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Optimality and Preservation of Consumer Defenses—A Model for Reform

Benjamin Geva*

Recent legislation in the United States and Canada has cut back on the traditional insulation from consumer claims and defenses which has been enjoyed by third party financers. This Article examines the theoretical underpinnings of a rule which preserves consumer claims and defenses against third party financers, in light of the objective of optimal resource allocation, and defines those situations in which application of such a rule is appropriate. The Article advocates that the scope of a preservation of defenses rule should include not only those situations in which the seller and financer have some form of an existing bargaining relationship, but also where credit is extended for a restricted use by independent lenders. The justifications for restrictions on a consumer's ability to assert claims and defenses and the extent of financer liability are also considered within an optimal resource allocation framework. The author concludes by proposing a model statute which implements his analysis of a proper preservation of consumer defenses rule.

INTRODUCTION

IN RECENT YEARS, the insulation of third party financers of consumer purchases from claims and defenses arising from a seller’s breach has been significantly curtailed. Legislatures in the United States and Canada have been actively launching an “assault upon the citadel” of insulation in order to preserve defenses under contracts for sale of consumer goods against the financers.

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1. These include: multiparty credit card issuers (see note 9 infra and accompanying text), direct lenders, holders of consumer notes evidencing sales, and beneficiaries of waiver of defense clauses under contracts of sales.


4. This use of the phrase is from Murphy, Another “Assault Upon the Citadel”: Limit-
The protection given by this legislation is, however, far from uniform. Statutes differ with respect to the types of transactions covered, the defenses available to the consumer, and the amount of financer's exposure to them.

These statutes normally provide consumers with protection against purchasers of consumer notes issued under sales transactions and against assignees of contracts of sale which contain waiver of defense clauses. However, protection given by statutes against purchase money lenders is generally limited to lenders who have had prior dealings with the seller involved in a transaction, for example, credit card issuers. Also, the amount of a third party financer's exposure to consumer defenses varies under the statutes from the amount financed, or the face value of the loan contract, to the amount owed to the financer either at the time of asserting the defense or notification of its existence.

This Article examines the justifications for, and the appropriate scope of, a rule preserving consumer defenses against third party financers in light of the underlying objective of optimal resource allocation, or optimality. Scholarly views concerning whether a preservation of defenses rule actually results in optimal

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5. For example, some state statutes impose time restrictions on when defenses may be raised against a holder in due course, varying from five days after the consumer is notified of the assignment in Illinois to a full year in Wisconsin. Hudak & Carter, supra note 2, at 259. Other statutes may require additional preconditions such as the duty to make a good faith effort to settle the dispute which is imposed by the Fair Credit Billing Act of 1974, 15 U.S.C. §§ 1666–1667 (1976).


7. Id.

8. A purchase money lender makes loans which enable debtors to buy goods from a third party; see U.C.C. § 9–107 (1972).

9. See, e.g., Consumer Protection Act of 1978, QUE. REV. STAT. c.9, § 116 (1978), which does not apply to multilateral credit card plans.

For the treatment of an issuer in a multilateral credit card plans as “lender,” see Harris Trust & Savings Bank v. McGray, 316 N.E.2d 209 (Ill. App. 1974). Under such a plan, an issuing bank contracts with consumers to pay the price of goods acquired from a merchant who works under an agreement with the issuer or with another bank which is a member in the same interchange system. Payment to the seller is made by the bank upon the presentment of invoices or “sale slips.” See Davenport, Bank Credit Cards and the Uniform Commercial Code, 85 BANKING L.J. 941, 950–61 (1968).

10. This is the exposure under the Federal Trade Commission Rule and Canadian provincial legislation; see notes 131–32 infra and accompanying text.

11. Such is the exposure under the Canadian federal Bills of Exchange Act, supra note 3, and most state legislation in the United States.

12. See note 31 infra.
resource allocation differ widely. Professor Alan Schwartz is the author of the classic presentation on the consistency between the preservation of consumer defenses and optimality. The opposite view is taken by Professors Richard Posner and Richard Epstein. This Article supports Professor Schwartz's analysis and extends its implications in two major respects. First, while Professor Schwartz deals only with situations where a seller and a financer have an established bargaining relationship, Part II of this Article argues that optimality is increased by extending protection also to consumers who obtain restricted use loans from institutional lenders. Second, this Article examines some questions which were not discussed by Professor Schwartz. These questions are concerned with the amount of a financer's exposure, the defenses available to a consumer, and the possible limitations on the right to assert these defenses.

The Article begins by presenting the goals of consumer defense preservation and its effect on optimal resource allocation. The discussion goes beyond existing literature by specifying the costs saved by preserving consumer defenses, and by being more explicit in tying the implementation of the goals of cost minimization and distribution to the pursuit of optimality. Parts II and III extend the implications of the framework established in Part I and set out those situations where preservation of consumer defenses is most consistent with the pursuit of optimality. Part II considers the financing arrangements in which consumer defenses should be preserved. Part III examines the appropriate scope of a financer's exposure to consumer defenses.

At the conclusion of the Article, following a short critique of some features of current legislation, two model statutes are presented. Appendix I is an unproclaimed section of the British Columbia Consumer Protection Act. It is suggested that this provision approximates optimality more closely than any other en-

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15. See notes 85-127 infra and accompanying text.

16. See notes 128-49 infra and accompanying text.

17. See notes 21-84 infra and accompanying text.

18. See notes 85-127 infra and accompanying text.

19. See notes 128-49 infra and accompanying text.

20. See Part IV infra.
acted statute in North America. Appendix II is my own proposed Model Preservation of Consumer Defenses Act which is designed to implement the analysis presented in this Article.

I. THE JUSTIFICATION FOR PRESERVING CONSUMER DEFENSES AGAINST FINANCERS

A seller of goods who is unwilling to make adjustments for a consumer's justified dissatisfaction is "legally responsible either in a direct suit by the purchaser or at the insistence of the third party [financer] . . . if the latter has been unable to collect because of the successful assertion of defenses based on dissatisfaction with the merchandise."21 A rule which preserves consumer defenses against a third party financer does not alter this framework, but minimizes and distributes the costs which are engendered by inadequate seller22 performance (cost of seller misconduct)23 in the consumer goods market.24

Absent a preservation of defenses rule, the initial loss created by a seller's breach is borne by the consumer-buyer; remedies can be pursued against the seller, but the buyer must continue payment to the financer.25 Under a preservation of defenses rule, the consumer can assert dissatisfaction with a seller's performance by withholding payment. Thus, the loss is initially allocated to the financer. A financer faced with a preservation of defenses rule, in addition to pursuing a claim against a seller who has breached,26 may withdraw credit from merchants with poor records and can


22. In this Article, "seller" in the context of "seller's breach" represents anyone liable for the performance or breach of the contract for sale. That person can be either the "immediate seller" (the party in privity under the contract for sale) or, absent privity requirements, the manufacturer or any intermediary in the chain of distribution. Likewise, "seller performance" refers to the performance of the contract for sale by any "seller."

23. Costs of "seller misconduct" are "the result of fraud, breach of warranty, or failure of consideration." Note, Direct Loan Financing of Consumer Purchases, 85 HARV. L. REV. 1409, 1411 (1975).

24. For this characterization of the issue, see id. at 1411. See also 40 Fed. Reg. 53,522 (1975).

25. See accord, Schwartz, supra note 13, at 499.

26. A financer's remedy against the seller can arise under contract or as a matter of law. The Model Act following this article includes a provision which would expressly recognize the financer's right to a remedy. See Model Act § 4 and Comment (Appendix II infra).
distribute projected losses. Loss distribution may be accomplished by charging more for credit from consumer borrowers or by shifting the loss to the merchants, thereby causing the internalization of this cost by the merchants. The latter option can be achieved by doing business with merchants on a pure recourse basis, by demanding more security from merchants in the form of larger reserve accounts, or by raising discount rates.\(^\text{27}\)

The preservation of defenses rule is designed to minimize the overall costs produced by a seller's breach. Those costs which cannot be eliminated are internalized by the seller and the financer so that the prices charged to consumers more accurately reflect the true social costs\(^\text{28}\) of engaging in a credit sale transaction.\(^\text{29}\) The underlying assumption is that the financer is better able to minimize the cost of seller misconduct than is the consumer.\(^\text{30}\)

In examining the validity of this assumption and its contribution to optimality,\(^\text{31}\) it should be noted that the superior ability of a financer to minimize the costs of seller misconduct emanates from "the very nature of his business."\(^\text{52}\) Comparing a financer and a consumer, the former has a stronger position in the market-

\(^{27}\) Discount rates can be raised directly or indirectly. One method of indirectly raising discount rates is to withhold from the merchant the incentive payments made in the form of a percentage of the finance charge. Another method is to withhold the discounted value of consumer obligations, by means of a reserve account, and to release these funds as the consumer obligations are satisfied. See generally Rohner, *Holder in Due Course in Consumer Transactions: Requiem, Revival, or Reformation?*, 60 CORNELL L. REV. 503, 538 (1975).

\(^{28}\) The social cost of production is the cost that society incurs when a resource is used to produce a given commodity. C. FERGUSON & S. MAURICE, ECONOMIC ANALYSIS 128 (1970).

\(^{29}\) Commenting on this situation, the Federal Trade Commission has noted that "prices paid by consumers [will] more accurately reflect the true social costs of engaging in a credit sale transaction." 40 Fed. Reg. 55,506, 53,523 (1975) (emphasis added). The language used by the FTC is somewhat unfortunate. See notes 50–51 infra and accompanying text.

\(^{30}\) See Note, supra note 23, at 1411–17.

\(^{31}\) There are two related but not identical concepts of efficiency—"economic efficiency", in which no output can be expanded without reducing some other output, and 'Pareto optimality'—particular efficient points to which voluntary exchange would lead, and at which no person can be made better off (as he himself sees his well-being) without making someone else worse off (as he himself sees his well-being). McKean, *Products Liability: Trends and Implications*, 38 U. CHI. L. REV. 3, 30 (1971). "Pareto optimality" is "the particular efficient point to which voluntary exchange would lead starting from a particular distribution of wealth." Id. at 36. But see R. POSNER, supra note 14, at 9–10. Following Professor Schwartz, supra note 13, this Article uses "efficiency" and "optimality" interchangeably.

\(^{32}\) See Note, supra note 23, at 1413.
place, better organization, and better access to information. A financer is also a more effective plaintiff.

The consumer sues the merchant only once or episodically. The financer, even though it does not control the merchant or participate in the breach of warranty, ordinarily has a continuing relationship with him and some experience of his performance of warranties. The financer is certainly better equipped with staff to check the merchant's reputation for reliability and fair dealing . . . and is best able to force redress by maintaining an action over against the merchant or by charging withheld amounts. . . .

Furthermore, a financer "can refuse to deal with undercapitalized dealers or with dealers with a history of unhappy customers." Indeed, empirical studies made in the United States in conjunction with state and federal preservation of defenses rules indicate the adverse effect of such rules on the operation of "marginal" or disreputable merchants.

It is a basic tenet of economics that efficiency, the optimal allocation of resources, is enhanced when all costs of an item are reflected in its price. Where "resources are shifted to those uses in which value to consumers, as measured by their willingness to pay is highest, . . . we may say that they are employed efficiently. . . . Efficiency is [thus] . . . determined by willingness to pay," and only where all costs are perceived by consumers can

34. Littlefield, Preserving Consumer Defenses: Plugging the Loophole in the New UCCC, 44 N.Y.U. L. REV. 272, 280–81, 281 n.29 (1969). The effectiveness of this power would be bolstered by conferring upon financers immunity from possible tort actions by merchants for a financer's refusal to deal. See Model Act § 7 and Comment, § 5 (Appendix II, infra).


37. See note 31 supra.
38. One of the two "economic advantages of a competitive price" is that the price is "such that marginal cost equals price." G. STIGLER, THE THEORY OF PRICE, 178–79 (3d ed. 1966).

39. R. POSNER, supra note 14, at 10. "Efficiency" is used by Professor Posner interchangeably with "Pareto optimality"; see note 31 supra.
willingness to pay be accurately expressed. As explained below, minimizing the costs of seller misconduct contributes to optimality by eliminating or reducing costs which are not reflected in the stated price of consumer credit goods.40

Notwithstanding the seller’s basic liability,41 absent a preservation of defenses rule, not all costs of seller misconduct are shifted to the responsible seller. For example, where the seller’s insolvency prevents the consumer from recovering the full amount of damages, or where the seller is able to avoid or limit liability because of the consumer’s inferior position as a litigant, the consumer would bear a portion of the loss.42 Moreover, the economic goal of compensating for breach of contract is to place the injured party in the position in which he or she would have been had the contract been honored.43 Yet, where a seller in breach of a consumer contract refuses to give redress voluntarily, this sum, even if entirely collected (together with expenses incurred in pursuing its recovery, plus legal interest), does not represent the entire loss to the consumer. As explained by Professor Schwartz, the consumer is not compensated for satisfaction loss44 or for the loss of the earning differential of the sum recovered (what the consumer could earn with this sum, less the legal interest).45 Additionally, loss to the consumer’s human resources cannot be compensated. The adverse effect on the consumer’s physical and emotional resources during the time between the breach and the recovery, or even shortly thereafter, results in decreased productivity due to sleepless nights or worries. The loss of the mental energy invested in obtaining redress also cannot be compensated. Finally, the loss resulting from an unforeseeable breach is not recoverable.46

40. “[C]onsumer credit and sales are considered a single activity.” Note, supra note 23, at 1416. But cf. Schwartz, supra note 13 (under whose model the effect of the rule is on the price of credit only).
41. See note 21 supra and accompanying text.
44. This is the loss of “consumer surplus,” defined in P. SAMUELSON, ECONOMICS 417 (8th ed. 1970) as the difference between total utility and total market value. See Schwartz, supra note 13, at 504–07.
45. “Put in the form of an equation . . . :
Loss (if defenses can be cut off) = earnings differential (on the part of the price paid that otherwise could be withheld), or satisfaction loss, + additional legal expenses (if any), + earning differential (resulting from repair costs when they would otherwise be incurred by the seller).” Schwartz, supra note 13, at 506–07 (defining “earning differential” at 504–05).
A preservation of defenses rule eliminates the loss of the earning differential of those amounts which would have been paid to the financer during the period of seller breach. Also, by reducing the number of cases where a breach occurs, the rule minimizes the loss of the earning differential of amounts paid before the breach (loss of satisfaction) and diminishes both the loss of human resources and the uncompensated, unforeseeable loss.

These gains, desirable as they may be, are not themselves a gain in optimality. Resources are allocated optimally where marginal private cost equals marginal social cost. Absent a preservation of defenses rule, however, a seller's private production costs, which are reflected in the stated price, are lower than the entire social production costs (stated price plus uncompensated loss). Yet, this situation does not represent a disparity between social and private costs. The entire cost to consumers consists of both the stated price and the value of the uncompensated loss. Insofar as consumers react rationally to this overall cost of consumer credit goods, resources will tend to gravitate toward their most valuable use if voluntary exchange is permitted. Therefore, without a preservation of defenses rule, the existence of uncompensated loss adversely affects optimality only when additional assumptions are made. These assumptions contemplate a model where part of the loss is not borne by either sellers or consumers, and the overall consumer reaction to the uncom-

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538-39; cf. Spartan Steel & Alloys Ltd. v. Martin & Co. (contractors) Ltd., [1972] 3 W.L.R. 502, 507 (C.A.) (plaintiff was unable to recover loss which did not flow "naturally and directly" from the defendant's wrongful act).

47. The existence of a preservation of defenses rule reduces the number of transactions in which a breach occurs by virtue of the superior ability of the financer, as compared with the consumer, to exert pressure on merchants. A financer can refuse to do business with a disreputable merchant, thereby reducing the number of financed sales transactions, and is a better plaintiff than a consumer in seeking redress for a breach. Through a financer's better ability to police the consumer goods marketplace, fewer breaches will occur. See notes 31-36 supra and accompanying text.

48. Of course, it is assumed that a reduction in the number of cases of breach reduces the overall cost of breach.

49. C. FERGUSON & S. MAURICE, supra note 28 at 275. "Private costs," whether explicit or implicit, are either amounts allocated to bid away the resources from alternative uses, or amounts that could be earned in the best alternative use. Id. at 128-29. "Marginal cost" is unit cost as a function of output. R. POSNER, supra note 14, at 8, 8 n.11. The social cost of production is the cost society incurs when a resource is used to produce a given commodity. C. FERGUSON & S. MAURICE, supra, at 128.

50. This is a major aspect of the "Coase theorem." See Coase, The Problem of Social Cost, 3 J. L. & Econ. 1 (1960); Schwartz, supra note 13, at 511, 511 n.16.

PRESERVATION OF CONSUMER DEFENSES

It seems clear that uncompensated loss is not always borne entirely by the consumer. Loss to human resources may adversely affect third parties, particularly the consumer's employer.\(^52\) Lost employee productivity is assumed by the employer.\(^53\) Where an owner of a resource—the consumer's employer, insofar as he or she is contractually entitled to the use of the consumer's human resources—cannot charge a price for its use, misallocation of resources results.\(^54\) Thus, the sale of a product at a price which does not include the loss borne by the employer results in a larger output than would occur if all costs were reflected in the final price.\(^55\) Thus, the first additional assumption seems to be reasonably based.

The second assumption, that consumers react irrationally to the risk of incurring uncompensated loss, also appears quite realistic.\(^56\) There is evidence that consumers' purchasing decisions are made essentially on the "best buy model": on the basis of stated price in relation to product quality.\(^57\) This decision would then exclude elements not embodied in the stated price.\(^58\) Also, "[c]omplex, fine print standard forms might be viewed as goods whose quality people cannot determine."\(^59\) Consumers are thus unlikely to consider that their right to withhold payment against financers could be forfeited. In today's markets "most agents . . .

\(^{52}\) Use of the courts also entails a cost. This cost of seller misconduct is not charged to the merchant or the consumer, but to society at large.

\(^{53}\) The employer's loss is not recoverable. C\(.]\) R. Posner, supra note 14, at 150.

\(^{54}\) C. Ferguson & S. Maurice, supra note 28, at 277.

\(^{55}\) G. Stigler, supra note 38, at 110-11.

\(^{56}\) On intervention with respect to information and coercion, the market "not to impede attainment of ideal equilibrium but rather to increase welfare by tending to correct imperfections in the market mechanism," see Birmingham, The Consumer as King: The Economics of Precarious Sovereignty, 20 CASE W. RES. L. REV. 354, 377 (1969).


\(^{58}\) Cf. Schwartz, supra note 13, at 507 (consumers are unable to value the earnings differential at the time of purchase, and they are unlikely to attempt to make such calculations since the usual buyer expectation is that the goods will work and the credit installments will be paid on time, precluding the incurrence of a legal interest charge).

interact only with *price*; they do not dicker over *terms* with other agents.\(^{60}\)

Some consumers may overestimate and overreact to the risk of uncompensated losses.\(^{61}\) Yet, a low income consumer "who scarcely knows where the money for his next meal is coming from is not going to worry much about the risk involved in obtaining some needed goods when he does not know where next month's and next year's installments are coming from."\(^{62}\) While awareness of credit costs among low income consumers in the United States has increased since the enactment of the Truth in Lending Act,\(^{63}\) it has tended to focus on the dollar finance charge,\(^{64}\) and, as such, has been limited to elements of the *stated* price. The failure to perceive costs which are not expressed in the stated price produces an underestimation of uncompensated loss. This underestimation results in an output increase and a misallocation of resources. In such circumstances, voluntary exchange does not lead to efficiency.\(^{65}\)

One argument which rejects the correlation between a preservation of defenses rule and optimality postulates that if the holder in due course doctrine\(^{66}\) were inefficient, competition would eliminate it without legal intervention. Therefore, "[t]he survival of the doctrine in a highly competitive market . . . suggests that it is an efficient doctrine."\(^{67}\) This view, however, ignores the underestimation of uncompensated consumer loss and financer self-interest

\(^{60}\) *Id.* at 1154 (emphasis added). *See also* Note, *supra* note 23, at 1412, 1412 n.14.

\(^{61}\) From this perspective, by shifting the risk of seller's breach to the financial community, a preservation of defenses rule increases the competitiveness of products manufactured by small firms. "No longer does the customer have to be so concerned about whether the lower prices at Big Al's discount store merely reflect the lower value of the goods because Big Al might not be there when you need him." Panel presentation by John P. Brown, *Holder in Due Course: Does the Consumer Pay?*, ABA Annual Meeting (August 9, 1976), reprinted in 32 Bus. L. 591, 614, 620 (1977).


\(^{65}\) *But cf.* notes 31 and 51 *supra* and accompanying text.

\(^{66}\) Recently, the "techniques . . . by which [financers] seek to insulate themselves from claims and defenses arising out of the underlying consumer transaction" have been treated as being within the holder in due course concept. Rohner, *supra* note 27, at 505. To avoid ambiguity and confusion, this Article uses the term "holder in due course" in its historical meaning which is a bona fide transferee for value of a negotiable instrument who takes it free from personal defenses of prior, remote parties.

of using it rather than eliminating it. Any device which increases consumer awareness of uncompensated losses or forces these costs to be included in the stated price would most likely result in a contraction of credit. Financer self-interest would therefore oppose a preservation of defenses rule. In a market where "the choice for a buyer, whether to pay for [a contractual term preserving his defenses against a third party financer], is one not central to consumer concerns which revolve around quality and elements of price," a financer's self-interest of providing more credit at a given price is served by a transactional scheme which lacks a preservation of defenses rule.

Obviously, a preservation of defenses rule is bound to produce costs which are not incurred under a scheme lacking this rule. First, there are costs of policing and evaluating merchant performance. Second, there are costs of buyer misconduct when payment is unjustifiably withheld. As these costs are initially allocated to the financer, a party who is better equipped to calculate the value and the probability of occurrence, the net effect of the rule will be to substitute a more accurate for a less accurate risk valuation. When these additional costs are internalized by financers and reflected in the price of consumer credit goods, consumers will be able accurately to perceive the cost of credit because all credit costs will be included in the stated price.

68. "The merchant, of course, is more interested in selling his product than in creating a knowledgeable non-customer." Birmingham, supra note 56, at 364.

69. See Schwartz, supra note 13, at 512. Since higher stated price reflects only higher cost, the financer will not gain from the effect of the preservation of defenses rule.

70. Schwartz, supra note 13, at 513.

71. See note 69 supra.

72. This proposition clearly supports the conclusion that the consumer's overall response to the risk of uncompensated loss (in a scheme lacking a preservation of defenses rule) tends to underestimate it. See notes 61-65 supra and accompanying text. Overall overestimation would produce the financer's interest in either minimizing the risk or informing consumers of its true value.

73. See Note, supra note 23, at 1414-15.

74. One result is that firms "can no longer finance part of their cost of entry by skimping on the cost of supporting a warranty. . . . [They] will have to back up their warranty in ways that are credible to experts—the financial community—rather than simply be credible to potentially gullible consumers." Brown, supra note 61, at 620.

75. While some shifting to cash purchases could result from erecting a preservation of defenses rule, the magnitude of the shift would depend on consumers' ability to avoid the use of credit. Note, supra note 23, at 1416-17, 1416 n.23. The following are factors which are likely to counterbalance or preclude such a shift: (a) The socioeconomic pressures which encourage the use of credit are unlikely to be affected by a preservation of defenses rule; (b) a portion of the cost of credit is likely to be reflected not in the price of credit but in the price of the goods themselves (see note 27 supra and accompanying text) and thus
One cannot, however, assert categorically that improved seller performance results from a preservation of defenses rule.\textsuperscript{76} Financers are likely to exclude disreputable merchants and engage in policing activities only when the costs incurred thereby are lower than the risk of buyer nonpayment. Should these costs be higher than the risk of nonpayment, financers are likely to charge the value of that risk rather than engage in policing merchants. As a result, less harm will be attributable to a seller's breach, but only because less value is purchased at the higher price.\textsuperscript{77}

Indeed, “price may rise as the result of [the preservation of defenses rule] . . . for . . . financers will attempt to recover the cost of the new risk they face.”\textsuperscript{78} Yet, it is wrong to assume that “[t]he price increase will probably make consumers worse off.”\textsuperscript{79} Credit in the absence of a preservation of defenses rule and credit under such a rule are two different commodities. “[O]nly if the cost of credit before the [rule] plus the cost of the insurance policy that would provide similar protection to the buyer against shoddy goods or bad service taken together is less than the cost of credit [under a preservation of defenses rule] can we say that the ruling is a mistake and that the cost of credit has gone up.”\textsuperscript{80}

Also, price should not be confused with cost, and “whether the actual cost of credit to consumers will rise depends on whether this new risk is greater or lesser in value than the risk buyers now bear under current law.”\textsuperscript{81} The new risk faced by a financer can have a different value than a buyer's risk in the absence of a pres-

\textsuperscript{76}. \textit{But see} the observation of the U.S. National Commission on Consumer Finance that the effect of the rule would be to provide “protections which the consuming public will receive in the form of better goods and services.” \textit{Nat'l Comm'n on Consumer Finance, Consumer Credit in the United States} 37 (1972) [hereinafter N.C.C.F. Report].

\textsuperscript{77}. Schwartz, \textit{supra} note 13, at 513–17.

\textsuperscript{78}. \textit{Id.} at 503.


\textsuperscript{80}. Brown, \textit{supra} note 61, at 618.

\textsuperscript{81}. Schwartz, \textit{supra} note 13, at 503 (emphasis in original).
ervation of defenses rule. The efficiency produced by the rule is based on the greater ability of the financer to evaluate the risk faced thereunder; a financer's actual risk is not necessarily less than that faced by a consumer in the absence of such a rule.

Finally, as the pre-rule price did not reflect all costs, the "price increase" produced thereunder may well be illusory. In this light, a decline in the amount of consumer credit and an impact on marginal consumers and the businesses which serve them is not alarming. Indeed, it is the inclusion of all costs of credit goods in their prices which leads to a more accurate evaluation of costs by consumers. As such, this reflects a proper move toward optimality.

II. TRANSACTIONS COVERED BY THE PRESERVATION OF DEFENSES RULE

The foregoing discussion has demonstrated that efficiency is promoted by preserving consumer defenses against third party financers. Efficiency results because financers can more accurately evaluate the risk of consumers withholding payment than consumers can evaluate the risk of being obliged to continue paying a financer when a seller breaches. This may suggest a limit to the preservation of defenses rule; an accurate financer risk evaluation is the keystone of its efficiency. Accurate risk analysis may, however, require a lending relationship which permits low transaction costs. When transaction costs become prohibitive, the financer may price the risk arbitrarily or ignore it, resulting in a distorted credit price. Alternatively, the financer might refuse to finance the sale, thereby offering less credit than demanded. These results would lead to misallocation of resources and the creation of an equilibrium based on defective decisionmaking. This result would be inconsistent with the goal of optimality. It is therefore argued that the preservation of defenses rule should be confined to situations where transaction costs are not so high that they prevent accurate risk evaluation.

82. Id. at 515 n.24.
83. See note 75 supra and accompanying text.
84. See note 75 supra and accompanying text.
85. See note 75 supra.
86. Professor Schwartz defines transaction costs as the cost of getting seller and financer together. Schwartz, supra note 13, at 519.
87. Id.
88. Id.
Professor Schwartz has noted that it is common for there to be low transaction costs "where credit sellers and financers are already in a bargaining relationship, as when the financer takes a negotiable note or is the beneficiary of a waiver of defense clause." Therefore, a rule which preserves consumer defenses against third party financers is clearly warranted when such a relationship exists. It is submitted that the interlocking loan pattern—"a course of dealing between lender and seller [where] the lender could be expected to contract for recourse rights for its own self-protection"—also represents such a relationship. Accordingly, Canadian and United States federal laws apply to interlocking loan patterns as well as to retail paper purchase arrangements. Indeed, empirical studies show that where a statute preserves consumer defenses only against purchasers of retail paper, "the direct loan loophole is being used."

While not committing himself to a complete acceptance of the interlocking loan pattern as an appropriate situation for imposing a preservation of defenses rule, Professor Schwartz concedes that his analysis "may be made more concrete by reference to . . . bank credit cards." Card-issuing banks insert chargeback privileges in their contracts with merchant members and may charge back merchants having contracts with other bank members through the mechanism of the interchange system. The preservation of defenses rule should therefore apply to a financer who is a party to the interlocking loan pattern created by a bank credit card chargeback system.

Credit card legislation in the United States is quite uniform in imposing geographical and dollar limitations on transactions that fall within the preservation of defenses rule. The geo-

89. Id. at 503; see also id. at 517-22.
90. Rohner, supra note 27, at 547; see also id. at 549.
91. See notes 2, 3, & 6 supra. Note, however, that the coverage of "the direct loan loophole" by section 189(3)(b) of the Canadian Bills of Exchange Act was quite narrowly construed in Canadian Imperial Bank of Commerce v. Lively, 46 D.L.R.3d 432, 440 (Can. 1974).
92. Note, Utah's UCCC, supra note 35, at 144.
93. But cf. Schwartz supra note 13, at 519 n.28 (acknowledging the existence of low transaction costs in connection with "closely related" lenders).
94. See notes 88-89 supra and accompanying text.
95. Schwartz, supra note 13, at 519.
96. Id. at 520-21; Rohner, supra note 27, at 541, 548.
98. Massachusetts is the exception to this rule. MASS. GEN. LAWS ANN. ch. 255, § 12F (Supp.) (West 1980); see Note, supra note 23, at 1436-37.
99. The geographical limitation is typically either 100 miles from the residence of
graphical limitation is traditionally explained by noting the inability of an issuer to police distant merchants with whom it has no direct course of dealing. 101 This explanation, however, ignores the issuer's ability to charge back through the mechanism of the interchange system.

A new problem is created when a distant merchant is subject to an issuer chargeback: the merchant may have practical difficulties in obtaining recourse against an out-of-state purchaser. This situation could be remedied by providing the merchant with an opportunity to force the cardholder-purchaser to submit to the jurisdiction of the merchant—the place of purchase. 102 The merchant, if successful in the action, could recover on the judgment through the interchange system. 103

A dollar amount limitation on imposing a preservation of consumer defenses rule against credit card issuers is supported by the argument that small dollar amount sales which involve credit card use are typically cash sales. The use of a credit card is merely a substitute means of payment and not an extension of credit. 104 A second argument is that card issuers should not be burdened with cardholders or state boundaries. See, e.g., section 170 of the Fair Credit Billing Act of 1974, supra note 2.

100. The minimum dollar amount of the individual transaction to which the preservation of defenses rule applies is typically $50.00. Id.


102. Another "geographic limitation on a sliding scale" is suggested in Note, Preserving Consumer Defenses in Credit Card Transactions, 81 Yale L.J. 287, 305 (1971), in the form of a "requirement that cardholders return unsatisfactory merchandise and communicate regarding alleged defects."

103. The proposed Model Act, included as an appendix to this Article, recognizes the necessity of providing distant merchants with a remedy and sets forth a Forum Selection Clause. Two exceptions to this general provision are suggested: (a) Where the buyer chooses to pay for the allegedly defective goods an action for breach could be brought in any forum having local jurisdiction over the matter, and (b) where the buyer alleges and can easily establish the likelihood that personal injury was caused by the breach, a court would have the power to ignore the Forum Selection Clause on equitable grounds. Model Act § 5 (Appendix II, infra).

A statute which forces the buyer to litigate in the merchant's jurisdiction in the United States complies with constitutional due process requirements. See Agrashell, Inc. v. Bernard Sirota Co., 344 F.2d 583, 588-89 (2d Cir. 1965), and Electric Regulator Corp. v. Sterling Extruder Corp., 280 F. Supp. 550, 556 (D. Conn. 1968) (both cases holding that the passage of risk of loss to the buyer is a sufficient basis for local jurisdiction). In a face to face consumer transaction, the risk passes to the buyer on the buyer's receipt of the goods. U.C.C. § 2-509(3) (namely in the merchant's jurisdiction). At the same time, there could be circumstances where the application of the suggested exceptions to the Forum Selection Clause will be unconstitutional for failure to meet the requirements of minimum contacts. See World Wide Volkswagen Corp. v. Woodson, 444 U.S. 286 (1980).

104. See Note, supra note 102, at 292.
minor complaints and, therefore, a dollar amount limitation functions as a screening device. Neither argument is convincing. Again, the card issuer, personally or through the interchange system, is in the best position to prevent seller misconduct and distribute the costs of such misconduct, regardless of the dollar amount. The administrative costs of processing the small complaints could be internalized by the issuer or could be handled by applying a small fee or service charge in connection with each complaint. Indeed, "a . . . dollar cut-off point for asserting defenses means that the bulk of all [credit card] purchases are defense-free as far as the issuer is concerned." Meaningful law reform should therefore remove the dollar and geographical limitations on the preservation of defenses rule in connection with multilateral credit card plans.

It has been demonstrated that when a financer and a seller are parties to an existing bargaining relationship, directly or indirectly through an interchange system, all transactions should fall within the preservation of defenses rule. If application of the rule is limited to the existence of such a relationship, independent lenders, those falling outside an interlocking loan pattern, will be excluded. Such exclusion, however, undermines the goal of loss spreading, a basic objective of the preservation of defenses rule and an element necessary for optimality.

Rather than spreading the cost of breach among all consumers, a rule which does not reach the independent lender will work to spread costs only among those who obtain credit from financers related to sellers. Practically speaking, the rule could work "to limit its own scope to the poorer consumer, and in so doing, to spread the cost of breach only among customers who purchase from sellers who cater to low

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106. Rohner, supra note 27, at 548. The American Bankers Association calculates that the average bank credit card transaction was less than $20.00 in the early 1970's. Id. n.208.

107. See Rohner, supra note 27, at 547-49; Note, supra note 23, at 1418-21, 1435; Littlefield, Preservation of Consumer Defenses in Interlocking Loans and Credit Card Transactions—Recent Statutes, Policies and a Proposal, 1973 Wis. L. REV. 471, 492-502. Under § 2(g) of the proposed Model Act (Appendix II, infra), an amount charged to an account under an open credit plan is a species of "restricted use loan." The card issuer is thus subject under § 3(a) to "all the consumer's defenses" without any geographical or dollar limitation.

108. See notes 85-107 supra and accompanying text.

109. See notes 28-30 supra and accompanying text.
income consumers." This will occur because low income consumers with marginal credit ratings may not be able to secure financing from lenders unrelated to the seller. A financer providing credit to low income consumers, who has an established relationship with a seller, because of the preservation of defenses rule, will internalize the cost of seller breach and distribute this loss by charging a higher price for credit. It is unlikely that a financer will choose to sever existing relationships with dealers on whom he or she depends in credit marketing. A consumer with a marginal credit rating who cannot obtain financing from an independent lender will have to pay a price partly reflecting the cost of seller breach.

Conversely, a consumer who has a good credit rating can shop around for the cheapest available financing. A financer who desires to attract more affluent borrowers may therefore deem it wise to sever existing bargaining relationships with sellers, avoid internalizing the costs of seller breach which are imposed by the preservation of defenses rule, and thereby provide credit at a lower price to those consumers who can meet the lender's credit risk standards. Thus, loss spreading would be diminished since only the price charged from the less creditworthy consumers will reflect the costs of seller breach. No part of the costs of seller breach will be reflected in the price charged from the more affluent consumers.

In addition, the exclusion of independent lenders from the scope of the preservation of defenses rule is based on unfounded premises. First, this exclusion embodies the unproven assumption that the inaccurate lender risk evaluation which results from prohibitive transaction costs disrupts efficient resource allocation more than the inaccurate risk evaluation of consumers who borrow from independent lenders not subject to a preservation of defenses rule. Second, because of the efficient methods of inform-
mation dissemination among business entities through organizations like the Better Business Bureau, it is of questionable validity to assume the existence of prohibitive transaction costs in connection with evaluating the risk of a merchant's breach. 116

Prohibitive transaction costs may nonetheless be involved in connection with financing a purchase with the proceeds of a small loan or a small fraction of a loan because the lender will not deem it necessary to know how these proceeds will be used. 117 It has also been suggested that "when a lender has no prior bargaining relationship with the seller and has no business need to know the use to which the money will be put, the gains in optimality . . . are unlikely to outweigh the losses in privacy which are entailed by requiring the bank to ask the consumer's purpose." 118 It appears, however, that apart from these situations, "the lender's superior ability to minimize the effect of seller misconduct on innocent parties" 119 should lead to preserving consumer defenses in all "loans involving institutional lenders and where the lenders can be made aware of the particular consumer transaction for which the proceeds will be used." 120 If a pre-existing recourse arrangement with the seller has not been established, a lender can either insist on an ad hoc security or recourse device, or adjust the finance charge to reflect the risk of breach by the particular merchant. 121

Extending the preservation of defenses rule to the independent lender who "can be made aware of the particular consumer transaction" 122 appears to exclude the independent lender who approves a loan where the use of loan proceeds is limited to a particular purpose—a restricted use loan—and permits the bor-

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116. This appears especially true when the independent lender takes a purchase money security interest in the consumer goods bought with the proceeds of the loan and acts "not merely upon the credit of [the consumer-borrower], but upon the credit also of the merchandise which is to be tendered as security." Maurice O'Meara Co. v. National Park Bank, 239 N.Y. 386, 401, 146 N.E. 636, 641 (1925) (Cardozo, J., dissenting) (dealing with the issuer of a letter of credit).

117. See Note, supra note 23, at 1437 n.128.

118. Schwartz, supra note 13, at 519 n.28.


120. Id. (emphasis added). The Note does not mention the privacy exception.

121. The proposed Model Act recognizes that the lender should be given a statutory right of subrogation to the consumer's claim against the seller. See Model Act § 4 (Appendix II, infra). See also Rohner, supra note 27, at 547 n.201.

122. Note, supra note 23, at 1437 (emphasis added).
rower to shop around for the best buy. Yet, under a preservation of defenses rule, this lender will calculate aggregate risk—the risk of breach by any given merchant dealing in a particular industry or a particular product. A lender is capable of evaluating this risk without prohibitive transaction costs. Therefore, this evaluation will be more accurate than a consumer's evaluation of the risk of losing the right to withhold payment, absent a preservation of defenses rule. Moreover, as contemporary warranties originate primarily from the manufacturer and not the retailer, the financer's risk evaluation is likely to be more concerned with the product than the merchant. Preserving consumer defenses thus promotes efficiency whenever the lender has knowledge of how the proceeds are used but not necessarily of the particular transaction to which the proceeds are applied. Nonetheless, defining the scope of a preservation of defenses rule by a lender's knowledge is bound to spawn additional litigation. The potential for litigation on the issue of lender knowledge could prompt a lender to question a consumer-borrower about the purpose of the loan, even in the absence of any other business need for such information. To avoid wasteful litigation and potential conflicts with a consumer's desire for privacy, the rule should be limited to restricted use loans—consumer loans given for a particular use, such as the purchase of a car or, generally, pursuant to an agreement which restricts the use of loan proceeds to a stated purpose.

Faced with a preservation of defenses rule applicable to such loans, lenders will adjust their rates to reflect the risk of breach in different industries, products, or locations. Because the probability of seller breach is determined by an analysis of a particular industry and not a particular transaction, transaction costs should not be prohibitive. Therefore, there is no justification for excluding low dollar amount restricted use loans from the scope of a preservation of defenses rule. Of course, a lender could also tailor its risk evaluation to reflect its experience with a particular retailer, when it is known which retailer will be a party to the

123. See note 75 supra and accompanying text.
124. The risk of nonperformance by an individual retailer nevertheless cannot be completely ignored. Merchant-based risk exists with regard to sales practices, product servicing, administration of manufacturer warranties, product installation, and seller insolvency. Yet, the value that a financer attaches to the risk of nonperformance by an individual retailer is normally less than the value which is given to the risk of product failure. The financer's risk evaluation is thus based primarily on the product.
underlying transaction, or even exclude certain retailers from receiving the proceeds of a restricted use loan by the terms of the loan agreement with the consumer. This action would be consistent with another objective of the rule—loss prevention.\footnote{126}

Thus, the goal of optimal resource allocation is furthered by a rule which preserves consumer defenses in two situations: against a financer who maintains a bargaining relationship with the seller and against an institutional lender extending a restricted use loan to a consumer.\footnote{127}

III. SCOPE OF FINANCER EXPOSURE TO CONSUMER DEFENSES

Once the transactional scope of a preservation of defenses rule has been established, it is necessary to determine the scope of financer exposure which is consistent with optimal resource allocation. The discussion will focus on the monetary limit of financer exposure. Attention will also be given to the type of consumer defenses available against the financer and restrictions on the consumer's power to raise them.

Commentators disagree about how much financer exposure should exist under a preservation of consumer defenses rule. It has been argued that a rule which limits financer exposure to the amount which the consumer owes the financer at the time of raising the defense "penalizes the conscientious consumer who continues making installment payments in reliance on the empty assurances of a dishonest dealer that the defect will be repaired."\footnote{128} Therefore, it is suggested that financer exposure should extend to either the amount which that lender has financed or the face value of the note and contract.\footnote{129} At a minimum, this liability should exist for the duration of the term of the contract, and could even exist without time limitation.\footnote{130} The Federal Trade Commission advocates an extended liability without time limitation.\footnote{131} This position has also been approved by Canadian

\footnote{126. The effectiveness of such responses should be bolstered by conferring upon financers immunity from tort actions by merchants. See Model Act, § 7 (Appendix II, infra); notes 28–30 supra and accompanying text.}

\footnote{127. Accordingly, the proposed Model Act applies to an assignee of "consumer sale" as well as to a creditor in a "restricted use loan" (including a credit card issuer). Model Act, § 3(a) (Appendix II, infra).}

\footnote{128. Comment, supra note 35, at 475 (1973).}

\footnote{129. Id.}

\footnote{130. Id. at 475 n.62. See also N.C.C.F. Report, supra note 76, at 34–38. Of course, these actions would be subject to the general time limitations on actions in the jurisdiction.}

\footnote{131. Under an FTC Trade Regulation Rule, the liability of the financer is limited to the amount of the "consumer credit contract." 16 C.F.R. §§ 433.1–.3 (1980).}
provincial legislatures dealing with an assignee’s exposure to consumer defenses.\textsuperscript{132}

A rule which extends financer liability and removes any time limitations on a consumer’s right to assert the defense has been criticized as inconsistent with “the identified goals of risk allocation, consumer protection, and marketplace policing.”\textsuperscript{133} It is contended that

\begin{quote}
[a]ny exposure for the financer beyond the amount owing at the time the consumer asserts his defense would . . . make the consumer’s tactical position against the financer better than that available against the defaulting merchant. . . . If the proclaimed evil of holder in due course is that it denies the consumer the tactical opportunity to withhold payments, the proper response is to restore that balance and no more.\textsuperscript{134}
\end{quote}

Although extended financer liability furthers loss prevention and distribution policies because it forces merchants to bear the full cost of their warranties,\textsuperscript{135} such a scheme is inconsistent with optimality considerations. Increasing the scope of financer liability undermines the accuracy with which the risk of liability can be evaluated. At the same time, apart from the risk of a seller’s fraud or insolvency, a scheme which permits consumers to withhold payment, but not to recover from a financer, does not appear to increase significantly a consumer’s inaccurately perceived risk; it is mere speculation to assume that in a case of a disputed consumer claim the financer will be a more lenient defendant than the seller. Also, as most warranty claims are likely to arise during the term of the contract,\textsuperscript{136} the financer will be involved in most disputes concerning seller breach even under a scheme which allows withholding payment only. Therefore, it is submitted that an appropriate preservation of consumer defenses rule should not extend financer liability to the full value of the contract. A consumer’s action should be limited to withholding the amount

\textsuperscript{132} See, e.g., Ontario Consumer Protection Act § 42a (under which recovery against an assignee is limited to “the balance owing on the contract at the time of the assignment”). The Consumer Protection Act, Ont. Rev. Stat. c.82, as amended by Ont. Stat. c.24, § 1 (1971).

\textsuperscript{133} Rohner, supra note 27, at 553.

\textsuperscript{134} Id at 555. The improvement in the consumer’s tactical position is actually the addition of another potential defendant, the financer.

\textsuperscript{135} See Part I supra.

\textsuperscript{136} With respect to hard goods or consumer durables, the credit period is typically longer than the warranty period. For example, in 1971 the warranties offered by manufacturers of cars were 12 months or 12,000 miles, Ontario Law Reform Comm’n, Report on Consumer Warranties and Guarantees in the Sale of Goods 83 (1972), but a $3,000 credit contract on a new automobile in the United States was for a term of 36 months. N.C.C.F. Report, supra note 76, at 15.
owed to the financer at the time of asserting the defense.  

Optimality principles suggest that the scope of a consumer's right to withhold financer payment should be coextensive with a consumer's right to withhold payment from a seller if a third party financer were not present. A consumer's right to withhold payment from a financer should not be subject to limits on the type of defenses available to the consumer, on the time to assert them, or to other conditions to which the right is tied under some statutes. Otherwise, the preservation of defenses rule will not eliminate the entire, undervalued risk of incurring uncompensated loss, and this failure will decrease the effectiveness of the rule as a device for achieving optimality.  

Nonetheless, the risk of seller fraud or insolvency is not fully eliminated by a rule which allows a consumer only to withhold payment. Although the value of these risks is an element of the cost of the credit or the goods, it is underestimated by consumers. Therefore, when the prices of credit and consumer goods under such a rule do not reflect the full cost, the efficient allocation of resources is disrupted. It is submitted, however, that insofar as the individual consumer can be aided by public law agencies in pursuing recovery from a dishonest seller, the benefits of extended financer exposure are outweighed by the decrease in the accuracy of a financer's risk evaluation. The preservation of defenses rule should therefore not include an exception for seller fraud.

The risk of insolvency may involve the risk of a more tangible

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137. The general rule proposed by the appended Model Act extends a financer's exposure to "the amount owed under the consumer obligation at the time of setting up the defense against his or her action on the consumer obligation." Thus, the consumer is only entitled to withhold payment. Model Act § 3(a) (Appendix II, infra).

138. A typical limitation is one which restricts available consumer defenses to "tort claims" (presumably defenses arising out of claims for consequential loss). See, e.g., section 170 of the Fair Credit Billing Act, supra note 2. See also section 191 of the Canadian Bills of Exchange Act, which provides that "the right of the holder of a consumer bill or consumer note . . . is subject to any defence or right of set-off, other than counter-claim." An Act to Amend the Bills of Exchange Act, CAN. REV. STAT. c.4 (1970 1st Supp.) (emphasis added).

139. See note 5 supra and accompanying text.

140. The most typical statutory obligation is the duty to make a good faith attempt to resolve the dispute with the seller before withholding payment from the financer. The burden imposed by this duty has, however, been dismissed as "a rough marketplace equivalent of the idea of exhausting administrative remedies and should not in any way inhibit the assertion of genuine defenses." Rohner, supra note 27, at 551.

141. The proposed Model Act explicitly states that a financer is subject to "all the consumer's defenses arising from the seller's breach of the consumer sale." Model Act § 3(a) (Appendix II, infra).

142. See note 75 supra and accompanying text.
loss. Although any increase in a financer’s exposure to liability is likely to engender some inaccuracy in the financer’s risk evaluation, placing the burden of seller insolvency on the financer will decrease a consumer’s unperceived risk.\textsuperscript{143} Yet, an unlimited financer’s exposure, even when confined to a seller’s insolvency, could upset the financer’s risk evaluation and affect its accuracy significantly. This danger may diminish, however, by eliminating as much uncertainty as possible from the financer’s risk evaluation. This could be done, for example, by increasing financer’s exposure in cases of seller insolvency only to a limited extent. Even then, it may be impossible to determine empirically whether the gain from decreasing a consumer’s unperceived risk outweighs the possible loss from increasing the inaccuracy of a financer’s risk evaluation. Where optimality considerations are neutral, however, equity would support a scheme in which losses created by seller insolvency are absorbed by financers.\textsuperscript{144} Accordingly, in cases of seller insolvency a financer should be subject to all consumer defenses, except consequential loss, up to the value of the financed contract or the amount financed.\textsuperscript{145}

The preceding discussion should not alter the power of courts to increase a financer’s exposure, on a case-by-case basis, within the framework of existing principles of law. A joint venture,\textsuperscript{146} or a parent-subsidiary relationship between financer and seller,\textsuperscript{147} and a financer’s duty to warn consumers where an intimate relationship with a seller should reveal the probability of that seller’s breach,\textsuperscript{148} are illustrations of this proposition.\textsuperscript{149}

\section*{IV. Conclusion}

The pursuit of optimality supports a preservation of defenses rule which applies to a financer who is in a bargaining relation-

\begin{itemize}
  \item \textsuperscript{143} See text following note 135 supra.
  \item \textsuperscript{144} The risk of seller insolvency is quite low. According to statistics cited by Professor Schwartz only 0.002\%-0.003\% of retail trade outlets went bankrupt in the U.S. in 1967, 1968, and 1969. Schwartz, \textit{supra} note 13, at 517 n.27.
  \item \textsuperscript{145} See Model Act, § 3(c)-(e) (Appendix II, infra).
  \item \textsuperscript{146} See Central Mortgage & Housing Corp. v. Graham, 43 D.L.R. 3d 686, 703–10 (N.S. Sup. Ct. 1973).
  \item \textsuperscript{147} See Jones v. Approved Bancredit Corp., 256 A.2d 739 (Del. 1969); Unico v. Owen, 232 A.2d 405 (N.J. 1967). \textit{But cf.} Block v. Ford Motor Credit Co., 286 A.2d 228 (D.C. 1972) (where the dealer was a franchisee of Ford rather than a subsidiary; \textit{query} whether this should have been a valid distinction).
  \item \textsuperscript{148} See, \textit{e.g.}, Connor v. Great Western Savings & Loan Ass’n, 447 P.2d 609 (Cal. 1969) (defendant Association failed to protect purchasers from contractor’s negligence).
  \item \textsuperscript{149} The power of courts to extend a financer’s exposure in specific situations is provided for in § 6 of the Model Act (Appendix II, infra).
\end{itemize}
ship with the seller. This includes a seller's assignee and a direct lender who is a party to an interlocking loan pattern. The rule should apply also to every restricted use loan given to a consumer-borrower by an institutional lender. Apart from specific situations covered by general principles of law, a financer's exposure should be confined to a consumer's right to withhold payment. This right to withhold payment from a financer should be coextensive with the right to withhold payment from a seller. It should thus encompass all types of defenses and should not be subject to time limitations or other preconditions. In the case of seller insolvency, where optimality considerations are equivocal, a financer's exposure to consumer defenses should increase. A financer should be subject to a consumer's defenses, with the exception of consequential loss, up to the value of the financed contract or the amount financed.

The adoption of legislation preserving consumer defenses against third party financers is consistent with the pursuit of optimality. Yet, existing statutes in the United States and Canada do not fully satisfy the optimality model suggested above. In particular, they do not apply to restricted use loans. Moreover, some statutory schemes do not address direct lenders or impose time limitations or other conditions and restrictions on the availability of consumer defenses. Another frequent statutory impediment to optimality is a scheme which extends financer exposure beyond the amount owed by the consumer to the financer without linking this increased exposure to seller insolvency. It is indeed regrettable that legislatures have failed to give adequate consideration to the principles of optimal resource allocation when determining the scope of a preservation of consumer defenses rule.

Appendix I

A British Columbia Model

A notably broad protection will be offered to consumers on the proclamation of section 8(1) of the British Columbia Consumer Protection Act. The section reads as follows: "A creditor in a purchase financing transaction has no greater rights than the seller and is subject to the same defences as may be raised against the seller." "Purchase financing transaction" is defined in section 1 to mean: "the extension of credit to a borrower by a creditor where the creditor knows or ought to know that the credit proceeds will be used by the borrower to purchase goods or services

from a seller.” “Creditor” under section 1 “includes a lender.” “Lender” under section 1 is “a person . . . who in the course of business extends credit.”

The overall effect of section 8(1) is that a lender who “knows or ought to know that the credit proceeds will be used by the borrower to purchase [consumer] goods” is subject “to the same defences as may be raised against the seller.” This covers the purchase money lender under a “one shot” loan as well as under a multilateral credit card plan.151

The scheme set up by the interaction of section 8(1) and section 3, dealing with the rights of a seller’s assignee,152 approximates optimality more than any other enacted statute in North America. This is achieved because the scheme is not limited to lenders “closely related” to sellers, does not impose restrictions on a consumer’s right to withhold payment, and, at the same time, probably limits a lender’s exposure to the balance which is due at the time of the assertion of consumer defenses.153 The scheme requires a few amendments, however. In particular an assignee’s exposure under section 3(2) should also be limited to the balance due at the time of the assertion of defenses. Also, the scope of section 8(1) should expressly extend to all multilateral credit card transactions.154

The scheme should, however, be limited to restricted use loans, rather than apply to every case of credit extension “where the creditor knows or ought to know that the credit proceeds will be used by the borrower to purchase [consumer] goods or services.”

151. Note, however, that since “credit” in the British Columbia Consumer Protection Act is defined in § 1 as “credit . . . for which a borrower incurs a cost of borrowing . . . ,” § 8(1) does not apply when the credit card is used as a means of cash payment because no “cost of borrowing” (charges payable “on the unpaid balance from time to time,” § 1) is incurred in connection with a particular purchase.

152. Section 3 provides, in its relevant part:

(1) Subject to subsection (2), an assignee of a . . . seller . . . has no greater right than, and is subject to the same obligations, liabilities and duties as the assignor.

(2) No debtor shall receive from, or is entitled to set off against, an assignee of the . . . seller an amount greater than the balance owing on the contract at the time of the assignment.

153. It is regrettable that this effect is not expressly directed. This effect emerges from the language of § 8(1) that follows § 191 of the Bills of Exchange Act in subjecting a creditor only to “defences.” This is different from the language of § 3(1) of the British Columbia Consumer Protection Act which provides that an assignee of a seller “is subject to the same obligations, liabilities and duties as the assignor” (but is nonetheless not liable to the consumer for “an amount greater than the balance owing on the contract at the time of the assignment”). British Columbia Consumer Protection Act, supra note 150, § 3(2).

154. See note 151 supra.
The application of the section should also be confined expressly to credit extended by an institutional lender. In addition, there is a need to extend a financer's exposure in a case of seller insolvency. There is also the need for explicitly recognizing a court's power to deal with a financer's liability within the framework of existing principles of law. Nonetheless, the course taken by section 8(1) of the British Columbia Consumer Protection Act appears to be a positive step in the pursuit of optimality.

Appendix II—Model Act
A Proposed Model Preservation of Consumer Defenses Act

1. Purpose

An Act to preserve consumer defenses against third party financers.

2. Definitions

In this Act:

(a) "consumer" means the debtor on a consumer obligation.

(b) "consumer obligation" means an obligation to pay on:
   (i) a credit sale obligation, or
   (ii) a restricted use loan, insofar as its proceeds were used in a consumer sale.

(c) "consumer sale" means the sale of goods or a contract for the sale of goods by a seller to a buyer for use not in the course of the buyer's business.

(d) "credit sale obligation" means an obligation to pay for goods sold in a consumer sale whose terms call for all or part of the purchase price to be paid after the conclusion of the contract.

(e) "financer" means:
   (i) a creditor in a restricted use loan or the creditor's assignee, and
   (ii) an assignee of the seller's right to enforce a credit sale obligation who advances money against credit sale obligations in the ordinary course of business.

(f) "open end credit plan" means a plan which estab-

155. Presently, while a "lender" is a person who extends credit "in the ordinary course of business," the definition of "creditor" is broader than that of "lender." See text following note 150 supra.
lishes accounts between one person and numerous accountholders and enables each accountholder to purchase goods from third party sellers by charging each purchase to his account. Amounts due from time to time on the account are to be paid under the terms of the plan.

(g) “restricted use loan” means:

(i) money lent in the course of one’s business, to a borrower for use not in the course of business, pursuant to an agreement which restricts the use of its proceeds to one or more of the following uses:

(1) the purchase of goods from a specific seller or class of sellers,
(2) the purchase of a specific product or type of goods,
(3) the purchase of goods in a designated locality, or
(4) the purchase of goods made wholly or partly by a specific manufacturer or class of manufacturers, or otherwise identified by a common element like a common origin, common source of distribution, trademark or name.

(ii) an amount, pertaining to a consumer sale, charged to an account under an open end credit plan.

3. Consumer’s Rights

(a) A financer suing on a consumer obligation is subject to all the consumer’s defenses arising from the seller’s breach of the consumer sale.

(b) A financer’s exposure under subsection (a) extends to the amount owed under the consumer obligation, at the time the defense is asserted against the financer’s action on the obligation.

(c) Notwithstanding subsection (b), when, due to the seller’s insolvency, the consumer is unable to recover from the seller the full amount of damage caused by the seller’s breach, the consumer may recover the balance of the damages from the financer, up to the price of the goods under the consumer sale.
(d) A seller is insolvent for the purpose of subsection (c) when:

(i) he has ceased to pay his debts in the ordinary course of business or cannot pay his debts when they become due, or

(ii) the aggregate of his property, exclusive of any property conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay creditors, is not sufficient in amount to pay his debts, or

(iii) he is subject to, or meets the requirements to be subject to, an assignment for the benefit of creditors, receivership proceedings, bankruptcy proceedings or other proceedings intended to liquidate or rehabilitate his estate, or

(iv) a discharge with respect to his liability on the consumer sale has been given under any of the proceedings specified in the preceding clause.

(e) The consumer's rights under subsection (c) are enforceable against the financer either in a separate action or in the financer's action on the consumer obligation. A judgment given in the financer's action on the consumer obligation does not bar a consumer's separate action to enforce the rights under subsection (c), provided that the facts forming the basis for these rights were not actually determined adversely to the consumer in the action on the consumer obligation.

4. **Financer's Recourse**

(a) Where a consumer refuses to pay the financer on the consumer obligation, alleging rights under section 3, so long as no final judgment denying the existence of these rights has been obtained, the financer may recover from the seller the amount he cannot or would not be able to collect from the consumer on the successful assertion of the consumer's rights. This remedy is without affecting possible alternative recourse or subrogation rights and absent an agreement to the contrary.

(b) Where a financer chooses to exercise the rights under subsection (a), on giving proper notice to the consumer, the seller may either sue the consumer on the
consumer obligation or continue in the financer's action, and for purposes of this action the consumer obligation will conclusively be presumed to be a credit sale obligation with respect to the goods sold. A prior final judgment on the consumer obligation is a bar to the seller's action under this subsection.

(c) A judgment obtained by the seller suing on the consumer obligation under subsection (b), or a judgment obtained by the financer on the consumer obligation prior to exercising his rights under subsection (a), can be recovered by the seller either from the consumer or from the financer. It can also be collected from the consumer by the financer.

(d) The purpose of this section is to prevent unjust enrichment and to prevent loss to an innocent party.

5. A Forum Selection Clause in an Open End Credit Plan

(a) Irrespective of any specific or general statute or rule of law or equity which denies or limits the effect or validity of a forum selection clause, the terms of an open end credit plan may provide that the purchase of goods in a consumer sale, to be charged to an account under the plan, is deemed to be a submission by the consumer to the exclusive jurisdiction of any competent court, otherwise exercising local jurisdiction over the dispute, which is situated within __ miles from the place of the purchase. Where provided, such a term is deemed to be incorporated in the consumer sale as a forum selection clause.

(b) A term in an open end credit plan authorized by subsection (a) is unenforceable where:

(i) the consumer chooses to pay on the consumer obligation without prejudice to his rights arising from the seller's breach, or

(ii) the consumer alleges and can easily establish the likelihood of personal injury caused by the seller's breach, and the court finds that enforcing the term would be inequitable.

6. Supplementary Principles of Law Applicable

General principles of law and equity which enable a court to find a financer liable in specific situations, even to the extent of the
whole damage caused by the seller's breach, are not affected by this Act. Where a court determines that the relationship between a financer and a seller is a joint venture or a parent-subsidiary relationship, or that the financer was involved in a scheme which was likely to produce the seller's breach, a financer is deemed to be liable to the consumer for the full damage caused by the seller's breach.

7. Financer's Defense Against Seller

The refusal to deal with a seller or class of sellers, whether absolute or conditional, and the inclusion in an agreement underlying a restricted use loan of any term relating to the choice of a seller by the consumer, is deemed lawful and is not actionable against a financer in tort or under any statute by any person adversely affected by such refusal or term. This presumption can be rebutted by a showing that the financer's decision to refuse to deal or to include the term was not made in good faith and in accordance with reasonable commercial standards for the protection of consumers or the financer's own rights.

8. No Waiver of Rights or Implicit Repeal

Except as provided in section 4(a), the provisions of this Act apply notwithstanding any contrary agreement, principle of law or equity, or statute.

9. Regulations

Regulations implementing this Act shall provide:
(a) the manner in which meaningful disclosure of rights under this Act shall be made to consumers,
(b) the manner in which a financer's exposure shall be computed regarding entries to accounts under open end credit plans, the use of the proceeds of a restricted use loan for purposes other than the purchase of goods under the consumer sale, the consolidation of accounts, or the application of lawful charges on the consumer obligation, and
(c) the manner of computing mileage in section 5(a).

10. Sanction for Failure to Comply with Regulations

[Such a provision is designed to enhance the effectiveness of the Act. Its content may be influenced by parallel provisions in]
consumer protection legislation in the adopting jurisdiction. No particular provision is proposed here.]

 Comments

§ 1 Introductory note

This Act is designed to implement the analysis presented in this Article and to set up a scheme preserving consumer defenses which effectuates optimal resource allocation. The Act establishes a scheme which preserves consumer defenses against third party financers (sections 3 and 6), and provides for rules governing the position of parties after the effective exercise of a consumer’s rights (section 4 and 5). The scheme is premised on the financer’s greater ability to minimize the cost produced by a seller’s breach and to internalize those costs which cannot be eliminated.156 The Act thus provides a framework which will enable financers to accomplish these goals with immunity from possible tort actions by merchants (section 7).

§ 2 Preservation of consumer defenses (sections 1, 3, and 6)

The Act governs the preservation of consumer defenses against third party financers (section 1). It provides in section 3(a) that a financer’s action on “a consumer obligation” is subject to all the consumer’s defenses arising from the seller’s breach of the “consumer sale.” “Consumer obligation” (as defined in section 2(b)) covers the “credit sale obligation” (defined in section 2(d)) as well as the “restricted use loan” (defined in section 2(g)). A “financer” is a creditor in a “restricted use loan” or an assignee of a “credit sale obligation” (section 2(e)). “Consumer sale,” defined in section 2(c), relates to the sale of goods to a buyer for use not in the course of the buyer’s business.

A financer’s exposure to defenses under the Act extends to “the amount owed under the consumer obligation, at the time the defense is asserted against the action on the obligation” (section 3(b)). This means that a consumer is entitled to withhold payment and assert these rights only as a defense to a financer’s action. A financer is not subject to an affirmative recovery. This limited financer exposure is subject to two exceptions: 1) In a case of a seller’s insolvency, as defined in section 3(d), the consumer may recover from the financer, in an action governed by section 3(e), “the balance of the damages from the financer, up to the price of

156. See generally notes 21–84 supra and accompanying text.
the goods under the consumer sale" (section 3(c)).\textsuperscript{157} 2) The Act does not purport to affect powers of courts, derived from "general principles of law and equity," to find a financer "liable in specific situations, even to the extent of the whole damage caused by the seller's breach" (section 6). Such situations are deemed to exist in the case of a joint venture or a parent-subsidiary relationship between a financer and seller, as well as where a financer has a duty to warn consumers arising from involvement with the seller's operations.\textsuperscript{158}

§ 3 The scheme as an effective means to achieve optimality

The scheme set up by the Act is effective in accomplishing the pursuit of optimality for the following reasons:

1) The scheme applies to an assignee of the sales contract (including a purchaser of a negotiable instrument given in payment thereunder) who is in the business of purchasing retail paper and to an institutional lender who extends a restricted use loan to a consumer-borrower (including an issuer under a multilateral credit card plan).\textsuperscript{159} The scheme is thus not limited to a financer "closely related" to the seller or otherwise in a bargaining relationship.

2) Apart from situations covered by general principles of law, and subject to a limited insolvency exception, a financer's exposure is confined to a consumer's right to withhold payment.\textsuperscript{160}

3) The consumer's right to withhold payment against the financer is coextensive with the right to withhold payment against the seller. It encompasses all defenses and is not subject to time limitations or other preconditions.\textsuperscript{161}

§ 4 Financer's recourse and merchants' rights (sections 4 and 5)

Where a consumer effectively exercises the rights under the Act and withholds payment against a financer, section 4(a) governs the financer's recourse against the seller.\textsuperscript{162} The purpose of this section is to prevent unjust enrichment (section 4(d)). It applies only "absent an agreement to the contrary" and "without affecting possible alternative . . . rights." No other provisions of

\textsuperscript{157} For a discussion of the insolvency exception, see notes 143–45 \textit{supra} and accompanying text.

\textsuperscript{158} See notes 146–48 \textit{supra} for examples of such involvement.

\textsuperscript{159} See notes 85–127 \textit{supra} and accompanying text.

\textsuperscript{160} See notes 128–49 \textit{supra} and accompanying text.

\textsuperscript{161} See notes 138–41 \textit{supra} and accompanying text.

\textsuperscript{162} See notes 21–36 \textit{supra} and accompanying text.
the Act can be modified by agreement or, even implicitly be repealed by statute (section 8). Where a financer exercises the rights under section 4(a), "the seller may . . . sue the consumer on the consumer obligation" (section 4(b)). The controversy regarding the seller's performance can therefore be resolved by the parties to the contract for sale. In a case of a multilateral credit card plan, the Act meets the legitimate grievance of a merchant, forced to sue a distant buyer who has withheld payment, by providing in section 5 for a forum selection clause. Such a clause is essential to the acceptability of multilateral credit cards from buyers living in distant jurisdictions and may provide for the submission by the consumer to the seller's jurisdiction. The clause is effective only where the consumer chooses to withhold payment. It does not preclude a consumer from paying on the debt and then pursuing his or her remedy in any court having local jurisdiction over the matter. A court could refuse to enforce the forum selection clause in a case of personal injury.163

§ 5 Financer defenses

The Act is premised on a financer's superior ability to minimize the costs produced by seller breach and to internalize those costs which cannot be eliminated. Therefore, so long as the financer acts "in good faith and in accordance with reasonable commercial standards," he or she should be given complete freedom in selecting merchants and negotiating agreements.164 Section 7 thus provides a financer with a good faith defense in any action in tort or under statute which is based on a "refusal to deal with a seller or class of sellers, whether absolute or conditional." This defense is also available in an action based on "the inclusion in an agreement underlying a restricted use loan of any term relating to the choice of a seller by the consumer." Such a defense would provide a measure of freedom to financers seeking to establish or terminate bargaining relationships with sellers. It would also permit an independent lender to exclude disreputable retailers from receiving the proceeds of restricted use loans and enable the lender to set different rates for restricted use loans, adjusted according to the reputation of the merchant to whom the proceeds would be directed.165

163. See notes 95–107 supra and accompanying text.
164. See notes 21–84 supra and accompanying text.
165. See note 126 supra and accompanying text.