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OPTIMALITY AND THE CUTOFF OF DEFENSES AGAINST FINANCERS OF CONSUMER SALES

ALAN SCHWARTZ*

When a consumer pays in cash or by check and the seller performs improperly, the consumer must initiate a lawsuit in order to recover his payments, and he cannot recover them or damages until the suit is concluded. Courts and commentators seem untroubled by these disadvantages which attend cash purchases, apparently for two reasons: First, people who pay cash present unsympathetic cases; they have money, and its presence is usually associated with an ability to take care of oneself. Second, cash sales are cheaper than credit sales because the investment income forgone as the result of a cash payment will usually be less than the cost of credit.¹ Buyers who purchase on credit are, of course, disadvantaged by having to pay credit costs, but in the event of improper seller performance they can withhold further installment payments; they therefore have a "weapon" to induce performance, they need not initiate law suits, and they can retain at least part of the price during the duration of an action. When, however, a credit purchaser has his note transferred to a finance company, or he waives sales defenses he may have against the seller as against a third party who has financed the sale, or he uses a bank credit card to make the purchase, state law often provides that if the seller breaches, the buyer must continue to make payments to the finance company or bank, and must proceed against the seller. The intervention of a third party, called here the financier, thus visits on the credit buyer the same disadvantages which attend cash purchases and it does this for those consumers who lack the resources to pay cash and who must nevertheless continue to bear the higher costs associated with credit buying.

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¹ This can be illustrated with a simple example. Assume a buyer with \$100 in cash, who must decide whether to pay for a product priced at \$100 with that money, or to finance the purchase. If the \$100 would otherwise have been in a savings account paying 5% interest, and the financing period is one year, the cost of paying cash is approximately \$105, \$100 for the price and \$5 for the forgone income the principal would have yielded. The cost of financing, however, may be as high as \$131: \$100 for the price, \$36 representing the 36% interest which is not uncommon for small loans—see Uniform Consumer Credit Code § 2.201(2)(i); H. Kripke, *Consumer Credit Text-Cases-Materials* 4 (1970); *Wall Street Journal*, Aug. 24, 1973, at 1, col. 6—less the \$5 the \$100 is earning. Paying cash is plainly more advantageous.

It is hardly surprising, therefore, that consumer spokesmen often urge the abolition of the holder in due course rule, as set forth for example in the Uniform Commercial Code § 3-305, and the prohibition of waiver of defense clauses, and more recently have been arguing that consumers should be able to assert sales defenses against credit card issuers. The standard response to these contentions, primarily by business interests, has been that insulating financiers against sales defenses reduces the risk to them of financing sales to consumers; that the reduction in risk is reflected in lower interest rates to sellers, which sellers pass on; and that consumers, in the aggregate, thus benefit from current law. Moreover, these interests assert, retailers who must finance their sales, rather than carry their own credit, are often small, individual concerns. Not only will reform hurt small businesses by raising their credit costs, but these are the businesses who frequently sell to the poor; hurting them thus constricts the opportunities of the poor to purchase.² Advocates of reform, in part accepting this view, stress the harm to consumers of being unable to withhold payments and the allegedly slight additional costs reform will impose,³ while those desiring to maintain the status quo stress the costs more heavily than the gains.

It is my purpose to assert the relevance of a different set of values to this debate, namely those values which underlie the pursuit of an optimal allocation of resources.⁴ Let us put aside the case

² See, e.g., McNeill, *The Necessity of Retaining the Holder in Due Course Doctrine*, 5 U.C.C.L.J. 149 (1972); Dennon, *The Uniform Consumer Credit Code Bombshell*, 22 Pers. Fin. L.Q.Rep. 125 (1968). For a scholarly version of this view, see R. Posner, *Economic Analysis of Law* 54-55 (1973). An empirical study of the effect of eliminating negotiability in financing home improvement sales provides some support for the business interests' claim, finding that the burden of reform fell most heavily on small dealers, who made credit sales mainly in low income areas. Comment, *A Case Study of the Impact of Consumer Legislation: The Elimination of Negotiability and the Cooling-Off Period*, 78 Yale L.J. 618, 647-50 (1969). The Yale study, it should be noted, was based only on the first year's experience with the law, when financiers were faced with new risks; and these financiers, in limiting credit to small dealers, may have reacted more cautiously than the facts warranted. The comment itself termed this behavior by banks and finance companies an "overreaction." *Id.* at 655.

Several observers have argued that negotiability was conferred on instruments to facilitate their circulation, as substitutes for cash, and that as consumer paper is usually only transferred once, from seller to financier, there is no need to accord financiers the protection traditionally accorded holders in due course of negotiable instruments. See, e.g., Rosenthal, *Negotiability—Who Needs It?*, 71 Colum. L. Rev. 375, 379 (1971); Murphy, *Another "Assault Upon the Citadel": Limiting the Use of Negotiable Notes and Waiver-of-Defense Clauses in Consumer Sales*, 29 Ohio St. L.J. 667 (1968). The business response is that whatever the function of negotiability once was, today it performs the service of facilitating consumer financing, a service worth preserving.

³ See, e.g., Leary, *Timely Demise of Holder in Due Course Doctrine*, 5 U.C.C.L.J. 117 (1972); Speaker, *Holder in Due Course—Burden of the Poor*, 5 U.C.C.L.J. 146 (1972); Rosenthal, *supra* note 2; Navin, *Waiver of Defense Clauses in Consumer Contracts*, 48 N.C.L. Rev. 505 (1970); Vernon, *Priorities, The Uniform Commercial Code and Consumer Financing*, 4 B.C. Ind. & Com. L. Rev. 531 (1963).

⁴ I have used an analysis similar to that to be employed below with respect to the

of the cash purchaser, for the reasons he is usually ignored, and focus on the two kinds of credit sales—those between seller and buyer, in which payments can be withheld, and those involving financiers, in which all payments must be made. A credit purchaser is in a worse position with financiers present than with them absent. He should then attempt to pay less for credit extended by financiers. If the expressly stated interest charges in seller transactions are identical to those in financier transactions, the “cost” of credit is nevertheless higher in the latter case, because of the consumer’s impaired tactical position. How much less the buyer should pay when a financier is present, or by how much more than the stated interest rate he should value his own credit cost, may be represented algebraically: Let C represent the cost to the consumer of the losses he will incur if the seller breaches and refuses to make redress voluntarily, and the consumer must continue to pay the financier. Let p represent the probability that cost C will be incurred—*i.e.*, that the seller will breach and not voluntarily make redress. The product of these two, pC , equals the risk, designated R , which a credit buyer bears if a financier is present; it is the increase of actual cost over stated price that third party financing under much current law imposes.⁵ A consumer should seek either to reduce the credit price by the value of R if, for example, his note is to be negotiated, or to increase the value of the credit cost to him by the value of R when deciding whether to purchase at all, or from the seller who will negotiate the note.

Credit buyers who face the possibility that financiers may be present must be able to value the risk that that presence creates, if they are to make rational decisions as to whether to take credit and from whom to seek it. Put simply, credit buyers should know what

problem of defective products, for optimality considerations are applicable there also. See Schwartz, *The Private Law Treatment of Defective Products in Sales Situations*, 49 *Ind. L.J.* 8 (1973). The relevance of a pursuit of optimality to the question whether consumers should be allowed to assert sales defenses against financiers who lend them money which is then used to purchase goods has been previously noted and intelligently elaborated in a thoughtful student note, with which I often disagree but which I nevertheless found quite helpful. Note, *Direct Loan Financing of Consumer Purchases*, 85 *Harv. L. Rev.* 1409 (1972).

⁵ Economic analysis sometimes equates the cost of goods to buyers with their price. This equation is inaccurate when sellers shift risks to buyers by contract. For example, when a seller successfully disclaims all warranties, his buyers bear the risk that the goods will be defective, but that the seller can nevertheless retain the price and pay none of the losses which defects could cause. Risks are, as the text indicates, costs to those who bear them, specifically a cost equal to the product of the probability that the risk will become real—in this illustration that the goods are in fact defective—and the losses if that probability materializes. If P represents the price and D the risk of defective goods, the buyer’s cost of goods sold with a disclaimer is actually $P + D$. Returning to the problem this article concerns, let P = the price of credit and R = the risk that a credit buyer will be disadvantaged by a financier’s presence. A buyer in a two-party installment sale thus faces a credit cost of P ; a buyer with a financier present faces a cost of $P + R$.

credit actually costs. If they cannot value the risk which financier presence creates, the cost of credit will be distorted because the stated price will inaccurately reflect the relevant costs. Such distortions prevent markets from reaching optimal states, *i.e.*, they prevent the economy from maximizing the output its resources can yield and from producing the types and amounts of goods which consumers want.⁶

In this article I intend to show that consumers misvalue R because they lack the information to calculate C , the monetary value of the losses which the presence of financiers could cause; nor can they properly evaluate p , the probability that those losses will be incurred. Moreover, I contend, the only effective cure for these misvaluations is to eliminate the risk altogether, by allowing credit buyers to interpose sales defenses against financiers. Should that be

⁶ Professor Stigler has explained the two "normative" properties of competitive equilibrium as follows:

First, the division of output among firms is efficient in the sense that with no other division would the same output be so cheap to produce. . . . Second, the output of the industry is "correct." The price is such that marginal cost equals price. The price is, for each consumer, the measure of the importance of an increment of the commodity—a demand price of \$2 is implicitly a statement by each consumer that a marginal unit of this commodity yields \$2 of utility.

G. Stigler, *The Theory of Price* 178, 179-80 (3d ed. 1966). Professor Solow recently gave a more vivid description:

[A] change in economic arrangements is a good thing if it makes everyone better off, or at least no one worse off (counting the possibility that there are initially gainers and losers, but the gainers compensate the losers, so that in the end everyone gains).

What does it mean for someone to be "better off"? Many criteria are possible: You could say that a man is better off if he makes a bigger contribution to the health of the state or the glory of God. In economic theory, however, it has usually meant that he is better off *in his own estimation*. If you want to know whether A prefers working over a hot stove or in a nice cool sewer, you ask him; or better still you offer him a choice between the two jobs and see which he chooses. Similarly for bundles of consumer goods.

[We should not conclude] that individuals' judgments about their own welfare should not be respected, whatever their origin. One need only ask what could be put in their place—presumably the judgments of an elite. The attack on consumer sovereignty performs the same function as the doctrine of "repressive tolerance." If people do not want what I see so clearly they should want, it can only be that they don't know what they "really" want.

Solow, *Science and Ideology In Economics*, in *Capitalism Today* 94, 104, 105 (D. Bell & I. Kristol eds. 1971) (emphasis in original). For particularly cogent and concise statements of the desirable properties of optimality, see also Lerner, *The Economics and Politics of Consumer Sovereignty*, 62 *Am. Econ. Rev.* 258 (1972); McKean, *Products Liability: Trends and Implications*, 38 *U. Chi. L. Rev.* 3 (1970). This is not to say that people cannot rationally prefer other economic states to optimality. The principal reason for such preferences is that the goal of optimality takes the existing income distribution for granted, maximizing choice and resources within it, while some may prefer to sacrifice optimality for more "just" distributions. See note 39 *infra*.

done, financiers and sellers will face a new risk—that consumers will exercise self help. These business entities, however, are more likely to value this new risk accurately than consumers now are likely to value R accurately. Thus if the law is changed, the price of credit may approximate its real costs, which today is often not the case because of consumer inability to value the risk that defenses will be cut off as against financiers.

The response to those who oppose such change because it allegedly raises consumer credit costs is that this view confuses price with cost and rests on an assumption strange to a market economy. Initially, price may rise as the result of law reform, for sellers and financiers will attempt to recover the cost of the new risk they face, that buyers will use self help; but whether the *actual* cost of credit to consumers will rise depends on whether this new risk is greater or lesser in value than the risk buyers now bear under current law. As the result of comparing these risks will vary from market to market, the new cost to buyers may therefore be higher or lower, depending on particular circumstances. Of greater significance, consumers, after the law is changed, will be able to value credit cost accurately, for all of that cost will be included in the price. Support for current law, under which buyers are likely to misvalue R and thus to perceive inaccurate credit costs, must therefore rest on the premise that buyers should be kept ignorant of the true cost of installment purchases, because they are unable to act sensibly when informed. This may be true, but it is so inconsistent with the assumptions underlying our society's commitment to a market system that policy should not be based on it unless it is proved.

Before turning to the demonstration of these points, it will be useful to indicate more precisely the scope and purpose of this article. The analysis concerns cases where credit sellers and financiers are already in a bargaining relationship, as when the financier takes a negotiable note or is the beneficiary of a waiver of defense clause. Where sellers and financiers ostensibly do not deal with each other, but rather sellers routinely refer buyers to a particular financier for the credit with which to make the sale, the argument made below at Section VI applies. Finally, my purpose is only to consider the conclusions which follow from a pursuit of optimality, in the economic sense. Were those conclusions our only criteria, change of existing law would be imperative. But the values optimality yields, principally that consumers decide what is produced, are plainly not the only ones a society may justly pursue; and other values often imply different courses of action than the pursuit of optimality mandates. These other values are not my concern here. I

want, in this article, only to put another weight in the scale, the weight which optimality carries.⁷

I. THE LOSSES CONSUMERS INCUR AS THE RESULT OF BEING UNABLE TO ASSERT DEFENSES AGAINST THIRD PARTIES

As previously discussed, the risk which a credit buyer faces—that defenses good against sellers will be cut off against financiers—can be represented as $R = pC$. This section discusses the difficulties consumers have in quantifying C , the monetary value of the losses which the presence of a financier could impose. Section II discusses the difficulties in quantifying p , the probability of these losses being incurred.

Assume a simple breach of warranty, for which the seller is liable. A consumer buyer would be entitled to recover that part of the purchase price which was paid before discovery of the breach.⁸ If the defect occurred during the payment period, and the consumer was compelled to make the remainder of the payments to the

⁷ The magnitude of the risk that consumers face when they are unable to assert sales defenses against financiers has never been quantified. If it is small, is the gain from legal change worth the administrative costs thereof? I suggest it probably is, as law reform is quite cheap because only legal rules need be altered. No administrative apparatus is necessary to police the new regime; the parties themselves will adjust to the absence of negotiability in their sales contracts, as today they adjust to its presence.

The states also have already significantly increased the exposure of financiers to buyer defenses, primarily by limiting negotiability and regulating waiver of defense clauses closely. For a compilation of statutes so doing, see Willier, *Need for Preservation of Buyers' Defenses—State Statutes Reviewed*, 5 U.C.C.L.J. 132 (1972). For discussions of similar judicial developments, see, e.g., Navin, *supra* note 3; *Recent Developments, Proposed Uniform Consumer Credit Code for Indiana: Restrictions on Negotiability and Waivers of Defenses in Consumer Credit Transactions*, 46 Ind. L.J. 114 (1970). The National Commission on Consumer Finance also recently recommended abolition of the holder in due course rule. See *Recommendations of the National Commission on Consumer Finance*, 5 U.C.C.L.J. 319, 326 (1973).

⁸ Section 2-711(1) of the Uniform Commercial Code provides that when a buyer "rightfully rejects or justifiably revokes acceptance," he "may cancel" and recover "so much of the price as has been paid." The textual statement is slightly inaccurate, however, since § 2-608(1) authorizes revocation of acceptance only when the "non-conformity substantially impairs its [the goods'] value to" the buyer, and when, *in ter alia*, the buyer's acceptance was "reasonably induced by the difficulty of discovery [of non-conformity] before acceptance . . ." Buyers who accept and later complain may therefore be unable to revoke and cancel when the defects are slight or were observable at the time of sale; such buyers are remanded to §§ 2-714 and 2-715, which, while they allow damage claims, do not authorize price actions. However, defects are seldom observable at the time of sale, and findings that consumers should have discovered defects which are latent or arguably so will be rare. Thus consumers who have accepted goods with serious problems will often be able to revoke and recover the price. The "price," as used above, also includes interest payments, for, although the Code is not explicit on the point, it would be anomalous to allow buyers to recover only price but not interest when the law plainly intends to let them rescind. Cf. *Thompson Chrysler-Plymouth, Inc. v. Myers*, 264 So. 2d 893 (Ala. 1972). A buyer's recovery, however, may be reduced by the rental value of the goods for the period of his use. See Uniform Commercial Code § 2-717.

financer and later recover them from the seller, he would thus lose the difference between what he could have earned with the money and the interest the law provides. For example, if at the time the defect became manifest there were twenty-five unpaid installments, aggregating \$420, the consumer loses the difference between what he could have earned with \$420 and legal interest awarded later in a judgment for \$420. This sum I call the earnings differential.⁹

It is sometimes said that the buyer suffers other deprivations from having to make payments on useless goods. These deprivations, however, are recoverable as damages, and therefore impose as costs only the earnings differential. Thus if the consumer purchased a second item, he could recover the expense of making the second purchase, together with any losses incurred by having to buy at a higher price.¹⁰ If, however, the buyer would not have invested the payments saved by a seller's breach, but would have replaced the item or bought something else, and if, by reason of having to make those payments, he is unable to carry a replacement or different item, the buyer does in fact suffer a deprivation; he loses the satisfactions the item, or a replacement for it, brings for the length of time it takes to obtain a judgment against the seller. This loss, the satisfaction loss, cannot be included in, nor be said to exist alongside of, the earnings differential, because the buyer would have either invested or repurchased, but cannot have done both, and thus cannot recover for both the earnings differential and satisfaction loss. However, a buyer faced with the decision whether to have negotiability or not must be able to value both kinds of losses, as they reflect the alternatives which negotiability withdraws from him.

⁹ The earnings differential could be negative. If a buyer would have used the payments not made to put losing bets on horses, requiring him to make payments to financiers which are later recoverable as damages is to force savings. Since valuing the earnings differential is not necessary to the analysis the text makes, I ignore the valuation issue and assume the differential to be positive. Also, the text uses the model of a breach of warranty for convenience, but the analysis is applicable to cases of seller fraud or other wrongs.

¹⁰ See Uniform Commercial Code §§ 2-712, 2-715. Professor Littlefield, among others, assumes that it will be more difficult for buyers to make payments on defective goods than on good ones. When the goods are in fact defective but consumers must continue to make payments to financiers they are thus more likely, he says, to default and face unpleasant collateral consequences, such as wage garnishment. Any computation of the losses resulting from a cutoff of defenses rule should then include these consequences. See Littlefield, *Preserving Consumer Defenses: Plugging the Loophole in the New UCCC*, 44 N.Y.U.L. Rev. 272, 284-85 (1969). A buyer, however, by agreeing to the contract, indicated his ability to make the payments, and would have had to make them if the goods worked. Littlefield's premise—that it is more difficult to make payments on defective goods—is thus valid only when the goods were income-producing, and the buyer planned to make payments out of their earnings, or the goods made possible savings, and a portion of those savings was to be devoted to payment. Few consumer goods produce earnings, and the savings a particular item makes possible are likely to be small.

Buyers may also incur legal expenses to recover installments whose payment was required by law. Foreclosing defenses against financiers, however, does not necessarily impose legal costs, because buyers may be motivated to sue sellers regardless of the presence of financiers. If a buyer in an ordinary installment sale, with no financier present, made a large down payment, or discovered a breach after paying many installments, or suffered personal injury or property damage or commercial loss, the buyer would probably sue his seller, rather than withhold the remaining payments and abandon the deal. If these things occurred with a financier present, suit would similarly be brought against the seller; and if suit were brought to recover, for example, personal injury damages, it would cost little to add a claim for installments paid. Moreover, if the number of unpaid installments is large, a financier may sue even though defenses may be asserted against him. The presence of a financier together with legal rules insulating him from buyer defenses will thus cause buyers to incur legal expenses they would not otherwise incur only when buyers would have preferred calling the deal off, rather than suing, and sellers or financiers, in the absence of a cutoff rule, would have let them do so.

In addition, in a two-party installment sale where the goods can be repaired, the seller has an inducement to repair if doing so will cost less than the value of the remaining installments the consumer may withhold. This inducement is lost when the seller has been paid in full by the financier, who himself can collect the remaining payments. The consumer can of course pay for repairs himself. These expenses may be recovered from the seller, but the buyer will have to sue for them. Thus the buyer may lose the earnings differential on the amount he paid for repairs (because if the seller repaired he would have incurred no expense) plus the costs of suit. The buyer, in sum, will lose the earnings differential on repair costs plus the legal expense of recovering them, when at the time repair became necessary the value of the unpaid installments exceeded the cost of fixing the item, and the defects were not such as would have caused the buyer to sue anyway:

The losses an installment buyer suffers when the seller commits a breach of warranty and the buyer cannot raise defenses against the financier are thus the earnings differential or satisfaction loss, and the additional legal expense.¹¹ Put in the form of an equation, this

¹¹ It has frequently been remarked that legal expenses are often so high as to preclude suit to recover small amounts. See, e.g., Eovaldi & Gestrin, *Justice for Consumers: The Mechanisms of Redress*, 66 *Nw. U. L. Rev.* 281 (1971); Mueller, *Contracts of Frustration*, 78 *Yale L.J.* 576, 592 (1969). The additional legal expenses the text notes could thus be so high in relation, say, to payments made that buyers will not sue to recover them, and the loss will

may be stated: Loss (if defenses can be cut off) = earnings differential (on the part of the price paid that otherwise could be withheld), or satisfaction loss; + additional legal expenses (if any); + earnings differential (resulting from repair costs when they would otherwise be incurred by seller). The ideal buyer, interested in maximizing his resources, will attempt to quantify these losses. Real buyers may not try, and would likely fail were they to make the effort.

Consumers will be unable to value the earnings differential at the time they purchase. Initially, consumers are unused to making such calculations. They will not, perhaps cannot, calculate the difference in money between what they could do with installments they need not pay, and the legal interest on those installments if the law compels their payment and they are later recovered in a law suit. In addition, such calculations are unlikely to be attempted at the time of sale, because the usual buyer expectation is that the goods will work and the concomitant expectation is that the installments will be paid. Finally, it is impossible to predict the earnings differential because its value depends on the point in time at which the breach becomes apparent; it is higher if that point is just after the first installment, lower if just before the last. Thus to value it one must be able to predict when defects will become manifest, which consumers cannot do.

It is also difficult to predict the satisfaction loss. Initially, it is difficult to give a monetary value to deprivations which may never occur, and if they do, will occur later. In addition, the components of that loss will vary with future circumstances—they turn on what the buyer will later have to forgo; and these circumstances may be hard to ascertain at the time of sale. Finally, buyers are unlikely to be thinking along these lines.

The legal expense element is also difficult to quantify. Businesses that have many law suits can roughly predict their legal expenses over time. But an individual, who probably retains lawyers irregularly, will ordinarily be unable to predict the costs of a future lawsuit, even were he to think about it; for not only does the cost of legal services vary, but the cost in any given case is largely a function of the nature of that case, whether for example it is complicated or simple, and this lay consumers probably cannot predict.

then be those payments. That this occurs is undoubted, but the statistical incidence is unknown. Moreover, some sellers perceive themselves to be more in the consumer's power for small claims than large ones; such sellers claim to be unwilling to risk loss of goodwill when consumers seek to recover small sums, and will thus voluntarily make redress even if no suit is brought, but will resist large claims because even goodwill has its price. How often, and in what markets, legal expenses deter small claims thus remains to be established. But they do deter some, and to that extent should be taken into account in the calculus the text makes.

II. THE LIKELIHOOD THAT LOSSES ASSOCIATED WITH ALLOWING DEFENSES TO BE CUT OFF WILL BE INCURRED

Consumer buyers cannot calculate the statistical probability that they will incur costs traceable to a cutoff of defenses rule. They must, *inter alia*, compute the odds of a seller not voluntarily making redress. Several factors, however, incline sellers to pay. First, the value of preserving goodwill induces sellers to comply without coercion; and many retailers allow refunds, sales credits and the like. It is also foolish for sellers to incur legal costs in an action they cannot win. In addition, many people will comply with the law because it is the law. Sellers will thus not make recompense voluntarily if, among other things, they honestly doubt the validity of the buyer's claim; if they care little about buyer goodwill, perhaps because they have a local monopoly; if their financial circumstances have changed so that they no longer can pay claims they previously planned to satisfy; or if they believe buyers will not sue and they care little about goodwill.¹² Buyers cannot accurately predict whether sellers will pay voluntarily because they are unable to measure these factors. For example, what are the odds that the goods will fail, that there is a colorable claim that this was not the seller's fault, and that the seller will assert that claim? What are the odds that a seller, who gave every indication before the sale of caring about buyer opinion, will later callously disregard it? What are the odds that a seller's business will worsen, so that he is less likely to pay claims voluntarily, and more inclined to put them off as long as possible?

As has been stated above, the value of the risk, R , that losses will be incurred because of legal rules prohibiting buyers from raising defenses against third parties is a function of the probability, p , of those losses being incurred. The most a buyer can say about that probability is that sellers may to *some* degree be less likely to comply voluntarily with the contract because they have been paid in full, and their financiers can obtain payment regardless of the quality of the underlying performance. Saying this, however, is saying too little, because buyers still cannot calculate *how much* less likely voluntary performance will be.

This difficulty is compounded by consumer inability to predict the composition of the losses they will incur should sellers not perform. We have already seen that consumers cannot value the earnings differential because its size depends largely on the point in the payment schedule at which breach becomes manifest, which is

¹² For a similar list, see Bergsten, *Credit Cards—A Prelude To The Cashless Society*, 8 B.C. Ind. & Com. L. Rev. 485, 513-14 (1967).

unpredictable. It may also be difficult to predict the size of the satisfaction loss, for that turns on a buyer's future circumstances, as well as future desires; only a slight loss may be incurred if the buyer gets a raise or a better job; but such loss could be huge if the buyer is no longer employed. Finally, it is hard to predict whether additional legal expenses will be incurred as the result of a cutoff rule, because, *inter alia*, the losses the breach causes may be so high that the buyer will sue although he must continue to make payments to the financier. Yet, at the time of sale, the size of the loss caused by breach is difficult to calculate because it depends on the nature of the breach and the buyer's future circumstances.

In sum, consumers will be unable even approximately to calculate the odds of their incurring losses because of legal rules permitting a cutoff of defenses, nor will they be able to predict either the composition or the amount of the losses they may incur. The value of a risk to the one who bears it is the product of the probability that the risk will become real and the costs reality imposes. Consumer buyers currently cannot value the risk which current law creates because they cannot compute the components of the valuation equation.

III. THE RESULTS OF CONSUMER IGNORANCE

The cost of credit to a consumer is the credit service charge.¹³ But when the sale is financed by a third party who has the right to require the consumer to pay him, and when state law insulates the third party from consumer defenses, that cost is increased by the value of the risk state law creates, *viz.*, that the consumer may be made worse off by his inability to withhold installment payments. A consumer who cannot value this risk cannot accurately price the credit he obtains. If the risk is overvalued, less credit will be extended than would have been the case had the real facts been known; and if, as seems more likely, consumers undervalue or ignore the cutoff risk, an excess of credit will be extended. Whichever is done, the amount of credit outstanding will be incongruent with consumer desires, and the policy of consumer sovereignty, or optimality, violated.

The results of this incongruity are worth pursuing. The cost of credit to consumers, called C_1 , is the sum of the credit service charge, called P , and the risk current law creates, R_1 . If the law were changed to allow consumers to assert defenses against

¹³ This sum includes time price differential, service or carrying charges, brokerage, insurance against default, and so forth. See Uniform Consumer Credit Code § 2.109; Consumer Credit Protection Act, 15 U.S.C. § 1605 (1970).

financers, the new cost, called C_2 , would be the same credit service charge, plus the charge the seller or financer makes for bearing the risk that buyers will withhold payments. For reasons which appear below, the value of this risk, called R_2 , is unlikely to equal the value of the risk consumers now face, and the charge made for bearing it will thus be called Y .¹⁴ Under much of current law, the consumers' credit cost can therefore be represented as: $C_1 = P + R_1$. If the law is changed, the cost will be represented as: $C_2 = P + Y$. Whether C_2 is greater than C_1 is of course determined by whether Y , which is largely a function of the value of R_2 , is greater than R_1 . Since the value of these risks is likely to vary with markets and the parties involved, it cannot be said that Y will always be greater than R_1 , and it is thus false to assert that costs to consumers will inevitably rise if they are enabled to assert defenses against financers.

There is, however, a difference between costs actually faced and costs believed to be faced. Consumers, we have seen, are unable to value R_1 , the risk a cutoff rule creates. It seems probable that they will tend to ignore it, since they may not be aware that defenses will be cut off or understand the implications of such a rule. Thus, many consumers may erroneously equate cost with price, perceiving C_1 as equal to P . If the law is changed, so that sellers and financers bear the risk that consumers will withhold payments, this risk is much more likely to make its way into the price, because its value over many transactions should not be negligible. The new total cost to consumers, we have seen, will be $P + Y$, which significantly will be the new price. All consumers will thus be more likely to perceive the true cost of credit to them. Those who previously misperceived $C_1 = P$, and now rightly see $C_2 = P + Y$, will subjectively perceive a cost increase; they will finally see what was true all along but has now become manifest—that credit is more expensive than they once thought.

The result of this awareness, assuming demand is constant, is that less credit will be sought.¹⁵ But that, to one who seeks optimality, is a good thing, for true consumer wants are being satisfied. That is to say, if consumers perceive a cost as low when it is not, because they undervalue a risk which is a component of it, they are then seeking more credit than they in fact want because they are

¹⁴ Briefly, the risk consumers face is that of bearing the costs of seller intransigence; the risk sellers and financers face is that the consumer will withhold payments either rightly, because the goods fail, or wrongly, when they conform. The consumer and business risks, being different, will have different monetary values. See note 24 *infra* and accompanying text.

¹⁵ This simply restates the law of demand, that people "buy less of a thing when its price rises." See G. Stigler, *supra* note 6, at 22. For interesting recent confirmatory evidence, see Sauter, Gabor & Granger, *The Effect of Price on Choice: A Theoretical and Empirical Investigation*, 3 *Applied Econ.* 167 (1971).

purchasing at artificially low prices. Argument against legal change thus necessarily implies that some consumers should be induced to take more credit than they want, because they cannot sensibly judge their own interests. This assumption of consumer incapacity may be true, but it is so inconsistent with the accepted assumptions of our legal and economic systems that policy should not be based on it unless it is empirically verified.

IV. REMEDIES FOR THE RESULTS CAUSED BY PRESENT LAW

When parties bargain it does not matter, in theory, which of them initially bears a risk because they will optimally allocate the value of that risk between them.¹⁶ Thus which party, seller or buyer, bears the risk of product failure is theoretically irrelevant to considerations of optimality. If the seller bears it he will charge more, because of the risk; if the buyer bears it he will pay less, because of the risk; but the total cost—price plus risk cost—will be the same; thus no misallocations will result if the risk is put on one rather than the other party.¹⁷ Buyers deal with sellers and financiers, and it would seem that the risk of being unable to withhold payments could also be optimally allocated by bargains, but this will not occur because bargains produce optimal outcomes only when the parties thereto are informed. For example, assume the seller discloses that the buyer's note may be negotiated,¹⁸ but agrees not to do this if the buyer pays an additional sum. This sum we have called Y , and in a competitive market it will approximate R_2 , the risk the seller faces of the buyer exercising self help.¹⁹ The buyer thus knows the cost of avoiding the risk of being unable to withhold payments, but what he also must know is what Y buys. If, for example, it is \$2, but the value of the risk the buyer faces from negotiability is \$1, the buyer would prefer to have the note transferred. The price a seller or financier charges for abandoning negotiability, in short, communicates to the buyer the price of insurance, but tells him nothing about the value of the risk being insured against. The buyer is therefore unable to know whether to insure or not. Put in economic terms, he cannot know whether having or not having negotiability will more closely satisfy his wants.²⁰

¹⁶ A detailed explanation of this statement and the exceptions to it is found in G. Calabresi, *The Costs of Accidents* 161-73 (1970).

¹⁷ This point is developed with respect to products in Schwartz, *supra* note 4, at 21-25.

¹⁸ The Federal Trade Commission recently held that the failure to disclose that a note will be negotiated is an unfair trade practice. See *In re All-State Indus., Inc.* [1967-1970 Transfer Binder] Trade Reg. Rep. ¶ 18,740 (FTC 1969), *aff'd*, 423 F.2d 423 (4th Cir.), cert. denied, 400 U.S. 828 (1970).

¹⁹ Risks are costs; in competitive markets price tends to equal cost.

²⁰ This argument demonstrates that informing buyers of their "legal rights," i.e., that the

There are, again in theory, two ways to resolve this difficulty. One is to leave the law unchanged but to provide consumers with the information necessary to value the relevant risk. The second is to change the law, thus eliminating the risk. The former choice is unwise for two reasons. First, there seems no practical way to provide consumers with the information. This is apparent from the nature of the costs and probabilities themselves, but some examples can be given. Initially, it will be difficult to provide buyers with the odds as to whether sellers will be unjustifiably intransigent, since sellers will deny the existence of the possibility; and the statistics requisite to provide the truth are likely to be prohibitively expensive to gather. Moreover, only buyers can value their own satisfaction loss, since it is so personal to them; but neither can they value it accurately. Finally, no one can predict, and thus inform the buyer of, the probability that he will incur additional legal expenses, because that turns on circumstances that are unpredictable, such as when in a payment schedule breach becomes manifest. In sum, the buyer cannot know these things; the seller is likely to be able to value only the risks facing him, not the buyer; and outsiders are unlikely to know more than the parties do. Providing buyers with information is unlikely to work because the information is unobtainable.

Second, the costs of providing information, if it could be done at all, probably exceed the gains. The advantage commonly claimed for the rules insulating financiers from buyer defenses is that they enable an expansion of credit. Financiers who bear fewer risks charge sellers lower rates for their money, and those lower rates are passed on to consumers, who are then able to obtain more credit. If buyers can value the cutoff risk, however, they will perceive these lower rates as increased by the risk cost. They will thus use less credit. But they would also use less credit if the law were changed and the cutoff risk abolished; for the price of credit would then increase by at least the value of R_2 . Therefore the benefit current law provides can in no event be retained, since either remedy—providing information or changing the law—will cause it to disappear. The choice of which remedy to pursue, then, apparently turns on the costs of implementation; and it seems cheaper simply to abolish legal rules than to set up what may be an extensive apparatus to provide for the disclosure and supervision of information to consumers.

note will be negotiated and the consequences of negotiation, is only a partial solution to this consumer problem. But of course informing consumers of those rights is useful. For thoughtful suggestions as to what can be done in this regard, see Miller, *An Alternative Response to the Supposed Direct Loan Loophole in the UCCC*, 24 Okla. L. Rev. 427 (1971).

There is, however, a gain from providing information rather than allowing defenses to be asserted against financiers, and prohibiting waivers of the right to assert those defenses: it increases buyer choice. If buyers are given the information to value the risk the law now creates, they can choose between bearing it, which means a lower cash payout for credit, or not bearing it, which means a higher payout. There is a value to letting this choice be made. The issue is whether the cost of providing information together with the fact that some buyers will not absorb it, thus continuing to act the way they now do,²¹ will outweigh the gains freedom yields. This is a balance we must all strike for ourselves, as freedom cannot be quantified. I suggest that the choice for a buyer, whether to pay for the absence of a cutoff rule, is one not central to consumer concerns, which revolve around quality and elements of price much larger than the value of this risk; and that the costs of providing information, if it can be done at all, are likely to be quite high. The better remedy, then, seems a repeal of those laws insulating financiers from buyer defenses. It would in fact be better only if abolition would produce fewer misallocations than current law. This seems to be the situation.

V. THE RESULTS OF CHANGING THE LAW

To appreciate the effect of changing the law, initially assume a two-party installment sale, in which the buyer is able to withhold payments. The seller will be relatively unconcerned with, and in any event can value, the risk of his own intransigence. The probability and costs of this he knows, if he plans so to act. Of concern is the risk that the buyer will unjustifiably withhold payments, thus imposing on the seller the cost of recovery and his own earnings differential—the difference between what the seller could earn with the payments and the interest on them the law later grants. Whether a given buyer will unjustifiably withhold payments is unpredictable; if that prediction were possible, such buyers could never purchase.

²¹ Whether buyers will find and absorb information depends on the outcome of their comparison between the costs of these activities and the gains; concretely, will visiting more sellers or reading more literature produce a sufficiently better deal to make the additional visits or reading worthwhile? Because the risk of being unable to withhold payments will probably not significantly increase the cost of purchase, the gains from reading data and checking out many sellers should be small, which is to say that buyers will often not be able to reduce purchase costs enough by doing these things to make doing them worthwhile. Thus buyers will probably absorb little additional information, which is another reason for not providing it. Economists refer to the activities of absorbing relevant data and seeking out sellers as searching; and, in their terms, I am asserting that search costs are likely to be sufficiently high in relation to risk costs to preclude much searching. For a more detailed discussion of search and cites to some of the economic literature, see Schwartz, *supra* note 4, at 15-16.

But sellers probably can calculate, over time and for an aggregate of buyers, the odds of breach and the legal expense and earnings differential such breaches impose: these calculations may be drawn from statistical evidence of buyer behavior, which the business experience of sellers enables them to obtain. A consumer's casual experience with sellers, on the other hand, renders the accuracy of his generalizations as to business behavior far less reliable. Installment sellers thus seem better able to value the risk which most concerns them—that consumers will wrongly not pay—than consumers can value the risk which faces them—that sellers will wrongly not redress breach.

If installment sales are financed by a third party, and buyers can assert defenses against him, he faces two risks—that the buyer unjustifiably will withhold payments and that he will justifiably do so. Both of these risks the seller probably can value, the former because of his experience with installment buyers and the latter because the risk of justifiable withholding is a function of the likelihood of defects and the willingness of the seller to remedy them, both of which the seller can be expected to know. Some financiers may be unable to make these calculations, except as regards the probity of the sellers with which they deal. But they are business entities, and can either shift the risk of buyer breach to sellers, by use of recourse financing,²² or require sellers to disclose the relevant information, and then price credit accordingly. Moreover, some financiers may develop their own experience of the probability and costs of buyer breach if they finance many consumer sales, and may thus be able to price credit accurately without much seller help.

Sellers and financiers plainly cannot value perfectly the risk that buyers will withhold payments. The question is whether these business entities are more likely to value correctly the risk that will face them than consumers are to value the risk which they now face; and, as we have seen, the business entities are much more likely than consumers to approach correct valuations. Change in the law will therefore enhance the chance of buyers knowing the actual costs of credit; the amount of it outstanding will then be much more a function of its cost and of buyer desires than it is today.

Law reform will also create a new risk for sellers and financiers,

²² In recourse financing, if the buyer fails to pay the financier, the financier recovers from the seller, who then has to collect from the buyer; in effect, the risk of consumer withholding remains on the seller. Where negotiability has been eliminated, commentators noted an increase in recourse financing. See Willier, *supra* note 7, at 143-44; Comment, *supra* note 2, at 640. Another response has been for financiers to make direct loans to consumers, thereby attempting to avoid the new law's impact. See, e.g., Comment, Consumer Protection—The Role of Cut-off Devices In Consumer Financing, 1968 Wis. L. Rev. 505, 524-25. I shall later argue, in Section VI, that such attempts to avoid the effect of law reform should fail.

which will probably alter their performance. An important question is whether, as some commentators now claim, change will be for the better.²³ Let us return to the world of models, and to the assumption that sellers and financiers can value risks precisely. Assume P , the credit service charge for a given item, is \$10; R_1 , the risk to consumers flowing from negotiability, is \$4; R_2 , the risk to financiers that buyers will withhold payments, is \$3;²⁴ and Y , the price financiers charge for bearing R_2 , is also \$3. If the holder in due course rule prevails, the credit cost is \$14 ($P + R_1$). Since more can be sold at prices under \$14, financiers and sellers will be stimulated to reduce R_1 by improving the product (reducing the occasions for withholding), or by voluntarily satisfying buyers (again reducing R_1). If negotiability is eliminated, the new credit cost, C_2 , is \$13 ($P + Y$). Y , which is presumed to equal R_2 , is the sum of two risks, that the buyer will wrongly not pay, and that he will rightly not do so, because, for example, the product is defective. Financiers and sellers will also seek to reduce R_2 , by selecting buyers more carefully (reducing wrongful withholding), and by improving product quality or service (reducing rightful withholding).

Since \$13 is less than \$14, financiers and sellers will be less inclined to reduce R_2 than they were to reduce R_1 , since they will make more sales without negotiability than with it; generalizing, whenever $R_2 < R_1$, seller and financier performance may be impaired by allowing defenses to be asserted against financiers.²⁵ Also, be-

²³ See, e.g., Kripke, *Consumer Credit Regulation: A Creditor-Oriented Viewpoint*, 68 Colum. L. Rev. 445 (1968); Note, *supra* note 4. See also Hogan, *Integrating the UCCC and the UCC—Limitations on Creditors' Agreements and Practices*, 33 Law & Contemp. Prob. 686 (1968).

²⁴ The risk to financiers and sellers, R_2 , can have a different value than the risk to buyers, R_1 , because risk values are product of costs and the probability of incurrence. For example, assume that pd is the probability that the goods will be defective and that the buyer will thus rightfully withhold payments; that Cd is the resulting cost to financiers, in lost profits which would have been earned had the transaction gone through; that pw is the probability that a buyer will wrongfully withhold payments when the goods are satisfactory; and that Cw is the cost, in legal expense and financier earnings differential (if any), which wrongful withholding imposes. Thus the value of the risk a financier faces from abolishing negotiability is: $R_2 = pdCd + pwCw$. If negotiability is retained, let pi = the probability that the goods will be defective and that the seller will not voluntarily make redress; and let Ci = the cost to buyers if this happens—the earnings differential or satisfaction loss and additional legal expenses (if any). See text at note 11 *supra*. Thus the value of the risk the buyer faces from negotiability is: $R_1 = piCi$. There is no reason why pi should equal pw , because there is no reason why the likelihood that sellers will be intransigent will be the same as that buyers will wrongfully not make payments. Nor is there any reason why $Cd + Cw$ should equal Ci , because the costs to businesses of buyers withholding payments are unrelated to the costs to buyers of intransigent business entities. Therefore, in all likelihood, $R_2 \neq R_1$.

²⁵ Since financiers and sellers can expand sales by eliminating negotiability when $R_2 < R_1$, one would expect negotiability only when $R_2 > R_1$. This may, however, be more true in theory than in fact because it will be difficult for the business entities to value R_1 , the risk facing consumers, and thus it will be difficult for them to make the requisite comparisons between R_1

cause R_1 , the risk facing buyers from negotiability, is a function of the quality of the product and of seller performance, the only way the business entities can reduce it is to improve one or both of these elements. R_2 , however, is a function of these elements, and of buyer misconduct; it can thus be reduced by more selective credit extensions. To return to the illustration above, if R_2 is composed of \$1 attributable to buyer misconduct and \$2 attributable to rightful withholding, it can be reduced to approximately \$2 by eliminating bad risks. This yields a price, and cost to buyers, of \$12, thus creating even less incentive for financiers and sellers to improve performance. Even where $R_2 > R_1$, financier and seller incentives to improve performance may, where a substantial component of R_2 is buyer misconduct, therefore be less without negotiability than with it. We cannot then say that allowing sales defenses to be asserted against third parties will always improve seller and financier performance. Whether it will or not depends on the relative size of R_2 and R_1 , and the composition of the former; the business entities will perform better after law reform than they now do in some markets, and worse in others.

This conclusion assumes that buyers accurately perceive C_1 ; that is, that when $P + R_1 = \$14$, buyers react to a \$14 cost. If buyers perceive C_1 as \$16, eliminating negotiability will substantially lessen incentives to improved performance; for C_2 can be reduced to \$13 or \$12 although the business entities improve nothing. If, however, buyers undervalue R_1 , which seems more common, law reform may improve performance. Assume that buyers value R_1 as zero, because they are unaware of or misunderstand negotiability. They then perceive $C_1 = P = \$10$. Eliminating negotiability forces them to react to a C_2 of at least \$12; and they will buy less. Sellers and financiers will then face an incentive, greater than under old law, to improve their performances. Law reform may also affect financier and seller performance favorably when buyers undervalue the risk they face.

However, the new incentive to improved performance, attributable to altering the risks the business entities bear, may sometimes be insufficient, with possibly undesirable results. An argument made in favor of abolishing the holder in due course rule is that abolition will cause financiers against whom defenses can be asserted to deal only with reputable sellers, thereby driving disreputable ones out of business, or to police the sellers with whom they do deal, thereby improving their performance.²⁶ Dealing with different sel-

and R_2 . The safest course may then be to rely on the law insulating financiers from defenses, i.e., to avoid bearing R_2 .

²⁶ See authorities cited in note 23 supra.

lers, however, or engaging in policing activities not previously performed, will impose new costs on financiers. They will do these things only if the costs are lower than R_2 . Should the costs of policing be higher than R_2 , financiers will charge its value, Y . This will result in fewer harms attributable to warranty breaches, but only because less will be purchased. Put another way, when the costs of policing or cutting off bad dealers exceed the costs of bearing the risk of buyer withholding, no buyer who purchases will have the quality of his seller's performance or product improved, but because the perceived cost will be higher than before law reform, fewer buyers will purchase, and thus fewer buyers will be harmed. Whether this is desirable depends on how one feels about who is excluded.

It therefore cannot be categorically said that improved seller and financier performance will result from allowing sales defenses to be asserted against financiers. In some cases, our models indicate, performance will be improved; in others it may be impaired; and in others fewer buyers will be harmed only because the number of buyers will diminish. What can be said with more assurance, however, is that changing the law will move consumer markets closer to an optimal state, which is a gain worth pursuing for its own sake.²⁷

VI. THE PROBLEM OF THE UNRELATED LENDER

The transaction the preceding analysis assumed was an extension of sales credit, with payments made to the financier. Assume,

²⁷ An argument often made in favor of exposing financiers to buyer defenses is that it will facilitate loss spreading: when a seller goes bankrupt, buyers bear the loss if they must continue to pay the financier while being unable to collect from the seller, while the financier bears the loss if buyers can cease making payments, for he is then left with a bankrupt defendant; financiers are better able to spread losses than buyers. See, e.g., Note, Preserving Consumer Defenses In Credit Card Transactions, 81 Yale L.J. 287 (1971); Murphy, *supra* note 2. The argument is valid because of the informational problems described above. Consumers who cannot value risks will be unable to know when it is wise to shift them (for example, by agreeing to a higher price in return for the elimination of negotiability), since they cannot measure the costs of a shift against the gains; they therefore may bear risks which, had they been properly informed, they would have avoided. See Schwartz, *supra* note 4, at 20. The gains in loss spreading from law reform, however, will be slight. Initially, the amounts involved are small, because buyers at most will save the price, including interest and less rent, if such rules as those protecting holders in due course are abolished, unless they are also permitted to recover consequential damages against financiers, which few now argue should be done. Moreover, the risk of seller bankruptcy is quite low. In 1967, only .003% of retail trade outlets went bankrupt; in 1968, .002%; in 1969, .002%. Dun & Bradstreet, *The Failure Rate Through 1968*, at 8-9 (1969); Dep't of Treasury, *Internal Revenue Statistics of Income 10* (1969); U.S. Dep't of Commerce, Bureau of the Census, *Statistical Abstract of the United States 468* (1970); U.S. Dep't of Commerce, Bureau of the Census, *Statistical Abstract of the United States 459* (1971); *Business Statistics, 18th Biennial Edition: A Supplement to the Survey of Current Business 38* (1971). Finally, fraud claims are not dischargeable in bankruptcy. 11 U.S.C. § 35 (1970). All of this is not to say that loss spreading considerations, arising from the risk of seller bankruptcy, do not point to law reform, but only that they point weakly.

however, that the consumer borrowed from a bank to buy a car. Under current law the loan and sale are considered unrelated; the sale was for cash, and the loan, as an independent transaction, must be repaid. Yet if the car malfunctions and the consumer must continue to make payments, he will incur the same losses as if the credit was extended by the automobile dealer and the sales contract then transferred. Previously, we said, the credit cost was the credit service charge, and the risk of being unable to withhold payments. The cost, in this illustration, is the charge the bank exacts and the risk of being unable to withhold payments to it. For the reasons given above, the consumer is as unable to value the risk when credit is extended by the bank as he is when credit is extended by the seller, and the price of credit is as much distorted. The consumer should thus be allowed to assert defenses against the bank.

Reform, however, is senseless if it produces as many misallocations as it cures, which can at times be the case with unrelated lenders. Assume, in the case above, that the bank has not dealt with the dealer from whom the car will be purchased, and that it has no expertise in the automobile field. Let the law be changed so that sales defenses can be asserted against it. The risk the bank faces, that the buyer will withhold payments, is a function, *inter alia*, of the nature of the product and the dealer; the former the bank seems ill-equipped to evaluate; and the bank may also have difficulty with the latter because the cost of evaluation, when measured against the profit from a single loan, may be so high as to justify only a superficial investigation. The bank, however, can make an ad hoc bargain with the dealer, refusing to finance the purchase unless the dealer bears the risk of withheld payments or communicates the facts necessary to value it. Whether this will be done depends on the cost to the bank of bargaining with the dealer, which in the case of a substantial purchase from an identified seller may not be prohibitive. But when the loan is small, the gains from such bargaining may not justify the costs; and when the loan is for unrestricted uses, consisting of cash to enable the buyer to live, where the buyer is likely to make several purchases the particulars of some of which, at the time of sale, he may not even know, the cost of transacting with potential sellers will often be too high.

When the costs of bargaining or valuing risks are perceived by financiers as being higher than the gains, they will price the risks they face arbitrarily, ignore them or refuse to finance sales. In the former two cases the credit service charge will not accurately reflect the relevant risks, which means that the price of credit will again be distorted; and in the latter case, there will be less credit offered than buyers would be willing to take. Whether consumers should be

enabled to assert sales defenses against financiers when they, rather than sellers, extend credit thus turns on the answers to two questions: (1) Will transaction costs, the costs of getting seller and financier together, be so high that it will be impossible to predict fewer misallocations from law reform than now exist? (2) If such a prediction is impossible, do policies other than optimality justify allowing buyers to assert sales defenses against unrelated financiers? The latter inquiry is beyond the scope of this article, the former beyond its grasp, depending as it does on the gathering of much data; but these are the questions legislatures should address.²⁸

This analysis may be made more concrete by reference to a problem which has caused much comment, that of bank credit cards.²⁹ Banks issue cards to consumers and pay participating merchants who honor those cards. The consumer's purchase is, from the

²⁸ Several commentators have argued that financiers who extend credit directly to buyers should be exposed to sales defenses when they are "closely related" to sellers. See, e.g., Littlefield, *supra* note 10. For an analysis of statutes in seven states (Arizona, California, Massachusetts, New York, Rhode Island, Vermont, Wisconsin) based on this approach, see Littlefield, *Preservation of Consumer Defenses In Interlocking Loans and Credit Card Transactions—Recent Statutes, Policies, and a Proposal*, 1973 Wis. L. Rev. 471, 478-92. "Closely related," however, is a phrase which can be given content only by reference to an underlying policy. Should that policy be to pursue optimality, the relevant question is whether transaction costs will prevent accurate risk valuations. And as to this, whether financiers and sellers are "closely related" is only evidence, not the answer. In concrete cases, the decision whether to expose financiers to defenses will often be the same, regardless of whether one considers transaction costs or the nature of the seller and financier relationship without reference to any underlying analytical framework, because transaction costs are likely to be low where the relationship is close. The question of independent lender liability, however, should explicitly turn on the relevant issue of transaction costs, for then one is more likely to address the right questions to the facts.

One particularly thoughtful note argues that lenders should be insulated from buyer defenses where the loan "is unrelated to any particular purchase," but not otherwise. Note, *supra* note 4, at 1423. If the lender is unaware of a loan's particular purpose, he should ask; the purpose of exposing him to buyer defenses is to make him ask, so that, apparently, he can then refuse to finance the sale if the seller is disreputable. See *id.* at 1437. The consumer, however, may not want to tell. Lenders can condition loans on knowing their purpose, and thus that purpose will be disclosed; but when the lender has no business need to know, we no longer have a simple issue but a value choice: Are the gains from making the bank ask the purpose of the loan worth the losses in privacy to consumers from having to disclose? We live now in an intrusive society with government and private industry wanting to know much about each of our businesses. Borrowing money may often be a sensitive matter, and bankers not the ones to whom many of us want our troubles told. I suggest that when the lender has no prior bargaining relationship with the seller, and has no business need to know the use to which the money will be put, the gains in optimality, or other things, are unlikely to outweigh the losses in privacy which are entailed by requiring the bank to ask the consumer's purpose. When, however, one puts a value like privacy in the scale, certainty tends to flee. My aim is therefore to call attention to a privacy issue which seems overlooked rather than to argue strongly for a particular resolution of it.

²⁹ For previous discussions of the problem as to whether sales defenses should be able to be asserted against credit card issuers, see, e.g., Brandel & Leonard, *Bank Charge Cards: New Cash or New Credit*, 69 Mich. L. Rev. 1033 (1971); Davenport, *Bank Credit Cards and the Uniform Commercial Code*, 85 Banking L.J. 941 (1968); Note, *supra* note 27.

merchant's viewpoint, for cash, for the merchant deposits the sales slip with the bank with whom it has an agreement, the depository bank, and is then paid. The depository bank, if it also issued the card to the consumer, will bill him; if not, it will send the slip to the issuing bank, which will credit the depository bank and bill the consumer. The process works much like the check clearing system. Should the consumer be allowed to assert defenses arising from the sale against the issuing bank which bills him?

Whether the consumer will use his card in a transaction with a merchant who bargains with the consumer's bank is a matter of chance, for it is the issuing bank which deals with the consumer, the depository bank which deals with the merchant, and there is no assurance that the consumer will buy from merchants who have credit card arrangements with his own bank. Thus the issuing bank which extends credit to the consumer, *i.e.*, the financier, and the seller may often be unrelated. Also, the consumer with a credit card is obtaining credit to make a variety of purchases, the relevant facts of most of which he does not himself know when the card is obtained. Nevertheless, the issuing bank, when defenses are asserted against it, could charge the disputed sum back to the depository bank, which itself dealt with the merchant who sold the goods at issue.³⁰ These two, merchant and depository bank, do bargain, and thus could allocate risks among themselves. It has, however, been claimed that a depository bank enlists "tens of thousands of merchants."³¹ Moreover,

[t]he insignificance of any individual merchant's activities in relation to the total anticipated profit from all charge card transactions would not warrant a continuing investigation of the merchant as a matter of course It would be as unfair and unrealistic to expect a depository bank to make such an investigation of a merchant who had an agreement enabling him to accept charge cards as it would be of a merchant who maintained nothing more than an ordinary checking account with the bank.³²

However, the depository bank need not investigate the merchant in the detail this objection assumes. It can instead enlist the merchant in the credit card plan only on condition that when issuing banks

³⁰ This suggestion has previously been made in Note, *supra* note 4, at 1420.

³¹ Brandel & Leonard, *supra* note 29, at 1053.

³² *Id.* Brandel and Leonard, however, do argue that sales defenses should be able to be asserted against issuing banks for sales of \$50 and up, *id.* at 1062-64, and when the sales are made in a limited geographic area, in which are likely to be both issuing and depository banks, *id.* at 1065-66. I find their distinctions between cases when defenses should be asserted, and cases when they should not, unpersuasive.

charge sums back to it as the result of disputes about the goods, the depositary bank will be repaid by the merchant, who will then have to deal with consumer complaints.³³ The merchant will thereby be put in the position, on disputed items, of having extended sales credit in a two-party transaction, in which payments can be withheld. The risks stemming from this he can value better than anyone else. He should then raise the cash price, in which case the cost of goods to the consumer will accurately reflect all costs.³⁴

This analysis, however, inaccurately presupposes that credit cards are used only to obtain credit. It appears that the average credit card purchase is under \$20; the great majority are under \$50; and a large, and rising, percentage of consumers pay for their purchases on the first billing, thereby avoiding interest charges. The bank credit card has, for many consumers, come to perform the function of a checking account.³⁵ When consumers obtain sales credit but the law enables defenses to be cut off against financiers, or when they obtain credit from financiers to make purchases and must pay the financiers if the goods fail, they are faced with a risk whose difficulty to value causes distortions in the price of credit. But when they in effect pay by check, they are making cash purchases; there is then no risk to value or misvalue, and no reason to change the law. There apparently should thus be two rules, one for credit card use when the consumer finances his purchase, making installment payments to the issuing bank, and one when he does not.

In reality, however, two rules are unnecessary. When it is said that a card is like a checking account, it is meant that the consumer intends to pay when billed. When consumers do this, there is no longer need for differentiation between credit and cash sales. The consumer is then in the position where, having paid, he must sue someone, and no case has been made for giving him the bank as defendant in addition to the seller; put simply, when consumers pay, the question whether defenses may be asserted against the issuing bank becomes irrelevant. When consumers fail to pay on the first billing, or only pay part, they are then obtaining credit, and as such the argument made above applies, that defenses should be able to be asserted against the bank.³⁶

³³ Recourse agreements already seem common in bank credit card arrangements. See Davenport, *supra* note 29, at 955-56.

³⁴ The Uniform Consumer Credit Code reaches a result contrary to that urged here. Section 3.106(3) provides that a loan, for the Code's purpose, includes "the creation of debt pursuant to a lender credit card . . ." Sales defenses cannot be asserted against lenders. The draftsmen explained the result on the ground that issuing banks cannot know enough about sellers to police them. Jordan & Warren, *The Uniform Consumer Credit Code*, 68 *Colum. L. Rev.* 387, 437-38 (1968). This may be true, but it is irrelevant.

³⁵ Brandel & Leonard, *supra* note 29, at 1059-60.

³⁶ A buyer may charge several items on his card during the relevant billing period and

Some buyers, however, may fail to pay at the first billing not because they are obtaining credit, but because the goods are defective; such buyers will be exercising a right similar to the right to stop a check.³⁷ Should the possibility that consumers will not pay only because the goods are defective justify a separate rule that consumers cannot convert cash to credit sales because of the seller's performance? Administrative convenience argues against this result. The question for a court would be why a buyer failed to pay when first billed, whether he sought credit or a remedy for defects. Such a rule would require inquiries into particular circumstances as well as states of mind, both of which are time-consuming. Having one rule—that consumers may assert defenses against issuing banks before payment—is simpler to administer and understand. Such a rule goes further than optimality considerations require, but rules are often extended or limited for administrative reasons; and since banks can charge card holders for the privilege of exercising "stops," extension here should not work undue hardship on them.

CONCLUSION

Credit buyers are often unable under current law to assert defenses arising out of their sales transactions against third parties who have financed those sales. Such buyers in consequence are unable to use the remedy of withholding payments to coerce seller performance; they must initiate law suits; and they cannot recover

pay only part of the bill. If one of the items was defective, does the payment relate to it, so that it was a cash purchase? Or has the consumer bought it on credit, so he may assert defenses? The answer should be the latter. A consumer who buys many items and pays part of the total has essentially obtained credit to make a variety of purchases. He thus faces credit risks, and since transaction costs seem low enough, defenses should be allowed to be asserted against issuers in this situation as well. Moreover, given the difficulty of deciding, after sales have been made, into which category, cash or credit, they fall, a rule presuming cash sales when the consumer pays in full but not otherwise has administrative advantages.

³⁷ The analogy to stops can be overstated. Customers may stop checks, under Uniform Commercial Code § 4-403(1), so long as the bank has not, *inter alia*, paid the check in cash, accepted it, completed the process of posting, "or otherwise . . . evidenced . . . its decision to pay the item." An issuing bank which credits a depository bank's account with the purchase price has in effect paid the item. If defenses are later asserted against it, little reliance can be placed on an analogy to the right to stop checks, for checks can only be stopped before payment. Moreover, customers are authorized to stop checks on the principle that they should be able to control the people to whom the bank pays their money, while in respect of credit cards the bank is giving credit with its own money. It will therefore be advanced herein that the consumer has a right to assert defenses not on the ground that the policies applicable to checks apply here as well, but primarily because of administrative convenience.

A few states, it may be added, do subject issuers to consumer defenses. See, e.g., Ariz. Rev. Stat. Ann. § 44-145 (Supp. 1973) (intrastate purchases of consumer durables); Cal. Civ. Code § 1747.90 (West) (intrastate purchases over \$50); Mass. Gen. Laws Ann. ch. 255, § 12F (Supp. 1973); Vt. Stat. Ann. tit. 8, § 1305 (1970) (intrastate purchases). Given that issuers may charge back sums to depository banks, wherever located, these geographical limitations need more justification than has so far been shown to exist for them.

the price or damages until legal action is concluded. This creates a risk, that the inability to withhold payments may significantly impair a buyer's position, whose value is the product of the losses to the buyer that the lack of a self help remedy may cause, and the probability that those losses will materialize. When buyers purchase on credit and their sales are financed, the total cost of credit to them is thus the credit service charge, which under current law must be disclosed, and the value of the risk state law often creates, that buyers will be disadvantaged by being required to pay regardless of the seller's performance. For buyers accurately to price credit, they must be able to value this risk. But it seems unlikely that they will be able to do so, for its loss component and the probability that losses will be incurred are both terribly difficult to quantify.

If one accepts the premise that the amount of credit outstanding should be a function of its cost and consumer desires, current law is then undesirable; for when consumers cannot price credit accurately, they may purchase too much or too little of it, with reference to their actual wants. Allowing buyer defenses to be asserted against financiers obviously eliminates the risk of buyers being unable to withhold payments, because they can then do so. Thus, changing the law eliminates a risk, difficult of valuation, which causes resource misallocations.

Should the law be changed, sellers and financiers will face a different risk, that buyers will withhold payments. However, sellers and financiers can probably value this risk more accurately than buyers can value the risk they now face. Thus the price of credit will be more likely to signal to buyers all of the costs incident thereto. In sum, changing the law should produce fewer misallocations than now exist.

Moreover, reform is cheap because only legal rules need be changed. This is important, for actual markets are much less perfect than the ideal markets used for analysis, largely because of consumer ignorance. There is thus a case to be made for eliminating such ignorance whenever it appears. Doing that, however, can be quite costly. For example, providing buyers with accurate information as to the probability and costs of defects in products, which I have elsewhere argued should be done,³⁸ is likely to be an expensive business, which may necessitate the creation of administrative agencies to facilitate and police seller disclosure. The misallocations due to buyer ignorance of the value of being unable to withhold payments to financiers can be avoided much more cheaply by simply altering legal rules. The market imperfections attributable to current

³⁸ See Schwartz, *supra* note 4, at 29-32.

law insulating financiers from consumer defenses, it must be said, seem small, because the relevant costs apparently are low; but those costs nevertheless are likely to be higher than the costs of cure, which makes change desirable.

Market efficiency, in the sense that economists use the term, is worthwhile primarily because it allows consumers to determine what is produced. This value of consumer sovereignty, I have shown, implies abolition of the holder in due course rule in consumer sales, the prohibition of waiver of defense clauses and the allowance of sales defenses against issuers of credit cards. Other values, of course, impinge on this issue, and may point in other directions.³⁹ My thesis is only that the pursuit of optimality, in which our society often engages, makes requisite this legal reform.

³⁹ The principal argument against change is that it may exacerbate the position of the poor. Prices are likely to be lower under current law than after reform because bearing risks costs buyers money only when harm ensues; shifting risks to sellers or financiers costs money always. A poor buyer may feel that although he is unable to value the risk the law now creates, it is one which is unlikely to bankrupt him and cannot cause him physical harm. These being so, and money being tight, he would rather gamble, whatever the odds may be; changing the law precludes this option. There is no logical answer to this objection, as it depends on which values one chooses. I reject it on utilitarian grounds, that more people, including many low income consumers, will be better off with reform than without it.

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