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Bonnie Packer

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THE FEDERAL TRADE COMMISSION RULE ON THE
PRESERVATION OF CONSUMERS' CLAIMS AND
DEFENSES—WHAT PRICE PROTECTION?

INTRODUCTION

When a consumer contracts to purchase an item such as a household appliance, he may sign a separate promissory note evidencing his credit arrangement with the retail seller. The seller, in turn, often discounts\(^1\) this note to a finance company, which will take over collection of the debt. Under the Uniform Commercial Code the finance company is considered a holder in due course (HDC) if it takes the note for value, in good faith, and without knowledge of any defenses the consumer may have against the seller.\(^2\) A holder in due course takes the contract free of any personal defenses the signer of the note would have against the original seller.\(^3\) Thus, if the appliance breaks down and the consumer is unsuccessful in his attempts to secure redress from the seller, he will probably stop payments on the note. The financer, asserting HDC status, can demand that the consumer complete his obligation regardless of complaints the

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1. A note is "discounted" when it is purchased for a price less than its face value.
2. **Uniform Commercial Code** § 3-302(1) [hereinafter cited as UCC] provides:
   (1) A holder in due course is a holder who takes the instrument
   (a) for value; and
   (b) in good faith; and
   (c) without notice that it is overdue or has been dishonored
   or of any defense or claim to it on the part of any person.
3. UCC § 3-305 provides:
   To the extent that a holder is a holder in due course he takes the instrument free from
   (1) all claims to it on the part of any person; and
   (2) all defenses of any party to the instrument with whom the
   holder has not dealt except
   (a) infancy; to the extent that it is a defense to a simple
   contract; and
   (b) such other incapacity, or duress, or illegality of the trans-
   action, as renders the obligation of the party a nullity; and
   (c) such misrepresentation as has induced the party to sign
   the instrument with neither knowledge nor reasonable opportunity
   to obtain knowledge of its character or its essential terms; and
   (d) discharge in insolvency proceedings; and
   (e) any other discharge of which the holder has notice when
   he takes the instrument.

The claims and defenses in parts (1) and (2) are known as personal defenses; the exceptions in (2) (a)-(e) are real defenses. Thus a holder in due course is always subject to real defenses.
consumer may have about the defective appliance.4

More often, the consumer will sign a conditional sales contract or a retail installment contract that includes the promissory note.5 The seller will assign the entire contract to a financing institution. An assignee of a contract is subject to the defenses which the obligor could have asserted against the assignor.6 However, this may be circumvented by including a valid waiver of defense clause in the contract,7 which insulates the taker of such a sales contract from the buyer's claims and defenses in much the same way as does the holder in due course concept.8

The holder in due course doctrine and similar devices which operate to cut off consumers' claims and defenses against assignees of credit contracts have been the subject of considerable controversy in recent years.9 These devices impose

4. The doctrine of holder in due course developed in eighteenth century England as a means of ensuring the negotiability of instruments at a time when communication was primitive and it was necessary to give protection to remote holders of commercial paper. Report of the National Commission on Consumer Finance, Consumer Credit in the United States 34 (1972) [hereinafter cited as NCCF REPORT]. Today it can be argued that with instant communication the holder can immediately ascertain whether the maker has any defenses. Bensen & Squillante, The Role of the Holder in Due Course Doctrine in Consumer Credit Transactions, 26 Hastings L.J. 427 (1974) [hereinafter cited as Bensen & Squillante].

5. See, e.g., Cal. Civ. Code § 1803.2(a) (West 1973), which states that every retail installment contract must be contained in a single document, including the promissory note.


7. UCC § 9-206.

8. Id.

a burden on the consumer who, because of problems stemming from the sales transaction, stops payments on a retail installment contract. Consequently, the finance company to whom the merchant assigned the contract initiates suit against the consumer, demanding payment. If the finance company can claim HDC status or the existence of a valid waiver of defense clause, it is shielded from liability for most of the consumer's grievances. The consumer has no choice but to continue payments on an unreceived service or an inoperable appliance.

In response to judicial and legislative efforts to restrict the use of these cutoff devices,10 lenders and merchants have developed another technique to finance consumer transactions and avoid liability for inadequate services or goods. Instead of negotiating a consumer note or assigning a retail installment contract, the merchant directs the consumer to a finance company or bank to obtain a loan. This loan, sometimes called an interlocking or direct loan, is made "independently" of the sales transaction. Consequently, the consumer cannot raise against this "direct" lender the defenses he could have asserted against the merchant.

In an effort to resolve the consumers' predicament, the Federal Trade Commission has promulgated a trade regulation rule preserving consumers' claims and defenses.11 With one blow, this new rule purports to abolish the holder in due course doctrine in consumer transactions and to eliminate the prob-

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10. See text accompanying notes 15-31 infra.


A last minute attempt by the National Automobile Dealers Association to defer the effective promulgation of the rule failed in the United States District Court for the Middle District of Louisiana on May 12, 1976. Rep. Waggonner (Dem., 4th Dist., La.) introduced H.R. 13897 on May 19, 1976, to prohibit the Federal Trade Commission from promulgating rules that limit the use of holder in due course in consumer transactions. The bill was referred to the House Committee on Interstate and Foreign Commerce. 122 Cong. Rec. 4632 (daily ed. May 19, 1976).
lems arising out of the interlocking loan. This comment will discuss the manner in which the FTC attempts to preserve consumer defenses within the two principal methods of consumer financing.\(^\text{12}\)

The first of these methods involves the merchant's assignment of a negotiable instrument or consumer credit contract to a finance company or bank with whom he has some prearrangement or relationship. The FTC rule, by requiring that consumer credit contracts contain a notice to the holder of the contract that he is subject to all claims and defenses which the debtor could have asserted against the seller,\(^\text{13}\) unconditionally destroys all shields\(^\text{14}\) that an assignee finance company could establish to circumvent liability for seller misconduct. The consumer will no longer be obliged to pay on an assigned retail installment contract for a service he never received.

The second method of consumer financing occurs when the consumer secures a "direct" loan from a lender who is in some way connected with the merchant—an "interlocking" lender.

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\(^{12}\) As of October, 1975, the aggregate amount of consumer credit in the United States totaled $190,839,000,000, more than twice the amount in 1965 ($89,883,000,000). The breakdown of consumer credit in October, 1975, was as follows (in millions of dollars):

<table>
<thead>
<tr>
<th>Type of Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total installment credit</td>
<td>165,989</td>
</tr>
<tr>
<td>automobile paper</td>
<td>52,722</td>
</tr>
<tr>
<td>other consumer goods paper</td>
<td>50,584</td>
</tr>
<tr>
<td>home improvement loans</td>
<td>8,136</td>
</tr>
<tr>
<td>personal loans</td>
<td>45,547</td>
</tr>
<tr>
<td>Total noninstallment credit</td>
<td>33,890</td>
</tr>
<tr>
<td>single payment loans</td>
<td>12,504</td>
</tr>
<tr>
<td>charge accounts</td>
<td></td>
</tr>
<tr>
<td>retail outlets</td>
<td>7,610</td>
</tr>
<tr>
<td>credit cards</td>
<td>2,215</td>
</tr>
<tr>
<td>service credit</td>
<td>11,620</td>
</tr>
</tbody>
</table>

Commercial banks held $82,888,000,000 of both installment and noninstallment credit and finance companies, credit unions, savings and loan associations and retail outlets held $38,411,000,000 of installment credit. 61 Fed. Reserve Bull. A 45-46 (Dec. 1975).

\(^{13}\) The required FTC notice reads:

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

\(^{14}\) However, the liability of the holder is limited to the amount paid by the consumer on the contract. See text accompanying note 171 infra.
The FTC rule is drafted to reach this method of financing as well. Unfortunately, the rule defines the necessary relationship between the seller and the lender in such broad terms as to include almost all lenders of consumer credit regardless of the extent of the relationship and the nature of the connection with the merchant. This may have the effect of exposing the consumer credit industry to a high degree of unpredictable liability, resulting in higher credit rates and lower credit availability. Such an effect is not necessarily in the best interests of the consumer.

The financer's ability to assert either HDC status or a valid waiver of defense clause upon assignment of a consumer note or contract has already been crippled to a large extent by judicial and statutory law. On the other hand, only a very few jurisdictions have attempted to reach the interlocking lender. The legislation that does exist is derived from the proposals of the National Commission on Consumer Finance, the National Conference of Commissioners on Uniform State Laws, and the National Law Center. The FTC approach to the interlocking loan differs radically from these proposals and recent state legislation.

To evaluate the viability of the FTC rule, this comment first will review the development of judicial and legislative restrictions on the assignment method of financing. Secondly, important policy considerations involved in exposing the interlocking lender to liability will be discussed, focusing upon the potential effect of the FTC rule on the cost and availability of consumer credit. It is the premise of this comment that carefully drawn proposals which itemize situations that characterize the interlocking loan are a more workable solution to the problem of consumer defenses than the overreaching FTC approach.

This comment will then consider how the various proposals and the FTC rule define the limits of liability of the holder of the contract, and how this may affect the ultimate cost of credit to the consumer. Finally, the potential effectiveness of the FTC rule in light of the recent expansion of FTC enforcement powers will be discussed briefly, with some attention to the interaction of the new rule with existing state law.
ASSIGNMENTS

Judicial and Legislative Responses

Long before the FTC rule, courts across the country\textsuperscript{15} had developed a number of interrelated theories to strip the assignee financier of his HDC status. The most widely accepted theory is known variously as the "co-participant,"\textsuperscript{16} "identity of parties,"\textsuperscript{17} or "proximity"\textsuperscript{18} theory, whereby the financer is found to be so closely connected with the merchant that he cannot be considered an innocent purchaser of the note or contract.\textsuperscript{19} Factors which trigger a finding of close-connectedness include the lender's active participation in the transaction from its inception, an exchange of forms between the merchant and lender, assignment to the finance company on the day of sale or soon after, and numerous assignments from the same seller.\textsuperscript{20} The financer is deemed to be so close to the seller that he no longer qualifies as a holder in due course under the Uniform Commercial Code, since he is in a position to have actual or constructive notice and lacks good faith.\textsuperscript{21} Some courts deny the financer HDC status on a finding of actual or constructive notice of the buyer's claims or defenses without further analysis of the relationship between the merchant and the lender.\textsuperscript{22}

\textsuperscript{15} For an excellent discussion of case law in this area see 3 \textsc{National Consumer Law Center, Consumer Law Handbook}, 526-42 (1973) [hereinafter cited as NCLC Handbook]; articles cited in notes 16-18 infra.

\textsuperscript{16} Note, Limitations, supra note 9, at 92.

\textsuperscript{17} Note, Consumer Defenses and Financers as Holders in Due Course, 4 \textsc{Conn. L. Rev.} 83, 95 (1971).

\textsuperscript{18} Hartman & Walker, supra note 9, at 120.

\textsuperscript{19} See, e.g., Commercial Credit Corp. v. Orange County Mach. Works, 34 Cal. 2d 766, 214 P.2d 819 (1950).

\textsuperscript{20} See, e.g., Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940); Vasquez v. Superior Court, 4 Cal. 3d 800, 484 P.2d 964, 94 Cal. Rptr. 796 (1971); Commercial Credit Corp. v. Orange County Mach. Works, 34 Cal. 2d 766, 214 P.2d 819 (1950); Jones v. Approved Bancredit Corp., 256 A.2d 739 (Del. 1969); Mutual Fin. Co. v. Martin, 63 So. 2d 649 (Fla. 1953); Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967); American Plan Corp. v. Woods, 16 Ohio App. 2d 1, 240 N.E.2d 886 (1968).


\textsuperscript{22} See, e.g., Morgan v. Reasor Corp., 69 Cal. 2d 881, 447 P.2d 638, 73 Cal. Rptr. 398 (1968); Industrial Credit Co. v. Mike Bradford & Co., 177 So. 2d 878 (Fla. Dist.
few courts have applied an agent-principal theory to closely connected dealers and lenders; others have held the practice unconscionable. Courts have also found that the use of waiver of defense clauses is against public policy, and that retail installment contracts cannot be treated like negotiable instruments.

It has been observed that the judicial challenges to the HDC doctrine and waiver of defense clauses lack uniformity and fail to make any meaningful legal or logical distinctions. Moreover, not all jurisdictions are equally willing to protect the consumer against the unfair results of these practices.

A number of jurisdictions have enacted legislation to deal with the problem of cutoff devices. At least 37 states prohibit the use of a negotiable instrument, other than a check, in consumer credit transactions, or provide that the use of a promissory note will not cut off consumer defenses. Thirty-nine jurisdictions have either prohibited the use of waiver of defense clauses or have made the assignee of a consumer credit contract subject to all claims and defenses of the consumer notwithstanding any agreement to the contrary.

Perceiving the need for uniform legislation in this area, the National Conference of Commissioners on Uniform State Laws and the National Consumer Law Center have proposed model acts covering all aspects of consumer credit including the preservation of consumer claims and defenses. The National Con-

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23. See, e.g., Calvert Credit Corp. v. Williams, 244 A.2d 494 (D.C. Cir. 1967); Associates Discount Corp. v. Goetzinger, 245 Iowa 326, 62 N.W.2d 191 (1954); International Fin. Corp. v. Rieger, 137 N.W.2d 172 (Minn. 1965).


27. Bensen & Squillante, supra note 4, at 447; Rohner, supra note 9, at 529.

28. See cases cited in Rohner, supra note 9, at 517 n.71.

29. For a descriptive breakdown of state law in this area as of June 1, 1973, see NCLC HANDBOOK, supra note 15, at 575-92.

30. Id.

31. Id. at 583-88. Twelve of these jurisdictions have qualified the restriction on waiver of defense clauses by requiring a notice of assignment to the consumer and consumer notice to the assignee within a specified time.
ference drafted the first version of the Uniform Consumer Credit Code (UCCC) in 1968. Variations of this draft have been enacted in seven states. A number of commentators considered the 1968 draft ineffective in preserving consumer defenses; and the 1974 draft of the UCCC represents considerable advances in this area. In 1970, the National Consumer Law Center issued the National Consumer Act (NCA) which has been called "the militant consumer response" to the 1968 UCCC. The Center revised the NCA in 1973 and re-named it the Model Consumer Credit Act (MCCA). Although neither of the Center's proposals have been adopted in any jurisdiction, the NCA has had a strong influence on legislation in Massachusetts and in Wisconsin.

The FTC Rule

The FTC rule preserving consumers' claims and defenses makes it an unfair or deceptive act or practice for a seller, directly or indirectly, to take a "consumer credit contract" which does not contain the required notice that any holder of the contract is subject to consumer claims and defenses. A consumer credit contract is defined in part as any instrument which evidences or embodies a debt arising from a "financed sale." "Financing a sale" is "[e]xtending credit to a consumer in connection with a 'Credit Sale' within the meaning


The 1968 UCCC has also influenced the Truth in Lending Act, Regulation Z and various state legislation. See, e.g., Wis. STAT. ch. 421, § 421.101, et seq. (1974).


34. A California version of the 1974 UCCC, S.B. 1019, died in committee this year.

35. Note, Direct Loan, supra note 9, at 1436.

36. Id.; NATIONAL CONSUMER LAW CENTER, MODEL CONSUMER CREDIT ACT iv (1973).

37. To understand the operation of the FTC rule one must look to the definitions for an explanation of each clause. To understand one definition, it is often necessary to refer to another definition. See Appendix A infra for the complete text of the rule.

38. The rule is drafted so that only the seller, not the creditor, can be in violation of § 5 of the Federal Trade Commission Act. The FTC is proposing an amendment to the rule that will also cover creditors. 40 Fed. Reg. 53530 (1975). See text accompanying notes 46-48 infra.

of the Truth in Lending Act and Regulation Z”—that is, “any sale with respect to which credit is extended or arranged by the seller,” including a lease. This covers seller-arranged retail installment contracts, either open-end or other than open-end, but does not cover bank-issued (three-party) credit cards. Thus, a seller who simultaneously arranges credit and negotiates a consumer credit contract which does not contain the requisite notice violates section 5 of the Federal Trade Commission Act.

The FTC notice in the contract, addressed to “any holder,” applies to all subsequent assignees of the contract and thereby preserves all claims and defenses which the debtor (the consumer) could assert against the seller. Although the Federal Trade Commission expects that all creditors will include this notice in all of their consumer credit contracts, the rule—primarily because the FTC has no jurisdiction over banks—does not make it an unfair or deceptive act or practice for financers to omit the notice. To correct this inequity, the FTC is proposing an amendment which would apply the rule

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40. 16 C.F.R. § 433.1(e) (1976).
42. Open-end credit refers to a plan whereby the creditor allows the consumer to make purchases or obtain loans from time to time; where the consumer may pay the balance either in full or in installments; and where a finance charge is computed from time to time on an outstanding balance. 12 C.F.R. § 226.2(x) (1976); 15 U.S.C. § 1602(i) (1970).
43. 16 C.F.R. § 433.1(c), (h) (1976).
44. Banks are the creditors in three-party credit card transactions and since the FTC does not have jurisdiction to regulate banks, 15 U.S.C.A. § 45(a)(6) (Supp. 1976), it could not include three-party credit cards within the rule. A three-party credit card is closely analogous to a direct loan and it is equally desirable to preserve consumer claims and defenses against the credit card issuer. See Brandel & Leonard, Bank Charge Cards: New Cash or Credit, 69 Mich. L. Rev. 1033 (1971); Note, Development of Consumer Defenses Under a Tripartite Credit Card System, 24 Syracuse L. Rev. 1279 (1973); Note, Preserving Consumer Defenses in Credit Card Transactions, 81 Yale L.J. 287 (1971).
45. The Fair Credit Billing Act, 15 U.S.C. § 1666, et seq. (Supp. IV, 1974), preserves consumer claims and defenses in three-party credit card transactions if three conditions are met: (1) a good faith attempt by the debtor to obtain satisfactory resolution from the merchant honoring the credit card; (2) the amount of the initial transaction exceeds $50; and (3) the place where the initial transaction occurred was in the same state or within 100 miles of the mailing address of the cardholder. 15 U.S.C. § 1666i (Supp. IV, 1974).
46. See note 11 supra.
47. See note 13 supra and Appendix A infra.
to creditors. Banks will be covered if the Federal Reserve Board adopts a similar provision pursuant to the Federal Trade Commission Improvements Act of 1975.

Aside from limits on liability, the rule places no qualifications on the rights of the consumer. For example, the financer’s notice of assignment to the consumer does not cut off subsequent defenses, nor is the debtor required to notify the assignee within a specified period in order to preserve his rights. Such time-notice provisions in existing state statutes have been criticized as being unfair to consumers whose claims arise after the cutoff point.

The rationale for an unqualified preservation of defenses where the seller arranges for or extends credit is clear. When a seller offers to assign a contract to a financer, the latter has every opportunity to learn where the proceeds of the credit contract were applied and the business practices of the seller. A financer who has not had previous dealings with the seller

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48. Act of Jan. 4, 1975, Pub. L. No. 93-637, 88 Stat. 2196-97. This Act mandates that the Federal Reserve Board issue regulations similar to any rule promulgated under the procedures outlined within the 1975 Act. 15 U.S.C.A. § 57(f) (Supp. 1976). The rule preserving consumer claims and defenses promulgated before the effective date of the 1975 Act is not subject to this provision. However, the Act does apply to the proposed amendment extending the coverage to creditors. 40 Fed. Reg. 53530 (1975). Thus, when and if the rule becomes applicable to creditors and the Federal Reserve Board issues a similar regulation, banks would be subject to penalties for taking a consumer credit contract that does not contain the notice preserving consumers’ claims and defenses.

The Board of Governors of the Federal Reserve System has proposed a similar regulation pursuant to the 1975 Act. It is currently receiving comments to consider whether or not to promulgate the rule. The Federal Reserve Board is not required to adopt a similar regulation if it finds that such acts or practices of banks are not unfair or deceptive or that implementation of similar regulations would seriously conflict with essential monetary and payments systems of the Board. 41 Fed. Reg. 7110-11 (1976).

As to the rule currently in effect, the Comptroller of the Currency has issued a release to the presidents of all national banks notifying them that the failure of banks to include the requisite notice in certain direct loan agreements will preclude sellers from accepting the proceeds of the loan. This release also warns banks that bank acquisition of seller contracts containing the FTC notice may subject these banks to potential claims and defenses which the consumer could assert against the seller. Banks are advised to review current dealings in consumer paper to ascertain the likelihood of potential liabilities and the conformance of all paper issued after May 14, 1976, to the requirements of the rule, 5 C.C.H. CONSUMER CREDIT GUIDE, ¶ 98,426.

49. See note 14 supra and text accompanying note 170 infra.
50. See note 31 supra.
51. See, e.g., NCCF REPORT, supra note 4, at 35; Warren, Comments on Vasquez v. Superior Court, 18 U.C.L.A.L. REV. 1041, 1068-70 (1971) [hereinafter cited as Warren]. See also the 1968 UCCC § 2.404 Alternative A and Alternative B; for commentators’ criticisms of these provisions, see note 33 supra.
can readily check the merchant's reputation for reliability, and if it is questionable, he can refuse the contract, set up a reserve account for bad debts with the seller, or require the seller to guarantee the loan. Costs thus incurred are passed on to the seller and then to the consumer in the price of the goods or services. As the National Conference on Consumer Finance (NCCF) has observed, "[S]preading the costs of abolishing third party cutoff devices to all consumers in the marketplace would be more than counter-balanced by the protections which the consuming public will receive in the form of better goods and services."

Interlocking Loans

The Problem

Current state provisions and the various model acts preserve consumer claims and defenses only in situations where the seller makes a direct assignment of the contract to the financer. After these statutes were enacted, lenders learned that they could still avoid liability for purchasers' claims and defenses through the use of an interlocking loan arrangement. In an interlocking loan—known also as a vendor-related loan, direct loan, and colloquially as "dragging the body"—the seller does not assign any note or contract, but refers his customer to an "independent" lender. This lender advances a loan to the consumer, enabling him to buy the particular good or service which the merchant is promoting. This is essentially a direct cash loan, and the lender is neither an assignee nor an HDC. Until recently, there was no legal theory which would attribute liability to this lender for any claims or defenses arising out of the consumer transaction; since the lender was not directly involved in the sales transaction, he could claim complete immunity from consumer defenses.

52. See note 62 infra.
53. See notes 58-63 and accompanying text infra.
54. NCCF Report, supra note 4, at 37.
57. The interlocking loan is frequently used to obtain downpayments for the purchase of automobiles—in this context it is often referred to as a "side loan."
Allocation of Costs and Policing the Marketplace

Drafters of legislation dealing with reform in consumer credit must consider the effect a particular method will have on the allocation of costs among the lender, the merchant, and the consumer. The adequacy of such legislation as a tool for policing the marketplace is also an important consideration.58

A rule preserving consumer claims and defenses operates to shift the risk of seller misconduct from the individual consumer to the financer. The financer allocates the costs of this risk among consumers in the form of higher credit rates, and/or shifts the cost back to the seller by means of recourse or repurchase arrangements.59 But despite the availability of protective maneuvers, financers made subject to consumer defenses are less likely to deal with sellers who have a history of misconduct. This has the effect, eventually, of eliminating disreputable merchants from the market.60

The proponents of such legislation contend that it is in the interest of public policy to impose the risks upon the finance company.61 The individual consumer has little bargaining power with the merchant and does not have the resources to maintain an action against a seller who may be insolvent or unavailable. Financers, on the other hand, with their access to information, their risk-shifting mechanisms and their ability to put pressure on the less reputable merchants, are in a better position than are consumers to police the market and bear the costs of seller misconduct.62

58. NCCF REPORT, supra note 4, at 36-37; FTC Statement, supra note 56, at 53522-23; Littlefield, supra note 9, at 494; Rohner, supra note 9, at 538-44; Note, Direct Loan, supra note 9, at 1411-15.
59. In recourse or repurchase agreements the seller repurchases from the financer all goods the financer has repossessed due to the consumer’s default. R. SPEIDEL, R. SUMMERS & J. WHITE, COMMERCIAL AND CONSUMER LAW 220 (2d ed. 1974).
60. See note 58 supra.
61. See, e.g., NCCF REPORT, supra note 4, at 36-37; FTC Statement, supra note 56, at 53523; Kripke, supra note 9, at 472.
62. See R. SPEIDEL, R. SUMMERS & J. WHITE, COMMERCIAL AND CONSUMER LAW 213-42 (2d ed. 1974) where various financing patterns are described. These mechanisms include the financing of inventory (floor planning) wherein the creditor takes a security interest in the inventory as well as in the proceeds. The proceeds include “chattel paper” which may be a retail installment contract and a note. As part of the financing agreement the debtor may assign all the consumer chattel paper to the creditor as the security interest which the creditor has in the proceeds. The creditor will take ordinary precautions to protect his security interest such as a routine check of the debtor’s records. See note 101 infra.
Maintaining reserve accounts for bad debts, transacting and following up recourse arrangements and policing merchants add to the cost of the financiers' operations. This cost is ultimately turned back to the consumer in the form of higher credit rates and/or a reduction in the availability of credit. Consequently, the central issue in reforming the interlocking loan situation is to determine how high the cost of reform should be. It is recognized that where a lender and merchant are "closely connected," the cost to the lender (and ultimately to the consumer) of protecting against seller misconduct is relatively small. However, the fewer the transactions between a lender and a particular merchant, the more tenuous and sporadic the relationship, the higher the cost of protecting against seller misconduct. In order to achieve an equitable distribution of risks and an effective policing of the market, therefore, the type of lender-merchant relationship that justifies stripping the financer of his traditional shield must be carefully defined.

One proposal suggests that a financer who knows that the proceeds of the loan will be used in a particular consumer transaction should be subject to consumer claims and defenses regardless of the closeness or remoteness of his relationship with the retailer. This commentator recognizes that the cost to the financers of repurchase agreements and other expedients designed to discourage seller misconduct will vary with the degree of interrelatedness of seller and financer. At the point where the costs of further policing exceed the gains, the lender would absorb the losses from bad debts as a cost of doing business. This cost would in turn be reflected in higher credit rates.

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64. The National Commission on Consumer Finance ran a cross state econometric study which indicated that in those states which have prohibited both holder in due course status and waiver of defense clauses there has been an observable reduction in the purchase of consumer chattel paper by finance companies and a reduction in the availability of total consumer credit. NCCF REPORT, supra note 4, at 36.

A survey was conducted in Connecticut to evaluate the effect of legislation which eliminated negotiability of notes in home solicitation sales. The students found a marked reduction in the financing of businesses engaged in door-to-door sales. Note, A Case Study of the Impact of Consumer Legislation: The Elimination of Negotiability and the Cooling-Off Period, 78 YALE L.J. 618 (1969).

There is no reliable empirical data reflecting the actual effect on cost and availability of credit from any of the jurisdictions which have severely restricted HDC status for interlocking lenders, and thus at present there is no way to evaluate accurately the economic impact of such legislation.

65. Note, Direct Loan, supra note 9, at 1418, 1421-22.

66. Id. at 1413, 1417, 1421-23, 1437.
The writer admits, however, that this is only possible if "unrealistic" credit rate ceilings are removed. The rationale here is that the cost to a consumer of a given product must approximate the "real social cost" of providing that product.

Another proposal is to preserve consumer defenses only against those interlocking lenders who either have recourse rights against the seller or are so closely connected with the seller that recourse rights are easily arranged. In this way the major cost of seller misconduct is passed back to the seller, a procedure which has the effect of either raising the price of the seller's product or discouraging future misconduct. The financier has only the costs of establishing recourse arrangements, maintaining reserve accounts and policing the merchants with whom he deals. When these costs are allocated among all the consumer transactions this lender is involved in, the cost to the consumer in the form of increased rates should be minimal. Thus, a proposal which limits "interlocking lender" liability to the situation where the lender is in a position to make recourse arrangements with the merchant is more consistent with the policies of equitable risk allocation and effective market policing.

The increasing use of the interlocking loan to circumvent restrictions on consumer cutoff devices has provoked a number of commentators, including the National Commission on Consumer Finance, to look for means of closing this loophole. Consequently, the 1974 UCCC, the NCA, and the MCCA have outlined criteria for determining when a lender is to be considered an "interlocking" lender subject to consumer claims. These model guidelines incorporate essentially the same factors which the courts considered important in defining a closely connected assignee financier. Accordingly, the same

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67. Id. at 1417.
68. Id. at 1415.
69. Rohner, supra note 9, at 545-47.
70. Id. at 547.
71. See, e.g., Erickson, supra note 9; Littlefield, supra note 9; Miller, An Alternative Response to the Supposed Direct Loan Loophole in the UCCC, 24 OKLA. L. REV. 427 (1971); Warren, supra note 51, at 1090-91; Note, Direct Loan, supra note 9.
72. NCCF REPORT, supra note 4, at 35-38.
73. 1974 UCCC § 3.405. See Appendix B infra for text.
74. NATIONAL CONSUMER LAW CENTER, NATIONAL CONSUMER ACT § 2.407 (1970) [hereinafter cited as NCA]. See Appendix F infra for text.
75. NATIONAL CONSUMER LAW CENTER, MODEL CONSUMER CREDIT ACT § 2.603 (1973) [hereinafter cited as MCCA]. See Appendix F infra for text.
logic used in reaching the conclusion that the assignee is not a holder in due course, it is urged, should be applied to the interlocking lender: if he is closely connected to the merchant and actively involved in the sales transaction, he should be treated as a party to the sale and subject to the same claims and defenses that the consumer would have against the original seller. A handful of states have enacted interlocking loan legislation. The 1976 FTC trade regulation rule also covers the interlocking loan situation, but includes a broader spectrum of creditors than do any of the other proposals or statutes.

The validity of any attempt to preserve consumer defenses in interlocking loans must be weighed against the cost of the reform since all such costs ultimately fall upon the consumer. The following sections of this comment will examine how these proposals attempt to preserve consumer defenses and, at the same time, keep the cost of reform to a minimum.

Proposed Legislation

The National Conference on Consumer Finance (NCCF) has observed that it is a difficult task to draft legislation in the interlocking loan area that does not also inhibit independent lending. The NCCF suggestions and the lists of criteria defining “close connectedness” in the National Consumer Act (NCA), the Model Consumer Credit Act (MCCA), the 1974 Uniform Consumer Credit Code (UCCC), the 1973 FTC proposed rule, and state statutes, are all attempts to pinpoint those situations in which the seller and lender cooperate to circumvent legislation that otherwise would remove the protection of HDC status and waiver of defense clauses. Since the state provisions embody bits and pieces of all the assorted proposals, this comment will focus its analysis upon the NCCF

76. See note 117 infra.
77. 16 C.F.R. § 433 (1976).
78. NCCF REPORT, supra note 4, at 37; Littlefield, supra note 9, at 494-95; Rohner, supra note 9, at 535-37; Wallace, The Logic of Consumer Credit Reform, 82 YALE L.J. 481 (1973); Note, Direct Loan, supra note 9, at 1411-12, 1415.
79. NCCF REPORT, supra note 4, at 35.
80. NCA § 2.407.
81. MCCA § 2.603.
82. 1974 UCCC § 3.405.
83. 38 Fed. Reg. 893 (1973) [hereinafter cited as 1973 FTC Rule § 433]. This was the second proposed version of the FTC rule to preserve consumers’ claims and defenses. See note 118 infra.
84. See note 117 infra.
suggestions, the NCA, the MCCA, the 1974 UCCC, and the 1973 FTC rule.

Each of these proposals represents a slightly different approach to the problem of defining the interlocking lender. The NCA suggests seven factors, any one of which involves sufficient participation in or connectedness with a consumer sale or lease transaction to establish interlocking lender status.\textsuperscript{85} Such a creditor is subject to all claims and defenses of the consumer arising from the sale or lease for which the proceeds of the loan were used.\textsuperscript{86} The NCCF proposes six such criteria.\textsuperscript{87} The MCCA list contains eleven factors, all of which are rebuttable by a showing that the lender acted in good faith and without knowledge that the proceeds of the loan were to be used in a consumer transaction.\textsuperscript{88} The 1973 FTC rule defines a "related" creditor as one who meets any one of nine rebuttable criteria,\textsuperscript{89} with no indication how the creditor can rebut the presumptions. The 1974 UCCC lists six factors,\textsuperscript{90} but provides that a consumer must make a good faith attempt to obtain satisfaction from the merchant before proceeding against the lender.\textsuperscript{91}

There are a number of elements common to all these proposed definitions. One is that the creditor be "related to" the seller.\textsuperscript{92} The NCCF and the 1973 FTC rule define "related to" as encompassing any familial relationship.\textsuperscript{93} These two proposals also define an interlocking lender as one who is directly or indirectly controlled by or under the common control of the seller, or otherwise affiliated with the seller.\textsuperscript{94} The 1974 UCCC qualifies the "related to" criterion by eliminating those relationships which are so remote as to be unlikely to affect the consumer transaction.\textsuperscript{95} Clearly, a relationship, whether familial or organizational, implies the lender's awareness of the seller's activities and ability to arrange for guarantees;\textsuperscript{96} there

\textsuperscript{85} NCA § 2.407(2)(a)-(g). See Appendix E infra.
\textsuperscript{86} NCA § 2.407(1).
\textsuperscript{87} NCCF REPORT, supra note 4 at 37-38. See Appendix C infra.
\textsuperscript{88} MCCA § 2.603. See Appendix F infra.
\textsuperscript{89} 1973 FTC Rule § 433.1(h)(1)-(9), supra note 83. See Appendix D infra.
\textsuperscript{90} 1974 UCCC § 3.405(1)(a)-(f). See Appendix B infra.
\textsuperscript{91} 1974 UCCC § 3.405(2).
\textsuperscript{92} Id. § 2.405(1)(b); 1973 FTC Rule § 433.1(h)(1), supra note 83; MCCA § 2.603(4)(a); NCCF REPORT, supra note 4, at 37; NCA § 2.407(2)(a).
\textsuperscript{93} NCCF REPORT, supra note 4, at 37; 1973 FTC Rule § 433.1(h)(1), supra note 83.
\textsuperscript{94} 1973 FTC Rule § 433.1(h)(4)-(5), supra note 83; NCCF REPORT, supra note 4, at 37.
\textsuperscript{95} 1974 UCCC § 3.405(1)(b).
\textsuperscript{96} See Jones v. Approved Bancredit Corp., 256 A.2d 739 (Del. 1969); Rehurek
is no problem reconciling a related merchant and creditor with the policy considerations of risk allocation and policing the marketplace.

Neither the NCA nor the MCCA, however, make any attempt to define what is meant by "relatedness," and their definitions of an interlocking lender could include very remote relationships that have no bearing upon the ability of the lender to absorb the costs or to investigate the merchant.

Another common feature of an interlocking loan situation is that the forms used by the consumer in securing the loan are either supplied or prepared for the seller by the lender, or conversely, supplied or prepared for the lender by the seller. There is perhaps no more convincing evidence of an interlocking loan than such an exchange of forms. The exchange is prima facie evidence of an arrangement between the financer and the merchant, indicating that the financer can also arrange for some recourse against the seller.

A third common factor is payment of consideration, directly or indirectly, by the lender to the seller for arranging the loan or for referring consumers to the lender. The NCA does not require that the consideration be in connection with any particular transaction. As with the exchange of forms, the lender's payment of some sort of fee or commission to the seller is clear evidence of a mutual agreement and is indicative of the lender's opportunity to inform himself of the seller's activities.

v. Chrysler Credit Corp., 262 So. 2d 452 (Fla. Dist. Ct. App. 1972); Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967). In these cases the seller and financer were organizationally related. This factor influenced the courts in determining that the financer took the assigned consumer contract without the good faith requisite for holder in due course status.

97. 1974 UCCC § 3.405(1)(d); 1973 FTC Rule § 433.1(h)(2)-(3), supra note 83; MCCA § 2.603(4)(b); NCCF Report, supra note 4, at 37; NCA § 2.407(2)(b)-(c).

98. See Mutual Fin. Co. v. Martin, 63 So. 2d 649 (Fla. 1953); Rehurek v. Chrysler Credit Corp., 262 So. 2d 452 (Fla. Dist. Ct. App. 1972); Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967). In these cases the exchange of forms between the assignee-financer and seller was strong indication to the courts of close connectedness.

99. 1974 UCCC § 3.405(1)(a); 1973 FTC Rule § 433.1(h)(6), supra note 83; MCCA § 2.603(4)(d); NCCF Report, supra note 4, at 38.

100. NCA § 2.407(2)(f).

101. See Associates Discount Corp. v. Goetzinger, 245 Iowa 326, 62 N.W.2d 191 (1954). Here part of the arrangement between seller and financer included a commission for all consumer paper acquired by the creditor. The facts in this case provide a good example of "floor planning." The creditor financed the automobile merchant's inventory and acquired all consumer paper. The commissions were held in a reserve account until the buyer completed payments.
With the exception of the 1974 UCCC, all the proposals provide that a seller’s referral of a consumer to a creditor suggests an interlocking loan. The NCA proposes that an unqualified seller referral be regarded as sufficient indication of close interrelatedness. The other proposals require more: the MCCA looks for a referral agreement between the seller and lender; the 1973 FTC rule proposes that referrals followed by at least five loans in one year in which the proceeds are used in transactions with the same seller be deemed evidence of interlocking situations. The NCCF looks for referrals connected with repeated and regular loans used with the same seller.

The drafters of these statutory schemes acknowledge that seller referral to a particular lender, in the absence of other evidence indicating a relationship between them, should not subject the lender to consumer claims and defenses. This is consistent with the policies of equitable risk allocation and effective market policing. Mere seller referral to a lender does not necessarily imply that the lender is even aware of the seller’s existence, and the seller may suggest a credit source to a consumer without expecting any specific advantage. It would be unwise to impose the costs of seller misconduct upon a lender who was not in any realistic sense involved in the particular consumer transaction. To do so would increase the costs of protecting against liabilities beyond the point where it would benefit the consumer. A lender, faced with referrals from an unknown seller with whom he has no recourse arrangements or other guarantees, may become reluctant to provide consumer loans. The 1974 UCCC wisely eliminates mere seller referral as evidence of an interlocking loan.

Three of the proposals consider any recourse arrangement or seller guarantee of the loan indicative of an interlocking situation. This factor is clearly the most consistent with risk allocation policies, since the lender is able to shift the cost of seller misconduct back to the seller. Such cost may be re-

102. NCA § 2.407(2)(e).
103. MCCA § 2.603(4)(h), (i).
104. 1973 FTC Rule § 433.1(h)(8), supra note 83.
105. NCCF Repost, supra note 4, at 38.
106. See text accompanying notes 137-45 infra.
107. 1974 UCCC § 3.405(1)(c); 1973 FTC Rule § 433.1(h)(7), supra note 83; MCCA § 2.603(4)(c).
108. Rohner, supra note 9, at 545-47; Note, Direct Loan, supra note 9, at 1414-15.
flected in the cash price of the seller's goods or services as a normal cost of doing business, but since the lender does not bear the cost, it will not be reflected in the price of credit—an advantage to the credit buyer. When the increased cost is absorbed by the price of the product, it is ultimately borne by all consumers, whether or not they buy on credit. The cost of credit, therefore, need not be raised beyond the reach of those consumers who rely on it. Any "unfairness" of this result is mitigated, however, by the fact that recourse agreements put a severe financial squeeze on sellers who acquire a reputation for not meeting the contract, since consumers cannot readily obtain credit funds to purchase their products or services. The premise here is that a slightly more expensive, yet reliable, product is more desirable than one that is lower priced, not as reliable, yet costs more to those who buy on credit.

Knowledge of consumer complaints about a particular seller's misconduct before a consumer loan is made is sufficient for interlocking lender status in three of the proposals, provided the creditor knows how and where the proceeds of the loan are to be spent. This criterion is clearly consistent with the policy of eliminating disreputable merchants from the marketplace. Subjecting a creditor with such knowledge to consumer defenses is in a sense a penalty for encouraging a dishonest merchant to remain in business.

A loan conditioned upon the consumer's purchase of goods or services from a particular seller is an interlocking one under the MCCA and the 1974 UCCC proposals. This is clear indication of lender knowledge and it may be presumed that a lender would not so condition a loan unless he could be assured of payment unobstructed by valid consumer claims. Thus, this factor is also consistent with the policy of pressuring the disreputable merchant.

The MCCA proposes consideration of some additional factors, including the lender's payment of the proceeds of the loan

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109. 1974 UCCC § 3.405(1)(f); 1973 FTC Rule § 433.1(h)(9)(ii), supra note 83; NCCF Report, supra note 4, at 38.
110. See, e.g., Beatty v. Franklin Inv. Co., 319 F.2d 712 (D.C. Cir. 1963) (financer had constructive knowledge of seller's usurious rates); Financial Credit Corp. v. Williams, 246 Md. 575, 229 A.2d 712 (1967) (financer deemed to have constructive notice of seller's activities through newspaper articles); Walker v. Commercial Credit Co., 107 S.W.2d 688 (Tex. Civ. App. 1937) (financer knew that repossessed car was not new as represented by seller).
111. Rohner, supra note 9, at 542-43.
112. 1974 UCCC § 3.405(1)(e); MCCA § 2.603(4)(f).
to the seller, either individually or jointly with the consumer.\footnote{113} In such a situation the lender clearly has knowledge of how the proceeds are to be used, but this does not necessarily indicate a previous agreement with the merchant. Nevertheless, if the lender knows who the seller is, he can inform himself about the seller's activities. The cost of such policing will vary with the remoteness of his contact with the merchant.\footnote{114} The MCCA also considers the taking of a security interest in the property which is the subject of the loan to indicate an interlocking lender.\footnote{115} As one commentator has noted, this would include those lenders who take a valid security interest in the debtor's consumer goods without specifically claiming those goods purchased with the proceeds of the loan.\footnote{116} Since the taking of a security interest does not necessarily indicate knowledge of the particular seller, it would be difficult for the lender to protect himself against liability for consumer claims. This result is not consistent with either risk allocation or policing considerations.

These five proposals outline specific factors and courses of dealing which, used as indicia of the interlocking loan, generally accord with the policies of risk allocation and policing.\footnote{117} The proposals list those practices which indicate an ongoing relationship between seller and financer or which suggest op-

\footnote{113} MCCA § 2.603(4)(e).
\footnote{114} Note, Direct Loan, supra note 9, at 1422.
\footnote{115} MCCA § 2.603(4)(j).
\footnote{116} Rohner, supra note 9, at 546.
\footnote{117} Seven jurisdictions have enacted legislation dealing with the interlocking loan. Arizona requires the loan to have been “arranged” by the seller: “arranged” means the seller received a commission or has knowledge of the terms of the loan and participates in the preparation of the forms. Ariz. Rev. Stat. Ann. tit. 44-145C (Supp. 1975-76). The District of Columbia statute, D.C. Code § 28-3809(a) (Supp. 1976-77), specifies that the creditor be under the same control as the seller, or pay the seller for referral, or that the seller prepare the documents. Kansas law, Kan. Stat. Ann. ch. 16a-3-405 (Supp. 1975), describes circumstances including the seller's guarantee of the loan or preparation of the forms, the creditor's furnishing of the forms, or a conditioned loan. Maryland's provision, Md. Code. Ann. tits. 12-207, 12-309 (1975), is patterned after the MCCA but does not include some of that Act's all-encompassing sections. The Massachusetts statute, Mass. Gen. Laws ch. 255, § 12F (Supp. 1976), is patterned after the NCA, omitting the situation where the lender rewards the seller for a loan. Only two, rather than the NCA twenty, connected transactions in one year are sufficient proof of an interlocking lender. New York's statute, N.Y. Gen. Bus. Law §§ 252-54 (McKinney Supp. 1975-76), has a rebuttable list including knowing participation in or direct connection with the sale, and family or formal business relationship, or an exchange of forms. In Wisconsin, an interlocking consumer loan is defined by one of five rebuttable conditions similar to NCA § 2.407(2)(a), (c), (f) and MCCA § 2.603 (4)(c), (g), as well as knowledge of the seller's bad reputation. Wis. Stat. Ann. ch. 422.408(3) (1974).
opportunities for the prudent, reputable financer to protect against unusual losses. The definitions of the interlocking lender are, on the whole, limited to a lender who is in a position to investigate the seller’s business activities, and, if necessary, to shift the major costs back to the seller.

The FTC Rule

The approach of the FTC to the interlocking loan differs from that of the model acts.\(^\text{118}\) The rule contains no rebuttable presumptions, nor does it itemize factors which could serve as useful guidelines to courts or the business community in determining when there has been a violation. Rather, the description of an interlocking loan must be found by piecing together the FTC definitions of “purchase money loan,”\(^\text{9}\) “contract,”\(^\text{11}\) and “business arrangement.”\(^\text{12}\) The generalizations contained in these definitions suggest the same situations outlined by the National Conference of Consumer Finance (NCCF), the National Consumer Law Center (NCA and MCCA), and the 1974 UCCC,\(^\text{12}\) but in addition encompass a good deal more. The FTC claims that its version of the rule achieves greater clarity and uniformity and allows for more flexibility.\(^\text{12}\) There may indeed be flexibility, but a more inartful rule could not have been drafted.\(^\text{12}\)

The critical question is whether a rule preserving consumer claims and defenses should expose to liability every lender who has informal connections with sellers of consumer goods and services, or whether such a rule should be limited only to those lenders who have a reasonable opportunity to protect themselves against the costs of seller misconduct. To evaluate the consistency of the FTC rule with the policies of risk allocation and policing the market, we will examine the

\(^{118}\) The original FTC rule on the preservation of consumers’ claims and defenses proposed in 1971 covered only the assignment of retail installment contracts; it did not deal at all with the interlocking loan. 36 Fed. Reg. 1211 (1971). The rule proposed in 1973 was revised completely to include vendor-related loans and credit cards. See notes 43, 83 supra.

\(^{119}\) 16 C.F.R. § 433.1(d) (1976). See Appendix A infra.

\(^{120}\) 16 C.F.R. § 433.1(f) (1976).

\(^{121}\) Id. § 433.1(g).

\(^{122}\) See text accompanying notes 79-116 supra.

\(^{123}\) FTC Statement, supra note 56, at 53525.

\(^{124}\) The staff of the Federal Trade Commission has issued Guidelines on the Trade Regulation Rule Concerning Preservation of Consumers’ Claims and Defenses, 41 Fed. Reg. 20022, May 14, 1976 [hereinafter cited as Guidelines], to help explain some of the ambiguities inherent in the rule.
rule closely to determine exactly which lenders may come under its wide umbrella.

The rule defines a consumer credit contract as "any instrument which evidences or embodies a debt arising from a 'Purchase Money Loan' transaction." The definition of a purchase money loan reflects the major ambiguities and deficiencies of the rule. The first portion of this definition states that a purchase money loan is a cash advance which is received by a consumer in return for a "Finance Charge" within the meaning of the Truth in Lending Act and Regulation Z, which is applied, in whole or substantial part, to a purchase of goods or services from a seller...

Under Regulation Z, a finance charge includes charges imposed by the creditor in connection with a checking account when these charges are related to an extension of credit.

Although the FTC cannot proscribe unfair or deceptive practices by banks, this rule affects the sources of all types of credit, including bank-derived credit. Thus, a purchase money loan may include a cash advance obtained by the consumer through a personal signature loan, his bank overdraft privileges, or the use of a guaranteed check card. It is also arguable that the "cash advance" definition covers bank loan checks, a service offered along with many bank-issued credit card programs. Even though the rule explicitly exempts from coverage any creditor acting in the capacity of a credit card issuer, it is not clear if the rule also excludes that same creditor

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126. Id. § 433.1(d).
128. See text accompanying notes 46-48 supra.
130. Letter from Roland E. Brandel, Morrison and Foerster, Legal Counsel to Western States Bankcard Association, to the Office of the Secretary, Board of Governors of the Federal Reserve System, March 30, 1976, at 5-6 [hereinafter cited as W.S.B.A. Letter] (on file at SANTA CLARA L. REV.); FRB Comments, supra note 129, at 12-13. See also Letter from Arthur F. Burns, Chairman of the Board of Governors, Federal Reserve System, to Calvin J. Collier, Chairman of the Federal Trade Commission, May 5, 1976 (on file at SANTA CLARA L. REV.). This letter was sent to the FTC as a last minute attempt to dissuade the Commission from promulgating the rule.
131. W.S.B.A. Letter, supra note 130, at 4-5.
when he provides loan services *collateral* to the credit card plan.\textsuperscript{132}

Cash advances of this type are made by the bank without any knowledge of how or where the cash is to be spent.\textsuperscript{133} Furthermore, under the rule, the consumer’s *personal check* becomes a consumer credit contract when used to take advantage of an overdraft privilege or check guarantee. It is absurd to expect the bank to print the FTC notice on these checks to avoid imposing the potential risk of violating the FTC Act upon a merchant.\textsuperscript{134}

Incorporating these cash advances within the definition of a purchase money loan creates other insoluble problems. The FTC does not define how substantial a part of the cash advance must be used for a consumer purchase to bring it within the rule.\textsuperscript{135} For example, will the bank be liable for the total purchase price of the consumer good or service, or will liability be limited to the portion of the overdraft applied to the purchase?

The FTC Guidelines note that application of the rule will not be triggered in most overdraft account situations. The rationale is that the extension of credit is completed at the time the overdraft privilege is approved, not at the time the monies are applied to a specific purchase.\textsuperscript{136} However, the rule itself is not explicitly restricted to the initial extension of credit; it refers to a cash advance applied in whole or substantial part to a particular purchase.

To fall within the rule, a cash advance received must be used for “a purchase of goods or services from a seller who (1) refers consumers to the creditor . . . .”\textsuperscript{137} Thus, the rule makes it an unfair or deceptive act for a seller to receive the proceeds of this loan if he also refers consumers to the issuer of that loan. There appears to be no requirement other than that the seller refer at least two consumers to the creditor. It is not necessary that the seller have referred the particular consumer involved

\textsuperscript{132} Id. at 2.

\textsuperscript{133} Id. at 3; FRB Comments, *supra* note 129, at 4-5, 13.

\textsuperscript{134} Compare legislation preserving consumer claims and defenses when negotiable instruments are used: in such legislation checks are explicitly excluded from coverage. See text accompanying note 30 *supra*; FRB Comments, *supra* note 129, at 13.

\textsuperscript{135} W.S.B.A. Letter, *supra* note 130, at 6-7; FRB Comments, *supra* note 129, at 22.

\textsuperscript{136} Guidelines, *supra* note 124, at 20026.

\textsuperscript{137} 16 C.F.R. § 433.1(d) (1976). See Appendix A *infra* for the complete text of this definition.
in the transaction at issue. In the Statement of Basis and Purpose for this rule, the FTC notes, "[W]e are persuaded that . . . the act of referral is sufficient to justify imposition of the rule, provided referrals are made in the course of some routine or arrangement . . . ."\footnote{138} However, by separating the "referral" clause, (1), from the "affiliation" clause, (2), in the remainder of the purchase money loan definition with the word "or," the FTC neglected to require that seller referrals, like affiliations, involve "some routine or arrangement." Two consumer referrals by a seller without any other criteria do not necessarily suggest an interlocking loan.\footnote{139} It is difficult, if not impossible, for a totally unrelated creditor to ascertain that a particular merchant is referring consumers to him.\footnote{140} In fact, a disreputable merchant unable to obtain commercial purchasers for his chattel paper because of his poor reputation will very probably suggest other sources of credit to potential buyers, without the creditor's complicity or sanction.\footnote{141} Rather than take the risk that a consumer has been referred to him by a disreputable merchant, independent lenders will be reluctant to extend loans unless they can impose limitations on where the proceeds are to be spent.\footnote{142}

The Staff Guidelines help to clarify what is intended by "refers consumers to the creditor." Apparently, when the seller suggests that there are loan companies in the area, or provides consumers with a list of local finance companies, this is not a referral but merely "information."\footnote{143} "In short, where there is no communication whatsoever between a seller and a lender, there is no referral unless the seller is actively steering his

\footnote{138}{FTC Statement, supra note 56, at 53525 (emphasis added).}
\footnote{139}{See text accompanying note 106 supra. See also Comments on behalf of the New York State Bankers Association to the Office of the Secretary, Board of Governors of the Federal Reserve System, January 14, 1976, at 7 [hereinafter cited as N.Y.S.B.A. Comments] (on file at SANTA CLARA L. REV.); Letter from Sharyn G. Campbell, Counsel to the Credit Union National Association, to Christopher W. Keller, Presiding Officer, Federal Trade Commission, March 5, 1976, at 6 [hereinafter cited as C.U.N.A. Letter] (on file at SANTA CLARA L. REV.).}
\footnote{140}{FRB Comments, supra note 129, at 7.}
\footnote{141}{N.Y.S.B.A. Comments, supra note 139, at 7.}
\footnote{142}{FRB Comments, supra note 129, at 6.}
\footnote{143}{Guidelines, supra note 124, at 20025.}
customers to a predesignated loan outfit for credit." This distinction is not implicit in the rule itself. The Guidelines are not intended to alter or amend the rule, yet this is exactly the effect of the Commission explanation of the referral clause. It is hoped that courts will be persuaded by the Guidelines, or preferably, that the FTC will amend this clause so that it adequately reflects what appears to be the intended meaning. Perhaps the following language would be acceptable: "routinely refers consumers to the creditor" or "engages in the practice of referring consumers to the creditor."

A purchase money loan—that is, a loan which subjects the lender to consumer claims and defenses—is alternatively defined as a cash advance used to purchase goods or services from a seller who "is affiliated with the creditor by common control . . . ." Although not defined in the rule, "common control" refers to a situation where there is common ownership or other organizational relationship between the seller and lender, such as an interlocking directorate or joint management. The Guidelines state that common control exists when a seller and creditor are functionally part of the same business entity. It indicates a continuing relationship, and there are strong arguments for presuming that common control facilitates lender knowledge of seller activities and potential for recourse arrangements.

The seller may also be "affiliated" with the creditor by contract. "Contract" is defined as

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

This definition encompasses agreements relating to the financing of the sale of goods or services, such as payment of consideration to the seller for referral of consumer borrowers, recourse

144. Id. (emphasis added).
145. Id. at 20022.
146. 16 C.F.R. § 433.1(d) (1976).
147. Guidelines, supra note 124, at 20025.
149. Id. § 433.1(f).
arrangements, and seller guarantees. It also includes financing arrangements between the seller and lender where the lender has a security interest in the proceeds of the seller's inventory, including chattel paper. Evidence of a contractual relationship regarding the financing of consumer purchases is certainly proof that the lender has knowledge of the seller's activities and potential to arrange for recourse agreements. In fact, any financer of a seller's inventory will, in the ordinary course of business, check the seller's records. Further policing of the seller's relationship with consumers should not produce an additional burden for the financer, and holding such lenders liable to consumer-purchasers is consistent with the policies of risk allocation and policing the marketplace.

However, an informal contract between a merchant and lender may also contemplate activity in connection with the sale of goods or services to consumers unrelated to the financing of the sale. Conceivably, a creditor might enter into a contract to help finance an advertising campaign of the merchant, without taking any security interest in the inventory and proceeds. A contract of this sort does not affect the extension of credit to any customer of the seller, but it does contemplate activity connected with the sale of goods or services. Why should this creditor be subject to the claims and defenses of a consumer to whom he extends credit when a substantial part of the proceeds of the loan are used to purchase an appliance from this merchant? Since this creditor does not control the way the proceeds of his loans are spent, extending the rule to such a creditor clearly cannot serve the policy of policing the marketplace. Nor is the risk allocation policy furthered: a creditor in this situation has no way of passing the cost to the merchant. The creditor's absorption of the entire loss will result in increased credit rates and a reduction of independent direct loans.

The "affiliation criterion" may also be met by a "business arrangement," defined as "[a]ny understanding, procedure, course of dealing, or arrangement, formal or informal, between a creditor and seller, in connection with the sale of goods or

150. See note 62 and accompanying text supra.
151. Id.
152. N.Y.S.B.A. Comments, supra note 139, at 11-12.
153. FRB Comments, supra note 129, at 9-10.
services to consumers or the financing thereof." This includes such circumstances as the exchange of forms between seller and lender, direct payment of the proceeds of the loan by the lender to the seller, and conditioning the loan on purchase from a specified seller. It also includes any of the situations previously described that were not the product of a contractual agreement. For example, a checking account with the creditor in which the seller makes daily deposits of the cash income from the sale of his goods might qualify as an "arrangement . . . in connection with the sale of goods." A creditor with such nebulous connections with the seller should not be subject to defenses a consumer may have against this seller when he independently advances a loan, the proceeds of which (unknown to the creditor) are used to purchase goods from the seller. Suppose both consumer and seller have checking accounts with the same lender. Does the lender make an interlocking loan whenever the consumer buys something from the seller using the overdraft privileges he has with his checking account?  

The FTC's catch-all definition includes many other types of "understandings" or "procedures" which a merchant may have with a creditor that relate to the sale of his goods but which do not relate at all to the consumer-creditor relationship, and which have no bearing on the ability of the creditor to absorb the losses that result from seller misconduct. The Guidelines specifically state that a commercial checking account (as well as other general commercial arrangements such as a commercial lease, a general business loan, or a credit card agreement) does not invoke the rule. Yet these activities all fall within the concept of "affiliation" by contract or by "business arrangement." If the Federal Trade Commission did not intend the rule to cover these activities, the rule, not the Guidelines, should be the source for these exceptions.  

While the FTC rule properly and legitimately covers many situations where the creditor is in a position to have some recourse arrangement with the merchant or to police his activities, its broad sweep also covers situations where this would not be the case. In the area of preservation of consumer claims and

155.  Id. § 433.1(g).
156.  Id.
157.  See FRB Comments, supra note 129, at 9-12.
158.  Guidelines, supra note 124, at 20026.
defenses, it is seller misconduct, not creditor misconduct, which is the source of consumer problems. The disreputable merchant assigns the retail installment contract or arranges for an interlocking loan so he can take his money and run, leaving the "innocent" financer and consumer to fight it out. By policy decision, the risk is then placed upon the financer because he can best bear the costs and distribute them among all consumers. In any statutory scheme defining an interlocking loan, the activities of the seller which connect the consumer with the financing institution must be clearly outlined. The FTC rule does not describe specific situations; it covers many standard commercial relationships in which the seller has no role in the consumer's obtaining cash and the lender has no knowledge of how the proceeds of the loan will be spent. Thus, the financer is called to account, even if he is without recourse to transfer the cost to the seller and unable to learn of disreputable practices of particular merchants. The result can only be unrealistically high credit rates and a reduction in the availability of direct credit,\textsuperscript{159} with no appreciable gain for the consumer.

As noted previously,\textsuperscript{160} the rule does not mandate that creditors include the requisite notice in their loan contracts; however, a merchant is in violation of the FTC Act when he accepts the proceeds of a consumer credit contract which did not contain the notice. Thus, a seller may be reluctant to accept any cash that might be the proceeds of a loan advanced by a bank with whom the seller happens to deal. The seller must first ask the consumer the source of his cash and examine the loan contract to determine if it contains the FTC notice. The seller is not only put in an absurd position, but the consumer is subjected to the humiliating experience of protracted questioning—even when he pays in cash!\textsuperscript{161}

**LIABILITY OF THE HOLDER**

Once it is established that defenses and claims can be asserted against the holder of a consumer credit contract in a private action,\textsuperscript{162} what should be the extent of the holder's lia-

\textsuperscript{159} See opposition to the 1973 FTC Rule as described in FTC Statement, supra note 56, at 53517. See also W.S.B.A. Letter, supra note 130, at 8; C.U.N.A. Letter, supra note 139, at 15-22. The latter is an interesting discussion of the effect of the rule on the credit union industry. It is noteworthy that credit unions, generally concerned with the plight of the consumer, have taken a strong stand against the FTC rule.

\textsuperscript{160} See text accompanying notes 46-48 supra.

\textsuperscript{161} FRB Comments, supra note 129, at 4-5.

\textsuperscript{162} See text accompanying notes 173-74 infra for a discussion of public remedies.
bility? As with the definition of an interlocking lender, consider-
eration must be given to the policies of risk allocation and polici
ging the market.\footnote{163} If the holder would be subjected to un-
limited liability arising from the sale or lease transaction\footnote{164}—all con-
sequential damages, including tort injury to the con-
sumer\footnote{165}—then the holder would in fact become the mer-
chant's liability insurer. Such a result would drastically in-
crease the price of credit and decrease its availability.

Another approach is to limit the holder's liability to the t]

The UCCC limits the liability of the holder to the amount o
owing on the contract.\footnote{169} The advantage of this measure of re
covery is that it provides a built-in statute of limitations.\footnote{170}
However, such recovery is probably only beneficial to a con
sumer who learns of a claim or defense soon after entering into

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\footnote{163}{Rohner, \textit{supra} note 9, at 553.}
\footnote{164}{MCCA § 2.603(1)-(2) provide that the assignee of a consumer credit obliga-
tion or an interlocking lender is liable to the full extent of all claims and defenses which
arise from the transaction unless the assignee receives the obligation in good faith and
without knowledge and unless the direct lender can show he did not know how the
proceeds of the loan were to be used. If either can be shown, liability is limited to the
total amount of the transaction.}
\footnote{165}{There is no need to extend the liability of the holder to include personal
injury recovery. In many jurisdictions where the Second Restatement of Torts § 402A
is adopted, consumers can recover from the manufacturer for bodily injury proximately
caused by a dangerous product. \textit{See} W. Prosser, \textit{The Law of Torts} § 98, at 666-58
2d 57, 377 P.2d 897, 27 Cal. Rptr. 697 (1963).}
\footnote{166}{NCA § 2.407. \textit{See} Appendix E \textit{infra}.}
\footnote{167}{Rohner, \textit{supra} note 9, at 555.}
\footnote{168}{\textit{Id.}}
\footnote{169}{1974 UCCC § 3.405(2), (3). \textit{See} Appendix B \textit{infra}.}
\footnote{170}{\textit{See} W.S.B.A. Letter, \textit{supra} note 130, at 10.}
the loan obligation. If the claim arises when the loan is nearly paid, the consumer has lost almost as much as one who pays entirely in cash.

The FTC approach is the converse of limiting recovery to the amount owing on the contract: liability is limited to the amount already paid.\(^{171}\) The consumer is no longer obligated on his loan and he can recover whatever has already been paid to the creditor. This is equivalent to a rescission of the loan agreement. However, the consumer cannot claim consequential damages. When the consumer claim is not pursued until the obligation has been paid, or almost paid, the finance company becomes potentially liable for an amount equal or nearly equal to the full amount of the transaction. Because the FTC rule contains no statute of limitations, a creditor may be liable for this amount in perpetuity. Since the creditor is subject to all claims, including tort claims, it is possible that he may be liable (up to the amount paid) for a tort injury occurring many years after the contract account has closed.

It is difficult to determine which degree of liability best serves both the interest of the consumer and the right of the finance company to protect against excessive losses. However, it seems clear that in order to provide a measure of predictability for the financer, a statutory limit on the amount and the time period during which the holder is liable is desirable. This would allow the creditor to determine the terms of the recourse agreement with the seller and it would also keep the credit rates down. Since federal remedies for a violation of the rule do not preempt state law,\(^{172}\) there is no reason why a court, in proper circumstances, could not award recoveries beyond the FTC limit.

**Impact of the FTC Rule**

The new enforcement powers granted to the FTC in the Federal Trade Commission Improvements Act of 1975 strengthen the legislative mandate of the FTC trade regulation rule.\(^{173}\) The FTC is now empowered to bring civil actions to obtain redress for consumers or others who have been injured

\(^{171}\) 16 C.F.R. § 433.2(a)-(b) (1976). The last sentence of the notice reads: "Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder."


by violations of rules defining unfair or deceptive acts or practices. Of particular importance to consumers is the provision that

[s]uch relief may include, but shall not be limited to, resciission or reformation of contracts, the refund of money or return of property, the payment of damages, and public notification respecting rule violation . . . .

However, these enforcement powers may be of little aid to a consumer forced to continue payments for a broken appliance or unreceived service.

The Commission relies heavily upon consumer complaints to direct its attention to a particular act or practice in violation of section 5. Since there is no required notice to the consumer of his rights under this rule, the consumer will not learn that the holder's copy of his contract did not contain the FTC notice until the holder initiates action against him.

What recourse does the consumer have? The courts have established that an FTC rule does not provide a private right of action. The consumer can notify the FTC of the violation, but if the seller has absconded, the Commission will be powerless to enforce a penalty or to obtain redress. If the seller is still in business, the FTC will probably take steps to enforce the rule only when it learns that the seller is accepting a large volume of such contracts and is thus affecting a significant number of consumers. With a limited budget and an increasing number of trade regulation rules to enforce, it is unlikely that the FTC will act on individual complaints. The consumer, therefore, is in exactly the same position as he was before the rule was promulgated: he must stop payments, either instigate his own action or await action against him by the finance company, and then look to existing state law to determine if he can assert claims and defenses against the lender.

It is difficult to evaluate the impact the FTC rule will have upon state law. The amended FTC Act explicitly declares that

174. Id. § 57b(a)-(b).
175. Id. § 57b(b).
177. 1973 FTC Rule §§ 433.3, 433.4, supra note 83. The FTC decided that since there was evidence that most consumers fail to read their contracts, a consumer notice would be unnecessary. FTC Statement, supra note 56, at 53525-26.
179. The FTC has recently promulgated 23 final trade regulation rules. 41 Fed. Reg. 3322 (1976).
the remedies provided therein do not preempt other state or federal law. Therefore, states are free to fashion their own remedies. Those states with provisions defining unfair acts or practices similar to the FTC Act could add this rule to their lists of such acts or practices. States that do not have effective statutes barring cutoff devices or legislation dealing with the interlocking lender may regard the FTC rule as an impetus for drafting similar legislation. The states may well provide both public and private remedies which are far more effective, given the limited ability of the FTC to enforce this rule.

It is uncertain how state courts will interpret the FTC rule when a consumer attempts to assert a defense against the holder of a contract which does not contain the FTC notice. Is such a contract enforceable? According to the FTC, “The purpose of the rule is to permit courts of competent jurisdiction to examine equities where a consumer has a claim against the seller.” A liberal court may consider a holder to be in bad faith for taking a consumer credit contract that does not contain the notice. On the other hand, assuming the contract does contain the notice but the holder can show he had no relationship with the merchant and no knowledge of where the proceeds of the loan were to be spent, a conservative court might ignore the FTC notice.

Nor is it clear to what extent courts will be bound by the FTC rule. It has been observed that because the FTC Act does not show Congressional intent to supersede state law, courts may be reluctant to permit FTC rulings to negate exist-

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181. Cf. Cal. Civ. Code § 1770 (West Supp. 1976) which sets out a list of unfair or deceptive acts or practices to which the FTC rule on preserving consumer claims and defenses could be added. See also note 182 infra.
182. Erickson, supra note 9, at 259.
183. FTC Statement, supra note 56, at 5326.
184. In California the provisions dealing with unfair or deceptive acts or practices are Cal. Civ. Code §§ 1770, 3369 (West Supp. 1976); Cal. Bus. & Prof. Code § 17000 et seq. (West 1964). The California courts have held that federal court decisions interpreting the FTC Act “are more than ordinarily persuasive” in interpreting Cal. Civ. Code § 3369 (West Supp. 1976). The similarity of the FTC Act and section 3369 “in relation to unfair business practices indicates . . . a common purpose and must be considered as supplementing each other rather than being in conflict.” People v. Nat’l Research Co., 201 Cal. App. 2d 765, 773, 777, 20 Cal. Rptr. 516, 522, 524 (1962). Therefore, it is likely that California courts will also look to federal decisions interpreting the rule preserving consumer claims and defenses.
ing state statutes.\textsuperscript{185} How the consumer will fare in his state court remains to be seen.

CONCLUSION

The inequity of a financer asserting holder in due course status in many consumer transactions has long been recognized. Many jurisdictions have attempted to preserve consumer claims and defenses where the consumer credit contract has been assigned to a third party. However, despite a number of model proposals in the area, the interlocking lender loophole has not been closed in most states.

The FTC rule is a federal attempt to abolish HDC status of the assignee financer as well as to close the interlocking lender loophole. Although many jurisdictions provide some protection for the consumer whose credit contract has been assigned, the coverage varies considerably from state to state. The FTC rule is an attempt to provide uniformity in this area. Moreover, since only a few states protect the consumer from the interlocking lender, the FTC rule serves to fill a significant void.

Unfortunately, the FTC rule spills over into unwarranted areas, reaching innocent creditors and making them the guarantors of all consumer transactions where credit has been extended. Rather than draw on the carefully articulated proposals of the Uniform Consumer Credit Code or the Model Consumer Credit Act, the FTC drafters designed a convoluted but sweeping rule which could have an effect on consumer credit that the drafters did not intend.

Principles of risk allocation and market policing demand that the definition of “interlocking lender” be made clear and precise. If this is not done, the protections consumers gain from reform will be overshadowed by inevitable results: increased costs and decreased availability of credit. In an attempt to make a “flexible” rule, the FTC may have created a Pandora’s box.

This threat is made more troublesome by the FTC’s increased enforcement powers. On the other hand, even with its new powers, the nature of the rule may make it difficult for the FTC to detect violations until the harm to the consumer is

nearly irremedial. The individual consumer may still be fighting over the contract for his broken appliance while the FTC is deciding whether (and how) to penalize a bankrupt merchant.

It is laudable that the FTC chose to protect the borrowing consumer confronted with the unassailable holder in due course. However, this sweeping rule fails in its purpose. It is hoped that the FTC will amend the rule entirely by returning to the format it proposed in 1973, requiring a careful definition of the interlocking lender, a consideration of risk allocation and market policing, and a balancing of the interests of the consumer with the realities of the credit industry.

Bonnie Packer
Appendix A

Federal Trade Commission Trade Regulation Rule Concerning Preservation of Consumers’ Claims and Defenses*

Section 433.1 Definitions.

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

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

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

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

(e) **Financing a sale.** Extending credit to a consumer in connection with a “Credit Sale” within the meaning of the Truth in Lending Act and Regulation Z.

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

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

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

(i) **Consumer credit contract.** Any instrument which evidences or embodies a debt arising from a “Purchase Money Loan” transaction or a “financed sale” as defined in paragraphs (d) and (e).

Section 433.2 Preservation of Consumers' Claims and Defenses, Unfair or Deceptive Acts or Practices.

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

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

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

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

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.
Section 3.405. Lender Subject to Claims and Defenses Arising from Sales and Leases.

(1) A lender, except the issuer of a lender credit card, who, with respect to a particular transaction, makes a consumer loan to enable a consumer to buy or lease from a particular seller or lessor property or services is subject to all claims and defenses of the consumer against the seller or lessor arising from that sale or lease of the property or services if:

(a) the lender knows that the seller or lessor arranged for the extension of credit by the lender for a commission, brokerage, or referral fee;
(b) the lender is a person related to the seller or lessor, unless the relationship is remote or is not a factor in the transaction;
(c) the seller or lessor guarantees the loan or otherwise assumes the risk of loss by the lender upon the loan;
(d) the lender directly supplies the seller or lessor with the contract document used by the consumer to evidence the loan, and the seller or lessor has knowledge of the credit terms and participates in preparation of the document;
(e) the loan is conditioned upon the consumer's purchase or lease of the property or services from the particular seller or lessor, but the lender's payment of proceeds of the loan to the seller or lessor does not in itself establish that the loan was so conditioned; or
(f) the lender, before he makes the consumer loan, has knowledge or, from his course of dealing with the particular seller or lessor or his records, notice of substantial complaints by other buyers or lessees of the particular seller's or lessor's failure or refusal to perform his contracts with them and of the particular seller's or lessor's failure to remedy his defaults within a reasonable time after notice to him of the complaints.

(2) A claim or defense of a consumer specified in subsection (1) may be asserted against the lender under this section only if the consumer has made a good faith attempt to obtain satisfaction from the seller or lessor with respect to the claim
or defense and then only to the extent of the amount owing to
the lender with respect to the sale or lease of the property or
services as to which the claim or defense arose at the time the
lender has notice of the claim or defense. Notice of the claim
or defense may be given before the attempt specified in this
subsection. Oral notice is effective unless the lender requests
written confirmation when or promptly after oral notice is
given and the consumer fails to give the lender written confir-
mation within the period of time, not less than 14 days, stated
to the consumer when written confirmation is requested.

(3) For the purpose of determining the amount owing to
the lender with respect to the sale or lease;

(a) payments received by the lender after consolida-
tion of two or more consumer loans, except pursuant to
open-end credit, are deemed to have been applied first to
the payment of the loans first made; if the loans consoli-
dated arose from loans made on the same day, payments
are deemed to have been applied first to the smallest loan;
and

(b) payments received for an open-end credit ac-
count are deemed to have been applied first to the pay-
ment of finance charges in the order of their entry to the
account and then to the payment of debts in the order in
which the entries of the debts are made to the account.

(4) An agreement may not limit or waive the claims or
defenses of a consumer under this section.

Appendix C

Factors Proposed by the National Commission on Consumer
Finance for Determining the Existence of an Interlocking
Loan*

(1) The lender supplied forms to the seller, lessor or sup-
plier of services which the consumer used in obtaining the loan.

(2) The seller, lessor or supplier prepared or assisted in
preparation of documents used to evidence the loan.

(3) The lender is related to or affiliated with the seller,
lessor or supplier of services.

* Report of the National Commission on Consumer Finance, Consumer Credit
(a) With regard to individuals, "related to" refers to any familial relationship;
(b) with regard to corporations, firms, partnerships, trusts, and other organizations, "affiliated with" refers to (1) direct or indirect control of or by any such organization, (2) interlocking directorates or other form of joint or common management of two or more organizations, or (3) familial relationship with an officer, director, owner, partner, trustee, or similar official of an organization.

(4) The lender directly or indirectly pays the seller, lessor, or supplier of services, any commissions, fees, or other consideration measured by or based in any way on the consumer loan.

(5) The lender has knowledge—including knowledge from dealing with other customers of the seller, lessor or supplier of services or knowledge from records or notices of complaints by other such customers—that the seller, lessor, or supplier of service failed to perform agreements with customers or fails to remedy valid complaints.

(6) The lender has repeatedly and regularly made loans in a 1-year period to finance purchases of goods or services from the seller, lessor, or supplier of services, or persons related to or organizations affiliated with the seller, lessor, or supplier of services, and the lender was recommended to the consumer for the loans in question.

Appendix D

Federal Trade Commission Proposed Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses (1973)*

Section 433.1. Definitions.

(h) Related creditor. Any person, partnership, corporation, or association, which is engaged in making loans to consumers to enable payment to be made for consumer goods or services and which either participates in or is directly connected with the consumer transaction. Without limiting the scope of the immediately preceding language, there shall be a rebuttable presumption that a creditor is a related creditor under any one of the following circumstances:

(1) The creditor is a person related by blood or marriage to the seller or to the seller’s spouse.

(2) The creditor prepared, supplied or furnished the seller with the forms or documents used to evidence or secure the consumer loan.

(3) The seller prepared, supplied or furnished the creditor with the forms or documents used to evidence or secure the consumer loan.

(4) The creditor is directly or indirectly controlled by, under common control of, or is otherwise affiliated with the seller.

(5) The creditor and the seller are engaged in a joint venture to produce consumer obligations payable either directly or by transfer to the creditor.

(6) The creditor directly or indirectly pays the seller any consideration for the referral of consumer borrowers.

(7) The seller guaranteed the consumer loan or otherwise assumed the risk of loss by the creditor upon the loan.

(8) The creditor made five or more loans within a 1-year period the proceeds of which are used in transactions with the same seller following referral of the consumer to the creditor by the seller.

(9) (i) The creditor knew or had reason to know that the loan proceeds would be used in whole or in substantial part to pay the seller for an obligation of the consumer, and (ii) the creditor had notice that the seller failed or refused to perform contracts with the consumers, or failed to remedy complaints within a reasonable time.

Appendix E

National Consumer Law Center, National Consumer Act (1970)

Section 2.407 (Interlocking Loans and Sales)

(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.

Appendix F

National Consumer Law Center, Model Consumer Credit Act (1973)

Section 2.603 Liability of Lender and Transferee

(1) The lender who extends credit to a consumer in the form of a loan and the transferee of that obligation is liable to the consumer to the full extent of all claims, defenses and equities of the consumer arising out of the consumer transaction in which the proceeds of the loan are used, except as otherwise provided in this Section.

(2) If the lender extends the loan or the transferee acquires the obligation of the consumer in good faith, without notice of any claims, defenses or equities and continues to act in good faith throughout the transaction, the liability of the lender or transferee shall not exceed the amount of the proceeds of the loan used in the consumer transaction and, in addition, any finance or other charges arising out of the loan which are attributable to that amount.

(3) The lender or transferee of the lender has no liability pursuant to this Section if
(a) with respect to the lender who acts in good faith he establishes by a preponderance of the evidence that he did not know and had no reason to know that the proceeds of the loan, or any part of them, would be used in a consumer transaction, or

(b) with respect to the transferee who acts in good faith he establishes by a preponderance of the evidence that the lender would have qualified for exemption from liability under subsection (3)(a) and that the transferee did not know and had no reason to know that the proceeds or any part of the loan were used in a consumer transaction.

(4) Without limiting the scope of the inquiry pursuant to subsection (3) regarding the knowledge or reason to know of the lender, the lender will be deemed to have knowledge that the proceeds of a loan will be used in a consumer transaction when

(a) the lender is a person related to the seller; or

(b) the lender supplies to the seller or the seller prepares documents used to evidence the loan obligation of the consumer; or

(c) the lender has recourse to the seller for nonpayment of the loan through guaranty, reserve account or otherwise; or

(d) the lender directly or indirectly pays to the seller any commission, fee or other consideration based upon the assistance or cooperation of the seller in the obtaining of the loan; or

(e) the lender makes payment of the proceeds of the loan to the seller either individually or jointly with the consumer; or

(f) the lender conditions the extension of credit upon the purchase of goods or services from the seller; or

(g) the lender knew or should have known that the loan was arranged by the seller or a person acting on behalf of the seller; or

(h) the lender and seller participate in any arrangement, formal or otherwise, in which the seller refers consumers to the lender; or

(i) the lender permits the reference to his services to be used by the seller in connection with the consumer transactions; or

(j) the lender takes a security interest in the property which is the subject of the consumer transaction; or
(k) the lender otherwise participates in or is connected with the consumer transaction.

(5) The lender has the right, without penalty, to rescind a loan commitment if the consumer has not irrevocably obligated himself in reliance upon the commitment and if, after the commitment is made but before the loan is extended, the lender acquires knowledge of facts giving rise to a substantial risk of liability which risk was not known at the time the commitment was initially made and he thereupon promptly gives the consumer notice of the facts and of the election to rescind the contract.