SCHOOL OF LAW
CASE WESTERN RESERVE
UNIVERSITY

Case Western Reserve Law Review

Volume 27 | Issue 4

1977

Let the Holder Beware--A Problematic Analysis of the FTC Holder in Due Course Rule !

Timothy J. Grendell

Follow this and additional works at: https://scholarlycommons.law.case.edu/caselrev

Part of the Law Commons

Recommended Citation
Timothy J. Grendell, *Let the Holder Beware--A Problematic Analysis of the FTC Holder in Due Course Rule !*, 27 Case W. Res. L. Rev. 977 (1977)
Available at: https://scholarlycommons.law.case.edu/caselrev/vol27/iss4/13

This Note is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Case Western Reserve Law Review by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.

LET THE HOLDER BEWARE! A PROBLEMATIC ANALYSIS OF THE FTC HOLDER IN DUE COURSE RULE

As price increases continue to outdistance wage increases, America's reliance upon credit has become a dependence: "The day of the cash-and-carry transaction is gone. Buying now and paying later has become a way of life for all Americans except the very rich."[1] *In view of this dependence, it is important that a consumer's power to bargain with a merchant and with the subsequent purchaser of a consumer credit instrument be preserved. However, application of the holder in due course doctrine in consumer transactions has distressingly tipped the balance of bargaining power in favor of creditors. The author analyzes this problem as well as the substantive and procedural problems caused by the FTC's solution.*

I. INTRODUCTION

OF ALL THE TECHNIQUES used by creditors in consumer credit transactions to insulate themselves from consumers' claims or defenses, few have generated as much interest and controversy as the "Holder In Due Course" (HDC) doctrine.[2] Consider the predicament of a consumer who purchases a defectively manufactured automobile or appliance on an installment contract. The defect in the product quickly renders it nonfunctional, but the merchant refuses to repair or replace the item. The consumer tries to withhold payment on the installment contract, only to be informed that his contract has been sold to a third party. The third party purchaser asserts that as the purchaser of a presumably valid contract, the HDC doctrine affords him a legal right to collect payment on the contract irrespective of the condition of the merchandise. Thus, the consumer is bound to continue paying for a defective product.

---

1. B. CLARK & J. FONSECA, HANDLING CONSUMER CASES § 1, at 1 (1972).

2. *See generally* Countryman, *The Holder in Due Course and Other Anachronisms in Consumer Credit,* 52 TEX. L. REV. 1 (1973); Gilmore, *The Commercial Doctrine of Good Faith Purchase,* 63 YALE L.J. 1057, 1097-1100 (1954); Kripke, *Consumer Credit Regulation: A Creditor-Oriented Viewpoint,* 68 COLUM. L. REV. 445, 459-73 (1968); Kripke, *Chattel Paper as a Negotiable Specialty Under the Uniform Commercial Code,* 59 YALE L.J. 1209, 1215-16 (1950); *Consumer Credit Symposium: Developments in the Law: Finance Companies and Banks as Holders in Due Course of Consumer Installment Credit Paper,* 55 NW. U.L. REV. 389 (1961); Comment, *Judicial and Statutory Limitations on the Rights of a "Holder in Due Course" in Consumer Transactions,* 11 B.C. INDUS. & COM. L. REV. 90 (1969); Note, *Consumer Financing, Negotiable Instruments, and the Uniform Commercial Code: A Solution to the Judicial Dilemma,* 55 CORNELL L. REV. 611 (1970); Note, *Direct Loan Financing of Consumer Purchases,* 85 HARV. L. REV. 1409 (1972); Comment, *Financing Consumer Goods Under the Uniform Commercial Code: Installment Buyers and Defaulting Sellers,* 37 U. CHI. L. REV. 513 (1970); Comment, *Consumer Protection–The Role of Cut-Off Devices in Consumer Financing,* 1968 WIS. L. REV. 505.

This scenario illustrates an unfortunate ramification of the well established HDC doctrine.[3] Simply stated, the doctrine immunizes the subsequent holder of a negotiable instrument[4] from the personal defenses the purchaser of the defective product could have maintained against the original holder of the note, provided the subsequent holder took the instrument for value, in good faith, and without notice of any defenses against it or claim to it.[5] In response to the harsh consequences of the application of the doctrine in consumer credit transactions, the Federal Trade Commission (FTC) promulgated its "Preservation of Consumer Claims and Defenses" Trade Regulation Rule.[6] This Rule, commonly referred to as the "Holder in Due Course Rule," protects consumers by making merchants bear the loss for defective mechandise, poor services, and merchants' misrepresentations. The regulation became effective on May 14, 1976. This Note will examine the various problems emanating from the FTC's HDC Rule and its proposed amendment, paying particular attention to the Rule's methodology, the FTC's authority to promulgate such an expansive regulation, and the Rule's overall effect on consumer credit.

II. BACKGROUND

A. *The HDC Doctrine*

The purposes underlying the HDC doctrine were first articulated in the eighteenth century[7] by the King's Bench of England in *Miller v. Race.*[8] In *Miller*, the court held that when a bank note was stolen and later sold to a good faith purchaser who was unaware of the theft, the purchaser of the note would prevail over all parties claiming the note. Because bank notes

---

3. For a detailed discussion of the holder in due course concept, see W. BRITTON, HANDBOOK OF THE LAW OF BILLS AND NOTES §§ 98-124 (2d ed. 1961).

4. The Uniform Commercial Code (UCC) requires that a negotiable instrument
(a) be signed by the maker or drawer; and
(b) contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this Article; and
(c) be payable on demand or at a definite time; and
(d) be payable to order or to bearer.
(2) A writing which complies with the requirements of this section is
(a) a "draft" ("bill of exchange") if it is an order;
(b) a "check" if it is a draft drawn on a bank and payable on demand;
(c) a "certificate of deposit" if it is an acknowledgment by a bank of receipt of money with an engagement to repay it;
(d) a "note" if it is a promise other than a certificate of deposit.
U.C.C. § 3-104.

5. The major statutory provisions concerning the holder in due course doctrine are codified in sections 3-301 to 307 of the UCC.

6. 16 C.F.R. § 433.1-.2 (1976).

7. *See* J. HOLDEN, THE HISTORY OF NEGOTIABLE INSTRUMENTS IN ENGLISH LAW 182-83 (1955).

8. 97 Eng. Rep. 398 (K.B. 1758).

were "treated as money,"[9] the court reasoned that any other result would have hampered commerce.[10]

The primary goal in formulating the HDC doctrine was to precipitate the growth of commerce by assuring liquidity of commercial paper.[11] Liquidity makes consumer credit transactions more common, thereby enabling merchants to increase sales volume as goods become available to more buyers. Furthermore, liquidity enables merchants to sell their consumer paper at a discount to lenders if the installment sales process causes cash flow problems.

Courts in the United States adopted the HDC doctrine on the premise that the free flow of commerce was a desirable goal in the advancement of a commercial economy.[12] These same principles were incorporated, in part, in the Uniform Commercial Code (UCC) and its predecessor, the Uniform Negotiable Instruments Law.[13]

The Uniform Commercial Code is now the major statutory source of the HDC doctrine in consumer transactions.[14] Under the UCC, a subsequent holder of a consumer credit instrument qualifies as a HDC if he takes the instrument for "value,"[15] "in good faith,"[16] and "without notice that it is overdue or has been dishonored or of any defense against it or claim to it."[17] A HDC is entitled to full repayment of the instrument. More impor-

---

9. *Id.* at 402.

10. *Id. See also* Jones, *Finance Companies as Holders in Due Course of Consumer Paper*, 1958 WASH. U.L.Q. 177, 183-85.

11. *See* J. STRONG, PROMISSORY NOTES 13 (7th ed. 1878).

12. For a review of judicial development of the holder in due course concept, see J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 14-8, at 479-84 (1972).

13. *See* Britton, *Holder in Due Course—A Comparison of the Provisions of the Negotiable Instruments Law with Those of Article 3 of the Proposed Commercial Code*, 49 NW. U.L. REV. 417 (1954).

14. *See* J. WHITE & R. SUMMERS, *supra* note 12, at §§ 14-1 to 14-6.

15. U.C.C. § 3-302 (1) (a). The UCC provides:

A holder takes the instrument for value
(a) to the extent that the agreed consideration has been performed or that he acquires a security interest in or a lien on the instrument otherwise than by legal process; or
(b) when he takes the instrument in payment of or as security for an antecedent claim against any person whether or not the claim is due; or
(c) when he gives a negotiable instrument for it or makes an irrevocable commitment to a third person.

16. U.C.C. § 3-302 (1) (b). UCC section 1-201 (19) defines good faith as "honesty in fact in the conduct or transaction concerned."

17. U.C.C. § 3-302 (1) (c). Section 1-201 (25) defines notice:

A person has "notice" of a fact when
(a) he has actual knowledge of it; or
(b) he has received a notice or notification of it; or
(c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists.

tantly, he takes the instrument free from all "claims and defenses" of any party to the instrument with whom he has not dealt. To the consumer this means that if the subsequent holder of the credit note is a HDC, he can enforce the note against the consumer even though the consumer would have a valid defense against the original seller.

Those defending the application of the HDC doctrine to current consumer transactions cite for support the realities and practical needs of the consumer credit market.[18] It has been argued that despite the adverse effect upon a consumer whose promissory note is sold to a HDC, the practical needs of merchants who extend consumer credit argue for the application of the HDC doctrine to the sale of consumer paper. The desirability of HDC status for anyone regularly purchasing consumer paper from a merchant is obvious. The subsequent holder takes a greatly reduced risk of nonrecovery, while the consumer assumes the risk of defective manufacture, or merchant misconduct or insolvency.

The advantage taken of the HDC doctrine by banks, credit unions, and other financing institutions has resulted in an expanded consumer goods industry, permitting more families the opportunity to enjoy the fruits of our industrial society.[19] Notwithstanding the utility of the HDC doctrine in consumer credit financing, however, its application has often resulted in harsh and unjust results for consumers.[20]

---

18. The anticipated consequences of abrogating the holder in due course doctrine in consumer transactions has been described as follows:

> Lenders will be forced to litigate many issues which have no relationship to the normal risks of lending money but instead are directly related to the quality of the products or services sold or the performance of warranties by the seller. To date, we know of no financial institution which has included such costs in its rate calculations. However, if enforcing warranties or guaranteeing product performance is to be forced upon financial institutions as a cost factor, you can rest assured that those additional costs will be passed on to the consumers of our products through increased consumer interest rates or through restrictions on the availability of consumer credit or both.

Rohner, *Holder in Due Course in Consumer Transactions: Requiem, Revival, or Reformation,* 60 CORNELL L. REV. 503, 528 n.133 (1975).

19. In August, 1974, consumer finance companies held $38.9 billion in installment credit. The extent to which Americans presently rely upon installment credit is apparent if the 1974 figure is compared to the $5.3 billion finance companies held in December, 1950. NATIONAL COMMISSION ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 35 (1973) [hereinafter cited as NCCF REPORT].

20. *See, e.g.,* W. MAGNUSON & J. CARPER, THE DARK SIDE OF THE MARKETPLACE 3-6 (1968).

Instances in which a subsequent holder of consumer paper established HDC status and foreclosed the consumer's right to assert a claim or defense against the HDC demonstrate the problem. For example, consumers signed installment contracts in payment for membership in a health club. The club went out of business with approximately fifteen hundred customers still making payments on the contracts which had been sold to a third party. These consumers were obligated to continue payments on their contracts to the third party who had HDC status. 40 Fed. Reg. 53,513 n.10 (1975). In another case, a consumer contracted to buy meat through a supply plan on a deferred payment schedule. The quality of the food delivered was inferior to

B. Judicial Relief

A new method of separating the consumer's obligation to pay from the merchant's duty to perform has evolved as a result of the credit industry's discontent with growing resistance to the HDC doctrine in consumer credit transactions.[21] The merchant, remaining independent of the loan transaction, merely directs the consumer to a third-party lender for an installment loan. The consumer then uses the money from the loan to finance his purchase from the merchant. Typically, the purchased item is employed as collateral for the indebtedness. As a result of these techniques, the creditor has HDC status, and the obligation to repay the loan is not subject to claims or defenses arising out of the consumer sales transaction.

Recently, a number of courts confronted with collection actions by subsequent holders of consumer paper have tried to mitigate the harsh impact of the HDC doctrine in consumer transactions.[22] Most of the recoveries are based upon the close relationship between the merchant and the subsequent holder. Under this "close connectedness" doctrine,[23] a holder of a consumer credit instrument loses his status as a HDC if he is too closely connected to the merchant from whom he purchases the instrument.[24]

The landmark decision applying the "close connectedness" test in order to deny HDC status in a consumer credit transaction was *Unico v. Owen.*[25] In *Unico*, the consumers entered into an agreement to purchase more than one hundred record albums and a stereo, executing a promissory note to the merchant, Universal Stereo Corporation. When Universal Stereo discontinued delivery after delivering only twelve albums, the consumers stopped

---

that agreed upon and the monthly shipments ceased. The consumer attempted to withhold payment only to be informed that his contract had been sold to a third party, who, as a HDC, was entitled to repayment. W. MAGNUSON & J. CARPER, *supra* at 17.

21. NCCF REPORT, *supra* note 19, at 35. *See generally* Note, *Direct Loan Financing of Consumer Purchases*, 85 HARV. L. REV. 1409 (1972).

22. *See generally* Comment, *Judicial and Statutory Limitations on the Rights of a "Holder in Due Course" in Consumer Transactions*, 11 B.C. INDUS. & COM. L. REV. 90 (1969).

23. *See, e.g.*, Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940); Jones v. Approved Bankcredit Corp., 256 A.2d 739 (Del. 1969); Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967); Westfield Inv. Co. v. Fellers, 74 N.J. Super. 575, 181 A.2d 809 (1962); American Plan Corp. v. Woods, 16 Ohio App. 2d 1, 240 N.E.2d 886 (1968).

24. The earliest case to apply this theory was Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940). In that case, the consumer entered into a conditional sales contract, drawing a promissory note as a consideration for the purchase of an automobile. The finance company, which had purchased the note from the dealer, brought an action in replevin in response to the consumer's default on the note. The consumer asserted as a defense that the dealer had committed fraud. The court held that although the finance company had not been actually aware of the fraud, it had sufficiently participated in the underlying consumer transaction by supplying the forms, and so did not qualify as a HDC of the consumer note.

25. 50 N.J. 101, 232 A.2d 405 (1967). The *Unico* decision has even been used to instruct students in judicial treatment of the holder in due course doctrine. *See, e.g.*, R. NORDSTROM & A. CLOVIS, PROBLEMS AND MATERIALS ON COMMERCIAL PAPER 341 (1972).

making payments on the notes and Unico, the finance company which purchased the notes from Universal Stereo, sued. The court did not deem Unico a HDC because Unico was too closely connected with the dealer's business.[26] The court observed that Unico was created for the purpose of financing Universal Stereo and "not only had a thorough knowledge of the nature and method of operation of Universal's business, but also exercised extensive control over it"[27] by supplying the form for the contract and note used by Universal.

In response to the judicially created close connectedness test, a second method was adopted by creditors to separate the consumer's duty to pay from the merchant's duty to perform. This method involves the use of a "waiver of defense" clause.[28] The consumer signs an installment contract which contains a waiver provision insulating any subsequent holder of the note from defenses to payment which the consumer may be able to assert against the merchant. If the requirements of good faith and lack of notice are met, the subsequent holder may assert rights analogous to a HDC. The clause, in effect, provides the subsequent holder with the privileges of a HDC through a contractual provision. The UCC expressly allows the use of such provisions in commercial transactions.[29]

This subterfuge, however, has not escaped judicial notice. In *Rehurek v. Chrysler Credit Corp.*,[30] the Florida District Court of Appeals held that the defendant, to whom an automobile dealer assigned a retail installment contract containing a waiver of defense clause, did not take an assignment in good faith because it furnished the forms, investigated the buyer's credit rating, and generally had a close working relationship with the seller, and therefore, could not rely on the buyer's waiver of defenses. The court further concluded that any boiler plate waiver of defense provision must fail as against public policy.

---

26. 50 N.J. at 115, 232 A.2d at 413.

27. *Id.*

28. A typical waiver of defense clause states:

> If the seller should assign the contract in good faith to a third party, the buyer shall be precluded as against such third party from attacking the validity of the contract on grounds of fraud, duress, mistake, want of consideration . . . .

NCCF REPORT, *supra* note 19, at 35.

29. UCC section 9-206 (1) provides:

> Subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods, an agreement by a buyer or lessee that he will not assert against an assignee any claim or defense which he may have against the seller or lessor is enforceable by an assignee who takes his assignment for value, in good faith and without notice of a claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the Article on Commercial Paper (Article 3). A buyer who as part of one transaction signs both a negotiable instrument and a security agreement makes such an agreement.

30. 262 So. 2d 452 (Fla. Dist. Ct. App. 1972).

Some jurisdictions deny an assignee of consumer paper HDC status by refusing to treat retail sales contracts as negotiable instruments. In *Geiger Finance Co. v. Graham,*[31] a finance company sued to collect on a consumer contract, claiming to be a HDC, and therefore not subject to the consumer's defense of failure of consideration. The contract in issue contained the terms of a promissory note, a conditional sales contract, and a provision purporting to waive any defense against a subsequent holder which the consumer could have asserted against the merchant. The merchant assigned the contract to a finance company shortly after it had been signed by the consumer. The court ruled that the finance company was not a HDC because a contract containing both a promissory note and the terms of a conditional sales agreement is not a negotiable instrument under Georgia law.[32] As a result, the assignee of a consumer credit contract in Georgia takes the contract subject to any defenses that the consumer could have asserted against the merchant.

A unique decision of the California Supreme Court[33] held that a consumer could bring an action for rescission against a finance company that was a subsequent holder of his notes if he could show the existence of a close relationship between the merchant and the subsequent holder. This decision was the first to give a consumer the right to assert his claims and defenses on a consumer credit instrument without having to wait for the subsequent holder to attempt to enforce the instrument. It would represent a major advance if the same procedure were allowed under other theories of recovery, and there appear to be no theoretical obstacles to that course.

These cases are representative of an increasing movement by the judiciary to scrutinize and reevaluate the necessity for and impact of the HDC doctrine in consumer credit transactions.[34] The courts have been limited in dealing with the problem because they have had to choose between two innocent parties—the subsequent holder and the consumer—in imposing liability. Denial of HDC status to the subsequent holder would result in an economic loss to a holder who may have purchased a note in good faith

---

31. 123 Ga. App. 771, 182 S.E.2d 521 (1971). For a detailed discussion of this decision, see *Commercial Law—Conditional Sales Contract Held Not a Negotiable Instrument Under the U.C.C.*, 8 GA. ST. B.J. 400 (1972).

32. GA. CODE ANN. § 109A-3-105. With very few variations, the 1962 official draft of the UCC has been adopted by Georgia. GA. CODE ANN. §§ 109A-3-101 to 109A-3-805 (1973).

33. Vasquez v. Superior Ct., 4 Cal. 3d 800, 484 P.2d 964, 94 Cal. Rptr. 796 (1971).

34. These decisions reflect the courts' risk allocation perception that creditors are in a better position to absorb and reallocate losses. As one court stated:

> We think the buyer—Mr. & Mrs. General Public—should have some protection somewhere along the line. We believe the finance company is better able to bear the risk of the dealer's insolvency than the buyer and in a far better position to protect his interests against unscrupulous and insolvent dealers.

Mutual Fin. Co. v. Martin, 63 So. 2d 649, 653 (Fla. 1953). *See also,* Commercial Credit Corp. v. Orange County Mach. Works, 34 Cal. 2d 766, 214 P.2d 819 (1950).

and without notice. Because this approach would eliminate any protection for subsequent holders of consumer paper, the purchase of consumer paper would become unattractive and risky. On the other hand, rigid application of HDC status to all subsequent holders would be inequitable to the consumer, particularly when the subsequent holder and merchant were involved in a cooperative effort.

The equitable standards adopted by the courts have achieved a necessary flexibility by protecting consumers in certain cases, yet recognizing HDC status when the subsequent holder was not too closely involved with the original merchant. Despite the promise shown by these emerging judicial amendments to the HDC doctrine in certain jurisdictions, however, a commercial society demands a more uniform and predictable rule. For this reason, legislative action appears to provide a more workable solution to the problem.

C. *State Legislation*

In response to the growing concern for consumer protection, there has developed a trend to equalize the positions of parties in installment sales transactions through the use of state statutes.[35] Many states have expressly limited or eliminated the HDC doctrine in the consumer credit area.[36] A number of states have prohibited the utilization of negotiable instruments in consumer installment sales transactions.[37] The value of this type of statute is limited, however, because it usually does not apply to a consumer credit transaction in which a waiver of defense clause is utilized to foreclose a consumer's defense against the subsequent holder.[38] Other states have established a mandatory "complaint period" during which the consumer may reconsider his purchase agreement prior to the protection of HDC status being granted to the subsequent holder.[39] In these states, the subsequent

---

35. The FTC in a statement regarding the basis and purpose of the Act noted: "Some forty jurisdictions have enacted legislation bearing on foreclosures of equities in installment sales." 40 Fed. Reg. 53,508 (1975).

36. For a discussion of these statutes, see Willier, *Need For Preservation of Buyers' Defenses—State Statutes Reviewed,* 5 U.C.C.L.J. 132 (1972).

37. *E.g.,* MASS. GEN. LAWS ANN. ch. 255, § 12C (West 1959); MD. ANN. CODE art. 83, § 147 (1975); VT. STAT. ANN. tit. 9, § 2455 (Supp. 1976); WASH. REV. CODE ANN. § 63.14.020 (Supp. 1976).

38. Some states' statutes, however, do prohibit waiver of defense clauses in consumer credit contracts. *See, e.g.,* CAL. CIV. CODE § 1804.2 (West Supp. 1976); HAWAII REV. STAT. § 476-18(b)-18(c) (1968); MASS. GEN. LAWS ANN. ch. 255D, § 10(6), 25A (Supp. 1972). *See also* UNIFORM COMMERCIAL CREDIT CODE § 2.404, alternative A.

39. *See, e.g.,* DEL. CODE ANN. tit. 6, § 4312 (1975) (15 day notification period covers all retail sales); ILL. ANN. STAT. ch. 121-1/2, § 262(d) (Smith-Hurd Supp. 1977) (5 day notification period covers all installment sales except motor vehicles); PA. STAT. ANN. tit. 73, § 50-207 to 208 (Purdon Supp. 1972) (15 day notification period for home improvement retail installment sales); PA. STAT. ANN. tit. 69, § 1402 (Purdon Supp. 1972) (45 day notification period covers all retail installment sales except home improvement and motor vehicles).

holder of a consumer contract or note must notify the consumer that the original merchant has sold the note. The consumer then has a specific time period in which he may notify the subsequent holder of any related claims or defenses. Under this type of statute, the consumer reserves the right to assert any claim or defense raised during the "complaint period" in a subsequent suit for payment.[40]

Since many states have enacted some form of legislation to limit or eliminate the abusive use of the HDC doctrine in consumer credit transactions, the question arises whether a federal legislative solution is necessary. Opponents of any national attempt to moderate the HDC doctrine in consumer transactions contend that the states are best suited to provide the balanced protection necessary to meet the needs of both the consumers and the credit industry.[41] They further contend that in the normal case the credit institutions are intrastate businesses and thus the states should be allowed and are in the best position to regulate and oversee their behavior.[42] The rationale behind this viewpoint is the constitutional limitation on the federal government's power to regulate intrastate commerce.[43] These opponents argue that even under the broader federal power to regulate commerce indicated by the modern interpretation of the commerce clause,[44] any attempt to preempt the legislative endeavors already undertaken by the majority of the states would be an improper overextension of federal power.

On the other hand, proponents of a national approach emphasize that the scattergun pattern of state legislation has failed to establish any uniform standard for dealing with the HDC problem.[45] The crux of their argument is that although a consumer may be highly protected in one state, he may be totally unprotected in another. The federal government, through its commerce clause power, is the logical instrument for achieving uniformity in such situations, and thus it, rather than the states, should act.

---

40. *Id.*

41. 40 Fed. Reg. 53,521 n.53a (1975).

42. A credit industry representative testifying during the FTC hearing on the HDC Rule, took the position that the FTC action unnecessarily duplicated state statutes. *In re* Revised Proposed Trade Regulation Rule, 40 Fed. Reg. 53,521 (1975) (statement by James Schintz, Pennsylvania Independent Automobile Association).

43. It is unlikely that the intrastate commerce argument enunciated by opponents of a uniform rule can prevail because of the Supreme Court's expansion of federal commerce power. Perez v. U.S., 402 U.S. 146 (1971); Wickard v. Filburn, 317 U.S. 111 (1942); U.S. v. Darby, 312 U.S. 100 (1941).

44. U.S. CONST. art. I, § 8, cl. 3.

45. Proponents of the FTC Rule have emphasized their belief that a comprehensive trade rule would be uninfluenced by local pressures and would be a major step toward achieving uniformity. *See, e.g., In re* Revised Proposed Trade Regulation Rule, 40 Fed. Reg. 53,521 (1975) (Statement by Atlanta Legal Aid Society).

III. THE FTC HDC RULE

A. *History*

The Federal Trade Commission had been concerned with the ill effects of the HDC doctrine in consumer affairs for several years.[46] On January 21, 1971, the FTC took the initial step toward abolishing the HDC doctrine in consumer transactions by announcing that it was proposing a "Trade Regulation Rule concerning the maintenance and retention of buyers' claims and defenses in retail consumer installment sales."[47] After a series of public hearings on the proposed Rule, it became apparent that merchants could circumvent even a strict HDC rule by arranging direct loans between creditors and consumers. Therefore, the FTC proposed a revised version of its Rule on January 5, 1973.[48]

On November 14, 1975, shortly after having been granted increased rule-making authority,[49] the FTC promulgated a final Trade Regulation Rule.[50] With this version of the Rule, the FTC resolved that any action by a merchant in financing a consumer purchase that makes the consumer's duty to pay independent of the merchant's duty to perform "constitute[s] an unfair and deceptive practice."[51] The Rule assures consumers a greater opportunity to assert claims and defenses that arise from the underlying consumer credit transaction, such as breach of contract, breach of warranty, and fraud, against a subsequent holder of the note.

In adopting this Rule, the FTC did not question the need for the HDC doctrine to insure the negotiability of certain forms of commerical paper.[52] The agency indicated, however, that it had documented a substantial

---

46. In 1968, Paul R. Dixon, Chairman of the FTC, indicated during his testimony before the Senate Subcommittee on Financial Institutions that the FTC recognized the need for equalization of consumer and credit rights through the elimination of holder in due course defenses in consumer affairs. Hartman & Walker, *The Holder In Due Course Doctrine and the Consumer*, 77 COM. L.J. 116, 122 (1972).

47. FTC News Release, Jan. 21, 1971. The proposed rule was published for comment on January 26, 1971. 36 Fed. Reg. 1211 (1971).

48. Revised Proposed FTC Trade Regulation Rule on Preservation of Consumers' Claims and Defenses §§ 433.1-.4, 38 Fed. Reg. 892 (1973).

49. Magnuson-Moss Warranty—Federal Trade Commission Improvement Act, Pub. L. No. 93-637 § 202 (a), (c), (d), 88 Stat. 2183 (1975) (codified at 15 U.S.C. § 57a (Supp. V. 1975)).

50. FTC Trade Regulation Rule on Preservation of Consumers' Claims and Defenses, 16 C.F.R. § 433.1, .2 (1975).

51. FTC, STAFF GUIDELINES ON TRADE REGULATION RULE CONCERNING PRESERVATION OF CONSUMERS' CLAIMS AND DEFENSES 4 (1976) [hereinafter cited as STAFF GUIDELINES].

52. The FTC's desire to retain the holder in due course doctrine in nonconsumer business transactions is reflected in the following statement of Mary Gardner Jones, FTC Commissioner, to Robert P. Hartman and H. William Walker, Jr.: "[T]he holder in due course doctrine began as a valuable factor in promoting confidence in negotiable instruments and is still necessary in the area of commercial transactions." Hartman & Walker, *The Holder in Due Course Doctrine and the Consumer*, 77 COM. L.J. 116, 122 (1972).

amount of abuse in situations involving the HDC doctrine in consumer transactions—in particular, conduct such as collusion, affiliation, and referrals between the merchant of consumer goods and subsequent holders of consumer credit paper.[53] The HDC Rule attempts to protect the consumer against all of these abuses, reflecting an agency determination that consumer interest should prevail over commercial needs.

B. *Methodology*

1. *Notice Requirement in Consumer Credit Contracts*

The FTC Rule requires merchants connected with any consumer installment sales transaction affecting commerce to insert a prescribed notice in all instruments of consumer indebtedness.[54] This notice[55] states that any subsequent holder of such credit instrument is subject to all claims and defenses that could be asserted against the merchant. A merchant's failure to include the notice in consumers' sales instruments "constitutes an unfair or deceptive act or practice within the meaning of Section 5 of the Federal Trade Commission Act."[56] A merchant who commits such an unfair or deceptive practice is exposed to FTC sanction or monetary penalty.

The FTC's Rule, in effect, abrogates the HDC doctrine with respect to consumer credit transactions involving the sale of notes by merchants. Because the prescribed notice of the consumer's right to assert claims and defenses against the instrument becomes an integral provision in all contractual instruments of consumer credit financing, subsequent holders of the contract do not qualify for HDC status because they could not have taken possession of the instrument without notice of defenses against it.[57] A merchant cannot sell or assign the credit contract to a subsequent holder without subjecting such holder to the same liability that the merchant might have under the contract.

---

53. The FTC's Statement of Basis and Purposes issued with the HDC Rule reveals that the accumulated record contained over 14,000 indications of consumer credit inequities. 40 Fed. Reg. 53,510 (1975).

54. 16 C.F.R. § 433.2 (1977).

55. The notice must read in at least ten point, boldface type:

NOTICE

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

16 C.F.R. § 433.2(a) (1977).

56. STAFF GUIDELINES, *supra* note 51, at 4.

57. *See* U.C.C. § 3-304. *See also* text accompanying note 17 *supra*.

Even if a merchant sells a consumer note without the prescribed written notice, the subsequent holder still may not qualify for HDC status. It is questionable whether the purchaser of a consumer credit instrument lacking the prescribed notice can have purchased in "good faith." The UCC defines "good faith" as "honesty in fact in the conduct or transaction concerned."[58] The cases, however, clearly apply this criteria using a certain quantum of subjective insight.[59] Most sectors of the financing industry, the predominant purchasers of consumer credit paper, are aware of the FTC HDC Rule and its notice requirement, as reflected by the industry's mounting opposition[60] to the proposed amendment to the Rule which would even more directly involve them. Therefore, it is likely that any attempt by an institutional purchaser of a consumer note to claim HDC status will fail since a court is likely to impute to it knowledge of the FTC notice requirement. Thus, the holder could not argue that he took the instrument in good faith and without notice. The Rule also effectively abolishes the use of waiver of defense clause provisions in consumer credit instruments, which the UCC specifically permitted,[61] by prohibiting the qualification of the prescribed notice by any other clause in the instrument.[62] Thus, whether a merchant includes or excludes the notice provision, the subsequent holder is likely to be denied HDC status.

The FTC's approach is much more radical than judicial efforts to restrict the HDC doctrine in consumer matters have been. The FTC's HDC Rule, unlike the common law efforts, is not based upon the intimacy of the relationship between the subsequent holder and the merchant. The FTC, by requiring insertion of a prescribed notice in all consumer credit instruments, has much more broadly abrogated the HDC doctrine in consumer affairs than has the common law "good faith"–"close connectedness" method. Under common law, for example, a subsequent holder who neither played an active role in the underlying consumer credit transaction nor purchased consumer paper on a regular basis was entitled to HDC privileges. Since the

---

58. U.C.C. § 1-201(19).

59. These courts have been "impelled for reasons of *equity* and *justice* . . . to deny holder in due course status in consumer goods sales cases to those financiers whose involvement with the seller's business is . . . close." Unico v. Owen, 50 N.J. 101, 115, 232 A.2d 405, 413 (1967) (emphasis added).

60. *See, e.g., Hearings on the FTC Trade Regulation Rule Concerning the Preservation of Consumer's Claims and Defenses Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce,* 94th Cong., 2d Sess. (1976) (statement of Walter W. Vaughan representing the American Bankers Association).

61. U.C.C. § 9-206(1).

62. To avoid manipulative interpretation of the requirement that a consumer credit instrument "contain" the prescribed notice, the FTC has stated that: "Notice is not satisfied if the text of the Notice is printed in the contract with additional recitals which limit or restrict its application." STAFF GUIDELINES, *supra* note 51, at 6.

promulgation of the HDC Rule, however, this holder cannot achieve HDC status because he has notice that potential claims or defenses could arise from the consumer debt instrument.

As an administrative agency, the FTC has the flexibility to promulgate a broad, yet uniform standard to deal with a problem which the courts recognized, but could not solve. The FTC did not face the dilemma of choosing between two innocent parties as did the courts, since it could deal with the HDC doctrine in consumer credit transactions at its initial level—the original transaction between the consumer and the merchant. Furthermore, an FTC rule could have a preventative effect because, unlike a judicial decision which would deny HDC status to a subsequent holder after the fact, the HDC Rule's notice requirement puts all parties to a consumer credit transaction on notice from the beginning. Instead of having a court choose which of two innocent parties should bear the loss, the HDC Rule does not result in direct harm to either innocent party; the subsequent holder has notice and will likely pay less for the instrument, while the consumer maintains his claims and defenses.

The FTC Rule also has an advantage over state-imposed legislation because it provides uniformity in consumer credit. It is especially important to a society which is both so transient and so intertwined as ours that there be predictability in commercial affairs. Consumers and purchasers of credit instruments should be aware of their rights, and those rights should not vary from state to state. Only a single national rule can effectively insure uniform treatment.

2. *Purchase Money Loans*

In the promulgated version of the HDC Rule, the FTC extended its application beyond the traditional HDC situation to include "purchase money loans"[63]—direct loans from a creditor to a consumer in which the seller plays an active part. Under the FTC's Rule, it is an unfair or deceptive trade practice for a merchant to accept the proceeds of a "purchase money loan" if the loan document does not include the prescribed notice.[64] The insertion of the notice extends liability to the creditor for any claims that the consumer could bring against the merchant as a result of the consumer transaction.

---

63. 16 C.F.R. § 433.2 (1977).

64. The Notice must read in at least ten point, boldface type:

NOTICE

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

16 C.F.R. § 433.2(a) (1977).

The purchase money loan provision applies to direct loans where a third party creditor and a merchant are "affiliated"[65] or where the merchant "refers"[66] the consumer to the "creditor"[67] even though the creditor nominally makes a direct loan to the consumer and takes the wares to be purchased as collateral. The FTC's affiliation and referral standards are intended to "delineate those business relationships where sellers and creditors engage in concerted or cooperative conduct to arrange credit for consumers."[68] The Rule is applicable to those situations where there is a joint activity or concerted action between a creditor and a merchant of consumer goods. An examination of the affiliation and referral standards is necessary for a broader understanding of the purchase money loan provision of the Rule.

a. *Affiliation.* There are several types of affiliations which will bring creditors and merchants within the scope of the new FTC Rule.[69] The two most prevalent types are designated as "common control" and "business arrangement." The "common control" criterion applies when creditor and merchant function as part of the same business entity.[70]

A "business arrangement"[71] is some formal or informal agreement between creditor and merchant, either oral, written, or established through a course of dealing, which contemplates a cooperative or concerted activity involving the sale of goods or services to consumers or the financing thereof. The definition of "business arrangement" is broad enough to include agreements between issuers of credit cards and merchants, but this form of affiliation is "specifically exempted from the Rule."[72] To clarify the affiliation concept, the FTC published examples of various business arrangements

---

65. *See* text accompanying notes 57-62 *supra.*

66. *See* text accompanying notes 63-65 *supra.*

67. The HDC Rule defines creditor as:

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

16 C.F.R. § 433.1(c)(1977).

68. FTC Statement of Enforcement Policy. 41 Fed. Reg. 34,596 (1976).

69. Under the Rule a seller can be affiliated with the creditor "by common control, contract, or business arrangement." FTC Statement of Basis and Purpose, 40 Fed. Reg. 53,525 (1975).

70. An example of this form of relationship is a national automotive finance company which is created by the parent corporation for the specific purpose of financing its car sales such as the relationship between General Motors and the General Motors Acceptance Corporation.

71. The HDC Rule defines business arrangement as "[a]ny understanding, procedure, course of dealing, or arrangement, formal, or informal, between a creditor and a seller, in connection with the sale of goods or services to consumers or the financing thereof." 16 C.F.R. § 433.1(g) (1977).

72. STAFF GUIDELINES, *supra* note 51, at 10.

which fall within the scope of the Rule.[73] The FTC noted that while generally a creditor and merchant must confer over a particular transaction, every such communication does not in itself create a business arrangement. For example, the mere fact that a creditor issues a joint proceeds check to a merchant and a consumer or that the merchant and creditor must confer in order to perfect the security agreement under applicable state law does not establish a business arrangement[74] or contract which would constitute an affiliation under the Rule.

b. *Referral.* The "referral" provision is aimed at those situations in which a seller channels consumers to a specific creditor on "a continuing basis."[75] Unlike the affiliation standard, the referral provision does not contemplate a preexisting contractual or business arrangement between merchant and creditor. The referral relationship arises from a pattern of cooperative activity directly related to the arranging of credit. The requisite element of the referral test is "whether the seller routinely refers his customers"[76] to a specific creditor.

Differentiating between routine and occasional referrals is a difficult task. The FTC recognizes that the mere fact that a merchant may suggest credit sources or otherwise provide information to his customers on this subject will not by itself trigger application of the Rule.[77] However, when merchant and creditor work together in the ordinary course of business to arrange financing for the merchant's customers, the prescribed notice must be incorporated into the loan contract. There are no specific guidelines to suggest when a number of occasional referrals crosses into the category of referrals "on a continuing basis." No formal consideration need pass between the merchant and creditor. The fact that the merchant and creditor are

---

73. Examples of various business arrangements which are reached by the rule include:
(1) Maintenance of loan application forms in the office of the seller;
(2) Seller's agreements with creditor to prepare loan documents;
(3) Creditor's referrals of customers to a sales outlet;
(4) Payment of consideration to a seller for furnishing loan customers or to a creditor for furnishing sales prospects;
(5) Assignment of indirect paper or referral of loan customers to a creditor;
(6) Active creditor participation in a sales program;
(7) Joint advertising efforts;
(8) An agreement to purchase paper on an indirect basis.

FTC Statement of Enforcement Policy, 41 Fed. Reg. 34,595 (1976).

74. National Automobile Dealers, FTC Adv. Ops. No. 763-7007 (June 18, 1976), 3 TRADE REG. RPTR. (CCH) ¶ 21,156 (1976).

75. FTC Statement of Enforcement Policy, 41 Fed. Reg. 34,596 (1976).

76. STAFF GUIDELINES, *supra* note 51, at 15.

77. In the Statement of Enforcement Policy:

> [T]he Rule draws the line between situations in which the seller is acting as an information source or where credit is available and those in which the seller is arranging credit or serving as a conduit for the creditor.

41 Fed. Reg. 34,596 (1976).

cooperatively engaging in an effort which is mutually beneficial to their separate businesses is sufficient. However, once a referral or affiliation relationship is established, all credit contracts between that creditor and consumers who spend the proceeds at the merchant's establishment must contain the notice.[78]

Consider the merchant who has continually referred his customers to a specific creditor and now wishes to terminate the referral relationship. How does the merchant do so? According to the FTC, the referral relationship can be terminated at any time "as long as the termination is genuine and the seller is not attempting to temporarily avoid the Rule for a few transactions."[79] The merchant must discontinue the referrals and notify the creditor of the termination. The creditor may also terminate the relationship by notifying the merchant that the relationship is concluded and "by refusing to place the Notice in his loan contracts with purchasers from that seller."[80]

C. *Compliance*

1. *Transactions Requiring the Notice Provision*

In general, the burden of compliance with the HDC Rule rests solely on the merchant;[81] merchants are responsible for conforming their credit instruments to the new Rule. Subsequent holders are not required to comply with the Rule in its present form. Therefore, a subsequent holder's failure to check the consumer credit instrument for the requisite notice provision will not expose him to FTC sanctions.[82]

Not all sales transactions are consumer transactions within the meaning of the Rule. A "consumer" is defined by the Rule as "a natural person who seeks or acquires goods or services for personal, family, or household use."[83] Most consumer purchases, such as automobiles and appliances for personal or family use, fall within this definition. Consumer credit purchases of services, such as home remodeling, health spa membership, and educational services to individuals for nonbusiness purposes are also within the definition. The Rule is limited in its application to transactions involving goods and services. Realty and securities are unaffected because they are not

---

78. *Id.*

79. *Id.*

80. *Id.*

81. *Hearings on the FTC Trade Regulation Rule Concerning the Preservation of Consumer Claims and Defenses Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce*, 94th Cong., 2d Sess. (1976) (statement of Margery Waxman Smith, Acting Director of the Bureau of Consumer Protection).

82. It may, however, expose him to charges of bad faith. *See* text accompanying note 60 *supra*.

83. 16 C.F.R. §433.1(b) (1977).

considered to be within that category.[84] In addition, certain limitations of the Truth in Lending Act[85] and Trade Regulation Z[86] are incorporated into the Rule.[87] As a result of the Truth in Lending Act, consumer transactions, including expenditures made for public utilities[88] or totalling more than $25,000,[89] are not affected by the Rule. Moreover, only "credit sale" lease agreements[90] under Trade Regulation Z are within the Rule's scope. Sales contracts for goods or services to commercial buyers are excluded from the Rule,[91] as are contractual purchases by business entities and purchases of production and agricultural equipment.

2. *Extent of a Holder's Liability Under the Rule*

According to the FTC interpretation of the Rule, a subsequent holder's liability is limited to the total amount paid by the consumer pursuant to the credit contract.[92] For example, when a consumer who has purchased a five thousand dollar automobile pays three thousand dollars before becoming aware of a fraudulent misrepresentation, the consumer is only entitled to a recovery of the three thousand dollars. If a subsequent holder seeks to collect the two thousand dollars remaining under the terms of the contract, the consumer may assert a right not to pay the balance on the basis of his defense against the merchant. The limitation on the amount of a consumer's total recovery does not foreclose any local, state, or federal statutory right of the consumer;[93] it merely limits recovery resulting from failure to observe the notice provision.

---

84. STAFF GUIDELINES, *supra* note 51, at 9. The FTC explained that the realty and security exemption is not always guaranteed: "[T]he mere fact that a security interest in real property is taken does not mean that the sales transaction does not involve consumer goods or services." *Id.*

85. 15 U.S.C. §§ 1601-05 (1970).

86. Regulation Z of the Federal Reserve Board codifies the regulations issued by the Board pursuant to the Truth in Lending Act and the Consumer Credit Protection Act. 12 C.F.R. § 226 (1976).

87. The definition of "purchase money loan" and "financing a sale" rely on interpretations of certain terms found in the Truth in Lending Act and Regulation Z. 16 C.F.R. § 433.1(d)-.1(e) (1977).

88. The Truth in Lending Act exempts "[t]ransactions under public utility tariffs, if the Board determines that a State regulatory body regulates the charges for the public utility services . . . . " 15 U.S.C. § 1603(4) (1970).

89. The Truth in Lending Act exempts "Credit transactions, other than real property transactions, in which the total amount to be financed exceeds $25,000." 15 U.S.C. § 1603(3) (1970).

90. Regulation Z applies to leases in which the lessee pledges to tender as compensation for use an amount "substantially equivalent to or in excess of the aggregate value of the property . . . involved." 12 C.F.R. § 226.2(t) (1976).

91. *See* note 84 *supra.* This is further evidence of the FTC's intent to retain the holder in due course doctrine in nonconsumer commercial transactions. *See* note 52 *supra.*

92. The Rule's operative terminology is found in the last sentence of the prescribed notice: "Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder." 16 C.F.R. § 433.2(a),(b).

93. STAFF GUIDELINES, *supra* note 51, at 7.

A consumer who has been damaged as a result of a merchant's misconduct, therefore, has two courses of action available to him: he may sue the holder on breach of warranty to liquidate the remaining balance owed the subsequent holder and recover the money paid under the contract, or he may defend against the subsequent holder's action to collect the unpaid balance.[94] The Rule is silent as to the consumer's ability to recover interest and attorney fees incurred in a suit arising from the underlying consumer transaction. It can be implied from the FTC's Staff Guidelines that the recovery of these expenses is governed by the appropriate decisions and rules in each jurisdiction.[95]

The Rule does not create any new consumers' rights or defenses; it merely expands the opportunities for raising them. The legitimacy of the consumer's claim or defense is still dictated by the appropriate statutes and decisions in each jurisdiction. To illustrate, a consumer who buys a nonwarranty item has no warranty claim or defense and the Rule does not supply him one. Furthermore, the FTC noted in its staff guidelines that "the pertinent rules of law and equity, including rules of evidence, procedure and statutes of limitations, will continue to apply."[96]

3. *Purchase Money Loans—Seller's Burden*

When a valid purchase money loan relationship exists,[97] the merchant must request that the creditor insert the notice in the financing agreement. The creditor, at the present time, is not legally required to include the notice. In the future, however, if the pending amendment to the Rule is adopted,[98] creditors may be required to insert the notice. If the creditor does not insert the notice in his contract, the merchant is faced with two alternatives: complete the transaction in violation of the Rule and risk a penalty,[99] or refuse to complete the transaction and sacrifice a sale.

The creditor, on the other hand, is forced to analyze most consumer-related situations and determine if it is profitable to assume the added risk that accompanies the notice. This determination will certainly include a close scrutiny of the merchant to ascertain his responsibility and dependability. The creditor then must choose a course of action from among the following, considering the corresponding result of each:

---

94. *See* text accompanying note 56 *supra.*
95. *See* text accompanying note 96 *infra.*
96. STAFF GUIDELINES, *supra* note 51, at 7.
97. *See* text accompanying notes 63-80 *supra.*
98. *See* text accompanying notes 116-17 *infra.*
99. *See* text accompanying notes 104-06 *infra.*

(1) Exclude the notice. This could result in the cancellation of the loan by a wary consumer, or the refusal to complete the transaction by a hesitant merchant.
(2) Include the notice. The creditor then becomes the ultimate guarantor of the item.
(3) Include the notice with a collateral agreement, whereby the merchant indemnifies the creditor against liability for any damages.

Creditors not desiring to limit their credit markets will follow this third course of action and enter into "hold harmless" agreements[100] with merchants. The value of this type of agreement depends upon the responsible character and financial status of the merchant,[101] since a credit institution would be assured no protection from a financially unstable merchant who would default on the agreement if the creditor should attempt to collect from the merchant after a consumer had asserted his claims.

D. *Risk of Noncompliance*

1. *FTC Enforcement*

For many years the FTC lacked the authority to penalize effectively violators of its regulations.[102] Under Section 5 of the Federal Trade Commission Act, the FTC was merely empowered to ban "unfair or deceptive acts or practices."[103] Recently, however, the FTC has been delegated increased enforcement responsibility for consumer oriented legislation.[104] The FTC may now impose sanctions and/or a monetary penalty for violation of its regulations.[105]

---

100. The following is a typical recourse agreement:

Seller agrees to indemnify and hold Creditor harmless from any loss and any attorney's fees and any other expenses incurred as a result of any claim or defense against Creditor arising either by virtue of the prescribed notice being placed on the debt instrument or from the goods or services sold by Seller to the Borrower.

101. Like the HDC doctrine, hold harmless agreements, and their predecessor repurchase agreements, insulate creditors from consumer defenses. However, if the seller breaches either type of agreement, the consumer can still assert his defenses against the creditor. As a result, even withhold harmless agreements, creditors are unlikely to purchase the seller's paper unless the seller is in a relatively stable financial condition. *See generally*, Note, *A Case Study of the Impact of Consumer Legislation: The Elimination of Negotiability and the Cooling-off Period*, 78 YALE L.J. 618, 640 (1969).

102. *See* Comment, *Section 5 of the Federal Trade Commission Act–Unfairness to Consumers*, 1972 WIS. L. REV. 1071. For a strident criticism of the FTC failure to adopt an active role in consumer protection before 1970, see ABA COMM. TO STUDY THE FTC, A CRITIQUE OF THE CONSUMER PROTECTION RECORD OF THE FTC (1969).

103. 15 U.S.C. § 45(a)(6) (1970) (amended 1975).

104. 15 U.S.C. § 45(a)(2) (Supp. V 1975).

105. 15 U.S.C. § 45(*l*), (m) (Supp. V 1975).

The FTC is responsible for enforcing the HDC Rule against merchants who violate its provisions. The FTC may impose, among other things, a $10,000 fine per day per violation on merchants who fail to include the requisite notice in their consumer credit sales contracts, or are parties to a purchase money loan contract which excludes the notice. Presently, only merchants are penalized,[106] but adoption of the proposed amendment would subject creditors to the penalty for failure to include the notice in direct loan instruments for purchase money loans.[107]

2. *Private Right of Action*

The HDC Rule also exposes sellers to potential private legal action by individual consumers. Although federal courts previously had held that no private right of action could be implied from the FTC Act,[108] a federal district court in *Guernsey v. Rich Plan of the Midwest*[109] has set a precedent[110] by permitting private individuals the right to seek relief from a merchant whose unfair or deceptive trade practices violate the FTC Act. In *Guernsey*, two consumers filed an action seeking injunctive relief as well as compensatory damages against a seller of a freezer food plan who allegedly violated the FTC Rule by committing certain fraudulent acts. The defendant moved to dismiss the case, claiming that the FTC Act did not contain a private enforcement provision. The court denied the motion to dismiss, and thereby supported the private litigants' right to assert a legal claim under the FTC Act, because

> [t]here is no legislative intent that the Federal Trade Commission was to have "exclusive" jurisdiction. To infer that once the Federal Trade Commission has entered a case and enforced compliance with the Act, that subsequent private consumer actions would frustrate the purposes of the Act would deny consumers who were victimized by further violations any recovery.[111]

Under the reasoning of *Guernsey*, not only would merchants who exclude the notice from consumer credit instruments risk FTC enforcement, they would also expose themselves to private actions seeking relief under the HDC Rule. Consumers could initiate suits in federal courts against mer-

---

106. *See* text accompanying note 81 *supra*.

107. *See* text accompanying notes 116-18 *infra*.

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

109. 408 F. Supp. 582 (N.D. Ind. 1976). The court in *Guernsey* was the first to hold that a private right of action exists pursuant to the FTC Act.

110. Since 1914, the Federal Trade Commission has been solely responsible for enforcing the provisions of the Act. *See* Comment, *Private Enforcement and Rulemaking Under the Federal Trade Commission Act: Expansion of FTC*, 69 Nw. U.L. REV. 462 (1974).

111. 408 F. Supp. at 588.

chants who excluded the prescribed notice in consumer credit contracts and purchase money loan agreements, since the terms of the Rule make such exclusion an unfair or deceptive practice. Nonetheless, recovery of compensatory or punitive damages by the consumer would be limited by the Rule's express recovery provision[112] to the amount that he had already paid.

However, merchants subject to private lawsuits in states with statutes patterned on the FTC Act would face higher damage claims because of this exposure to private litigation.[113] Many state courts are specifically advised by their respective "mini-FTC Act" statutes to follow the FTC and federal courts' interpretation of the FTC Act in construing their state statute,[114] but damages and penalties are governed by the individual state statute. Consumers in states with such "mini-FTC Act" statutes can even recover treble damages, costs, and attorney's fees for "unfair or deceptive acts or practices."[115]

In addition to merchants, the Rule exposes subsequent holders to legal actions that they would not have been exposed to if the HDC doctrine were applicable. Subsequent holders of consumer paper now have actual or constructive notice of possible claims and defenses, and therefore are exposed to actions that the consumer might have had against the original merchant. The impact of this development on the consumer market is substantial. Because subsequent holders may be deluged by consumer claims, legal costs incurred by subsequent holders in handling such claims will increase the cost of making consumer loans. This added cost of doing business will either be passed directly to the consumer in the form of higher prices or indirectly through reduction of the volume of consumer credit.

Another significant practical problem is created by the establishment of a private cause of action (based on *Guernsey*) without a provision for the ordering of claims. For example, a consumer who purchased a defective freezer from a merchant who then discounted the consumer's note to a bank could either stop paying on his note until the defect was repaired, or pursue one of two causes of action under the HDC Rule: one against the merchant for a breach of warranty, the other against the bank under the same theory by operation of the Rule. Nothing in the Rule prevents the consumer from asserting his claim against the bank without attempting to seek relief from the merchant. As a result, the bank would effectively become the original warrantor of the freezer. However, the Rule's purpose was not to make sub-

---

112. *See* text accompanying notes 92-93 *supra*.

113. *See, e.g.*, HAW. REV. STAT. § 480-2 (1968); N.C. GEN. STAT. § 75-1.1 (1975); S.C. CODE § 66.71 (Supp. 1974); WASH. REV. CODE § 19.86.020 (Supp. 1974).

114. *See* HAW. REV. STAT. § 480-3 (1968); S.C. CODE § 66.71.1(b) (Supp. 1975); TEX. BUS. & COM. CODE ANN. § 17.46 (c) (Vernon Supp. 1976).

115. *See, e.g.*, HAW. REV. STAT. § 430-13 (1968); N.C. GEN. STAT. § 75-16, -16.1 (1975); S.C. CODE § 66-71.13 (Supp. 1975); WASH. REV. CODE §19.86.090 (Supp. 1975).

sequent holders of consumer credit paper the warrantors of goods and services. Its purpose was to make subsequent holders responsible for goods and services only when a merchant's failure to adequately remedy the problem combined with the operation of the HDC doctrine would result in an inequity to the consumer. The Rule should be clarified by the inclusion of a provision requiring a consumer to exhaust his available remedies against the original merchant before raising an action against a subsequent holder.

E. *Proposed Amendment*

Simultaneously with the promulgation of the Rule, the FTC proposed an amendment which adds the word "creditor" to "seller" in defining who must include the prescribed notice.[116] Adoption of this amendment would create additional problems in consumer financing. An independent creditor would himself be obligated to determine whether the proceeds of a loan are to be used for a consumer contract. A creditor confronted with a purchase money loan situation would have to either insert the required notice in the debt instrument and assume the obligation to the consumer, not insert the notice and thereby be in violation of the Rule, or not grant the loan to the consumer. To date, there has been limited activity regarding the proposed amendment.[117] It appears that the FTC has adopted a more cautious wait-and-see attitude in respect to the amendment in view of the Congressional criticism prompted by the enactment of the initial HDC Rule.[118]

IV. PROBLEMS ARISING FROM THE HDC RULE

A. *Defects In The Rule's Application*

1. *Purchase Money Loans*

Two problems arise from the purchase money loan provision of the FTC Rule which warrant consideration. First, what is the effect of the Rule on

116. The proposed amended HDC Rule makes it an unfair or deceptive trade practice for a seller or a creditor to directly or indirectly execute a consumer credit contract which does not contain the notice prescribed in the original Rule. *See* note 55 *supra*, and the proposed amendment to FTC Trade Regulation Rule on Preservation of Consumer's Claims and Defenses, 40 Fed. Reg. 53,530 (1975).

117. The cautious outlook that the FTC has towards the pending amendment is reflected in the statement of Margery Waxman Smith, Acting Director of the Bureau of Consumer Protection: "The Commission has proposed an amendment which would apply the rule to creditors, but it recognizes that the situations are not identical and that many issues must be analyzed before a decision on any such extension is made." *Hearings on the FTC Regulation Rule Concerning the Preservation of Consumer Claims and Defenses Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce*, 94th Cong., 2d Sess. 9 (1976).

118. *See* notes 161-65 *infra* and accompanying text.

open-end credit transactions? Second, how can the merchant tell if he is being paid by a purchase money loan?

The view taken by the FTC is that the specific purchase requirement is "implicit in the definition of 'Purchase money loan' "[119] and in effect exempts most open-end credit transactions. This interpretation appears to afford unscrupulous creditors an opportunity to arrange a credit contract in the form of an open-end credit transaction solely to evade this Rule. The FTC, foreseeing such a possibility, has stated that the substance of the transaction will control, not its form.[120] The consumer's receipt of a portion of the loan proceeds does not place the transaction within the purchase money loan section of the Rule. The FTC's test is "whether the loan is applied in whole or substantial part" to a particular purchase.[121]

The application of the "whole" criterion to a credit transaction is understandable, but the "substantial part" criterion causes additional uncertainty. Although the FTC felt this qualification was necessary to prevent avoidance of the Rule by creditors who loaned a consumer a small sum of money in excess of the purchase price, the "substantial" criterion is itself quite vague and the FTC has not provided interpretive guidelines. One way to correct this ambiguity would be to apply a definite percentage test to purchase money loans. For example, if the standard were set at 75%, any loan in which more than 75% of the money was used for a consumer credit purchase would be covered by the Rule. Since a set percentage, like most static standards, could be manipulated by creditors to avoid the Rule, the test would be most useful if it were used to establish a prima facie violation of the Rule. In cases where the percentage standard was not met, the FTC or the consumer would bear the burden of proving the "substantial" criterion.

The second problem created by the purchase money loan provision concerns the merchant's determination of the source of a consumer's money. Since in purchase money loan situations the contract is between a consumer and an independent creditor, the merchant may not be able to determine that the money he is accepting is a purchase money loan. This inability to determine the loan's source will be of particular importance when the merchant and creditor are generally affiliated or involved in a referral relationship but in the particular instance the consumer approached the creditor without having been referred by the merchant. The FTC has determined that if the objective circumstances surrounding the transaction "do not indicate the source of the proceeds or do not provide reason to believe that the proceeds may be from a 'purchase money loan,' there is no obligation to

---

119. STAFF GUIDELINES, *supra* note 51, at 13.
120. *Id.*
121. *Id.*

further investigate the source."[122] Unfortunately for consumers, merchants can avoid the application of the purchase money loan provision by remaining uninformed of the circumstances surrounding the transaction since there is no duty of inquiry. By requiring consumers to pay for products with cash or personal checks instead of joint proceeds checks from a bank, the merchant can avoid receiving notice of the instrument's purchase money loan origin. Certainly, the HDC Rule makes ignorance desirable for both merchants and independent creditors.

2. *Ambiguous Terminology*

Some of the Rule's terms lack explicit legal definition so that many problems of interpretation remain for the courts. The term "refers," which is a key to the application of the Rule, is undefined, although the FTC has indicated standards for its application.[123] Consequently, it is questionable whether a merchant may be said to have referred consumers to a creditor if he mentioned the creditor's name in response to inquiries by buyers requesting reputable credit sources. It is also questionable whether a merchant could be deemed to have referred consumers to the creditor if he merely furnished a list of reputable credit sources to the consumer.

The term "common control" is also undefined. Application of the Rule is not expressly limited to situations where common control is exercisable by an active participant in both the retail and credit businesses. For example, if an automobile salesman is also a member of a local credit union, it could be argued that the automobile dealership and the credit union are in a common control relationship despite the fact that the salesman may never have directed credit buyers to the credit union. Common control might also be inferred between an appliance distributor and a local savings and loan because of a common member of their respective boards of directors. This assertion of common control could be made despite the fact that the board member did not play a direct or active role in the consumer affairs of either business and the consumer credit transaction did not arise pursuant to his duties to either business. Characterizing such tenuous relationships as common control relationships within the meaning of the Rule could have a stifling impact upon the consumer credit business community.

The FTC could resolve the problems resulting from these undefined terms by issuing more explicit definitions. Until the FTC decides how much protection consumers require in the common control situations and issues definitions accordingly, the courts must look to traditional case law tests in

---

122. 41 Fed. Reg. 34,596-97 (1976).
123. *See* notes 75-77 *supra*.

this area, such as the "close connectedness" test,[124] for guidance in determining the intimacy of a relationshp between merchant and creditor.

B. *The Preemption Dilemma*

Serious controversy has arisen over the FTC's authority to issue a rule that preempts a substantial number of state statutes.[125] Although most states have limited the scope of the HDC doctrine,[126] the majority have statutes which expressly permit some form of limitation on consumers' right to assert claims and defenses against subsequent holders which they could assert against the merchants who sold them the goods.[127] The HDC Rule prohibits any such limitation on consumers' rights.[128] Therefore, application of the FTC Rule will effectively preempt state statutory schemes that sanction a limited HDC doctrine in consumer transactions.

There are two schools of thought on the FTC's authority to promulgate rules which preempt state law. Those favoring state autonomy reject the theory that an administrative agency rule can preempt state statutes.[129] Those supporting the FTC Rule do so hoping that federal legislation will correct the present inequities created by diverse state statutes; consumers are highly protected in some states, but totally unprotected in others.[130]

The commerce clause empowers Congress to regulate interstate commerce by means of regulatory devices such as the FTC. The Commission has the power under its enabling act to adopt trade rules if it follows certain requisite administrative procedures. However, the permissible substance of those rules is open to question. The key question is whether Congress, through its passage of the Magnuson-Moss—FTC Improvement Act,[131] intended to give the FTC the power to preempt state laws.[132]

In the FTC Improvement Act, Congress changed the rulemaking procedure and jurisdictional provisions to broaden FTC authority over matters "in

---

124. *See* text accompanying notes 23-27 *supra.*

125. William J. O'Connor, Jr., speaking before the Committee on the Uniform Commercial Code of the ABA Corporation Banking and Business Law Section, warned that "the restrictions on the holder in due course doctrine imposed by some 45 states are now completely preempted by the FTC Rule," 45 U.S.L.W. 2097 (August 24, 1976).

126. For a synopsis of state legislation in this area, see generally C.C.H. CONSUMER CREDIT GUIDE ¶¶ 4380, 4390 (1969).

127. *See generally,* Hogan, *A Survey of State Retail Instalment Sales Legislation,* 44 CORNELL L.Q. 38 (1958); Willier, *Protection Instalment Buyers Didn't Get,* 2 B.C. IND. & COM. L. REV. 287 (1961).

128. *See* note 62 *supra* and accompanying text.

129. *See generally,* Verkuil, *Preemption of State Law by the Federal Trade Commission,* 76-2 DUKE L.J. 225, 227-29 (1976).

130. *See* note 45 *supra.*

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

132. *See* W. GELLHORN AND C. BYSE, ADMINISTRATIVE LAW 732 (6th ed. 1974).

or affecting" commerce.[133] Although the FTC Improvement Act expanded the agency's powers, Congress was apprehensive that the enhanced authority might lead to blanket preemption of state statutory and judicial schemes of consumer protection. An examination of the legislative history of the FTC Improvement Act also reveals that Congress did not intend to grant the FTC the broad power to "occupy the field."[134] The committee report accompanying the FTC Improvement Act specifically states:

> The expansion of the FTC's jurisdiction . . . is not intended to occupy the field or in any way to preempt State or local agencies from carrying out consumer protection or other activities within their jurisdiction which are also within the expanded jurisdiction of the Commission.[135]

An earlier Senate report also reflects the legislative intent to limit FTC power:

> In considering certain arguments against expansion of the Commission's jurisdiction, the Committee was mindful of the danger of making the Commission alone responsible for eradicating fraud and deceit in every corner of the marketplace. This is not the Committee's intent in expanding the jurisdiction of the Commission. State and local consumer protection efforts are not to be supplanted by this expansion of jurisdiction.[136]

This legislative history indicates that Congress could not have intended to give the FTC the power to totally abolish the respective distinctions and limitations of individual state consumer statutes which deal with the HDC doctrine.

Furthermore, the FTC, in its interpretation of the HDC Rule, acknowledges its limited authority. The Staff Guidelines accompanying the Rule state that the Rule does not "eliminate any other rights that the consumer

---

133. The Supreme Court had previously declared that only a congressional amendment could expand the scope of the FTC Act. FTC v. Bunte Bros., 312 U.S. 349 (1941). *Cf.* Ward Baking Co. v. FTC, 264 F. 330 (2d Cir. 1920); Winslow v. FTC, 277 F. 206 (4th Cir. 1921) (restricting FTC authority to interstate commerce).

134. H.R. REP. NO. 1107, 93d Cong., 2d Sess. 45 (1973), *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 7702, 7726, is illustrative of this intent:

> The expansion of the FTC's jurisdiction made by this section 201 is not intended to occupy the field or in any way to preempt State or local agencies from carrying out consumer protection or other activities within their jurisdiction which are also within the expanded jurisdiction of the Commission.
>
> Where cases of consumer fraud of a local nature which affect commerce are being effectively dealt with by State and local government agencies, it is the Committee's intent that the Federal Trade Commission should not intrude.

135. *Id.*

136. S. REP. NO. 151, 93d Cong., 1st Sess. 27 (1973).

may have as a matter of local, state, or Federal statute."[137] However, the House report implied that the FTC power is only limited by state statutes that are consistent with the FTC Rule. The House report further stated that "[w]here cases of consumer fraud of a local nature which affect commerce are being effectively dealt with by the State or local government agencies, . . . the Federal Trade Commission should not intrude."[138] This statement suggests that the FTC Rule can only preempt state laws that fail to effectively deal with the HDC problem. The Senate report also implies that the FTC has the authority to preempt state statutes that are not within the expanded jurisdiction of the Commission. The view of the expanded jurisdiction taken by both the House and the Senate in effect gives the states marginal authority to promulgate statutes that do not conform to the FTC Rule. As a corollary, it implies that an FTC Rule can occupy the field in those states which have no statutory scheme concerning the subject matter of the Rule. If Congress did not intend to permit FTC rulemaking to preempt conflicting state statutes, then the HDC Rule was passed without authority by the FTC. On the other hand, if Congress intended to give the FTC the power to expand upon state consumer laws or to preempt conflicting state statutes, such power must have been predicated on the additional, stricter procedural guidelines prescribed by the FTC Improvement Act, which minimize the damage that such a rule would cause to the federal-state balance. For this reason the procedural process used by the FTC to promulgate the HDC Rule merits consideration.

C. *The Question of Procedural Propriety*

The FTC Improvement Act revoked the Commission's power to enact trade regulation rules through the use of more lenient procedures which had been recognized previously as valid by the courts.[139] The pre-Improvement Act procedures merely required publication of the rule. Interested parties were granted the right to participate "through submission of written data, views, or arguments with or without opportunity for oral presentation."[140] The FTC Improvement Act, although it granted the FTC expanded powers to promulgate rules for consumer protection,[141] subjected this power to more stringent procedural safeguards and granted interested parties the following additional rights: (1) "to submit written data, views and arguments

137. STAFF GUIDELINES, *supra* note 51, at 7.

138. H.R. REP. NO. 1107, 93d Cong., 1st Sess. (1973), *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 7702, 7726.

139. National Petroleum Refiners Ass'n v. FTC, 482 F.2d 672 (D.C. Cir. 1973), *cert. denied*, 415 U.S. 951 (1974).

140. 15 U.S.C. § 553 (1970) (amended 1975).

141. 15 U.S.C. § 57a(a) (Supp. V. 1975). *See also* Verkuil, *supra* note 129.

[and to have] all such submissions publicly available;"[142] (2) to present their positions both orally and by documentary submission, during rulemaking hearings;[143] and (3) to cross-examine all persons who submit "oral or written testimony."[144]

An exemption in the FTC Improvement Act, however, permitted the FTC to continue promulgation of rules under pre-Improvement Act procedures where the presentation of data, views, and arguments regarding a rule proposed under pre-Improvement Act standards was "substantially completed."[145] The FTC, having already maintained several hearings on the proposed HDC Rule prior to the adoption of the FTC Improvement Act, promulgated the Rule under this exception.

If the HDC Rule, which is extremely broad and preempts most state approaches to this problem, is considered to fall under the exception, the result will be incongruous. Promulgation of the HDC Rule under the Improvement Act exception is inconsistent with congressional purpose. It is clear that Congress implemented the more strict Improvement Act procedures to insure careful analysis with public participation before such a radical result could occur. The intent of the Congress that passed the Improvement Act could not have been served by preemption of state laws by a rule promulgated under the lenient pre-Improvement Act procedures.

Although a review of the legislative history of the Improvement Act provides no clear indication of the intent of Congress regarding the HDC Rule specifically, a federal district court in *National Automobile Dealers Assoc. v. FTC*[146] appears to have upheld in dicta the legitimacy of procedures utilized by the FTC in promulgating the Rule. This result may not be entirely determinative because the court only focused on whether the procedures conformed to the procedural exception of the Improvement Act, not whether an FTC rule promulgated under these less restrictive procedures could preempt state law. Because the case was dismissed by the federal court in Louisiana for lack of subject matter jurisdiction[147] (since the Improvement Act requires all appeals of FTC Rules be filed in the Court of Appeals for the District of Columbia Circuit), it is impossible to use the discussion as precedent.[148] The case neither resolves the problem of reconciling the procedural exception of the Improvement Act with the congressional requirement that preemptive FTC rules be adopted according to the stricter pro-

142. 15 U.S.C. § 57a(b)(2) (Supp. V. 1975).
143. 15 U.S.C. §§ 57a(b)(3), (c)(1)(2) (Supp. V. 1975).
144. 15 U.S.C. § 57a(c)(1)(B) (Supp. V. 1975).
145. 15 U.S.C. § 57a (Supp. V. 1975).
146. 421 F. Supp. 31 (M.D. La. 1976).
147. *Id.* at 35.
148. 15 U.S.C. § 57a(e)(1)(A), (e)(5)(B) (Supp. V. 1975).

cedural requirements of that Act, nor provides a judicial determination of the constitutionality of the HDC Rule. Speculation regarding the FTC's authority to promulgate the Rule remains, leaving the Rule open to challenge.

D. *Creditors' Tort Liability*

The terminology of the notification that must be included in all consumer credit instruments exposes creditors to "all claims and defenses which the debtor could assert against the seller."[149] This language could be interpreted to expose subsequent holders of consumer credit instruments to tort liability claims, including personal injury and property damage caused by defective merchandise, as well as to warranty claims. The result would be that a consumer who had a valid product liability claim against the merchant under state law could defeat a subsequent holder's right to further payments and recover damages for his injury equal to the amount paid on the contract by the consumer[150] by asserting his claim against the holder.[151] Furthermore, express disclaimers of tort liability in a consumer credit instrument may not be adequate to limit the subsequent holder's tort liability because the Rule prohibits the qualification of any rights preserved by the notice provision by any other recital in the instrument.

The FTC has not explained its failure to follow the precedent established in the Truth in Lending Act Regulations, where the Federal Reserve Board specifically exempted credit card issuers from tort claims resulting from defective merchandise purchased with a credit card.[152] Tort claims by a consumer against a subsequent holder could be supported by none of the common policies which support such recovery against the seller. To prevent unjustified claims, the FTC should amend the Rule to include a tort claim exemption clause restricting subsequent holders' liability to purely contractual claims.

E. *Curtailment in the Availability of Consumer Credit*

Preservation of consumer claims and defenses may reduce the availability of consumer credit. As subsequent holders become more conservative about the consumer credit paper they purchase, merchants whose product line consists of lower quality goods will find it difficult to obtain credit for their customers and thus may be forced out of business. In most instances these customers will be lower income people who could not afford the same pro-

149. 16 C.F.R. § 433.2 (1977).
150. *See* note 92 *supra* and accompanying text.
151. The magnitude of subsequent holders' tort liability under the Rule has not yet been tested.
152. 12 C.F.R. § 226.13(i) (1977).

duct if forced to purchase only more expensive, higher quality goods.[153] In addition, curtailment of available credit sources may also reduce the degree of competition in consumer credit financing and lead to an increase in the cost of consumer credit.[154]

The economic effects of the HDC Rule will be felt not only on the microeconomic level by the individual consumer, but also on the macroeconomic level by the national economy. The United States has become a "credit society."[155] Since 1950 the population has grown at a 44% rate while the outstanding consumer debt rate "has multiplied more than twelve times."[156] What effect will the HDC Rule, which predictions say will reduce the volume of credit on a micro level, have on the macro level? In a statement before the House Committee on Banking, Currency, and Housing on July 27, 1976, Dr. Arthur Burns, Chairman of the Federal Reserve Board, referring to the HDC Rule, predicted:

> It may well be reducing somewhat the availability of credit to consumers and some retailers at the very time when a continued strong rise of consumer spending is needed to foster further gains in production and employment.[157]

Although it is too early to gauge precisely the long-term macroeconomic effects of the Rule on our "credit society," an interim study by the Wharton Forecasting Institute has estimated that the Rule resulted in a 5.5% reduction in consumer credit in 1976.[158] The HDC Rule has already created additional expenses for members of the retail and finance industries. Additional reviewing procedures, legal consultation fees, and printing costs have added to their operational expenses. These costs will be passed on to consumers through higher interest rates. The overall economic impact of the Rule will be felt most by consumers with lower incomes since they can ill afford to carry this increased cost.

To assess the merits of the HDC Rule, the burden of less available and more expensive credit must be balanced against the benefits that the Rule affords. Despite the fact that the Rule may make it more difficult for lower income individuals to obtain credit, many authorities favor the Rule as a

---

153. A coordinate effect may be to aid producers of less expensive, inferior quality goods by increasing their sales.

154. Shay, *The Impact of the Uniform Consumer Credit Code Upon the Market for Consumer Installment Credit*, 33 LAW AND CONTEMP. PROB. 752, 762 (1968).

155. TIME, Feb. 28, 1977, at 36. The author noted that "an insistence on buying only what can be paid for in cash seems as outmoded as a crew cut." *Id.*

156. *Id.*

157. *Hearings Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce*, 94th Cong., 2d Sess. 5 (1976) (Statement of the Honorable Albert W. Johnson of Pennsylvania).

158. N.Y. Times, Oct. 7, 1976, § L, at 81, col. 2.

much needed protective device for consumers, particularly those with lower income.[159] As one commentator stated:

> The buyer who is being protected by retail installment legislation is normally one who cannot afford the luxury of a lawsuit and may, therefore, be forced as a practical matter to submit to the demands of the financing agency though he has an otherwise valid claim.[160]

The ultimate determination of who shall bear the risks in consumer credit transactions remains one of policy. However, additional economic studies of the Rule's impact are necessary in order to best maintain a balance between protection of consumers' claims and their credit needs.

F. *Pending Legislative Solutions*

Federal legislative activity opposing the HDC Rule surfaced immediately after the Rule went into effect.[161] Two pending bills attempt to deal with the Rule. Senate Bill 3652,[162] introduced in July, 1976, would amend the Consumer Credit Protection Act[163] by restoring the HDC doctrine, reserving to the states the power to preempt this Federal law and abolish the HDC doctrine in consumer affairs. If enacted into law, this bill would effectively eradicate the FTC Rule, and place the states in the same position they were before the Rule's issuance. It also would reserve to Congress, rather than the FTC, the right to pass a substantive federal statute to abrogate the HDC doctrine in consumer credit transactions at a future time.

A congressional resolution[164] that is currently pending in the House of Representatives would require a reexamination of the HDC Rule under the stricter procedural requirements of the FTC Improvement Act. If enacted into law, this Resolution would suspend the HDC Rule until the results of a General Accounting Office study on the Rule's effect on the consumers' credit market is completed.[165] Once this information is available, the legis-

---

159. *See* Hartmand & Walker, *The Holder in Due Course Doctrine and the Consumer*, 77 COM. L.J. 116, 123-24 (1972); Project, *Legislative Regulation of Retail Installment Financing*, 7 U.C.L.A.L. REV. 623, 750 (1960).

160. Project, *supra* note 159, at 750.

161. Within 60 days of the Rule's effective date, both the Senate and the House were contemplating resolutions to abolish the FTC Rule. *See* text accompanying notes 162-65 *infra*.

162. S. 3652, 94th Cong., 2d Sess., 122 CONG. REC. 11412 (1976).

163. Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified in scattered sections of 15 U.S.C.).

164. H.R. 15082, 94th Cong., 2d Sess., 122 CONG. REC. 8467 (1976). Representatives Broyhill, McCollister, and Johnson introduced the bill on August 15, 1976. This bill was referred to the Committee on Interstate and Foreign Commerce.

165. The passage of the HDC Rule under the old procedural requirements may have led to a failure to fully investigate the economic effects of the Rule. This is another reason why the Rule should be reissued under the new, stricter procedural guidelines.

lation would require the FTC to review the data and reevaluate the Rule under the procedural guidelines of the Improvement Act.

The Senate proposal, if adopted, would not fill the need for a uniform, national regulation to alleviate the problems created by the application of the HDC doctrine to consumer transactions; rather, the bill would protect each state's right to deal with the HDC doctrine individually. If the bill required states to promulgate their respective statutes pursuant to a nationally approved standard, this defect could be alleviated. At best, however, the proposal as it stands would leave the states in the position they were in before the HDC Rule, but would fail to offer consumers any additional protection.

In contrast, the House resolution provides an equitable solution to the controversy over the scope of the Rule's application and the authority under which it was promulgated. The GAO study will offer statistical evidence of the Rule's impact. Furthermore, reevaluation of the Rule under the stricter procedural guidelines of the FTC Improvement Act would provide ample opportunity for affected parties to participate. This reassessment under new rulemaking procedures would assure compliance with the congressional perception that FTC rules may preempt conflicting state laws when promulgated under the procedural guidelines prescribed by the FTC Improvement Act.

In the interim, additional guidelines, more precise definitions of the Rule's terminology, and a second statement of the FTC's enforcement policy (especially fines and warnings for first offenders) would be useful. The FTC should also suspend its activity concerning the proposed amendments to the Rule until the problems with the original Rule are resolved.

V. Conclusion

The FTC's effort to protect consumers from those who sell defective merchandise and slipshod services on credit terms is laudable. But, the FTC, in its zealous efforts to resolve consumer problems created by the HDC doctrine, has created certain problems that now must be solved if the Rule is to be effective.

The confusion created by the Rule's vague language, undefined terms, and incomplete guidelines can be readily solved by the FTC through the issuance of additional definitions and guidelines. The preemption question, however, cannot be resolved so readily. The FTC's authority to preempt state statutes which are incompatible with the HDC Rule remains an open question as a result of the inconsistency between the procedural exception to the FTC Improvement Act and the Congressional intent to protect the balance of federalism through the coupling of expanded FTC power with stricter procedural standards.

In view of this issue and the other serious problems which have been raised, careful review of the HDC Rule and the facts surrounding its promulgation is necessary. Congress has within its authority the power to permanently resolve these issues. Because of the intricacies involved, the pending House Resolution to suspend the rule until further studies can be made is the most logical immediate solution.

Meanwhile, the HDC doctrine will remain inoperative in most consumer credit transactions. As a result, subsequent holders of consumer paper and independent creditors will continue to be more selective in their consumer loan commitments. The traditional legal axiom *caveat emptor* has been replaced in consumer credit transactions with a new warning—*caveat possessor.*

TIMOTHY J. GRENDELL