where to make his payments after it has purchased the note. Moreover the institution handles a number of transactions and is able to spread its losses, whereas the individual consumer cannot . . . Generally they will be able to tell by the name and manner in which the note is signed, the amount and the name of the payee of the note whether the maker is a consumer and consumer goods are involved. In addition such problems will not arise for the purchaser of a note who is dealing only with reliable companies.

Id. 210, 214.

and, second, that in most cases, a financier can recognize a consumer note by visual inspection. It is no doubt the uncertainty of these assumptions, or perhaps the difficulty of establishing them to a judge's satisfaction, which has impelled two consumer minded legislatures to enact laws forcing subsequent takers of commercial paper to take at their peril.¹¹² The consequence of taking a consumer note, albeit unknowingly, would be vulnerability to defenses the consumer could have raised against the seller, such as failure of consideration.

The enactment of these laws indicates that lawmakers are at last questioning the old balance of equities which has long weighed heavily against consumers. Today, the negotiation of commercial paper is big business, usually involving several middlemen each taking a cut of the proceeds. Evidence shows that consumer paper is rarely sold by a seller to a financier unless the transaction is a bulk transfer of so great a magnitude that the financier, as well as any subsequent holders to whom he might sell the notes, would be at the very least indifferent to his position with respect to the notes' makers.¹¹³ In light of this, one must ask why the law continues to afford the finance industry immunity which it denies to others. The legislatures of Vermont and Alaska have repudiated this policy. Perhaps the sentiments expressed by these lawmakers are a legacy from the past. In 1953, the Florida Supreme Court handed down the landmark decision of *Mutual Finance Co. v. Martin*.¹¹⁴ One passage of that case has been frequently cited as evidence of early judicial concern for the consumer in these situations. However, the decision is also significant because of its clear prescience as to what has been done in Vermont and Alaska, namely shifting the burden of risk of the seller's dishonesty from the consumer to the subsequent holder, regardless of the latter's lack of notice or bad faith. Following is that passage:

It may be that our holding here will require some changes in business methods and will impose a greater burden on the finance companies. We think the buyer—Mr. and Mrs. General Public—should have some protection somewhere along the line. We believe the finance company is better able to bear the risk of the dealer's insolvency than the buyer and in

112. Vermont & Alaska, 9 VT. STAT. ANN. § 2455 (amended 1969): "The holder of a promissory note or other evidence of indebtedness of a consumer delivered in connection with a contract shall take that note, instrument or evidence subject to all defenses of such consumer which would be available to him under this chapter."

113. Jordan & Warren, *The Uniform Consumer Credit Code*, 68 COLUM. L. REV. 387, 436 (1968).

114. *Mutual Finance Co. v. Martin*, 63 So. 2d 649 (Fla. 1953).

a far better position to protect his interests against unscrupulous and insolvent dealers.¹¹⁵

Surely, one of the most effective ways to force a financial institution to be selective in its dealings is to subject it to the possibility of being held to account for a seller's dishonesty. This in turn will have the equally desirable effect of forcing the seller to clean his house as well.

115. *Id.* at 653.