

Winter 1977

The FTC's Preservation of Consumers' Claims and Defenses: Consumer Security or Consumer Fraud?

Follow this and additional works at: <https://scholar.valpo.edu/vulr>

 Part of the [Law Commons](#)

Recommended Citation

The FTC's Preservation of Consumers' Claims and Defenses: Consumer Security or Consumer Fraud?, 11 Val. U. L. Rev. 263 (1977).

Available at: <https://scholar.valpo.edu/vulr/vol11/iss2/3>

This Notes is brought to you for free and open access by the Valparaiso University Law School at ValpoScholar. It has been accepted for inclusion in Valparaiso University Law Review by an authorized administrator of ValpoScholar. For more information, please contact a ValpoScholar staff member at scholar@valpo.edu.



THE FTC'S PRESERVATION OF CONSUMERS' CLAIMS AND DEFENSES: CONSUMER SECURITY OR CONSUMER FRAUD?

INTRODUCTION

Growing concern for consumer protection, partially the consequence of gross injustice toward the consumer evident in the common law and partially the result of strong consumer lobbies, has spawned dynamic legal developments.¹ Federal, state and local legislative bodies have all become active in the movement to protect the consumer. State legislatures have provided for easier consumer access to the courts;² local officials have attempted to enforce ordinances designed to prevent consumer injuries.³ On the federal level this drive has instigated attempts to create a federal consumer agency.⁴ While such an agency has never materialized, Congress has opted to expend the powers of the Federal Trade Commission in the hope that the FTC could assume the role of chief consumer protection agency in the United States.⁵ This note examines the scope and effect of a recent FTC regulation—"Preservation of Consumers' Claims and Defenses"⁶—which represents the latest attempt to introduce consumer protection into the modern credit process.

Consumerism is of rather recent vintage. For centuries the interests of the investor-merchant had been paramount in the legal and commercial decision-making processes of society. These merchant interests spurred development of the concept of negotiability in English law in order to increase the money supply within the economy and create for the holder of notes and contracts a means of

1. See, e.g., Uniform Consumer Credit Code (U.C.C.C.); Truth-in-Lending Act, 15 U.S.C. §§ 1601 *et seq.* (1968); Model Consumer Credit Act (proposed by the National Consumer Law Center). The development of strict products liability theory has also worked for consumers' benefit. See RESTATEMENT, (SECOND) OF TORTS § 402A; U.C.C. § 2-314 (1972 Official Text) [hereinafter cited as U.C.C.].

2. CONSUMER PROTECTION ACTIVITIES OF STATE GOVERNMENTS (Government Printing Office, Washington, D.C., 1963); COUNCIL OF STATE GOVERNMENTS, CONSUMER PROTECTION IN THE STATES (1970).

3. L. GORDON & S. LEE, ECONOMICS FOR CONSUMERS 651 (1972); Staff Studies Prepared for the National Institute for Consumer Justice on Federal Regulatory Agencies 60 (1972).

4. *Hearings on S.R. 707 and S.R. 1160 Before the Subcomm. on Reorganization, Research and Int'l Organization of the Senate Comm. on Gov't Operations*, 93d Cong., 1st Sess. (1973).

5. The result of this was the FTC Improvement Act of 1975, 15 U.S.C. §§ 41-57 (1975). See 4 U.S. CODE CONG. & AD. NEWS 7702 (1974).

6. 16 C.F.R. § 433 (1975). See note 16 *infra*.

obtaining immediate capital.⁷ These same interests also developed the notion of a holder in due course (HDC), which insured the ready negotiability of notes and contracts. Since their inception in the eighteenth century, the concepts of negotiability and the preferred holder have become firmly entrenched in our legal heritage.⁸

While negotiability was originally a tool used primarily among merchants, today it directly affects millions of *consumers*. Merchants no longer do the bulk of credit buying; it is the consumer who has totally adopted the credit purchase and in so doing has been faced with the likelihood of having his credit contract or promissory note negotiated or assigned. In the past few decades the volume of consumer credit buying has more than doubled.⁹ Credit buying has so permeated every aspect of consumer sales that it may be on the way toward replacing cash as the principle value mechanism.¹⁰

Negotiability and the HDC status are useful tools when employed in an all-merchant transaction; but when used in a consumer transaction, they create great potential for injury to the consumer—a potential which in the past has often been realized.¹¹ An illustrative case highlights the dangers and problems facing the consumer when his notes or contracts are assigned.

7. Negotiability is the ability to transfer the right to receive payment on a promissory note to a subsequent holder. See Littlefield, *Good Faith Purchase of Consumer Paper*, 39 S. CAL. L. REV. 48 (1966) [hereinafter cited as Littlefield, *Good Faith Purchase*]; Rosenthal, *Negotiability—Who Needs It?*, 71 COLUM. L. REV. 375 (1971). The primary benefits of negotiability are that it creates immediate capital for the negotiator, increases the overall money flow, and increases the incidence of credit buying.

8. The first judicial recognition of negotiability was made in *Race v. Miller*, 97 Eng. Rep. 398, 402 (K.B. 1758). See Rosenthal, *supra* note 6, at 378. Most merchant-creditors believed that a note would be useless unless some promise could be made by which payment could be guaranteed to a transferee. When only a consumer credit contract is used the same result can be achieved by use of a waiver of defenses clause. See U.C.C. § 9-206.

9. Figures indicate that in 1976 there was well over \$190 billion in outstanding consumer credit, marking an increase from \$90 billion in 1965. 58 FED. RES. BULL. 961 (Oct. 1972); B. CURRAIN, TRENDS IN CONSUMER CREDIT LEGISLATION 8-14 (1965). These figures represent amounts of credit outstanding at the end of the year. 61 FED. RES. BULL. A-45 (Dec. 1975). For an explanation of these figures, see 58 FED. RES. BULL. 961 (Oct. 1972). See also Littlefield, *Preserving Consumer Defenses: Plugging the Loopholes in the New UCCC*, 44 N.Y.U.L. REV. 272, 293 (1969) [hereinafter cited as Littlefield, *Preserving Consumer Defenses*].

10. I. FISHER, PURCHASING POWER OF MONEY 79 (1927); L. MANDELL, CREDIT CARD USE IN THE UNITED STATES 94-104 (1972).

11. For examples of consumer injury see 40 Fed. Reg. 53506 (1975), and W. MAGNUSON, THE DARK SIDE OF THE MARKET PLACE 9-33 (1972).

In response to an advertisement in a local newspaper, residents signed up to begin classes in an electronics school. Upon enrollment each student signed a tuition installment contract for \$2000. The contract contained a waiver of defenses clause which abrogated any right in the signer to assert a defense against a subsequent holder of the contract. Like most schools, this one required immediate cash to maintain its operation. Thus, to negotiate the contracts for the maximum amount, the school had to include such a waiver. The school later assigned the contracts to a financier. Because the financier purchased the contracts for value, in good faith, and without notice of a defense to payment, he held the contract with all the rights of a holder in due course.¹² Unfortunately the school went bankrupt. When the students arrived for classes they were confronted with an empty building and a creditor who had a perfect legal right to receive \$2000 from each. Since the school was judgment-proof, the students had no meaningful recourse against it and were bound by the contract and waiver clause to pay the full tuition price.¹³

This example, repeated in innumerable variations, illustrates at least two points. First, there is a conflict of interest between the seller (school) who desires, quite properly, to get the most cash for assigned contracts and notes, and the consumer who hazards paying without getting any benefits. Secondly, this example highlights the potential dangers which negotiability and the HDC status present to the consumer.¹⁴ These dangers are realized when the duty of the seller to perform is separated from the consumer's duty to pay. The separation is effected in a way which cuts off the consumer's right to assert defenses against the financier-holder. The consumer becomes liable to a third party without immediate recourse to the seller to enforce the contract. Another danger created by negotiability and the HDC status is that the seller may become bankrupt or may disappear, leaving the consumer without any recourse.¹⁵ For these

12. The requirements for holder in due course status (HDC) are found in U.C.C. § 3-302. Since the holder here has a contract and not a negotiable instrument, U.C.C. § 9-206 would apply, giving the holder of the contract with waivers all the rights of an HDC. See Note, *The Status of UCC § 9-206—The Waiver of Defense Clause*, 31 U. PITT. L. REV. 687 (1971) [hereinafter cited as *Status of UCC § 9-206*].

13. A similar case was reported to the FTC during its hearings on the proposed Seller Rule. 40 Fed. Reg. 53506, 53515 (1975).

14. "HCD status" is used here to mean any situations in which the seller and creditor may successfully cut off the consumer's defenses. See note 11 *supra*.

15. It is generally not worth the effort or expense for a consumer to attempt to find a seller who has suddenly disappeared. Even the best small claims court procedure cannot help when the defendant seller is not amenable to service of process.

reasons, consumer protection measures have concentrated on limiting the seller's ability to cut off consumers' defenses by transfer of the sales note or contract.

The latest, and to date the most sweeping, step in the battle to preserve consumers' defenses has come in the form of a regulation promulgated by the Federal Trade Commission. This regulation, which became effective in May of 1976, is entitled "Preservation of Consumers' Claims and Defenses."¹⁶ The regulation prevents the seller from cutting off a consumer's right to assert defenses to payment for goods and services against that party whom the consumer-debtor must pay. Negotiability is not forbidden in consumer credit transactions by this "Seller Rule," but the Rule does purport to deny HDC status or the rights thereof to certain transferees of consumer credit instruments and to certain related creditors.

The Seller Rule itself is deceptively clear and straightforward. Its brief text reads:

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.

16. 16 C.F.R. § 433 (1975). This regulation was first proposed by the FTC in 1971, 35 Fed. Reg. 1211 (1971); it was altered and proposed again in 1973, 38 Fed. Reg. 892 (1973); in its final form it was issued in 1975. 40 Fed. Reg. 53506 (1975). The Seller Rule was adopted according to the prescribed procedures which require the FTC to hold public hearings on the proposal. Promulgation must be published in the Federal Register and accompanied with a statement of basis and purpose. 16 C.F.R. §§ 1.7 *et seq.* (1975).

or, (b) Accept as full or partial payment for 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.¹⁷

The Federal Trade Commission's Seller Rule brings a long needed protection to the consumer as debtor. Its preservation of defenses in the interlocking loan transaction is of particular merit. Although a significant improvement from earlier attempts to preserve the consumer's claims and defenses, it poses some new problems as well. Not the least of these problems is the inability of the FTC to enforce the Seller Rule adequately. The FTC structure and resources are not geared for enforcement of such a pervasive rule, affecting as it does millions of transactions. The consumer injured by a violation of the Seller Rule does, however, have several possible alternatives to enforcement through normal FTC procedures. Should the Seller Rule be amended as proposed,¹⁸ implication of a private cause of action would offer the consumer a direct remedy. Even without that amendment, the consumer may still have a viable remedy through the good faith requirements of the U.C.C.¹⁹

17. 16 C.F.R. § 433 (1975). A consumer credit contract is defined: "Any instrument which evidences or embodies a debt arising from a 'Purchase Money Loan' transaction or a 'financed sale' as defined in [this section]." 16 C.F.R. § 433.1(g) (1975). A purchase money loan is defined:

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.

16 C.F.R. § 433.1(d) (1975).

18. See note 130 *infra* and accompanying text.

19. See notes 209-21 *infra* and accompanying text.

SEPARATION AND THE HDC STATUS AS PROBLEMS FOR THE CONSUMER

In many cases where the consumer is injured, as in the illustrative case above, his defenses are cut off by negotiation to an HDC in the furtherance of some clandestine purpose of the seller. Such bilkings are possible because in many states the law permits separation²⁰ of the transactional duties.²¹ Separation occurs when the seller's duty to abide by the contract is separated from the consumer's duty to pay the loan required to buy those goods or services. The consumer's defenses are entirely cut off when separation includes a waiver of defenses by the consumer or involves a promissory note transferred to an HDC. There are five types of sales transactions in which separation of duties can act to cut off consumers' defenses:

1. The seller may force the consumer to sign a promissory note in addition to the sales contract, later discounting the note to another holder.
2. The seller may include in the terms of the sales contract a waiver of defenses against subsequent holders and then assign the contract. This method was used in the illustration above.
3. The seller may refer the consumer to a creditor with whom the seller is related and have the consumer arrange for a loan with which to make the purchase.
4. The seller may leave the consumer to arrange his loan independently.
5. The seller may accept payment on the card of a third-party credit card company.²²

In each of these situations the seller increases the value of the consumer credit contract or note and insulates himself and the holder of the note or contract from the consumer, who would stop payment in response to breach by the seller. Although it is advantageous to the seller and creditor, separation generally works a burden on the consumer.

In every situation in which the seller successfully separates the transactional duties to cut off defenses, the consumer retains the legal

20. In this analysis, "separation" will be used to refer to the separation of the duty of the consumer-debtor to pay for goods or services from the duty of the seller to provide those goods or services.

21. "Transactional duties" are the corresponding duties of the consumer to pay and the seller to produce.

22. These five were recognized and described by the FTC in hearings held prior to promulgation of the Seller Rule. 40 Fed. Reg. 53506 (1975).

right to bring suit against the seller directly when a breach occurs.²³ However, separation denies the consumer the simplest and most reasonable remedy—non-payment.²⁴ Unlike the costly and time-consuming process of litigation, non-payment has the benefit of being readily employable, placing the burden of litigation on the creditor or seller. In many cases it would be economically impracticable for the consumer to seek legal redress, since the cost of the seller's breach is less than the cost of litigation. Thus when separation of duties cuts off defenses, the consumer will often absorb the loss rather than chance a costly suit.²⁵ Even assuming that the consumer were in an economic position to litigate, if the seller could not be found, or were beyond the jurisdiction of the court, or were judgment-proof, the consumer would remain essentially without recourse.²⁶ Separation, therefore, burdens the consumer in three ways when the seller breaches: first, the consumer is forced to litigate instead of simply refusing to pay; second, separation makes it too expensive for the consumer to remedy many seller breaches; and third, the consumer faces a total loss if the seller is inaccessible to direct suit.

Recent developments in other areas of the law, primarily procedural in nature, have helped reduce the potential for harm to the consumer. Many states have organized small claims courts to handle minor claims, generally those involving sums less than \$3000.²⁷ Other states have given their courts leeway to develop new

23. See, e.g., *Smith v. Regina Mfg. Corp.*, 396 F.2d 826 (4th Cir. 1968); *Universal Major Elec. Appliances v. Glenwood Range Co.*, 223 F.2d 76 (4th Cir. 1955).

24. Non-payment has been considered reasonable or possible in the limited situation where the only parties involved are the seller and the consumer. If the consumer were to stop payment to a creditor, his first concern may be his credit rating. The Seller Rule, however, is an attempt to permit the refusal without causing repercussions for the consumer. As this right of non-payment becomes part of the contract it should not be used against the consumer. If a poor credit rating is threatened by the creditor, the FTC suggests a direct suit against the creditor to clear up the rating. See note 59 *infra* and accompanying text.

25. This same problem faces the consumer where the item purchased costs just enough to justify credit buying but not enough to justify filing suit to retrieve the loss. These cases, of course, rarely find their way into court, but many such examples have been recorded. See 40 Fed. Reg. 53506, 53509-12 (1975); W. MAGNUSON, *THE DARK SIDE OF THE MARKETPLACE* 9-33 (1972); *Cook v. Lilly*, 208 S.E.2d 784, 787 (W. Va. 1974).

26. The freezer meat industry has been particularly known for disappearing after making credit sales. See 40 Fed. Reg. 53506, 53511 (1975). Even the worst record should not detract from the fact that most sellers are reputable and if alerted to a breach would remedy the situation without the coercion of litigation. Rosenthal, *supra* note 6; Miller, *An Alternative Response to the Supposed Direct Loan Loophole in the UCCC*, 24 OKLA. L. REV. 427, 438, 443 (1971).

27. D. GOULD, *STAFF STUDIES PREPARED FOR THE NATIONAL INSTITUTE FOR CONSUMER JUSTICE ON SMALL CLAIMS COURTS* (1972).

concepts in consumer arbitration.²⁸ In federal tribunals, allowing recovery of attorneys' fees and expanding the scope of consumer class actions under Federal Rule of Civil Procedure 23(b)(3) have also helped alleviate the pressure on the consumer.²⁹ The primary benefit of these developments is that they have made it easier and cheaper for the consumer to assert his claims against the seller. Such remedies, however, are of no avail if the seller is bankrupt or has absconded. Further, they generally either require the consumer to exert some financial effort over and above simple refusal to pay, or they are limited to losses of minor amounts.

In recognition of the present inadequacies of these remedies and the need for a direct substantive remedy, attempts have been made to alleviate the detrimental impact of separating the transactional duties in consumer transactions for the purposes of cutting off claims and defenses. Most of these attempts have tried to reunite the duties of seller and consumer. Forty states have passed legislation relating to the consumer's duty to pay in response to seller breach,³⁰ while various state courts have made advances in mitigating the effect of separation by developing novel interpretations of existing law.³¹ The

28. For example, a Michigan statute gives the local judge the option of developing his own method for consumer redress:

The judge of such court may by rule provide for the establishment and maintenance of a conciliation division of the court for the purpose of adjusting, in an informal manner, controversies submitted to it involving \$300.00 or less, and the judges of such court shall, upon the establishment of such conciliation division adopt rules governing the submission of controversies to such conciliation division and the practice and procedure to be followed therein.

MICH. COMP. LAWS ANN. § 728.18 (1969).

29. Note, *Allowance of Attorney Fees in Civil Rights Action*, 7 COLUM. J.L. & SOC. PROB. 381 (1971); Note, *Attorney's Fees: Where Shall the Ultimate Burden Lie?*, 20 VAND. L. REV. 1216 (1967).

30. 40 Fed. Reg. 53506, 53521 (1975). The most complete consumer legislation has been passed in Massachusetts, New York and Wisconsin. Other states operating under less extensive laws preserving consumers' claims and defenses include Connecticut, Mississippi, Nevada, Texas, New Mexico, Maryland and California. See, e.g., CAL. CIV. CODE § 1804.1 (West 1973); MD. ANN. CODE art. 83, § 147 (1957); MASS. ANN. LAWS ch. 225, § 12c (Michie/Law Co-op 1966); Littlefield, *The Continuing Demise of the HDC Concept*, 79 COMM. L.J. 41, 46 (1974); Skilton & Helstead, *Protection of the Installment Buyer of Goods Under the Uniform Commercial Code*, 65 MICH. L. REV. 1465, 1465-68 (1967).

31. Any judicial remedy to separation has been limited because the courts are bound by the clear meaning of the U.C.C. Yet some courts have sought a limited remedy. There have been a few areas of encroachment by state courts in which the HDC status of holders of consumer notes and contracts has been limited. The most prevalent has been the "proximity rule" or "close-connectedness doctrine."

general tenor of these laws and decisions, however, has been less than adequate.³²

Uniform national laws which have been adopted by some states have also begun to reflect the change in emphasis toward consumer credit protection. In nearly all states the basis of commercial law is the Uniform Commercial Code (U.C.C.).³³ The U.C.C., however, both sanctions the use of the HDC status in consumer transactions and gives authority to the use of waivers of defenses in consumer contracts.³⁴ The more recently proposed Uniform Consumer Credit

This rule states that where the assignor and assignee are sufficiently close the court will hold the assignee to have had notice of any defense of the consumer, or to be so closely related that the exchange of the instrument will not be considered a transfer. *International Finance Corp. v. Rieger*, 272 Minn. 192, 137 N.W.2d 172 (1965); Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1097-1100 (1954); Marinelli, *Negotiable Instruments and the Holder in Due Course of Consumer Paper*, 8 AM. BUS. J.L. 253 (1971); Note, *Bills and Notes—The Close Association Doctrine Revisited*, 16 LOY. L. REV. 457 (1970); Comment, *Judicial Limitation on Holder in Due Course Claim*, 42 U. COLO. L. REV. 439 (1971). See also *Unico v. Owens*, 50 N.J. 101, 232 A.2d 405 (1967).

Other courts have held waiver of defense clauses invalid as oppressive terms in contracts of adhesion and thus against public policy. See, e.g., *Gross v. Appelgren*, 171 Colo. 7, 467 P.2d 789 (1970); *Mutual Finance Co. v. Martin*, 63 So. 2d 649 (Fla. 1953). *Contra*, *Commercial Credit Corp. v. Childs*, 199 Ark. 1073, 137 S.W.2d 260 (1940). States that have eliminated the use of waiver of defense clauses in consumer credit contracts include Alabama, Arizona, California, Hawaii, Massachusetts, Michigan, New Mexico, Oregon, Utah, Vermont and Washington. *Status of UCC § 9-206, supra* note 11, at 689.

Some courts have held that a promissory note accompanying the contract of sale is merged into the contract and thus inseparable from its terms. See, e.g., *Equipment Acceptance Corp. v. Arwood Can Mfg. Co.*, 117 F.2d 442 (6th Cir. 1941); *International Finance Corp. v. Rieger*, 272 Minn. 192, 137 N.W.2d 172 (1965). Still other courts have bypassed the intent of the U.C.C. by applying an objective test of good faith in judging the status of the holder. See, e.g., *Unico v. Owens*, 50 N.J. 101, 232 A.2d 405 (1967).

32. See Hartman & Walker, *The Holder in Due Course and the Consumer*, 77 COM. L. J. 116 (1972) [hereinafter cited as Walker, *Holder in Due Course*].

33. All American jurisdictions except Puerto Rico and Canal Zone have adopted the U.C.C., although states have made numerous changes. See UNIFORM LAWS ANN. Directory of Acts (1976).

34. The basis of the holder in due course is given in U.C.C. § 3-302. This section states that if the holder of a negotiable instrument takes it in good faith without notice of a defense to the instrument and gives value, he is a holder in due course. This status permits the holder to cut off the debtor's defenses, but in § 3-305 those defenses *not* cut off are listed:

- 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 transaction 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

Code (U.C.C.C.)³⁵ takes a more positive stand against separation of duties to cut off defenses. According to the U.C.C.C., the seller may not accept any negotiable instrument other than a check as payment,³⁶ while the use of the waiver of defenses device is greatly restricted.³⁷ The proposed Model Consumer Credit Act (C.C.A.) takes

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.

U.C.C. § 3-305.

The test of good faith by the holder is "honesty in fact" in the taking—a subjective test. U.C.C. § 1-201(19). The test of notice is objective, yet the holder must have notice of an actual defense in existence at the time of the taking. U.C.C. § 1-201(26) (1962 version). Mere knowledge of a limitation such as a security agreement is not sufficient to destroy the HDC status.

Where waiver of defenses is used a different section applies:

[A]n agreement by a buyer or lessee that he will not assert against an assignee any claim or defense which he may have against the seller or lessor is enforceable by an assignee who takes his assignment for value, in good faith and without notice of a claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the Article on Commercial Paper.

U.C.C. § 9-206. This gives the holder of a consumer credit contract all the rights of an HDC. U.C.C. § 9-206, however, expressly limits the effectiveness of these waivers if there are other conflicting state laws; subsection one reads, "[s]ubject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods . . ." In Comment 2 following the section, the drafters acknowledged that some legislatures had restricted the use of such waivers: "[t]his Article takes no position on the controversial question of whether a buyer of consumer goods may effectively waive defenses." See *Status of UCC § 9-206*, *supra* note 11, at 687.

35. The U.C.C.C. was drafted in the summer of 1968 and published in final form in 1969. It has since been adopted in eleven states: Colorado, Idaho, Indiana, Iowa, Kansas, Maine, Oklahoma, South Carolina, Utah, Wisconsin, Wyoming. *UNIFORM LAWS ANN.* 36 (Supp. 1976).

36. "[T]he seller or lessor may not take a negotiable instrument other than a check as evidence of the obligation of the buyer or lessee. A holder is not in good faith if he takes a negotiable instrument with notice that it is issued in violation of this section." U.C.C.C. § 2.403 (1969 Official Text) [hereinafter cited as U.C.C.C.]. For a generally critical analysis of the U.C.C.C. approach to separation see Topucki, *The Uniform Consumer Credit Code: Consumers' Code—or Lenders' Code*, 22 U. FLA. L. REV. 335 (1970).

37. U.C.C.C. § 2.404 offers two alternative means of dealing with the waiver of defense clause. Alternative A [Assignee Subject to Defenses] makes the waiver clause unenforceable. Alternative B [When Assignee Not Subject to Defenses] permits the waiver but requires the assignor to notify the consumer of the assignment. The consumer is given three months after notice in which he can assert defenses. "This agreement is enforceable only with respect to claims or defenses which have arisen before the end of the 3-month period after notice was mailed." This alternative has been severely criticized for the nominal protection it offers. Fritz, *Would the Uniform Consumer Credit Code Help the Consumer?*, 25 BUS. LAW. 511, 514 (1970). *Contra*

an even stronger stand against separation in consumer transactions.³⁸ Unfortunately, neither the U.C.C.C. nor the C.C.A. has been adopted by very many states.³⁹

In each of these attempts, reunion of the obligation of the consumer to pay with the duty of the seller to perform was deemed the best answer to the problem facing the consumer. Reunion of the transactional duties was aimed at maintaining reciprocal duties, but it was generally not concerned with maintaining the same parties. Thus the duties may have been reunited, with the parties involved being the consumer and creditor. Several reasons may be suggested for the emphasis on reunion. Reunion provides the consumer with an immediate remedy to the seller's breach in that the consumer may simply stop payment. Further, it shifts the burden of initiating litigation to the creditor.⁴⁰ While minimizing the cost of breach within the whole system, reunion diffuses the cost of breach to reflect and social cost more naturally.

Striving to avoid the effect of the U.C.C.'s clear intent to sanction separation and the cutting off of defenses, past attempts at reunion have created new problems and revitalized old ones. First, most states have not gone far enough in protecting the consumer from the effects of separation.⁴¹ Second, new interpretations of the U.C.C. have created confusion as to what the Code really means.⁴² Finally,

OKLA. STAT. ANN. 14A § 2-404 (West 1969) (time period reduced to thirty days). See MODEL CONSUMER CREDIT ACT Introduction iv (1973).

38. This act was proposed for state adoption by the National Consumer Law Center in Boston, as an alternative to a perceived void left by the U.C.C.C.:

At the same time the National Conference of Commissioners on Uniform State Laws promulgated the initial version of the Uniform Consumer Credit Code (UCCC). Consumer dissatisfaction with the UCCC was so widespread, however, that it became immediately apparent that the need for reform at the state level was to remain unfulfilled. In an attempt to fill the void the [NCLC] published in 1970 the National Consumer Act (NCA) as a model bill to which legislatures could look for a standard.

MODEL CONSUMER CREDIT ACT Introduction iv (1973). The C.C.A. makes the transferee or lender of a consumer liable in all cases to claims of the consumer against the seller and if that transferee or lender is in good faith the creditor or transferee is liable only to the extent of the loan. C.C.A. §§ 2.601-2.604.

39. See note 34 *supra*. No state has fully adopted the C.C.A.

40. This seems to follow the goals of the FTC. 40 Fed. Reg. 53506 (1975). See note 25 *supra* and accompanying text.

41. See Walker, *Holder in Due Course*, *supra* note 31, at 127.

42. While the U.C.C. requires quite clearly that the holder take without subjective knowledge of a defense to qualify as an HDC, the added requirements of *International Finance Corp. v. Rieger*, 272 Minn. 192, 137 N.W.2d 172 (1965), and *Unico v. Owens*, 50 N.J. 101, 232 A.2d 405 (1967), create confusion as to what the U.C.C. really requires of the transferee to qualify as an HDC. See note 30 *supra*.

these attempts have created a great deal of variation and conflict among the states—a result that directly frustrates the unifying purpose of the U.C.C. and of all commercial law.⁴³ The FTC's intent in adopting the Seller Rule was to respond to all three of these problems.⁴⁴

Separation of transactional duties creates great potential for harm to the consumer when the transferee or creditor is an HDC or holds the commercial paper with all the rights of one. Should the seller breach his duty, the consumer is forced to continue payment for the goods or services while being unable to seek the logical remedy of non-payment. If the seller is not available for suit, the consumer is totally without recourse. Previous attempts to alleviate this danger by reunion of the transactional duties have caused more problems: disuniformity, confusion, and conflict. It was in this atmosphere that the FTC promulgated the Seller Rule.

THE SCOPE AND SCHEME OF THE SELLER RULE

In an economy in which many sellers and consumers deal in more than one state, the need for a nationally uniform remedy was urgent. The combined impact of the previous approaches to reunion had not been sufficient to create adequate nationwide protection and failed to develop uniformity and clarity in the field. In promulgating the Seller Rule, the FTC attempted to bring clarity, uniformity and meaningful remedy to preservation of consumers' claims and defenses.⁴⁵

Evaluation of the Seller Rule since its implementation indicates that it has the potential for being a significant step in the preservation of consumers' rights. While the primary goal behind the Rule is to prevent the foreclosure of consumer defenses,⁴⁶ its proclaimed broader goals are to minimize the overall social costs produced by seller breach and to internalize those costs which cannot be limited, thus keeping the costs within the price establishment system of the seller and creditor.⁴⁷ To do this, the Seller Rule

43. The underlying purpose and policy of the U.C.C. is "to simplify, clarify and modernize the law governing commercial transactions" and "to make uniform the law among various jurisdictions." U.C.C. § 1-102(2).

44. "[A] Trade Regulation Rule should serve the threefold function of uniformity, fairness, and clarity." 40 Fed. Reg. 53506, 53525 (1975).

45. See *id.* at 53515.

46. FTC, STAFF GUIDELINES ON TRADE REGULATION RULE CONCERNING PRESERVATION OF CONSUMERS' CLAIMS AND DEFENSES 5 (1976) [hereinafter cited as STAFF GUIDELINES].

47. Concerning minimizing cost of seller breach, the FTC stated, "[F]irst we would employ our remedial authority to modify existing commercial behavior such

encompasses three specific types of transactions: when promissory notes are used in consumer sales, when waiver of defense clauses are used in consumer credit contracts, and when the seller refers the consumer to a particular creditor for a purchase money loan.⁴⁸ The Seller Rule's ability to achieve its goals while maintaining uniformity, clarity and fairness is a matter calling for constant re-evaluation.

The Underlying Scheme of the Seller Rule

Like previous attempts at preservation of claims, the Seller Rule is designed to "prevent sellers from foreclosing consumer equities in credit sale transactions . . . [and to] prevent the use of direct loan foreclosing to accord the same end."⁴⁹ The fundamental belief behind the method of the Seller Rule was that the holder in due course concept has no place in consumer transactions because it throws the cost of seller breach onto individual consumers.⁵⁰ The FTC desired to return the cost to the seller and then spread it among all consumers.⁵¹ By preserving the consumer's claims and defenses, the FTC sought to accomplish two ends: to minimize the social cost of seller breach to its lowest level within the retail distribution system, and to internalize the costs which cannot be eliminated.

By "internalization" the Commission intended that the cost of individual breach either be absorbed by the creditor or passed back to the seller by the use of recourse mechanisms often employed between such parties.⁵² Most of the cost should ultimately be returned

that the costs occasioned by seller misconduct in the consumer market are reduced to the lowest possible level in the retail distribution system." 40 Fed. Reg. 53506, 53523 (1975). Internalization was also characterized: "Second, where certain seller misconduct costs cannot be eliminated from the market we would require that such costs be internalized, so that the prices paid by consumers more accurately reflect the true social costs of engaging in a credit sale transaction." *Id.*

48. *Id.* at 53524-25. See note 22 *supra* and accompanying text.

49. 40 Fed. Reg. 53506, 53522 (1975).

50. "Our primary concern, in the course of these proceedings, has been the distribution or allocation of costs occasioned by seller misconduct in credit sale transactions." *Id.*

51. *Id.* at 53523.

52.

We believe that a rule which compels creditors to either absorb seller misconduct costs or return them to sellers, by denying sellers access to cut off devices will discourage many of the predatory practices and schemes The Commission has received substantial evidence that such agreements are routinely employed in sales-finance transactions, and that the provisions contained therein can be tailor-made to the needs of both parties.

Id.

to the breaching party. That cost which could not be returned should be absorbed and passed on to the consumer as borrower, thus resulting in a more accurate reflection of "the actual costs of sales finance."⁵³ In each of these instances the cost of breach would be retained in the price structure; it would not fall on individual consumers but would be a part of the cost of goods and credit.

The Rule was also designed to minimize the social cost of the seller's breach. This was to be achieved in two ways. If the creditor were made responsible for the breach of the seller, then he would refrain from forming business affiliations with or purchasing notes or contracts from disreputable sellers.⁵⁴ In this way the source of credit on which such sellers rely would be dried up. Further, the FTC determined that the creditor was in a better position to return the breach cost to the seller than was the consumer.⁵⁵ The process by which the consumer would return the cost to the seller often included litigation. Under the Seller Rule, while much more of the breach cost would be returned, it could be done by non-payment on the part of the consumer. The creditor could then employ any number of techniques to guard against seller breach and readily return the cost when breach occurs. This would be much more economical than a consumer attempt to return the cost directly to the seller. Among these devices the creditor might use are his access to information systems, ready means of initiating lawsuits, familiarity with the legal process, and contractual agreements for facilitating return to the seller.⁵⁶ Further, mere affiliation with the seller over a period of time would place the creditor in a much better position to guard against breach.⁵⁷ The FTC determined that these attributes of the creditor help provide for enforcement more efficient than that available to the consumer. Therefore in placing the burden of returning the cost of seller breach on the creditor, the overall social cost of the breach would be minimized.

A hypothetical case may more clearly illustrate how costs are minimized and internalized by the Seller Rule. Ryle purchased fifty pairs of shoes for his soccer team from Peele's Hop Shop. To pay for

53. *Id.*

54. "Creditors will simply not accept the risks generated by the truly unscrupulous merchant. The market will be policed in this fashion and all parties will benefit accordingly." *Id.*

55. "As a practical matter, the creditor is always in a better position than the buyer to return seller misconduct costs to sellers, the guilty party." *Id.*

56. *Id.*

57. It could be argued, however, that the consumer who deals directly with the seller is best able to protect himself from fraud. *See id.* at 53517-21.

the shoes, which cost \$20 a pair, Peele directed Ryle to Easy Credit Finance (E.C.). After acquiring a loan for \$1000, Ryle discovered that the shoes were defective. Without the aid of the Seller Rule, Ryle would have to continue making payments to E.C. and file suit against Peele if he refused to correct the situation. Unaware of his legal rights, Ryle would also have to obtain the services of a lawyer to sue for restitution. If Ryle would win his case, Peele would pass the cost of the breach and the litigation on to all consumers. Should Peele be judgment-proof, Ryle would have to take the shoes as they were and pay the complete price to the creditor.⁵⁸

The Seller Rule requires that the creditor (E.C.) assume responsibility for the seller's (Peele's) breach. If the consumer (Ryle) has a valid defense against the seller, he may assert it against the creditor. At this point the creditor has three options. E.C. could sue the consumer for payment, threaten the consumer with a bad credit rating for failure to pay, or accept the consumer's defense as valid. If the creditor were to sue the consumer for payment, the consumer may assert defenses; if the defenses are valid, the loss will fall on the creditor. Should the creditor choose to apply pressure on the consumer, the consumer may file suit affirmatively to clear his credit rating.⁵⁹ Whether returned by one of these methods or by the creditor simply accepting the consumer's defense, most costs are returned to the seller by means of a contract or litigation mechanism. These mechanisms, according to the FTC, work more economically so that all costs are internalized and at less social cost. Thus, while the creditor is now returning all breach costs to the seller, forcing him to charge more for his product, this is a smaller social cost than the combined cost without the Rule.

The clear scheme of the Seller Rule, then, is to prevent the cutting off of consumers' defenses and thereby to make the creditor initially responsible for the seller's breach. The responsibility would in turn reduce availability of credit to disreputable sellers, minimize the overall cost of seller breach because of the ease with which the creditor can act, and internalize breach cost by returning it to the seller where it is spread to all consumers evenly in the form of higher

58. This hypothetical case assumes that this state has neither passed special legislation on consumer credit nor developed comparable theories in common law. See notes 29 and 30 *supra*.

59. The FTC recognized the possible impact non-payment may have on the consumer's credit rating. Therefore the Rule gives the consumer the right to bring suit against the creditor for payments already made which exceed the value received by the consumer. This would clear up the credit rating as well. 40 Fed. Reg. 53506, 53524 (1975).

prices. To construct this scheme the FTC extended the scope of the Seller Rule only to particular transactions and parties.

Consumer Transactions Affected by the Seller Rule

The Seller Rule affects three situations in which the seller and creditor were previously able to separate the transactional duties. These three cases are transactions in which a promissory note is signed in addition to the sales contract; transactions in which a consumer credit contract contains a waiver of defenses clause; and transactions in which the consumer receives his loan from a creditor related to the seller.⁶⁰

When the seller has the consumer sign a promissory note in addition to the contract, the Rule requires that the notice of preservation become part of the agreement.⁶¹ As a part of the agreement the notice should be placed in the note itself. This would not destroy the negotiability of the note, as the notice is only of a possible, not an actual, defense.⁶² The purchaser of such a note may technically be an HDC under U.C.C. § 3-302, but he would be subject to all of the terms of the note, including preservation of consumer claims and defenses.

The second type of transaction encompassed by the Seller Rule is the consumer sale in which the credit contract with the seller contains a waiver of defenses against subsequent transferees. In this transaction no note is used or negotiated, but the credit contract, when assigned, achieves the same purpose for the seller. The FTC Staff Guidelines state that the notice must be placed in this type of contract unconditionally so as to insure the liability of the transferee to defenses of payment held by the consumer.⁶³ The FTC, however, left the seller a ready means of avoiding the impact of the notice, as it stated: "When the text of the notice is qualified by additional language, the contract fails to 'contain' the required notice."⁶⁴ With a waiver in the contract in addition to the notice, the Commission suggests, the waiver will have precedence, as the notice is then considered not "contained" in the contract.⁶⁵ Although this

60. See note 22 *supra* and accompanying text. The FTC, however, only noted three of these transactions in its Staff Guidelines. STAFF GUIDELINES, *supra* note 46, at 9.

61. *Id.* at 5. See also 40 Fed. Reg. 53506, 53524 (1975).

62. A negotiable instrument is not made non-negotiable by the inclusion of a limitation of liability or of a notice of a possible defense. U.C.C. § 3-119(1).

63. STAFF GUIDELINES, *supra* note 46, at 6.

64. *Id.*

65. *Id.* [1974 - Transfer Binder] CONSUMER CREDIT GUIDE CCH ¶ 98, 295, ¶ 98,296 (1977).

would then be a violation of the Seller Rule and thus subject the seller to FTC investigation, this may be of little help to the consumer who simply desires to assert immediately his defenses as guaranteed in the notice, without having to rely on FTC enforcement procedures.⁶⁶

The Commission considered both the waiver of defenses clause and the promissory note to be boilerplate forced on the consumer in a contract of adhesion.⁶⁷ Consequently, the FTC considered both to be void as against public policy. In the Statement of Basis and Purpose issued in conjunction with the Seller Rule, the Commission stated: "We have reached a determination that it constitutes an unfair and deceptive practice to use contractual boilerplate to separate a buyer's duty to pay from a seller's duty to perform."⁶⁸ The FTC may find that use of such devices is invalid as an unfair and deceptive practice if the notice is not included in the proper note or contract.⁶⁹ The consumer, however, may assert his defenses directly, without resort to the FTC, only if the notice is included; without the notice there is no state law basis upon which to base his right to assert these claims. The only right he has is that created by the FTC—a right historically unenforceable in the courts.⁷⁰

The most progressive, and most confusing aspect of the Seller Rule is its inclusion of the vendor-related or interlocking loan transaction.⁷¹ The Rule applies here only to those contracts arising between creditor and consumer where the consumer intends to use the proceeds for purchase from a seller "related" to the creditor. The Commission's definition of "related" was ambiguous in the Statement of Basis and Purpose.⁷² In that statement the Commission revealed that it had received "substantial evidence that sellers *work cooperatively* with the lenders to foreclose consumer equities."⁷³ In a later

66. See note 135 *infra* and accompanying text.

67. 40 Fed. Reg. 53506, 53523 (1975).

68. *Id.* at 53524.

69. What the Seller Rule actually does is define more clearly the general prohibition of Congress against unfair and deceptive practices. 15 U.S.C. §§ 45 *et seq.* (1975). The unfair and deceptive act should really be identified as the cutting off of consumer claims, not merely the omission of the prescribed notice. The Rule, however, identifies only the failure to place the notice in proper contracts as the unfair practice. 16 C.F.R. § 433 (1975).

70. See note 167 *infra* and accompanying text.

71. See Note, "Dragging the Body" — *Deceptive Automobile Financing in Pennsylvania: With Proposed Legislative Remedies*, 34 U. PITT. L. REV. 429 (1973).

72. 40 Fed. Reg. 53506, 53525 (1975).

73. *Id.*

publication the FTC explained the cooperative aspect of the connection between creditor and seller.⁷⁴

The nature of the cooperation between seller and creditor sufficient to bring the consumer credit contract within the purview of the Rule was indicated in the definition of the terms "purchase money loan," "contract" and "business arrangement." The definition of these terms include,

[a]ll formal and informal arrangements and procedures which, based on the record, would justify imputation of *an established and continuing course of dealing* between a lender and a seller We are not persuaded that knowledge alone suggests a course of dealing, even though questions of a creditor's knowledge are relevant to a determination of his relationship with a seller [W]e are persuaded that while the act of referral is sufficient to justify imposition of the rule, provided referrals are made *in the course of some routine or arrangement*, there is no justification for choosing a specific number [of referrals].⁷⁵

The definition denotes two types of cooperation: a course of dealing, or affiliation, and referral. The distinction between these two may be academic, for they often overlap. The real problem is discerning what constitutes "continuing course of dealing" and "referral in the course of some routine." According to the Staff Guidelines, affiliation between the seller and creditor adequate to require the notice could arise in a number of ways.⁷⁶ Among the more usual of these ways are where the creditor and seller are under common control; where the two are connected by a contract; and where there is a business arrangement between them. Generally, "[c]ooperative activity on a continuing basis (over a period of time) is what is specified by the Rule."⁷⁷

The Staff Guidelines also detail the types of referrals necessary to create a relationship between the parties sufficient to trigger the

74. "We believe that the record in this proceeding supports application of the rule to all situations where concerted or cooperative conduct between sellers and creditors is employed" *Id.* See also 41 Fed. Reg. 34594 (1976).

75. 40 FED. REG. 53506, 53525 (1975). See also STAFF GUIDELINES, *supra* note 46, at 14-16.

76. Those situations indicative of a cooperative arrangement listed by the FTC include: relation by blood or marriage, relation due to preparation of forms, relations due to processing credit application, common control, joint venture, payment of consideration by creditor to seller, guarantee of loan by seller, five or more loans by creditor to seller's consumers, relation by knowledge. 40 Fed. Reg. 53506, 53515 (1975).

77. STAFF GUIDELINES, *supra* note 46, at 16.

Seller Rule.⁷⁸ The seller's actions must show that "he is doing more than passively engaging in an information process."⁷⁹ When the seller, by regularly naming a particular source of credit, does more than supply loan information to the consumer by actually advocating the use of a particular creditor, then a referral relationship arises. Regardless of number of referrals, the Commission seems to require some communication between the parties. The number of referrals, however, may be one factor in determining the existence of a relationship. Once there are sufficient referrals of the proper nature to imply a relationship between the seller and creditor, *all* loans issued to consumers purchasing from a related seller must contain the notice, even if that particular consumer had not been referred.⁸⁰

In a staff evaluation the Federal Reserve Board asked the FTC to be more specific as to the duties of banks under the Seller Rule.⁸¹ In making this request, the Board of Governors of the Federal Reserve System highlighted the vagueness evident in the Rule:

[The] possible scope of the term "business arrangement" and the provision regarding "referrals" are such that banks do not know when loan contracts will have to include the notice to avoid placing the seller who accepts the proceeds of the loan in possible violation. Banks are also unsure of their possible liabilities, should they decide to make such consumer loans under contracts containing the notice.⁸²

Aware of the ambiguity of its definitions, the FTC issued a revised Statement of Enforcement Policy in an attempt to clarify the two forms of "relation."⁸³ The Commission stated that the affiliation must be one associated or concerned primarily with the advancement of credit to the consumer. Thus, a commercial checking account, or any commercial agreement "which has no relationship to consumer sales activities or the financing thereof," would be inadequate to impute a course of dealing.⁸⁴ This statement also underlined the fact that no consideration need pass between the seller and creditor.⁸⁵

78. It should be noted that actually referral is merely another form of affiliation between the seller and creditor, but it is one which appears to be at arms length while often it is not.

79. STAFF GUIDELINES, *supra* note 46, at 14.

80. 41 Fed. Reg. 34594 (1976).

81. Comments of the Staff of the Board of Governors of the Federal Reserve System on the FTC Rule Entitled "Preservation of Consumers' Claims and Defenses" 1 (May 5, 1976).

82. *Id.* at 2

83. 41 Fed. Reg. 34594 (1976).

84. 4 TRADE REG. REP. (CCH) ¶ 38,031 (1976).

The Statement of Enforcement Policy also clarified the scope of referral by the seller. While earlier definitions mentioned only that referral must emanate from some routine or arrangement, the Statement of Enforcement Policy focused on the nature of that routine:

The intent of this provision is to reach those situations in which a seller cooperates with a lender to channel consumers to that credit source on a continuing basis. Unlike an "affiliation," which contemplates some pre-existing arrangement or agreement, a referral relationship arises from a *pattern of cooperative activity* directly relating to the arrangement of credit.⁸⁶

Application of the Seller Rule on the basis of referrals, then, requires the showing of three things: first, that the seller channels consumers to a particular creditor (though he may do so with more than one creditor); second, that he does so on a continuing basis; and third, that the creditor knows that the consumers in general are being referred to him. As with affiliation, no consideration need pass between the parties. If each of those conditions are met, then a relationship exists, and credit contracts issued by the related creditor for purchases from the seller must contain the designated notice.

The key concept to understanding the scope of referral cooperation is that there must be a "pattern." An occasional referral would not suffice if there were no intended or resulting pattern. No minimum number of referrals is explicitly required, although the Commission did state that the number required before a pattern is found will vary depending on exterior factors such as population and business climate.⁸⁷ A pattern may be based on the seller's intent or inferred from the number of referrals made. When there is sufficient evidence to conclude that there is a pattern, the notice must be incorporated in all contracts resulting from purchase money loans given to the affiliated seller's customers.

Although the creditor must have knowledge that the seller is referring consumers to him before a referral relationship will be recognized, he need not know of the particular consumer's referral. Example Seven of the Statement of Enforcement Policy suggests that when a buyer independently obtains a purchase money loan from

85. *Id.* at 41,135-4.

86. *Id.* at 41,135-3 (emphasis added). See *National Auto. Dealers Ass'n v. FTC*, 421 F. Supp. 31 (M.D. La. 1976); STAFF GUIDELINES, *supra* note 46, at 14.

87. STAFF GUIDELINES, *supra* note 46, at 14.

a related seller, the notice must be included—"whether the particular loan contract was a product of a referral or not."⁸⁸

When determining whether the notice is required in a particular credit contract, it is not important whether a particular referral has been made. The only important points are whether there is a relationship and whether the seller had knowledge of the source of the consumer's loan.⁸⁹ It is, however, important to show particular referrals when proving the existence of the relationship. The following graph illustrates the paramount importance of the seller's knowledge. Further, unless there is a general established relationship, neither the parties' knowledge nor the fact of a particular referral will bring the consumer credit transaction within the reach of the Seller Rule.⁹⁰

<i>Relationship</i>	<i>Particular Referral</i>	<i>Seller Knowledge</i>	<i>Creditor Knowledge</i>	<i>Notice?</i>
X	X	X		YES
X	X		X	NO
X		X		YES
X			X	NO
X				NO
X	X	X	X	YES

Although the Seller Rule applies to three basic types of transactions, not all transactions of these types are subject to the

88. 41 Fed. Reg. 34594 (1976).

89. Knowledge may be either actual or constructive, attributed to related sellers by "objective circumstances surrounding the transaction." *Id.* at 34595.

90. This would be different if the proposed FTC amendment to the Seller Rule were adopted. This so-called Creditor Rule would place the same burden on the creditor to assure that the Notice is included in the appropriate contracts as presently exists for the seller. The relevant portion of the amendment reads:

In connection with any Purchase Money Loan . . . or any sale or lease of goods or services, in or affecting commerce . . . , it constitutes an unfair or deceptive act or practice within the meaning of Section 5 of [the FTCA] for a seller or a creditor, directly or indirectly, to 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 BE LIMITED TO AMOUNTS PAID BY THE DEBTOR HEREUNDER.

40 Fed. Reg. 53506, 53530 (1975).

notice requirement. There are other limitations. Foremost among these is that the sale must be to a consumer and not a commercial user.⁹¹ Any purchase for agricultural purposes is therefore excluded.⁹² Sales of real property, commodities and securities are also excluded.⁹³ All limits placed on the scope of the Truth-in-Lending Act and Regulation Z also apply to the Seller Rule.⁹⁴ This means that where the sale is in excess of \$25,000⁹⁵ or involves a public utility service,⁹⁶ the Rule does not apply. Finally, when the Rule is applied because of an interlocking loan, unless a substantial portion of the loan is used to purchase from an affiliated seller, the credit contract does not come within the requirements of the Seller Rule.⁹⁷

These limitations remain minor in light of the broad scope of the Seller Rule—a scope which encompasses three of the five basic methods of separation of transactional duties in consumer sales: the promissory note transaction, the credit contract with a waiver of defenses, and the vendor-related loan. In each of these, the Seller Rule requires the prescribed notice be included, thus preserving the consumer's right to assert defenses against subsequent holders of the note or contract. Consequently, the duties and rights of the consumer, creditor and seller are affected.

Consumers Included—Rights Conferred

A consumer is defined for purposes of the Seller Rule as "a natural person who seeks to acquire goods or services for personal, family, or household use."⁹⁸ According to this definition a wholesale

91. 16 C.F.R. § 433.2 (1975); STAFF GUIDELINES, *supra* note 46, at 9.

92. 16 C.F.R. § 433.2 (1975).

93. *Id.*

94. Both the purchase money loan and the financing of a sale for purposes of the Seller Rule were limited "within the meaning of the Truth-in-Lending Act and Regulation Z." 16 C.F.R. § 433.2 (1975). See generally 15 U.S.C. §§ 1602, 1603 (1968).

95. At FTC hearings many sellers of more expensive goods suggested an even lower limit. They argued that consumers who purchase consumer goods in excess of \$5000 are generally more sophisticated and less likely to be cheated. Further, these sellers contended they have greater need for immediate transferability of their notes and contracts to maintain the more costly inventory. The FTC found these arguments unconvincing. 40 Fed. Reg. 53506, 53527 (1975). There does seem to be a sound argument for maintaining some limit, as otherwise the creditor would be an insurer of long term loan contracts.

96. STAFF GUIDELINES, *supra* note 46, at 12.

97. This means that if the loan is used for a number of purchases only one of which is from a related seller, the notice is not required. See 16 C.F.R. § 433.1(d) (1975); STAFF GUIDELINES, *supra* note 46.

98. 16 C.F.R. § 433.1(b) (1975); [1974 - Transfer Binder] CONSUMER CREDIT GUIDE CCH ¶ 98,294 (1977) (credit purchase of vending machine not a consumer purchase).

purchase or business transfer would not be within the Rule. The transfer must be the final transfer in the retail chain. The reason for excluding intermediaries from the protection of the Seller Rule is that the wholesaler is considered "in the business" and thus able to protect himself adequately. The wholesaler is likely to possess many of the legal and contract recourse devices which would place costs on the seller even without the Rule.⁹⁹

It is questionable whether the Rule includes purchases by consumer cooperatives. The Staff Guidelines indicate that the Rule would not preserve the claims of the consumer when the purchase is by this method.¹⁰⁰ Yet, since consumer cooperatives are rarely in as good a position to protect against seller fraud as is a full-time business or financier, the policy reasons for applying the Seller Rule exist to preserve the defenses of the cooperative as well as the individual.

Where the notice is included in a consumer credit contract, the consumer may assert against the holder of the contract or note any claim or defense which he could have asserted against the seller,¹⁰¹ including all tort and contract claims. The claims may not exceed the amount paid or loaned by the holder and are limited to only those claims arising from transactions which that creditor financed. This also means that if the seller limited his own liability by the use of waivers, those same limitations apply to the consumer in an action against subsequent holders.¹⁰²

The general rule is that all consumers, and consumers only, who purchase on credit from the seller directly or on credit from a source related to the seller, are entitled to the protection of the Seller Rule. As will be seen, the consumer, although apparently protected by the Seller Rule, may still find his defenses cut off, because either the creditor or the seller may not be within the scope of the Rule.

99. STAFF GUIDELINES, *supra* note 46, at 9; 40 Fed. Reg. 53506, 53523 (1975).

100. The Staff Guidelines do not speak directly to this point, but state, "Nor does the Rule apply when a purchase is made by or for an *organization* rather than a natural person." STAFF GUIDELINES, *supra* note 46, at 8 (emphasis added). *Contra*, I TRUTH-IN-LENDING MANUAL § 1.03(3)(b) (1975).

101. "It [Seller Rule] will require that all consumer credit contracts generated by consumer sales include a provision which allows the consumer to assert his sales-related claims and defenses against any holder of the credit obligation." 40 Fed. Reg. 53506, 53524 (1975).

102. Thus, if the seller were to disclaim all warranties in accordance with U.C.C. § 2-316, the disclaimer would apply to the creditor as well. STAFF GUIDELINES, *supra* note 46, at 7-8. See also [1974 - Transfer Binder] CONSUMER CREDIT GUIDE CCH ¶ 98,271 (1977).

Creditors Included in the Seller Rule

The Seller Rule does not place a direct duty on any creditor to place the notice in the proper contracts or to inform the seller of the source of a consumer's purchase money loan. The nature of the creditor, however, is important in determining whether a duty rests on the seller to abide by the Rule and to insure that notice is included. The Rule imposes a duty on the seller only when the creditor who is related to the seller is a person or corporation 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.*"¹⁰³ As a direct lender, the creditor need not include the notice if he is not in the business of making loans, even if he is affiliated with the seller.¹⁰⁴ Private party lenders, therefore, do not subject the seller to the notice requirement.¹⁰⁵ Such a creditor may, however, be unable to cut off the consumer's defenses under other state law theories.¹⁰⁶ If the creditor is one who purchases notes or contracts drafted by the seller, his nature is of no consequence, as all such notes and contracts must contain the notice of preservation.

The Seller's Duty

Unlike the creditor's responsibility, the seller's duty under the Rule is direct and affirmative. That duty is to insure that the prescribed notice is placed in all consumer credit contracts and notes that meet the Rule's definitions. The FTC has also proposed a corresponding duty to be applied to the creditor,¹⁰⁷ but until that proposal is adopted, the seller has the sole responsibility for including the notice.

When the seller also performs as a creditor he must place the notice in all credit contracts which he drafts with consumers. Regardless of his intent to hold all notes or contracts, the notice must be included; however, a violation would only be meaningful upon transfer.¹⁰⁸ If the seller employs an open-ended credit arrangement,

103. 16 C.F.R. § 433.1(c) (1975) (emphasis added). See also [1974 - Transfer Binder] CONSUMER CREDIT GUIDE CCH ¶98,272 (1977) (insurance premium financing not included).

104. However, if he is affiliated with the seller but not in the business of making loans, those states recognizing the close-connectedness" doctrine would still find the lender subject to claims against the seller. See note 30 *supra*.

105. I TRUTH-IN-LENDING MANUAL § 1.03(2) (1970). See also 16 C.F.R. § 433.1(a) (1975).

106. See note 30 *supra*.

107. See note 130 *infra*.

108. This conclusion is inevitable since the consumer is burdened only when the seller breaches and the right to payment has been transferred to another.

he must insert the notice in the original agreement, but he need not renew it every time further credit is advanced.¹⁰⁹

In the vendor-related or interlocking loan transaction, the seller's duty is somewhat different due to the fact that the Rule requires the *creditor* to actually place the notice in the appropriate contracts, while it identifies the *seller* as the violator when such notice is not included. The standard of the seller's duty is a combined objective and subjective one. If the seller has objective knowledge that the consumer is using the proceeds of a loan from a related creditor, then the seller has a particular affirmative duty to ascertain whether the loan was in fact from a related creditor.¹¹⁰ Whether he has sufficiently discovered the source of the loan is judged subjectively. Before the seller has a duty to determine the source of the loan, however, a reasonable inference from the surrounding situation must place him on notice that a loan was used. The seller is not required to initiate an investigation into the source of every consumer's funds. When the seller does receive reasonable notice from surrounding circumstances that the consumer is using proceeds of a loan, he must determine whether the loan was extended by a related creditor.¹¹¹ Initially this may require simply asking the consumer where he received his loan. If the consumer refuses to divulge the source or if the seller has reason to believe the consumer is lying, he would have an affirmative duty to check with any creditor with whom he is related to see whether it issued the loan.¹¹² If the loan was made by a related creditor, the seller may not accept the proceeds thereof until the notice designated in the Seller Rule is inserted into the loan contract.

The notice of preservation of consumer's claims and defenses against subsequent holders is deceptively simple. The notice operates in state contract law to preserve defenses in three types of transaction: promissory notes, waiver of defense clauses, and vendor-related loans. When the seller acts initially as the creditor, the scope

109. STAFF GUIDELINES, *supra* note 46, at 10.

110. 41 Fed. Reg. 34594 (1976).

111. In the Commission's later "Statement of Enforcement Policy," this hypothetical was given with the concluding comment: "When the seller has a relationship with a creditor, the best source of information concerning the Notice is the creditor. He cannot escape liability through the ignorance of the buyer." 41 Fed. Reg. 34594, 34597 (1976).

112. While no statement is directly on point, it appears from FTC hypotheticals that if the seller has a reasonable belief that the consumer is using a purchase money loan, based on any surrounding fact, he must determine the source of the loan and if it was from a related creditor, whether the Notice was included. *Id.*

of the Seller Rule is universal, as all such consumer credit contracts must contain the notice. When the related creditor extends credit to consumers, the seller must assure that the notice is included only if the creditor is either affiliated with the seller or if they are related by a pattern of referrals. On the surface the Rule appears to be simple and complete; a more stringent analysis indicates several possible problems with its scope and impact.

PROBLEMS WITH THE SELLER RULE

The Seller Rule is too recent a development to permit a certain determination of problems in its mechanics and application. However, certain potential problems with the Seller Rule are evident. If these problems should materialize, they would reduce the effectiveness of the Rule. Among these problems is the interesting possibility that the effect of the Rule may be to narrow its own sphere of application to the poor consumer who has a marginal credit rating, while the more affluent consumer with a good credit rating will generally avoid the protection of the Rule voluntarily by seeking cheaper sources of credit. Another possible trend detrimental to the stated FTC intent is that the social cost of seller breach may even increase if the Rule spawns a large number of spurious claims by the consumer. The Seller Rule may also have the affect of reducing the availability of credit and increasing its costs.¹¹³ Finally, there is serious doubt that the Rule is adequate as it now exists, as it fails to apply to creditors in any transaction or to any party in the credit card transaction.¹¹⁴ For the Seller Rule to have significant impact, it should operate more rapidly and at less cost to the individual consumer than would a direct suit against the seller. Whether or not the Rule satisfies this requirement will deserve continuing evaluation.

When the Seller Rule was promulgated, the FTC made it clear that the intent was to remove the cost of seller breach from the individual consumer, to return it to the seller—often by way of the creditor—and eventually to disperse it among all consumers in the form of slightly higher prices.¹¹⁵ What the Rule is likely to do, however, is work in such a way as to limit its own scope to the poorer consumer, and in so doing, to spread the cost of breach only among consumers who purchase from sellers who cater to low income

113. For FTC discussion on this point see 40 Fed. Reg. 53506, 53519 (1975).

114. See note 89 *supra*.

115. 40 Fed. Reg. 53506, 53522 (1975).

customers.¹¹⁶ This may be seen by analyzing both the consumer's and creditor's points of view.

When the consumer makes a credit purchase he has three options: to buy on credit with the seller, to obtain credit from a creditor related to the seller, or to obtain credit from an independent creditor. If he gets credit from the seller, the Seller Rule will always apply.¹¹⁷ Should the seller not offer his own credit plan but send the consumer to a related creditor, the consumer must decide whether to borrow from that creditor or go elsewhere. In analyzing how the consumer makes this decision, several factors are important. First, the related creditor will very likely charge more for the loan than the unrelated lender.¹¹⁸ The related creditor has added costs and liabilities due to the Seller Rule and may consider the protection of the Rule a saleable commodity. Secondly, the consumer may not be able to go to an unrelated creditor because he has a marginal credit rating. This, in effect, gives the creditor another reason for increasing the cost of the loan. Consumers who have good credit ratings, however, are generally free to obtain credit from unrelated creditors. Most knowledgeable consumer borrowers, if given the opportunity,¹¹⁹ will pay a lower price even if that means a possibility of being injured by seller breach. In the case of the Seller Rule, consumers may forego the protection of the Rule in order to get cheaper credit, taking the risk of breach. The consumers who have the option are those not bound to use the seller's creditor, that is, the consumers with good credit ratings. On the other hand, those consumers unable to shop around—the marginal credit rating consumer—are tied to the related creditor and ultimately to the higher cost of credit.

The creditor, meanwhile, must also make a determination whether or not to maintain a commercial relationship with a

116. For an analysis of credit practices among low-income consumers, see FTC, ECONOMIC REPORT ON INSTALLMENT CREDIT AND RETAIL SALES PRACTICES OF DISTRICT OF COLUMBIA RETAILERS (1968); Harrison, *The Consumer Credit System and the Low-Income Consumers*, 13 J. FAM. L. 1 (1973); Note, *Consumer Legislation and the Poor*, 76 YALE L.J. 745 (1967).

117. 40 Fed. Reg. 53506, 53525 (1975).

118. The Commission, however, felt that credit costs would not increase because creditors would be lending to consumers more likely to pay. *Id.* at 53520. However, if the creditor makes use of recourse mechanisms as acknowledge by the Commission, his fear of consumers should be removed and he will be free to charge higher prices for credit. See note 51 *supra* and accompanying text.

119. The consumer must be aware of the options open to him before he can make the decision. Discussing the need for consumer notice, the FTC expressed the conviction that following a public education program consumers would be sufficiently aware of their rights under the Seller Rule. 40 Fed. Reg. 53506, 53527 (1975).

particular seller. This determination depends directly on the nature of that seller and his customers. When the bulk of the customers are good credit risks, they will be able to obtain credit elsewhere, thus reducing the amount of business that the creditor gets because of the relationship. The creditor may resolve that he could increase his loan market by dissolving the affiliation with the seller. By being related to the seller, the creditor must charge more for the credit; he may be able to make more loans by competing independently than by developing the relationship with the seller. But if the seller's customers are unable to shop for their loans because of marginal credit ratings, the creditor affiliated with such a seller may find it possible and profitable to maintain the relationship, compensating for the cost of the Seller Rule through increased prices.

It is only when the creditor maintains this relationship that the Seller Rule operates to return and distribute breach costs.¹²⁰ Such creditors are those dealing with the consumers with marginal credit ratings who are likely to be poorer consumers. The result is that the Seller Rule liabilities and costs may cause many creditors who deal with middle or upper income consumers to disassociate themselves from sellers and thus avoid the Seller Rule altogether, while those related to sellers dealing with consumers with marginal credit ratings will maintain their relationships. According to the plan behind the Rule, these latter creditors will return costs to the seller who in turn passes them on to his customers, the poorer consumers. While the more affluent consumer avoids the Seller Rule, he pays lower prices; the poorer consumer, although protected by the Rule, pays proportionately higher prices to the creditor and the seller. Breach costs are distributed only to poorer consumers.

This result seems to conflict with one of the FTC's major tenets.¹²¹ Although the Commission did intend to restrict the source of credit relied on by certain sellers, it was the seller who posed the greatest risk to the consumer, not the seller who deals with more affluent consumers, who was the supposed focus of this intent.

In addition to diversifying the cost of seller breach among consumers, the FTC expressly intended to reduce the social cost of

120. Behind this criticism is the assertion that the consumer faces the possibility of injury from separation where the purchase money loan is not obtained from a related creditor as well.

121. The Commission did seem to acknowledge that the Rule would affect all classes. "They [proponents] also pointed out that consumers in all economic classes have been harmed by application of the cutoff devices the rule will prohibit." 40 Fed. Reg. 53506, 53520 (1975).

that breach by requiring the creditor to perform the actual task of returning the cost to the seller.¹²² Yet for several reasons this may not be the result. First, whether breach cost is returned by the consumer to the seller or by the creditor to the seller as required by the Seller Rule, that reversion itself increases the social cost. Whenever a breach cost is returned, the social cost increases from the mere cost to the consumer to the cost of the breach plus the added cost of returning costs. Since the Seller Rule will undoubtedly cause many more consumers to return the breach cost instead of absorbing it, there will be more reversions carried out than there were without the Rule, thereby increasing the social cost. Secondly, the Seller Rule may compound the stages of litigation. Before the Rule there was generally only one step of litigation, if costs were returned at all—that between the consumer and the seller. Litigation may now be doubled, with suits between the consumer and creditor, and between the creditor and seller. This, too, will tend to increase the social cost of seller breach.

Thirdly, permitting the consumer to assert his claims and defenses by non-payment will undoubtedly encourage some consumers to withhold payment erroneously or fraudulently.¹²³ This will generate further litigation between the creditor and the consumer. Without the Rule the consumer had no theory under which to withhold payment, while under the Rule consumers may be tempted to use the slightest excuse for non-payment.

Finally, as the creditor and seller are required to incur increased costs as a result of the Seller Rule, they will quite naturally return these costs to the consumer in the form of higher prices for goods and higher credit costs. The natural tendency on the part of both will be to overcompensate for these costs. In addition, they will be tempted to inform the consumer of the value of the new Rule and thereby justify higher prices to him as the cost of the Rule's protection in case of seller breach.

When the effect of all these costs is added together, it seems unreasonable to contend, as the FTC does,¹²⁴ that the social cost of seller breach will be reduced by the preservation of defenses. This is not to say that the Seller Rule will be ineffective, but only that the primary effect of the Rule will be to return costs to the seller and thus

122. See notes 50-56 *supra* and accompanying text.

123. 40 Fed. Reg. 53506, 53523 (1975).

124. "This rule approaches these problems by reallocating the costs of seller misconduct in the consumer market. It would, we believe, reduce these costs to the minimum level obtainable in an imperfect system and internalize those that remain." *Id.*

diversify costs among consumers. The primary impact will not be to minimize the social cost of that breach. The overall social cost may well rise instead of diminish.

Several other possible problems with the Seller Rule are evident. Will the Rule increase the cost of credit and limit its availability? Much was said on this point in FTC hearings on the then-proposed Seller Rule.¹²⁵ No one conclusion was drawn; however, it seems clear that if the creditor is in the business of extending credit he is not likely to reduce his level of business simply on the basis of the Seller Rule.¹²⁶ The result is more likely to be a change in the manner in which the creditor extends credit than in the amount offered. As discussed above, more credit will likely be extended directly to the consumer and less by means of affiliation or by a referral relationship.¹²⁷ If the creditor maintains the relationship with the seller it seems inevitable that the cost of this credit will increase somewhat to compensate for increased costs and liabilities. Because of this factor there will undoubtedly be certain consumers who will be unable to afford the increased costs. This effect, by itself, would be minimal and the unavailability of credit due to the increased cost will not foreseeably be a major effect.

Foremost among the seeming mechanical deficiencies of the Seller Rule is the fact that the Rule does not apply to creditors, although in many transactions it is the creditor who actually causes the Rule to be avoided.¹²⁸ According to its present reading, even if the creditor knows that the consumer to whom he issues a loan intends to purchase from a related seller, he is not required to include the notice or to inform the seller of the source of the loan. On the contrary, where the seller knows of the source of the loan, the notice of preservation would be required.¹²⁹ Given a commercial relationship which justifies recognition and application of the Seller Rule to one party, it makes little sense to permit the other party knowingly to frustrate the purpose of the Rule.¹³⁰

125. *Id.* at 53519.

126. One expert estimated that the reduction of credit available as a result of the Rule would be minimal, ranging from five to ten per cent. REPORT OF THE NATIONAL COMMISSION ON CONSUMER FINANCE 36 (1972).

127. See notes 120-21 *supra* and accompanying text.

128. The creditor's action cannot be termed a violation of the Seller Rule even if he used the most intentional and devious means to prevent the seller from discovering the source of the consumer's loan. He has merely caused the Rule to be avoided. See note 90 *supra*.

129. See notes 89 and 90 *supra*.

130. The FTC has proposed an amendment which would apply the Rule to the creditor as well. 40 Fed. Reg. 53506, 53530 (1975). See note 90 *supra*. The difficulty

Another possible deficiency of the Seller Rule is that it leaves the seller with a ready means of separating the transactional duties. He need only accept payment with a charge on the credit card of a third party. In light of the factors needed to show affiliation between the seller and creditor in the vendor-related loan transaction, it is incongruous that in the credit card transaction, in which the parties are connected by a contract, the Rule would not apply.¹³¹ The Commission argued that there was no indication that this method of credit had been abused in the past, and thus it did not require a regulation which may have adversely inhibited this growing industry.¹³² Yet, past evidence that this transaction has not been used by sellers to separate the duties may be a poor indication of how the credit card method of separation will be used in the future.¹³³ The actuality of this problem will only become evident after the Rule has been enforced for a period of years; thus, continued evaluation of this transaction should be maintained.

Even considering all of these potential problems, the Seller Rule must be considered a major step in the protection of consumers. Yet, the injury at which the Seller Rule is aimed is one primarily affecting only a portion of the economy — the poor consumer likely to suffer from seller breaches. The real value of the Seller Rule depends upon its ability to offer the individual consumer a more immediate and less

with the amendment, which places a burden on the creditor as well to place the notice in the proper consumer credit contracts and notes, is that the FTC cannot make rules governing banks. 15 U.S.C. § 45(a)(6) (1975). However, the Magnuson-Moss Warranty—FTC Improvement Act of 1975 added a subsection which requires the Board of Governors of the Federal Reserve System to promulgate a parallel rule to any FTC rule that would affect banks. Such rules become effective within 60 days of the FTC rule unless the Board can show good cause why the rule should not affect banks. Pub. L. No. 93-637, § 202(a), 88 Stat. 2196 (1975), adding 15 U.S.C. § 57a(f) (1975). Correspondence by the Board indicates a distinct aversion to the FTC Creditor Rule. Unless the Creditor Rule applies to banks, it will be of little effect. See Official Correspondence of the Board of Governors of the Federal Reserve System (May 24, 1976). In a recent case, however, one court held that the Seller Rule was promulgated under the new act as well as the old, and thus the FRB would be obligated to make a parallel rule immediately, should the creditor rule be adopted as proposed. See *National Auto. Dealers Ass'n v. FTC*, 421 F. Supp. 31, 34 (M.D. La. 1976). See also Federal Reserve System Report Letter No. 29 (June 1976).

131. One of the easiest means of proving that the seller and creditor are related for purposes of the Seller Rule is to show that the two were bound by a contract. 40 Fed. Reg. 53506, 53515 (1975).

132. *Id.* at 53516-17.

133. For example, following passage of a law restricting separation by assignment of consumer credit contracts in New York, the use of the vendor-related loan method increased greatly to accomplish separation of transactional duties. *Id.* at 53515. See [1969 - 1973 Transfer Binder] CONSUMER CREDIT GUIDE CCH ¶ 99,216 (1972).

expensive means of asserting his defenses than suit against the seller, as well as its ability to preserve a cause of action when the seller is totally beyond the reach of the court. In any case, the Seller Rule will only be of marginal value unless it is dynamically enforced.

ENFORCEMENT OF THE SELLER RULE

The utility of any rule of law depends in large part upon its enforceability. With the Seller Rule, where hundreds of thousands of sellers and creditors are affected, it is especially true that unless capable of swift and pervasive enforcement, the Rule's substance will be of little value. If notice of preservation of defenses is included in the sales instrument the Seller Rule can be expediently asserted through non-payment.¹³⁴ The Rule must hold these same benefits for those consumers whose sellers have violated the Rule by omitting the notice. Those parties who in the past have injured consumers by separation of duties are those who are likely to violate the notice requirement, thereby still cutting off consumer defenses. The Commission has determined through enactment of the Rule that separation of transactional duties is an unfair and deceptive act, thus suggesting that the consumer should have the protection intended by the notice requirement even if notice is omitted. To provide this protection enforcement of the Seller Rule must be extensive and swift.

Presently the consumer's only apparent means of asserting his defenses when the seller omits the required notice is through the prescribed FTC enforcement procedures. An analysis of the powers and problems of the FTC, however, shows that the procedures are inadequate to serve the purposes of the Seller Rule because they are too complicated and tenuous to constitute an improvement over direct suit against the seller. All enforcement by the FTC is discretionary, selective, and applied as a deterrent for the public good rather than for the individual good of injured consumers. In addition, the resources of the FTC are insufficient to permit the Commission to enforce the Rule thoroughly, even if it desired to do so. Each of these characteristics of FTC enforcement will be explored. Two other possible methods of enforcement, which may serve to make the Seller Rule more effective, will also be examined.

Problems with the Enforcement Process of the FTC

The Federal Trade Commission is neither physically nor philosophically equipped to enforce the Seller Rule adequately. The

134. The Seller Rule has the important additional benefit of preserving a cause of action when the seller is unavailable.

congressionally designated purpose and structure of the FTC are antithetical to proper enforcement of any law as pervasive as the Seller Rule. The Commission acts only at its own discretion, and when it does investigate violations it does so selectively and for the sole purpose of deterring future violations, not to compensate for past injury.¹³⁵ In addition, the FTC has developed an unfortunate reputation for sluggishness.¹³⁶

Utilization of any of the FTC's powers, whether rule-making,¹³⁷ investigative¹³⁸ or adjudicative,¹³⁹ is totally at the discretion of the Commission itself. The enabling statute for the FTC reads:

135. The FTC Improvement Act did give the FTC authority to seek restitution for injured parties where the Commission feels it is the proper corrective measure to prevent future violations. 15 U.S.C. § 57(b) (1975). For an analysis of this new power, see Note, *Restitution for Consumer Fraud Under Section 5 of the Federal Trade Commission Act*, 10 VAL. U.L. REV. 69 (1975).

136. G. HENDERSON, *THE FEDERAL TRADE COMMISSION: A STUDY IN ADMINISTRATIVE LAW AND PROCEDURE* (2d ed. 1924); E. COX, R. FELMETH & J. SCHULZ, *THE CONSUMER AND THE FEDERAL TRADE COMMISSION* (1969) (Nader Report).

137. 16 C.F.R. § 1.1 *et seq.* (1976) Rules and regulations are promulgated under a general mandate from Congress to restrict the use of unfair and deceptive practices in commerce. Authority to issue specific rules in furtherance of its mandate given in Section 5 of the FTCA was validated in *National Petroleum Refiners Ass'n v. FTC*, 482 F.2d 672 (D.C. Cir. 1973), *cert. denied* 415 U.S. 951 (1974). Several years later the FTC Improvement Act of 1975 granted the specific right to make such rules. Pub. L. No. 93-637, 88 Stat. 2193 (codified at 15 U.S.C. § 2301 (1975)). The Seller Rule was initiated under the claimed authority of Section 5 of the Act, while its adoption was pursuant to the authority granted in the FTC Improvement Act. See note 130 *supra*.

138. 16 C.F.R. § 2.1 *et seq.* (1976).

139. *Id.* at § 3.1 *et seq.* Adjudicatory proceedings are initiated when the FTC issues a complaint to all alleged violators. Adjudication is only one of many means of enforcement for the FTC. It may simply warn the violator, issue a consent agreement or initiate informal investigation. *Id.* at § 2.31 *et seq.* Adjudication can be stimulated by requests from any party in the economy or by the FTC itself. Once begun, the investigation may terminate in a number of ways. First, the file may simply be closed without reason. *Id.* at § 2.14(b). Recognition of compliance may be given to end further action. Finally, the consent order may be accepted. *Id.* at § 2.31 *et seq.*

When the Commission determines that there has been a violation and completes proceedings, the FTC may issue a cease and desist order. Discretion is used in determining how much time will be given for the violator to cease the practice. *Id.* at § 3.61. Beyond this, the FTC is powerless without recourse to the courts. However, the Commission may seek a number of remedies through the courts: "If the Commission satisfies the court that the act or practice to which the cease and desist order relates is one which a reasonable man would have known under the circumstances was dishonest or fraudulent, the court may grant relief . . ." 15 U.S.C. § 57b(a)(2) (1975). Neither the FTC nor the parties concerned may seek enforcement or appeal until the original process is complete and an order issued. The violator's right of review is by way of the Administrative Procedure Act, which states: "A person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof." 5 U.S.C. § 702 (1966).

*Whenever the Commission shall have reason to believe that any such person, partnership, or corporation has been or is using any unfair method of competition or unfair or deceptive act or practice in commerce, and if it shall appear to the Commission, . . . the Commission may at any time, upon such notice and in such manner as it shall deem proper, modify or set aside, in whole or in part, any report or any order made or issued by it under this section.*¹⁴⁰

This discretion has been justified on the ground that the FTC needs great freedom to use its expertise most effectively.¹⁴¹ As a general principle this is true, if the FTC is to maintain its original purpose and nature. However, what this means for regulations such as the Seller Rule is that the FTC need not, and probably will not, investigate or attempt to enforce the Rule simply because a consumer is injured by a breach.¹⁴² Since all proceedings are discretionary, the FTC investigates violations on a basis broader than individual injury; its basis of action is the general public good. The individual consumer is of only peripheral concern.

Even with recent revitalization the FTC has retained as its primary purpose the preservation of the public good.¹⁴³ The FTC's Rules of Practice state: "The Commission acts only in the public interest and does not initiate investigation or take other action when the alleged violation of law is merely a matter of private controversy and does not tend adversely to affect the public."¹⁴⁴ Two pertinent distinctions can be drawn from the meaning of "in the public interest." First, the FTC acts as a guide to the commercial interests in America, not as a guard for the parties foreseeably injured. Second, the FTC acts for the public good, not for the individual good of the consumer actually injured.¹⁴⁵ The Commission is not a court in which injured consumers may seek redress, but is a forum where trade expertise is employed to infuse general standards of fairness. The 1966 Annual Report of the FTC noted: "The Commission's purpose is not to bring an even greater number of adversary actions;

140. 15 U.S.C. § 45(b) (1975) (emphasis added).

141. See *FTC v. Colgate-Palmolive Co.*, 380 U.S. 374, 392-95 (1965); *Holloway v. Bristol-Myers Corp.*, 485 F.2d 986, 997 (D.C. Cir. 1973).

142. See *Regina Corp. v. FTC*, 322 F.2d 765 (3d Cir. 1963).

143. See generally *FTC Improvement Act of 1975*, Pub. L. No. 93-637, 88 Stat. 2183 (codified at 15 U.S.C. § 2301 (1975)).

144. 16 C.F.R. § 2.3 (1973).

145. K. DAVIS, *DISCRETIONARY JUSTICE* 67 (1971); *FTC v. Cinderella Career & Finishing Schools, Inc.*, 404 F.2d 1308 (D.C. Cir. 1968).

its function is essentially one of *guidance*."¹⁴⁶ For the consumer this can only mean that there is no basis for expecting investigation of his case should the seller violate the Seller Rule. While the Commission may indeed investigate such violations, there is no guarantee that any particular consumer's case will be handled. The consumer can only hope that the seller is a major violator—major enough to provoke FTC action.

Since the FTC's function is primarily one of guidance, it enforces regulations on a selective basis and for the purpose of deterring future actions deemed unfair or deceptive.¹⁴⁷ Enforcement is not concerned with the particular injury of a consumer but solely with stopping the violator from repeating his act in the future. If deterrence can be achieved by forcing violators to compensate the consumer for his injury, the FTC may order restitution.¹⁴⁸ The theory of selective enforcement as practiced by the FTC assumes that the majority of businesses affected by any regulation will follow its requirements without prodding from the agency. To insure that they do comply, FTC enforcement resources are used against target violators who provide examples to others who might consider violating the regulation. This, it is hoped, provides impetus for the particular industry to police itself.¹⁴⁹

Many sellers, however, have not policed themselves, as evidenced by the very need for regulations such as the Seller Rule. If the Rule is to improve the consumer's lot, then it should be enforced strictly, and not on a selective basis. When enforcement is selective the individual seller has little fear of being penalized for separating duties, and the individual consumer has no assurance of relief. The consumer weighing his chances for relief would be foolish to rely on the FTC to investigate and remedy his case unless the seller were totally beyond the court's reach.

The Seller Rule and the Limited Resources of the FTC

Not only are the nature and purpose of the FTC detrimental to proper enforcement of the Seller Rule in that it cannot be applied with the requisite regularity and certainty, but the Commission itself

146. DAVIS, *supra* note 145, at 69 (emphasis added). See *Regina Corp. v. FTC*, 322 F.2d 765 (3d Cir. 1963).

147. See *Joseph A. Kaplan & Sons, Inc. v. FTC*, 347 F.2d 785 (D.C. Cir. 1965).

148. See note 135 *supra*; *Curtis Publishing Co.*, [1970-1973 Transfer Binder] TRADE REG. REP. (CCH) ¶ 19,719 (1970). See also *Koscot Interplanetary, Inc.*, [1970-1973 Transfer Binder] TRADE REG. REP. (CCH) ¶ 20,345 (1973).

149. STAFF STUDIES FOR THE NATIONAL COMMISSION FOR CONSUMER JUSTICE ON THE FEDERAL TRADE COMMISSION 480 (1975).

also lacks the resources to enforce anything except in a selective manner.¹⁵⁰ Furthermore, the FTC's past record indicates that even those resources that the Commission does have are often misapplied.¹⁵¹ Proceedings that are initiated often take years to complete.¹⁵² If the benefits of the Seller Rule are to be maintained when the Rule is violated, enforcement and remedy must be completed in time for the consumer to assert his defenses against the creditor before legal action. The history of FTC adjudication indicates that it is unlikely that the Commission has the resources necessary for such efficiency.

There has been a trend to increase the resources of the FTC, but the trend has not kept pace with the expansion of FTC authority. In the past five years over eight new areas of regulation have been opened by FTC, with a corresponding increase in its budget of only \$23 million.¹⁵³ The entire Commission employed only 531 attorneys in 1975; they had the sole responsibility of developing regulations, investigating all existing regulations, and adjudicating all violations in the vast area of FTC authority.¹⁵⁴ With each new regulation the FTC promulgates, it spreads itself even thinner. Indeed, selective enforcement is the only viable method of enforcement available to the FTC.

Those resources which are available to the FTC are often wasted on inconsequential litigation. In hearings by the Senate Committee on Commerce during investigation of the FTC, it was found that, "the Commission has failed to properly utilize the limited resources it has. . . . [T]he apparent attitude is that the powers will be used sparingly and only in carefully selected cases."¹⁵⁵ Two reports were extremely critical of the Commission's use of its resources. One report, issued by the American Bar Association, stated: "Our study has led us to the conclusion that the FTC's efforts to investigate the basis in fact for this public outcry [against deceptive schemes] and to find ways of

150. *FTC Oversight: Hearings Before the Senate Comm. on Commerce*, 93d Cong., 2d Sess. 61 (1974) (statement of Ann Brown) [hereinafter cited as *Hearings*].

151. *Id.*

152. *See, e.g.*, *Holloway v. Bristol-Myers Corp.*, 485 F.2d 986, 997 (D.C. Cir. 1973).

153. *See, e.g.*, "Negative Option Plans," 16 C.F.R. § 425 (1974); "Cooling Off Period," 16 C.F.R. § 429 (1974). For figures on the budget see BUDGET OF THE UNITED STATES GOVERNMENT (1976).

154. Federal Government Legal Career Opportunities 122 (1976) (government publication). In 1974 the Commission employed 1600 in all. *Hearings, supra* note 150, at 312 (statement of Commissioner Engmon).

155. *Hearings, supra* note 150, at 283 (statement of George Zervas).

coping with whatever underlying problems exist have been inadequate."¹⁵⁶ Another highly critical study was published by Ralph Nader's organization.¹⁵⁷ While some of the criticism has died since the passage of the Alaska Act¹⁵⁸ and the Magnuson-Moss Act,¹⁵⁹ others have continued their attacks on the FTC's performance.¹⁶⁰

This combination of limited and misallocated resources has resulted in extremely protracted investigations. Even if a particular consumer's injury is selected for investigation, it may be years before the problem is resolved. The injured consumer also faces the possibility that the Commission will find that in the public good it would be better not to seek restitution from the violator.¹⁶¹ The consumer injured by violation of the Seller Rule will generally find these characteristics totally debilitate his rights under the Rule. If forced to wait for the FTC to investigate and adjudicate, the consumer would be wiser to pay the creditor and sue the seller, thus foregoing the protection of the Rule altogether. It is only where the seller is beyond suit that the consumer would be justified in relying on the FTC to enforce the Rule; yet by that time state law would probably require that he pay the creditor.

Because of all these factors, the FTC is not the ideal body to effectuate the Seller Rule's purpose of preserving consumers' claims and defenses. Enforcement within the FTC is totally discretionary, selective, and done for the public good rather than for individual relief; hence it affords the individual consumer no guarantee of a remedy when the Rule is violated. The impact of the Seller Rule will be slight to most consumers unless alternative theories of enforcement can be found.

POSSIBLE SOLUTIONS FOR ADEQUATE ENFORCEMENT OF THE SELLER RULE

Perhaps the best solution to enforcing the Seller Rule would be to recognize a private cause of action in the consumer injured by a violation. One means of recognition would be to imply a federal cause

156. REPORT OF THE ABA COMM'N TO STUDY THE FTC 36 (Sept. 1969).

157. See note 136 *supra*.

158. Trans-Alaska Pipeline Act, Pub. L. No. 93-153, § 205, 87 Stat. 588 (43 U.S.C. § 1654 (1973)).

159. Pub. L. No. 93-637, 88 Stat. 2183 (1975).

160. See Note, *The Magnuson-Moss Warranty—Federal Trade Commission Improvement Act: Should the Consumer Rejoice?*, 15 J. FAM. L. 77 (1976-77).

161. See Curtis Publishing Corp., [1970-1973 Transfer Binder] TRADE REG. REP. (CCH) ¶ 19,719 (1973).

of action from the Seller Rule through the doctrine of implication. A second possible means of enforcement would be for the state courts to hold that knowing acceptance by the transferee of a note or contract which violates the Seller Rule is bad faith within the meaning of the U.C.C. Such a ruling would prevent the holder from cutting off the claims and defenses of the consumer. By asserting a cause of action under either of these theories, the consumer would be able to claim the rights guaranteed in the prescribed notice even if it were omitted from the note or contract. Although both alternatives are limited remedies, they do supply the speed and ease of adjudication needed for enforcement of the Seller Rule.

Recognition of a Private Cause of Action—The Doctrine of Implication

One of the possible solutions to the problems involved in FTC enforcement of the Seller Rule would be to imply a private cause of action from the Federal Trade Commission Act as clarified in the Seller Rule.¹⁶² The legal theory under which this would be possible is the doctrine of implication. This doctrine states that the courts will imply a cause of action from a federal act, even if such a cause of action is not specifically granted, if certain criteria are met.¹⁶⁴ Implying a private cause of action has the primary benefit of giving the consumer the full rights contained in the Seller Rule's notice, even if the notice is omitted; the principal stumbling-block of the doctrine is that implication would alter the traditional nature of the FTC. However, if the Commission is to enter the area of consumer protection with any force, implication of such private remedies must be recognized.

In the past the majority rule on implication in cases dealing with federal regulatory agencies has been that Congressional intent was clear: enforcement was solely vested in the agency, and thus no private cause of action would be implied. Such agencies, it has been argued, are not legislative and should not be used to create

162. FTC rules are actually clarification of what the FTC considers to be a violation of 15 U.S.C. § 45(a)(1): "Unfair methods of competition in commerce, and unfair or deceptive acts or practices in commerce, are declared unlawful." Therefore, the implication of a private cause of action would be based on this broad statement, but actually recognized through the specific rules such as the Seller Rule. See 15 U.S.C. § 57(a)(1)(A) and (B) (1975).

163. See *Bivens v. Six Unknown Federal Narcotics Agents*, 403 U.S. 388 (1971).

164. See *Cort v. Ash*, 422 U.S. 66 (1975); notes 173-74 *infra* and accompanying text.

165. Enforcement has been considered as much a part of FTC policy as rule-making. See *United States v. St. Regis Paper Co.*, 355 F.2d 688 (2d Cir. 1966).

substantive rights in the individual. Until recently, this analysis has been applied with particular unanimity to claims arising from FTC regulations.¹⁶⁶

In recent years judicial and legislative changes have brought about an erosion of the hard line against granting private causes of action where administrative agencies are involved. With increasing frequency Congress has deferred to the expertise of federal agencies to act as the regulators and legislators of whole areas of law.¹⁶⁷ Since it is the agency and not Congress which is the primary actor in a given field, the pressure to imply private causes of action from regulations has increased. Some courts have taken the initiative by recognizing private causes of action.¹⁶⁸ These new cases warrant a renewed look at private enforcement as a viable alternative to FTC enforcement of the Seller Rule.

Because of the wording of the Seller Rule, implication of a private cause of action appears to be a very limited solution to the problems posed by enforcement solely through the FTC. The Rule designates the seller as violator. Thus, when the creditor approaches the consumer seeking payment on a transferred note or contract, the assertion of a violation of the Seller Rule will be useless against that creditor—the creditor did not technically violate the Rule.¹⁶⁹ Only if the seller is available and can be joined in the action is the assertion of a violation feasible. Yet, consideration of the implication of private remedy remains meritorious for several reasons. First, joinder of the seller followed by assertion of a violation of the Seller Rule is superior to the two actions often necessary without the Rule. Secondly, and more significantly, the FTC has proposed an amendment to the Seller Rule which would place the same duty on the

166. *Alfred Dunhill Ltd. v. Interstate Cigar Co.*, 499 F.2d 232 (2d Cir. 1974); *Holloway v. Bristol-Myers Corp.*, 485 F.2d 986 (D.C. Cir. 1973); *Carlson v. Coca-Cola Co.*, 483 F.2d 279 (9th Cir. 1973); *LaSalle St. Press, Inc. v. McCormick & Henderson, Inc.*, 293 F. Supp. 1004 (N.D. Ill. 1968), *aff'd*, 445 F.2d 84 (7th Cir. 1971); *Bott v. Holiday Universal, Inc.*, 5 TRADE REG. REP. (CCH) ¶ 60,973 (1976).

167. *See Cross v. Board of Supervisors of San Mateo County*, 326 F. Supp. 634, 637 (N.D. Cal. 1968), *aff'd*, 442 F.2d 362 (9th Cir. 1971). Cases where private action has been implied from administrative agency acts include: *Moore v. New York Cotton Exchange*, 270 U.S. 593 (1923); *Alfred Dunhill Ltd. v. Interstate Cigar Co.*, 499 F.2d 232 (2d Cir. 1974); *Holloway v. Bristol-Myers Corp.*, 485 F.2d 986 (D.C. Cir. 1973); *Carlson v. Coca-Cola Co.*, 483 F.2d 279 (9th Cir. 1973); *Regina Corp. v. FTC*, 322 F.2d 765 (3d Cir. 1963); *Marquette Cement Mfg. Co. v. FTC*, 147 F.2d 589 (7th Cir. 1945).

168. *Evans v. Krebs & Co.*, 411 F. Supp. 616 (S.D.N.Y. 1976); *Rauch v. United Instruments, Inc.*, 405 F. Supp. 435 (E.D. Pa. 1975).

169. *Gard, Purpose and Promise Unfulfilled: A Different View of Private Enforcement Under the Federal Trade Commission Act*, 70 NW. U.L. REV. 274, 281 (1975).

creditor as presently rests on the seller.¹⁷⁰ If this amendment is adopted, the implication of a private cause of action would be a significant benefit. The consumer could then assert such violation against the creditor and vitiate any waiver of defenses clause or HDC status the holder may claim.

There are several stages at which a private cause of action could be implied from the Rule. Broad recognition could be made of the consumer's right to assert a violation of the Rule for a *de novo* determination. Implication could be more restricted, however, and a cause of action implied only after the Commission had investigated and designated the seller-creditor a violator. Finally, implication could be further delayed until the FTC had issued a cease and desist order which the seller-creditor violated.

To provide the consumer a meaningful alternative to the lengthy and unlikely enforcement through the FTC, implication should be broad, permitting courts to make a *de novo* determination of violation. While the expertise of the Commission would not be relied on, it is doubtful such reliance would be necessary. The Seller-Creditor Rule makes determination of a violation a relatively simple investigation.¹⁷¹

The doctrine of implication states that when a federal act does not specifically grant a private cause of action, courts may imply the same under certain conditions. These criteria, expressed in varying forms since first adopted, were most clearly stated in *Cort v. Ash*.¹⁷² Mr. Justice Brennan, writing for the Supreme Court of the United States, explained:

In determining whether a private remedy is implied in a statute not expressly providing one, several factors are relevant. First, is the plaintiff "one of the class for those especial benefit the statute was enacted"? . . . Second, is there any indication of legislative intent explicit or implicit, either to create such a remedy or deny one? . . . Third, is it consistent with the underlying purpose of the legislative scheme to imply such a remedy for the plaintiff? . . . And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so

170. The text of the Rule reads: "It shall be an unfair or deceptive act for a seller to . . ." 16 C.F.R. § 433.2 (1975) (emphasis added).

171. See notes 90 and 170 *supra*.

172. See notes 164 and 165 *supra* and accompanying text.

that it would be inappropriate to infer a cause of action based solely on federal law?¹⁷³

The basis of the *Cort* test is the congressional intent in passing the considered act. That intent is analyzed in three of the criteria: intended persons affected, intent to create or deny private cause of action, and the action being consistent with the underlying scheme intended.¹⁷⁴ Once the congressional intent is determined the courts will apply the four criteria listed in *Cort* and either imply or reject a private action.

In recent years there has been a subtle change between the traditional analysis of congressional intent and analysis of intent from agency enabling statutes. This recent analysis has looked at congressional intent with more concern for the deeper intent of Congress and the needs of the individual.¹⁷⁵ It is this broadening analysis, more attuned to individual needs, that holds the possibility for implication of a private cause of action under the Seller Rule.

The first criterion of the *Cort* test asks whether the petitioner is a member of the class which Congress intended to protect. Traditional analysis of this criterion has required that the petitioner be the primary and directly intended beneficiary of the act.¹⁷⁶ In *Cort v. Ash* this analysis was used to deny plaintiffs in a stockholder derivative suit a cause of action from the Federal Election Campaign Act, which made it unlawful for the corporation to make political contributions without stockholder consent.¹⁷⁷ Plaintiffs argued that the act was to protect stockholders from misuse. The Court noted, however, that the purpose of the statute was to destroy influence which corporations may have over elected officials: "ordinary stockholders [were] at best a secondary concern."¹⁷⁸

In *Rauch v. United Instruments, Inc.*,¹⁷⁹ a federal district court gave the criterion a different and more expansive reading. In *Rauch*

173. *Cort v. Ash*, 422 U.S. 66 (1975). The doctrine of implication has been developing since *Texas & P. Ry. v. Rigsby*, 241 U.S. 33 (1915), and has been used in many cases. See, e.g., *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412 (1975); *National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers*, 414 U.S. 453 (1975); *Bivens v. Six Unknown Federal Narcotics Agents*, 403 U.S. 388 (1971).

174. 422 U.S. at 80-84.

175. See *Guernsey v. Rich Plan of the Midwest*, 408 F. Supp. 582 (N.D. Ind. 1976).

176. See *Cort v. Ash*, 422 U.S. 68, 81 (1975).

177. 18 U.S.C. §610 (1907). See 40 Cong. Rec. 96 (1905); *United States v. CIO*, 335 U.S. 106 (1948).

178. 422 U.S. 68, 81 (1975).

179. 405 F. Supp. 435 (E.D. Pa. 1975).

parties who had been forced by the Federal Aviation Authority (FAA) to replace an instrument in their planes brought suit under the FAA order against the manufacturer for the economic loss incurred in the replacement. While the court recognized that the purpose of the FAA was to maintain safety in flights and not to protect the owners of aircraft from economic loss, it permitted the cause of action.¹⁸⁰ Even though the plaintiffs were not the primary beneficiaries of the FAA action, and even though the economic loss was only indirectly encompassed by the FAA order, this court's analysis determined that the first criterion of the *Cort* test had been met.¹⁸¹

The consumer invoking the Seller Rule would likely meet the first criterion even under the traditional analysis. However, *Rauch* and similar cases¹⁸² indicate a broadening of the scope in which implication will be allowed. Later cases also show a willingness on the part of some courts to extend the law by implying a cause of action where justice requires it—even in the case of administrative regulations.

While analysis of the second criterion, legislative intent to create or deny a private cause of action, has remained rather stable, the real difference between the traditional analysis and the newer analysis lies in the respective approaches to the third criterion: is implication of a private cause of action consistent with the underlying purpose of the legislative scheme? The traditional approach has focused on the congressional intent for enforcement. On this, the methodological level, courts ask whether a private cause of action would be contrary to the enforcement scheme set up by Congress. In *Holloway v. Bristol-Meyers Corp.*,¹⁸³ a case in which private action under the Federal Trade Commission Act was denied, the methodological purpose analysis was used. The court stated that the method of enforcing FTC regulations was clearly laid out in the Act. Therefore, implication of a private cause of action would be contrary to the underlying scheme.¹⁸⁴

In a case decided nine years before *Holloway*,¹⁸⁵ the Supreme Court adopted an approach which concentrated on the ultimate purpose of Congress rather than on the enforcement scheme.

180. *Id.* at 441-42.

181. *Id.* at 439.

182. See notes 167 and 168 *supra*.

183. 485 F.2d 986 (9th Cir. 1973).

184. *Id.* at 998.

185. *J.I. Case v. Borak*, 377 U.S. 426 (1964).

Implying a private cause of action from a regulation of the Securities and Exchange Commission,¹⁸⁶ the Court stated: "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose."¹⁸⁷ This was clearly not a methodological purpose analysis; the analysis concentrated instead on the "ultimate purpose" of Congress.

The ultimate purpose analysis is a total appraisal of congressional intent. Unlike the methodological analysis which looks no deeper than to determine whether implication would be within the expressed methods of enforcement, the ultimate purpose analysis goes well beyond that point to discern the purpose of the act itself. The analysis then requires appraisal of stated enforcement procedures to determine whether a private action would help or frustrate the reason for enforcement—that is, the ultimate purpose.

In applying the ultimate purpose analysis, the federal District Court for the Northern District of Indiana rejected the holding of *Holloway* and recognized a private cause of action based on a violation of a FTC cease and desist order. In *Guernsey v. Rich Plan of the Midwest*,¹⁸⁸ the court made an objective appraisal of the FTC enforcement prescribed by the Act and ruled that FTC enforcement ability was insufficient. If the ultimate purpose of Congress were to be effectuated, the court held, a private cause of action must be implied: "In weighing the benefits to the consumer against any possible damage to the FTC's role in 'providing certainty and specificity to the broad purpose of the Act,' the court must opt in favor of the consuming public."¹⁸⁹ The court held that a private cause of action had to be implied "[i]n order to effectuate the purpose of the act."¹⁹⁰

The doctrine of implication is a viable solution to the inadequacy of Seller Rule enforcement by the FTC. The trend among the courts is toward an ultimate purpose analysis of Congressional intent; courts have shown a willingness to increase the effectiveness of agency enforcement for those protected by the regulations. Further, there is a trend to extend the benefit of such regulations to those only peripherally concerned.

186. The regulation violated was 17 C.F.R. § 240.14a-9 (1963).

187. *J.I. Case v. Borak*, 377 U.S. 426, 433 (1964).

188. 408 F. Supp. 582 (N.D. Ind. 1976), noted in Comment, *Divesting the FTC of Exclusive Enforcement of the Federal Trade Commission Act*, 38 U. PITT. L. REV. 113 (1976). See also *Carlson v. Coca-Cola Co.*, 483 F.2d 279, 281 (9th Cir. 1973) (Solomon, C.J., dissenting).

189. 408 F. Supp. at 588.

190. *Id.*

Courts which have implied a private action from FTC regulations have done so only in a restricted manner. Even the *Guernsey* court made no blanket recognition of a right of private parties to claim a cause of action. The facts of that case permitted only recognition of private action to enforce a cease and desist order issued by the FTC. The *Guernsey* court was still concerned with the need to employ the commercial and economic expertise of the Commission in the enforcement of rules and regulations.¹⁹¹ However, this case does show the trend toward a broad recognition of private causes of action from FTC regulations. For the Seller Rule and its proposed Creditor Rule amendment, the *Guernsey* court's consumer approach holds real hope that the courts will consider the ultimate purpose analysis and imply a broad private right of action. To do less would leave the impact of the Rule severely restricted.¹⁹²

The final criterion of the *Cort* test requires inquiry into whether the cause of action claimed by the plaintiff is one that can be exercised under state law.¹⁹³ It is clear that Congress did not intend to preempt state law by passage by the FTCA.¹⁹⁴ Thus if there is a solid state law cause of action open to the consumer, courts will be less likely to imply a federal cause of action. The consumer under the Seller Rule does have a possible state cause of action which, if recognized, would reduce the likelihood of implication but would also reduce the need for such a federal cause of action. If the state cause of

191. One of the major arguments favoring the FTC as the only enforcement body is the need for expertise in that enforcement. Because this is the reason enforcement was delegated to the FTC originally, those who oppose private enforcement argue that removing the FTC from the scene would be contrary to the intent of Congress. However, in *Guernsey*, the FTC had already acted, designating the defendant as a violator. The problem remained that the FTC was too preoccupied or bogged down or unconcerned to enforce the cease and desist order. Since the FTC had already brought its expertise to bear in the case, the court felt that there was little need to defer further to that body. But the *Guernsey* court went further:

To conclude that, without exception the Federal Trade Commission, with its overview of the national economy, is in a better position than a private litigant to gauge the injury a deceptive practice will cause to the public and to balance this against the likely cost of eliminating the practice would be to seemingly ignore the basic premise of the free enterprise economy—that consumers should have the opportunity to choose between competing merchants on the basis of price, quality, and service.

192. However, a recent case in the Federal District Court for the District of Columbia has followed the *Holloway* approach and denied private action. *Bott v. Holiday Universal, Inc.*, 5 TRADE REG. REP. (CCH) ¶ 60,973 (1976).

193. *Cort v. Ash*, 422 U.S. 66, 84 (1975).

194. 15 U.S.C. § 57b(e) (1975).

action is not recognized, the need for implication is all the more pressing.¹⁹⁵

Alternative Enforcement in State Law through Reflection

Faced with established precedent denying private enforcement of an FTC regulation and the restricted nature of that solution even if recognized, the consumer who has been injured by a violation of the Seller Rule may seek a cause of action through the Uniform Commercial Code, a state theory based on statute. Even if the state does not specifically reject separation of transactional duties to cut off defenses,¹⁹⁶ the Seller Rule's requirements may reflect on that state law so as to create a cause of action in the individual consumer—a claim that would permit him to assert his defenses against the creditor immediately. This reflection theory of enforcement reasons that when a seller or creditor fails to place the requisite notice in the proper credit note or contract, and does so knowingly, he has acted in bad faith. Having acted in bad faith, he is estopped from cutting off the personal defenses of the consumer through U.C.C. § 3-302.¹⁹⁷

To implement such an enforcement theory the state law must be able to recognize the indirect effect that violation of the federal law has on state law; state law requirements must enforce federal law indirectly. Further, violation of the Seller Rule must be found to be "bad faith" within the meaning of Articles Three and Nine of the U.C.C. Neither of the questions are addressed, however, if federal law totally preempts state law in the area of preservation of consumer claims and defenses.

Federal preemption of state law may be either explicit or implicit.¹⁹⁸ If Congress expresses an intent to preempt the field, then the state law in that area is preempted.¹⁹⁹ When Congress does not expressly preempt, state law may still be preempted if the terms of the state law conflict with federal law, or if the effect of state law

195. Recently a bill was introduced before the House of Representatives which would provide that "a civil action may be brought . . . by any person, partnership, or corporation injured by such unfair or deceptive acts or practices." H.R. Res. 1767, 95th Cong., 2d Sess. TRADE REG. REP. (CCH) No. 268 at 6 (Feb. 15, 1977).

196. See notes 29 and 30 *supra*.

197. Separation through the HDC status of U.C.C. § 3-302 requires the holder to take in good faith. If the holder fails to take in good faith he is subject to all personal defenses of the obligor-consumer. See note 33 *supra*.

198. See Hirsch, *Toward a New View of Federal Preemption*, 1972 U. ILL. L.F. 515.

199. See *Carson v. Roane-Anderson Co.*, 342 U.S. 232 (1952).

either conflicts with or frustrates that of the federal law.²⁰⁰ Problems with implied preemption can be avoided if there exists a savings clause in the federal law.²⁰¹

Explicit preemption is no obstacle to state law recognition of the protections granted in the Seller Rule. Congress has made it clear that once the FTC enters an area of regulation it does not preempt state law, except where the two are in direct conflict: there is no explicit preemption. The FTC enabling statute states that consumer rules are in addition to and not in lieu of state law.²⁰² Acknowledging that the FTC did not preclude state action, a federal circuit court stated, "This Act does not purport to affect a consumer's right to obtain damages in a common law action that may evolve in common law jurisprudence."²⁰³ Clearly the Seller Rule implicitly preempts U.C.C. §§ 3-302 and 9-206 which grant holder in due course status whenever consumer transactions are involved. The conflict here is direct; however, the other requirements of the U.C.C. remain intact.

The extent to which implicit preemption will be avoided where FTC regulations are concerned was examined at length in *Double-Eagle Lubricants, Inc. v. Texas*.²⁰⁴ A manufacturer of reconditioned motor oil had been ordered by the state to place the words "Reconditioned Motor Oil" on the front and back panels of all cans of oil it sold. The FTC meanwhile promulgated a rule which required manufacturers of such oil to disclose on the front panel that the oil had been made from previously used oil.²⁰⁵ Petitioners felt that they should not have to comply with both regulations and thus sought injunctive and declaratory relief against enforcement of the state law. The court permitted both regulations to stand. Silence by Congress on the issue of preemption was interpreted as rejection of any intent to preempt explicitly.²⁰⁶ The court then gave the rule for

200. See *Perez v. Campbell*, 402 U.S. 637 (1971) (frustration of purpose); *Brotherhood of Locomotive Eng'rs v. Chicago, Rock Island & Pac. R.R.*, 382 U.S. 423 (1966) (clearly implied intent to preempt); *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132 (1963) (conflict of purpose).

201. Hirsch, *supra* note 198, at 538.

202. 15 U.S.C. § 56b(e) (1975). In an advisory opinion dated Oct. 12, 1976 the FTC stated, "The Commission staff does not believe that the required Notice will impair a consumer's right to a larger recovery than that set forth in the Notice [other state actions not preempted]." [1974- Transfer Binder] CONSUMER CREDIT GUIDE CCH ¶ 98,284 (1977).

203. *Holloway v. Bristol-Myers Corp.*, 485 F.2d 986, 999 (D.C. Cir. 1973).

204. 248 F. Supp. 515 (N.D. Tex.), *aff'd*, 360 F.2d 268 (5th Cir. 1965), *dismissed*, 384 U.S. 434 (1966).

205. 16 C.F.R. § 406.5(b) (Supp. 1965).

206. 248 F. Supp. at 518.

determining implied preemption: "Therefore, state laws providing for regulation of unfair or deceptive practices in commerce are valid unless they conflict with the federal law *to the extent that both cannot stand* in the same area."²⁰⁷

It is clear, then, that only those terms of the U.C.C. that directly conflict with the Seller Rule are preempted.²⁰⁸ An aggrieved consumer has a choice of either relying on the FTC to resolve violation of the Seller Rule, or of resorting to a possible state theory. The Seller Rule does not explicitly preempt any state law, and implicitly preempts only that part of the U.C.C. which specifically permits cutting off consumer defenses; other causes of action are in force and may be used to create a cause of action even though the Seller Rule designates the Commission as the enforcer.

Upon violation of a federal law or rule which is not directly enforceable in a state court, the state court may recognize the secondary effect that such violation may have on the requirements of certain state laws.²⁰⁹ Such recognition often occurs in a negative sense, as where state courts must refrain from certain debtor-creditor actions until federal law is enforced through bankruptcy.²¹⁰ It has also been recognized by state recidivist laws that federal prosecutions may be taken into consideration.²¹¹ Under the Seller Rule, the reflection theory of enforcement requires the state court to respond positively by enforcing the federal requirement on the basis of the effect that the federal law has on state law.

In *Miller v. American Telephone & Telegraph*,²¹² the United States Court of Appeals for the Third Circuit noted the effect of federal on state law. Stockholders brought a derivative action against the corporation with both state and federal claims for failure to collect a \$1.5 million debt from the Democratic National Com-

207. *Id.* at 518 (emphasis added).

208. The other tests often applied in cases of preemption—interference and occupying the field—do not call for preemption to any greater extent than the HDC status of U.C.C. §§ 3-302, 9-206. See Hirsch, *supra* note 198, at 526-33.

209. For want of a better term, this enforcement theory will be called "reflection."

210. *Kesler v. Utah Dep't of Pub. Safety*, 369 U.S. 153 (1962); *Jerry Davidson, Inc. v. Michigan Nat'l Bank*, 54 Mich. App. 278, 220 N.W.2d 714 (1974).

211. In *State v. Jones*, 387 S.W.2d 408 (Tex. 1965), the state court permitted prior federal prosecutions to be considered for recidivist state laws. While this is not a direct recognition of federal law in the application of state law, it does recognize federal activity as having sufficient effect on state law so as to alter enforcement of state law. It does not further a federal purpose, however, as would reflection of the Seller Rule on state law.

212. 507 F.2d 759 (3d Cir. 1974).

mittee. The federal counts were based on rules issued by the Federal Election Commission. Enforcement of these rules had been consigned to the FEC, and thus these claims were dismissed.²¹³ The state law claims by themselves would have also been dismissed as they sought judicial review of a business judgment of the directors of a corporation; this was an area which the state law would not scrutinize. However, since the directors' decision was itself a violation of the agency rule, the effect that this had on the state law was to bring the directors' action under review. Refusing to dismiss the otherwise invalid state claim, the court stated: "Where, however, the decision not to collect a debt owed its corporation is itself alleged to have been an illegal act [according to the FEC regulation], different rules apply. . . ."²¹⁴ This court concluded that the directors' act, "though committed to benefit the corporation . . . , amounted to a breach of fiduciary duty in New York."²¹⁵

By analogy from *Miller*, states should recognize the violations of the Seller Rule as bad faith within the meaning of the U.C.C., enforcing the reflexive effect the FTC violation has on the Code requirements. This, of course, requires finding that it constitutes bad faith for a creditor or seller to transfer or accept consumer credit contracts or notes which do not include the Seller Rule notice of preservation.

According to § 3-302 of the U.C.C., before the transfer of a negotiable instrument can cut off personal defenses, the transferee or holder must take in good faith.²¹⁶ That term is defined to mean "honesty in fact in the conduct or transaction concerned."²¹⁷ Without good faith, the holder is not an HDC and the consumer is free to assert personal defenses against him. Good faith by the transferee is also required where credit contracts are concerned if a waiver of defenses clause it to be binding on the consumer.²¹⁸ Thus, in all situations where the Seller Rule applies, except for the interlocking loan transaction, good faith must exist for the holder of the instrument to cut off the defenses of the consumer.

213. The Third Circuit refused to imply a private cause of action from the Congressional Act. See notes 167-68 *supra* and accompanying text.

214. 507 F.2d at 762.

215. *Id.* See also *Cort v. Ash*, 402 U.S. 66 (1975).

216. See note 33 *supra*.

217. U.C.C. § 1-201(19).

218. The Code validates waivers only for the assignee "who takes his assignment for value, in good faith and without notice of a claim or defense." U.C.C. § 9-206(1).

Good faith does not exist where the holder knows the note or contract is tainted with illegality.²¹⁹ It is rare that a debtor raises illegality as a means of defeating HDC status of a creditor, for the illegality itself is often a stronger suit such as fraud.²²⁰ In the Seller Rule context, however, the assertion of the illegality directly is time consuming and without guarantee. The illegality then may be used to indicate lack of good faith to preserve the consumer defenses and claims against the holder.²²¹

The primary benefit of this reflection theory of enforcement is that the creditor is directly affected. The Seller Rule requires only the seller to include or to insure that the notice be included in proper instruments. Reflection, however, denies the creditor the ability to sit back and benefit from the seller's violation. The creditor's knowledge of the need for the notice, which can often be assumed in a business setting, is sufficient to deny him the ability to cut off the consumer's defenses. The consumer may assert bad faith directly against the creditor upon the creditor's petition for payment under the instrument.

The defectiveness of this enforcement theory is two-fold. First, it cannot reach the interlocking loan transaction because the creditor deals directly with the consumer and makes no transfer. The consumer's only possible relief beyond the FTC process would be under a fraud theory. The problem with this is that the creditor cannot really be said to have intended to defraud the consumer except in those cases where he works closely with the seller in a concerted effort to work a separation of duties. The second problem posed by state law enforcement is that it requires the court to make a determination as to whether the FTC regulation was in fact violated—a determination which courts have in the past been wont to avoid in deference to the FTC's expertise. Courts also face the problem of collateral estoppel if the FTC were to adjudicate at the same time.²²² Yet, the violation of the Seller Rule is a rather simple

219. *Appel v. Morford*, 62 Cal. App. 2d 36, 144 P.2d 95 (1943); 11 AM. JUR. 2D, *Bills and Notes* § 425 (1963). See Littlefield, *Good Faith Purchase*, *supra* note 6.

220. *But see*, *Ingenito v. Bermec Corp.*, 376 F. Supp. 1154 (S.D.N.Y. 1974).

221. The creditor must, however, have actual knowledge of the illegality. This should be fairly easy to prove in the business situation where the creditor may be presumed to know the legal requirements of his business.

222. For a discussion of possible collateral estoppel effect that agency proceedings might have in court determinations, see Dawson, *Why a Decision by the NLRB Under 8(b)(4) Should Be Determinative on the Issue of Liability in a Subsequent Section 303 Damage Suit*, 27 OKLA. L. REV. 680 (1974). It must be noted that in the NLRB context, the Board is required to act, while FTC action is discretionary. Thus, in

question which could be made with only a minor investigation, or could be assumed from an earlier FTC determination. Should state courts recognize this reflection of the Seller Rule into state law, the consumer's promised protection, preventing cutting off of claims and defenses, could be realized.

CONCLUSION

The FTC's regulation, "Preservation of Consumers' Claims and Defenses," is one more step in the movement to extract the concept of the holder in due course from the consumer credit field. Extension of the Rule's protection beyond the promissory note and the seller credit transaction to the interlocking loan is a daring and necessary move. Surely, the FTC has made progress; whether it can achieve uniformity and clarity in the field is yet to be seen.

The Seller Rule cannot be the final step in consumer credit protection. Presently the Rule holds too many possible loopholes and suggests too many detrimental side effects. The scope of the Rule should be extended to include the creditor as well as the seller. The fact that the credit card transaction is growing in popularity and remains as a possible means of separating transactional duties to cut off defenses demands that this method of consumer buying be closely monitored in the future to determine whether it will be used by the disreputable seller to avoid the intent of the Rule. Continuing analysis of the effect the Rule is having on the cost and availability of credit must also be made. In that regard, the sociological impact of the Rule in its division of the lower income consumer from the middle and upper income consumers, and the simultaneous reduction of the scope of the Seller Rule, require more consideration in the future.

Furthermore, complete reconsideration should be given to the use of the FTC as the body from which this type of regulation is issued. The general nature, the purposes, and the limited resources of the FTC make it difficult for that body to act as a consumer agency. It is even more difficult for the FTC to enforce the pervasive Seller Rule effectively. Any FTC action, however, can be commended if it raises the level of awareness among the states, so as to spawn parallel protection where such consumer protection can be more fully realized.

Apart from future development, there are several possible means by which the consumer may assert his defenses directly even if

the FTC situation, the question arises as to whether conflict between a judicial determination *prior* to action by the FTC has a reverse collateral estoppel effect.

the Seller Rule is violated. Courts may imply a private cause of action from the Rule, permitting the consumer to assert this right when the creditor seeks payment. The consumer may also claim that the creditor or holder, having knowledge of the seller's violation of the Seller Rule, has acted in bad faith and is estopped from cutting off the consumer's defenses. This solution is also limited since it does not speak to the interlocking loan transaction. The ultimate impact of the Rule and the acceptability of these possible means of enforcement must await the verdict of future use.

**Valparaiso University Student Bar Association
AMERICAN BAR ASSOCIATION—LAW STUDENT DIVISION**

**Persons interested in interviewing or hiring
Graduates of the School of Law
are invited to contact the
Placement Director**

**SCHOOL OF LAW
VALPARAISO UNIVERSITY
VALPARAISO, INDIANA 46383
TELEPHONE 464-5436
AREA CODE 219**