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CONSUMER-CREDIT LEGISLATION: LIMITATIONS ON CONTRACTUAL TERMS

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I. INTRODUCTION: THE PLIGHT OF THE BUYER

Early efforts to protect consumers in credit transactions were mainly directed at eliminating "loan sharks" and inducing legitimate lenders to enter the small loan market.[1] To accomplish this program small loan laws were enacted in almost every state. In recent years, attention seems to have turned to protecting the indigent consumer involved in an installment sales transaction.

Studies on the plight of the low-income consumer describe an individual, usually a wage earner and often at or near the poverty level, who is lured into a store by clever advertising.[2] He probably is not difficult to lure; members of low-income families have been found particularly susceptible to "compensatory consumption."[3] Once in the store, the consumer is subjected to high-pressure salesmanship and, as a result, is often sold a much higher-priced item than the inferior goods advertised. If the merchandise nevertheless turns out to be defective or substandard, as sometimes happens, the buyer may have difficulty trying to recover from the seller. The buyer may discover that the installment sales contract which he signed has been assigned to a sales finance company or to a bank which claims ignorance about the deal between the seller and buyer. In effect, it asserts that it is a holder in due course, not subject to any of the buyer's defenses against the seller.

If the buyer refuses to make payments to the assignee when due, the latter may resort to the remedies available to a creditor when a

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1 Curran, Trends in Consumer Credit Legislation 2, 16 (1965) [hereinafter cited as Curran].

2 Among such studies are Caplovitz, The Poor Pay More (1963); Willging, Installment Credit: A Social Perspective, 15 Catholic U.L. Rev. 45 (1965); Comment, Instalment Sales: Plight of the Low-Income Buyer, 2 Colum. J. Law & Soc. Prob. 1 (1966); Comment, Translating Sympathy for Deceived Consumers into Effective Programs for Protection, 114 U. Pa. L. Rev. 395 (1966).

3 The term "compensatory consumption" has been used to describe a phenomenon observed by several persons who have studied the buying habits of persons with low incomes and with little hope of improving their economic or social status. Such persons have little chance of breaking out of the hard-core pocket of poverty in which they find themselves or of moving up the social ladder, so their natural striving for self-respect and esteem make them eager listeners to the "dollar-down, dollar-a-week" sales pitch, which in turn causes them to buy goods their income suggests they really cannot afford. "The car—or television or stereo—helps to compensate for [their] . . . other failures." Willging, supra note 2, at 52-53. See also Caplovitz, op. cit. supra note 2, at 12-13.

debtor has defaulted.[4] This usually includes the right to repossess the goods sold. In fact, the buyer may find that he has given a security interest in property other than the item sold and that this property is also subject to seizure. In states where it is legal, the buyer may discover that he has signed a cognovit note under which he has confessed judgment and thereby relieved the creditor of the burden of bringing him into court. Execution may then be levied on the debtor's non-exempt property, or, more likely, his wages will be garnished to recover the amount due on the installment sales contract. The latter course of action may in turn lead to the debtor's discharge from his job due to his employer's dissatisfaction with an employee who is in such a financial situation.

It is not suggested that this illustration is representative of the typical merchant who sells on credit, nor even of the typical consumer.[5] Regulatory laws, however, seldom are enacted to control the typical person or transaction. The illustration *is* representative of a sufficiently large number of transactions to have induced action by lawmakers and others, including those who are preparing the Uniform Consumer Credit Code (hereinafter the Credit Code).

Consumer education and full disclosure of credit information may be part of the answer to the problem of equalizing the bargaining power of the parties to the consumer-credit transaction, but at best it would seem to be a long-range solution.[6] To effectively equalize this relationship, therefore, the law must step in and remove the parties' control over some of the items normally left to bargaining. This is the basic function of the contract-limiting provisions discussed in this article.

In a sense, almost every provision of a consumer-credit law imposes some limitation on freedom of contract. Only a few of such contract-limiting provisions are discussed in this article. Such areas

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4 See Felsenfeld, Some Ruminations About Remedies in Consumer-Credit Transactions, pp. 555-65 infra.

5 The term "consumer," of course, is broad enough to cover a wide range of persons—the wealthy as well as the poor, the educated as well as the uneducated. It has been suggested, however, that

> problems of poor consumers differ more in degree than in nature from the problems of the middle-class consumer. [The poor consumers] . . . are more gullible, more easily cheated, less conscious of quality in the goods they buy, more likely to over-commit themselves, less likely to deal with middle-class stores where prices are lower, more likely to deal with high cost neighborhood stores and peddlers, less aware of credit charges, and less able to understand and assert their rights than are middle-class consumers.

Report of Special Committee on Retail Installment Sales, Consumer Credit, Small Loans and Usury to the National Conference of Commissioners on Uniform State Laws 39 (1965).

6 The principal draftsmen of the Credit Code have noted the limitations of disclosure legislation. See Jordan & Warren, Disclosure of Finance Charges: A Rationale, 64 Mich. L. Rev. 1285, 1320-22 (1966).

as limitations on finance charges, requirements as to disclosure of information, regulation of home-solicitation sales, and licensing of lenders are not examined. Rather, the focus is on certain provisions which sometimes are grouped together under the heading of "prohibited contract provisions." These include limitations on the collateral which may be taken to secure performance, on the size and spacing of payments, on confession of judgment, on wage assignments, on the negotiability of notes, and on the waiver of the law's protective provisions.[7]

II. RESTRICTIONS ON COLLATERAL

In its restrictions on the type of collateral which may be taken to secure performance under a consumer-credit transaction, the Second Tentative Draft of the Credit Code follows the pattern of existing laws by giving separate treatment to loans on the one hand and sales of goods or services on the other. This section analyzes these transactions from the standpoint of the type of collateral involved—real property, consumer goods, and wage assignments.

A. *Real Property*

The Second Draft permits a seller to contract for a security interest in real property in connection with a consumer-credit transaction only if the sale of goods or services involves maintenance, repair, or improvement of the buyer's real property and only if the debt amount is $1,500 or more.[8] On the other hand, in regulated small loan transactions (those of $2,500 or less),[9] the lender is forbidden to contract for a security interest in real property.[10] In both transactions, a security interest taken in violation of the statutory prohibition is void. In addition, such a violation of the Credit Code might subject the creditor to forfeiture of his credit service charge or loan finance charge and also to injunctions and civil monetary penalties;[11] and a lender licensed to make "regulated loans" may have his authority revoked for repeated and willful violations.[12]

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7 See, e.g., Cal. Civ. Code §§ 1804.1-.3 (West Supp. 1966); Md. Ann. Code art. 83, § 130 (1965); Mass. Acts 1966, ch. 284, §§ 10, 15; Pa. Stat. Ann. tit. 69, §§ 615-16 (Purdon 1965).

8 Credit Code § 2.406. Unless otherwise provided, all Credit Code references are to the Second Tentative Draft.

9 A regulated loan is defined in § 3.402 as a consumer loan in which "the amount financed is no more than [$2,500]" and the rate of the loan finance charge is in excess of 18% per year calculated on the unpaid balance of the debt. Section 4.201 of the First Tentative Draft had designated $1,500 to be the dividing line with regard to regulated consumer loans. In the Second Tentative Draft, the placing of the figure "$2,500" in brackets seems to indicate doubt as to what this dividing line ought to be.

10 Credit Code § 3.411.

11 Credit Code §§ 5.201(4), 6.105(1), (2).

12 Credit Code § 3.414(1)(b).

The Credit Code's pattern of restrictions on the taking of real property as security is similar to that of existing laws, insofar as a pattern can be discerned under those laws. The largest number of restrictions is found in small loan laws which deal with loans similar to the Code's "regulated loan." The small loan laws of about half the states prohibit the taking of security in real property.[13] A few of the existing installment sales acts also restrict the taking of collateral to the goods sold and accessions.[14]

On the whole, the policy of the Credit Code with regard to the taking of real estate as collateral would seem to be the proper one in that it prohibits a creditor from clouding the title of the debtor's real property where only a small credit transaction is involved. The restrictions are, of course, also designed to prevent overreaching by creditors in situations usually involving gross inequality of bargaining power between creditor and debtor and in which deceptive practices have occurred in the past.

B. *Consumer Goods*

As a general rule, the Second Tentative Draft provides that a seller in a consumer-credit sale may take a security interest only in the goods sold in the transaction and accessions to such goods.[15] This general rule, however, is subject to two exceptions. The first is analogous to the rule discussed above which permits a security interest to be taken in *real* property if the sale involves maintenance, repair, or improvement of that property. Thus, in the case of *personal* property, if the debt is more than a certain amount (undetermined in the Second Draft), the seller may take a security interest in the personal property maintained, repaired, or improved, even though such personal property itself was not sold in the transaction.[16] The second exception relates to add-on sales and cross collateral. The Credit Code permits a seller of goods to secure the debt arising from the present sale by contracting for a security interest in goods he previously sold to the buyer if either the seller or a transferee holds an existing security interest in them.[17] Goods sold in a subsequent sale also may be made security for a debt owing under a previous sale.

Such security interest in goods previously or subsequently sold apparently may be contracted for even though the installment contracts and payments thereunder are not consolidated. If, however,

13 See Curran 40 & n.237.

14 See id. at 108 & n.220.

15 Credit Code § 2.406.

16 Ibid.

17 Credit Code § 2.407. In this section the reference to "transferee" is bracketed, apparently indicating doubt as to whether the rule permitting cross collateral should apply when the chattel paper from the previous sale has been transferred.

the debts arising from two or more consumer-credit sales are consolidated into one debt payable on a single schedule, section 2.408 provides the standard formula for determining when specific collateral is released.[18] This section states that payments received by the creditor are "deemed to have been applied to payment of the debts arising from the various sales in the same proportion as the original debts arising from these sales bear to one another."

This pro-rating formula applies only to payments made after the consolidation of the contracts, not to payments made prior thereto. Thus, if a buyer purchases a refrigerator for $200, arranging monthly payments of $20, and six months later buys a television set for $300, the consolidated payments are $25 per month; the security interest in the refrigerator would be released first, because $10 of the $25 monthly payments would be allocated to the refrigerator. Even so, this formula is not as favorable to the buyer as the one used in the new Massachusetts law. Under that formula, the entire $25 payment each month would be allocated to the refrigerator for the purpose of determining when the security interest in the refrigerator is released.[19]

Comparing these provisions with similar provisions in existing laws, one finds that only the "all goods" installment sales laws of California, Connecticut, Delaware, and Massachusetts contain any restrictions on the taking of personal property as collateral.[20] They generally prohibit the taking of a lien on goods already paid for or not previously sold by the seller. The new Massachusetts law goes further and provides that a security interest may not be taken in goods previously sold by the seller unless there is a consolidation of the installment contracts.[21] Eight of the existing motor vehicle installment sales laws limit the taking of a security interest to the motor vehicle sold or accessions thereto.[22]

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[18] See statement by Professor William D. Warren, Reporter-Draftsman for the Uniform Consumer Credit Code, Proceedings in Committee of the Whole, National Conference of Commissioners on Uniform State Laws 11 (Aug. 4, 1966).

[19] Mass. Gen. Laws Ann. ch. 255D, § 18B (Supp. 1966) provides that "payments made under the consolidated agreement shall be applied toward the unpaid amounts in the order of the purchase of the goods or services."

Both the Credit Code and the Massachusetts law would preclude the type of practice held unconscionable in Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965). The contractual provision in that case stated that "all payments now and hereafter made by [purchaser] . . . shall be credited pro rata on all outstanding leases, bills and accounts" due the seller at the time each payment is made. Id. at 447. (Italics omitted.) The effect of this provision was to keep a balance due on every item purchased until the balance due on all items had been paid, and thus to maintain the seller's security interest in all items that the buyer purchased from him, past or future.

[20] See Curran 312-22 (chart 19, col. 15), which lists all but the Massachusetts act which was enacted in 1966. Mass. Gen. Laws Ann. ch. 255D, §§ 15, 18 (Supp. 1966).

[21] Mass. Gen. Laws Ann. ch. 255D, § 15(c) (Supp. 1966).

[22] Those states are California, Hawaii, Illinois, Kentucky, Massachusetts, New Hampshire, New York, and North Dakota. Curran 312-22 (chart 19, col. 16).

Although the Credit Code limits the taking of security interests in personal property in connection with consumer *sales*, the Second Tentative Draft imposes no restrictions on the taking of such security interests in consumer *loans*. In this respect, it follows the general pattern of existing law; a lien on household goods is only rarely prohibited by existing small loan laws.[23] One of the reasons for distinguishing lenders from sellers may be that the former have traditionally been more closely supervised by various state regulatory agencies than have sellers. This supervision would continue under the proposed Credit Code.[24]

It should be noted that several existing small loan laws, although not prohibiting security in personal property, require the signature of both the borrower and his spouse on any instrument creating a security interest in household goods.[25] It is doubtful whether this requirement has provided significant protection against imprudent borrowing or overreaching lenders, and it has not been incorporated into the Credit Code.

C. *Wage Assignments*

The Second Tentative Draft absolutely prohibits a seller from taking an assignment of earnings of the debtor as security for payment of a debt arising out of a consumer-credit sale.[26] There is no such prohibition against a wage assignment in connection with a consumer-loan transaction, although the drafters did restrict any assignment to that part of a debtor's earnings which exceeds $100 in any calendar week.[27] For the purpose of determining a debtor's weekly earnings, amounts encumbered by garnishment or like proceedings or by other irrevocable assignments are to be excluded. The purpose is to safeguard at least $100 of the debtor's earnings on the theory that the debtor is entitled to a living wage free from the claims of his creditors. A similar restriction is imposed on wage garnishments.[28]

Unlike the sections which restrict the taking of security interests in real property and tangible personal property, the sections restricting wage assignments do not state specifically that the prohibited assignments are void.[29] Such an assignment, however, would of course be

[23] Id. at 41.

[24] Lenders wishing to make regulated loans (loans of $2,500 or less on which the interest rate exceeds 18% per year) would have to have "authority" from the state regulatory agency. See Credit Code §§ 3.403, .412, .413. The proposed Code imposes no similar licensing requirement for installment sellers.

[25] Curran 41-42.

[26] Credit Code § 2.409.

[27] Credit Code § 3.106.

[28] Credit Code § 5.103.

[29] See Credit Code §§ 2.409, 3.106.

unenforceable,[30] and a seller or lender who takes such an assignment would violate the Code and presumably subject himself to the injunctive and monetary sanctions of section 6.105.

Wage assignments are presently regulated in almost every state, but the exact degree of regulation varies widely.[31] The state regulations may be found in small loan laws, in installment sales laws, in general laws relating to wage assignments, and sometimes in all three[32]—all of which would have to be reconciled with a uniform consumer-credit law. Most states which permit wage assignments under their small loan laws follow the Uniform Small Loan Law by requiring that the assignment be in writing, signed by the spouse, and executed at the time the loan proceeds are delivered to the borrower.[33]

In the early thirties, a study was conducted on the burdens which wage assignments imposed upon the low-income debtor.[34] It was common practice at that time for employees to assign their wages as security for payment of consumer loans and installment sales contracts. If the employee defaulted in his payments, the lender or seller would threaten to file the assignment with the debtor's employer. Of course, the mere threat to file, which was carried out if the debtor remained in default, constituted enormous pressure on the debtor in view of the general attitude of employers to disfavor wage assignments. The policy of many employers was to discharge an employee when three wage assignments had been filed against him. Although this discharge policy was not uniformly followed, nevertheless the employee was often subjected to other abuses. For example, an employer who must routinely handle a large number of assignments often enforces the invalid along with the valid ones.[35]

It is not known whether employers disfavor wage assignments today to the same extent that they did thirty years ago. There has probably been little change, since the extra clerical work involved continues to be an expense and a nuisance.[36] Since wage assignments often represent a threat to an employee's job, a provision which prohibits or limits them in consumer-credit transactions is laudable.[37]

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30 See Restatement, Contracts §§ 580, 598 (1932).

31 Thirty-four states have general laws on the subject of wage assignments. See Curran 342-47.

32 See id. at 40-42, 108, 128-29, 342-47 (chart 22). The laws vary from outright prohibition of wage assignments to a mere requirement that they be made in writing.

33 Id. at 42.

34 See Fortas, Wage Assignments in Chicago—State Street Furniture Co. v. Armour & Co., 42 Yale L.J. 526 (1933).

35 Id. at 536-38.

36 Wage assignments, however, would seem to be somewhat less onerous than garnishments since the former do not require court appearances.

37 If wage assignments are not to be absolutely prohibited in such transactions, it makes sense to provide for the same kind of exemption as is provided with regard to

Of course, a broad wage exemption policy may mean that credit will not be available in some instances where it might otherwise have been granted, but these probably are instances in which credit should not be extended at all. An alternative to absolute prohibition of wage assignments in connection with consumer-credit sales might be to permit them only if the employer consents to the assignment at the time it is made. Such a provision, however, still ought to be coupled with a limited monetary exemption in order to insure a minimum living wage.

III. Restrictions Relating to Payment

A. *Balloon Payments*

Section 2.405 of the Second Tentative Draft states that when "a consumer credit sale is payable in instalments no instalments contracted for may be substantially greater than any preceding instalment, except that the last instalment may be as much as twice the average of the preceding payments." An exception is allowed "if the payment schedule is adjusted to the seasonal or irregular income of the buyer or to acommodate the nature of the buyer's employment such as acquiring goods from his employer for use in demonstrating or selling similar products." Regulation is necessary in this area since the "balloon payment"—an abnormally high payment generally due at the end of the contract period—has been subject to abuse. Its use allows the creditor to quote unusually small installment payments, leaving the debtor with a final payment so large that it may force him to default.

There are, of course, legitimate uses for balloon payments, such as in the case of the seasonal worker with uneven income. The nature of certain kinds of employment also calls for valid uses of balloon payments. An example of the latter is the automobile salesman who buys a demonstrator under a balloon-payment contract with the anticipation of selling the car and making the large payment at the end of the model year.

A balloon-payment provision similar to that on sales applies to regulated loans under the Credit Code. Section 3.410 states that if such a loan "is payable in instalments no instalment may be more than twice as large as the average of all other instalments." Presumably, both sections relate to installments "contracted for," even though section 3.410 does not explicitly so state. Unlike section 2.405 on sales, there is no exception in section 3.410 for seasonal or irregular employment of the borrower. It is unclear whether the draftsmen thought such an exception unnecessary in the case of small loans or

garnishments. For an excellent exposition of the problems stemming from wage garnishments, see Brunn, Wage Garnishment in California: A Study and Recommendations, 53 Calif. L. Rev. 1214 (1965).

whether the different phraseology of section 3.410 will permit sufficient flexibility to take care of any adjustments that the nature of the employment might warrant. As an example of such flexibility, section 3.410 would seem to permit some large payments if the other payments were proportionately small, and large payments would not necessarily have to come at the end of the payment period.

Prohibitions of or restrictions on balloon payments are fairly common in existing consumer-credit laws. Many states have adopted the Uniform Small Loan Law's provision that installments must be payable at approximately equal intervals of time and that no installment shall be substantially greater in amount than the preceding installment. Most of these laws, however, make no exceptions for special employment situations.[38] Some of the existing installment sales acts also prohibit balloon payments, but others contain special provisions which differ from those in the proposed Credit Code. Under a few of these acts, the installment buyer is entitled to have his payments rescheduled if he defaults on a payment which is two or more times the average amount of all the installments. Under two acts, the seller may arrange for balloon payments but is limited to a charge of six per cent per annum on such payments, a restriction which tends to discourage their use.[39]

The new Massachusetts Retail Installment Sales Act provides that the amount of the installments must be substantially equal, except for the down-payment. Moreover, the intervals between installments must be substantially equal. An exception to these requirements is made if the buyer is given an absolute right upon default in any "excess or irregular installments" to have the schedule of unpaid installments revised to conform both in amount and intervals to the average of all preceding installments and intervals.[40] Like the Credit Code, the Massachusetts law also contains an exception for the buyer who has an uneven seasonal income, but, unlike the Code, Massachusetts does not attempt to accommodate the nature of the buyer's employment.

The relatively flexible balloon-payment provisions of the Credit Code probably provide somewhat less protection to consumers than some of the more rigid restrictions in existing consumer-credit laws. It should also be noted that the proposed Credit Code guarantees the right of the debtor to pay the debt in full prior to maturity,[41] so that in a sense a debtor can voluntarily make a balloon payment even

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38 See Curran 31 n.133.

39 See id. at 106.

40 Mass. Gen. Laws Ann. ch. 255D, § 10(3) (Supp. 1966).

41 Credit Code §§ 2.401, 3.105, .407.

though the contract does not provide for it.[42] This may eliminate some of the need for special exceptions to the general prohibition against contractual provisions for balloon payments.

B. *Acceleration Clauses*

Another contractual provision which may be subject to the same kind of abuse found in the balloon payment is a provision giving the creditor the right to accelerate payments at will or whenever he deems himself insecure. Apparently, therefore, a number of existing retail installment sales acts prohibit provisions which permit the creditor arbitrarily to accelerate any part or all of the amounts owing. Some would permit such acceleration only upon the debtor's default.[43] Unfortunately, there is no similar prohibition in the Second Tentative Draft. The Code ought to include a provision which would prohibit a contractual clause permitting the seller or lender to accelerate payments other than upon the debtor's substantial default. Although an unrestricted acceleration clause would probably be held void,[44] the matter should not be left to judicial determination.

IV. Restrictions on the Remedies of the Seller and His Assignee

A. *Unconscionable Contractual Provisions*

To what extent should consumer-credit legislation prohibit specific unconscionable contract clauses? For example, is it necessary for the statute to contain a specific prohibition against clauses whereby the buyer waives benefits which the law provides, or agrees not to assert a claim against the creditor for the illegal repossession of property or the illegal collection of accounts? Some existing installment sales laws do contain such prohibitions.[45] Although there are no similar prohibitions in the Second Tentative Draft, courts would still very likely refuse to enforce such clauses since they are so inconsistent with the general public policy behind consumer-credit laws. Nevertheless, it would seem desirable to prohibit them expressly so as to remove any doubt of their illegality.

The Second Tentative Draft does, however, move in this direction by the insertion of a general unconscionability section. Like the

[42] A few existing laws (notably the small loan laws) have also been concerned about unduly extending the payment schedule and hence have placed limits on it. Curran 32. A similar limitation has been included in the Second Tentative Draft with regard to the length of terms of "regulated loans." No such restriction, however, has been placed on the schedule of payments under consumer-credit sales.

[43] Id. at 312-22 (chart 19, cols. 4, 5).

[44] See U.C.C. § 1-208, Comment.

[45] E.g., Cal. Civ. Code §§ 1804.1(d)-(i) (West Supp. 1966); N.Y. Pers. Prop. Law § 403(3)(d)-(g) (McKinney 1962). See Curran 107-08.

Uniform Commercial Code, the Draft authorizes a court to refuse to enforce a contract or any clause which it finds as a matter of law to be unconscionable at the time the contract was made.[46] Note that since the Uniform Commercial Code is directed only at contracts for the sale of goods,[47] enactment of the Credit Code would have the effect of extending the unconscionability rationale to contracts involving the sale of services.

The problem of defining unconscionability is acute. One court said that it involves an absence of meaningful choice on the part of one of the parties and the presence of contractual terms which are unreasonably favorable to the other party.[48] Gross inequality of bargaining power, together with lack of reasonable opportunity to understand the terms of the contract due to lack of education or deceptive sales practices, is indicative of the absence of meaningful choice. Reasonableness or fairness are difficult to determine, but will generally depend on whether the terms are so extreme as to appear outrageous according to the mores and business practices of the time and place of the contract's formation.

It is submitted that in a regulatory law designed to protect the weaker party to a commercial transaction, the function of a flexible concept such as unconscionability should be to buttress the specific regulatory provisions of the law rather than to substitute for them. From the buyer's standpoint, the ability to point to specific rules which control the seller in the exercise of his remedies, or which control other practices which commonly lend themselves to abuse, is important. From the seller's or financing agency's standpoint, it should be equally important that the borderline between lawful and unlawful conduct is spelled out to the greatest degree practicable.

B. *Confession of Judgment*

Although most states have passed laws dealing with cognovit clauses, the manner of treatment varies greatly. Seven states specifically allow them to be used, but some of these states limit or even prohibit their use in certain consumer-credit transactions. Twenty-three states, while allowing a confession of judgment, place various procedural limitations on it. Finally, and most drastically, fifteen states make cognovit clauses void.[49]

The Uniform Small Loan Law contains a provision stating that "no licensee shall . . . take any confession of judgment or any power

46 Credit Code § 2.411.

47 See U.C.C. §§ 2-102, -302.

48 Williams v. Walker-Thomas Furniture Co., supra note 19.

49 Hopson, Cognovit Judgments: An Ignored Problem of Due Process and Full Faith and Credit, 29 U. Chi. L. Rev. 111, 126-27 (1961).

of attorney running to himself or to any third person to confess judgment or to appear for the borrower in a judicial proceeding."[50] This or a similar provision has been incorporated into the small loan laws of most states.[51] In addition, some of the existing installment sales laws contain a provision prohibiting the creditor from taking a power of attorney to confess judgment.[52] There is no comparable provision in the Second Tentative Draft of the Credit Code.

In 1961, a survey on the use of cognovit clauses was conducted among lawyers and executives of sales finance companies, small loan companies, banks, and trade associations.[53] It appeared from this study that the finance industry is sharply divided on the use of cognovit judgments.[54] Most of the persons contacted implied that cognovit judgments were rarely taken in the case of small consumer loans. However, a survey of cases in the Municipal Court of Chicago for 1960 showed that there were 45,402 suits on confession of judgment out of a total of 193,191 suits filed that year.[55] Most of the finance companies which did not use cognovit clauses appeared to have been concerned with two factors: (1) the ill will resulting from public reaction to the clause, and (2) the inherent unfairness of the judgment procedure involved. Those who defended the cognovit clause presented two basic arguments: (1) the clause provides justice to the lender who needs a quick and cheap lien against a debtor whose only excuse for nonpayment is inability or unwillingness; and (2) the clause does not overpower the debtor since judges liberally vacate a confession judgment whenever the debtor alleges any defense, no matter how weak. With reference to the latter argument, it should be noted that there probably are not many defendants who obtain a lawyer and avail themselves of the opportunity to reopen the judgment.[56]

On the basis of this survey, it was concluded that there are at best limited arguments in favor of the use of cognovit clauses in any type of credit instrument, and that the finance industry itself would not object too strenuously to complete abolition.[57] In addition, an increasingly substantial hostility to the use of cognovit judgments was noted among state legislatures and high courts.[58] To the extent that this report accurately reflects contemporary thinking, it would seem appropriate to incorporate into the Credit Code a prohibition on the

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50 Curran 154.
51 Id. at 41.
52 Id. at 108, 312-22 (chart 19, col. 6).
53 Hopson, supra note 49, at 114.
54 Id. at 117.
55 Id. at 119.
56 Id. at 119-22.
57 Id. at 125.
58 Id. at 131.

use of cognovit clauses in instruments relating to consumer-credit transactions.

C. *Debtor's Waiver of Defenses Against Creditor's Assignee*

The buyer often must contend with a sales finance company or bank which, as the assignee of the installment sale contract, asserts that it is not subject to any of the buyer's defenses against the seller-assignor, *i.e.*, that it is a "holder in due course." This problem has led a number of states to incorporate into their installment sales laws a provision prohibiting clauses by which the buyer agrees not to assert against an assignee any claims or defenses which the buyer might have against the orginal seller. In addition, some of these laws restrict the use of negotiable notes in connection with installment sales contracts or restrict the negotiability of notes which are used.[59] It does little good to prohibit a waiver of defenses in the installment sale contract if the defenses may be waived by the buyer giving the seller a negotiable note which may be negotiated to a holder in due course. Conversely, it does little good to prohibit use of negotiable notes in connection with installment sales if, in effect, negotiability may be imparted to the sales contract by a waiver clause effective to cut off the buyer's defenses.

The Second Tentative Draft properly recognizes the need for restrictions both on the transfer by the seller of the credit-sale contract and on the use of negotiable promissory notes. Section 2.404 renders ineffective a clause in the sales contract by which the buyer waives any defenses against the seller's transferee which he may have had against the seller.[60] Unlike similar provisions in some existing laws, there is no prohibition against inserting the clause itself in the contract. This omission may seem unimportant, but it may be desirable to make it a violation of the Credit Code to include unenforceable clauses in a contract. It is conceivable that the mere presence of such unenforceable clauses may have an *in terrorem* effect and

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[59] See Curran 108, 312-22 (chart 19, cols. 1, 3). Restrictions on the "holder-in-due-course" status of a financing company may be the result of the often close relationship between transferor and transferee. See Littlefield, Parties and Transactions Covered by Consumer-Credit Legislation, pp. 466-69 supra. Among the many other recent commentaries which have discussed this issue are the following: Jones, Finance Companies as Holders in Due Course of Consumer Paper, 1958 Wash. U.L.Q. 177; Comment, 55 Nw. U.L. Rev. 389, 394-402 (1960); Note, 102 U. Pa. L. Rev. 782 (1954). In addition, there is an extensive annotation in 44 A.L.R.2d 8 (1955).

[60] That section provides:

> Except as provided in section 2.403, with respect to a consumer credit sale a transferee of the seller's rights is subject to all claims and defenses of the buyer against the seller arising out of the sale notwithstanding an agreement to the contrary, but the transferee's liability may not exceed the amount of the debt at the time the transferee acquires his rights.

consequently may deter buyers from pursuing remedies which are available to them.

Section 2.403 prohibits a seller in a consumer-credit sale from accepting a promissory note payable to order or bearer as evidence of the obligation of the debtor. However, if the seller violates this provision and takes a negotiable note, he may nevertheless negotiate it to a holder in due course who may then enforce it according to its terms. An unscrupulous seller, therefore, could nullify the buyer's statutory protection simply by violating the Code's mandate not to accept a negotiable note from the buyer. It is exactly this kind of seller against whom the buyer most needs protection. Therefore, a better provision would be to make a holder of a "negotiable" note, given in connection with a consumer-credit sale, subject to the claims and defenses which the buyer might have asserted against the original seller. By avoiding a statutory declaration that the note is nonnegotiable, certain procedural advantages of holders of negotiable instruments could be preserved,[61] while at the same time subjecting the holders to substantive defenses which the maker might have claimed against the seller.

The basic policy problem is one of balancing the interest of the commercial community in the unrestricted negotiability of commercial paper against the interest of installment buyers in the availability of their normal remedy of withholding payment when defective merchandise has been sold to them. Some existing installment credit laws attempt to balance these interests by providing that assignees of consumer sales contracts and transferees of notes take subject to defenses which the buyer might have against the seller, but that they may free themselves from such defenses by following a specific procedure.[62] This procedure generally requires sending to the buyer a fairly complete statement of the transaction involving the transfer. If this statement is not correct, or if the buyer has some claim or defense against the seller, he must so notify the assignee from whom he received the notice. He is generally given only ten or fifteen days in which to make the reply. If he does not notify the assignee of a claim or defense within that period, he is barred from subsequently raising it. The Second Tentative Draft does not provide for such a procedure, but the comment which was appended to section 6.102 of the First Tentative Draft indicates that some thought had been given to it at one time. The comment noted that experience has shown that a period of ten or fifteen days may be too short, and that a period of at least thirty days may be desirable. It is submitted that even a thirty-day

61 See U.C.C. § 3-307.

62 See, e.g., Cal. Civ. Code § 1004.3 (West 1954); N.Y. Pers. Prop. Law § 403 (McKinney 1962).

period may be too short a time in which to discover latent defects in the goods purchased.

Like existing consumer-credit laws, the Second Tentative Draft does not attempt to bar the use of negotiable notes in consumer-loan transactions, as distinguished from consumer sales. There may be a number of valid reasons for this distinction, among the more important of which is that the problem of defective or undelivered merchandise is not present in the case of consumer loans.

Perhaps the basic question here is whether the buyer or the financial institution which purchases the seller's paper should bear the risk of an unethical or insolvent seller. Where one of two equally "innocent" persons must suffer a loss, the loss should be placed on the person best able to bear it. The financial institution, through use of its investigative facilities, or through recourse agreements and dealer reserves, is much better equipped than the buyer to avoid the risk, or to avoid any loss. Furthermore, the institution can pass the loss on to others in the form of increased credit costs.[63]

V. Conclusion

Anyone attempting to evaluate the contract-limiting provisions of the Uniform Consumer Credit Code might do well to consider some of the points made by the committee assigned the task of drafting it. In its 1965 report to the Conference of Commissioners on Uniform State Laws, the committee noted that since consumer-credit legislation is aimed at protecting the consumer, it is fair to ask from what precisely is the consumer to be protected.

> Must he be protected from his own lack of knowledge or discipline which leads him to take advantage of easy credit to buy things he does not need or cannot afford? Is he to be protected from the "fringe" operator who may take advantage of the ignorance and gullibility of the consumer to cause him to overbuy or to pay too much? . . . [Or rather should attention] be focused on making the credit market more

[63] There is some evidence that the barring of waiver clauses or negotiable notes in consumer-credit transactions does not present any great problem to financers. Thus, it has been said that Pennsylvania bankers experienced no trouble with the pre-1957 version of U.C.C. § 9-206 which made assignees of installment sales contracts or holders of negotiable notes subject to defenses which a buyer of consumer goods might have asserted against the seller. Felix, Experience with Dealer and Consumer Financing Under the U.C.C., 73 Banking L.J. 229, 233 (1956). It also has been said that a 1943 decision of the New Mexico Supreme Court holding the financer subject to the buyer's defenses did not materially affect sales financing in that state. "The only real difference between pre- and post-1943 financing in New Mexico was that the financing institutions of the state required the retailer to establish a larger reserve to take care of possible warranty defenses." Vernon, Priorities, the Uniform Commercial Code and Consumer Financing, 4 B.C. Ind. & Com. L. Rev. 531, 547 (1963).

> perfectly competitive by, among other things, requiring full disclosure of credit terms on a uniform basis to the extent that such disclosure is feasible, by educating consumers for more intelligent use of credit, and by putting the credit grantor and the consumer on a more equal bargaining basis[?][64]

It seems clear, as the committee noted, that consumer education and full disclosure of credit information is not enough, and that what is needed is a balanced approach designed to encourage the use of legitimate sources of credit while ridding the credit industry of the harmful practices of the minority.[65]

One aspect of this balanced approach is the limitation imposed by statutory provisions on the right of the parties to bargain freely on the terms of the credit transaction. An attempt has been made in this article to examine critically some of these provisions of the proposed Credit Code, particularly in comparision with similar provisions in existing legislation. The objective was to focus attention on this area of consumer-credit legislation in the hope that further consideration might be given to some of the problems raised. It seems clear that the Code, when enacted, will substantially improve consumer protection in most states, and that it will do so without impairing the important social and economic functions which consumer credit serves.

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64 Report of Special Committee on Retail Installment Sales, Consumer Credit, Small Loans and Usury to the National Conference of Commissioners on Uniform State Laws 9 (1965).

65 Id. at 10.