Mr. Fly-by-Nite Meets the FTC

Those of our clients who are used to buying consumer retail installment contracts are very familiar with the mandatory language required by the Federal Trade Commission (FTC) on such consumer contracts: "NOTICE: ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF."

That warning's purpose is to prevent the assignee/holder of the installment contract from being promoted to the very desirable status of a "holder in due course." Every creditor would like to be a holder in due course, because the debtor of such a creditor can only assert very limited defenses against it.

Under Section 355.3-305 of the Uniform Commercial Code (UCC), a holder in due course takes the instrument free from all claims on the part of any person and all defenses of any party to the instrument with whom the holder has not dealt with the following exceptions:

1) infancy—that is, the debtor is under the age required for a contract to be enforceable against him;

2) incapacity, duress, or such illegality of the transaction that renders the obligation of the debtor a nullity;

3) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms;

4) discharge in bankruptcy or any other discharge of which the holder has notice when he takes the instrument.

That may seem like a lot of exceptions, but they seldom apply to most cases. But for the FTC's requirement that every consumer retail installment contract bear the warning that the holder is subject to defenses assertable against the seller, the retail installment purchaser of an automobile, for example, could not raise breach of warranty or other charges that the car is a "lemon" as a defense to payment of the contract.

The history behind the FTC's regulation requiring this notice cutting off the possibility of holder in due course status to any purchaser of consumer installment contracts is a colorful one.

It seems that in years past it was not unusual for such merchants as aluminum siding salesmen, window salesmen, car dealers, and other such retail businessmen to have their buyers sign contracts in two parts.

The top part contained the contract to provide the services or goods being purchased by the consumer, and the second part would consist of an unconditional promise to pay the agreed upon price thereof—in effect, a negotiable instrument. A line of perforation would separate the two parts so that the seller could then tear off the bottom and negotiate it to a holder in due course.

The consumer, having contracted for new aluminum siding for his home, but never having received it or having the work performed in a manner unsatisfactory to him, would nonetheless be bound to pay the holder of the note so long as it took for value, in good faith, without knowledge of any defenses to the note when it purchased it. The consumer could only seek satisfaction from the aluminum siding salesman, who all too often it seems, left town for richer pastures after having pocketed the proceeds of the sale of the promissory note.

Never hesitating to wield a meat cleaver where a scalpel would do, the FTC responded to such abuses with the requirement of the mandatory notice on all consumer contracts, thereby eliminating holder in due

course status for anyone purchasing consumer paper. Holder in due course status is, of course, still available under the law of negotiable instruments in other situations, as is attested by Article 3 of the UCC on commercial paper, which has been adopted in some form in all fifty states.

The holder in due course doctrine is also still very much alive in the area of commercial retail installment contracts. UCC 9-206 gives statutory approval to the so-called "waiver of defense" clause which allows for the enforcement of clauses in contracts obligating buyers or lessees in commercial transactions to not assert any claim or defense which they might have against the seller or lessor against any assignee of the contract who takes an assignment for value, in good faith, without notice of a claim or defense.

Although such waiver of defense clauses are enforceable in the commercial context, they are of course subject to those defenses available

against a holder in due course. Not surprisingly, such a clause in a commercial contract for the purchase or lease of goods makes the subsequent purchase of that contract much more desirable to a potential assignee.

The Kentucky Court of Appeals, however, has followed case law elsewhere in carving out a "close connectedness" doctrine which is an exception to holder in due course status in the commercial arena. Under the "close connectedness" doctrine, the contract debtor can nullify the effect of a "waiver of defense" clause on a commercial contract for the sale or lease of goods where it can demonstrate that the assignee is so closely connected to the seller as to be identified with it.

For example, in the case of *Massey Ferguson, Inc. v. Utley*, 439 S.W.2d 57 (Ky.Ct.App. 1969), the court held that, where the holder of a contract was also the manufacturer of the merchandise sold and took an assignment of the finance contract from its dealer, to which it had supplied blank sales contracts and from which it received immediate and routine assignments, and where a factory representative had visited and participated in sales, the plaintiff's conduct put it in the status of a "seller" which outweighed its status as "assignee."

The facts in *Massey-Ferguson v. Utley* show sufficient close connectedness between the seller and assignee that even a creditor's counsel believing fully in the doctrine of freedom of contract would be hard pressed to criticize the holding. The court's finding in *Utley* does not therefore appear to be a significant undermining of the usual enforceability of waiver defense clauses in the commercial context.

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