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THE LEGAL IMPACT OF THE FEDERAL TRADE COMMISSION'S HOLDER IN DUE COURSE NOTICE ON A NEGOTIABLE INSTRUMENT: HOW CLEVER ARE THE RASCALS AT THE FTC?

MICHAEL F. STURLEY*

Since 1975 a Federal Trade Commission regulation known as the Holder in Due Course Rule has governed most consumer purchases financed by third-party creditors. The Rule was designed to protect consumers by allowing them to withhold payment for purchases giving rise to contract defenses, such as a defect in the goods, even if the creditor is not the seller. But for this regulation, Article 3 of the Uniform Commercial Code generally would permit a holder in due course to take a negotiable instrument free of most claims and defenses. The regulation does not negate the Code's Holder in Due Course doctrine explicitly; it merely requires the seller to include on the credit instrument a notice that any holder will be subject to all claims and defenses that could be asserted against the seller.

In this Article Professor Sturley considers the possible effects of the required notice. He disputes the generally accepted conclusion of Professors White and Summers, whose commercial law treatise interprets the notice to destroy negotiability of consumer credit instruments. This analysis deprives all parties to a transaction of the benefits provided by Article 3 of the Code. Professor Sturley argues that the drafters of the Holder in Due Course Rule never intended such a broad result. The Article examines possible alternative constructions that would exempt consumer transactions from the Code's Holder in Due Course doctrine, but not from the rest of negotiable instruments law. Professor Sturley concludes, however, that none of these alternatives is entirely satisfactory. The Article recommends amending either the Code or the regulation to achieve the Federal Trade Commission's intent.

> In one stroke of their pen the clever rascals at the FTC did what Congress would have feared to do, what the courts could do only piecemeal and over decades, and what state legislatures had refused to do.[1]

I

In 1975 the Federal Trade Commission (FTC) concluded that unethical merchants and their financers were using the venerable Holder in Due Course

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1. J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 14-8, at 639 (3d ed. 1988).

doctrine from the law of negotiable instruments to victimize thousands of innocent consumers.[2] Inner-city stores were selling shoddy furniture, fly-by-night contractors were promising to install aluminum siding that never appeared, the proverbial used car dealers were hawking lemons, and countless other shady characters were operating in similar fashion in scores of different fields.[3] In each of these cases, the defrauded consumer was saddled with the bill when a holder in due course demanded payment.

Although the evidence before the FTC revealed a wide variety of transactions, a simple hypothetical illustrates the classic problem under then-existing law.[4] Suppose Boris buys a refrigerator on credit from Sarah. To evidence his obligation to pay the purchase price, Boris (the maker) issues a negotiable note to Sarah (the payee). She then negotiates the note to Finance Company, which qualifies as a "holder in due course" (HDC) under Article 3 of the Uniform Commercial Code (U.C.C.).[5] Thereafter Boris discovers that the refrigerator was defective when he bought it, which generally means that he has a valid defense in any action that Sarah might bring to collect the purchase price.[6] She, however, has already been paid. If Boris refuses to honor the note, it is Finance Company that will seek to collect from him.[7] His defense will be worthless because the company, as a holder in due course, takes free of all personal defenses—including Sarah's breach of warranty.[8] Boris must pay the note and seek recovery for the defective refrigerator from Sarah.[9]

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2. Promulgation of Trade Regulation Rule and Statement of Basis and Purpose, 40 Fed. Reg. 53,506, 53,509-10 (1975) [hereinafter Statement of Basis and Purpose].

3. *Id.* at 53,510-11. The range of different fields in which the Commission found that unethical merchants were abusing the Holder in Due Course doctrine included the sale of home appliances, such as televisions, stereo systems, washing machines, sewing machines, and vacuum cleaners; home improvements, including carpeting, alarm systems, and swimming pools; foods, particularly frozen meat; instructional courses, including language training, television and modeling school courses, computer schools, flying lessons, and karate school; health spas; encyclopedias; and cemetery plots. *Id.*

4. The hypothetical discussed in the text considers the application of the Uniform Commercial Code (U.C.C.) to the facts described without regard for other laws that might have applied in some states, such as the Uniform Consumer Credit Code (U.C.C.C.). *See, e.g.*, U.C.C.C. § 3.307 (1974) (prohibiting the use of negotiable instruments in consumer credit sales).

5. *See* U.C.C. § 3-302(1) (1987) (defining holder in due course).

6. *Id.* § 2-601(a) (buyer entitled to reject nonconforming goods); *id.* § 2-602(2)(c) (buyer has no obligation to pay for rightfully rejected goods).

7. Under the facts of this hypothetical, Finance Company may also recover from Sarah for breach of her transfer warranty under U.C.C. § 3-417(2)(d). If she negotiated the note by indorsement, the company may also be able to recover from her under her § 3-414 indorser's contract.

8. U.C.C. § 3-305(2); *see id.* § 2-314 (seller's implied warranty of merchantability).

9. An extra step in the process can protect Sarah from the risk that the holder in due course will seek to recover from her. *Cf.* U.C.C. §§ 3-414, 3-417 (establishing a holder's potential liability to subsequent holders under a contract of indorsement and transfer warranties). For example, suppose she took a bearer note from Boris, then negotiated it to Finance Company by mere delivery (rather than by indorsement and delivery). *See id.* § 3-202(1). Suppose the company then delivered the note (without indorsement) to National Bank, which also took as a holder in due course (or at least had HDC rights under the shelter doctrine, *see id.* § 3-201(1)). The bank takes free of Boris's personal defense, and thus it may collect from him. It may not collect from Sarah. Absent her indorsement, her transfer warranties under § 3-417(2) do not run beyond her immediate transferee (Finance Company) and she did not make a contract of indorsement under § 3-414(1). Furthermore, the bank may not collect from Finance Company. Because the company was an HDC, Boris's defense was not good against it. Thus it did not breach its transfer warranty under § 3-417(2)(d). In the absence of its indorsement, the company also has no liability under § 3-414. The bank's only

The FTC decided that the HDC doctrine unfairly "ma[d]e the consumer's duty to pay [for goods or services] independent of the seller's duty to fulfill his obligations."[10] It designed the Holder in Due Course Rule[11] to avoid this result, intending instead to permit consumers (such as Boris) who were sued by third-party creditors (such as Finance Company) to raise defenses that would have been good against sellers (such as Sarah).[12] This Article considers how the HDC Rule seeks to achieve this goal.

The Commission, neither abolishing the HDC doctrine nor prohibiting creditors from relying on it, chose to pursue its goal indirectly. The HDC Rule simply makes it illegal for a seller to participate in a typical consumer credit transaction[13] unless the credit instrument includes a specified "notice."[14] The required notice declares:

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

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option is to collect from Boris. Unless the company voluntarily takes up the instrument, Sarah avoids all liability except to Boris.

10. Guidelines on Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses, 41 Fed. Reg. 20,022, 20,023 (1976) [hereinafter Guidelines].

11. Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses, 16 C.F.R. §§ 433.1-.3 (1989).

12. The HDC Rule was also designed to eliminate two other "cut-off devices" that many sellers employed to make a consumer's duty to pay independent of the sellers' duty to perform their obligations: "waiver of defenses" clauses and "dragging the body." Under U.C.C. § 9-206, a "waiver of defenses" clause in a sales contract prevented a buyer from raising personal defenses against an assignee of the contract who took the assignment for value, in good faith, and without notice of a claim or defense. Using such clauses, therefore, was very similar to using the HDC doctrine. In "body-dragging," the seller arranged a loan for the buyer with a third-party lender who was nominally independent of the seller. Because the loan transaction was legally separate from the sales transaction, defenses arising in the latter did not affect the obligation to repay under the former—even though the two were in reality part of the same transaction. The FTC therefore designed the HDC Rule not only to preclude the use of the HDC doctrine in consumer transactions but also to prevent sellers from using either of these alternatives. *See, e.g.*, Statement of Basis and Purpose, *supra* note 2, at 53,508.

13. The HDC Rule does not apply to every consumer credit transaction. *See, e.g.*, 16 C.F.R. § 433.1(d) (1989) (definition of "Purchase money loan" that effectively limits the Rule's application to cases in which there is a sufficient nexus between the seller and the creditor); *id.* § 433.1(c) (definition of "Creditor" that excludes credit card issuers). The details of the Rule's scope, however, are irrelevant in the present context. The concern here is with the impact of the FTC notice when it appears. This analysis does not depend on whether the Rule required the inclusion of the notice. *See, e.g.*, Bendix Home Systems, Inc. v. Jessop, 644 P.2d 843, 845 n.7 (Alaska 1982) (FTC notice included in contract when not required by the Rule is nevertheless effective); Jefferson Bank & Trust Co. v. Stamatiou, 384 So. 2d 388, 390-91 (La. 1980) (same).

14. Section 433.2(a) of the HDC Rule provides that a seller in a covered transaction commits an unfair or deceptive act or practice under § 5(a)(1) of the Federal Trade Commission Act, 15 U.S.C. § 45(a)(1) (1982), if it takes or receives "a consumer credit contract" that does not include the required notice. 16 C.F.R. § 433.2(a) (1989). A "consumer credit contract" is defined as "[a]ny instrument which evidences or embodies a debt arising from [a covered transaction]." *Id.* § 433.1(i). Section 433.2(b) makes it a violation for a seller to accept the proceeds of a covered loan if the "consumer credit contract" that the consumer executed in connection with the loan does not include a similar notice. *Id.* § 433.2(b).

AMOUNTS PAID BY THE DEBTOR HEREUNDER.[15]

Curiously enough, the Rule only mandates the inclusion of this language.[16] Once it is part of the instrument, the seller has satisfied the federal law obligation. State law is then left with the task of determining the impact of the language in any subsequent dispute between the consumer and a third-party creditor.[17] The task is not simple, despite the simple answers that some courts and commentators have given.[18]

This Article examines possible explanations for the legal impact (if any) of the FTC notice and demonstrates that the most popular analysis is inconsistent with the Commission's intent when promulgating the HDC Rule. Alternative analyses, on the other hand, are either unpersuasive or inadequate to accomplish the purposes of the Rule. The Article concludes with several suggestions for ways in which interested parties might correct this problem.

II

In the current edition of the leading U.C.C. treatise, Professors White and Summers address the impact of the HDC Rule in two sentences.[19] They conclude that the FTC notice deviously renders the buyer's promise to pay conditional, thus defeating negotiability under U.C.C. section 3-104(1)(b) and as a result making it impossible for anyone to be a holder in due course. This explanation is not only concise but effective. Section 3-104(1)(b) requires a note, to be negotiable under Article 3,[20] to "contain an *unconditional* promise . . . to pay a sum certain in money."[21] The words "subject to," which are prominent in the FTC notice, generally indicate that what follows is an impermissible condition rather than an acceptable reference.[22] When an item is not negotiable, Article 3's provisions (including the HDC doctrine) do not apply to it.[23] And when the

15. 16 C.F.R. § 433.2(a) & (b) (1989). The § 433.2(a) notice includes the bracketed language; the § 433.2(b) notice does not. Otherwise the two are identical.

16. *See supra* note 14 and accompanying text.

17. *See* Statement of Enforcement Policy in Regard to Trade Regulation Rule on Preservation of Consumers' Claims and Defenses, 41 Fed. Reg. 34,594, 34,595 (1976).

18. *See infra* notes 24-27 and accompanying text.

19. J. WHITE & R. SUMMERS, *supra* note 1, § 14-8, at 639. The previous edition of the treatise contained a nine-page appendix explaining the Rule and its operation. J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 1137-45 (2d ed. 1980). This offers slightly more explanation of the analysis discussed in the text. *Id.* at 1138. The current edition, however, sacrifices these pages in favor of an eleven-page appendix titled "WESTLAW References." J. WHITE & R. SUMMERS, *supra* note 1, at 1256.

20. The U.C.C. leaves open the possibility that a note could be negotiable outside of the Code. U.C.C. § 3-104 comment 1.

21. *Id.* § 3-104(1)(b) (emphasis added).

22. *See id.* § 3-105(2)(a) & comment 8. Although the words "subject to" generally defeat negotiability, other phrases do not. For example, the Code explicitly sanctions the phrase "as per." *Id.* § 3-105(1)(b).

23. Section 3-805 allows a nonnegotiable instrument to have the benefit of all of Article 3's provisions except the HDC doctrine, but only if the instrument satisfies the requirements of § 3-104(1)(a), (b), and (c). Thus, an otherwise negotiable instrument that fails to include order or bearer language, § 3-104(1)(d), benefits from § 3-805. Section 3-805 would not apply to a "conditional" promise or order.

HDC doctrine does not apply, a third-party creditor cannot become a holder in due course and will not take free of the consumer's personal defenses.

The White and Summers explanation is also the most popular in current use. Although courts generally apply the FTC notice without any explanation of how it achieves its purpose (other than a conclusory statement that it preserves consumer claims or precludes HDC status),[24] some courts have explained that the notice renders a promise conditional.[25] Much of the secondary literature similarly assumes, without analysis, that the HDC Rule is effective,[26] but several commentators state that the FTC notice destroys negotiability by making the promise conditional.[27] To the extent there is any accepted wisdom on this issue, therefore, it is the wisdom of White and Summers. No one seriously chal-

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24. *E.g.*, Tinker v. De Maria Porsche Audi, Inc., 459 So. 2d 487, 492 (Fla. Dist. Ct. App. 1984) ("The effect of the federal rule is to defeat the holder in due course status of the assignee institutional lender, thus removing the lender's insulation from claims and defenses which could be asserted against the seller by the consumer."), *rev. denied*, 471 So. 2d 43 (Fla. 1985); General Motors Acceptance Corp. v. Daniels, 377 So. 2d 346, 349 (La. 1979) ("[FTC] notice . . . makes the holder of the paper subject to all the claims and defenses which the debtor may assert against the seller of the goods"); Home Savings Ass'n v. Guerra, 733 S.W.2d 134, 135 (Tex. 1987) ("In abrogating the holder in due course rule in consumer credit transactions, the FTC preserved the consumer's claims and defenses against the creditor-assignee."); *cf.* Federal Trade Comm'n v. Winters Nat'l Bank & Trust Co., 601 F.2d 395, 397 (6th Cir. 1979) ("[T]he effect of this Rule is, of course, to strip the ultimate holder of the paper of its traditional status as a holder-in-due-course and to subject it to any potential defenses which the purchaser might have against the seller.").

25. *E.g.*, Capital Bank & Trust Co. v. Lacey, 393 So. 2d 668, 669 (La. 1980) ("It is the inclusion of the required language that, by making the promise to pay conditional, prevents a subsequent holder from becoming a holder in due course.") (dicta); Thomas v. Ford Motor Credit Co., 48 Md. App. 617, 622, 429 A.2d 277, 281-82 (1981) ("The language of the notice deprives the paper of its negotiability in that it becomes a conditional promise.") (dicta); *cf.* Jefferson Bank & Trust Co. v. Stamatiou, 375 So. 2d 1185, 1187 (La. Ct. App. 1979) (Lemmon, J., dissenting) ("the note . . . is non-negotiable, because the promise to pay is conditional, being 'subject to' the claims and defenses of the debtor against the seller"), *rev'd*, 384 So. 2d 388 (La. 1980).

26. *E.g.*, J. CALAMARI & J. PERILLO, THE LAW OF CONTRACTS § 18-17, at 747 & n.82 (3d ed. 1987); Comment, *Preservation of Consumer Claims and Defenses: Miller's Tale Tolled by FTC (Or is it?)*, 47 MISS. L.J. 768, 774-75 (1976); Comment, *The Federal Trade Commission Rule on the Preservation of Consumers' Claims and Defenses—What Price Protection?*, 16 SANTA CLARA L. REV. 815, 822-25 (1976).

27. *E.g.*, Lawrence & Minan, *The Effect of Abrogating the Holder-in-Due-Course Doctrine on the Commercialization of Innovative Consumer Products*, 64 B.U.L. REV. 325, 334 n.34 (1984); Whitford, *A Critique of the Consumer Credit Collection System*, 1979 WIS. L. REV. 1047, 1087 n.143; Comment, *Consumer Protection: Proposed Federal Trade Commission Rule—Preservation of Buyers' Claims and Defenses in Consumer Installment Sales*, 21 J. PUB. L. 169, 182 & n.72 (1972) [hereinafter Comment, *Consumer Protection*]; Comment, *The FTC Legend in Louisiana*, 48 LA. L. REV. 1435, 1436-38 (1988); Comment, *Implied Consumer Remedy Under FTC Trade Regulation Rule—*Coup de Grâce *Dealt Holder in Due Course?*, 125 U. PENN. L. REV. 876, 888 (1977); *cf.* Hersbergen, *Developments in the Law, 1979-1980: Private Law: Banking Law*, 41 LA. L. REV. 313, 315 n.6 (1980) ("A plausible argument can be constructed that the FTC clause conditions the maker's undertaking, thereby destroying the negotiable character of the writing under [U.C.C. § 3-104(1)(b)]."). Other commentators argue or assert that the FTC notice destroys negotiability, but do not explicitly mention the unconditional promise requirement. *E.g.*, Rubin, *Policies and Issues in the Proposed Revision of Articles 3 and 4 of the UCC*, 43 BUS. LAW. 621, 623 & n.4, 625-26 & n.17 (1988) [hereinafter Rubin, *Policies and Issues*]; Rubin, *Toward a General Theory of Waiver*, 28 UCLA L. REV. 478, 526 n.276 (1981); Comment, *The FTC Holder in Due Course Rule: A Rule Without a Private Remedy*, 44 MONT. L. REV. 113, 120 (1983); Comment, *The FTC's Holder-in-Due-Course Rule: An Ineffective Means of Achieving Optimality in the Consumer Credit Market*, 25 UCLA L. REV. 821, 824 (1978); *cf.* Miller & Meacham, *The FDIC and Other Financial Institution Insurance Agencies as "Super" Holders in Due Course: A Lesson in Self-Pollinated Jurisprudence, 40* OKLA. L. REV. 621, 623 n.15 (1987) (HDC Rule "may operate to preclude negotiability or the HDC aspect of that concept").

lenges their view or proposes an alternative explanation.[28]

The White and Summers analysis accomplishes the FTC's stated goal of eliminating the HDC doctrine in covered transactions. Unfortunately, it goes far beyond that limited result. Third-party creditors not only lose holder in due course status; they are denied simple holder status as well.[29] This is not a trivial concern. Although the HDC doctrine may be the most spectacular attribute of negotiability, the U.C.C. implicitly recognizes that there are important benefits to being a holder that are entirely independent of being a holder in due course.[30] Even Professors White and Summers (in a different section of the treatise) admit the serious consequences of losing simple holder status: "[A] sketchy and uncertain common law" governs the rights and liabilities of the parties instead of Article 3 of the Code.[31]

The loss of holder status triggers a number of practical consequences beyond loss of HDC status. Article 3 transfers, for example, are generally a simple matter. A holder negotiates an instrument by delivery with any necessary indorsements.[32] Without Article 3, the parties must use the more complicated rules governing the assignment of contracts. It is not necessarily more difficult to comply with contract rules than with negotiable instrument rules. Indeed, even an oral assignment can be effective.[33] A major part of the problem, in fact, is that contractual assignment is so easy that a third party may have difficulty ensuring that the assignor has not already assigned the rights to someone else. A large part of the law in this area, therefore, involves the issue of priority among competing assignees.[34] But this is only one problem. As Professor Corbin explains, "It is not always easy to determine whether the owner of a right has made an assignment, or a mere promise to assign later on, or a promise to pay

28. A few of the commentators supporting the White and Summers analysis also suggest other explanations. *E.g.*, Whitford, *supra* note 27, at 1087 n.143 (suggesting "separate written agreement" analysis); Comment, *Consumer Protection*, *supra* note 27, at 182-83 (suggesting "notice" analysis); *cf.* Hersbergen, *supra* note 27, at 316-17 (suggesting "agreed variation" analysis).

29. A "holder" under Article 3 is a person in possession of a negotiable instrument "drawn, issued, or indorsed to him or his order or to bearer or in blank." U.C.C. § 1-201(20). A "holder in due course" is a holder who satisfies the additional requirements of § 3-302. Although HDC status is often valuable, holders who do not qualify as HDCs ("mere holders") nevertheless have certain rights. *See, e.g.*, U.C.C. § 3-301.

30. Under § 3-805, certain instruments are subject to all the rules of Article 3 except the HDC doctrine. *See supra* note 23. This provision would be meaningless if holder status had no value by itself. *See supra* note 29; *infra* notes 32-46 and accompanying text (discussing implications of mere holder status).

31. J. WHITE & R. SUMMERS, *supra* note 1, § 14-4, at 620.

32. *See* U.C.C. § 3-202(1).

33. RESTATEMENT (SECOND) OF CONTRACTS § 324 (1979).

34. Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1067 & n.31 (1954) [hereinafter Gilmore, *Commercial Doctrine*]; *see, e.g.*, McKnight v. Rice, Hoppner, Brown & Brunner, 678 P.2d 1330, 1334-36 (Alaska 1984). *See generally* E.A. FARNSWORTH, CONTRACTS § 11.9, at 790-92 (1982) (discussing rules for priority of competing assignees). It is worth noting that, although Professor Gilmore subsequently revised many of his earlier conclusions in this field, he continued to recognize the significance of the difference between negotiable and nonnegotiable instruments. *See, e.g.*, Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 610-11 & nn.22-23 (1981).

out of a fund to be collected."[35] As a result, transferees are more likely to be uncertain of the rights they are acquiring, or uncertain about whether they are acquiring any rights at all. In an extreme case, a transferee will pay for rights that are not conveyed or the uncertainty will prevent a potential transfer from occurring.[36]

After a third-party creditor has qualified as an assignee, serious problems still remain. The holder of a negotiable instrument automatically receives the benefit of indorsers' contracts to pay the instrument on dishonor[37] and prior transferors' implied warranties regarding the instrument.[38] A contractual assignee, by contrast, does not necessarily have these benefits.[39] If the original consumer refuses or is unable to pay, the creditor's remedies against intermediate parties, including the seller who breached the sales contract in the typical scenario that motivated the FTC to adopt the HDC Rule, must be based on the contract of assignment. Furthermore, when a holder needs to collect from an irresponsible maker who has no valid defense, it may rely on Article 3's simple procedures and presumptions.[40] An assignee, on the other hand, must bring a more complicated and expensive suit under Article 2 or the law of contracts.[41] Finally, a holder receives significant protection simply by possessing the instrument. Only the person in possession of the instrument, for example, can discharge the underlying debt.[42] Creditors of the holder can assert their claims against the instrument only by obtaining possession.[43] Those benefits are, for the most part, denied to the contractual assignee. Before notice of assignment, payment to the assignor discharges the obligor.[44] After notice, the debtor obtains discharge by paying the person entitled to payment, whether or not that

35. 4 A. CORBIN, CORBIN ON CONTRACTS § 879, at 531 (1951); *see also* E.A. FARNSWORTH, *supra* note 34, § 11.3, at 754-55 (distinguishing promises from assignments).

36. *See, e.g., McKnight*, 678 P.2d at 1334-36 (apparent assignee not entitled to benefit of contract due to competing assignment).

37. *See* U.C.C. § 3-414(1). An indorser may explicitly disclaim this contract when making the indorsement.

38. *See id.* § 3-417(2). A transferor may limit these warranties only slightly. *See id.* § 3-417(3).

39. *See, e.g.*, Northern Trust Co. v. E.T. Clancy Export Corp., 612 F. Supp. 712, 715-16 (N.D. Ill. 1985). Depending on the circumstances of the assignment, the assignor may impliedly make warranties comparable to those of U.C.C. § 3-417(2) for transfers "without recourse." *See* RESTATEMENT (SECOND) OF CONTRACTS § 333 (1979). These warranties do not run to subsequent assignees. *Id.* § 333(4). Furthermore, they may be disclaimed. *Id.* § 333 comment b; *cf. supra* note 38 (noting restrictions on ability to limit Article 3 transfer warranties).

40. Under U.C.C. § 3-307(2), a holder establishes a prima facie case simply by producing the instrument. The holder benefits from a presumption that all signatures are valid unless specifically denied in the pleadings. *Id.* § 3-307(1).

41. Under normal contract law, the burden will be on the plaintiff to establish the traditional elements of a contract case, such as offer, acceptance, and consideration. *E.g.*, United States Suzuki Motor Corp. v. Johnson, 673 S.W.2d 105, 106 (Mo. App. 1984).

42. Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441, 449-50 (1979); *see, e.g.*, Lambert v. Barker, 232 Va. 21, 25, 348 S.E.2d 214, 216 (1986). Section 3-601(1) of the Code lists the situations in which a party's liability on an instrument is discharged. Under § 3-802(1)(b), discharging liability on the instrument generally discharges the obligor on the underlying debt.

43. Gilmore, *Commercial Doctrine*, *supra* note 34, at 1064 & n.18.

44. RESTATEMENT (SECOND) OF CONTRACTS § 338(1) (1979); *see, e.g.*, Taylor v. Roeder, 234 Va. 99, 102, 360 S.E.2d 191, 193 (1987).

person has possession of the original document.[45] And claimants may assert their claims by serving a garnishment order on the obligor.[46]

The would-be holder is not the only party to suffer when an instrument is not negotiable. In some situations, the consumer (the intended beneficiary of the Rule) can suffer as well. Just as a holder in possession of a negotiable instrument is protected by the knowledge that payment to someone else will not discharge the underlying debt, so the maker is protected by the knowledge that payment to the holder will discharge the debt—usually even in cases where the maker is aware of others' claims to the instrument.[47] When nonnegotiable contracts are involved, an obligor with actual or constructive notice of a purported assignment must pay the party actually entitled to payment, without regard to whether that person has possession of the contract.[48] If the obligor pays the apparent assignee and it turns out that the assignment was ineffective, the debt is still due the original creditor. If the obligor pays the original creditor and it turns out that the assignment was valid, the assignee is still entitled to the money.[49] In the introductory scenario that justified the HDC Rule, therefore, the burden is on Boris (the helpless consumer) to determine the "sketchy and uncertain common law"[50] of assignments or face double liability on the debt.[51]

III

Did the Commission really intend such drastic measures to accomplish its goal? Have Professors White and Summers accurately portrayed the HDC Rule as a triumph for "the clever rascals at the FTC?" The language of the notice itself suggests that only the HDC doctrine, not Article 3 in its entirety, was the target of the Rule. The notice begins with a reference to the "holder" of the instrument.[52] If Professors White and Summers are correct and the instrument is not negotiable, there cannot be a "holder" in the technical sense of the term; the notice would be superfluous because there would be no one to whom it applied. This is probably no more than the imprecise use of technical language,[53] but at the very least it suggests that the FTC did not intend the White and

45. *See, e.g.*, Continental Purchasing Co. v. Van Raalte Co., 251 A.D. 151, 152-54, 295 N.Y.S. 867, 870-71 (1937).

46. Gilmore, *Commercial Doctrine*, *supra* note 34, at 1067 & n.29.

47. U.C.C. § 3-603. *See generally* Gilmore, *supra* note 42, at 450 & n.16 (discussing merger theory under which the payor is entitled to discharge of the underlying debt on payment to the holder).

48. RESTATEMENT (SECOND) OF CONTRACTS § 338(1) & comment a (1979).

49. *See* Gilmore, *supra* note 42, at 450-51; Gilmore, *The Assignee of Contract Rights and His Precarious Security*, 74 YALE L.J. 217, 227 (1964).

50. J. WHITE & R. SUMMERS, *supra* note 1, § 14-4, at 620; *see supra* text accompanying note 31.

51. *See supra* notes 4-12 and accompanying text.

52. 16 C.F.R. § 433.2(a) & (b) (1989). *See supra* text accompanying note 15.

53. There is very good evidence that the FTC was simply using technical language imprecisely. The HDC Rule was directed not only at the HDC doctrine, but also at "waiver of defense" clauses. *See supra* note 12. Thus, the Commission intended the Rule to apply when a "consumer credit contract," *see supra* note 14, did not purport to be a negotiable instrument, and the third-party creditor could not possibly claim to be a "holder" in the technical sense, *see supra* note 29. The use of the term "holder," therefore, may not prove that the FTC intended to recognize the continued

Summers result. A rascal clever enough to eliminate the HDC doctrine by using a technical rule to destroy holder status would not be likely, as part of the process, to misuse a technical term at the heart of the scheme.

When the inquiry goes beyond the language of the Rule to examine the history behind it, there is no suggestion that the Commission ever imagined that it was effectively prohibiting the use of negotiable instruments in consumer-credit transactions. The official *Statement of Basis and Purpose* published with the Rule, for example, was intended "to state, with particularity, the purpose of each provision of the rule"[54] and "to define, with particularity, the reasons the [FTC] . . . decided to take this action,"[55] yet it describes only the elimination of the HDC doctrine as the relevant goal. This detailed explanation frequently refers to the abuses associated with the HDC doctrine and related cut-off devices.[56] The *Statement* nevertheless criticizes the use of negotiable instruments and the negotiation process only in the context of the HDC doctrine,[57] despite the FTC's recognition that banning negotiable instruments in consumer transactions was widely recognized as a potential solution to the problem.[58] Indeed the *Statement* explicitly recognizes that a simple ban on negotiable instruments would be ineffective.[59]

Two pieces of affirmative evidence from the *Statement* are particularly revealing. First, one justification for shifting the risk of seller default from the consumer buyer to the third-party creditor is the implicit assumption that Article 3 would continue to govern the creditor's relationship with the seller. At one point, for example, the Commission discussed the financer's "recourse against the seller based on the seller's endorsement of the instrument,"[60] a right derived from section 3-414(l) of the Code. Elsewhere the Commission not only recognized the transferor's warranty of freedom from valid defenses, but quoted section 3-417(2)(d) which imposes the warranty.[61] The assumption that these Article 3 provisions will apply, however, is accurate only if the FTC notice does not destroy negotiability.[62]

existence of holder status, but it at least suggests that the FTC did not deliberately intend the Rule to eliminate holder status.

54. Statement of Basis and Purpose, *supra* note 2, at 53,506.

55. *Id.* at 53,506-07.

56. *E.g.*, *id.* at 53,507-12, 53,517-24, 53,527.

57. *E.g.*, *id.* at 53,507-08, 53,510-11, 53,517, 53,519.

58. *See, e.g.*, *id.* at 53,508. The FTC also considered the recommendations of the National Commission on Consumer Finance (NCCF). *See, e.g.*, *id.* at 53,509. The NCCF had advocated that "[n]otes executed in connection with consumer credit transactions should not be 'negotiable instruments.'" CONSUMER CREDIT IN THE UNITED STATES: REPORT OF THE NATIONAL COMMISSION ON CONSUMER FINANCE 35 (1972). The NCCF would have done this simply and straightforwardly by requiring the legend "Consumer Note—Not Negotiable" to be printed on each note. *Id.* With such a simple model before it, one wonders why the FTC would want to destroy negotiability in the manner described by Professors White and Summers.

59. Statement of Basis & Purpose, *supra* note 2, at 53,508. The FTC recognized that in states that had simply banned negotiable instruments, sellers responded with alternative devices to accomplish the same result. *Id.*; *see supra* note 12. Thus the FTC knew that such a simple solution would be ineffective. *See, e.g.*, Statement of Basis and Purpose, *supra* note 2, at 53,508, 53,515.

60. Statement of Basis and Purpose, *supra* note 2, at 53,509.

61. *Id.* at 53,518 (quoting U.C.C. § 3-417(2)(d)).

62. *See supra* notes 37-39 and accompanying text.

The second piece of affirmative evidence focuses more directly on the issue of negotiability. The 1973 version of the proposed HDC Rule, which also provided for the inclusion of a specified notice in relevant documents, defined its scope in part by reference to "[a]ny negotiable promissory note or other negotiable instrument of indebtedness."[63] This definition shows that the Commission believed that notes containing the earlier version of the notice would be negotiable, despite being every bit as "conditional" as notes containing the final version.[64] The FTC ultimately changed the definition, but explained in the *Statement* that it did not intend to change the substance of the Rule:

> [B]y eliminating references to terms such as "negotiable" . . . we have simplified the rule. We have also avoided potential litigation in enforcement proceedings by eliminating consideration of the technical nature of a non-conforming contract.[65]

The FTC was not moving to destroy negotiability through the application of a technical rule; it was moving to make "the technical nature" of the consumer credit contract irrelevant to the application of the Rule.

The staff's *Guidelines* on the Rule also suggest a limited approach. They explain the HDC doctrine immediately before stating that the Rule's purpose is "to preserve the consumer's legally sufficient claims and defenses so that they may be asserted [against] a creditor."[66] The obvious implication is that the staff saw the Rule's purpose solely in terms of modifying the HDC doctrine. The staff's explanation of the mechanism of the Rule also refers only to preserving the claims that the HDC doctrine would invalidate, suggesting that the Rule will accomplish this straightforwardly under the explicit terms of the notice.[67] There is no hint that the notice is merely the first step of an indirect assault on the HDC doctrine through technical rules of negotiability.

Finally, a congressional subcommittee held hearings on the HDC Rule barely three months after its effective date. The almost contemporaneous reaction of those most interested and involved in the process provides further evidence of what the Commission was trying to do. The first four speakers, all congressmen, consistently described the Rule as abolishing the HDC doctrine (and related cut-off devices), and as nothing more.[68] The acting director of the

63. Proposed Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses § 433.1(e), 38 Fed. Reg. 892, 893 (1973).

64. The 1973 version of the proposed HDC Rule provided for the following notice:

> It is agreed that any holder of this instrument takes this instrument subject to all claims and defenses which would be available to the maker in an action arising out of the contract which gave rise to the execution of this instrument, notwithstanding any agreement to the contrary. Recovery by the maker under this provision shall not exceed the full amount of this instrument.

Id. § 433.2(a).

65. Statement of Basis and Purpose, *supra* note 2, at 53,524.

66. Guidelines, *supra* note 10, at 20,023.

67. *Id.* at 20,023-24.

68. *Consumer Claims and Defenses: Hearings Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce*, 94th Cong., 2d Sess. 1 (1976) (statement of Congressman John M. Murphy) [hereinafter *Hearings*]; *id.* at 2 (statement of Congressman John Y. McCollister); *id.* at 3 (statement of Congressman Frank Annunzio); *id.* at 4 (same); *id.* at 5 (same); *id.* at 6 (same); *id.* at 7 (statement of Congressman John M. Murphy); *id.* at 9

FTC's Bureau of Consumer Protection testified that "[t]he mechanism of the rule is straightforward."[69] She called the notice "a provision which expressly prevents the cutoff of buyer's legal rights [and] simply preserves against the creditor any legal claims and defenses the consumer would have against the seller under applicable State law."[70] Like the four congressmen, she characterized the effect of the Rule as the "elimination of the holder in due course [doctrine]."[71] Although there were sharp disagreements between supporters and opponents on a number of issues,[72] everyone apparently viewed the debate to be about the HDC doctrine. No one argued that the FTC had taken the far more radical step of completely abolishing negotiability in consumer cases. Perhaps the Commission accomplished the intended result (eliminating the HDC doctrine in consumer transactions) in the manner that Professors White and Summers suggest (eliminating the use of negotiable instruments in consumer transactions). If so, however, the "rascals" were not very "clever" about it. Not only did they check the cancer in one of the patient's fingers by amputating both arms, they apparently did so unintentionally.

IV

Because the White and Summers explanation is so drastic, it is helpful to consider alternative explanations for the HDC Rule. Perhaps a different analysis will permit the FTC to accomplish its true purpose without entirely sacrificing negotiability in consumer transactions.

Because the FTC intended the Rule to eliminate HDC status, an obvious starting point is the HDC definition. Section 3-302(1) of the Code defines a holder in due course as "a holder who takes the instrument (a) for value; and (b) in good faith; and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person."[73] Four independent requirements thus exist under the statutory definition: holder, value, good faith, and notice.[74] Analysis of the first two requirements offers no solutions. Attacking HDC status through the holder requirement is essentially what Professors White and Summers have already suggested. The problem remains: destroying holder status eliminates the use of negotiable instruments entirely. Refusing to recognize a third-party creditor's payment to the original seller as "value" would accomplish the Commission's goal, but there is no apparent way

(statement of Congressman John Y. McCollister); *id.* at 10 (statement of Congressman Albert W. Johnson).

69. *Id.* at 18 (statement of Margery Waxman Smith).

70. *Id.* (statement of Margery Waxman Smith).

71. *Id.* at 20 (statement of Margery Waxman Smith).

72. *See, e.g.*, *id.* at 3-9 (statement of Congressman Frank Annunzio) (supporting the HDC Rule); *id.* at 10-13 (statement of Congressman Albert W. Johnson) (criticizing the HDC Rule).

73. U.C.C. § 3-302(1).

74. Professors White and Summers list a fifth requirement: "the holder in due course [must] take an 'instrument,' " meaning a "negotiable instrument." J. WHITE & R. SUMMERS, *supra* note 1, § 14-4, at 618. Whenever the writing in question is not a negotiable instrument, however, no one can be an Article 3 "holder" of it. *See* U.C.C. §§ 1-201(20), 3-102(1)(e). This extra requirement, therefore, adds nothing to the definition that is not already subsumed in the requirement that an HDC must be a "holder."

in which the FTC notice does this.[75]

The good faith requirement offers more promise, particularly because some courts used this requirement to protect consumers in pre-Rule cases.[76] In most situations, however, the approach is inadequate. The Code defines "good faith" as "honesty in fact in the conduct or transaction concerned,"[77] which courts and commentators recognize as creating a subjective standard.[78] A holder who takes an instrument in subjective honesty is protected, regardless of how dishonest the action may appear to a reasonable person viewing the known facts objectively; a holder who acted dishonestly is not.[79] Thus the good faith requirement always has been relevant when a holder colludes with a seller to defraud a consumer,[80] and the FTC notice does not change this analysis. Nothing about the notice itself, though, makes it dishonest for a typical creditor to purchase a typical consumer note. The notice could not imply anything dishonest about a particular contract because the notice must appear in *every* consumer note. It would be difficult to argue that every consumer-credit transaction is necessarily dishonest and every third-party creditor who finances a consumer transaction accordingly acts dishonestly by participating. It would be even more difficult to argue that it is the FTC notice that somehow makes the transaction dishonest.[81]

The notice requirement also has some surface appeal. Not only does the required language begin with the heading "NOTICE," but at least one court has held that the language is effective because it gives a subsequent holder "notice of

75. The Code's use of the value requirement to defeat HDC status is not always intuitively obvious. When a depository bank receives a check indorsed "for deposit only," for example, it must follow the restrictive indorsement to qualify as a holder in due course. The Code accomplishes this obvious result by a less-than-obvious application of the value requirement: only if the bank applies value "consistently with the indorsement" does it become a holder for value. U.C.C. § 3-206(3). What appears to be "value," if paid to the wrong person, does not count as "value" in this context. The good faith and notice requirements must be satisfied separately. *Id.*

76. *E.g.*, Commercial Credit Co. v. Childs, 199 Ark. 1073, 1077, 137 S.W.2d 260, 262 (1940); Unico v. Owen, 50 N.J. 101, 109-21, 232 A.2d 405, 410-16 (1967).

77. U.C.C. § 1-201(19).

78. *See* F. MILLER & A. HARRELL, THE LAW OF MODERN PAYMENT SYSTEMS AND NOTES 103 (1985).

79. This standard is colorfully described as a "pure heart, empty head" test. *See, e.g.*, Black v. Peoples Bank & Trust Co., 437 So. 2d 26, 29 (Miss. 1983); *cf., e.g.*, Financial Credit Corp. v. Williams, 246 Md. 575, 584, 229 A.2d 712, 716 (1967) ("white heart, empty head").

80. *E.g.*, *Childs*, 199 Ark. at 1077, 137 S.W.2d at 262 (the holder prepared the instrument and arranged for its immediate assignment upon execution); *Unico*, 50 N.J. at 109-21, 232 A.2d at 410-16 (the holder was established to finance the seller and exerted significant control over the seller's operations).

81. Perhaps one could argue that it would be an act of bad faith for an apparent HDC to claim HDC rights against the maker of a note containing the FTC notice. Under this argument, any holder who claimed HDC rights would automatically lose the rights as a result. Such an analysis could, if accepted, accomplish the FTC's goals. Although a third-party creditor would be a holder (even an HDC) for most purposes, the consumer would retain personal defenses. The problem with this analysis is that a holder's status as an HDC is determined when the note is acquired (or when value is given), not when the holder seeks to enforce payment. If an HDC could lose its status at this later point, few HDCs would retain their protection when the issue became most relevant. When the consumer has a personal defense, the holder is likely to receive notice when it demands payment—before enforcement proceedings begin. Thus the holder could never enforce payment as an HDC, and the doctrine would lose most of its importance.

possible claims and defenses,"[82] and at least one commentator has argued that the language defeats HDC status through the notice requirement.[83] Once again, however, the approach is inadequate. A holder has notice of a defense when it has notice that a party is entitled to avoid his or her obligation on the instrument.[84] This generally[85] occurs in one of three ways: having "actual knowledge of [the party's entitlement to avoid the obligation],"[86] having "received a notice or notification of it,"[87] or having "reason to know that it exists" based on "all the facts and circumstances" actually known "at the time in question."[88] The FTC notice does not assist the analysis under any of these tests.

The "actual knowledge" test is irrelevant. The FTC itself recognized that the notice does not create any new defenses that did not already exist under state law on the facts of the transaction.[89] Because the Rule requires the inclusion of the specified language on virtually all consumer notes—without regard for the existence of an actual defense[90]—in most cases involving the notice the consumer will not be entitled to avoid the original obligation on the instrument. Thus, the notice by itself does not give a third-party creditor any information about the existence of a defense. At most, it tells the creditor that if a defense arises in this case, the consumer will have the right to assert it. It could not give a creditor "actual knowledge" that a defense exists in any particular case.

The notification test is also of limited importance in this context.[91] It ensures that a creditor who purchases an instrument containing the Commission's required language will have notice of its terms, even without actually reading the instrument, because the creditor will have "received a notice or notification" of them.[92] Having notice of these terms, however, does not give the creditor notice of an underlying defense. The FTC notice purports only to tell subsequent holders what will happen if a defense does exist; it does not tell a creditor whether a consumer will be entitled to avoid the original obligation on the instrument in any particular case.

The constructive notice test is the broadest of the three. It establishes a "mixed" standard—an objective test based on what was subjectively known at the relevant time.[93] To apply the test in the context of the HDC Rule, it is

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82. Mahaffey v. Investor's Nat'l Sec. Co., 747 P.2d 890, 892 (Nev. 1987) (per curiam) (applying U.C.C. § 3-302(1)(c)).

83. Comment, *Consumer Protection*, *supra* note 27, at 182-83.

84. U.C.C. § 3-304(1)(b).

85. Section 3-304 governs a number of specific situations in which a holder is held to have, or not to have, notice. Section 3-304(1)(a), for example, covers incomplete instruments. Section 3-304(4) covers situations in which knowledge of specific facts is held not to give a purchaser notice of a claim or defense. None of the specific rules of § 3-304 suggest that a purchaser of a note containing the FTC notice would have notice of any claims or defenses.

86. U.C.C. § 1-201(25)(a).

87. *Id.* § 1-201(25)(b).

88. *Id.* § 1-201(25)(c).

89. *See, e.g.*, *Hearings*, *supra* note 68, at 18-19 (statement of Margery Waxman Smith).

90. *See supra* notes 13-16 and accompanying text.

91. The notification test is important to the analysis in the following section. *See infra* note 101 and accompanying text.

92. *See* U.C.C. § 1-201(25)(b).

93. *See* U.C.C. § 1-201(25)(c).

necessary to ask what a reasonable person should know based on the inclusion of the FTC notice in an instrument. Would knowledge of the FTC notice's existence be enough for a reasonable person to know that a consumer was entitled to avoid the original obligation on the instrument? Clearly not. The FTC notice appears in thousands of notes in which the consumer does not even claim a defense. At best it puts a creditor on notice that the underlying sale is a consumer transaction. Because the Commission requires the inclusion of the notice on all consumer notes without regard for the actual existence of any defenses, its presence cannot reasonably be equated with the existence of a defense.[94] The FTC notice does not give notice of a defense for purposes of defeating HDC status under any of the three possibilities.

A careful consideration of the HDC definition reveals no easy solution to the problem. If a third-party creditor is recognized as a "holder," the FTC notice does nothing to affect value, good faith, or notice. Thus HDC status should follow holder status in all but the most extreme cases. And in those extreme cases in which HDC status is lost,[95] the FTC notice should have little to do with the analysis.

V

Section 3-119 of the Code suggests a completely different approach for explaining the impact of the FTC notice.[96] This rarely cited provision declares that "any other written agreement executed as a part of the same transaction" may modify or affect the terms of a negotiable instrument, "except that a holder in due course is not affected by any limitation of his rights arising out of the

94. One might logically ask whether it would matter if a reasonable person seeing the FTC notice would investigate to discover any defenses. As far as the notice requirement is concerned, however, the unreasonable failure to investigate is irrelevant. The question under § 1-201(25)(c) is whether a reasonable person would have known, not whether a reasonable person would have investigated and discovered. *See, e.g.*, Eldon's Super Fresh Stores, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 296 Minn. 130, 138, 207 N.W.2d 282, 288 (1973) ("Failure to make such inquiry may be negligence and lack of diligence, but it is not 'notice' of what he might discover.") Furthermore, most courts agree that a simple failure to investigate when a reasonable person would have done so does not constitute bad faith. *See, e.g.*, Bankers Trust Co. v. Crawford, 781 F.2d 39, 43-45 (3d Cir. 1986) (applying Pennsylvania law); Dallas Bank & Trust Co. v. Frigiking, Inc., 692 S.W.2d 163, 166 (Tex. Ct. App. 1985).

95. *E.g.*, Commercial Credit Co. v. Childs, 199 Ark. 1073, 1077, 137 S.W.2d 260, 262 (1940); Unico v. Owen, 50 N.J. 101, 109-21, 232 A.2d 405, 410-16 (1967).

96. Two commentators have, without elaboration, suggested this type of analysis. Professor Whitford begins a sentence in a footnote with the observation that the FTC notice "probably renders a contract containing it non-negotiable," but concludes the sentence with the alternative suggestion that "even if it does not [render the contract non-negotiable], any holder, even a holder in due course, would be subject to defenses arising from the underlying sales transaction." Whitford, *supra* note 27, at 1087 n.143 (citing U.C.C. § 3-119(1)). Professor Hersbergen argues that the FTC notice should take effect as an agreed variation under § 1-102(3). Hersbergen, *supra* note 27, at 316-17. Elsewhere, however, he recognizes that § 1-102 does not permit "an instrument [to] be made negotiable by agreement." Hersbergen, *The Bank-Customer Relationship Under the Louisiana Commercial Laws*, 36 LA. L. REV. 29, 46 (1975); *see also* § 1-102 comment 2 ("private parties cannot make an instrument negotiable within the meaning of Article 3 except as provided in Section 3-104"). In view of the similarity between §§ 1-102(3) and 3-119(1), Professor Hersbergen may be relying on § 3-119(2) to establish negotiability. Section 1-102(3) by itself simply provides that an agreed variation may take effect, thus leaving open the possibility that the variation will destroy negotiability in the process.

separate written agreement if he had no notice of the limitation when he took the instrument."[97] As between immediate parties, there is nothing remarkable about this result. For the parties, the instrument is simply a contract and they are undoubtedly free to modify its terms by separate agreement.[98] The provision goes further, however, and states that the modification is binding "[a]s between the obligor and . . . any transferee," including an HDC (except one that did not have notice of the agreement when it acquired the instrument).[99] Furthermore, subsection (2) provides that "[a] separate agreement does not affect the negotiability of an instrument."[100]

If courts were to treat the FTC notice as a separate agreement under section 3-119, the FTC would effectively accomplish its purpose in adopting the HDC Rule. Applying the notice's explicit language, the consumer would be able to raise "all claims and defenses" that would have been valid against the seller. This would effectively modify the terms of the instrument to prevent an HDC from claiming to be free from the consumer's personal defenses, assuming that it had notice of the limitation when it took the instrument. In view of the physical placement of the required language, subsequent holders necessarily will have "received a notice or notification of it."[101] Thus the assumption would always be justified and the consumer's rights would be preserved. In the process, the other benefits of negotiability and Article 3 would also be preserved. The creditor would even retain the benefits of HDC status except against the consumer. (This would be important if, for example, a third party had a claim against the instrument.) The FTC would not only accomplish its narrow purpose, but would do so with minimal disruption to the system.

The principal question is whether the FTC's notice can be a separate agreement. Section 3-119 itself offers little explanation of what it requires, stating merely that a "separate agreement" must be in writing and it must be "part of the same transaction."[102] Satisfying the first requirement is clearly no problem. The HDC Rule even specifies the typeface in which the notice must be written.[103] Satisfying the second requirement also seems easy. To satisfy the Rule, the notice must be part of the same transaction as the note. The difficulty is that it is so much a part of the transaction that it is peculiar to characterize it as a *separate* agreement. The Rule requires that the instrument "contain" the relevant language, and the official comments seem to contemplate a "separate agreement" as something that does not appear on the face of the instrument.[104]

97. U.C.C. § 3-119(1).

98. *Id.* § 3-119 comment 3; *see also id.* § 1-102(3) (permitting parties to vary the effect of the Code by agreement).

99. *Id.* § 3-119(1).

100. *Id.* § 3-119(2).

101. *Id.* § 1-201(25)(c); *see supra* text accompanying notes 91-92.

102. U.C.C. § 3-119(1).

103. 16 C.F.R. § 433.2(a) & (b) (1989).

104. Comment 5 justifies the result of § 3-119(2), which provides that a separate agreement does not affect negotiability. The comment explains that "[t]he negotiability of an instrument is always to be determined by what appears on the face of the instrument alone," and thus is not affected by a separate agreement—which impliedly does not appear on the face of the instrument. U.C.C. § 3-119 comment 5.

Judicial decisions have failed to resolve the problem. Most of the caselaw under section 3-119 involves the opposite question: How independent can two admittedly separate agreements be before they are no longer part of the same transaction?[105] The little relevant authority that does exist is not directly on point. The Oklahoma Court of Appeals, citing section 3-119, treated a note and a security agreement on the same sheet of paper as separate instruments, but stressed that the two were "so situated on the paper that they could be detached from each other and each would appear to be an agreement complete in itself."[106] In contrast, the Louisiana Supreme Court, without mentioning section 3-119, treated a note and a "Sale and Chattel Mortgage" on the same piece of paper as a single agreement despite the fact that they could be (and, in fact, were) detached because "[t]here was no perforated line separating" them and no "other indication that the note was likely or possibly to be employed separately."[107] Finally, in a case in which detachability was not an issue, the Texas Court of Civil Appeals treated an agreement between two comakers that was written on the back of a note as an entirely separate agreement, but the payee of the note was not a party to the separate agreement.[108]

Perhaps the strongest argument in favor of the section 3-119 analysis is that, despite the artificial construction, it best accomplishes the FTC's intent and it best describes the actual behavior of parties in the commercial world. As explained in Part III,[109] the FTC simply wanted to protect consumers from HDCs claiming to hold free of personal defenses. Treating the notice as a separate agreement does this consistently (albeit not comfortably) with established precedents and with none of the disadvantages associated with a loss of negotiability.[110] Furthermore, the section 3-119 analysis allows businesses to deal with consumer paper just as they have always done except in the relatively unusual case in which a consumer has a valid defense to payment.[111]

The strongest argument to the contrary is that the FTC notice is not, in

105. *E.g.*, Peters & Fulk Realtors, Inc. v. Shah, 140 Ill. App. 3d 301, 305-06, 488 N.E.2d 635, 637-38 (1986); A.G. King Tree Surgeons v. Deeb, 140 N.J. Super. 346, 349-51, 356 A.2d 87, 88-90 (1976); Sanden v. Hanson, 201 N.W.2d 404, 408 (N.D. 1972).

106. Walls v. Morris Chevrolet, Inc., 515 P.2d 1405, 1407 (Okla. Ct. App. 1973).

107. Jefferson Bank & Trust Co. v. Stamatiou, 384 So. 2d 388, 392 (La. 1980). This case is particularly relevant because the FTC notice was included in the "Sale and Chattel Mortgage." This relevance is limited, however, by the court's failure to address the possible applicability of § 3-119, which could have enabled the court to reach exactly the same result. The court also failed to address the impact that the FTC notice had on the note's negotiability.

108. Charles v. Charles, 478 S.W.2d 133 (Tex. Civ. App. 1972). The payee apparently was not affected by the separate agreement. *Id.* at 136. The fact that the separate agreement was on the back of the note, rather than on its face, seems irrelevant. Terms written on the back of a note that are intended to be part of it certainly can be treated as such. *E.g.*, First State Bank v. Clark, 570 P.2d 1144, 1146 (N.M. 1977).

109. *See supra* notes 52-72 and accompanying text.

110. One weakness in the theory of this argument is that it relies on the intent of the FTC when drafting the HDC Rule to construe the meaning of a statute, § 3-119 of the U.C.C., that the FTC did not draft. In theory, the only relevant intent is that of the drafters of § 3-119.

111. Construing commercial law to meet the needs of the commercial community has long been a goal of the legal system. *See, e.g.*, Miller v. Race, 1 Burr. 452, 459, 97 Eng. Rep. 398, 402 (K.B. 1758). The desire to protect consumer interests may be a more important goal, but when consumer interests are not implicated the original goal continues to be significant.

fact, separate. The HDC Rule requires the notice to be part of the note; if it were truly a separate agreement the seller would violate the Rule. The notice must accordingly be part of the note, and if it makes the promise conditional it destroys negotiability (even if the FTC did not intend that result). In essence the notice says that the obligation to repay is subject to any defenses that exist under the sales contract. An explicit statement to that effect would destroy negotiability under section 3-104(1)(b). The FTC notice arguably has the same impact.

VI

None of the analyses considered thus far is entirely satisfactory. The White and Summers explanation goes well beyond the FTC's intent and leads to serious negative consequences for consumer paper transactions.[112] Alternative explanations for defeating HDC status through the FTC notice are simply ineffective. The required language does not affect the value, good faith, or notice requirements.[113] And the separate agreement approach strains the ordinary understanding of "separate," perhaps to the breaking point.[114] What, then, remains? It is at least worth considering whether the FTC notice has any effect at all.

By its terms, the FTC notice is a simple declaration of fact: any holder is subject to certain defenses. Unlike the 1973 version of the notice, it is not phrased in terms of an agreement or promise by the parties.[115] Contrary to the implications of the White and Summers argument, it is not phrased as a condition on the maker's obligation to pay. Perhaps the notice is completely ineffective—a statement of a "fact" that is actually false under the well-established HDC doctrine. In other words, it is no different from a "notice" that the moon is made of green cheese.[116] Holders who otherwise satisfy the HDC requirements remain free to assert their HDC rights.

There is, of course, no hint that the FTC intended this bizarre result. If that is the relevant test, however, then the White and Summers argument must fail, too. It may strain ordinary usage to suggest a difference between an enforceable statement that a maker's obligation to pay will be subject to any defenses that may exist under the sales contract and the simple assertion that a holder will be subject to those defenses. This distinction, though, is no more strained than the suggestion that a notice in a contract is legally a separate agreement. Within the range of unsatisfactory possibilities for the FTC notice, excess verbiage is at least an option.

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112. *See supra* notes 29-51 and accompanying text.

113. *See supra* notes 73-95 and accompanying text.

114. *See supra* notes 96-111 and accompanying text.

115. *See supra* note 64 (text of the 1973 version of the notice).

116. The law is certainly familiar with the all-too-common situation in which an unenforceable contract term purports to protect the party who prepared the contract. *See* Kuklin, *On the Knowing Inclusion of Unenforceable Contract and Lease Terms*, 56 U. CIN. L. REV. 845 (1988). Perhaps the FTC notice creates a comparable situation from the opposite perspective.

VII

Because none of the possible interpretations of the HDC Rule is entirely satisfactory, those involved in the commercial paper system should consider how to avoid the difficulties raised here. The U.C.C.'s sponsoring organizations[117] are currently in the best position to address these issues, for they are already considering a major revision of Article 3.[118] If they fail to correct the problem, the FTC would seem to be the obvious candidate to do so, but political constraints make such a simple solution unlikely. In any event, state legislatures, state courts, and even the parties to a consumer-credit transaction can all take action of some kind to protect their interests, at least in part.

The problem discussed in this Article exists through the interaction of the HDC Rule and the U.C.C., so amending the Code could alleviate these difficulties. A number of different approaches would accomplish this objective effectively. One possibility would be to broaden the class of instruments that qualify as "negotiable."[119] Narrower possibilities include amending section 3-119 (or at least the official comments following it) to declare that the FTC notice shall be treated as a separate agreement,[120] or amending section 3-805 to include notes containing the FTC notice within the class of quasi-negotiable instruments subject to all the provisions of Article 3 except the HDC doctrine.[121] The section 3-119 solution achieves the consumer-protection goals most narrowly, leaving a holder in due course with superior rights against third parties.[122] The section 3-805 solution, on the other hand, comes closest to achieving the Commission's specific goal in promulgating the Rule.[123]

Whatever the ideal solution might be, the easiest solution will be the one that is most consistent with other amendments that the U.C.C.'s sponsoring organizations wish to make. Thus any suggestion should consider the current status of the proposed amendments. Unfortunately, this is easier said than done. New drafts are being proposed, considered, and revised so quickly that any

117. The Uniform Commercial Code is a joint project of the American Law Institute and the National Conference of Commissioners on Uniform State Laws. *See, e.g.*, AMERICAN LAW INSTITUTE, 1989 ANNUAL REPORTS 169-74 (reprinting Agreement Describing the Relationship of the American Law Institute, The National Conference of Commissioners on Uniform State Laws, and the Permanent Editorial Board with Respect to the Uniform Commercial Code).

118. *See generally* Ballen, Cooper, Davenport & Nyquist, *Commercial Paper, Bank Deposits and Collections, and Other Payment Systems*, 43 BUS. LAW. 1305, 1334-39 (1988) (discussing proposed revisions to U.C.C. Articles 3 and 4); Rubin, *Policies and Issues*, *supra* note 27, at 621-64 (same).

119. *See supra* notes 20-23 and accompanying text. The U.C.C. drafters originally took this approach when they revised the Negotiable Instruments Law (NIL) to cover specific problematic situations. *See, e.g.*, U.C.C. § 3-105(1)(g) & comment 6 (U.C.C. expands NIL to permit governmental agencies to issue negotiable instruments with payment limited to a particular fund); *id.* § 3-106(1)(c) & comment 1 (U.C.C. resolves uncertainty under NIL to permit negotiable instruments to provide a discount for early payment); *id.* § 3-109(1)(c) & comment 4 (U.C.C. resolves uncertainty under NIL to permit negotiable instruments payable at a definite time subject to acceleration); *id.* § 3-112(1)(b) & comment 1 (U.C.C. expands NIL to permit negotiable instruments to authorize sale of collateral on default prior to maturity).

120. *See supra* notes 96-111 and accompanying text.

121. *See supra* note 23 (discussing U.C.C. § 3-805).

122. *See supra* notes 96-101 and accompanying text.

123. *See supra* note 23.

scholarly discussion may be rendered obsolete by the time it is published. This Article will therefore discuss potential solutions in the context of the two most recent drafts that were available when it went to press. Because the two drafts are materially different, the suggestions here illustrate how simple it would be to include a suitable amendment as part of the ongoing process, whatever form the revisions ultimately take. So long as the final amendments implement the same basic policies, a solution should be readily available, even if the details vary from those discussed here.[124]

At its annual meeting last summer, the National Conference of Commissioners on Uniform State Laws (NCCUSL) considered proposed amendments to Article 3 that would fundamentally change existing provisions on negotiability.[125] The NCCUSL Draft even goes so far as to declare that "[t]he only effect of nonnegotiability . . . is that there cannot be a holder in due course of a nonnegotiable instrument."[126] Much of this apparent change, though, is really a change in terminology. Under this proposal, the revised Article 3 would continue to exclude conditional promises from its scope by excluding them from the definition of the term "instrument"[127] unless there is an express statement that Article 3 shall govern.[128] In other words, the NCCUSL Draft would create three categories of documents: "negotiable instruments" (which, like current negotiable instruments, would be subject to all of Article 3, including the HDC doctrine), "nonnegotiable instruments" (which, like current quasi-negotiable instruments under section 3-805,[129] would be subject to all of Article 3 except the HDC doctrine), and other documents (which would not be "instruments" and

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124. As this Article was going to press, the author received a copy of a new draft prepared for discussion by the National Conference of Commissioners on Uniform State Laws (NCCUSL). This draft differs from the two drafts discussed in the text of this Article in several ways. *See infra* notes 125-40 and accompanying text. In particular, proposed § 3-104(d) explicitly permits a promise or order that otherwise complies with the negotiability requirements to be a negotiable instrument even if it "contains a statement, however expressed, that the rights of a holder or transferee are subject to defenses or claims of the issuer." NCCUSL, DRAFT AMENDMENTS TO UNIFORM COMMERCIAL CODE ARTICLE 3—NEGOTIABLE INSTRUMENTS § 3-104(d) (Feb. 1, 1990); *cf. infra* notes 131-32 and accompanying text (discussing an analogous provision in an earlier draft). The only effect of such a statement is that the instrument cannot have a holder in due course. NCCUSL, DRAFT AMENDMENTS TO UNIFORM COMMERCIAL CODE ARTICLE 3—NEGOTIABLE INSTRUMENTS § 3-104(d) (Feb. 1, 1990). One of the proposed official comments explains that the FTC notice required by the HDC Rule is "[t]he prime example" of the type of statement that § 3-104(d) is intended to cover. *See id.* § 3-104 comment 3. This proposed new section was written after the reporters for the Article 3 amendments had read an earlier draft of this Article. Thus proposed § 3-104(d) and comment 3 fully address the concerns of this Article. If the sponsoring organizations accept this proposal in its current form and the state legislatures enact it, they will correct the difficulties identified and documented here.

125. I am grateful to Millard H. Ruud, one of the Commissioners on Uniform State Laws, for keeping me apprised of the status of the proposed amendments to Article 3 with the National Conference.

126. NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, DRAFT AMENDMENTS TO UNIFORM COMMERCIAL CODE ARTICLE 3—NEGOTIABLE INSTRUMENTS § 3-104(d) (98th Annual Meeting, 1989) [hereinafter NCCUSL DRAFT]; *see also infra* note 131 (quoting NCCUSL DRAFT § 3-104(d)).

127. NCCUSL DRAFT, *supra* note 126, § 3-104(a) (requiring an "instrument" to be "an unconditional promise or order").

128. *Id.* § 3-104(e); *see also infra* note 144 (quoting NCCUSL DRAFT § 3-104(e)).

129. *See supra* note 23 (discussing U.C.C. § 3-805).

thus would not be subject to Article 3 at all, much as nonnegotiable instruments are currently excluded from Article 3).

Under this tripartite classification, notes containing the FTC notice most logically belong in the intermediate category, the new "nonnegotiable instruments" governed by all of Article 3 except the HDC doctrine. This categorization would achieve the FTC's narrow goal in full without depriving honest merchants and their financers of the benefits of the commercial paper system. A very modest change in the NCCUSL Draft could accomplish this result.

NCCUSL Draft section 3-106(a) labels a promise conditional if "a condition to payment is stated in the promise . . . or in another writing expressly incorporated by reference in the promise . . . or to which the promise . . . is expressly made subject."[130] Draft section 3-104(d) nevertheless recognizes an instrument with an express statement "that no holder can have rights as a holder in due course" in a "nonnegotiable instrument,"[131] that is, an instrument in the intermediate category. Thus a provision saying, in effect, that a holder will be subject to *all* personal defenses implicitly is not a "condition," at least for purposes of the "instrument" definition, even though a provision saying that a holder will be subject to a particular defense is impermissible. Under the NCCUSL Draft, an instrument governed by all of Article 3 except the HDC doctrine can include a provision saying that a holder will be subject to all of the maker's personal defenses.

The FTC notice is not phrased in terms of a statement "that no holder can have rights as a holder in due course," but that is the obvious effect of the notice (as well as the intention of the FTC in promulgating the HDC Rule). Moreover, the notice does not establish a specific "condition to payment" distinct from its attempt to preclude HDC status. The NCCUSL Draft, therefore, need only clarify that the FTC notice is a suitable expression, for purposes of section 3-104(d), of the concept "that no holder can have rights as a holder in due course." Indeed this clarification probably could be accomplished by an appropriate statement in the official comments without changing the proposed statutory language. This simple statement would allow the FTC notice to accomplish what it was designed to do while retaining the benefits of Article 3 that the FTC intended to retain.[132]

Last December, the Council of the American Law Institute considered a newer draft of the proposed amendments to Article 3 that differed substantially

130. NCCUSL DRAFT, *supra* note 126, § 3-106(a).

131. NCCUSL Draft § 3-104(d) provides:

> An instrument may be negotiable or nonnegotiable. The only effect of nonnegotiability under this Article is that there cannot be a holder in due course of a nonnegotiable instrument. A check, teller's check, or cashier's check is negotiable. Any other instrument is negotiable unless at the time it comes into possession of the first holder, it indicates by a conspicuous statement, however expressed, that it is nonnegotiable, or that no holder can have rights as a holder in due course.

Id. § 3-104(d).

132. *See supra* notes 29-51 and accompanying text.

from the draft that the NCCUSL had considered barely four months before.[133] This draft returns to more traditional terminology to describe the familiar tripartite classification. Documents in the intermediate category are described as "instrument[s]" for which "there cannot be a holder in due course."[134] Section 3-104 no longer permits makers of conditional promises to opt into Article 3 coverage,[135] and an "instrument" with a statement that "no holder can have rights as a holder in due course" is no longer included in the intermediate category for which "there cannot be a holder in due course."[136] Furthermore, under section 3-106 a promise is conditional if "it states a condition to payment or states that it is subject to or governed by another writing,"[137] thus rejecting the less restrictive approach of the NCCUSL Draft in favor of an approach that is very similar to existing law.[138]

One of the most controversial proposals in the ALI Council Draft is closely related to these changes, and partially explains them. Draft section 3-104(e) recognizes a holder in due course of a note only when the note contains a "conspicuous statement" warning the maker of the consequences of the HDC doctrine.[139] In other words, the ALI Council Draft expands the intermediate category (governed by Article 3 except for the HDC doctrine) to lengths far beyond those instruments explicitly disclaiming the HDC doctrine. This expansion makes section 3-104(d) of the NCCUSL Draft unnecessary. Not surprisingly, the controversy surrounding the new proposal makes its future uncertain.[140]

If the ALI Council Draft continues in substantially its present form, the changes necessary to ensure the intended operation of the FTC notice are still fairly minor. Proposed section 3-104(e) places a note without the "conspicuous" warning to the maker in the intermediate category of instruments governed by all of Article 3 except the HDC doctrine. The FTC notice simply makes clear that a note containing it is not one in which the maker receives appropriate

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133. AMERICAN LAW INSTITUTE, UNIFORM COMMERCIAL CODE: CURRENT PAYMENT METHODS (Council Draft No. 1, Nov. 20, 1989) [hereinafter ALI COUNCIL DRAFT].

134. *See, e.g., id.* § 3-104(e).

135. *See id.* § 3-104; *cf.* NCCUSL DRAFT, *supra* note 126, § 3-104(e) (allowing makers of conditional promises to opt into Article 3 coverage); *supra* note 128 and accompanying text (discussing NCCUSL DRAFT § 3-104(e)); *infra* note 144 (quoting NCCUSL DRAFT § 3-104(e)).

136. *See* ALI COUNCIL DRAFT, *supra* note 133, § 3-104(e) (superseding NCCUSL DRAFT, *supra* note 126, § 3-104(d)); *cf. supra* note 131 and accompanying text (quoting NCCUSL DRAFT § 3-104(d)).

137. *See* ALI COUNCIL DRAFT, *supra* note 133, § 3-106(a) (superseding NCCUSL DRAFT, *supra* note 126, § 3-106(a)); *cf. supra* text accompanying note 130.

138. *See* ALI COUNCIL DRAFT, *supra* note 133, § 3-106 comment 3. The most notable change from existing law is the elimination of the "particular fund" doctrine. *See id.*

139. ALI Council Draft § 3-104(e) provides, in relevant part, as follows:

> There cannot be a holder in due course of a note unless, at the time it is issued or first comes into possession of a holder, it contains a conspicuous statement indicating that the maker of the note may not have a right to assert, against a transferee of the note with rights of a holder in due course, claims or defenses that the maker may have against the original payee of the note.

Id. § 3-104(e).

140. There was, for example, substantial opposition to this provision at the December 1989 meeting of the ALI Council.

warning of the consequences of the HDC doctrine. The legal impact of the notice, therefore, should be no different than the impact of omitting the "conspicuous statement." It should thus be fairly simple to amend section 3-104(e) of the ALI Council Draft to cover notes that either omit the "conspicuous statement" or include a disclaimer of HDC status. The accompanying official comment could then offer the FTC notice as a typical example of a disclaimer of HDC status and explain that the new section expands on the principles of the HDC Rule.

It is difficult to predict with any confidence how the various proposals to amend Article 3 will proceed. Perhaps the ALI Council Draft will receive substantial support and the U.C.C.'s sponsoring organizations will move toward its enactment. Perhaps elements from the earlier NCCUSL Draft will resurface. More likely, a completely new draft will emerge. Whatever the final revision, however, a relatively simple change should suffice to correct the problems raised in this Article and to ensure that the HDC Rule operates as the FTC intended.

If for some reason the U.C.C. is not amended, or if new amendments fail to resolve the problem, other solutions are still possible.[141] Because the FTC created the problem by failing to consider the interaction of the HDC Rule and the technical requirements of negotiability, the most straightforward solution would seem to be for the Commission to amend the Rule to satisfy these requirements. This solution should not be difficult. As noted above, section 3-119 permits a "separate agreement" to be effective without destroying negotiability.[142] So long as subsequent HDCs have notice of the separate agreement, it will work. All the FTC needs to do, therefore, is amend its Rule to require the original parties in a consumer-credit transaction to enter into a separate agreement on substantially the same terms as the present notice. The present notice could then be replaced with a true notice, saying something along the lines of "Notice—This is a 'consumer credit contract' as defined under regulations of the Federal Trade Commission, 16 C.F.R. § 433. These regulations give certain rights to the consumer." Such language should not destroy negotiability,[143] but would put subsequent holders and HDCs on notice that a separate agreement in the prescribed form will be binding on them.[144]

141. As long as proposals to amend the U.C.C. are under active consideration, *see supra* notes 117-40 and accompanying text, it seems unwise to pursue other alternatives. Not only may other solutions interfere with the ongoing revision of the U.C.C., but potential solutions that work under the existing U.C.C. may be ineffective or unnecessarily complicated under an amended U.C.C.

142. *See supra* notes 96-101 and accompanying text.

143. At most, the proposed notice should render the maker's promise subject to implied or constructive conditions. This is permissible under § 3-105(1)(a).

144. If the NCCUSL Draft were enacted, the solution could be even easier. Draft § 3-104(e) provides as follows:

> A conditional promise or order that is otherwise an instrument is an instrument if it (i) is of a kind which in the ordinary course of business is transferred by indorsement and delivery, and (ii) indicates by a statement, however expressed, that it is governed by this Article. Such an instrument is nonnegotiable. Nonsatisfaction of the condition stated in the instrument is a defense to payment.

NCCUSL DRAFT, *supra* note 126, § 3-104(e). A consumer note containing the FTC notice "is of a kind which in the ordinary course of business is transferred by indorsement and delivery," so the FTC would only need to amend the notice to include a statement that the note is governed by Article

The biggest risk in attempting such a solution is that the Commission might be forced to reevaluate the entire debate on the HDC Rule, and nothing would happen for years.[145] The FTC could avoid this risk by treating the suggested change as nothing more than a technical amendment. The Commission decided the policy issue a decade and a half ago. The only remaining issue is how best to implement that policy. The suggestion here closely follows the original approach while avoiding a technical difficulty that no one anticipated when the Rule was originally promulgated. The change in detail should not itself be controversial, and the Commission should not allow the technical change to serve as an excuse for reopening a question that was (and may still be) highly controversial.[146]

State legislatures, of course, must participate in the U.C.C. amendment process, for they must implement the proposals of the sponsoring organizations. If the proposed revision of the Code does not resolve the issue, however, legislatures may also enact nonuniform amendments to the Code, thus correcting the problem in specific states but losing the benefits of uniformity.[147] As a general matter, nonuniformity is a serious problem that should not be created lightly.[148] In this context the loss is somewhat less serious because current law prescribes no uniform approach to implementing the FTC notice. The risk remains, however, that individual states attempting nonuniform solutions will make it more difficult to achieve a uniform solution in the future.

In the absence of administrative or legislative reform, state courts will be left with the task of applying existing law to notes containing the FTC notice.[149]

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3 to the extent that it applies. This would make the note a "nonnegotiable instrument," meaning that it would be subject to all of Article 3 except that there could not be a holder in due course. *See id.* § 3-104(d); *supra* note 131.

145. The Commission first proposed the HDC Rule in January 1971. 36 Fed. Reg. 1211 (1971). It did not take effect until May 1976. 40 Fed. Reg. 53,506 (1975). During the intervening five years, the Commission held two rounds of hearings (generating a 2250-page transcript) in three different cities and received 7362 pages of written comments. Statement of Basis and Purpose, *supra* note 2, at 53,506; *see also Hearings, supra* note 68, at 1 (statement of Congressman John M. Murphy) (reviewing history of HDC Rule's enactment). When the Commission finally promulgated the HDC Rule it also proposed an amendment, 40 Fed. Reg. 53,530 (1975), but never took any action on the proposal.

146. There should be little doubt that the FTC would have the authority to issue a regulation along the lines proposed in the text, for the proposal is substantially the same as the existing HDC Rule. In a previous edition of their treatise, Professors White and Summers expressed doubts about the FTC's authority to issue the existing HDC Rule. *See* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 14-8, at 571 & n.60 (2d ed. 1980). The doubts are not repeated in the current edition, however, and the FTC's authority is generally accepted. *See* National Petroleum Refiners Ass'n v. Federal Trade Comm'n, 482 F.2d 672, 674-98 (D.C. Cir. 1973) (§ 6(g) of the Trade Commission Act, 15 U.S.C. § 46(g) (1982), empowers FTC to promulgate "Trade Regulation Rules"—substantive rules of business conduct), *cert. denied*, 415 U.S. 951 (1974).

147. *See, e.g.*, TENN. CODE ANN. § 47-3-106(1)(f) (Supp. 1988) (nonuniform amendment to U.C.C. § 3-106(1) to permit negotiable instruments with variable interest rates).

148. The value of uniform laws governing commercial transactions is well recognized, and has been generally accepted for generations. *See, e.g.*, 1984 HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS OF THE ANNUAL CONFERENCE 205-06; Dunham, *New Reasons for Uniformity*, 16 U. CHI. L. SCH. REC. 3, 26-27 (1968); Lawther, *Uniform State Laws*, 18 TEX. L. REV. 436, 437 (1940); Pound, *Unification of Law*, 20 A.B.A. J. 695, 695-96 (1934).

149. If the NCCUSL Draft were to be enacted, a solution could be fairly easy for state courts.

A court would find it very difficult, consistent with the statutory language, to expand the scope of negotiability under section 3-104 or quasi-negotiability under section 3-805. A state court, however, could construe the FTC notice as a separate agreement under section 3-119. On a linguistic level, this may be an artificial construction, but at least it is a potential construction that accomplishes the Commission's goals with minimal disruption.

On a policy level, recognizing the FTC notice as a separate agreement will not adversely affect the existing negotiable instrument structure. This analysis simply permits notes with the FTC notice to be treated in the same way as a number of other instruments that are subject to Article 3 rules except for the HDC doctrine. Examples under existing law include overdue notes[150] and notes lacking order or bearer language.[151] Indeed courts and the business community do not appear to have realized the full implications of the White and Summers analysis; they are already treating notes with the FTC notice as negotiable instruments without HDCs, despite the lack of a satisfactory theory to explain this result.

If a court is uncomfortable with the artificial construction that requires it to treat a "notice" on the note as a "separate" agreement, other options enable it to accomplish the same result. An official comment to the Code invites state courts to find instruments negotiable outside of Article 3,[152] although most have hesitated to accept this invitation.[153] A more appealing alternative may be for a state court to conform the common law rules of assignment to the Article 3 rules of negotiability (except for the HDC doctrine) whenever a note is negotiable in all respects except for the inclusion of the FTC notice.[154] Given the plausible assumption that all the parties to the transaction believed the note to be negotiable, it should not be difficult for a court to find implied terms in their contracts

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Under the NCCUSL Draft, a document can be treated as a "nonnegotiable instrument" if "it indicates by a conspicuous statement, *however expressed*, . . . that no holder can have rights as a holder in due course." NCCUSL DRAFT, *supra* note 126, § 3-104(d) (emphasis added); *see supra* note 131. As a "nonnegotiable instrument," it would be subject to all of the provisions of revised Article 3 except the HDC doctrine. Ideally, this section or the official comments thereto would clarify that the FTC notice is a "conspicuous statement" expressing the concept "that no holder can have rights as a holder in due course" rather than "a condition to payment . . . stated in the promise" under § 3-106(a). *See supra* notes 130-32 and accompanying text. Even without this clarification, however, the NCCUSL Draft would leave a court free to reach this conclusion anyway. Doing so would be consistent with the policies of both the FTC and the Code.

150. U.C.C. §§ 3-302(1)(c), 3-304(3). If an HDC existed before the note became overdue, the shelter doctrine permits a transfer of HDC rights. *See id.* § 3-201(1). But no new HDCs may be created.

151. *Id.* § 3-805; *see supra* note 23.

152. *See* U.C.C. § 3-104 comment 1.

153. *See, e.g.*, Taylor v. Roeder, 234 Va. 99, 104-05, 360 S.E.2d 191, 194-95 (1987) (declining invitation to hold note with variable interest rate negotiable outside of Article 3).

154. To some extent, the common law of assignments has already adopted many of Article 3's principles when a contract right is evidenced by a "symbolic writing." *See, e.g.*, E.A. FARNSWORTH, *supra* note 34, § 11.7, at 777 & n.4 (discussing the obligation to pay the person in possession of the writing); RESTATEMENT (SECOND) OF CONTRACTS § 333 comment a (1979) (noting similarity between contractual warranties on assignment and transfer of a negotiable instrument without indorsement under U.C.C. § 3-417). Furthermore, courts in analogous areas already look to the U.C.C. to provide rules in non-Code cases. *See, e.g.*, Ford v. Darwin, 767 S.W.2d 851, 855 (Tex. Ct. App. 1989) (holding guarantor of payment of nonnegotiable "promissory note agreement" subject to Article 3 rules).

comparable to the negotiation rules, the indorser's contract to pay on dishonor, the transfer warranties, and so on. Although this solution leaves the parties subject to the common law of assignment, this law will not be so "sketchy and uncertain"[155] if the courts announce that, to the extent possible, it will be the same as Article 3 in these situations. And until the courts rule on the matter, suggesting this result is no more "uncertain" than wondering if the courts will accept the separate agreement analysis.

While waiting for an authoritative answer from someone—the FTC, legislatures, or courts—the parties to a consumer-credit transaction must protect themselves as best they can from the possibility that they will be relegated to the "sketchy and uncertain common law."[156] Financing agencies that buy consumer paper from merchants should have little trouble demanding protection comparable to the transfer warranties or indorsers' contracts when they receive an assignment. Individual consumers are unlikely to have the information and bargaining power necessary to protect themselves, but consumer organizations may be able to influence the drafting of standard forms to ensure that payment to a quasi-holder will discharge the underlying debt (if the FTC notice destroys negotiability) and that HDCs will not take free of consumer defenses (if the FTC notice is completely ineffective). It would be impossible to achieve all the benefits of negotiability by contract,[157] but the parties can at least protect themselves to some extent.

VIII

Three possible explanations of current law have emerged. At one extreme is the possibility that the FTC notice destroys negotiability.[158] In other words, the HDC Rule preserves consumer defenses, but it also relegates the consumer paper industry to the "sketchy and uncertain common law" of contractual assignment. A second possibility is that the FTC notice operates as a separate agreement under section 3-119 of the Code.[159] Although this analysis is not intuitively obvious, it permits the HDC Rule to preserve consumer defenses as intended by the FTC with minimal disruption to the rest of the system. A third possibility, at the opposite extreme from the first, is that neither of the previous analyses is convincing. The FTC notice is completely ineffective, and third-party creditors bold enough to claim HDC rights should be permitted to do

155. *See supra* text accompanying note 31.

156. If the NCCUSL Draft were enacted, the parties to a consumer-credit transaction could solve the problem fairly easily. Under the NCCUSL Draft, a "conditional promise or order that is otherwise an instrument" can be made "an instrument," and thus subject to Article 3, "if it (i) is of a kind which in the ordinary course of business is transferred by indorsement and delivery, and (ii) indicates by a statement, however expressed, that it is governed by this Article." NCCUSL DRAFT, *supra* note 126, § 3-104(e); *see supra* note 144. A dishonest merchant may have little incentive to include such a statement in the note, but the financing agencies on which the merchant relies should have both the incentive and the leverage to insist that the statement be included.

157. The parties would be unable, for example, to require in the contract that third-party creditors could assert claims only by obtaining possession of the instrument. *See supra* notes 43 & 46 and accompanying texts.

158. *See supra* notes 19-28 and accompanying text.

159. *See supra* notes 96-111 and accompanying text.

so.[160] In effect, the FTC notice under this analysis is no different from a "notice" that the moon is made of green cheese.

While some segments of the industry might welcome the third possibility, it is depressing to think that so many have spent so much time and accomplished so little. Only the most cynical could argue that this was the FTC's intent. The first possibility, however, is also inconsistent with the expressed intent of the Commission.[161] If the FTC notice really destroys negotiability, it is despite what the HDC Rule was designed to accomplish—not because of it. Under existing law, therefore, the second possibility may well be the best of the three because it accomplishes the FTC's limited goal in a manner consistent with prior doctrine. This analysis, however, stretches the statutory language so seriously that it is not an entirely satisfactory explanation.

Ideally, the U.C.C.'s sponsoring organizations or the FTC will amend either Article 3 of the Code or the HDC Rule to correct the problem created by this unanticipated interaction between them. Alternatively, state legislatures and state courts can provide an authoritative solution, but their options are limited. In the meantime, the parties to a consumer-credit transaction can protect themselves to some extent by contract.

In any event, whichever analysis is followed and whatever steps are taken to correct the problems that arise, the accepted wisdom on the HDC Rule should be revised. Even if Professors White and Summers correctly conclude that the FTC notice destroys negotiability, they are surely wrong to argue that the Commission or its staff intended such a drastic result. The characterization "clever rascals" is probably a good deal less accurate than "overworked civil servants who did not give enough thought to some of the intricacies of the law of negotiable instruments."

160. *See supra* text accompanying notes 112-16.

161. *See supra* notes 52-72 and accompanying text.