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Proposed Uniform Consumer Credit Code for Indiana: Restrictions on Negotiability and Waivers of Defenses in Consumer Credit Transactions

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Mr. Unwary Buyer decides to purchase a relatively expensive appliance from the Shoddy Appliance Co. Since he is unable to pay the entire purchase price in cash, he executes a conditional sales contract and a promissory note providing for installment payments of the balance due. Shoddy assures delivery pending a favorable credit check by the Honest Credit Co. Shortly after the sale, Honest buys Buyer's promissory note and takes an assignment of the conditional sales contract from Shoddy. Buyer receives the appliance from Shoddy, but soon discovers that it is defective. Shoddy refuses Buyer's demands to replace or repair the appliance; having already received payment from Honest, Shoddy has little financial incentive to meet Buyer's demands. Honest demands that Buyer continue payments on the promissory note and threatens legal action in the event of Buyer's default.

The above is illustrative of a dilemma in which a consumer who buys on credit finds himself if he is the recipient of defective merchandise. The typical consumer, having no knowledge of the intricacies of negotiable instruments law, reasonably believes that his contract is with Shoddy and, therefore, his obligation to pay for the appliance ends with Shoddy's failure to provide an appliance as warranted. However, if Mr. Unwary Buyer is in Indiana he would discover to his amazement and misfortune that he is legally obligated to continue payments to the Honest Credit Co. in accordance with his promissory note and contract.¹ While

¹. If Buyer refuses to pay, Honest can enforce payment through a lawsuit. Even if Buyer proves that he has a defense or a claim against Shoddy on the contract, Honest will normally have minimal difficulty proving that he is a holder in due course and is therefore entitled to enforce the note free from such claims or defenses. See IND. ANN. STAT. §§ 19-3-301 through 19-3-305 (Burns Repl. 1964). If Honest bought the note from Shoddy without “good faith” or with notice of Buyer’s claim or defense, he is not a holder in due course and is subject to Buyer’s claim or defense against Shoddy. However, Indiana has adhered to the traditional rules that “notice” means actual knowledge and the purchaser of a negotiable note has no duty to inquire into the underlying transaction unless it has knowledge of suspicious circumstances. IND. ANN.
Buyer has legal recourse against Shoddy in the form of a breach of warranty action, in most instances the legal fees involved in prosecuting such a lawsuit are prohibitive in relation to his relatively small claim.8

The credit consumer’s dilemma has stimulated a re-examination of traditional doctrines on the subject of negotiable instruments and waiver of defense provisions as they relate to consumer credit transactions. Consequently, in many jurisdictions the result has been judicial decisions and legislative enactments providing consumer protection.

Since an inflexible application of traditional negotiable instruments law inevitably places an unfair burden on the consumer, courts thirty years ago began manipulating the doctrines in an effort to protect the consumer.4 In Commercial Credit Co. v. Childs, a finance company brought a replevin action against an automobile buyer who had executed a promissory note and conditional sales contract, which the finance company now held. The buyer alleged that the car was of little or no value and, attempting to impugn the plaintiff’s good faith, further alleged that the finance company had provided the automobile dealer with an instrument containing both a conditional sales contract and a promissory note, and that the finance company had purchased the note and an assignment of the contract from the dealer on the day of the buyer’s

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8. STAT. §§ 19-3-302, -304, Indiana Comments (Burns Repl. 1964); Woodsmall v. Myers, 87 Ind. App. 69, 158 N.E. 646 (1927); Greencastle Production Credit Association v. Riddell National Bank, 137 Ind. App. 686, 210 N.E.2d 872 (1965). Even in the event Honest is unable to establish holder in due course status, he will probably be able to enforce payment. Buyer’s contract with Shoddy normally contains a clause in which he acknowledges that the contract will be assigned and waives, as against any assignee of the contract, any claims or defenses which he may have against Shoddy. Such a waiver of defenses is enforceable in Indiana. IND. ANN. STAT. § 19-9-206 (Burns Repl. 1964) clearly makes such waivers enforceable and, although the section makes its authorization of such waiver clauses “subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods,” an Indiana Comment indicates that “there is no policy in Indiana law which would apply a different rule in favor of consumers.” Id. Indiana Comment (Burns Repl. 1964).

4. In an article tracing the development of the commercial law doctrine of negotiability, Grant Gilmore pointed to and endorsed a then embryonic body of case law subjecting what should have been a “holder in due course” to consumer contract defenses and rendering waivers of defenses invalid. The author also notes some early legislation protecting consumers in this situation and warns that the distinction between “commercial” and “non-commercial” [consumer] transactions ought to be observed. Gilmore, The Commercial Doctrine of Good Faith Purchase, 63 Yale L.J. 1057, 1097-1102 (1954).

5. 199 Ark. 1073, 137 S.W.2d 260 (1940) [hereinafter cited as Childs].
signing. The Arkansas Supreme Court, refusing to reverse a jury finding for the buyer, stated that the finance company was:

... so closely connected with the entire transaction ... that it cannot 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 . . . a party to the agreement and instrument from the beginning.  

Although Childs involved a transaction in which consumer goods were involved, the court said nothing which would indicate a different policy were it a case involving a transaction between businessmen (a "commercial transaction") where there was a "close connection" between the seller and financer. It is not clear whether the court's decision was based upon the theory that the "close connection" impugned the finance company's good faith, thus preventing it from becoming a holder in due course, or that there was no negotiation of the note because the "close connection" made the seller a mere agent of the finance company. In spite of the Arkansas court's failure to clearly articulate its rationale, Childs has become a landmark in the area of consumer protection.

A different approach, reaching the same result, was taken in State National Bank of El Paso v. Cantrell. The court held that a finance company suing to enforce payments on a promissory note, although a holder in due course, was subject to defenses and claims on the conditional sales contract which had been assigned to it. The court reasoned that since the note and contract were both executed and transferred simultaneously, the note became burdened with the contract obligations. Although this theory had an advantage by virtue of its ease of application, it never enjoyed the popularity of the Childs "close connection" rationale.

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6. Id. at 1077, 137 S.W.2d at 262.
8. 47 N.M. 389, 143 P.2d 592 (1943).
9. Mutual Finance Co. v. Martin, 63 So.2d 649 (Fla. Sup. Ct. 1953), rejected Cantrell in holding that the concurrent execution of a promissory note and a conditional sales contract did not impair the negotiability of the note. However, the court followed Childs in holding that the buyer could interpose a defense of failure of consideration against the finance company suing on a promissory note, where the note and conditional sales contract were executed together, the finance company had investigated the buyer's credit, furnished the note and agreement, and approved the terms of the note and agreement, since the "close connection" barred the finance company from holder in due course status. See also Commercial Credit Co. v. Orange County Machine Works, 34 Cal.2d 766,
An important difference between the approach of the early and the modern cases is that today an express distinction is made between "consumer transactions" and "commercial transactions." Unico v. Owen is illustrative of the modern approach. Unico involved a suit by a finance company to enforce payment on a promissory note and contract executed by the defendant in connection with a sale of stereophonic records. The New Jersey Supreme Court, after discussing decisions in other jurisdictions and policies favoring consumer protection, held that as to consumer goods transactions the finance company is not a holder in due course if it sets or approves the dealer's standards for the underlying transaction, and agrees to take a given quantity of the dealer's negotiable paper.

Of further import is the court's treatment of a waiver provision contained in the contract. The defendant, in addition to giving a promissory note, also signed a conditional sales contract containing a clause whereby he waived, as against any assignee of the contract, any claim or defense which he might have against the seller. Unico, assignee of the


The finance industry rapidly developed a device to counteract the ruling in Cantrell. They simply inserted a clause in the conditional sales contract whereby the buyer acknowledges that the contract will be assigned and waives, as against assignees, all defenses and claims which he might have against the seller. The conditional sales contract was thus made "negotiable." Gilmore, supra note 4, at 1094-95. After the passage in many states of the Uniform Commercial Code, courts were all but precluded from following Cantrell. Section 9-206 of the UCC provides that a buyer who signs both a negotiable instrument and a security agreement as a part of the same transaction is deemed to have waived all defenses, as against the assignee, which he might have against the seller—the precise opposite of the effect which Cantrell attached to such a concurrent signing. See Uniform Commercial Code, § 9-206 [Ind. Ann. Stat. § 19-9-206 (Burns Repl. 1964)].

10. 50 N.J. 101, 232 A.2d 405 (1967) [hereinafter cited as Unico].

11. It was undisputed that the defendant buyer had not received the promised consideration from his seller, and that his seller was now insolvent; therefore, the court was forced to choose between two innocent parties, the buyer and the financier, as to who ought to bear the loss occasioned by the seller. Id.

12. The court phrased its holding as follows:

For purposes of consumer goods transactions, we hold that where the seller's performance is executory in character and when it appears from the totality of the arrangements between dealer and financier that the financier has had a substantial voice in setting standards for the underlying transaction, or has approved the standards established by the dealer, and has agreed to take all or a predetermined or substantial quantity of the negotiable paper which is backed by such standards, the financier should be considered a participant in the original transaction and therefore not entitled to holder in due course status.

Id. at 122-23, 232 A.2d at 417.

13. See notes 1 and 9, supra.
contract as well as holder of the promissory note, argued that the con-
tract, independent of the promissory note, was enforceable free of Owen's
defenses. The court rejected this contention, ruling that the waiver of
defense clause was void as against public policy. Unico is "illustrative
of a developing judicial attitude" toward protection of the consumer at
the expense of financers of consumer credit.

State legislatures have also modified traditional negotiability doc-
trine in an effort to protect reasonable consumer expectations. By the
time Unico was decided in 1967, many states had restricted the negoti-
ability of notes given in consumer credit transactions. Numerous states
had taken the further step of prohibiting the use or limiting the effect of
waiver of defense clauses in various types of consumer credit trans-
actions.

14. The New Jersey Supreme Court gave three reasons for finding the waiver
of defense clause void:

(1) [I]t is opposed to the policy of the Negotiable Instruments Law which
had established the controlling prerequisites for negotiability, and provided
also that the rights of one not a holder in due course were subject to all legal
defenses which the maker of the instrument had against the transferor. (2)
[I]t is opposed to the spirit of N.J.S. 2A: -25-1, N.J.S.A., which provides
that an obligor sued by an assignee "shall be allowed . . . all . . . defenses
he had against the assignor or his representatives before notice of such assign-
m ent was given to him"; and (3) the policy of our state is to protect condi-
tional vendees against imposition by conditional vendors and installment sellers.


15. Murphy, supra note 7, at 675. See also American Plan Corp. v. Woods, 16 Ohio App. 2d 1, 240 N.E.2d 886, 889 (1968):

In our opinion, the doctrine so well stated in Unico strikes the proper balance
between the protection of the commercial need for negotiability and the indi-
vidual's need for relief against fraud. As that court stated, we are impelled to
"join those courts which deny holder in due course status in consumer goods
sales cases to those financiers whose involvement with the seller's business is as
close, and whose knowledge of the extrinsic factors—i.e., the terms of the under-
lying sale agreement—is as pervasive, as it is in the present case."

16. See, e.g., Cal. Retail Instalment Sales Act, CAL. CIV. CODE §§ 1803.2 (a),
1810.9 (West Supp. 1967); Conn. Home Solicitation Sales Act, PUB. ACT 749 (West
Conn. Leg. Ser. 1063 (1967); Ill. Consumer Fraud Act, ILL. ANN. STAT. ch. 121
1/2, § 262 D (Smith-Hurd Supp. 1967). For exhaustive listing, see Murphy, supra note
7, at 674, n. 22.

As early as 1951, the Maryland legislature enacted a statute providing that the
holder of a note given in a retail installment transaction is subject to all defenses which
the buyer might have asserted against the seller or payee. Maryland Retail Installment

17. See, e.g., Cal. Retail Installment Sales Act, CAL. CIV. CODE §§ 1804.1-2
(West Supp. 1967); Ill. Consumer Fraud Act, ILL. ANN. STAT. ch. 121 1/2, § 262
In addition to courts and legislatures, the drafters of the Uniform Commercial Code saw a need for consumer protection and thus included the following provision in its 1952 version of the Uniform Commercial Code:

An agreement by a buyer of consumer goods as a part of a contract for sale that he will not assert against an assignee any claim or defense arising out of the sale is not enforceable by any person. If such a buyer as part of one transaction signs both a negotiable instrument and a security agreement even a holder in due course of the negotiable instrument is subject to such claims or defenses if he seeks to enforce the security agreement by attaching or levying upon the goods in an action upon the instrument.\(^\text{18}\)

However, the bitter opposition of the banking lobby\(^\text{19}\) resulted in the adoption of the existing provision which expressly authorizes waiver of defense clauses in commercial transactions, while attempting to defer to prior state law as to consumer goods.\(^\text{20}\)

In spite of the trend toward consumer protection, Indiana continues...
to adhere to traditional doctrines and refuses to draw a distinction between commercial and consumer transactions. Indiana courts early rejected the argument that a "close connection" between the dealer and financer warranted a finding that the financer could not be a holder in due course. Furthermore, Indiana has neither judicially nor legislatively invalidated or limited the effect of waiver of defense clauses in consumer credit transactions. In light of recent developments, however, the Indiana General Assembly will have an opportunity to re-evaluate this position. The Uniform Consumer Credit Code, a comprehensive piece of consumer protection legislation, was introduced in the 1969 General Assembly. Because of its breadth and complexity, a joint resolution was passed creating a legislative study committee to examine the UCCC and make recommendations to the 1971 General Assembly. That committee has completed its work and has recommended passage of an amended version of the UCCC.

The UCCC contains two important and controversial sections which attempt to penetrate the insulation presently enjoyed by holders in due course of consumer notes and assignees of consumer contract obligations. Section 2.403, if passed as recommended, would prohibit the seller in a consumer credit sale or lease from taking a negotiable instrument, other than a check, as evidence of the obligation of the buyer or lessee. It further provides that a holder of a negotiable instrument is not a holder in due course if he had notice that the instrument was issued in a consumer transaction. Section 2.404, if enacted, would protect the

21. IND. ANN. STAT. §§ 19-3-301 through 19-3-307, Comments, Decisions Under Prior Law (Burns Repl. 1964); IND. ANN. STAT. § 19-9-206, Indiana Comment (Burns Repl. 1964); See also note 1 supra.

22. In a suit by a financer on a promissory note given by the defendant for the balance due on a conditional sales contract for an oil burner, the defendant alleged that the plaintiff financer was in the habit of buying and discounting notes taken by the sales company for such burners, that the plaintiff had knowledge of all the conditions of the underlying contract, and that the promissory note contained a recital that it covered installments due under a conditional sales contract for an oil burner. The court sustained plaintiff's demurrer to defendant's answer and granted summary judgment for the plaintiff. Berry v. Brandt C. Downey Co., 89 Ind. App. 545, 167 N.E. 136 (1929). See also Dorbecker v. Brandt C. Downey Co., 88 Ind. App. 557, 163 N.E. 535 (1928); Congress Financial Corp. v. J-K Coin-Op Equip. Co., 353 F.2d 683 (7th Cir. 1965).

23. IND. ANN. STAT. § 19-9-206, Indiana Comment (Burns Repl. 1964); See also note 1 supra.


25. For a brief report from the chairman of the Indiana UCCC Study Committee, see Rubin, Proposed Indiana Uniform Consumer Credit Code, RES GESTAE, September, 1970, at 6.

26. UCCC, § 2.403:
consumer from the impact of signing a sales contract in which he waives his claims and defenses as to assignees. Since this section is quite controversial, two alternatives have been proposed.\(^7\) Alternative A un-

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 on rights of parties (Section 5.202) and the provisions on civil actions by Administrator (Section 6.113).

27. UCCC, § 2.404:

Alternative A: With respect to a consumer credit sale or consumer lease, other than a sale or lease primarily for an agricultural purpose, an assignee 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 assignee's liability under this section may not exceed the amount owing to the assignee at the time the claim or defense is asserted against the assignee. Rights of the buyer or lessee under this section can only be asserted as a matter of defense to or set-off against a claim by the assignee.

Alternative B: (1) With respect to a consumer credit sale or consumer lease, other than a sale or lease primarily for an agricultural purpose, an agreement by the buyer or lessee not to assert against an assignee a claim or defense arising out of the sale or lease is enforceable only by an assignee not related to the seller or lessor who acquires the buyer's or lessee's contract in good faith and for value, who gives the buyer or lessee notice of the assignment as provided in this section and who, within 3 months after the mailing of the notice of the assignment, receives no written notice of the facts giving rise to the buyer's or lessee's claim or defense. This agreement is enforceable only with respect to claims or defenses which have arisen before the end of the 3-month period after the notice was mailed. The notice of assignment shall be in writing and addressed to the buyer or lessee at his address as stated in the contract, identify the contract, describe the goods or services, state the names of the seller or lessor and buyer or lessee and the number, amounts and due dates of the installments, and contain a conspicuous notice to the buyer or lessee that he has 3 months within which to notify the assignee in writing of any complaints, claims or defenses he may have against the seller or lessor and that if written notification of the complaints, claims or defenses is not received by the assignee within the 3-month period, the assignee will have the right to enforce the contract free of any claims or defenses the buyer or lessee may have against the seller or lessor which have arisen before the end of the 3-month period after notice was mailed.

(2) An assignee does not acquire a buyer's or lessee's contract in good faith within the meaning of subsection (1) if the assignee has knowledge or, from his course of dealing with the seller or lessor or his records, notice of substantial complaints by other buyers or lessees of the seller's or lessor's failure or refusal to perform his contracts with them and of the seller's or lessor's failure to remedy his defaults within a reasonable time after the assignee notifies him of the complaints.

(3) To the extent that under this section an assignee is subject to claims or defenses of the buyer or lessee against the seller or lessor, the assignee's liability under this section may not exceed the amount owing to the assignee at the time the claim or defense is asserted against the assignee and rights of the buyer or lessee under this section can only be asserted as a matter of defense or set-off against a claim by the assignee.
conditionally invalidates waiver of defense clauses in consumer credit contracts. The Indiana study committee has chosen Alternative B, generally considered the weaker in terms of consumer protection, which would make a waiver of defense clause unenforceable unless (1) an unrelated assignee acquires the buyer's or lessee's contract in good faith, and (2) the assignee gives notice to the buyer or lessee of the assignment, and (3) the buyer or lessee fails to notify the assignee within three months of any claim or defense which he has against the seller or lessor. If the buyer's or lessee's claim or defense against the seller arises more than three months after notice from the assignee, the buyer is not obligated to notify the assignee. The adoption by the 1971 Indiana General Assembly of sections 2.403 and 2.404 of the UCCC would mean a reversal in the policy and law of Indiana related to holders in due course and waivers of defenses in connection with consumer transactions. Such a reversal warrants a study of its policies and possible effects, and of the problems and criticisms

28. Id. Alternative A.
29. Id. Alternative B. The Indiana legislative study committee has also recommended shortening the specified notice period from 3 months to 45 days:

... the Committee noted that sellers would be forced to maintain high cash reserves with their financial institutions to protect assignees from losses if assignees were made subject to the defenses of the buyer. Balanced against the burden of maintaining reserves was the theory that assignees should review the practices of their client sellers with more care. The Committee determined that the liability of assignees should be limited and the period of 45 days was chosen as much as the existing practice is to allow 45 days between the consummation of a credit sale and the first installment payment. Interim Committee Report of the Uniform Consumer Credit Code Study Committee, 6.

Given that the committee has chosen Alternative B to § 2.404, it is possible that the amendment changing the notice period to 45 days will indirectly benefit consumers. Alternative B provides that waiver of defense agreements are "enforceable only with respect to claims or defenses which have arisen before the end of the 3-month (45 day) period after the notice was mailed." UCCC § 2.404, Alternative B. Thus if a breach of warranty arises after the end of the notice period, the claim is available (i.e., the agreement is not enforceable) to the consumer even if he never notifies the assignee. By shortening the notice period, claims which would formerly have arisen within the period during which notice is required to preserve the claim or defense (e.g., on the 50th day) will now fall outside the notice period and be available to the consumer without the burden of giving notice.

One commentator has pointed out that Alternative B could be interpreted to cut off warranty claims as to latent defects by deeming them to have arisen "when tender of delivery is made." See UCC § 2-725. However, he adds, there is no reason for courts to reach to the UCC in order to "disembowel" the intent of § 2.404. Hogan, Integrating the UCCC and the UCC—Limitations on Creditors' Agreements and Practices, 33 Law and Contemp. Problems 686, 689 (1969). To prevent such a castration of § 2.404, it is surely advisable that the UCCC should include a definition of "when a claim arises" for the purposes of that section, where latent defects giving rise to warranty claims are concerned. Such a definition could be phrased in terms of the consumer's actual knowledge of the existence of a defect, or reason to know that such a defect exists.
of the two sections intended to bring it about.

The doctrine of negotiability holds that one who purchases commercial paper meeting the requirements of a negotiable instrument, in good faith and for value, without notice of any defect in the instrument or title, is accorded certain procedural advantages in suing thereon and the substantive advantage of holding the paper free and clear of claims or defenses arising out of the underlying transaction. The premise upon which the doctrine rests is that it encourages a free flow of commercial paper by alleviating prospective buyers' concerns about the possibility of time consuming and expensive litigation involving the underlying contract. With prospective buyers' fears thus alleviated, commercial paper becomes a highly liquid asset readily transferable in a commercial transaction. By facilitating commercial transactions, the doctrine of negotiability encourages a free flow of commerce which in turn stimulates economic growth. Since economic growth is a desirable end, the conclusion that the doctrine of negotiability should be encouraged follows inevitably. Similarly, if parties to a contract are free to insert a clause whereby one party waives claims and defenses against the other party's assignee, thus making a non-negotiable instrument "negotiable," the free flow of commerce will be further encouraged. The waiver of defense clause finds additional support in the doctrine of freedom of contract, which is firmly rooted as one tenet of our society's belief in freedom of thought and action.

The doctrine of negotiability and arguments supporting it are so widely accepted and firmly entrenched that most advocates of consumer protection have chosen not to attack it frontally. Instead, they bypass

30. The doctrine of negotiability was established relatively early in the law of commercial paper and parallels the doctrine of good faith in the law of sales. Lawson v. Weston, 4 Esp. 56, 170 Eng. Rep. 640 (1801); Goodman v. Harvey, 4 Ad. & E 870, 111 Eng. Rep. 1011 (1836). For a discussion of the early cases see Littlefield, supra note 9, at 50-52; Gilmore, supra note 4.

31. UCC § 3-104 [IND. ANN. STAT. § 19-3-104 (Burns Repl. 1964)].

32. UCC §§ 3-302, 3-303, 3-304 [IND. ANN. STAT. §§ 19-3-302, 3-303, 3-304 (Burns Repl. 1964)]. There has been a split in the jurisdictions within the United States over whether the test of good faith to establish holder in due course status is an objective or subjective test, with the majority by far applying the so-called subjective test. Under the subjective test the purchaser of a negotiable note is in good faith unless he has some actual knowledge of a claim or defense or defect in the instrument. The objective test uses some form of "reason to know" or "duty to make reasonable inquiry" as a part of the test of good faith. See Littlefield, supra note 9.

33. UCC § 3-307 [IND. ANN. STAT. § 19-3-307 (Burns Repl. 1964)].

34. UCC § 3-305 [IND. ANN. STAT. § 19-3-305 (Burns Repl. 1964)]; Littlefield, supra note 9, at 49, 50.

35. Murphy, supra note 7, at 668.

36. Id.

37. An exception is Homer Kripke, an avowed advocate of creditor interests who
the entire line of argument by conceding its applicability to commercial transactions while contending that conflicting and overriding policies are involved in consumer credit transactions.\(^3\) The doctrine of negotiability contemplates that commercial paper will be circulated freely. Since most consumer notes are transferred only once, from the dealer to the finance company, the policy behind negotiability does not really support its application to consumer credit transactions.\(^3\) Furthermore, commercial law doctrines contemplate parties dealing at arms length with relatively equal bargaining power. This relationship does not exist in the typical consumer credit transaction in which a form contract is imposed upon the consumer whose bargaining power is minimal. It has even been said that the normal consumer credit contract is so one-sided as to be an “adhesion contract.”\(^\text{40}\)

Aside from the above distinctions between consumer and commercial transactions, there are sound policies against the application of the negotiability doctrine in the consumer credit area. The consumer is under considerable financial burden if he must continue payments to the finance company while attempting to legally “encourage” the dealer to comply with the contract. Other than customer good will, the dealer has no incentive to fulfill his contract obligations, since he has already received payment from the finance company. The consumer may be able to enforce compliance through a lawsuit, but only if he can afford to pay an attorney in addition to the finance company.\(^\text{41}\) However, if the finance company were subject to the defenses which the consumer has against the dealer, its ability to collect from the buyer would be conditioned upon

\(^{38}\) Grant Gilmore was one of the first to draw a distinction between commercial and consumer (“non-commercial”) transactions. Gilmore, supra note 4, at 1101-02. See also Jordan and Warren, The Uniform Consumer Credit Code, 68 COLUM. L. REV. 387, 436 (1968).

\(^{39}\) Jones, supra note 9, at 183-85.

\(^{40}\) Schuchman, Consumer Credit by Adhesion Contracts II, 35 TEMP. L.Q. 281 (1962); Kripke, supra note 19, at 472.

\(^{41}\) See note 3 supra and accompanying text. These burdens upon the consumer, which he suffers even if the dealer is solvent and available, have been called the “inertia of litigation” and the “strain of current cash outlay.” Littlefield, Preserving Consumer Defenses: Plugging the Loophole in the New UCCC, 44 N.Y.U.L. REV. 272, 284 (1969).
the dealer's performance of his contract obligations. Thus the finance company, with the bargaining power and resources necessary to coerce the dealer into compliance with his contract, would have an incentive to apply such coercion. Since the finance company may ultimately find it necessary to seek restitution from the dealer, it will also have an incentive to protect itself by not financing insolvent or fraudulent dealers, thus reducing their number. Finally, in the situation in which the dealer is insolvent or has disappeared, the court must decide which of two innocent parties ought to bear the loss occasioned by the dealer. Where both parties are solvent ongoing businesses, as in the commercial situation, the negotiability doctrine does not conflict with a policy of choosing the better loss bearer, since either party is capable of absorbing and spreading the loss. Where the two innocent parties are a finance company and an individual consumer, the doctrine of negotiability runs headlong into the policy of loss spreading since it causes financial hardship by placing the burden on the consumer.

These arguments in favor of eliminating negotiability in consumer transactions take on their greatest appeal where the relationship between the finance company and the dealer is a close one. In fact most courts, in eliminating negotiability in consumer transactions, limited their holdings to cases in which there was a close relationship. The UCCC has incorporated some of the elements of the courts' "close connection" limitation into sections 2.403 and 2.404. For example, section 2.403 prohibits the taking by a dealer of a negotiable instrument in a consumer credit transaction, but permits a subsequent taker to attain holder in due course status if he did not have notice that the note was issued in a consumer transaction. The Comment explains that "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." Thus, although section 2.403 does not expressly incorporate the "close connection" test, the financer retains the opportunity to prove

42. See McEwen, Economic Issues in State Regulation of Consumer Credit, 8 B.C. IND. & COM. L. REV. 387, 401-02 (1967); Kripke, supra note 19, at 472.
43. See Littlefield, supra note 41, at 283-85.
44. See, e.g., Mutual Finance Co. v. Martin, 63 So.2d 649 (Fla. Sup. Ct. 1953); Unico v. Owens, 50 N.J. 101, 232 A.2d 405 (1967); American Plan Corp. v. Woods, 16 Ohio App. 1, 240 N.E.2d 886 (1968). However, the statutes in many states prohibiting the use of negotiable instruments in retail installment sales do not require any close relationship between financer and dealer. Such a statute more fully implements a policy of spreading losses caused by insolvent and fraudulent dealers, rather than limiting itself to a policy of forcing financiers to police such dealers. Littlefield, supra note 41, at 283-84.
45. UCCC § 2.403, Comment.
that he was "sufficiently removed" from the dealer so as not to have notice of the consumer origin of the instrument.

Section 2.404, Alternative B, allows enforcement of a waiver of defense clause "only by an assignee not related to the seller or lessor." In addition, the assignee must acquire the buyer's or lessee's contract in "good faith." A negative definition of good faith incorporating elements of the "close connection" test, is given in section 2.404, Alternative B(2):

An assignee does not acquire a buyer's or lessee's contract in good faith within the meaning of subsection (1) if the assignee has knowledge or, from his course of dealing with the seller or lessor or his records, notice of substantial complaints by other buyers or lessees of the seller's or lessor's failure or refusal to perform his contracts with them and of the seller's or lessor's failure to remedy his defaults within a reasonable time of the events of section 2.404, Alternative B(1).

These provisions make a waiver of defense clause absolutely unenforceable if the assignee has a close relationship with the dealer. In the absence of a close relationship, an assignee of a consumer credit contract can enforce a waiver of defense clause by following the notice requirements of Section 2.404, Alternative B(1).

Thus, the results which UCCC sections 2.403 and 2.404 are intended to achieve are readily apparent: shift the initial burdens of seller fraud, breach of contract and insolvency onto the financers in order to encourage them to screen and police dealers who do not perform their contracts. In spite of the long history of court decisions and legislation intended to achieve similar results, little has been written about the effects of such legislation. The most comprehensive attempt to study the effects of the elimination of negotiability was undertaken by the Yale Law Journal. In order to determine the impact of an act of the 1967 Connecticut legislature providing that "the obligation to pay arising from a home

46. UCC § 2.404, Alternative B. Text at note 27 supra.
47. Id.
48. Id.
49. See notes 27 and 29, supra and accompanying text.
50. Questionnaires were sent to financial institutions in the Springfield, Massachusetts area. Less than 50 per cent responded. 55.5 per cent said the change in the law had no effect; 44.4 per cent said it had caused a shift toward direct loans; 22.2 per cent said it caused an increase in time spent on consumer credit investigations. Comment, Consumer Protection—The Role of Cut-Off Devices in Consumer Financing, 1968 Wisconsin L. Rev. 505, 525, note 98. See also Felix, supra note 18; McEwen, supra note 42, at 402.
solicitation sale cannot be evidenced by a negotiable instrument,"52 Yale used questionnaires and interviews to discover the effects upon and reactions of banks, finance companies, and dealers. The report concluded that the act had caused banks to impose new restrictions which should reduce the extent of dealer fraud, but that "overreaction" by most banks had the effect of raising the cost of credit and making it difficult for small, legitimate businessmen to market their consumer paper. However, the report continued, further experience with non-negotiable consumer notes should result in a more rational calculation of risk by the financers, and in any event, the relief to the consumer in the form of loss spreading is worth the slight increases in the costs imposed on dealers and consumers.53

Since the experience with elimination or restriction of negotiability in consumer credit transactions has not been one of drastic upheaval, but rather of minor drawbacks accompanied by considerable relief for consumers, arguments on both sides have shifted from principle to extent and method. Consequently, because of a desire on the part of the drafters that the UCCC be widely promulgated, sections 2.403 and 2.404 have become a focal point of the controversy. Obviously a section drafted to reflect a compromise between consumer and financial interests in Indiana would not satisfy consumers in a state which already has a strong consumer protection law. Predictably, neither consumer protection advocates nor financial interests are satisfied with the final draft of the UCCC54 although the consumer advocates are more vocal in their criticism of sections 2.403 and 2.404.

One of the chief criticisms directed toward section 2.403 is that it fails to abolish the holder in due course doctrine in consumer credit transactions.55 Since section 2.403 merely prohibits the taking of a negotiable instrument by a seller in a consumer credit transaction, but upholds the holder in due course doctrine where a seller takes and negotiates a prohibited instrument to an innocent purchaser, it is argued that the UCCC does not adequately protect the consumer.56 A Comment

52. Id. at 619, CONN. GEN. STAT. §§ 42-134 to -143 (Supp. 1968) (P.A. 749).
53. See note 51, supra at 655-66.
54. One commentator has suggested that the fact that no single interest group is completely satisfied with the UCCC may be its strongest endorsement. Moo, Consumerism and the UCCC, 25 BUS. LAW. 957 (1970).
55. See note 45 supra and accompanying text.
56. See, e.g., NATIONAL CONSUMER ACT: A MODEL ACT FOR CONSUMER PROTECTION § 2.405(2) (First Final Draft, 1969) [hereinafter cited as NATIONAL CONSUMER ACT]:

Any holder of an instrument, contract or other writing evidencing an obligation of the consumer takes it subject to all claims and defenses of the consumer up to and including the amount of the transaction total arising out of the
of the drafters counters by pointing out that in order to attain holder in
due course status, a purchaser of a negotiable instrument must prove a
lack of notice that the instrument was issued in violation of the section.
Since the prohibition of section 2.403 will be well-known in the financial
community, and since financers know which dealers sell consumer goods,
a financer will normally not qualify as a holder in due course. It may
be, as the drafters suggest, that to subject a holder without notice to
consumer defenses would “cast a cloud over negotiable instruments
generally.” However, if it really would be such a “rare case” as the
drafters indicate, it is difficult to see how it would create a general fear
among financers. Furthermore, since it would be a “rare case,” why not
place the burden of the loss on the financer, who can absorb and spread
it readily rather than on the consumer to whom it may mean financial
disaster.

Another criticism of section 2.403 is based upon a belief that dealers
and financial institutions will simply evade it by changing the form of
their transactions to make them appear as loans. For example, instead
of executing a promissory note and a conditional sales contract as part of
the transaction with the dealer, the consumer may be referred by the
the dealer to a particular financer pursuant to a prior agreement between
the dealer and financer. The buyer would then receive a “direct loan”
from the financer with which to make his purchase. Preliminary but
inconclusive studies have shown an increase in “direct loans” as a result
of the elimination of negotiability of consumer credit paper. It has been
proposed to amend the UCCC in order to prevent this evasive technique
by preserving consumer defenses against the “closely related” lender.

transaction whether or not it is payable “to order or to bearer.”

A comment to the above section criticizes the UCCC for pretending to prohibit the
use of negotiable instruments in consumer credit sales while still recognizing that
there may be holders in due course.

57. UCCC § 2.403, Comment.
58. Id.
59. See Littlefield, supra note 41, at 283-85.
60. Littlefield, supra note 41, at 292; NATIONAL CONSUMER ACT § 2.407, Comment.
61. See note 50 supra; Note, A Case Study of the Impact of Consumer Legisla-
tion: The Elimination of Negotiability and the Cooling-Off Period, 78 YALE L.J.
62. Littlefield, supra note 41, at 293. Littlefield’s proposal is as follows:
(1) Where a lender makes a consumer loan in close connection [subsection
(2) of this section] with a sale or lease of goods, services or an interest
in land purchased primarily for a personal, family, or household purpose,
such lender 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 lender’s liability may not exceed the
amount owing to the lender at the time the claim or defense is asserted against
the lender.
The difficulty with such a proposal is in establishing criteria to determine what constitutes a "close relationship" between dealer and lender since the pattern of such a relationship is yet to evolve. If the criteria adopted are over-inclusive, legitimate lenders may be affected, and sound reasons exist for not subjecting them to the same treatment as financers of consumer credit sales. In the typical loan transaction, the consumer obtains his loan independent of his transaction with the seller. Therefore, he has no reason to believe that his obligation to the lender is subject to the dealer's compliance with the sales contract. A lender who has neither a continuing relationship with nor an opportunity to select his borrower's dealer, ought not be burdened with the costs of dealer breach or fraud. It is arguable that a lender could insure the compliance of even an independent dealer more readily than could a consumer. However, in the context of a direct loan transaction the lender has no recourse or claim

(2) A lender makes a loan in close connection with a sale or lease where:
   (a) The lender is a person related to the seller; or
   (b) The lender chose to make the loan directly to the buyer in preference to becoming an assignee of the rights of the seller or lessor for the purpose of denying the buyer or lessee the protection of Section 2.403 or 2.404; or
   (c) The lender made the loan, and a seller or lessor made a sale or lease, under circumstances where the lender knew of the purpose of the loan he was making, the seller or lessor had caused the buyer or lessee to transact the loan with the lender, and the lender made the proceeds of the loan, directly or indirectly, payable or endorsable over to the seller or lessor, whether or not the lender takes a security interest in the subject matter of the sale or lease; or
   (d) The lender, within ten days after the sale is made, takes a security interest in the consumer goods which are the subject matter of the sale or lease. See also, National Consumer Act § 2.407.

(1) The creditor in consumer loan transactions shall be subject to all of the claims and defenses of the consumer up to the total amount financed, arising from the consumer sale or lease for which the proceeds of the loan are used, if the creditor participated in or was connected with the consumer sale or lease transaction.
(2) Without limiting the scope of subsection (1), the creditor participates in or is connected with a consumer sale or lease transaction when:
   (a) the creditor is a person related to the seller or lessor; or
   (b) the seller or lessor prepares documents used in connection with the loan; or
   (c) the creditor supplies forms to the seller or lessor used by the consumer in obtaining the loan; or
   (d) the creditor makes 20 or more loans in any calendar year, the proceeds of which are used in transactions with the same seller or lessor, or with a person related to the same seller or lessor; or
   (e) the consumer is referred to the creditor by the seller or lessor; or
   (f) the creditor, directly or indirectly, pays the seller or lessor any consideration whether or not it is in connection with the particular transaction; or
   (g) the creditor is the issuer of a credit card which may be used by the consumer in the consumer sale or lease as a result of a prior agreement between the issuer and the seller or lessor.
of its own against the dealer to use as leverage.

Attempting to draft legislation to deal with a non-existent problem is a highly speculative operation, and probably ought not be undertaken. If financers do in fact resort to a sham loan transaction so as to defeat the purpose of section 2.403, the courts can effectuate the policy of the UCCC by recognizing and treating the sham as a credit transaction within the scope of section 2.403. Once the material characteristics of an evasive loan transaction come to light, more meaningful legislation can be drafted.\(^3\)

Elimination or restriction of the negotiability of consumer notes through section 2.403 would be of minimal benefit to the consumer in the absence of similar restrictions on waiver of defense clauses. If waiver of defense clauses are left untouched, dealers and finance companies could make consumer contract obligations "negotiable" without the use of a negotiable instrument prohibited by section 2.403.\(^6\) For this reason section 2.404 is a necessary adjunct to section 2.403.

Section 2.404 was originally drafted to subject an assignee of the rights of a seller or lessor to all claims and defenses of the buyer or lessee, notwithstanding the existence of a waiver of defense agreement.\(^5\) In conjunction with section 2.403 it thus embodied a strong policy of preserving consumer defenses, shifting the burdens of dealer breach, fraud, and insolvency onto the finance company. However, it was argued that such an inflexible policy would result in financers refusing to finance small, undercapitalized businessmen and would therefore be harmful, if not destructive, to small business.\(^6\) In response, Alternative B was added as a compromise.\(^6\) This section also preserves consumer defenses against an assignee in spite of a contrary waiver agreement, but only if the consumer gives notice to assignee of claims or defenses which he has against the dealer within three months of receiving notice of the assignment. The notice requirement operates only as to claims or defenses which arise within three months; the waiver of defense agreement is absolutely unenforceable as to claims or defenses which arise after the three month period.\(^8\)

One criticism of Alternative B is that it is well-suited to the middle-class consumer, but fails to aid the poor consumer most in need of

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64. See notes 1 and 9 supra.
65. UCCC § 2.404, Alternative A. Text at note 27 supra.
66. Moo, supra note 54, at 967. This view is lent a modicum of support by the Yale study of the impact of the elimination of negotiability on the Connecticut home improvement industry. See note 19 supra, at 647-50.
67. UCCC § 2.404, Alternative B. Text at note 27 supra.
68. See note 29 supra.
protection. The section assumes that the consumer will read and understand the notice from the assignee, realize that he has a claim or defense against his seller, and notify the assignee of his claim or defense, all within three months. These assumptions may be valid as to a knowledgeable consumer, but certainly not as to a poor, uneducated one. This criticism takes on even greater significance if a state chooses to shorten the notice period, as Indiana's legislative study committee has recommended doing.

It is also possible that financers or dealers may employ unscrupulous means without violating Alternative B. For example, if the consumer fails to give notice of a claim or defense as required by Alternative B, the financer can present an image of being in an even stronger position than under present law by referring the consumer to a statute which expressly authorizes waiver of defense clauses in consumer transactions. The consumer may be defrauded into paying, though he may have been able to defeat the finance company by a showing of a close relationship with the dealer or a lack of good faith. Furthermore, it is unlikely that the typical consumer will be aware of section 2.404 of the UCCC. If he is not, the mere existence of an absolute waiver of defense clause in his contract, when pointed out by an unscrupulous financer or dealer, may frighten him into paying. Section 2.404 should therefore be amended to prohibit the insertion of an absolute waiver of defense clause in a consumer credit contract, and to subject violators to the liabilities set forth in the UCCC. It is also advisable that a waiver of defense clause be absolutely unenforceable unless it sets forth conspicuously the limitations imposed upon it by Alternative B.

Both alternatives to section 2.404 provide that the consumer may not sue the assignee affirmatively on a claim which he has against the

70. See note 29 supra.
72. Helstad, Consumer Credit Legislation: Limitations on Contractual Terms, 8 B.C. Ind. & Com. L. Rev. 519, 531 (1967).

This criticism goes to Alternative A as well, since it does not prohibit the use of waiver of defense clauses in consumer contracts, but merely renders them unenforceable. A financer or dealer could still use such a clause "extra-legally" to frighten the consumer without fear of penalty.

73. UCCC § 5.202 provides that if a creditor violates the provisions of § 2-403, the consumer is not obligated to pay the credit service charge and may recover from such creditor or an assignee attempting to enforce payment a penalty not in excess of three times the amount of the credit service charge in addition to reasonable attorney's fees. UCCC § 6.113(2) provides that the Administrator [to be appointed by the state to enforce the UCCC] may bring a civil action against a creditor for willfully violating the Act, and if the court finds a course of repeated and willful violations it may assess a penalty not to exceed 5,000 dollars.
dealer, but rather may only assert these rights as a matter of defense or set-off against a claim by the assignee.\textsuperscript{74} In addition, the assignee's liability may not exceed the balance due on the consumer's obligation to the assignee.\textsuperscript{75} Several critics advocate permitting the consumer to recover from the assignee any claim which he would have against the seller of the goods, to the full extent of the consumer's loss.\textsuperscript{76} The underlying policy is that financers should bear and spread \textit{all} losses which a consumer suffers as a result of dealer fraud, breach, or insolvency. Such a policy is questionable. It places costs on financers which they are in no position to predict and possibly could not absorb without a severe tightening of credit or a drastic increase in costs.\textsuperscript{77} In the case where the consumer has paid most of his installments, he will have also had the use of the product for a considerable time. If the payments are viewed as "rental" for the use of the product, the UCCC rule does not appear to be inequitable.\textsuperscript{78}

\textbf{CONCLUSION}

The typical consumer credit transaction, as a part of which the consumer executes a promissory note and a conditional sales contract containing a clause in which he waives all defenses as against assignees, gives rise to a consumer dilemma if the seller of the merchandise does not fulfill his part of the bargain. The seller negotiates the promissory note and assigns the contract to a finance company shortly after the sale thereby receiving payment and, according to the traditional negotiability and contract doctrines to which Indiana adheres, divorcing the consumer's payment obligation from the seller's obligations regarding the purchased merchandise. The consumer is thus deprived of his most effective weapon for insuring that the seller performs: the ability to stop payment. In order to receive what he contracted for he must continue paying the finance company while carrying the additional burden of a lawsuit against the seller. If the seller is insolvent or disappears, his loss is even greater. Many states have recognized the consumer's dilemma and have subjected the finance company to defenses and claims which the consumer has against his seller. When the finance company's right to collect from the consumer is thus made contingent upon the seller's

\textsuperscript{74} UCCC § 2.404. Text at note 27 \textit{supra}.
\textsuperscript{75} Id.
\textsuperscript{76} \textit{National Consumer Act}, \textit{supra} note 56, § 2.405(2). See also Littlefield, \textit{supra} note 41, at 288-89, who believes that the assignee's liability should be limited to the cash price of the goods, or the amount financed, whichever is greater.
\textsuperscript{77} See Littlefield, \textit{supra} note 41, at 289.
\textsuperscript{78} Robertson, \textit{supra} note 63, at 56-57.
performance of the underlying sales contract, the finance company has an incentive to encourage the seller to perform and to refrain from financing unreliable sellers. The result is consumer protection in the form of "policing" of sellers and "spreading" of losses occasioned by sellers.

Regrettably, Indiana has not yet joined this trend toward consumer protection. However, with the introduction of the UCCC in the 1969 General Assembly and the legislative study committee's recent recommendation of adoption in the 1971 Session, Indiana has an opportunity to re-examine its position. In spite of a few deficiencies, the enactment of sections 2.403 and 2.404 of the UCCC would provide Indiana with long-awaited and necessary reform in the area of preservation of consumer defenses against holders in due course of consumer notes and assignees of consumer contracts. Section 2.403 compromises consumer interests by failing to reject entirely the "close connection" and "notice" concepts thereby preserving elements of holder in due course doctrine as to consumer notes. The Indiana study committee has further compromised consumer interests by amending and recommending Alternative B of section 2.404. The notice requirement of Alternative B would be difficult to work with and hardly compares with the consumer protection offered by the absolute unenforceability of waivers of defenses provided for in Alternative A. It may be that these compromises will alleviate some of the fears of UCCC opponents thereby improving its chances of adoption. Although the proposed UCCC sections 2.403 and 2.404 would not provide the best possible form of consumer protection, their enactment should be encouraged.

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