CONSUMER SALES FINANCING: PLACING THE RISK FOR DEFECTIVE GOODS

The rising standard of living and extensive advertising of appliances and other large consumer items creates a desire for goods beyond the ability of many purchasers to pay cash. Dealers, unwilling to extend long-term credit on personal security because of the uncertainties and delay of repayment, have adopted the retained title instalment sale device in order to turn over their stock. The instalment sale has become economically significant during the last thirty years [1] and a rapid increase in the volume of time sales, compared with personal loans and other types of credit, is noticeable since the Second World War.[2] Instalment selling in consumer goods develops where there exists a demand for the goods and an acceptance in the law and the community of time purchasing. A particular commodity will be the subject of instalment sales if there is either an orderly second-hand market for the commodity or consumers able to make a down payment sufficient to cover a large portion of the costs.[3] Few sellers are able to assume the burden of credit extension; the finance company and its counterpart, the consumer sales division of the bank, have developed to supply this service.[4] The financing institution is now an in-

1. PLUMMER AND YOUNG, SALES FINANCE COMPANIES AND THEIR CREDIT PRACTICES 73-6 (1940).

2. FED. RES. BULL. 186 (1954):

CONSUMER CREDIT
(Estimated amounts outstanding in millions of dollars)

End of Year	Installment Credit: Automobile Paper	Installment Credit: Other Consumer Goods Paper	Installment Credit: Personal Loans	Noninstalment Credit
1939	1,497	1,620	1,008	2,719
1945	455	816	1,009	3,203
1950	6,342	4,337	2,805	6,323
1953	10,289	5,605	4,307	7,089

3. Isaacs, *Instalment Selling: The Relation between Its Development in Modern Business and the Law*, 2 LAW & CONTEMP. PROB. 141, 141-5 (1935).

4. CHAPMAN, COMMERCIAL BANKS AND CONSUMER INSTALMENT CREDIT 21-6 (1940); Adelson, *The Mechanics of the Instalment Credit Sale*, 2 LAW & CONTEMP. PROB. 218, 218-9 (1935).

FED. RES. BULL. 186 (1954):

INSTALMENT CREDIT, BY HOLDER
(Estimated amounts outstanding in millions of dollars)

End of Year	Commercial Banks	Sales Finance Companies	Total Instalment Credit
1939	1,079	1,197	4,503
1941	1,726	1,797	6,085
1945	745	300	2,462
1949	4,439	2,950	11,516
1953	8,856	6,147	21,807

The term "financing institution" is used in this Note to refer to a bank or finance company in the business of purchasing instalment contracts and promissory notes from dealers.

tegral part of the merchandising system,[5] adding flexibility and increased purchasing power to the economy.

The problem with which this Note is concerned is illustrated by the following situation. Buyer agrees to an instalment purchase of an ultimately defective household appliance on the terms offered by Dealer. As is routine in such sales, Dealer notifies Finance Company which, determining Buyer's credit standing to be satisfactory, agrees to finance the impending sale. Buyer then signs a formal agreement which usually retains title to the goods in Dealer, either a conditional sales contract, a chattel mortgage or a bailment lease,[6] collectively referred to in this Note as instalment contracts. Concurrently, Buyer executes a promissory note for the unpaid balance, insurance and a carrying charge. The contract and note, both executed on forms supplied to Dealer by Finance Company,[7] are negotiated to Finance Company which then appears to be a bona fide purchaser for value of the contract and a holder in due course of the note [8] with a possible action for the purchase price free of Buyer's defenses.[9] Dealer becomes insolvent and Buyer refuses to make payments on the instalment contract because of the defects in the appliance. The subject

5. Note, 57 YALE L.J. 1414, 1416 (1948); Adelson, *supra* note 4, at 219.

6. A *conditional sale contract* is one in which the buyer takes immediate possession but title to the goods is reserved in the seller, usually until payment of part or all of the purchase price. UNIFORM CONDITIONAL SALES ACT § 1; National Cash Register Co. v. Pfeifer, 149 Kan. 582, 88 P.2d 1032 (1939); *see* Universal Finance Corp. v. Hamner, 61 S.D. 540, 544, 250 N.W. 33, 35 (1933); Russell v. Martin, 232 Mass. 379, 382, 122 N.E. 447, 448 (1919).

In a sale secured by a *chattel mortgage,* in a majority of states buyer takes title but seller maintains a lien on the goods. *See* Thurston v. Buxton, 218 Ind. 585, 589, 34 N.E.2d 549, 550 (1941); Loudon v. Cooper, 3 Wash.2d 229, 236, 100 P.2d 42, 45-6 (1940); Midland National Bank & Trust Co. v. Peterson, 229 Wis. 19, 20, 281 N.W. 683, 684 (1938). In a minority of states, the seller is said to reserve the legal title to the goods mortgaged and the buyer receives only the equitable title. *See* Cambridge Production Credit Ass'n v. Patrick, 140 Ohio St. 521, 527, 45 N.E.2d 751, 754 (1942); Personal Finance Co. of Providence v. Henley-Kimball Co., 61 R.I. 402, 410, 1 A.2d 121, 125 (1938). In either type of jurisdiction the mortgagee has first a money claim and, on default, the right to satisfy the debt from the goods mortgaged and a claim for a deficiency.

The *bailment lease* is seldom used for chattel sales, but proceeds on a theory that the goods are delivered to the bailee (buyer) with an option to buy or have rental payments applied to the purchase price. *See* Decker v. Williams, 130 Pa. Super. 100, 104-5, 196 Atl. 910, 912 (1938); Donnelly v. Mitchell, 119 Iowa 432, 436, 93 N.W. 369, 371 (1903).

7. The bank or finance company supplies the instalment contract and promissory note forms to the dealer as a matter of convenience and protection for itself. Were the financing institution required to rely on forms drafted by each vendor, it would be forced to have its counsel study each instrument, adding delay and expense to the financing process.

Information regarding the operation of consumer credit institutions has been gained through interviews with the officers and counsel of many of the banks and finance companies in the Philadelphia area. For a comprehensive discussion of the practical operations of consumer credit financing, see PLUMMER AND YOUNG, *op. cit. supra* note 1; Cox, THE ECONOMICS OF INSTALMENT BUYING (1948); Adelson, *supra* note 4.

8. Cotton v. John Deere Plow Co., 246 Ala. 36, 18 So.2d 727 (1944); B. A. C. Corp. v. Cirucci, 131 N.J.L. 93, 35 A.2d 36 (Sup. Ct. 1944); United States v. Novsam Realty Corp., 125 F.2d 456 (2d Cir. 1942).

9. See text *infra* at notes 24-9.

of this Note, of importance to both Buyer and Finance Company, is whether Buyer or Finance Company will bear the loss from the sale of the defective goods.

Under the Uniform Negotiable Instruments Law, a financing institution is usually deemed a holder in due course when it takes a negotiable instrument in good faith and without notice of an infirmity in the instrument or a defect in the title of the one negotiating it to him.[10] As a holder in due course, the financing institution holds the instrument free from any defenses of breach of warranty and failure of consideration which may be available to the maker against the dealer and "may enforce payment of the instrument for the full amount thereof against all parties liable thereon." [11] Ordinarily, therefore, a buyer of defective goods is liable to the financing institution for the full contract price with only an action against the dealer; such an action has little value if the dealer is insolvent.[12] Under some recent statutes and decisions,[13] however, the financing institution is made subject to the buyer's defenses and thus held responsible for the quality of goods sold by denying to the financing institution the rights of a holder in due course. Presumably, the basis for such a result is that the necessitous borrower should be protected from bearing the burden of the dealer's defaults when the financing institution is so close to the original sale that it is, or should be, aware of defects in the goods sold by the dealer.

Because of the split in opinion as to whether the financing institution, regularly taking from dealers simultaneous indorsements of buyers' notes and assignments of instalment contracts, is a holder in due course and because courts frequently appear to neglect the practical implications of such a decision, it is desirable to examine the problem and the doctrines most widely used to meet it.[14] In so doing, this Note will discuss the applicable provisions of the Negotiable Instruments Law, indicate the pos-

10. NEGOTIABLE INSTRUMENTS LAW § 52: "A holder in due course is a holder who has taken the instrument under the following conditions:

. . .

3. That he took it in good faith and for value;

4. That at the time it was negotiated to him he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it."

NEGOTIABLE INSTRUMENTS LAW § 56 provides:
"To constitute notice of an infirmity in the instrument or defect in the title of the person negotiating the same, the person to whom it is negotiated must have had actual knowledge of the infirmity or defect, or knowledge of such facts that his action in taking the instrument amounted to bad faith."

11. NEGOTIABLE INSTRUMENTS LAW § 57. The Negotiable Instruments Law is cited hereafter in this Note as the NIL.

12. United States v. Novsam Realty Corp., 125 F.2d 456 (2d Cir. 1942); Peoples Loan & Finance Co. v. Ledbetter, 69 Ga. App. 729, 26 S.E.2d 671 (2d Div. 1943); White System of New Orleans v. Hall, 219 La. 440, 53 So.2d 227 (1951).

13. PA. STAT. ANN. tit. 69, § 615 G (Purdon Supp. 1953); Mutual Finance Co. v. Martin, 63 So.2d 649 (Fla. 1953) and cases cited *infra* note 28.

14. For similar problems arising in the fields of industrial, accounts receivable and inventory financing, see SAULNIER AND JACOBY, FINANCING EQUIPMENT FOR COMMERCIAL AND INDUSTRIAL ENTERPRISE (1944); Koch, *Economic Aspects of Inventory and Receivables Financing*, 13 LAW & CONTEMP. PROB. 566 (1948); SAULNIER AND JACOBY, ACCOUNTS RECEIVABLE FINANCING (1943).

sible changes under the Uniform Commercial Code, and attempt to suggest a practical solution acceptable to both the consumer and the financing institution.

RIGHTS OF THE FINANCING INSTITUTION ON DEFAULT

Although the financing institution's action on the promissory note of a defaulting buyer is the primary concern of this Note, it is important, for the sake of perspective, to examine briefly the alternative remedies available to the financing institution. These consist, generally, of an action to gain possession of the goods and an action for the sales price according to the terms of the assigned contract.

Repossession of the Chattel

When a buyer defaults in his payments, he is sent a series of form letters of increasing severity and, if payments are not forthcoming, he personally is contacted, usually by the financing institution's claim adjuster. In practice, the financing institution ordinarily will respect a valid claim that the goods are defective and will attempt to secure an adjustment between the buyer and dealer before taking any action against the buyer.[15] The continued prosperity of the financing institution depends upon the dealer's remaining in business; excessive litigation injures both the good will of the financing institution and the reputation of the seller. If the buyer's dissatisfaction seems unwarranted, however, procedures to repossess are instituted.

Most contracts used in instalment sales provide that upon default the seller may take possession of the article sold without demand and without legal process. The same result may be reached even in the absence of such a repossession clause under the basic title retention clause.[16] However, a repossession action is generally ineffective where the goods are either unavailable, or of greatly diminished value, or where repossession by legal action would subject the financing institution to personal defenses.

Recovery on the Contract

Since the rights of the assignee of an instalment contract are no greater than those of his assignor, the right of the financing institution to recover the sales price in an action on the contract, rather than on the negotiable instrument, will be subject to the defenses of the buyer, although a few cases holding that the note "imports negotiability" to the contract have

15. These conclusions are drawn from interviews with officers in the consumer credit departments of leading banks and finance companies in the Philadelphia area. It is recognized that there are wide variances in these practices in the instalment financing field.

16. Blackford v. Neaves, 23 Ariz. 501, 205 Pac. 587 (1922); Federal Sales Co. of Philadelphia v. Kiefer, 273 Pa. 42, 116 Atl. 545 (1922).

"Repossession" is a term of art employed by the courts and in this Note to mean gaining of possession, whether by the dealer or his assignee, of the chattel which is the subject and security of the instalment sale.

permitted replevin of the goods free of contract defenses.[17] Conscious of the availability of buyers' defenses, financing institutions seek to employ devices which will bar the defenses. The principal device used for this purpose is, of course, a negotiable instrument executed for the purchase price (these notes are discussed below),[18] but occasionally similar results are obtained by including waiver clauses in the instalment contract itself. Many courts have found no reason for denying parties the right to contract away *specific* defenses which involve no moral turpitude or statutory illegality. For instance, specific waivers of breach of warranty are usually enforced.[19] However, the majority of cases hold *general* waivers of defenses invalid as attempts to settle the substantive rights of the parties and oust the courts of their jurisdiction, contrary to public policy.[20] Such a rule is warranted by a recognition of the disparity of bargaining power between buyer and dealer (most buyers have little choice but to accept a contract drawn by the skilled attorneys of the financing institution) and an awareness that denying the buyer a defense on the contract against the assignee shifts the risk of loss to the one least able to afford it.[21]

Recovery on the Negotiable Instrument

The financing institution resorts to its action on the promissory note when it has no recourse against the dealer or when repossession or a suit

17. Commercial Credit Co. v. Seale, 30 Ala. App. 440, 8 So.2d 199 (1942); Thal v. Credit Alliance Corp., 64 App. D.C. 328, 78 F.2d 212 (1935); Howard v. Trusco Finance Co., 87 Ga. App. 509, 74 S.E.2d 379 (2d Div. 1953); Commercial Credit Co. v. Summers, 154 Miss. 501, 122 So. 541 (1929).

18. See text following note 21 *infra*.

19. United States *ex rel.* and for benefit of Administrator of FHA v. Troy-Parisian, Inc., 115 F.2d 224 (9th Cir. 1940); President and Directors of Manhattan Co. v. Monogram Associates, Inc., 87 N.Y.S.2d 753 (Sup. Ct. 1949); Anglo-California Trust Co. v. Hall, 61 Utah 223, 211 Pac. 991 (1922). See Beutel, *Negotiability by Contract*, 28 ILL. L. REV. 205, 214-7 (1933); VOLD, SALES 468-9 (1931); Gilmore and Axelrod, *Chattel Security: I*, 57 YALE L.J. 517, 544-6 (1948); Comment, 8 WIS. L. REV. 272 (1933).

Section 71 of the Uniform Sales Act permits an express waiver of any implied warranties of title or quality created under §§ 13-6. This policy is apparently followed in § 2-316 of the Uniform Commercial Code.

A waiver of failure of consideration has been held to be effective. Jones v. Universal C. I. T. Credit Corp., 88 Ga. App. 24, 75 S.E.2d 822 (1st Div. 1953) (waiver consistent with public policy allowed by statute). But the purchaser was not bound by his waiver where a total failure of consideration was shown. American National Bank of San Francisco v. A. G. Sommerville, Inc., 191 Cal. 364, 216 Pac. 376 (1923) (nondelivery and no estoppel *in pais*).

20. Equipment Acceptance Corp. v. Arwood Can Mfg. Co., 117 F.2d 442 (6th Cir. 1941); Industrial Loan Co. of Cape Girardeau v. Grisham, 115 S.W.2d 214 (Mo. App. 1938); Progressive Finance and Realty Co. v. Stempel, 231 Mo. App. 721, 95 S.W.2d 834 (1936); Motor Contract Co. v. Van Der Volgen, 162 Wash. 449, 298 Pac. 705 (1931); Malas v. Lounsbury, 193 Wis. 531, 214 N.W. 332 (1927); San Francisco Securities Corp. v. Phoenix Motor Co., 25 Ariz. 531, 220 Pac. 229 (1923) (interpreting state statute). *Contra:* Refrigeration Discount Corp. v. Haskew, 194 Ark. 549, 108 S.W.2d 908 (1937).

21. However, a clause commonly inserted in the instalment contract whereby buyer acknowledges delivery and represents that he has no defense against the dealer, has been held to estop the buyer from denying delivery where assignee had no prior notice of nondelivery. Thorp Finance Corp. v. LeMire, 264 Wis. 220, 58 N.W.2d 641 (1953). *Contra:* American National Bank of San Francisco v. A. G. Sommerville, Inc., 191 Cal. 364, 216 Pac. 376 (1923).

on the contract would fail to satisfy the debt, as when the value of the chattel is low or the buyer's defenses in a legal proceeding are effective. When a dealer becomes insolvent its financing house can be left holding contracts and notes with many years to run. Where its recourse against the dealer is inadequate, the financing institution is forced, despite buyers' complaints, to abandon its adjustment policy in favor of actions on the notes. If these actions are successful, the remedies of the buyers against an insolvent dealer on his personal contracts are of little value. Therefore, the buyer with a good defense requires protection when the dealer becomes insolvent or when a financing institution presses its claim without regard to the equities of the buyer.[22] The buyer may protect himself only by asserting his defenses against the financing institution and these are not available if the financing institution is a holder in due course.

The financing institution can be a holder in due course only of a negotiable instrument. To be negotiable, the note must be in writing, must contain an unconditional promise to pay a sum certain in money and must be payable at a fixed or determinable future time.[23] Generally, a note, if otherwise negotiable, does not lose its negotiability because it was executed concurrently with an instalment sale agreement[24] or because it evidences its identification with the contract,[25] since these facts do not render unconditional the promise to pay. On occasion, the contract itself has been drafted successfully as a negotiable instrument.[26] In the usual case, however, as a measure of protection to the buyer from the ultimate loss on defective merchandise, most courts hold that an instalment contract is not negotiable and cannot be made so merely by a specific stipulation.[27]

Physical attachment of the note to an instalment sale contract with intent that it be detached does not destroy negotiability,[28] nor is detachment

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22. For a description of improper practices of the predatory finance company see PLUMMER AND YOUNG, *op. cit. supra* note 1, at 231-43.

23. NIL § 1.

24. Each document is to be interpreted as a separate entity. Northwestern Finance Co. v. Crouch, 258 Mich. 411, 242 N.W. 771 (1932); National Bond & Investment Co. v. Lanners, 253 Ill. App. 262 (1928); *cf.* International Finance Co. v. Magilansky, 105 Pa. Super. 309, 161 Atl. 613 (1932).

25. NIL § 3: "An unqualified order or promise to pay is unconditional . . . , though coupled with—

1. . . .
2. A statement of the transaction which gives rise to the instrument. . . ."

First & Lumbermen's National Bank of Chippewa Falls v. Buchholz, 220 Minn. 97, 18 N.W.2d 771 (1945); Shawano Finance Corp. v. Julius, 214 Wis. 637, 254 N.W. 355 (1934); National Bond & Investment Co. v. Lanners, 253 Ill. App. 262 (1928); Continental Guaranty Corp. v. Peoples Bus Line Inc., 31 Del. 595, 117 Atl. 275 (Super. Ct. 1922).

26. Abingdon Bank & Trust Co. v. Shipplett-Moloney Co., 316 Ill. App. 79, 43 N.E.2d 857 (1942); Commercial Credit Co. v. Seale, 30 Ala. App. 440, 8 So.2d 199 (1942); both cases holding that the contract is negotiable and giving judgment for the financing institution as a holder in due course. *Cf.* Peoples Loan & Finance Co. v. Ledbetter, 69 Ga. App. 729, 26 S.E.2d 671 (2d Div. 1943).

27. *E.g.*, Carpenter v. Commercial Credit Co., 196 Ark. 475, 118 S.W.2d 581 (1938); Taylor v. Goodrich Tire & Rubber Co., 20 Tenn. App. 352, 98 S.W.2d 1094 (1935); American National Bank of San Francisco v. A. G. Sommerville, Inc., 191 Cal. 364, 216 Pac. 376 (1923).

28. See text at note 23 and note 25 *supra*.

of the note from the instalment contract a material alteration which would discharge the buyer from liability.[29] However, a few decisions conclude that the note is nonnegotiable where an instalment contract is concurrently assigned to the indorsee, on the theory that the promise to pay in the note is conditioned on the payee's performance of his contractual duties.[30] If it is the conditional character of the contract which deprives the note of negotiability, it seems that this theory should prevail even where the contract was not assigned, but such is not the law.[31]

The financing institution as an indorsee of a negotiable note has rights greater than those of the dealer-payee and is free of personal defenses only if it is a holder in due course.[32] To achieve this status, it must take the negotiable instrument in good faith and without notice of an infirmity in the instrument or a defect in the title of its indorser.[33] Knowledge that the note was issued concurrently with an instalment contract does not charge the financing institution with notice of infirmities, if none appear on the face of the instrument,[34] or of defenses of the maker, if it had no actual knowledge of a breach in the contract at the time of indorsement [35] even though the condition is known to be executory.[36] Thus a

29. Muskegon Citizens' Loan & Investment Co. v. Champayne, 257 Mich. 427, 241 N.W. 135 (1932); Crane v. Guaranty Finance Corp., 141 Miss. 692, 105 So. 485 (1925); Stevens v. Vermillion, 109 Kan. 504, 200 Pac. 277 (1921).

NIL § 124: "Where a negotiable instrument is materially altered without the assent of all parties liable thereon, it is avoided, except as against a party who has himself made, authorized or assented to the alteration. . . ."

30. Cooke v. Real Estate Trust Co., 180 Md. 133, 22 A.2d 554 (1941); Von Nordheim v. Cornelius, 129 Neb. 719, 262 N.W. 832 (1935); *cf.* Federal Credit Bureau, Inc. v. Zelkor Dining Car Corp., 238 App. Div. 379, 264 N.Y.S. 723 (1st Dep't 1933), *overruled on other grounds,* Gellens v. 11 West 42d Street, Inc., 259 App. Div. 435, 19 N.Y.S.2d 525 (1st Dep't 1940) (rental agreement for a sign having features of a conditional sales contract).

31. See text at note 23 and see note 25 *supra.*

32. Peoples Loan & Finance Co. v. Ledbetter, 69 Ga. App. 729, 26 S.E.2d 671 (2d Div. 1943); *cf.* United States v. Novsam Realty Corp., 125 F.2d 456 (2d Cir. 1942).

NIL § 58: "In the hands of any holder other than a holder in due course, a negotiable instrument is subject to the same defenses as if it were nonnegotiable. . . ."

33. See note 10 *supra.*

34. United States v. Novsam Realty Corp., 125 F.2d 456 (2d Cir. 1942); Robertson v. Northern Motor Securities Co., 105 Fla. 644, 142 So. 226 (1932); *cf.* B. A. C. Corp. v. Cirucci, 131 N.J.L. 93, 35 A.2d 36 (Sup. Ct. 1944) (by terms of contract, dealer gave no warranties, express or implied).

35. Cotton v. John Deere Plow Co., 246 Ala. 36, 18 So.2d 727 (1944); White System of New Orleans, Inc. v. Hall, 219 La. 440, 53 So.2d 227 (1951); Standard Acceptance Corp. v. Chapin, 277 Mass. 278, 178 N.E. 538 (1931); Baker State Bank v. Grant, 54 Mont. 7, 166 Pac. 27 (1917); Eastern Acceptance Corp. v. Kavlick, 10 N.J. Super. 253, 77 A.2d 49 (1950); International Finance Co. v. Magilansky, 105 Pa. Super. 309, 161 Atl. 613 (1932).

36. Thal v. Credit Alliance Corp., 64 App. D.C. 328, 78 F.2d 212, *cert. denied,* 296 U.S. 598 (1935); Cotton v. John Deere Plow Co., 246 Ala. 36, 18 So.2d 727 (1944); People's Bank v. Porter, 58 Cal. App. 41, 298 Pac. 200 (3d Dist. 1922); Petroleum Acceptance Corp. v. Queen Anne Laundry Service, Inc., 265 App. Div. 692, 40 N.Y.S.2d 495 (2d Dep't 1943).

financing institution which is a bona fide purchaser of an instalment contract and a promissory note may be a holder in due course, and it is usually so held.[37]

Notwithstanding this generally accepted interpretation of the Negotiable Instruments Law, some cases in which personal defenses were raised shift the loss to the financing institution. Some of these cases, while acknowledging the negotiability of the note, hold that the financing institution is limited to the rights and obligations of its assignor and subject to all defenses, on the theory that, since the contract and note were assigned together, the financing institution takes the note with notice that payment is subject to fulfillment of the contract conditions and therefore cannot be a holder in due course.[38] Some other recent cases deny the financing institution the rights of a holder in due course because of the closeness of its relationship with the dealer.[39] In *Mutual Finance Co. v. Martin*,[40] a buyer executed an instalment contract and a promissory note in favor of the dealer for the purchase of a deep freezer. The paper was indorsed and assigned immediately to the finance company which had investigated the buyer's credit rating and had agreed to purchase the contract and note, both of which were executed on its forms. In denying the status of holder in due course to the finance company, the court held that the company was so close to the sale that it could not claim to be an innocent purchaser of the note without notice that the deep freezer was defective.[41]

Ordinarily, the mere furnishing to the dealer of the sales forms is not sufficient to impute knowledge of existing defenses to the financing institution,[42] but it is a factor which courts may utilize to find the necessary close relationship.[43] In *Mutual Finance Co. v. Martin* and similar decisions,[44] the courts emphasized not only that the financing institution

37. Cases cited notes 34-6 *supra.*

38. First & Lumbermen's National Bank of Chippewa Falls v. Buchholz, 220 Minn. 97, 18 N.W.2d 771 (1945); State National Bank of El Paso v. Cantrell, 47 N.M. 389, 143 P.2d 592 (1943); C. I. T. Corp. v. Joffe, 157 Misc. 225, 283 N.Y.S. 881 (N.Y. Munic. Ct. 1935), *rev'd on other grounds,* 162 Misc. 328, 293 N.Y.S. 659 (1st Dep't 1937); Heiman v. Murphy, 143 Misc. 81, 256 N.Y.S. 20 (N.Y. Munic. Ct. 1932); Sloan Lumber Co. v. Ambrose, 26 S.W.2d 348 (Tex. Civ. App. 1930).

39. Mutual Finance Co. v. Martin, 63 So.2d 649 (Fla. 1953), 39 VA. L. REV. 830; Commercial Credit Corp. v. Orange County Machine Works, 34 Cal.2d 766, 214 P.2d 819 (1950), 25 ST. JOHN'S L. REV. 107; Palmer v. Associates Discount Corp., 124 F.2d 225 (D.C. Cir. 1941); Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940); Buffalo Industrial Bank v. De Marzio, 162 Misc. 742, 296 N.Y.S. 783 (Buffalo City Ct. 1937), *rev'd by default,* 6 N.Y.S.2d 568 (Sup. Ct. 1937); Taylor v. Atlas Security Co., 213 Mo. App. 282, 249 S.W. 746 (1923). *But cf.* Standard Motors Finance Co. v. Yellow Bayou Gin & Planting Co., 1 La. App. 424 (1925); Mayer v. American Finance Corp., 172 Okla. 419, 45 P.2d 497 (1935); International Finance Co v. Magilansky, 105 Pa. Super. 309, 161 Atl. 613 (1932).

40. 63 So.2d 649 (Fla. 1953).

41. See note 10 and text at note 11 *supra.*

42. International Finance Co. v. Magilansky, 105 Pa. Super. 309, 161 Atl. 613 (1932); Standard Motors Finance Co. v. Yellow Bayou Gin & Planting Co., 1 La. App. 425 (1925) (by implication).

43. See note 39 *supra.*

44. Cases cited note 39 *supra.*

supplied the forms, often being named in an assignment printed on them, but also that it bought the paper from the dealer in the regular course of its business, after first checking the buyer's credit and approving the sale, took an indorsement of the note and a simultaneous assignment of the sales agreement immediately after the sale, and collected the instalments as they fell due. After examining the business relation between the dealer and the financing institution, these cases conclude that the financing institution is not entitled to protection as a holder in due course either because it was so close to the original sale that it could not be an innocent purchaser of the note or because it is deemed a party to the sale. The tenor of these decisions is that the financing institution should not be permitted "to isolate itself behind the fictional fence of the law merchant" [45] and thereby achieve an unfair advantage over the buyer.[46]

The effect of decisions which deprive the indorsee of its status as a holder in due course may be to force financing institutions to dissociate from dealers to the extent that they will enter transactions only after the sales are consummated. If this is the result, a buyer would lose what benefit he now secures from supervision of the dealer by a financing institution and would still be unable to set up his defenses against the holder of the note.[47] It is possible, on the other hand, that the financing institution would abandon attempts to become a holder in due course and tighten its control over the sales of the dealer to eliminate some causes of buyer dissatisfaction; but this alternative is less likely. Bank officers point out that all of the activities which courts have felt deprive a financing institution of its status as a holder in due course are commonly carried on by the financing institution to facilitate sales and to permit the dealer to learn in advance whether the instruments will be marketable if the sale is effected. Financing organizations in fact learn little of the quality of the goods or of the fairness of the price from these general business practices upon which the courts base their decisions.[48] But the courts in these cases are warranted in their interpretation of the Negotiable Instruments Law where the dealer is no more than an agent of the financing institution for the loan of its funds.

While cases such as *Mutual Finance Co. v. Martin* do prevent injury to an innocent buyer of defective merchandise, such decisions are not general remedies since they leave unaltered the conditions and practices which create the need for adequate defenses. These will be corrected only by

45. Buffalo Industrial Bank v. De Marzio, 162 Misc. 742, 744, 296 N.Y.S. 783, 786 (Buffalo City Ct. 1937), *rev'd by default*, 6 N.Y.S.2d 568 (Sup. Ct. 1937).

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

47. But one court has found that where the bank requires a certificate of satisfactory completion signed by the buyer as a condition precedent to purchase of the paper, the bank relies on more than the negotiability of the note, and has denied it the rights of a holder in due course in such circumstances. Allied Building Credits, Inc. v. Ellis, 258 S.W.2d 165 (Tex. Civ. App. 1953).

48. Kripke, *Chattel Paper as a Negotiable Speciality Under the Uniform Commercial Code*, 59 YALE L.J. 1209, 1220-1 (1950).

special legislation designed to regulate instalment sales. The current of mutual interest between the dealer and the financing institution runs much deeper than the cases disclose. The degree of control which the financing institution exercises over the dealer's sales and the several devices it employs in order to protect itself from loss offer bases for a legislative determination of the amount of protection which should be afforded to the buyer or the financing institution.

THE INTERRELATION OF DEALER AND FINANCING INSTITUTION

The dealer depends upon the financing institution to establish a financing charge which will permit a large volume of business at a competitive price,[49] and, in turn, the financing institution secures its profits from the instalment sales the dealer is able to make. Recognizing that its business is dependent on the financial standing and past experience of the dealer, a financing institution will check the credit rating of a dealer with his suppliers and banks and run spot checks at frequent intervals on his methods of selling and quality of merchandise.[50] In addition to supervision of the dealer, a financing institution employs several contractual devices in its relationship with the dealer to protect itself from ultimate loss where defective goods are sold.

Recourse Indorsements.—The contract and note forms which the financing institution provides often have three or more bases of assignment or indorsement printed on them.[51] The dealer may adopt a full recourse indorsement by which he will be liable for the balance due if the buyer defaults on any instalment. If the dealer wishes a measure of security for the possible conversion or destruction of the item sold he might sign without recourse.[52] This relieves him of all liability except for the statutory warranties made by a qualified indorsement[53] or any warranties

49. Ecker, *Commentary on "Usury in Instalment Sales,"* 2 LAW & CONTEMP. PROB. 173, 179-84 (1935).

50. PLUMMER AND YOUNG, *op. cit. supra* note 1, at 113-4.

51. See Palmer v. Associates Discount Corp., 124 F.2d 225, 227 (D.C. Cir. 1941); Schuck v. Murdock Acceptance Corp., 220 Ark. 56, 247 S.W.2d 1 (1952). See generally Adelson, *supra* note 4, at 220-2; Cavers, *The Consumer's Stake in the Finance Company Code Controversy,* 2 LAW & CONTEMP. PROB. 200, 202-10 (1935).

52. An indorsement without recourse is not restrictive under § 36 of the Negotiable Instruments Law but is a qualified indorsement under § 38, which does not impair the negotiable character of the instrument. *E.g.,* Eastern Acceptance Corp. v. Kavlick, 10 N.J. Super. 253, 77 A.2d 49 (1950); Standard Acceptance Corp. v. Chapin, 277 Mass. 278, 178 N.E. 538 (1931). See note 53 *infra.*

53. NIL § 38: "A qualified indorsement . . . may be made by adding to the indorser's signature the words 'without recourse,' or any words of similar import. Such an indorsement does not impair the negotiable character of the instrument."

NIL § 65: "Every person negotiating an instrument by delivery or by a qualified indorsement, warrants

1. That the instrument is genuine and in all respects what it purports to be;
2. That he has a good title to it;
3. That all prior parties had capacity to contract;
4. That he has no knowledge of any fact which would impair the validity of the instrument or render it valueless. . . ."

or guarantees he may give the financing institution by separate agreement. Banks are circumspect in accepting paper on a nonrecourse basis and demand that the purchaser be a good risk or that the dealer give other guarantees with the indorsement.

Repurchase Agreements.—It is common to accompany a nonrecourse indorsement with a repurchase agreement which, if the repossessed chattel is delivered by the financing institution to the dealer, may either bind him to pay the entire unpaid balance on default or give him an option to pay the unpaid balance or a stated amount. In either case, the dealer is released from liability and has possession of the chattel. In such repurchase plans, the financing institution ordinarily is obliged to repossess within a given period after default, thus giving the dealer some protection against losses on a stolen or destroyed article.[54] In other types of agreements, the dealer may consent to partial liability, such as a guarantee of a certain number of payments or of an amount equal to the deficiency between the buyer's down payment and the down payment requested by the financing institution.

Warranties.—In addition, a dealer customarily signs a standard contract with the financing institution by which he unconditionally warrants and guarantees his title to the merchandise he sells, the validity of the paper he indorses to the financing institution, delivery of the goods and the absence of any claims or set-offs against the contracts. The dealer may also agree to file or record the instruments. Such warranties offer the financing institution protection against loss resulting from these defects and are valuable where no other recourse is available.

Reserve Plans.—The nonrecourse indorsement and repurchase plan is often accompanied by a reserve arrangement under which the financing institution credits to the dealer's account a fixed percentage (commonly one-third) of the financing charge, *i.e.,* the difference between the instalment contract price and the cash sale price. Against this reserve the financing institution will charge any losses suffered by it on delinquent payments, added collection expenses and any other liabilities incurred in handling the dealer's paper. When the reserve exceeds a certain fixed percentage of the total payments receivable on that dealer's sales or when the financing institution has little paper of that dealer outstanding and the dealer-financing organization arrangement is terminated, the excess or total amount is paid to the dealer.[55] For the efficient dealer whose customers seldom default, this reserve bonus arrangement offers a real source of income in addition to the ordinary profit on his sales and is exploited as a competitive device by financing institutions in bidding for the accounts of automobile and large appliance dealers.

54. Pacific Finance Corp. of California v. Burkhart, 56 Ariz. 383, 108 P.2d 380 (1940).

55. See Schuck v. Murdock Acceptance Corp., 220 Ark. 56, 60, 247 S.W.2d 1, 3-4 (1952).

The financing institution holds a dominant position in three-party instalment sales and is better equipped than the average buyer to check on the over-all operations and continuing solvency of its dealers. The usual control which a financing institution enjoys over a dealer demonstrates the logic of those decisions which permit personal defenses against the financing institution. It is important to the financing institution to have the rights of a holder in due course of a note given with an instalment contract when its recourse against the dealer is inadequate or when the dealer is insolvent. Yet granting these rights to the financing institution when the dealer is insolvent places the ultimate loss for defective goods on the buyer, for his remedy against the dealer is worthless. The buyer pays a premium for the privilege of buying on time; his instalments include a charge for insurance, a profit for the financing institution and often a bonus for the dealer. These payments should also entitle the buyer to protection against defective goods, but few courts have interpreted the Negotiable Instruments Law to afford this protection to the buyer.

THE SOLUTION OFFERED BY THE CODE

The Uniform Commercial Code, by offering limited but definite rights to the buyer, represents an advance over the Negotiable Instruments Law, but the advance is a compromise and far from satisfactory. Under the Code, the instalment buyer of any goods not to be used for personal, household or family purposes[56] may effectively waive all claims and defenses against the financing institution which takes for value, in good faith and without notice of a claim or defense.[57] The waiver may be made explicitly in the contract or by executing a note with the instalment contract. This

56. The author of a recent article points out what he considers to be two serious technical defects in the handling of this problem by the Code. Kripke, *supra* note 48, at 1217. The Code does not disclose how an indorsee is to discover, first, that the note arose in a secured transaction and, second, that the article purchased was a consumer good, both of which facts affect his rights as a holder of the paper under § 9-206. Kripke points out, *supra* note 48, at 1217 n.21, that:

> "'Consumer goods' are defined in § 9-109 (1) to mean goods used for the debtor's personal, family or household purposes. Thus a passenger automobile is or is not a consumer good depending on whether it is used for family or for business purposes."

All references to the Uniform Commercial Code (cited throughout this Note as UCC) are to the Official Draft of the Uniform Commercial Code as proposed by the American Law Institute and the National Conference of Commissioners on Uniform Laws, Text and Comments Edition (1952). The only state to adopt the Code to date is Pennsylvania where it will take effect on July 1, 1954. See PA. STAT. ANN. tit. 12A (Purdon Supp. 1953).

57. But a waiver of those defenses which may be asserted against a holder in due course is ineffective. UCC § 9-206 (2) provides:

> "In all other cases an agreement by a buyer that he will not assert against an assignee any claim or defense arising out of the sale is enforceable by an assignee who takes his assignment for value, in good faith and without notice of claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the Article on Commercial Paper (Article 3). A buyer who as part of one transaction signs both a negotiable instrument and a security agreement makes such an agreement."

codifies the view that the purchaser of goods for industrial or business purposes is not in so weak a bargaining position as to deserve special protection.

However, a contractual waiver of defenses against the assignee of the instalment contract is not effective if it is made by a purchaser of consumer goods. Similarly, a holder in due course of a note executed concurrently with the instalment sale of consumer goods is subject to defenses only if he seeks either to enforce the contract or to levy on the goods themselves after getting a judgment on the note.[58] These are apparently the only protections gained by the purchaser of consumer goods under an instalment sale agreement governed by the Code. With regard to whether the financing institution is subject to the defenses of the buyer in a suit on the note, a comment to the relevant section states that:

> ". . . there are indications in the case law that courts are beginning to question the holder-in-due-course status of finance companies or banks regularly discounting a dealer's consumer chattel paper. This Article takes no position on whether such a bank or finance company is or is not a holder in due course; that question remains to be determined under . . . [the Article on negotiable instruments]." [59]

The determination of this question appears to be no clearer under the Code than it is under the NIL.

The Code adds as a qualification to the usual requirements of the NIL,[60] that:

> "A holder in due course is a holder who takes the instrument
>
> (a) . . .
>
> (b) in good faith *including observance of the reasonable commercial standards of any business in which the holder may be engaged. . . .*" [61]

This added clause may offer a peg on which courts might hang a denial to financing institutions of holder in due course status in instalment sales and thus make effective the buyer's defenses in those cases not specifically covered by the Code; at least it would make such a decision easier to support. Yet it does not appear that the new language imposes upon the bank

58. UCC § 9-206 (1) provides:

"An agreement by a buyer of consumer goods as part of the 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 interest either by proceeding under the security agreement or by attaching or levying upon the goods in an action upon the instrument."

59. UCC § 9-206, comment 2.

60. See note 10 *supra*.

61. UCC § 3-302 (italics added).

or finance company a higher duty of investigation and supervision of the dealer's transactions than does the present case law of each state under the NIL. A comment to this section states that:

> "The 'reasonable commercial standards' language added here . . . merely makes explicit what has long been implicit in case law handling of the 'good faith' concept." [62]

Since there are few cases in which the "good faith" of the financing institution is successfully challenged,[63] this section is not likely to alter current business practices in any way favorable to the consumer. A more adequate and predictable solution demands that the problem be dealt with by specific legislative action.

LEGISLATIVE REMEDIES

As part of a comprehensive scheme to regulate the entire instalment sales transaction, some states solve the problem of when the financing institution should be a holder in due course by allowing the buyer who executes a negotiable instrument in addition to the contract to assert against subsequent holders all defenses he may have against the dealer.[64] Such legislation might, like the Maryland Retail Instalment Sales Act,[65] encompass all retail instalment sales, or, like the Pennsylvania Motor Vehicle Sales Financing Act,[66] it might apply only to the sales of a specific class of merchandise. This type of legislation offers needed protection to the buyer and eliminates uncertainties in the position of the financing institution, forcing it to arrange for adequate recourse against its dealers and to adjust the financing charge to meet the risks involved.

CONCLUSION

Those cases which permit a financing institution to exercise the rights of a holder in due course against an instalment buyer when the dealer is insolvent place the loss for defective merchandise squarely on the buyer, for his remedy against the dealer is worthless. A similar burden rests

62. UCC § 3-302, comment 1.

63. See cases cited note 39 *supra*.

64. MD. ANN. CODE GEN. LAWS art. 83, § 134 (Flack 1951):

"If, as part of an instalment transaction, a note is taken by the seller or finance company, such note shall refer to the instalment agreement out of which it arises and, in the hands of any subsequent holder, such note shall be subject to all defenses which the buyer might have asserted against the seller or . . . [finance] company. . . ."

PA. STAT. ANN. tit. 69, § 615 G (Purdon Supp. 1953):

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

65. MD. ANN. CODE GEN. LAWS art. 83, §§ 116-40 (Flack 1951).

66. PA. STAT. ANN. tit. 69, §§ 601-37 (Purdon Supp. 1953).

on the buyer even if the dealer is solvent, because few buyers are able to afford the cost of legal action to recover their loss on the sale. The best solution lies in special legislation providing for regulation of the entire instalment sales system and permitting a buyer to assert such defenses against the financing institution as he may have against the dealer.

It may be contended that denying holder in due course status on instalment bank notes to banks and financing companies will force them to resort to personal loans or to deal only with financially sound houses, driving the small firm out of business. Even if the small dealer who is a sound moral risk is not able to find a market for his paper, there is no reason consciously to protect the economically weak dealer to the detriment of a large class of instalment buyers. Under such instalment sales legislation, the financing institution, unless it wishes to be a self-insurer, will deal with reputable dealers on a full recourse and repurchase basis, which should not cause a decrease in the volume of consumer sales. The financing institution would discount instalment contracts and notes where the charge is commensurate with the risk and, if a default occurs and a contract defense is asserted, require that the dealer repurchase the paper and adjust for himself the dissatisfaction of the consumer. This would shift from the buyer to the financing institution the risk of dealer insolvency, placing the risk on one better able to anticipate it and to bear any resulting losses.