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Robert F. McLaughlin

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WAIVER OF DEFENSE CLAUSES IN THREE PARTY CONSUMER CREDIT CARD TRANSACTIONS

There are two ways that an institution involved in the financing of retail installment sales of consumer goods can enforce its claim for payment against a purchaser in spite of his dispute with the merchant over the conformity¹ of the goods: (1) it can claim holder in due course status of the buyer's promissory note,² or (2) it can seek to enforce a waiver of defense clause to which the purchaser has agreed as part of his sales contract.³ Issuers of three party consumer credit cards⁴ have thus far found it unnecessary to use either means, since under the provisions of virtually all consumer protection legislation they enjoy the status of lenders.⁵ Lenders are not subject to the borrower's defenses against the seller of goods which were bought with the borrowed money. Nevertheless, credit cards issued by banks generally contain waiver of defense clauses, perhaps in anticipation of the possibility that these card transactions will lose their status as consumer loans and will be considered as consumer credit sales. If this happens then the issue of whether or not to enforce these waiver of defense agreements will be squarely presented.

In the area of consumer credit sales, financiers have witnessed a slow but gradual loss of their status as holders in due course. Similarly, their ability to enforce waiver of defense agreements against consumers has been subject to increasing legislative restriction. This comment examines the question whether the enforcement of waiver of defense clauses should also be prohibited in the context of consumer credit card transactions.

I. Section 9-206 of the Uniform Commercial Code

In the drafting of Article 9 of the Uniform Commercial Code, the question of the consumer-buyer and his defenses against the seller's assignee was a subject of great debate and controversy.⁶ The

¹ U.C.C. § 2-106(2) provides that goods or performance "conform" to the contract, "when they are in accordance with the obligations under the contract." All references to the Uniform Commercial Code are to the 1962 official text.

² U.C.C. §§ 3-302(1), 3-305(2).

³ U.C.C. § 9-206.

⁴ A 3-party credit card normally involves a bank or card company (the card issuer), the person using the card (the cardholder), and a merchant who has contracted with the issuer to honor the issuer's cards when presented and to sell the accounts arising from the honoring of these cards to the issuer at a discounted rate. This should be distinguished from a 2-party credit card issued by large department stores to their customers. Since these large stores are in a position to finance the charges of their customers without resorting to independent financing from an issuing company, the relationship is directly between store and customer.

⁵ See generally Littlefield, *Parties and Transactions Covered by Consumer-Credit Legislation*, 8 B.C. Ind. & Com. L. Rev. 463 (1967). Compare the Uniform Consumer Credit Code (U.C.C.C.) § 2-104 (definition of a "consumer credit sale") with U.C.C.C. § 3-104 (definition of a "consumer loan").

⁶ For an example of the legislative history surrounding the drafting of U.C.C.

early drafts manifested an intent to protect the consumer against contracting away these defenses by incorporating a specific prohibition against waiver of defense clauses in Section 206 of Article 9.⁷ The drafters ultimately decided, however, to leave such protection to the courts of the individual states or to their respective Retail Installment Sales Acts.⁸

Proponents of waiver of defense clauses, banks and other financing institutions, argued that they were able to participate in the field of consumer sales financing only by being free of the personal defenses which a buyer might be able to assert against a seller.⁹ Those who argued the consumer's cause reasoned that waiver clauses should be made unenforceable by statute since no one would freely choose to forego rights which under the appropriate circumstances might be the only ones available.¹⁰

Section 9-206, as ultimately drafted, gives a seller's assignee the right to enforce "an agreement by a buyer or lessee that he will not assert against an assignee any claim or defense which he may have against the seller or lessor"¹¹ Under section 9-206, an assignee who seeks to enforce such an agreement must be one, "who takes his assignment for value, in good faith and without notice of a claim or defense"¹² Because of the controversy engendered by attempting to make such agreements enforceable against consumers, however, section 9-206 makes enforceability in the consumer goods area, "subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods"¹³ In jurisdictions which enforce waiver of defense clauses against consumers, "a buyer who as part of one transaction signs both a negotiable instrument and a security agreement"¹⁴ waives his defenses by implication.

If the failure of the U.C.C. to adopt a uniform prohibition against waiver agreements was a victory for those engaged in the financing of consumer transactions, the victory has been subject to legislative and judicial erosion with the passage of time. In *Unico v. Owen*,¹⁵ for example, after the court found that an assignee did not

§ 9-206, see New York Law Revision Commission, Report of the Law Revision Commission and Record of Hearings on the U.C.C. 1018-1250 (1954) [hereinafter cited as New York Report].

⁷ Id. at 1046-51.

⁸ See U.C.C. § 9-206(1) which contains the following proviso: "Subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods"

⁹ New York Report 1105.

¹⁰ Id. at 1046-51.

¹¹ U.C.C. § 9-206(1). Under this section a buyer can not contract away defenses which, under U.C.C. § 3-305(2), would be good against a holder in due course.

¹² Id.

¹³ Id.

¹⁴ Id.

¹⁵ 50 N.J. 101, 232 A.2d 405 (1967). Among other cases denying holder in due course status are *Calvert Credit Corp. v. Williams*, 244 A.2d 494 (D.C. Mun. Ct. App.

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qualify for holder in due course status because of its proximity to the underlying sales transaction, it also struck down the waiver clause written into the conditional sales contract as being against public policy in consumer goods transactions.¹⁶ In view of the growing importance of credit cards in consumer transactions, the problem of whether or not to enforce waiver agreements has presented itself in a new and important context. Part of the solution to the problem involves the applicability of section 9-206 to three party consumer credit cards. This applicability, in turn, depends on an examination of the buyer-assignee relationship in consumer sales.

II. THE PROBLEM: BUYER V. ASSIGNEE

Many consumer items are purchased on a retail installment basis whereby the buyer makes periodic payments on the item until the price is paid in full. The normal expectation of such a buyer is that if this merchandise is defective he can stop making payments, demand that any payments already made be returned, and return the defective goods to the seller. If the merchant had himself held the contract of sale and the promissory note, then the buyer's expectations would be fulfilled. This, however, is seldom the case.

In most instances the merchant, whose own limited capital resources prevent him from financing these transactions, "discounts" this promissory note ("chattel paper")¹⁷ by selling it to a financing institution for a price which is a certain percentage lower than the price of the goods. This transaction involves an assignment of the sales contract and a negotiation of the promissory note to the financier, whereupon the buyer will receive notice to make his payments to the financier.

The problem arises when, owing to defective merchandise or to some other default on the part of the seller, the purchaser withholds his payments to the financing institution. The financier notifies the buyer that continued failure to pay will lead to legal action for the balance of the purchase price or to repossession of the goods. Barring legislation to the contrary, section 9-206 gives the financier-assignee an option. Suit can be brought on the balance due free of the buyer's claim against the seller if the financier qualifies as a holder in due course of the buyer's promissory note.¹⁸ Secondly, the financier-assignee may sue on the sales contract free of the buyer's claim,

1968); *American Plan Corp. v. Woods*, 16 Ohio App. 2d 1, 240 N.E.2d 886 (1968); *Westfield Inv. Co. v. Fellers*, 74 N.J. Super. 575, 181 A.2d 809 (L. Div. 1962); *Commercial Credit Co. v. Childs*, 199 Ark. 1073, 137 S.W.2d 260 (1940).

¹⁶ 50 N.J. at 125, 232 A.2d at 418.

¹⁷ "Chattel paper" means a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods. When a transaction is evidenced both by such a security agreement or a lease and by an instrument or a series of instruments, the group of writings taken together constitutes chattel paper, see U.C.C. § 9-105(1)(b), Comment 4.

¹⁸ U.C.C. §§ 3-302(1), 3-305(2).

either because it contains an express waiver of defense clause, or because the buyer's execution of a negotiable note and a security agreement as part of the contract of sale is, under section 9-206, an implied-in-law agreement by the buyer that he will not assert such claims against an assignee of that contract.¹⁹ In any event, the buyer will owe the full purchase price on a purchased item which is unsatisfactory to him.

To place the magnitude of the problem in its proper perspective, however, it is accurate to say that most consumers are satisfied with the goods or services which they have purchased. Even in the event that they are not, most merchants choose to satisfy these complaints with a credit for the returned merchandise or with an appropriate price adjustment. Difficulties arise most often in the case of the low income consumer who is forced to deal with merchants of questionable business ethics who often deal in substandard goods. This type of merchant may never intend to give satisfaction whether or not the complaint is justified, and he may already have become insolvent or disappeared by the time a product manifests a defect. Aside from these situations, the issue arises again when a merchant decides that the goods are not defective and thus refuses to give his customer satisfaction for what he considers to be justifiable reasons.

III. THE APPLICABILITY OF SECTION 9-206 TO BANK-ISSUED CONSUMER CREDIT CARDS

The credit card has already become a nationwide purchasing instrument and is quickly replacing cash, checks, and various forms of purchase money financing. The selection of goods and services available to cardholders is extremely broad and credit card are accepted by restaurants, hotels, clothing and appliance stores, gas stations and airlines. Three party credit cards fall into three general categories: travel and entertainment cards, oil company cards, and bank-issued cards.²⁰

With respect to the first two categories, the issue of enforcing waiver of defense clauses has somewhat limited viability. Travel and entertainment cards are invariably presented to merchants who deal in services or in the type of goods in which defects will be immediately apparent. Most often these services have already been provided before the card is presented for payment. In the case of dining, for example, a dispute with a restaurant over the quality of the food or service would in all likelihood be resolved before a cardholder made his payment. If the customer's complaint was not remedied, he would undoubtedly refuse to tender payment until his claim was settled.

¹⁹ U.C.C. § 9-206 provides: "A buyer who as part of one transaction signs both a negotiable instrument and a security agreement makes such an agreement."

²⁰ The three established travel and entertainment cards are American Express, Diners' Club and Carte Blanche. BankAmericard and Master Charge comprise the two major bank-issued card systems.

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When this cardholder does present his card for payment, any price adjustments made in settlement of the dispute would be reflected in the price of the goods or services.

The majority of oil company cards are presented to merchants who are either lessees of the card-issuing corporation or are de facto agents of the issuer by virtue of their identification with his products. Thus a breach of warranty²¹ or some other nonconforming²² performance arising from a purchase from such a merchant might be imputable to the issuer by virtue of this relationship. Under the rationale of section 9-206, the issuer could be denied the status of an assignee taking without notice of a claim or defense, and could accordingly be denied the benefit of a waiver of defense clause.²³ Furthermore many oil company cards do not include waiver of defense clauses.

Bank-issued cards, on the other hand, are often used to purchase the type of consumer goods, like home appliances, in which defects arise only after the sales transaction has been consummated. Unlike travel and entertainment or oil company cards, both of which are generally issued to middle or high income consumers,²⁴ bank cards are available to relatively low income purchasers who are more likely to deal with unreliable merchants.²⁵

Like retail installment sales, bank card programs operate on the principle of facilitating the purchase of consumer goods or services by delaying payment until some future time. At the time of the sale, the cardholder presents his card to the merchant who imprints it on a sales ticket. This record of the transaction is forwarded to the issuer, who pays the merchant in cash and in turn bills the cardholder.

The bank's primary financial interest in the transaction is twofold: (1) member merchants pay discounts of from 1 to 6 percent on each card transaction slip which they sell to the bank, and (2) cardholders pay finance charges on their purchases.²⁶ The formula for computing these charges is generally as follows: the cardholder agrees that he will pay to the issuer the amount due within 25 days of the billing date, either by paying the entire balance or an amount equal to a designated percentage (5 to 10 percent) of the total amount. If he chooses to defer his payments according to the latter method, a carrying charge at rates which range up to 18 percent per year is imposed.²⁷

²¹ See U.C.C. §§ 2-313, 2-314, 2-315 wherein the various warranties which may arise from a sales transaction are explained.

²² See U.C.C. § 2-106(2).

²³ U.C.C. § 9-206(1).

²⁴ American Express, Diners' Club and Carte Blanche, for instance, require that their applicants earn at least \$7,500 per year. O'Neil, *A Little Gift From Your Friendly Banker*, *Life*, March 27, 1970, at 50A [hereinafter cited as O'Neil].

²⁵ *Id.* at 55; Hearings on Credit Cards Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking & Currency, 90th Cong., 2d Sess. 64 (1968).

²⁶ O'Neil 55.

²⁷ *Id.* at 48.

Bank credit card issuers include waiver of defense clauses as part of their application forms, on separate information statements, or in collateral material which accompanies the card at the time of issue.²⁸ Many banks include the agreement on the reverse side of the card. By making this agreement, the cardholder waives and releases the bank from all defenses, rights and claims which he may have against the merchant. This agreement is identical with those invariably incorporated into retail installment sales contracts. The only difference between the two is that in the credit card transaction the cardholder makes the agreement directly with the issuer, while in the installment sale the waiver of defense promise is made to the merchant for the ultimate benefit of the financier. If the legal relationship between the merchant and the card issuer is characterized as that of assignor-assignee, however, under section 9-206 both agreements are identical in purpose and effect.

Bank credit card transactions and retail installment sales are identical in other respects: both the issuer of a card and the assignee of a sales contract purchase the sales contracts of a merchant at a discount, and both utilize interest charges on the outstanding balance of the purchase price.

Whether section 9-206 applies to waiver of defense clauses in bank credit cards as it does to retail installment sales contracts involves three separate inquiries: (1) whether the applicable state retail installment sales act covers credit card transactions; (2) whether the card issuer's claim can be said to arise out of an assignment of accounts rather than out of a direct obligation; and (3) whether any line of case law has held waiver of defense clauses in consumer credit sales to be unenforceable.

Apparently no state has enacted any legislation containing a specific prohibition against enforcing waiver agreements in credit card sales. The Uniform Consumer Credit Code (U.C.C.C.), recently enacted in Oklahoma and Utah,²⁹ specifically excludes credit card transactions from the definition of "consumer credit sale."³⁰ Thus, although U.C.C.C. Section 2-404 specifically makes waiver of defense clauses unenforceable in the context of consumer credit sales,³¹ this is inapplicable to credit cards. Under the U.C.C.C., credit card sales fall

²⁸ South, *Legal Steps and Pitfalls in Bank Credit Cards*, 87 *Banking L.J.*, 222, 223 (1970).

²⁹ Okla. Stat. Ann. tit. 14A, §§ 1-101 to 9-103 (Supp. 1969); Utah Code Ann. tit. 70B, §§ 1-101 to 9-103 (Supp. 1969). Both states adopted the U.C.C.C., effective July 1, 1969.

³⁰ U.C.C.C. § 2-104(2)(a).

³¹ See U.C.C.C. § 2-404 (alternative A). Alternative B provides that waiver clauses are enforceable if the assignee is not "related to" the seller. However, to enforce such an agreement an assignee must notify the buyer of the assignment in writing. If the assignee receives no such notice of a claim or defense within 90 days, he may enforce the agreement. Oklahoma changed this statutory period to 30 days. See Okla. Stat. Ann. tit. 14A, § 2-404(1) (Supp. 1969).

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within the statutory definition of "consumer loans,"³² and lenders (card issuers) are, of course, not subject to the borrower's defenses against the seller of goods purchased with the borrowed money (credit cards).

Notwithstanding the effect of the U.C.C.C., there is nothing to prevent a court, if it characterizes the issuer's claim for payment as one arising from an assignment of accounts, from prohibiting the enforcement of these agreements in three party credit card sales. This would comply with the statutory license which U.C.C. Section 9-206 gives to any judicial decision which "establishes a different rule for buyers or lessees of consumer goods."³³

While a few states have enacted a legislative prohibition against waiver of defense clauses in consumer installment purchases, some states have imposed the same prohibition through judicial decision.³⁴ The most recent of these, *Fairfield Credit Corp. v. Donnelly*,³⁵ relied on the statutory license to adopt a different rule for consumers.³⁶ But these cases arose out of the assignment of retail installment sales contracts.

The only issue of possible legal application to waiver of defense clauses in credit cards is the liability of a cardholder for the unauthorized use of his card. In the cases dealing with this issue, the card issuer-holder contract provided that the liability for charges incurred while the card was lost be placed on the holder until he had given notice of loss to the issuer. It is significant that in two of these cases,³⁷ *Gulf Ref. Co. v. Williams Roofing Co.*,³⁸ and *Diners' Club, Inc. v. Whited*,³⁹ the relationship between the merchant and the issuer was characterized as that of assignor-assignee. The *Williams* case was decided in favor of the cardholder. In the course of its opinion, the court stated:

If these dealers were independent contractors and not agents of appellant, it necessarily follows that they were assignors of the forged invoices upon which appellant seeks to recover in this suit. These invoices, which were duly assigned by the respective dealers to appellant, were not negotiable instru-

³² U.C.C.C. § 3-104.

³³ U.C.C. § 9-206(1).

³⁴ For cases involving pre-Code law, see *Unico v. Owen*, 50 N.J. 101, 232 A.2d 405 (1967); *Quality Fin. Co. v. Hurley*, 337 Mass. 150, 148 N.E.2d 385 (1958).

³⁵ — Conn. — — A.2d — (1969).

³⁶ *Id.* at —.

³⁷ *Union Oil Co. v. Lull*, 220 Ore. 412, 349 P.2d 243 (1960), was the first case to articulate the assignment theory and held in favor of the cardholder on a negligence theory. The court construed the risk-shifting clause as a type of guarantee rather than the direct obligation of the cardholder. As such it was an "essentially gratuitous" one since the only benefit to the cardholder was the convenience of the card's use. Since the law favors gratuitous sureties, the court implied a duty of care on the indemnitee-issuer to protect the guarantor-holder. *Id.* at 426, 349 P.2d at 249.

³⁸ 208 Ark. 362, 186 S.W.2d 790 (1945).

³⁹ Civil No. A10872 (Los Angeles Super. Ct., Aug. 6, 1964).

ments. . . . It is well settled that the assignment of a non-negotiable instrument passes the rights of the assignor subject to all defenses that would be available if the assignor brought suit direct on the instrument It follows that appellant took the invoices subject to all equities and defenses existing between [the holder] and the various dealers, although appellant may well be a *bona fide* purchaser for value without notice of such equities or defenses.⁴⁰

In *Diners' Club, Inc. v. Whited*,⁴¹ the court once again found for the cardholder. Since the issuer, by virtue of its contract with the merchant, was not obligated to purchase forged invoices, the court reasoned that the issuer could not claim damage.⁴² The court, moreover, characterized Diners' Club as the assignee of the merchant's rights and, as such, subject to the cardholder's defenses against the merchants.⁴³

As noted above, the effect of section 9-206 is to allow a consumer to contract away his defenses which ordinarily could be asserted against an assignee. In other words, the parties to the sale can by agreement impart the legal characteristics of a negotiable instrument to a sales slip which would otherwise be non-negotiable.⁴⁴ In *Williams* and *Diners' Club*, the waiver of defense issue was not litigated. If the contracts had contained a waiver of defense provision, or if the matter had been raised by the pleadings, then the issue of applying the rationale of section 9-206 would have been presented.

As the above quoted portion of the *Williams* opinion indicates, the court felt that since Gulf was the assignee of a non-negotiable instrument, it was immaterial whether these merchants were agents or independent contractors. It is submitted that, had there been a waiver of defense clause in this card contract, the fact of independent operation would have been material,⁴⁵ since the negligence of these merchants would not have been necessarily imputable to Gulf,⁴⁶ and since the waiver clause would have imparted negotiability to the sales slips. On the facts of *Williams*, the issuer might have prevailed since negli-

⁴⁰ 208 Ark. at 367, 186 S.W.2d at 793.

⁴¹ Civil No. A 10872 (Los Angeles Super. Ct., Aug. 6, 1964).

⁴² The court said

voluntary payment is not damage. The cardholder has not agreed to pay for money which Diners' Club voluntarily pays to promote its own goodwill among merchants. That is promotion, not damage. It should be charged to that account.

Id. at 6.

⁴³ *Id.*

⁴⁴ See U.C.C. § 9-206, Comment 1. For a complete discussion of the assignee theory, see Bergsten, *Credit Cards—A Prelude to The Cashless Society*, 8 B.C. Ind. & Com. L. Rev. 485, 509-13 (1967).

⁴⁵ With respect to bank-issued credit cards, it should be pointed out that the member merchants are always independent of the issuer and that, unlike oil company cards, a waiver of defense clause is invariably part of the issuer-cardholder contract.

⁴⁶ Negligence, a personal defense, is waivable under U.C.C. § 3-305(1).

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gence of the merchant is the type of defense⁴⁷ which is waivable under the rationale of section 9-206.

In any event, the characterization of the three party credit card transaction in these cases in the same terms as a retail installment sales contract is in itself significant, for it may indicate a judicial willingness to apply similar policy considerations when deciding the enforceability of waiver agreements in bank-issued credit cards. However, most courts would undoubtedly consider this decision a proper legislative function. Viewed as such it becomes immediately apparent that most jurisdictions would enforce these agreements against cardholders since the majority of states now enforce these agreements against consumers in the context of retail installment sales.

IV. LEGISLATIVE POLICY CONSIDERATIONS

Section 9-206 anticipates that a state's legislative policy with respect to preserving the rights of consumers may be expressed either through the courts or through its legislatures.⁴⁸ Up to now only a few courts have exercised this prerogative to deny efficacy to waiver agreements in retail installment sales.⁴⁹ However, at least 12 legislatures have enacted statutes which purport to protect consumers against the claims of assignees.⁵⁰ These statutes take two forms: some absolutely prohibit the use of negotiable notes in consumer transactions,⁵¹ while others provide that subsequent holders of a negotiable note taken in connection with a consumer sale are subject to any defenses that a buyer may have by virtue of the original sale transaction.⁵² These states, at least by implication, would deny effect to that

⁴⁷ In the *Williams* case, for instance, the negligence of the merchants was manifest: the lost card had been issued to a trucking firm and the limitation "Good for Trucks Only," had been typed on the card. One of the firm's drivers had mistakenly left the card in a gas station whose attendant misappropriated it to his own use for some 90 days. Many of the merchants who honored the card knew that the attendant had wrongfully come into its possession, but nevertheless sold to him and in some instances falsified the sales slips. 280 Ark. at 364, 186 S.W.2d at 792.

⁴⁸ U.C.C. § 9-206(1), Comment 2.

⁴⁹ See *Unico v. Owen*, 50 N.J. 101, 232 A.2d 405 (1967); *Quality Fin. Co. v. Hurley*, 337 Mass. 150, 148 N.E.2d 385 (1958); *Fairfield Credit Corp. v. Donnelly*, — Conn. —, — A.2d — (1969).

⁵⁰ Cal. Civ. Code § 1810.7 (West Supp. 1968); Del. Code Ann. tit. 6, § 4342 (Supp. 1968); Hawaii Rev. Laws § 476-18(c) (1968); Mass. Gen. Laws Ann. ch. 255, § 12 C (Supp. 1969); Md. Ann. Code art. 83, § 147 (1964); N.Y. Pers. Prop. Law § 403(1) (McKinney 1962); Okla. Stat. Ann. tit. 14A § 2-404(1) (Supp. 1969); P.R. Laws Ann. tit. 10, § 748 (Supp. 1968); R.I. Gen. Laws Ann. § 6-37-6 (Spec. Supp. 1968); Utah Code Ann. tit. 70B § 2-404(1) (Supp. 1969); Vt. Stat. Ann. tit. 9, § 2455 (Supp. 1969); Wash. Rev. Code Ann. § 64.14.020 (Supp. 1968).

⁵¹ Cal. Civ. Code § 1810.7 (West Supp. 1968); Del. Code Ann. tit. 6, § 4342 (Supp. 1968); Hawaii Rev. Stat. § 476-18(c) (1968); Mass. Gen. Laws Ann. ch. 255 § 12 C (Supp. 1969); N.Y. Pers. Prop. Law § 403(1) (McKinney 1962); P.R. Laws Ann. tit. 10, § 748 (Supp. 1968).

⁵² Md. Code Ann. art. 83, § 147 (1965); R.I. Gen. Laws Ann. § 6-27-6 (Spec. Supp. 1968); Vt. Stat. Ann. tit. 9, § 2455 (Supp. 1969); Wash. Rev. Code Ann. § 63.14.020 (Supp. 1968).

portion of section 9-206 which provides that signing a negotiable instrument and a security agreement is an implied agreement to waive defenses.⁵³

Most of these same states have correlative statutes which deny effect to express waiver of defense agreements in a retail installment sales contract. At first glance this denial would seem a necessary corollary to implement the express legislative policy of that particular state. But Rhode Island, for instance, while it requires that a note taken in connection with a consumer transaction bear the legend "non-negotiable consumer note,"⁵⁴ has enacted no companion legislation denying to assignees the benefit of an express waiver of defense clause.⁵⁵ The question which immediately suggests itself is whether this is consistent with an express legislative policy to protect consumers.

Legislation which does not permit a consumer to waive his defenses by implication (by signing a negotiable instrument and a security agreement),⁵⁶ but does allow the same consumer to expressly contract away his right to assert claims against an assignee, is manifestly consistent.⁵⁷ Freedom of contract is the most compelling policy argument advanced by financiers in support of enforcing express waiver of defense agreements. In the case of bank credit cards, what issuers bargain for when seeking enforcement of these clauses is the smooth flow of payments since the entire credit card collection system is postulated on that assumption. Controversies over relatively minor amounts produce a disproportionate increase in administrative costs. Assuming that bank credit cards were never envisioned as a vehicle to promote consumer bankruptcies, the only benefit accruing to the holder of such a card is the convenience arising from its use.⁵⁸ Indeed a bank may never realize any financial gain directly from the cardholder since he can avoid all charges by paying within 25 days. Since a ban on the mailing of unsolicited credit cards by the federal government seems to be imminent,⁵⁹ the benefit of a card's convenience will soon be available to a consumer only upon application.

It can be argued that a clause whereby a party in a far superior

⁵³ U.C.C. § 9-206(1).

⁵⁴ R.I. Gen. Laws § 6-27-6 (Spec. Supp. 1968).

⁵⁵ See 3 CCH Consumer Credit Guide § 4350, at 47,014 (1969).

⁵⁶ It should be noted that the issuer of a 3-party credit card must rely on an express waiver clause since the memorandum sales slip utilized in a credit card transaction is not negotiable. See generally U.C.C. §§ 3-103, 3-104.

⁵⁷ The possibilities for frustrating a state's legislative policy would seem to inhere only in the manner in which such an agreement was drafted and the circumstances under which it was entered into. This would seem to be a subject for separate legislative control.

⁵⁸ This rationale was articulated in *Union Oil Co. v. Lull*, 220 Ore. 412, 349 P.2d 243 (1960), see note 37 supra.

⁵⁹ S. 721, 91st Cong., 2d Sess. (1969), a bill to safeguard the consumer by requiring greater standards of care in the issuance of unsolicited credit cards, passed the U.S. Senate on April 15, 1970.

bargaining position seeks to avoid liability for losses as against a person with little bargaining power should be unenforceable as being against public policy. The logical defect in applying this argument to support the conclusion that waiver agreements in credit cards ought not to be enforced is that the buyer is free to purchase the same goods or services with cash, under another credit arrangement with the merchant, or with the proceeds of a personal loan. As long as this purchaser is free *not to contract* for the use of a consumer credit card, freedom of contract would seem to indicate that banks and cardholders should be allowed the benefit of their bargain.

A minority of states have refused to enforce express waiver of defense agreements in retail installment sales.⁶⁰ The policy reasons underlying this choice are somewhat applicable to bank-issued credit cards.⁶¹ As previously stated, the waiver of defense issue is viable in only a few situations. The first involves merchants, solvent or insolvent, who do not intend to satisfy their customers' claims, regardless of their merits. These merchants usually operate in low income areas, and because bank cards are apparently available to low income consumers and usable in these areas,⁶² public policy would probably dictate against enforcement of waiver clauses. This is especially true when the low income consumer is forced to continue his payments to the bank, thereby diminishing his available funds to exact legal satisfaction from the merchant.

The existence of unethical or insolvent merchants presents the most compelling argument for the non-enforcement of waiver clauses, but the argument becomes less compelling if bank cards are viewed as national instruments of commerce, and the relationship between merchant and issuer becomes increasingly tenuous. It has already been suggested that a major reason for relieving a bank of a buyer's defenses is that of cost, since the entire system is postulated on the smooth flow of payments. But those who support the non-enforcement of waiver agreements assert that if issuers cannot enforce claims arising out of substandard merchandise, they will ultimately weed out the unethical merchants who are interfering with their administrative machinery. While there is logic to this argument, its application to credit cards could produce equally unfortunate results. Issuers can simply increase the discount rate to these particular merchants who, in turn, will pass it on to consumers in the form of increased costs. Also, in view of the fact that most bank cards are now honored na-

⁶⁰ See statutes cited at note 29 supra.

⁶¹ For a discussion of all of the policy considerations concerning waiver of defense clauses in retail installment sales, see Felsenfeld, Some Ruminations About Remedies in Consumer-Credit Transactions, 8 B.C. Ind. & Com. L. Rev. 535, 549-553 (1967).

⁶² "[Travel credit] cards . . . are issued to relatively high-income consumers, and are used largely to charge airline tickets . . . and similar things. Bank cards are issued largely to lower-income consumers, who use them mostly to charge purchases at retail establishments, many of which are small." Wall Street J., Jan. 17, 1967, at 1, col. 8 (Midwest ed.).

tionally, it is perhaps somewhat unfair to make banks sureties for a merchant's performance when the presentation of a card establishes instant credit among an unlimited choice of merchants.

The most vexing problem exists where both merchant and buyer are engaged in a legitimate dispute over the quality or conformity of the merchandise. One can only suggest that the issuer bank be entitled to the benefit of its contract and that the buyer be left to pursue his remedy against the merchant as his agreement with the issuer provided. The issue at the heart of the waiver of defense problem is the buyer's loss of leverage against a merchant when the buyer agrees not to assert his defenses against a bank. To the extent that this bargain with the bank was fairly made, however, these agreements ought to be enforced.⁶³

V. NATIONAL LEGISLATIVE POLICY

Although the retail installment sale and the consumer credit card transaction are so similar as to raise almost identical policy issues,⁶⁴ there is an essential difference. Whether the policy of a state favors enforcement or non-enforcement of waiver of defense clauses in retail installment sales contracts, the effects of such a policy are limited in scope to that state. Experience has shown that a decision one way or the other has virtually no effect on the availability of financing for these contracts.⁶⁵ Bank credit cards, on the other hand, have become instruments of national commerce. It is submitted that the adoption of a federal policy with respect to enforcing waiver of defense clauses could have profound effects on the development of the consumer credit card industry.

Virtually all of the banks involved in the credit card business utilize one of two national licensing systems—BankAmericard or Master Charge.⁶⁶ Statistics indicate that Master Charge cards are presently honored by a substantial number of merchants in 49 states while BankAmericard is similarly accepted in 44 states.⁶⁷ Both systems have formed regional "interchange" associations which are comprised of member banks who collectively finance and operate computerized accounting centers.⁶⁸

Because of this widespread dissemination, bank credit cards are

⁶³ The court in *Union Oil Co. v. Lull* would probably agree:

But the fact that there is a widespread misconception on the part of cardholders as to their liability does not warrant us in rephrasing the contract to accommodate that misunderstanding. The plaintiff company was entitled to the terms of its bargain with those who elected to use its credit cards, assuming of course, as we have, that the bargain was fairly made.

220 Ore. 412, 421, 349 P.2d 243, 247 (1960).

⁶⁴ See Felsenfeld, *supra* note 61, at 549-53.

⁶⁵ *Id.* at 551.

⁶⁶ O'Neil 50A.

⁶⁷ *Id.*

⁶⁸ *Id.* at 57.

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responsible in part for inflationary trends in the economy. Merchants who are forced to pay discounts ranging up to 6 percent to banks to which they sell their accounts must necessarily raise their prices to make up for this loss. If proportionate savings of up to 6 percent were passed on to cash customers, no problem would exist and cash transactions would be encouraged. This, however, is seldom the case, as member merchants normally charge one price for their goods.

It has been the hallmark of the past decade to champion the cause of the consumer, and such efforts are praiseworthy. But it may not be the credit card consumer who is in need of protection. In view of the price discrimination which the large scale use of credit cards inflicts upon noncardholders, and in view of the undesirable effects which such discrimination has on the economy in general, it is submitted that it is from the point of view of the cash consumer that the waiver of defense problem should be approached as it applies to bank issued cards.

In view of the strong possibility that bank credit cards will become a major national medium of exchange,⁶⁰ it is more than likely that federal legislation will be required to regulate these transactions. It is submitted that, with respect to the policy issues raised by the waiver of defense problem, a uniform federal credit card statute should include the following provisions: (1) standards for the content and conspicuousness of waiver clauses so as to preclude any misunderstanding by the card applicant concerning the effect of the clause; (2) requirements that merchants participating in a national credit card plan give effect, in both their advertising and in their charges, to the price differential between a credit card and a cash sale; and (3) a provision which would deny to a card issuer or a member bank the benefit of a waiver of defense agreement to the extent that either involved itself in the advertising or promotion of the goods of their participating merchants.

With respect to the first of these provisions, by guaranteeing the understanding of a card applicant that he is contracting away his ability to exert leverage against a merchant to compel proper performance by withholding payment, one preserves the freedom of the card issuer and applicant to contract. Analogous to the Truth-in-Lending Law requiring full disclosure of credit terms, the issuer should be required to execute an agreement with the cardholder clearly indicating the nature and effect of the waiver of defense clause. An applicant who executed such an agreement can be presumed to have considered the convenience of the card's use as a fair exchange for the loss of potential leverage against a merchant.

The second provision addresses itself to the problem of national inflationary price discrimination resulting from the large scale use of

⁶⁰ Although credit cards are presently responsible for only 2% of today's \$98.2 billion in consumer debt, some experts believe that they will ultimately become the dominant medium of exchange. *Id.* at 58.

credit cards. The effect of such a price differential and disclosure requirement would be to prevent a merchant from passing along prices inflated by the amount of discount which he must pay the card issuer to cash purchasers. The effect of requiring this price disclosure and price differential should, when combined with a card applicant's clear understanding of his waiver of defense agreement, inhibit the unfettered growth of the credit card industry and effect a stabilizing of the inflationary price trend attributable to credit cards.

The third suggested provision would be responsive to the basic problems resulting from the advertising and promotion of goods by card issuers. Since the effect of a waiver of defense clause in either a retail installment contract or a credit card transaction is to impart negotiability to what might otherwise be non-negotiable instruments, section 9-206 requires that an assignee of such an instrument (in the credit card sale, the imprinted transaction slip) must take his claim, "in good faith and without notice of a claim or defense . . ." ⁷⁰ To the extent that card issuers encourage cardholders to patronize certain merchants, participate in common advertising with the merchants, or participate in "piggyback advertising" ⁷¹ by promoting goods or services with materials included along with the monthly billing statement, the issuers should be held to answer for the non-conforming performance of those merchants or products and take those accounts subject to the claims of consumers.

CONCLUSION

Perhaps the hesitancy of the individual states to enact comprehensive legislation with respect to bank-issued credit cards is a recognition that the use of these cards raises more than local problems. Indeed, the characterization of the three party card relationship as an assignment of accounts ignores the fact that it is a hybrid relationship, capable of many characterizations, ⁷² and is unique. The utilization of local retail installment sales statutes to remedy the problems raised by these cards is not an acceptable alternative for the economic uniformity desirable in the solution of commercial problems that are essentially national in scope.

The continued rise in credit card sales underscores the need for uniform federal legislation. It is submitted that an integral part of such legislation should include a general license to enforce waiver of defense agreements, but subject to the safeguards suggested. A unilateral prohibition against enforcing such clauses, while ostensibly protecting cardholders, would serve only to make the card contract

⁷⁰ U.C.C. § 9-206(1).

⁷¹ See South, *supra* note 28, at 237.

⁷² It has been suggested that the 3-party credit card incorporates the characteristics of many relationships: (1) an assignment from the merchant; (2) the holder's direct promise in consideration of the merchant's extension of credit; (3) the issuer's status as a "payor bank" under Art. 4 of the U.C.C.; and (4) the issuer's status as issuer of a letter of credit under Art. 5 of the U.C.C. See Bergsten, *supra* note 44, at 509.

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more desirable and encourage an obviously inflationary trend. Enforcement of these agreements, with companion price disclosure provisions, would curtail that trend and eliminate price discrimination against cash customers.

ROBERT F. McLAUGHLIN