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Consumer Financing Negotiable Instruments and the Uniform Commercial Code a Solution to the Judicial Dilemma

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CONSUMER FINANCING, NEGOTIABLE INSTRUMENTS, AND THE UNIFORM COMMERCIAL CODE: A SOLUTION TO THE JUDICIAL DILEMMA

An unscrupulous seller approaches an unsophisticated[1] buyer and applies high pressure tactics to persuade her to buy a color television, saying that the television will be inexpensive because the company will pay twenty dollars for the name of each purchaser she finds.[2] He further persuades her to sign both an installment contract containing a waiver-of-defense clause and a promissory note attached to the contract. The seller then assigns the contract and negotiates the note to a financial institution[3] with whom he has some continuing relation: the financial institution undoubtedly provides form notes and contracts, may purchase all the seller's consumer paper, and may know the seller's marketing techniques and the quality of his goods. The seller, after the first twenty-dollar payment, fails to pay the consumer for the names of buyers she has provided. The television, of course, is defective.

Deciding to withhold payment, the consumer is sued on the note by the financer, who asserts his protected position as a holder in due course.[4] If the consumer must pay on the note, she may be unable

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1 Judicial recognition of consumer ignorance and naïvete regarding the ramifications of credit purchases recurs in the cases in this area. *See, e.g.*, Taylor v. Atlas Security Co., 213 Mo. App. 282, 249 S.W. 746 (1923); American Plan Corp. v. Woods, 16 Ohio App. 2d 1, 240 N.E.2d 886 (1968); Fidelity Trust Co. v. Gardiner, 191 Pa. Super. 17, 155 A.2d 405 (1959). For a discussion of unequal bargaining power, see Unico v. Owen, 50 N.J. 101, 110-13, 232 A.2d 405, 410-12 (1967); Curran, *Legislative Controls as a Response to Consumer Credit Problems*, 8 B.C. IND. & COM. L. REV. 409, 435-36 (1967). Some cases, however, deny holder-in-due-course protection to financial institutions even when defendant is a business enterprise. *See, e.g.*, Commercial Credit Corp. v. Orange County Mach. Works, 34 Cal. 2d 766, 214 P.2d 819 (1950); International Fin. Corp. v. Rieger, 272 Minn. 192, 137 N.W.2d 172 (1965). It would seem that some of the policies involved (text at notes 14-20 *infra*) apply to commercial transactions, though to a lesser extent. Comment, *Unico v. Owen: Consumer Finance Companies as Holders in Due Course Under the UCC*, 54 U. VA. L. REV. 279, 286 (1968).

2 For cases involving similar schemes, 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). *See generally* Comment, *Translating Sympathy for Deceived Consumers into Effective Programs for Protection*, 114 U. PA L. REV. 395 (1966).

3 In this note "financial institution" and "financer" will be used interchangeably. Both terms include commercial banks and sales finance companies. At the end of October 1969, retail outlets held less than 13% of their own consumer paper. Of the remainder, commercial banks held about 48% and sales finance companies held about 23%. *See* 55 FED. RES. BULL. A54 (Dec. 1969).

4 Failure of consideration and fraud in the inducement are among the defenses the consumer most frequently seeks to assert against the financer. *See* Littlefield, *Good Faith*

to recoup this loss by suing the seller, who may be insolvent or have absconded.[5] The consumer's plight in such situations has resulted in many legislative and judicial modifications of the holder-in-due-course concept in consumer sales financing.

I

Legislative Solutions

A. *State Statutes*

It is often argued that the competing policies involved in the consumer paper problem[6] necessitate a legislative solution,[7] and over one-quarter of the states have statutes on the subject.[8] Some statutes preclude issuance of consumer notes in fields where abuse has been most common, such as automobile sales.[9] Others require the term "consumer note" to be printed on these notes and deny holder-in-due-course protection to possessors of such notes.[10] The Uniform Consumer Credit Code,[11] exhibiting the broadest sweep, both precludes issuance of consumer notes and, in effect, denies financial institutions a protected position.[12]

Purchase of Consumer Paper: The Failure of the Subjective Test, 39 S. Cal. L. Rev. 48, 62-63 (1966). These are personal, rather than real, defenses, and only real defenses are available against a holder in due course. For an enumeration of real defenses, see Uniform Commercial Code §§ 3-305(2)(a)-(e) [hereinafter cited as UCC] (All Uniform Commercial Code citations are to the 1962 Official Draft unless otherwise specified.). Fraud in the inducement must be distinguished from fraud in the factum, a real defense. *See id.* § 3-305(2)(c) & Comment 7.

5 *See, e.g.*, International Fin. Corp. v. Rieger, 272 Minn. 192, 137 N.W.2d 172 (1965); Taylor v. Atlas Security Co., 213 Mo. App. 282, 249 S.W. 746 (1923); Westfield Inv. Co. v. Fellers, 74 N.J. Super. 575, 181 A.2d 809 (L. Div. 1962).

6 *See* text at notes 14-29 *infra*.

7 *See* Swanson v. Commercial Acceptance Corp., 381 F.2d 296, 299 n.6 (9th Cir. 1967); Comment, *Negotiable Instruments: Consumer Versus Financer in Consumer Goods Financing—A Judicial Dilemma*, 52 Marq. L. Rev. 285, 301-02 (1968); Comment, *supra* note 1, at 292-94.

8 *See* Murphy, *Another "Assault Upon the Citadel:" Limiting the Use of Negotiable Notes and Waiver-of-Defense Clauses in Consumer Sales*, 29 Ohio St. L.J. 667, 673-74 & n.22 (1968); notes 9-11 *infra*.

9 Ore. Rev. Stat. § 83.650(1) (1967); Pa. Stat. tit. 69, § 615G (1965). Sellers who violate these provisions are subject to penalties. In Oregon the rights of a holder in due course are not impaired if the seller takes a consumer note in violation of the law. Ore. Rev. Stat. § 83.650(2) (1967). Pennsylvania has no provision on this subject.

10 *E.g.*, Md. Ann. Code art. 83, § 147 (1969); Mass. Ann. Laws ch. 255, § 12C (1968). The latter statute also precludes collection or action on a note obtained in violation of the provision.

11 The Uniform Consumer Credit Code [hereinafter cited as UCCC] was approved by the National Conference of Commissioners on Uniform State Laws on July 30, 1968, and was enacted in Oklahoma (Okla. Stat. tit. 14a, §§ 1-101 to 9-103 (Supp. 1969)) and Utah (Utah Code Ann. §§ 70B-1-101 to -9-103 (1970)).

12 UCCC § 2.403 provides:

In a consumer credit sale . . . the seller . . . may not take a negotiable instru-

B. *Conflicting Policies*

There are several arguments in favor of such sweeping statutes.[13] One of the most popular is the financer's better ability to bear the loss;[14] he can recoup a loss in subsequent transactions whereas the innocent consumer might find himself bankrupt if defrauded in a single transaction.[15] Also, the financer has facilities the consumer lacks to investigate the dealer's reliability.[16] If the financer is involved with the seller in some continuing relationship, he may have power to correct abuses.[17] He can, often does, and should protect himself by arrangements with the seller, such as dealing on a full recourse basis.[18]

Requiring recourse dealing is not, however, the solution to the consumer paper problem. A recourse agreement does not help the financer spread the loss if the seller is insolvent or absconds, a frequent occurrence, and the financer is thus compelled to pursue the buyer.

> ment other than a check as evidence of the obligation of the buyer . . . . A holder is not in good faith if he takes a negotiable instrument with notice that it is issued in violation of this section.

The comment to this section states that professional financers would normally not qualify as holders in due course with respect to negotiable instruments taken in violation of § 2.403 because the section's prohibition would be well known in financial circles.

13 For cases holding for the consumer on the flimsiest facts, to which the policies are equally applicable, see Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940) (financer prepared the form notes and contracts, with a printed assignment to him on the back); Buffalo Indus. Bank v. De Marzio, 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) (financer provided form notes and contracts with its name printed at the top; financer gave credit approval before consummation of the sale). *Contra*, Universal C.I.T. Credit Corp. v. Ingel, 347 Mass. 119, 196 N.E.2d 847 (1964), where the court protected the financer even though he allegedly knew of the seller's bait advertising and of frequent complaints to the Better Business Bureau. In such a case, contrary policies are applicable.

14 *See* NATIONAL CONFERENCE OF COMM'RS ON UNIFORM STATE LAWS, PROCEEDINGS, PUBLIC HEARING ON SECOND TENTATIVE DRAFT OF THE UNIFORM CONSUMER CREDIT CODE 141A (June 16-17, 1967) (written comments received) [hereinafter cited as PROCEEDINGS]. The langnage from Mutual Fin. Co. v. Martin, 63 So. 2d 649, 653 (Fla. 1953), is frequently quoted:

> We think the buyer . . . should have some protection somewhere along the line . . . . [T]he finance company is better able to bear the risk of the dealer's insolvency than the buyer and in a far better position to protect his interests against unscrupulous and insolvent dealers.

15 Comment, *supra* note 2, at 417-18.

16 *Id.* at 417.

17 *See id.*

18 *See id.* By signing a note with recourse, the seller guarantees the financer prompt payment of the obligations contained in the note without requiring any proceeding against the purchaser. A variation is the full repurchase agreement whereby the seller promises to repurchase the goods upon repossession and to pay the unpaid portion of the time balance. Comment, *Consumer Protection—The Role of Cut-Off Devices in Consumer Financing*, 1968 WIS. L. REV. 505, 506-07 & n.14. Some financers have reserve agreements with sellers, whereby the financer sets aside a certain percentage of the finance charges as a reserve to cover liabilities for losses on repossession. *Id.* at 507.

Furthermore, although requiring the financer to extract a recourse agreement has the advantages of preventing lending to marginal sellers and of sending needy buyers to more responsible outlets, it has the grave disadvantage of hindering the development of new businesses[19] that have insufficient assets to enter such agreements.

Another argument supporting strict statutory regulation of the installment sale is that only this will make reality accord with appearances. The buyer thinks he is borrowing from the seller;[20] he is unaware that his note is being transferred and his defenses cut off. Refusing to protect the financer may remedy this situation by encouraging direct lending,[21] but direct lending does not improve the consumer's position: he must still repay the loan if the seller defaults. In addition, since direct lending is subject to usury laws, consumers who are not creditworthy at lower rates of interest will be unable to get loans to buy goods. Conditional sales, on the other hand, are governed by the time-price doctrine,[22] a judge-made exception to the usury laws. Consequently, direct lending will undoubtedly cause sellers to lose sales,[23] and financers, money.

The primary argument against consumer protection statutes is economic. The financer's protected position as a holder in due course encourages him to grant consumer credit; he is willing to take consumer notes because he knows they will be free from defenses.[24] To deprive the financer of his protection or to preclude issuance of consumer paper may restrict the supply of consumer credit, with resulting inability of some individuals to purchase goods and contraction of the economy.[25]

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19 *See* PROCEEDINGS 215-20 (transcript of oral remarks).

20 Jones, *Finance Companies as Holders in Due Course of Consumer Paper*, 1958 WASH. U.L.Q. 177, 183.

21 There is some evidence that this is already occurring. Comment, *supra* note 18, at 524-25 & n.98.

22 Under this doctrine a time-price differential in conditional sales does not come within the usury statutes even though the differential exceeds the lawful rate of interest. Lundstrom v. Radio Corp. of America, 17 Utah 2d 114, 119, 405 P.2d 339, 342 (1965); L. VOLD, HANDBOOK OF THE LAW OF SALES § 62 (2d ed. 1959).

23 C. PHELPS, INSTALMENT SALES FINANCING: ITS SERVICES TO THE DEALER 10 (1953).

24 Indeed, before accepting an assignment of the contract, the financer usually insists on a waiver-of-defense clause as additional protection. On the validity of these clauses, see Unico v. Owen, 50 N.J. 101, 123-26, 232 A.2d 405, 417-18 (1967); UCC § 9-206. *See generally* Murphy, *supra* note 8, at 670-71.

25 *See* Shay, *The Impact of the Uniform Consumer Credit Code Upon the Market for Consumer Installment Credit*, 33 LAW & CONTEMP. PROB. 752, 761-63 (1968). *But cf.* Felix, *Experience with Dealer and Consumer Financing Under the Uniform Commercial Code*, 73 BANKING L.J. 229, 233 (1956); Comment, *supra* note 18, at 524-25 & n.98. Opinions that credit will not contract seem to be based on experiences of large financers, who undoubtedly do not deal with marginal sellers.

The statutes will also harm the consumer and the economy by making inventory financing more expensive. Financers lend to sellers for inventory purchases at low rates of from five to eight percent in order to secure profits from consumer paper.[26] Since such a low return is hardly worth the costs,[27] destroying the financer's protected position will undoubtedly cause inventory interest rates to go up, with resulting higher costs passed on to the consumer.

Another problem with these sweeping statutes is their implicit assumption that in all cases sellers have great need of financers and that therefore financers can control sellers' transactions. Financial institutions often keenly compete to finance sellers.[28] The statutes fail to distinguish between those financers who have such a close relationship to the seller that they should be denied their protected position and those who do not. In the latter case, the state should not pass to financers its responsibility of policing sellers.[29] Indeed, the differences in seller-financer relationships make case-by-case development of this problem more desirable than solution by legislative fiat.

II

JUDICIAL THEORY

A. *Uniform Commercial Code Section 3-302(1)*

Absent a remedial statute, the essential question in each case is whether the financial institution is a holder in due course. Of the few cases decided under the Uniform Commercial Code, those that proceed from the statutory definition of "holder in due course"[30] either twist

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26 R. SPEIDEL, R. SUMMERS & J. WHITE, TEACHING MATERIALS ON COMMERCIAL TRANSACTIONS 189 (1969). For cases involving inventory financing, see Mutual Fin. Co. v. Martin, 63 So. 2d 649 (Fla. 1953); Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967); Implement Credit Corp. v. Elsinger, 268 Wis. 143, 66 N.W.2d 657 (1954).

27 SPEIDEL, SUMMERS & WHITE, *supra* note 26, at 189.

28 PHELPS, *supra* note 23, at 10; Kripke, *Consumer Credit Regulation: A Creditor-Oriented Viewpoint*, 68 COLUM. L. REV. 445, 471 (1968). During 1960-65 commercial banks gave finance companies increasing competition, particularly in the area of passenger car loans. Larger finance companies shifted to other areas; smaller ones merged or went out of business. *Survey of Finance Companies, Mid-1965*, 53 FED. RES. BULL. 534, 536 (1967). For a case emphasizing competition among financers, see Lundstrom v. Radio Corp. of America, 17 Utah 2d 114, 405 P.2d 339 (1965).

29 *Cf.* PROCEEDINGS 296 (transcript of oral remarks). *But cf.* Westfield Inv. Co. v. Fellers, 74 N.J. Super. 575, 588-89, 590, 181 A.2d 809, 817, 818 (L. Div. 1962).

30 UCC § 3-302(1) provides:

A holder in due course is a holder who takes the instrument
(a) for value; and
(b) in good faith; and

the language and legislative intent or follow the language and produce injustice.

1. *Good Faith*

Norman v. World Wide Distributors, Inc.[31] is a prime example of judicial twisting of the UCC's good faith provision.[32] The court held that the financer was in bad faith because he had knowledge of suspicious circumstances which should have caused him to inquire into the seller's method of obtaining the note.[33] This reasoning virtually ignores the statutory definition[34] and the legislative history of "good faith." The 1952 draft of the Uniform Commercial Code added "observance of reasonable commercial standards" to the requirement of good faith[35] in order to make explicit what had long been implicit in the case law,[36] but this language was later deleted to make clear that a subjective standard of good faith was intended.[37]

An attempt to hold for the consumer by use of the good faith test violates legislative intent in most cases. Because a semi-objective good faith standard has already been considered and rejected, it is too late to argue, as some do,[38] that this test will help achieve proper results.

2. *Notice*

Nor do the notice provisions[39] help a judge achieve a desirable result. Section 1-201(25)(c), the most easily satisfied notice requirement,

(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.

Negotiable Instruments Law § 52 [hereinafter cited as NIL] is similar. The concept of a holder in due course presupposes a holder (UCC § 3-301) and a negotiable instrument (*id.* §§ 3-102(1)(e), 3-104(1)).

31 202 Pa. Super. 53, 195 A.2d 115 (1963).

32 "Good faith" is "honesty in fact in the conduct or transaction concerned." UCC § 1-201(19). *See* Comment, *supra* note 1, at 280 n.10.

33 For similar cases twisting the subjective good faith test, see Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967) (close connection theory predominates); Westfield Inv. Co. v. Fellers, 74 N.J. Super. 575, 181 A.2d 809 (L. Div. 1962). Although the NIL was applicable in these cases, the courts cited the UCC and apparently tried to reach a result consistent with it.

34 Note 32 *supra*.

35 UCC § 3-302(1)(b) (1952 version) provided: "A holder in due course is a holder who takes the instrument . . . in good faith including observance of the reasonable commercial standards of any business in which the holder may be engaged . . . ."

36 UCC § 3-302, Comment 1 (1952 version).

37 *See* ALI NATIONAL CONFERENCE OF COMM'RS ON UNIFORM STATE LAWS, 1956 RECOMMENDATIONS OF THE EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE 103.

38 *See, e.g.*, Littlefield, *supra* note 4.

39 UCC §§ 3-304(1)(b), (6), & § 1-201(25). The latter section provides in part that [a] person has "notice" of a fact when

(a) he has actual knowledge of it; or

suggests that one has reason to know of a defense only when such knowledge necessarily follows from knowledge of other facts.

The consumer paper cases decided under the notice provisions of the UCC support this view. They hold that knowledge of several previous complaints about the seller does not constitute notice of a defense.[40] A more liberal interpretation of the notice provision, in addition to violating the statutory language, undercuts the subjective good faith test. Moreover, since defenses seldom arise before the financer purchases the note, use of the "notice" definition entails rewriting it to read "reason to know that [the defense] *will* exist." Thus following the Code necessitates holding for the financer[41] in all but the most extreme cases.

B. *The Common Law Approach: The Close Connection Theory*

Many of the Negotiable Instruments Law cases and some of the UCC cases iguore the statutory language and develop common law theories;[42] some use common law theories almost interchangeably with the statutory theories of good faith and notice.[43]

The most common extra-statutory theory relied on in the consumer paper dilemma is the close connection theory, also referred to as the original party theory and the moving party theory.[44] The classic

(b) he has received a notice or notification of it; or
(c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists.

40 Universal C.I.T. Credit Corp. v. Ingel, 347 Mass. 119, 196 N.E.2d 847 (1964), held knowledge of bait advertising, knowledge of frequent complaints to the Better Business Bureau, and knowledge of a report to the Attorney General would not, if proven, constitute notice of a defense. Citing *Universal C.I.T.*, Waterbury Sav. Bank v. Jaroszewski, 4 Conn. Cir. 620, 238 A.2d 446 (1967), held that receipt of several previous complaints did not constitute notice.

41 Using the unconscionability provision, § 2-302, to hold for the consumer (*see* Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967)) is dubious. "Section 2-302 was included in the *sales article* solely for the purpose of authorizing judicial nullification of *contract terms* which are unconscionable." Comment, *supra* note 1, at 287 (emphasis added). For rejection of the idea that § 9-206 helps the consumer defend against suit on his note, see *id.* at 287-88.

42 The use of common law theories is more understandable under the NIL, where "good faith" is not defined and where "notice" is defined in terms of "bad faith." *See* NIL § 56.

43 *See, e.g.*, Mutual Fin. Co. v. Martin, 63 So. 2d 649 (Fla. 1953) (notice and close connection theories); Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967) (good faith and close connection theories); Westfield Inv. Co. v. Fellers, 74 N.J. Super. 575, 181 A.2d 809 (L. Div. 1962) (notice, good faith, agency, and close connection theories); Davis v. Commercial Credit Corp., 87 Ohio App. 311, 94 N.E.2d 710 (1950) (good faith, notice, and original party theories).

44 The agency theory and joint venture theory are variations. Under the agency theory, the financer cannot be a holder in due course because he is the seller's principal. For use of this theory, see International Fin. Corp. v. Rieger, 272 Minn. 192, 137 N.W.2d 172 (1965). For a criticism of its theoretical soundness, see Littlefield, *supra* note

formulation of this theory appears in the landmark case of *Commercial Credit Co. v. Childs*:[45]

> We think appellant was so closely connected with the entire transaction . . . that it can not be heard to say that it, in good faith, was an innocent purchaser of the instrument for value before maturity. . . . 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.[46]

This theory has the advantage of focusing judicial attention on the relevant question, the nature of the relationship between the seller and the financer. Unfortunately, the application of this theory has been defective. Some courts have muddled the close connection test with the question of good faith,[47] thus introducing all the problems of the latter term of art; some have used the test almost exclusively, ignoring the statutory definition of a holder in due course.[48] If the only way to use this theory is to ignore section 3-302(1), then consumer-oriented decisions based on this rationale are erroneous. Section 3-302(1) was apparently intended to cover consumer notes.[49]

C. *UCC Section 3-305(2)*

Section 3-305(2),[50] often overlooked in this context,[51] appears to be a solution to the judicial dilemma imposed by the holder-in-due-

4, at 67-68. For use of the joint venture theory, see Buffalo Indus. Bank v. De Marzio, 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).

45 199 Ark. 1073, 137 S.W.2d 260 (1940).

46 *Id.* at 1077, 137 S.W.2d at 262. Swanson v. Commercial Acceptance Corp., 381 F.2d 296, 299 (9th Cir. 1967), expressed this theory as follows:

> [A] financing company should be denied holder in due course status if it was a moving party in the sales transaction itself and thus in substance an original party to the note which the sale produced; but . . . a financing company should be accorded holder in due course status if it was a business entity separate and apart from the seller and confined itself to extending a line of credit upon being presented with an acceptable business venture.

Jones v. Approved Bancredit Corp., 256 A.2d 739, 742 (Del. 1969), expressed the rationale of this theory:

> [T]he more the holder knows about the underlying transaction . . . , the more he controls or participates in it, the less he fits the role of good faith purchaser for value; and the less justification there is for according to him the protected status of holder in due course considered necessary for the free flow of paper in the commercial world.

47 *See, e.g.*, quotation in text at note 46 *supra*.

48 *See, e.g.*, Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967); American Plan Corp. v. Woods, 16 Ohio App. 2d 1, 240 N.E.2d 886 (1968).

49 *See* UCC § 3-103; § 9-206, Comment 2.

50 Section 3-305(2) provides: "To the extent that a holder is a holder in due course he takes the instrument free from . . . all defenses of any party to the instrument with whom the holder has not dealt . . . ."

51 Courts have not made use of the language "party . . . with whom the holder

course concept, for it implies that mere satisfaction of the requirements of section 3-302(1) is insufficient to allow the financer to take an instrument free from personal defenses.[52]

This inference is supported by the distinction the Code makes between the claims from which a holder in due course is free and the defenses to which he is subject: while he "takes the instrument free from all claims to it on the part of *any* person,"[53] he takes it only "free from . . . all defenses *of any party to the instrument with whom [he] has not dealt* . . . ."[54] The Code also makes a distinction between those who can assert defenses against a holder in due course and those who can assert them against a holder not in due course.[55]

The history of section 3-305(2), notwithstanding silence in the explanatory comment, also suggests that the draftsmen did not want all who satisfy section 3-302(1) to take free from personal defenses.[56] Instead of adopting the NIL provision that a holder in due course takes "free from defenses available to *prior parties among themselves*,"[57] the drafters used the language "*any party*."[58] This language was later changed to "*any party to the instrument with whom the holder has not dealt* . . . ."[59]

Since the UCC does not define "dealt," a liberal interpretation can be given to it.[60] Thus section 3-305(2) allows the courts to find that a sufficiently close seller-financer relationship makes the buyer a "party with whom the financer has dealt;" the consumer can then assert personal defenses against him.[61]

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has not dealt" in § 3-305(2) in the context of the consumer paper problem. Some cases and law review notes deal with whether a *payee* can be a holder in due course, a problem under NIL § 52(4) and § 30 that § 3-302(2) was designed to solve. *See, e.g.*, Waterbury Sav. Bank v. Jaroszewski, 4 Conn. Cir. 620, 238 A.2d 446 (1967); Saale v. Interstate Steel Co., 27 App. Div. 2d 1, 275 N.Y.S.2d 532 (1st Dep't 1966), *aff'd*, 19 N.Y.2d 933, 228 N.E.2d 397, 281 N.Y.S.2d 340 (1967); L. & N. Sales Co. v. Stuski, 188 Pa. Super. 117, 146 A.2d 154 (1958); Note, *The Concept of Holder in Due Course in Article III of the Uniform Commercial Code*, 68 COLUM. L. REV. 1573, 1578-79 (1968); 16 CATH. U.L. REV. 450, 453 (1967). There is nothing in § 3-305(2), however, that confines its application to payee problems.

52 *See* Note, *supra* note 51, at 1578-79.

53 UCC § 3-305(1) (emphasis added).

54 *Id.* § 3-305(2) (emphasis added).

55 *Compare* § 3-305(2), *with* § 3-306(b) ("all defenses of *any party*") (emphasis added).

56 *See* Note, *supra* note 51, at 1578-79.

57 NIL § 57 (emphasis added). *Compare* COMMERCIAL CODE art. III, § 48 (Tent. Draft No. 1, 1946): "In the hands of any person including a holder in due course an instrument is subject to the following defenses on the part of *any prior party* . . . ." (emphasis added).

58 COMMERCIAL CODE art. III, § 48 (Tent. Draft No. 2, 1947) (emphasis added).

59 UCC § 3-305(2) (emphasis added).

60 *See* 16 CATH. U.L. REV. 450, 453 (1967).

61 While the consumer should be able to defend himself against suit by such a

III

CLOSE CONNECTIONS QUALIFYING THE FINANCER AS HAVING "DEALT" WITH THE BUYER: FACTUAL VARIATIONS

Generally the cases do not specify which aspect of a given relationship makes the seller and the financer so closely related that the financer is an original party, or whether only the combination of relationships is decisive. Rational decision-making and the desirability of predictability require analysis of the facts.

Some functions of the financer are essentially credit functions rather than selling functions;[62] they do not so involve the financer in the seller's business that the financer has control over the seller or knowledge of his dishonesty. These functions include the following: providing the seller with forms of contracts and notes,[63] even if they contain the financer's name,[64] or a form endorsement to the financer;[65] supplying interest tables to the seller;[66] making a credit check on the buyer before approving credit;[67] buying the note at discount soon after the consumer's execution of it;[68] and having a reserve

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financer, he should not be able to sue him; the policies favoring use of the close connection theory as a shield—concern about unequal bargaining power, dishonest sellers, risk-spreading—do not apply equally to use of the close connection theory as a sword. Moreover, § 3-305(2) applies only to defenses.

62 *See* Swanson v. Commercial Acceptance Corp., 381 F.2d 296, 298 (9th Cir. 1967).

63 This relationship is present in virtually every consumer paper case. Since the financer hesitates to purchase notes or contract rights on unfamiliar forms, denying holder-in-due-course status in such a situation would have serious effects on the free flow of credit. Implement Credit Corp. v. Elsinger, 268 Wis. 143, 66 N.W.2d 657 (1954).

64 *See, e.g.,* Swanson v. Commercial Acceptance Corp., 381 F.2d 296 (9th Cir. 1967); Waterbury Sav. Bank v. Jaroszewski, 4 Conn. Cir. 620, 238 A.2d 446 (1967). *But cf.* Palmer v. Associates Discount Corp., 124 F.2d 225 (D.C. Cir. 1941). The presence of the financer's name on the note, as for example payee, is still essentially a part of the credit function of the financer. Also, the consumer in such a case should be aware that another party is involved in addition to the seller.

65 *See, e.g.,* Mann v. Leasko, 179 Cal. App. 2d 692, 4 Cal. Rptr. 124 (1960). *But cf.* Palmer v. Associates Discount Corp., 124 F.2d 225 (D.C. Cir. 1941), in which the financer is denied holder-in-due-course status. *Palmer* is perhaps distinguishable from the former case in that the note contained five alternate forms of endorsement, suggesting that the financer tried to secure the legal status most advantageous to him in each case.

66 *See, e.g.,* White System of New Orleans, Inc. v. Hall, 219 La. 440, 53 So. 2d 227 (1951).

67 *See, e.g.,* Swanson v. Commercial Acceptance Corp., 381 F.2d 296 (9th Cir. 1967); Universal C.I.T. Credit Corp. v. Ingel, 347 Mass. 119, 196 N.E.2d 847 (1964). *Contra,* Mutual Fin. Co. v. Martin, 63 So. 2d 649 (Fla. 1953).

68 *See, e.g.,* Swanson v. Commercial Acceptance Corp., 381 F.2d 296 (9th Cir. 1967). *Contra,* Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W.2d 60 (1940).

or repurchase agreement with the seller.[69] To deny a financer his protected position because he has one or all of these relationships with the seller discourages consumer credit and unduly hinders the development of new businesses. In such cases it is inequitable to make the financer bear the loss and the consequent responsibility of policing the seller.

However, financer control of the seller, for example, by setting the terms of the seller-buyer agreement,[70] or substantial involvement in the seller-buyer transaction should cause him to lose his protected position. Such involvement includes: seller-financer consultation about the seller-buyer transaction; knowledge of its details;[71] and carrying out part of the bargain.[72] In these cases the policy of encouraging negotiability is weak and that of making the financer bear the loss is strong; since the financer undoubtedly has power to correct the seller's abuses,[73] he should not take consumer notes free from personal defenses.

Knowledge of the seller's dubious marketing techniques,[74] knowledge of his inferior merchandise,[75] or knowledge of numerous customer complaints[76] should also cause the financer to lose his protected position. While these factors do not present as strong a case for the consumer as does financer control or involvement, they still support imposing the loss on the financer rather than on the consumer. The financer's mere credit functions are tainted.

In many cases there is no direct evidence of the financer's knowl-

69 For discussion of these agreements, see note 18 and accompanying text *supra*. For a case in which a reserve account did not preclude the financer's taking free of personal defenses, see Implement Credit Corp. v. Elsinger, 268 Wis. 143, 66 N.W.2d 657 (1954).

70 *See* Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967), in which the court found that the financer set the terms of an unfair phouograph record agreement; the financer-seller contract required the seller-buyer contract to couform to it. Generally, the effect of such a provision on the financer's freedom from defenses should depend on the kinds of provisions in the financer-seller contract.

71 Both elements were present in Commercial Credit Corp. v. Orange County Mach. Works, 34 Cal. 2d 766, 214 P.2d 819 (1950).

72 In Calvert Credit Corp. v. Williams, 244 A.2d 494 (D.C. Ct. App. 1968), financer procured insurance for the buyer and obtained the television repair contracts that the sales contract required. For another case in which financer's obtaining of insurance had relevance, see Taylor v. Atlas Security Co., 213 Mo. App. 282, 249 S.W. 746 (1923).

73 *See* text at note 17 *supra*.

74 *See, e.g.*, Norman v. World Wide Distribs., Inc., 202 Pa. Super. 53, 195 A.2d 115 (1963). *Contra*, Lundstrom v. Radio Corp. of America, 17 Utah 2d 114, 405 P.2d 339 (1965).

75 *See, e.g.*, Taylor v. Atlas Security Co., 213 Mo. App. 282, 249 S.W. 746 (1923); Davis v. Commercial Credit Corp., 87 Ohio App. 311, 94 N.E.2d 710 (1950).

76 *Contra*, Universal C.I.T. Credit Corp. v. Ingel, 347 Mass. 119, 196 N.E.2d 847 (1964).

edge of the seller's dishonesty.[77] The following factors are relevant in weighing the circumstantial evidence of the connection between the seller and the financer: the financer's access to information about the seller's goods;[78] knowledge of the seller's financial status;[79] discount rate;[80] percent of the financer's business which comes from the seller;[81] percent of the seller's notes which the financer buys; formation of the financial institution to finance the seller;[82] and common membership in the selling and financing institutions.[83] If the quantity and quality of circumstantial evidence make it highly probable that the financer knew of the seller's dishonesty, the financer should be denied a protected position.

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77 *See* Comment, *supra* note 1, at 290.

78 In Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967), the financer had the right to inspect seller's inventory.

79 Commercial Credit Corp. v. Orange County Mach. Works, 34 Cal. 2d 766, 214 P.2d 819 (1950). If the defense the consumer seeks to assert is failure of consideration, knowledge of seller's pending insolvency might preclude the financer's protected position. *See* Comment, *supra* note 1, at 290 n.42. Otherwise such information should not deprive the financer of his protected position, since a credit check on the seller is essential to the financer in determining whether to finance the dealer's inventory.

80 A high discount rate could show merely the seller's need for money rather than the financer's control of a fraudulent transaction. In Mann v. Leasko, 179 Cal. App. 2d 692, 4 Cal. Rptr. 124 (1960), the financer purchased an $850 note for $589; the court held that a high discount does not destroy a financer's holder-in-due-course status unless the consideration is merely nominal or the discount rate compels the inference that the negotiation is fraudulent, illegal, or unauthorized. In Financial Credit Corp. v. Williams, 246 Md. 575, 229 A.2d 712 (1967), the court held that an 80% discount alone was insufficient to show bad faith. However, the high discount rate together with the woeful history of the dealer, which was known to every Marylander, caused the financer to lose his protected position.

81 *Compare* Jones v. Approved Bancredit Corp., 256 A.2d 739 (Del. 1969) (99% of financer's business came from the selling subsidiaries of its parent corporation), *with* Swanson v. Commercial Acceptance Corp., 381 F.2d 296 (9th Cir. 1967) (10% of financer's business came from seller). There were, of course, other factors distinguishing the unprotected financer in the former case from the protected one in the latter.

82 *Compare* Jones v. Approved Bancredit Corp., 256 A.2d 739 (Del. 1969), *and* Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967) (protected position denied), *with* Implement Credit Corp. v. Elsinger, 268 Wis. 143, 66 N.W.2d 657 (1954) (protected position allowed).

83 Family relationship between the members of the two companies, when taken with other factors, argued against the financer's protected position in Taylor v. Atlas Security Co., 213 Mo. App. 282, 249 S.W. 746 (1923). The financer was not protected when he wholly owned both the selling and financing agencies. Toms v. Nugent, 12 So. 2d 713 (La. Ct. App. 1943). Where the owner of the finance company once owned the selling company, but sold it "some time ago" and severed connections with it, a protected position was granted. International Fin. Co. v. Magilansky, 105 Pa. Super. 309, 161 A. 613 (1932).