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PURCHASE OF CONSUMER PAPER AND SUBJECTION TO COLLATERAL DEFENSES

Benjamin Geva*

I. INTRODUCTION

The purchase of commercial paper¹ issued in return for consumer goods² [hereinafter referred to as consumer paper] is a common and wide-spread sales financing practice.³ Various judicial techniques and legislative schemes have been employed to disqualify purchasers of consumer paper⁴ from becoming holders in due course [hereinafter referred to as HDC],⁵ thus rendering these purchasers subject to defenses to the instrument based upon consumer dissatisfaction with the goods.⁶ Underlying the denial of HDC status to purchasers of consumer paper are the following premises: (1) the sale of consumer goods is not a commercial transaction and should

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1. Covered by the Uniform Commercial Code (U.C.C. or Code), 1962 Official Text, Article 3. For our purposes, "commercial paper" means a negotiable instrument as defined in U.C.C. §3-104.

The reason for citing the 1962 version of the Code rather than the 1972 Official Text is the wider adoption of the former in the American jurisdictions. Yet, the 1972 changes do not affect the conclusions of this paper. Cf. note 27 *infra* (changes in § 9-318(3) designed to eliminate difficulties in the 1962 Code).

2. Defined by U.C.C. § 9-109(1) as goods which "are used or bought for use primarily for personal, family or household purposes."

3. Littlefield, *Preserving Consumer Defenses: Plugging the Loophole in the New UCCC*, 44 N.Y.U. L. Rev. 272, 274 (1969) [hereinafter cited as Littlefield]. For a discussion of the distinctions between the markets for consumer paper and commercial paper see *id.* at 285.

4. Expressions such as "consumer purchases financier," "financier" and "purchaser of consumer paper" are used in this article interchangeably.

5. Defined in U.C.C. § 3-302(1) as a holder (U.C.C. § 1-201(20)) who takes the instrument for value (U.C.C. § 3-303), in good faith (U.C.C. § 1-201(19)) and without notice (U.C.C. § 1-201(25), (27)) of any defect relating to it (U.C.C. § 3-304). The rights of a HDC are governed by U.C.C. § 3-305 and are characterized by freedom from most defenses of parties with whom he has not dealt.

6. For a guide to the enormous amount of literature dealing with this issue, see REPORT OF THE NATIONAL COMMISSION OF CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES, ch. 3 nn.58-77 (December 1972) (chairman: R. Braucher, succeeded by I.M. Millstein). See also Rohner, *Holder in Due Course in Consumer Transactions: Requiem, Revival or Reformation?* 60 CORNELL L. REV. 503 (1975) [hereinafter cited as Rohner].

not be governed by commercial law;⁷ (2) usually a close connection exists between sellers and consumer purchases financiers;⁸ (3) there is a basic inequality between consumers and the commercial community;⁹ (4) the maintenance of consumer defenses against sellers alone is inadequate;¹⁰ and (5) the desired goals of minimizing costs of seller misconduct and internalizing the remaining costs in the price of consumer credit should be accomplished by allowing consumer defenses against purchasers financiers.¹¹

The subject of this article, however, is not the consumer's right

7. Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1101 (1954) [hereinafter cited as Gilmore]; Murphy, *Another "Assault Upon the Citadel": Limiting the Use of Negotiable Notes and Waiver-of-Defenses Clauses in Consumer Sales*, 29 OHIO ST. L.J. 667, 672 n.18 (1968) [hereinafter cited as Murphy]. *But see* Kripke, *Consumer Credit Regulation: A Creditor Oriented Viewpoint*, 68 COLUM. L. REV. 445, 471 (1968) [hereinafter cited as Kripke].

8. See generally Feltham and Feltham, *Retail Installment Sales Financing—Rights of the Assignee-Endorsee—Identification of the Finance Company with the Dealer to Protect the Buyer*, 40 CAN. B. REV. 461, 479-81 (1962) [hereinafter cited as Feltham]; Mooney, *Judicial and Statutory Limitation on the Rights of a "Holder in Due Course" in Consumer Transactions*; 11 B.C. IND. & COM. L. REV. 90, 99 (1969-70). For a discussion of the evolution of the close connection pattern, see Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 S. CAL. L. REV. 48, 63-64 (1966) [hereinafter cited as *Good Faith Purchase*]. For an examination of the pretensions of closely connected purchases financiers who seek to qualify as HDC's, see McEwen, *Economic Issues in State Regulation of Consumer Credit*, 8 B.C. IND. & COM. L. REV. 387, 401 (1967); Comment, *Translating Sympathy for Deceived Consumers into Effective Programs for Protection*, 114 U. PA. L. REV. 395, 414 n.147 and accompanying text (1966). Usually sellers and financiers operate together without considering the interests of the consumer. See Littlefield, *supra* note 3, at 274.

9. Gilmore, *supra* note 7, at 1101; Kripke, *supra* note 7, at 472; Kripke, *Chattel Paper as Negotiable Specialty Under the Uniform Commercial Code*, 59 YALE L.J. 1209, 1219 (1950) [hereinafter cited as *Chattel Paper*]; Schuchman, *Consumer Credit by Adhesion Contracts, Pts. I&II*, 35 TEMP. L.Q. 125, 130, 281 (1962). The consumer executing the notes seldom realizes that his signature might amount to an obligation to pay regardless of the seller's performance. See Murphy, *supra* note 7, at 671 n.16; Eldridge, *The Holder-in-Due Course and the Installment Buyer of Consumer Goods*, 36 U.M.K.C. L. REV. 368, 376 (1968). The typical consumer may be characterized as a low-moderate income earner whose inferior bargaining power vis-a-vis the business community necessitates adequate protection. See Schricker, *Unfair Competition and Consumer Protection in Western Europe*, 1 I.I.C. 415, 434 (1970).

10. This is due to "the burden of inertia of litigation" and the "strain of current cash outlay." Littlefield, *supra* note 3, at 285. *Contra*, *Chattel Paper*, *supra* note 9, at 1215-16. *But cf.* Kripke, *supra* note 7, at 471-73 (modifying his earlier views).

11. See generally Note, *Direct Loan Financing of Consumer Purchases*, 85 HARV. L. REV. 1409, 1411-17 (1972); Littlefield, *supra* note 3, at 280-85 (referring to the policies of "policing the retailer" and "spreading costs and assuming risks").

to assert defenses arising directly from the underlying transaction. Rather, the present concern is the maintenance of "collateral defenses," i.e., claims and defenses which arise against the seller out of a transaction separate and independent¹² from the financed contract for sale,¹³ but which are nevertheless applicable to the seller's claim upon the financed contract. The precise issue is whether these collateral defenses are available to the consumer against purchasers of consumer paper who are not HDCs.

In analyzing this issue, it will be argued in Section II that the question should be resolved according to the law of instruments. Section III will then be devoted to the presentation of a number of arguments in support of the conclusion that present commercial and consumer credit legislation may be interpreted as subjecting purchasers of consumer paper to collateral defenses.¹⁴

II. CONSUMER PAPER RETAINS ITS IDENTITY AS AN INSTRUMENT

A. *The Inapplicability of U.C.C. § 9-318*

Two assumptions are basic to this discussion of consumer paper and subjection to collateral defenses. First, consumer paper retains its identity as an instrument.¹⁵ Second, the issue of whether a purchaser of consumer paper is subject to collateral defenses ought to be resolved in the light of the law applicable to instruments rather than the law of chattel paper.

The law of instruments is applicable to consumer paper despite the fact that the typical financed consumer sale involves the contemporaneous execution of a security agreement¹⁶ and a negotiable

12. See note 43 *infra*.

13. "Contract for sale" is defined in U.C.C. § 2-106(1). Unless indicated otherwise, such expressions as "contract for sale", "sale agreement", "sale", "agreement", "contract" and "transaction" will be used here interchangeably.

14. The present inquiry will be confined to a conceptual analysis of the legal relations and will avoid a functional examination of policies and problems of risk allocation.

15. "Instrument" is defined in U.C.C. § 9-105(1)(g) as "a negotiable instrument [defined in Section 3-104] . . . or any other writing which evidences a right to the payment of money and is not itself a security agreement or lease and is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment. . . ." Cf. U.C.C. § 3-102(1)(e) (defining "instrument" for the purpose of Article 3).

16. "Security agreement" is defined in U.C.C. § 9-105(1)(h) as "an agreement which creates or provides for a security interest" (defined in U.C.C. § 1-201(37)).

instrument,¹⁷ a "group of writings" which when taken together constitutes "chattel paper."¹⁸ As explained hereinafter¹⁹ in dealing with rights upon an instrument which constitutes part of chattel paper, the signer of the instrument is not an "account debtor," the name given by the Code to the person who is obligated on chattel paper.²⁰ Therefore, U.C.C. § 9-318, being confined to the rights of an *account debtor*,²¹ does not govern the rights of a person who is obligated on such an instrument, and hence the section cannot constitute a direct authority for his power to assert collateral defenses against an assignee who seeks to enforce the obligation embodied in the instrument.²² Instead, the rights of this obligor are determined by the law applicable to instruments. Indeed, apart from the rights that stem from *security interests* in instruments, Article 9 of the Code does not purport to deal with the rights and liabilities of parties thereto: "an instrument which is secured by chattel paper is itself part of chattel paper, while also retaining its identity as an instrument."²³

The exclusion from the definition of "account debtor" of the person who is obligated on chattel paper in his capacity as the signer of the instrument is required to maintain harmony between the provisions of Article 9 and two fundamental rules underlying the nature of instruments. The first rule is that an obligation evidenced

17. See Feltham, *supra* note 8, at 461; *Good Faith Purchase*, *supra* note 8, at 74.

18. See U.C.C. § 9-105(1)(b)(last sentence). See also § 9-304(1); 1972 Official Text, § 9-308, Comment 4, § 9-309, Comment 2.

19. See notes 23-33 *infra*, and accompanying text.

20. "Account debtor" is defined in U.C.C. § 9-105(1)(a). The definition does not refer to an obligor upon an instrument, but it encompasses "the person who is obligated on . . . chattel paper" (emphasis added). Because an instrument which is executed contemporaneous with a security agreement is viewed by the Code as part of chattel paper; *id.*; the person who is obligated on it might be considered an account debtor. *But see* notes 23-33 *infra* and accompanying text.

21. It should be noted that § 9-318(1) which deals with defenses of an account debtor against an assignee applies only when an enforceable agreement not to assert defenses as provided in § 9-206(1) is not involved. However, denying HDC status to purchasers of consumer paper amounts to "a different rule for buyers . . . of consumer goods" within the purview of § 9-206 (1) so as to hold such agreements unenforceable and hence to hold § 9-318(1) applicable.

22. U.C.C. § 9-318(1)(b) provides that the rights of an *assignee* are subject to collateral defenses of the *account debtor*. Whether "assignee" is broad enough to cover also a holder of an instrument will not be determined here. For definitions of "assignee" and "assignment," see BLACK'S LAW DICTIONARY 152, *et seq.* (rev. 4th ed. 1968).

23. U.C.C. § 9-105(1)(g), Comment 3.

by an instrument is merged into the instrument,²⁴ rather than the instrument becoming part of the obligation.²⁵ Taking a negotiable instrument for an underlying obligation has the effect of suspending the obligation. The discharge of the underlying obligation is an incident to the discharge of the liability upon the instrument and can effectively be given only by the holder of the instrument. Hence, when an obligation on an instrument is sought to be enforced, the additional capacity of the obligor as "account debtor" is beyond the issues that are before the court. The obligor is sued as a person who is obligated on an instrument, rather than on chattel paper, whether or not the holder of the instrument also took the security agreement. The range of permissible defenses against the claim is therefore determined by the law applicable to the obligation upon the instrument, rather than by the law which governs the obligation upon the underlying contract. Whether the latter law can be triggered by the former law is nonetheless an entirely different question.

The second fundamental rule is that an obligation which is embodied in an instrument is "reified" or "thingnified",²⁶ i.e., is transferred by delivery of the instrument, with or without any necessary endorsement, rather than by mere agreement or notification. Unlike an assignee of chattel paper who is entitled to collect from the obligor under § 9-318(3) by giving him notice of the assignment,²⁷ a transferee of an instrument must rely on his possession of the paper.²⁸ Likewise, while under § 9-318(3) chattel paper can be gar-

24. See U.C.C. § 3-802(1)(b). ". . . [T]he obligation [evidenced by the instrument] is *suspended pro tanto* until the instrument is due or if it is payable on demand until its presentment" (emphasis added). *Id.*

25. This appears to be the case under U.C.C. § 9-105(1)(b). See note 18 *supra*, and accompanying text.

26. See J. FALCONBRIDGE, *ESSAYS ON THE CONFLICT OF LAWS*, 489-90 (2d ed. 1954).

27. "Account" in U.C.C. § 9-318(3) should not be limited to its definition in § 9-106 but should rather be construed to include all choses in action on which an account debtor is obligated, including chattel paper. See U.C.C. § 9-318, Comment 3; 1972 Official Text § 9-318(3); Appendix to the 1972 Official Text, Reason for 1972 change of § 9-318 (second paragraph).

28. See note 14 *supra*, and accompanying text. See also U.C.C. § 3-603(1). The liability of a party to an instrument is discharged "to the extent of his payment or satisfaction to the holder. . . ." *Id.* (emphasis added). Possession is a prerequisite to acquiring a holder status. U.C.C. § 1-201(20). For a discussion of the assignment of rights upon instruments without their delivery, see W. E. BRITTON, *HANDBOOK OF THE LAW OF BILLS AND NOTES*, 120 nn.12-16 and accompanying text (2d ed. 1961); *Scheid v. Shields*, 269 Or. 236, 524 P.2d 1209

nished by creditors of a secured party by mere notification to the account debtor, without reaching the paper itself, an obligation embodied in an instrument cannot be garnished unless the paper is seized.²⁹

The inapplicability of U.C.C. § 9-318 to rights upon instruments which are part of chattel paper is further demonstrated in instances where HDC status is not denied.³⁰ If by virtue of § 9-318(3) an obligor on an instrument, which constitutes part of chattel paper, must pay the assignee when he receives notice of the assignment, he runs the risk that the instrument be separated from the "group of writings" and reach the hands of a HDC³¹ against whom the defense of payment cannot be asserted.³² Of course, this obligor will not have to pay an assignee merely upon receiving notice of the assignment if § 9-318 does not apply to situations where instruments are involved.³³

B. *The Effect of the FTC Holder in Due Course Trade Regulation Rule*

A recent Federal Trade Commission Trade Regulation Rule³⁴ makes it "unfair or a deceptive act or practice" for a seller to take or receive a "consumer credit contract" which fails to contain the following provision: "Any holder of this consumer credit contract is subject to *all claims and defenses which the debtor could assert against the seller. . . .*"³⁵ Because "consumer credit contract"³⁶ is

(1974). However, under § 3-603(2) payment to an assignee without consent to the *holder* will not discharge the payor.

29. See U.C.C. § 3-603; cf. §§ 7-602, 8-317 (which even though more explicit, are to the same effect). Whether effective garnishment in either case, chattel paper or instruments, requires a court order is beyond the present point.

30. This is the general rule in transactions other than sale of consumer goods.

31. A HDC's elevated status is preserved by U.C.C. § 9-309.

32. This is true under U.C.C. § 3-305(2), subject to the qualifications of subsections (a)-(e) thereof and § 3-602.

33. Some courts view U.C.C. § 9-318 as limited to instances of assignments of *executory contracts*. See *Gramatan Co. v. D'Amico*, 50 Misc. 2d 233, 269 N.Y.S.2d 871, 873 (1966).

34. 16 C.F.R. §§ 433.1, 433.2 (1977). The original version of the Rule was published on January 26, 1971, 36 Fed. Reg. 1211 (1971). A revised version was published in 38 Fed. Reg. 892 (1973). The present version appears also in [1976] 5 CONS. CRED. GUIDE (CCH) ¶¶ 10,182-83. It was promulgated on November 14, 1975 and became effective on May 14, 1976.

35. 16 C.F.R. §§ 433.1, 433.2(1977) (emphasis added).

36. "Consumer credit contract" is defined as "Any instrument which evidences or embod-

broad enough to include consumer paper and the Rule is not limited to claims and defenses *arising from the sale*,³⁷ a literal reading of the provision seems to lead to the conclusion that the Rule encompasses subjection to collateral defenses. This interpretation, however, appears to be rebutted by the legislative history of the Rule. It is quite clear that the Federal Trade Commission addressed itself only to the application of the HDC doctrine to consumer transactions.³⁸ Having abolished the doctrine with respect to these transactions the FTC did not intend to upset the law of instruments any further.³⁹ Keeping this in mind,⁴⁰ it will be assumed hereinafter that only statutes and principles of law governing the rights of a purchaser of consumer paper are determinative in disposing of the present issue of subjection to collateral defenses.

C. *The Result*

Hence, whether a purchaser of consumer paper is held subject to collateral defenses is a question to be answered by the law of instruments. Underlying the foregoing analysis is the practical consideration that the subjection of purchasers of consumer paper to collateral defenses may be warranted for the same reasons HDC status is

ies a debt arising from . . . a 'financed sale' as defined in paragraph . . . (e)." *Id.* §433.1(i).

37. See note 47 *infra*.

38. Other matters covered by the Rule are waiver of defenses clauses inserted into consumer contracts and connected, or related, loans in consumer transactions. These matters are beyond the coverage of the present discussion.

39. In this context, consider chapters II, III and VII of the Statement of Basis and Purpose of the Rule, given by the FTC in 40 Fed. Reg. 53506 *et seq.* (1975). Consider also the FTC Release of October 3, 1969, which appears in [1976] 5 CONS. CRED. GUIDE (CCH) ¶¶ 10,182-83. Most writers who analyzed the Rule ignored its effect on the question of subjection to collateral defenses. See, e.g., Gains, *Consumer Protection: FTC Rule-Preservation of Buyer's Claims and Defenses in Consumer Installment Sales*, 21 J. PUB. L. 169 (1972); Merrit, *New FR: Preservation of Claims and Defenses in Consumer Credit Transactions—Uniform Protection Comes to the Scene*, 9 U.C.C.L.J. 65 (1976). But see McNeill, *The Necessity of Retaining the Holder in Due Course Doctrine*, 5 U.C.C.L.J. 149, 159-60 (1973) (suggesting that the Rule, taken at face value, appears to subject the holder to collateral defenses).

40. It should also be kept in mind that there are some doubts with respect to the scope of the Rule. These doubts are attributed to the limitations placed on both the Commission's intrastate jurisdiction and its authority to regulate banks, as well as to the questionable enforcement power of the Commission. Individual consumers lack the power to enforce violations of the Federal Trade Commission Act. See generally Rohner, *supra* note 6, at 524-26. But cf. Guernsey v. Rich Plan of the Midwest, 408 F. Supp. 582 (N.D. Ind. 1976) (private relief against a violator [in this case the seller, not the financier] of the FTC Act).

denied to these purchasers.⁴¹ Obviously, where a holder of consumer paper is entitled to HDC status the present issue of collateral defenses does not arise.

III. ARGUMENTS IN SUPPORT OF SUBJECTING PURCHASERS OF CONSUMER PAPER TO DEFENSES ARISING OUT OF ANOTHER TRANSACTION

A. *An Overview*

A consumer may face a demand for goods delivered to him under one sales transaction while he has defenses⁴² against the same seller arising out of a different transaction.⁴³ The issue here is to what extent, if any, these collateral defenses⁴⁴ are available to the consumer in a suit instituted by the financier upon an instrument given by the consumer in return for goods with which he is completely satisfied.

The case of a consumer having more than one sales agreement with the same seller is quite realistic. In fact, this situation was expressly referred to by the National Commission of Consumer Finance in another context.⁴⁵ Surprisingly, there are no cases which

41. See notes 7-11 *supra*, and accompanying text.

42. The word "defenses" is used here in its broadest sense so as to include rights of recoupment, set-off and counterclaim. See 4 CORBIN, CORBIN ON CONTRACTS § 896 (1951) [hereinafter cited as CORBIN].

43. A "contract" is defined in U.C.C. § 1-201(11) as "the total legal obligation which results from the parties' agreement. . . ." (i.e. from their bargain in fact; see U.C.C. § 1-201(3)). Claims and defenses of the consumer which arise from binding collateral promises given by the seller in connection with the financed contract of sale, rather than from separate and different transactions, are considered as part of its terms. See U.C.C. § 3-119(1), Comments 1 and 3 (collateral promises contained in a separate written agreement executed as part of the sales transaction are to be used together with the underlying contract); U.C.C. § 2-202(b) (admissibility of evidence designed to establish "consistent additional terms" to agreed terms contained in a writing). It follows that the Code rejects the holding of the English case of [1911] 1 K.B. 181, under which an assignee of a contract for sale was found to take his right free from a claim of the buyer, based on misrepresentation of the seller with respect to the actual value of the goods, even though the buyer's claim was submitted to the court merely by way of defense to the assignee's claim in an attempt to reduce the price of the goods. See also U.C.C. §§ 2-312 through 2-315 (warranties); U.C.C. § 2-313, Comment 2.

44. Expressions such as "collateral defenses," "defenses arising from another transaction," "mere personal defenses" and "equities of the parties" are used interchangeably.

45. Multiple purchases from a single seller are also involved in the problem of cross-collateral given by a consumer in "add-on" sales. See NATIONAL COMMISSION OF CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 26 (December 1972) [hereinafter cited as

deal with the issue presented above, nor has it been discussed by commentators.⁴⁶ Most consumer credit legislation has ignored it as well.⁴⁷ The present discussion, therefore, will focus on the law dealing with commercial paper in general and on the principles which govern its application to the consumer credit market. The effect of statutory regulation of consumer paper will also be considered.

B. *Interpreting the U.C.C. as Subjecting Purchasers of Consumer Paper to Collateral Defenses*

Prior to the passage of the English Bills of Exchange Act of 1882,⁴⁸ English courts rejected the idea of subjecting a holder of a bill⁴⁹ to

N.C.C.F. Report]; *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965)(thirteen purchases from the same seller over a five year period).

The technique of taking cross-collateral in "add-on" sales stresses the connection between the contracts rather than their independence. A financier who attempts to benefit from this technique presumably will be barred from evading subjection to the terms of another contract covered by the cross-collateral. See Section III (E) *infra*.

46. The issue was mentioned without discussion in Feltham, *supra* note 8, at 462-63. See also McNeill, *supra* note 39, at 159-60.

47. Thus the UNIFORM CONSUMER CREDIT CODE (U3C) (1974) deals only with "claims and defenses of the consumer against the seller . . . arising from the sale . . ." or with claims and defenses of a card-holder against the seller . . . arising from the sale . . ." U3C §§ 3.404, 3.405 and 3.403 (emphasis added). The U3C prohibits the use of negotiable instruments in consumer installment sales. This is irrelevant, however, in determining that the U3C ignores the issue of collateral defenses. See note 127 *infra*. See also *National Consumer Law Center, Model Consumer Credit Act*, §§ 2.601, 2.602, 2.603 (1973) [hereinafter cited as *Model Act*]; N.C.C.F. Report, *supra* note 45, at 35-36. But see FTC Trade Regulation Rule, May 14, 1976, which states that "any holder . . . is subject to all claims and defenses which the debtor could assert against the seller . . ." [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 10,183 (emphasis added). Unlike the other statutes just referred to, this Rule is not limited to claims and defenses arising from the sale, hence it may be plausible to argue that it allows collateral defenses. Moreover, the argument that "defenses" in this Rule should be interpreted according to the meaning given the word in the law merchant does not seem to apply here. See note 21 *supra*, and accompanying text; notes 99 and 137 *infra*, and accompanying text. But see note 39 *supra*, and accompanying text.

Some statutes have expressly dealt with the issue of defenses arising from another transaction. See An Act to Amend the Bills of Exchange Act, CAN. REV. STAT., c.2 (1st Supp. 1970) [hereinafter cited as the Canadian statute] which provides that "the right of a holder of a . . . consumer note . . . is subject to any defense or right of set-off, other than counterclaim. . . ." Canadian statute § 191 (emphasis added). See notes 127-32 *infra*, and accompanying text.

48. 45 & 46 Vict., c.61 (Eng).

49. The fact that the cases referred to in previous notes dealt with a holder of an overdue instrument rather than with a holder of a due instrument who is disqualified from being a HDC is irrelevant. The law which covers both situations is identical. The special problem of

defenses not arising from the specific underlying transaction. "The indorsee of [a] . . . bill takes it subject to all the *equities that attach to the bill itself* . . . but . . . does not take it subject to claims arising out of *collateral matters* . . ."50 or "*equities of the parties*."⁵¹ This rule survived the Bills of Exchange Act. It is accepted by all leading commentators who have examined the English Act, and similar enactments in other jurisdictions⁵² modeled on the Act, that a holder of a bill, though not in due course, takes it free from "mere personal defenses" which are beyond the scope of the transaction underlying the bill.⁵³

The language of American legislation was troublesome because of the ambiguity in the scope and meaning of the term "defenses." The Negotiable Instruments Law⁵⁴ (NIL) § 58 states that: "In the hands of any holder other than a holder in due course, a negotiable instrument is subject to the *same defenses as if it were non-negotiable* . . ."55 It was argued under NIL § 58 that whenever a state statute made a collateral defense available to an assignee of a non-negotiable instrument, which for that purpose was identical with any ordinary chose in action,⁵⁶ the defense applied also to a negotiable instrument. This argument was rejected in *Lincoln v. Grant*⁵⁷ which construed the word "defenses" in § 58 as not applicable to collateral transactions.⁵⁸ The argument was accepted, how-

the bona-fide holder of an overdue bill, discussed in Chafee, *Rights in Overdue Paper*, 31 HARV. L. REV. 1104 (1918), has no bearing upon our case.

50. *Oulds v. Harrison*, 156 Eng. Rep. 566, 569 (1854) (emphasis added).

51. *In re Overend, Gurney & Co.*, L.R. 6 eq. 344, 359 (1868) (emphasis added).

52. For a complete list of these jurisdictions see FALCONBRIDGE, ON BANKING AND BILLS OF EXCHANGE 431-32 (7th ed. 1969) [hereinafter cited as Falconbridge].

53. See CHALMERS, ON BILLS OF EXCHANGE 123 (13th ed. 1964) [hereinafter cited as Chalmers]; Falconbridge, *supra* note 52, at 667; COWEN, ON THE LAW OF NEGOTIABLE INSTRUMENTS IN SOUTH AFRICA 274 (4th ed. 1966) [hereinafter cited as Cowen]; BYLES, ON BILLS OF EXCHANGE 194-95 (23rd ed. 1975) (also referring to Canada and South Africa).

54. The Negotiable Instruments Law (NIL) promulgated in 1896 was the first major project of the National Conference of Commissioners on Uniform State Laws. Up to 1924 when it was last enacted it was adopted by 48 states. See Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798, 799 (1958).

55. NIL § 58 (emphasis added).

56. *But cf.* U.C.C. § 9-308(3), Comment 3 ("non-negotiable instrument" in the section is not "as broad as the common law concept of 'chose in action'").

57. 47 D.C. App. 475 (1918).

58. The exhaustive discussion in the *Lincoln* case with regard to collateral defenses was dictum as the court found that the defendant might have used fraud, a clear defect of title, as a defense.

ever, in *Litcher v. North City Trust Co.*⁵⁹ where the court said:

We see no reason for withholding from the words of this section [NIL § 58] *their plain and unambiguous meaning*. We think that it means just what it says: that, irrespective of what the law may have been prior to the passage of that act [NIL], thereafter the same defenses as if the instrument were nonnegotiable could be made against negotiable paper, if it was in the hands of any holder other than a holder in due course. . . .⁶⁰

These two conflicting authorities were examined in *Stegal v. Union Bank & Federal Trust Co.*⁶¹ where it was concluded that the opinion in the *Litcher* case “does not bear internal evidence of very careful consideration of the subject, and is less convincing in its reasoning than is *Lincoln v. Grant*.”⁶² The court admitted that:

At first blush it may appear that [NIL § 58] in effect makes the provisions [which govern non-negotiable instruments] applicable to a negotiable instrument . . . [However,] . . . that view has been seriously controverted on the ground that “defenses” was used in section 58, N.I.L. in the same sense that it was used in the *Law Merchant* [i.e., technical defenses as distinguished from set-offs]. . . . A careful examination of the subject leads us to the conclusion that this is the correct interpretation of the word “defenses.”⁶³

The moving force behind the court’s conclusion was undoubtedly the origin, history and purpose of the NIL, which was mainly “to codify and make certain and uniform the rules of the law-merchant.”⁶⁴ Britton considers the *Stegal* decision as “the better view.”⁶⁵

59. 111 Pa. Super. Ct. 1, 169 A. 409 (1933).

60. *Id.* 169 A. at 410 (emphasis added).

61. 163 Va. 417, 176 S.E. 438 (1934).

62. *Id.* at 455, 176 S.E. at 454.

63. *Id.* at 452-53, 176 S.E. at 453. (emphasis added). *Accord*, *First & Citizens Nat’l Bank v. Federal Deposit Ins. Corp.*, 210 Va. 434, 440-41, 171 S.E.2d 856, 861 (1970); *Goldberg v. Rothman*, 66 Misc. 2d 981, 322 N.Y.S.2d 931, 934 (1971).

64. *Stegal v. Union Bank & Fed. Trust Co.*, 163 Va. 417, 459, 176 S.E. 438, 456.

65. BRITTON, *HANDBOOK OF THE LAW OF BILLS AND NOTES*, 450 (2d ed. 1961) [hereinafter cited as BRITTON]. *See also* 20 Am. Jur.2d *Counterclaim, Recoupment and Set-off* §§ 131-38.

Thus it would appear that on the eve of the adoption of the U.C.C. the majority rule in this country was that unless a state had a statute expressly making specific collateral defenses available against a holder of a negotiable instrument,⁶⁶ none of these defenses were available against him.⁶⁷

Does this rule remain in force under the U.C.C.? It is provided in the Code that "[u]nless he has the rights of a holder in due course any person takes the instrument subject to all *defenses of any party* which would be *available in an action on a simple contract*."⁶⁸ It is stated in the Comments that "paragraph (b) restates the first sentence of the original Section 58."⁶⁹ But note that, unlike NIL § 58, U.C.C. § 3-306(b) speaks of "defenses of any party" rather than of defenses to the *instrument*, thereby implying the subjection of the holder also to the "equities of the parties," i.e., to collateral defenses.⁷⁰ Even assuming that the language of U.C.C. § 3-306(b) is not different from that of NIL § 58, a closer analysis of the relation between § 3-306(b) and § 9-318 makes the question of collateral defenses under the Code considerably more complex.⁷¹

66. *Stegal v. Union Bank & Fed. Trust Co.*, 163 Va. 417, 447, 176 S.E. 438, 450 (1934) (concise history of enactment of such statutes).

67. *See Curlee v. Ruland*, 56 Okla. 329, 155 P. 1182 (1916). It should also be kept in mind that original parties to a transaction may include within its framework terms relating to collateral defenses so as to make them part of the agreement binding the holder. *See National Surety Corp. v. Algernon Blair, Inc.*, 114 Ga. App. 30, 150 S.E.2d 256, 258 (1966). In both situations, the holder is subject to the collateral defenses included within either the statute or the agreement. Our concern, however, is with the meaning of "defenses" in the section dealing with rights of a holder not in due course in the enactment applicable to commercial paper.

68. U.C.C. § 3-306(b) (emphasis added). *Cf.* § 3-306(c) (subjection to particular defenses, including failure of consideration which is a defense to a simple contract and therefore also covered by U.C.C. § 3-306(b)).

69. U.C.C. § 3-306, Comment 3. Two recent cases applied the *Stegal* interpretation upon U.C.C. § 3-306(b) somewhat mechanically without questioning whether the rule had changed. *See Goldberg v. Rothman*, 66 Misc. 2d 981, 322 N.Y.S.2d 931, 934 (1971); *United Overseas Bank v. Veneers, Inc.*, 375 F. Supp. 596, 606-07 (D.C. Md. 1974). The latter case gave considerable weight to U.C.C. § 3-306, Comment 3.

70. *See* note 51 *supra*, and accompanying text; *cf.* notes 92-97 *infra*, and accompanying text.

71. This is true, at least in situations where the instrument evidences a contract assignment of which would have been governed by Article 9 of the Code. Note that under U.C.C. § 9-102(1)(b), Article 9 applies not only to creating security interests in accounts, contract rights on chattel paper, but also to their outright sales. Neither § 9-104(f) or any other section makes any exception applicable to our case as described in notes 3 and 16 *supra*, and accom-

Before looking at § 9-318, it is necessary to analyze the reasoning which led to the rule making collateral defenses unavailable against a holder unless there was a specific statute to the contrary. At common law, in contrast to the civil law "compensation" which operates automatically by the sole operation of law to extinguish mutual obligations,⁷² collateral defenses⁷³ were regarded as personal privileges and not incidents or accompaniments of the debt.⁷⁴ The obligor was free to raise these defenses at his option. Alternatively, however, he could maintain an independent action even after judgment against him on the principal debt.⁷⁵ Collateral defenses were incidents of the enforcement of the principal obligation rather than its modification,⁷⁶ and they operated merely as a convenient mode of settling mutual accounts or preventing multiplicity of actions.⁷⁷ The subjection of an assignee to collateral defenses did not rest upon the concept of assignment; neither was it rooted in statutes regulating rights and liabilities of an assignee of a simple contract.⁷⁸ Rather, it

panying text. The situation under other statutes dealing with assignment of contracts is mentioned in note 82 *infra*.

72. Nicholls, *The Legal Nature of Bank Deposits in the Province of Quebec*, 13 CAN. B. REV. 635, 647 (1935).

73. Most authorities dealt only with one type of collateral defense, the right of set-off. See cases and authorities cited in notes 53, 59 and 61 *supra*. Set-off is a right to a liquidated sum of money determined by a mere process of subtraction. See Falconbridge, *supra* note 52, at 163; CORBIN, *supra* note 42, at §§ 896-97. See generally Loyd, *The Development of Set-Off*, 64 U. PA. L. REV. 541 (1916) [hereinafter cited as Loyd]. For a discussion of the similarities and distinctions between compensation and set-off see Falconbridge, *supra* note 52, at 437, 852.

The reasoning given by these authorities may be applied to all collateral defenses. It may be noted that in at least one legal system, South Africa, set-off is evidently considered as a defect in title rather than a collateral defense. *Walker v. Syfret*, A.D. 141, 162 (1911). See Cowen, *supra* note 53, at 274. This does not mean, however, that the rules developed with regard to set-off in other common law jurisdictions do not apply to collateral defenses which are recognized as such in South Africa. What constitutes a collateral defense is determined by each state's law.

74. *Lincoln v. Grant*, 47 D.C. App. 475, 783 (1918).

75. *Stegal v. Union Bank & Fed. Trust Co.*, 163 Va. 417, 445-46, 176 S.E. 438, 450 (1934), citing BIGLOW, ON BILLS, NOTES AND CHECKS § 551 (3d ed.).

76. Falconbridge, *supra* note 52, at 852.

77. *Id.* at 671.

78. Neither the English statute nor the one in force in the Province of Ontario, Canada, cited in Falconbridge, *supra* note 52, at 159, refers to collateral defenses, but is rather confined to "equities. . ." "An equity of this class must be inseparably connected with, or inherent in, the assigned debt, or be part of the transaction out of which the debt arose. . ." *Id.* at 162. But *cf.* note 83 *infra*, and accompanying text. The relevant English statute is the Law of Property Act 1925, s. 136.

depended upon the existence of a specific and separate statute dealing with the effect of collateral defenses.⁷⁹ Hence collateral defenses were not considered defenses to which an instrument was subject within the contemplation of NIL § 58.

It appears that this legal framework was not adopted by the Code. In dealing with the effect of assignment of simple contracts, U.C.C. § 9-318(1)(b) subjects the rights of an assignee to "any other defense or claim of the account debtor⁸⁰ against the assignor which accrues before the account debtor receives notification of the assignment."⁸¹ The obligor still must indicate some rule of law making the collateral defenses available to him against the claim of the *assignor*.⁸² Once he has done so he may assert these defenses against the *assignee* by the mere operation of § 9-318(1). Another kind of possible defense is provided by § 9-318(1)(a) which subjects the rights of an assignee to claims and defenses which may arise from the terms of the contract. The fact that only § 9-318(1)(b) requires the obligor to show some rule of law making the defenses available against the assignor does not affect the equality in treatment of both kinds of

79. Falconbridge, *supra* note 52, at 671, 163. See also RESTATEMENT (SECOND) OF CONTRACTS § 168, comment c (Text. Draft Nos. 1-7, 1973) [hereinafter cited as RESTATEMENT], which refers to collateral defenses only within the context of "statutes or rules of courts."

80. An account debtor is defined in U.C.C. § 9-105 (1)(a) as "the person who is obligated on an account, chattel paper, contract right or general intangible." The omission of the term "contract right" in the 1972 Official Text is irrelevant. A person who is obligated on a negotiable instrument is not an account debtor.

81. This time limit is viewed as the general rule, at least with respect to the right of set-off. See Falconbridge, *supra* note 52, at 163. This limitation is practically immaterial in non-notification or "indirect collection" arrangements. These arrangements prevail, for example, in the furniture field where payments from consumers are made to the dealer-assignor who receives them under a duty to remit to his financiers. See U.C.C. § 9-308, Comment 1. See generally Rothstein, *Practice: Maturity of Counterclaims Against Assignees*, 19 CORNELL L. REV. 130 (1934) (discussing accrual of rights against an assignee).

82. U.C.C. § 9-318(1)(b) states that the rights of an assignee are subject to "any other defense or claim of the account debtor *against the assignor*." *Id.* (emphasis added). This section should be construed, however, as subjecting the assignee's rights to any other defense or claim of the account debtor *against the assignor's claim upon the contract*, rather than merely "against the assignor." It is unlikely that the draftsmen of the Code meant to enable the account debtor to assert claims against the assignee which are not available to him in an action upon the contract instituted by the assignor. Most typical would be a personal injury claim of the account debtor against the assignor. As long as the assignor's claim under the contract is not subject to this kind of unliquidated collateral claim it does not make any sense to read § 9-318(1)(b) as subjecting the assignee's right to it.

defenses under § 9-318(1); the subjection of the right of the original creditor to the terms of the contract, obvious as it may be to the modern jurist, is also based upon some rule of law⁸³ embodied implicitly in § 9-318(1)(a).

While not governing directly the rights of a person who is obligated on a negotiable instrument, § 9-318(1) stands for the proposition that collateral defenses affect the right to a sum of money payable under a contract in the same manner as defenses arising from the underlying transaction. Consequently, collateral defenses become "incidents or accompaniments" of the principal debt to the same extent as defenses arising from the underlying contract. This result stands clearly in contrast to the assumptions underlying both the *Lincoln* and the *Stegal* decisions and the common law under which rights under a contract are subject only to defenses arising therefrom.

Inasmuch as before the enactment of the Code many American jurisdictions already had statutes providing that an assignment of contractual rights is without prejudice to any *set-off* or defense existing before notice of the assignment,⁸⁴ § 9-318(1)(b) made no change in prior law.⁸⁵ By establishing that an assignee takes the right of the assignor subject to collateral defenses thereto, those state statutes preceded the Code in reversing the contrary common law rule.⁸⁶ However, despite the contemporaneous existence of such

83. Thus under the old common law up to the beginning of the 19th century a breach of contract by the creditor could not be asserted by the obligor as a defense to the claim of the creditor upon the contract. The obligor had to pay even though he had a valid claim for damages against his creditor that could be submitted to a court in separate proceedings. This result stemmed from the theory of independent covenants. See Loyd, *supra* note 73, at 545-46. The subjection of the creditor's right to his performance is explained only by the concept of the bilateral mutual executory contract which is a "rule of law," equal to any other "rule of law" which makes the creditor's right subject to collateral defenses. Until the beginning of the 19th century, breach of warranty could not be raised as a defense of the buyer against the seller's claim. See Kaps v. McGregor, 13 D.L.R.3d 732, 734-35 (1971) (containing a concise history of the rights of set-off and counterclaim with regard to matters arising from the same transaction). The modern rule is stated in U.C.C. § 2-717.

84. See, e.g., *Stegal v. Union Bank & Fed. Trust Co.*, 163 Va. 417, 176 S.E. 438 (1934). See generally RESTATEMENT, *supra* note 79, at 321 *et seq.*

85. See U.C.C. § 9-318, Comment 1.

86. *But cf.* STATE OF NEW JERSEY STUDY ON THE UNIFORM COMMERCIAL CODE, SECOND REPORT TO THE GOVERNOR, THE SENATE AND THE ASSEMBLY OF THE STATE OF NEW JERSEY (November 1975)(subjection of an assignee to defenses under U.C.C. § 9-318 (1)(b) is referred

statutes and the NIL, collateral defenses could be excluded from "defenses" in NIL § 58, since another section thereof stated that "[i]n any case not provided for in *this act* [i.e., the NIL] the rules of the law merchant shall govern."⁸⁷ The meaning of "defenses" in NIL § 58, as a "case not provided for" in the NIL, was thus governed by a rule of the law merchant. Being compatible with the general principle of the common law under which collateral defenses do not affect the right under the principal contract, the definition of "defenses" derived from the law merchant could determine the scope of "the same defenses as if [the instrument] were non-negotiable."⁸⁸ The state statutes which subjected an assignee of a contractual right to collateral defenses could be held inapplicable since the NIL was an independent enactment, with no provision that principles of law derived from other statutes were to supplement it.

In contrast, when we construe the language of U.C.C. § 3-306(b), subjecting one not a HDC to "all defenses of any party which would be available in an action on a simple contract," we find that the Code provides that "the principles of law . . . including the law merchant . . ." shall supplement the provisions of the Code "[u]nless displaced by the particular provisions of *this Act* [i.e., the U.C.C.]."⁸⁹ Hence, the provisions of Article 3 of the Code should not be supplemented by "principles of law" displaced by "the particular provisions" of Article 9 thereof; rather they should be supplemented by the rules established by the displacing provisions.⁹⁰ As applied to our case, "the particular provisions" of U.C.C. § 9-318(1), making a right under a simple contract subject to collateral defenses, have displaced the inconsistent principle of the common law

to as "the common law rule"). Presumably, the New Jersey commentators referred to "the common law" in its broadest sense, including statutes enacted in common law jurisdictions.

87. NIL § 196 (emphasis added).

88. NIL § 58.

89. U.C.C. § 1-103.

90. See generally *Lincoln Bank & Trust Co. v. Queenan*, 344 S.W.2d 383, 385 (Ky. 1961) (advocating as a rule of construction the view that the Code is plenary and exclusive except where the legislature has clearly indicated otherwise); *Starkey Constr., Inc. v. Elcon Inc.*, 248 Ark. 958, 457 S.W.2d 509, 519 (1970); *Bowling Green, Inc. v. State Street Bank & Trust Co.*, 307 F. Supp. 648, 652 (D.C. Mass. 1969) ("this act" in U.C.C. § 1-103 construed to mean the entire Code). It should also be recalled that U.C.C. § 3-103(2) expressly makes the provisions of Article 3 subject to those of Article 9.

and thus preempted the inconsistent principle of the law merchant in supplementing the provisions of Article 3 of the Code.⁹¹ Thus, although § 9-318(1) is not directly applicable to suits on an instrument, its delineation of defenses that may be raised in a suit by an assignee of a contract would seem to be incorporated by reference under § 3-306.

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A position disregarding the distinction between defenses arising from the contract and collateral defenses can be supported by a close reading of Article 3 itself. It is well settled law, explicitly provided for in NIL § 57, that a HDC takes the instrument free from most claims and defenses, whether they are collateral or resulting from the contract.⁹² It is not surprising therefore to find it assumed in Article 9 of the Code that a holder in due course takes the instrument free from collateral defenses.⁹³ However, U.C.C. § 3-305, titled

91. It seems unlikely, however, that courts will reject the application of the law merchant in construing "defenses" in U.C.C. § 3-306(b) only when they deal with consumer paper. That is true even though a consumer purchase might be regarded as a non-commercial transaction beyond the scope of commercial law. See note 7 *supra*, and accompanying text.

The counterargument, which is likely to prevail, is that as long as both kinds of transactions are governed by the same statute, it is unsound to construe one word to mean two different things according to the kind of transaction involved. Cf. note 117 *infra*, and accompanying text (Code treats all commercial paper the same). For a discussion of the meaning of "defenses" in consumer credit legislation see note 47 *supra*; note 137 *infra*, and accompanying text.

92. See Chalmers, *supra* note 53, at 127 (England); BRITTON, *supra* note 65, at 334 (U.S.A. under the NIL); Falconbridge, *supra* note 52, at 661 (Canada). "A holder in due course holds the instrument free from any defect of title of prior parties and free from defenses available to prior parties among themselves. . . ." NIL § 57 (emphasis added).

93. U.C.C. § 9-318(1) recognizes the validity of "an enforceable agreement not to assert defenses or claims arising out of a sale as provided in U.C.C. § 9-206" (emphasis added). An assignee who can enforce this kind of agreement is also free from collateral defenses. U.C.C. § 9-318(1)(b). In this way U.C.C. § 9-318(1) establishes that freedom from collateral defenses is a mere incident of the freedom from defenses arising out of the sale. This freedom is enjoyed by an assignee who can enforce the agreement under U.C.C. § 9-206(1). A HDC of an instrument issued "as part of one transaction" with a security agreement is included in this category. U.C.C. § 9-206(1). This approach in U.C.C. § 9-318(1) with regard to collateral defenses also applies to a HDC of a negotiable instrument which was not signed simultaneously with a security agreement, since under U.C.C. § 9-206(1) the status of the privileged assignee cannot be more elevated than the status enjoyed by a HDC of a negotiable instrument.

"Rights of a Holder in Due Course," provides in its relevant part only that "he takes the instrument free from . . . (2) all defenses of any party to the instrument. . . ." There is no reference in this section to freedom from "mere personal defenses"⁹⁴ or "defenses available to prior parties among themselves."⁹⁵ Hence these defenses are included in "all defenses of any party to the instrument." To exclude collateral defenses from "all defenses of any party which would be available in an action on a simple contract" under § 3-306(b), while including these defenses in § 3-305(2) would result in construing "all defenses of any party" differently in each section.⁹⁶ Such an inconsistent interpretation seems unsound in terms of statutory construction.⁹⁷

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If "defenses" in U.C.C. § 3-306(b) includes collateral defenses as proposed in the preceding discussion, no particular difficulty arises in the case of the consumer-obligor. It may be argued against this suggested interpretation of § 3-306, however, that although the general rule was always that the mere existence of a simple statute of

94. The English Bills of Exchange Act of 1882, 45 & 46 Vict., c.61 §38(2)(Eng.).

95. NIL § 57, *supra* note 92.

96. Under the NIL the problem did not exist. While NIL § 58 referred to *defenses of a negotiable instrument*, NIL § 57 dealt with the *freedom of a HDC* from defects of title and "*defenses available to prior parties among themselves.*" NIL § 57 (emphasis added). The specific context of the word "defenses" in NIL § 57 and its relation to the parties rather than to the instrument, as it was in NIL § 58, enabled the court in *Stegal* to construe it for the purpose of NIL § 58 in a way which did not have to affect its interpretation under NIL § 57. See note 64 *supra*, and accompanying text. This is not the case under the U.C.C., where both §§ 3-305(2) and 3-316(b) refer to "defenses of any party." *But see note 97 infra.*

97. The only possible way to have preserved the *Stegal* interpretation under the U.C.C. would have been to indicate the somewhat literal distinction between "all defenses of any party to the instrument," U.C.C. § 3-305(2) (emphasis added), and "[a]ll defenses of any party which would be available in an action on a simple contract." U.C.C. § 3-306(b) (emphasis added). The fallacy of this argument seems to be that the expression used in U.C.C. § 3-305 should not be interpreted to refer to defenses which are outside those available in a suit upon the contract, i.e. instrument. See note 82 *supra*. In addition, the general policy of Article 9 seems to bar any strict interpretation of the expression used in U.C.C. § 3-306. However, to a too eager court, this somewhat different language seems to be the only way to free the holder of a negotiable instrument from collateral defenses under Article 3.

set-off, i.e., a statute which makes the right of set-off available to an obligor as a defense against his creditor, is sufficient to impliedly subject the assignee of a simple contract thereto,⁹⁸ this was never the rule under the old law merchant with regard to negotiable instruments.⁹⁹

By itself this counterargument does not present any difficulty with regard to the proposition that under the U.C.C. a holder is subject to collateral defenses; it is simply assumed that with respect to this point the Code rejects the ancient rule of the law merchant.¹⁰⁰ However, one might suggest that as neither the common law which governs the rights of an assignee¹⁰¹ nor the *explicit* provisions of a simple statute of set-off¹⁰² is the authority for subjecting the assignee of a simple contract to collateral defenses, this authority should be found within some "external force" which gives courts the competence to subject only an assignee of a simple contract, but not a holder of a negotiable instrument, to these defenses.

The validity of this suggestion seems doubtful. Once a claim is regarded as subject to certain defenses, whether arising from the contract underlying it or one collateral to it, the identity of its holder, whether the assignor or assignee,¹⁰³ should not make any

98. See *Stegal v. Union Bank & Fed. Trust Co.*, 163 Va. 417, 440, 176 S.E. 438, 448 (1934). A simple statute of set-off is "a statute which simply provides that, in an action brought against a defendant on his promise to pay, the defendant may have set-off against the demand of the plaintiff any cross-demands in the nature of a debt due which he has against the plaintiff." *Id.* at 440, 176 S.E. at 448.

The rule cited in the text above is also in force in the Province of Ontario, Canada, under the Judicature Act § 131 which provides that "where there are mutual debts *between the plaintiff and the defendant* . . . one debt may be set against the other" (emphasis added). This is a simple statute of set-off, nevertheless it was held to apply to debts due the defendant from the assignor of the plaintiff. See HOLMESTEAD AND GALE, 1 THE JUDICATURE ACT OF ONTARIO AND RULES OF PRACTICE (ANNOTATED) § 17 (1974).

A simple statute of set-off should be distinguished from statutes allowing prior party set-offs under which an assignee is explicitly held subject to set-offs. See *Stegal v. Union Bank & Fed. Trust Co.*, 163 Va. 417, 440-42, 176 S.E. 438, 447-48 (1934). See also note 84 *supra*, and accompanying text.

99. *Stegal v. Union Bank & Fed. Trust Co.*, 163 Va. 417, 443, 176 S.E. 438, 449 (1934).

100. See notes 80-97 *supra*, and accompanying text.

101. See note 78 *supra*, and accompanying text.

102. See note 98 *supra*, and accompanying text.

103. The special rule concerning the freedom of a HDC, or an assignee under U.C.C. § 9-206(1), from most defenses, being focused on the conditions of the acquisition of the claim rather than its inherent limitations, is irrelevant in this context.

difference.¹⁰⁴ Similarly, the form of the claim, whether arising from a simple contract or embodied in a negotiable instrument, should not constitute a valid ground for distinction as long as one accepts the principle that a holder takes the instrument subject to defenses "which would be available in an action on a simple contract."¹⁰⁵ If the application of the rule of the law merchant is rejected as suggested above no other "external force" is available, and "defenses" in § 3-306 should then be construed according to the provisions of § 9-318(1).

C. *Availability of Collateral Defenses under "Legal" and "Equitable" Title Theories*

The view that there is nothing in the common law to suggest a distinction between the effect of collateral defenses on the rights of an assignee of a simple contract and on those of a holder of a negotiable instrument, that such a distinction is derived only from the law merchant and that its applicability should be examined in light of relevant statutory provisions was not shared by at least two distinguished scholars. While not addressing themselves to the then non-existent U.C.C., Cook and Williston proposed conflicting theories, irrespective of the rule of the law merchant, explaining: (1) the subjection of an assignee of a simple contract to collateral defenses; and (2) the freedom of a holder of a negotiable instrument from collateral defenses. While the adoption of either of these theories prima facie entails the exclusion of collateral defenses from the "defenses" in § 3-306, one may still argue on the basis of either theory that a purchaser of consumer paper, at least the one closely related to the seller, is subject to the collateral defenses of the consumer.

(a) Cook, whose proposition is that the title of the assignee of a chose in action is legal, i.e., recognized by the common law as well

104. In a hypothetical legal system which recognizes the subjection of a creditor to defenses arising from the contract and gives effect to assignment of choses in action, but fails to provide a section such as U.C.C. § 9-318(1)(a), the assignee will not take the creditor's claim free from the defenses which are available against it. See note 83 *supra*. If this analysis is correct, there seems to be no specific "external force" which subjects the assignee to a right to set-off under a simple statute of set-offs.

105. U.C.C. § 3-306(b).

as in equity,¹⁰⁶ argues that the justification for permitting the creditors of the assignor to assert their set-offs against the assignee "is to be found ultimately in principles of fairness, of public policy, etc."¹⁰⁷ In no place does he attempt to apply this proposition to negotiable instruments. However, once the power of courts to develop rules of law based on these considerations is recognized, there seems to be no apparent reason to bar them from doing so even with respect to negotiable instruments. This power seems to be justifiably used with regard to consumer paper which is issued in what may be considered as a non-commercial set of facts,¹⁰⁸ especially when it is negotiated to someone closely related to the payee.¹⁰⁹

(b) Williston, whose basic thesis is that the assignee of a chose in action should be regarded as holding an equitable title to it,¹¹⁰ considers the equitable nature of the assignee's title as the only concept which can explain the subjection of the assignee to the right of set-off, based upon a debt due from the original creditor.¹¹¹ It is clear, however, that Williston does not suggest applying this contention to negotiable instruments whose legal title is vested in the holder.¹¹² Mr. Williston even goes so far as to exclude from his theory choses in action having a tangible form, assigned by delivery though not negotiable.¹¹³ Nevertheless, his view of the equitable right may be illuminating for our purposes. He defines it as "a right against a particular person, and exists against others only when their relation to that person is such that in conscience they should be subject to his duties."¹¹⁴ Since the subjection of a financier to consumer defen-

106. See Cook, *The Alienability of Choses in Action*, 29 HARV. L. REV. 816, 820-21 (1916).

107. See Cook, *The Alienability of Choses in Action: A Reply to Professor Williston*, 30 HARV. L. REV. 449, 475 (1917) [hereinafter cited as Cook].

108. See note 7 *supra*, and accompanying text.

109. See note 8 *supra*, and accompanying text.

110. See 3 WILLISTON, WILLISTON ON CONTRACTS § 447 (3d ed. 1960) [hereinafter cited as CONTRACTS]; Williston, *Is The Right of an Assignee of a Chose in Action Legal or Equitable?*, 30 HARV. L. REV. 97 (1916) [hereinafter cited as Williston].

111. CONTRACTS, *supra* note 110, § 447; Williston, *supra* note 110, at 101-02.

112. See Chafee, *Rights in Overdue Paper*, 31 HARV. L. REV. 1104, 1112 (1918).

113. See CONTRACTS, *supra* note 110, § 447; Williston, *supra* note 110, at 107; note 138 *infra*.

114. CONTRACTS, *supra* note 110, § 446A. See also Williston, *supra* note 110, at 97; Williston, *The Word "Equitable" and its Application to the Assignment of Choses in Action*, 31 HARV. L. REV. 822, 829 (1918) [hereinafter cited as *Word Equitable*] (answer to Cook, *supra*, note 107).

ses is justified, *inter alia*, by his special connection with the seller,¹¹⁵ the equitable title theory might be regarded as providing the ground for this subjection. According to Williston's view, as presented above, the application of this theory entails subjection to collateral defenses.¹¹⁶

Each theory, either Cook's or Williston's, while not addressing itself to the Code, seems to provide us with an alternative technique under which courts may establish in the case of the consumer an exception to the freedom of holders from collateral defenses. The remaining crucial issue under both theories is whether courts are free to shape different rules of law for one class of negotiable instruments when the Code treats all kinds of commercial paper uniformly.¹¹⁷

Under the "legal title" theory such judicial freedom seems very doubtful since that theory is more inclined to arguments based upon formalism and the objectivity of the definition.¹¹⁸ The "equitable title" theory must first overcome the general acceptance of the idea that a holder of a negotiable instrument has a legal title to it, which implies recognition of the preference to be given to formality and objectivity of the definition in this field of law.¹¹⁹ Second, it must overcome the fact that in the only context¹²⁰ where the issue of equitable title to a possessor of a negotiable instrument was ever

115. See notes 8 and 109 *supra*, and accompanying text.

116. This way the equitable title theory, being focused on the relation between the transferor and the transferee, is necessarily confined to explaining the subjection of the *closely related* financier to collateral defenses. On the other hand, the legal title theory which finds the collateral defenses in principles of fairness, of public policy, etc., see note 107 *supra*, may have a broader implication so as to establish a rule of law which also subjects the unrelated financier to collateral defenses.

117. Cf. note 91 *supra* (particular provisions of Code preempt inconsistencies).

118. Thus even though Cook recognizes the validity of fairness and public policy he supplies an additional ground for subjecting the assignee of a chose in action to set-offs, that is the "partial ownership" in the chose up to the notification. See Cook, *supra* note 107, at 474. This argument was criticized by Williston. See *Word Equitable*, *supra* note 114, at 830.

119. Cook, *supra* note 107, at 475-76. *But cf.* Tiger Motor Co. v. McMurtry, 284 Ala. 283, 224 So.2d 638 (1969) (invoking equity jurisdiction for protecting a consumer against a claim of a HDC). For a comment on the case see Williamson, 1 WM. SAM. L. REV. 291 (1970).

120. The context referred to involves the transferee for value of an undorsed instrument. In England it was held under the Bills of Exchange Act of 1882, 45 & 46 Vict., c.61, § 31(4), that such a transferee, a possessor of the instrument, obtains merely an equitable title. See Chalmers, *supra* note 53, at 111.

dealt with, even though rejected in this country,¹²¹ the question of collateral defenses was completely ignored.¹²² The general policy of the U.C.C. in reversing the English¹²³ and the old NIL¹²⁴ rule by establishing the possibility that even an agent for collection, whose agency is apparent from the note itself, may qualify as a HDC¹²⁵ implicitly rejects the creation of specific rules on the basis of any special relationship.

Thus it may be concluded that unless "defenses" in U.C.C. § 3-306(b) is interpreted to include "collateral defenses" for all kinds of transactions, it is very difficult to establish a specific rule applying only to instruments issued in return for consumer goods. Even the fact that the financier might have financed both the principal and collateral transactions does not make any material difference when his cause of action does not rest upon the collateral sales agreement. As long as collateral defenses are not regarded as available against his claim, they are simply beyond the scope of the issue submitted by the financier for judicial determination and hence cannot be raised by the consumer.

D. *Consumer paper subject to specific consumer credit legislation*

Up to this point it has been assumed that the rights of a purchaser of consumer paper are determined exclusively by U.C.C. § 3-306, either alone or with supplementary general principles of law. Numerous jurisdictions, however, have dealt with rights of purchasers

121. The idea of the equitable title of this transferee was rejected in the United States under NIL § 49, where it was held that he acquires a legal title to the instrument. See BRITTON, *supra* note 65, § 74. Presumably this is the situation under U.C.C. § 3-201.

122. The whole question of equitable title within this context is somewhat confusing, as the real issue is merely the independence of the transferee's cause of action. Equity, however, recognized the independent cause of action of the assignee long before the common law and eventually even common law courts gave effect to it based on either an equitable or legal title. See authorities cited in notes 106, 107, 110 and 114 *supra*. In fact, no leading commentator argues that the equitable title of a transferee, who is a possessor of an unindorsed instrument, implies his subjection to collateral defenses. Under U.C.C. § 3-306(b), dealing with *any* person who takes an instrument, the transferee of an unindorsed instrument is subject to the same defenses as a holder, hence the nature of his title turns out to be immaterial in determining the scope of his subjection.

123. Bill of Exchange Act of 1882, 45 & 46 Vict., c.61, §§ 35-36. See also Chalmers, *supra* note 53, at 128 (suing as agent or trustee).

124. NIL §§ 36, 47.

125. U.C.C. §§ 3-205, -206.

of consumer paper legislatively.¹²⁶ It will be determined now whether such legislation in any way affects the conclusions reached so far.¹²⁷ This determination must in turn depend upon the legislative approach, adopted in each jurisdiction. There are two major forms of legislation. The first is statutory regulation of consumer paper as part of the statute governing negotiable instruments except as otherwise indicated.¹²⁸ An example of this method of regulation, taken from a foreign jurisdiction not governed by the Code, is the Canadian statute¹²⁹ which governs bills and notes in general. An amendment thereto provides that the holder of consumer paper "is subject to any defense or right of set-off, other than counterclaim, that the purchaser would have had in an action by the seller on the consumer bill or consumer note."¹³⁰ Since the Canadian legislature explicitly provided for the subjection of a purchaser of consumer paper to the right of set-off,¹³¹ the consumer is protected against the

126. See generally Willier, *Need for Preservation of Buyers' Defenses—State Statutes Reviewed*, 5 U.C.C.L.J. 132 (1972).

127. Naturally no problem would arise under legislation which provides specific regulation of the collateral defenses issue. See note 47 *supra*. The problem of the availability of collateral defenses against purchasers of consumer paper would also not arise in legislation which prohibited the use of instruments following the definition of negotiable instruments in U.C.C. § 3-104 (as does U3C § 3.307). See also English Consumer Credit Act of 1974, 22 & 23 Eliz. II, c.39, § 123. However, the silence of the U3C with regard to collateral defenses in dealing with the rights of an assignee while explicitly subjecting him to defenses arising from the principal sale (see U3C § 3.404) may lead courts to interpret it as rejecting the subjection of an assignee to collateral defenses. On the other hand, it may be argued that this is an unwarranted negative implication and that U.C.C. § 9-318(1)(b) should govern the case as a supplementary provision as contemplated by U3C § 1.103. Due to policy considerations the second interpretation seems preferable.

128. Hence, for example, apart from the present issue of defenses, a holder of consumer paper in that system would enjoy the benefit of the presumption prescribed in U.C.C. § 3-307.

129. See note 47 *supra* (last paragraph).

130. *Id.* (emphasis added). It is noteworthy that, since 1884, this is basically the situation under the Canadian statute with regard to bills or notes given in return for a patent right, except their holder is also subject to counterclaims. See Canadian statute, *supra* note 47, § 15. Originally the 1884 amendment was enacted to prevent fraud in these transactions. See Ziegel, *Comment—Range v. Corporation De Finance Bélvédère—Consumer Notes—Status of Subsequent Holders—Need for Legislative Intervention*, 48 CAN. B. REV. 309, 320 n.54 (1970). Falconbridge proposed a repeal of the sections dealing with bills and notes given for a patent right. See Falconbridge, *supra* note 52, at 459. Nevertheless, this model was imitated by the Canadian legislature in regulating consumer bills and notes. See Ziegel, *Comment—Consumer Notes—Bill c-208—Bills of Exchange Amendment Act*, 49 CAN. B. REV. 121 (1971) [hereinafter cited as Ziegel].

131. See note 73 *supra*. It is worthwhile to recall that the general rule in Canada concern-

holder for a complete failure of consideration of a collateral transaction,¹³² or at least its partial failure expressed in an ascertained and liquidated sum of money.¹³³

The second form of legislation is the regulation of consumer paper outside the scope of the general statute applicable to commercial paper. In jurisdictions employing this form of legislation, a further distinction should be drawn between two kinds of legislative treatment:

(a) When the legislature does not go further than establishing "consumer paper" and subjecting its holder to claims and defenses permitted under U.C.C. § 3-306, the unavoidable implication is that except for disqualifying any holder of such an instrument from being a HDC, the legislature treats the paper as commercial paper under U.C.C. Article 3. In other words, the issue of subjection to collateral defenses should be determined in this system as under U.C.C. § 3-306(b). This is the situation under the Rhode Island statute.¹³⁴ In principle, the solution is identical to the one given when the problem is regulated within the statute which deals with commercial paper in general.

(b) However, when the legislature goes further and provides explicitly that consumer paper should not be regarded as commercial paper within U.C.C. Article 3¹³⁵ the solution lies beyond the scope of that Article.

A new problem then arises—what is this "consumer paper"? Because it is a writing which evidences a monetary obligation, is trans-

ing a holder of bills and notes issued *not* in return for consumer goods or patent rights is that he takes the instrument *free* from collateral defenses. See note 53 *supra*, and accompanying text.

132. See Ziegel, *supra* note 130, at 128.

133. This is, however, also the extent of the protection given to the obligor in Canada with respect to the underlying transaction itself. See Falconbridge, *supra* note 52, at 620. Cf. U.C.C. § 3-408 (last sentence).

134. R.I. GEN. LAWS § 6-28-6 (1970), § 6-27-5 (Supp. 1976). Similar effect should be granted to the N.C.C.F. Recommendation with regard to *Holder in Due Course Doctrine—Waiver of Defenses Clauses—Connected Loans*, N.C.C.F. Report, *supra* note 45, at 35-36.

135. This is the situation under ALASKA STAT. § 45.50.541(a) (Supp. 1971); HAWAII REV. STAT. ANN. § 476-36 (1968); MASS. GEN. LAWS ANN. Ch. 255 § 12C (Supp. 1972); N.J. STAT. ANN. § 17-16C-64.2 (1970). See also Legislation Note, 75 HARV. L. REV. 437 (1961) (1961 Mass. statute).

ferable by delivery and is not itself a security agreement or lease, consumer paper is certainly included within the category of "instrument" as defined in U.C.C. § 9-105(1)(g).¹³⁶ However, even though it complies with the formal pattern of a negotiable instrument, the principles of the law merchant should not be applied in determining rights of parties upon it.¹³⁷ Likewise, the person who is obligated on consumer paper is definitely not an account debtor,¹³⁸ thus his relations with the transferee are excluded from the coverage of U.C.C. § 9-318.

The problem which emerges here is determining what principles of law govern the rights of a transferee of a non-negotiable instrument. In this context it was implicitly suggested by Williston that a transferee of a chose in action having tangible form, assigned by delivery though not negotiable, takes it free from collateral defenses.¹³⁹ While it is clear that a non-negotiable instrument fits easily

136. " 'Instrument' means . . . any . . . writing which evidences a right to payment of money and is not itself a security agreement or lease, and is of a type which is in the ordinary course of business transferred by delivery with any necessary indorsement of assignment." U.C.C. § 9-105(1)(g). Query: Assuming that (a) no holder of consumer paper can qualify as a HDC, (b) a transferee for value of an unindorsed instrument acquires title thereto (see note 120 *supra*) and (c) the holder of this paper does not enjoy the presumptions given by U.C.C. Article 3 in favor of a holder of a negotiable instrument (see note 128 *supra*) what is the effect of indorsing consumer paper? What does indorsement add to delivery except its evidential value? Since U.C.C. §§ 3-414 and 3-417 do not apply, what contract and warranty obligations are undertaken by the indorsement of consumer paper?

137. See note 47 *supra*. This is in contrast to the postal money order pronouncement "Not a Negotiable Instrument" dealt with in *United States v. First National Bank*, 263 F. Supp. 298, 301 (D. Mass. 1967), where the court applied the law merchant due to the order's compliance with the general formal pattern of a negotiable instrument. Cf. U.C.C. §§ 3-104(3), -805 (which do not seem to apply to consumer paper).

138. As a signer of the instrument (see notes 16-34 *supra*, and accompanying text) he is not obligated on an account, U.C.C. § 9-106, chattel paper, U.C.C. § 9-105(1)(b), contract right, U.C.C. § 9-106, or general intangible, U.C.C. § 9-105(1)(a). The omission of the term "contract right" from the 1972 Official Text is irrelevant.

139. See note 114 *supra* and authorities cited concerning Williston's theory with regard to choses in action having tangible form assigned by delivery though not negotiable. As for latent equities, his contention is that such choses in action are governed by the same law which applies to negotiable instruments due to the legal title which is vested in their owner. Since Williston bases the subjection of an assignee to set-offs upon his mere equitable title (see notes 110-11 *supra*, and accompanying text) it follows that insofar as the assignee of a tangible chose in action has a legal title to it he should not be subject to set-offs. He does not say so explicitly, but it is implied from his general theory. Nevertheless, it should be noted that even with regard to latent equities, most cases do not give effect to any special rule concerning negotiable instruments, a fortiori, no such rule applies to choses in action having

into this category of choses in action,¹⁴⁰ the question is whether such doctrine exists at all in present law.

If chattel paper is also included in this category of choses in action having tangible form, assigned by delivery though not negotiable, as might be suggested from some of the Comments to the Code,¹⁴¹ the implication from Williston's view is rejected by U.C.C. § 9-318(1)(b), under which an assignee takes chattel paper subject to collateral defenses. However, the provisions of the Code go contrary to the opinion reflected in the Comments, and it seems clear that actual delivery is not a requisite of the ordinary mode of transfer of rights upon chattel paper; assignment of chattel paper as well as of the other rights dealt with in § 9-318 is affected by giving notice to the account debtor, rather than by delivery of the tangible paper which embodies it.¹⁴² Being inapplicable to the rights of a transferee of a non-negotiable instrument¹⁴³ in particular, as well as to the rights of a transferee of a tangible chose in action¹⁴⁴ in general, the wording of § 9-318(1) neither adopts nor rejects the existence of a specific doctrine which governs the rights of transferees of choses in action having tangible form, assigned by delivery though not negotiable.

On the other hand, the freedom of a transferee of a non-negotiable instrument or any other tangible chose in action from collateral defenses can be based only on the distinction between defenses against the *debt* and defenses against the *creditor personally*,¹⁴⁵ a distinction which is inconsistent with the rule of law that emerges

tangible form though not negotiable. See BRITTON, *supra* note 65, at 458-61. Williston's view with respect to latent equities and negotiable instruments has found support. See Chafee, *supra* note 112, at 1119-20.

140. See U.C.C. § 9-105(1)(g).

141. See U.C.C. § 9-105, Comment 3 (delivery of instruments as well as chattel paper "is only the minimum stated"). See also U.C.C. § 9-103, Comment 2 (claim evidenced by an instrument or chattel paper is merged or merely symbolized by the piece of paper). *But cf.* U.C.C. § 9-103 (Official Text 1972), Comment 6 (chattel paper as a "semi-intangible security interest").

142. See U.C.C. § 9-318(3). Notification of assignment (*see* note 28 *supra*) is sufficient to entitle the assignee to be paid. Presentment is not required. See also U.C.C. § 9-308, Comment 1 (second paragraph).

143. See note 138 *supra*, and accompanying text.

144. See note 142 *supra*, and accompanying text.

145. See notes 73-78 *supra*, and accompanying text.

from U.C.C. § 9-318(1).¹⁴⁶ Hence, while the implication from Williston's view is not rebutted by the *letter* of § 9-318(1), it is nevertheless rejected by the *principle of law* embodied therein. Neither the law of assignment¹⁴⁷ nor the Code¹⁴⁸ seems to adopt a specific theory relating to non-negotiable instruments, except for the mode of their transfer.

Hence, the scope of the defenses which are permissible against a claim arising from consumer paper which is not governed by Article 3 ought to be determined by the principles of the law of assignment of simple contracts.¹⁴⁹ Whether these principles are based on the assumption that the mere existence of a statute of set-off is sufficient to subject the assignee to collateral defenses,¹⁵⁰ or whether they embody the treatment of the Code with regard to the effect of these defenses,¹⁵¹ the conclusion is that in the hands of its purchaser consumer paper which is not governed by Article 3 is subject to collateral defenses.

E. *Agreement to Assert Collateral Defenses*

The last device to be considered here for subjecting financiers to collateral defenses relates to the contractual aspect of consumer protection rather than to construing "defenses" in the applicable legislation.

Obviously, parties to a contract for sale may agree to subject the

146. See notes 80-83 *supra*, and accompanying text.

147. See note 56 *supra*, and accompanying text. A writing which involved no security interest has been characterized as non-negotiable and governed by the law of contract assignment. See *Geiger Fin. Co. v. Graham*, 123 Ga. App. 771, 182 S.E.2d 521 (1971).

148. Hence, the only reference in Article 9 to non-negotiable instruments is with regard to their mode of transfer. See U.C.C. § 9-105(1)(g); cf. U.C.C. §§ 9-304, -308 (dealing with perfection but without affecting the premise that without taking possession of the instrument the transferee cannot enforce the claim); U.C.C. § 9-318(3) (not applying to non-negotiable instruments). U.C.C. § 3-805 applies only to one class of non-negotiable instruments.

149. It has been theorized that an instrument is a chattel governed by the law applicable to chattels, as well as an obligation governed by the general law of obligations. See Barak, *The Uniform Commercial Code—Commercial Paper: An Outsider View, Part I*, 3 *Is. L. Rev.* 7, 16 (1968). Barak's views concern the negotiable instrument, but his general proposition submitted above applies as well to any other instrument, including consumer paper. There is, however, no specific reference in his research to the issue of the applicability of the general law to the subjection of a holder to collateral defenses.

150. See note 98 *supra*, and accompanying text.

151. See notes 80-83 *supra*, and accompanying text.

seller's claim to defenses of the buyer that arise from a separate transaction.¹⁵² These defenses would then be covered by U.C.C. § 9-318(1)(a). They would affect the right of a holder of the instrument evidencing the obligation of the buyer, regardless of the meaning given to "defenses" under either U.C.C. § 3-306(b) or applicable consumer credit legislation.¹⁵³

Our concern is focused, however, upon a consumer goods contract which does not provide for it explicitly. To the extent that the availability of collateral defenses can be implied into this kind of contract, consumers are provided with an alternative technique for protection. Admittedly, there are factual situations where such implication can easily be inferred.¹⁵⁴ Whether courts may go further and as a general rule introduce this kind of contractual term into all consumer transactions is nevertheless doubtful.

While recent developments in the law relating to the contractual aspect of consumer protection involve a growing tendency to enlarge duties of sellers towards consumers,¹⁵⁵ a demarcation line ought to separate matters relating to the subject matter of the underlying contract from those which do not relate to it. It is only with respect to the former that the expansion of sellers' liability is warranted.¹⁵⁶ Obviously, regarding collateral defenses among matters of the first group involves distortion of reality. Hence, implying a warranty undertaken by the seller relating to performance of other contracts, or implying otherwise the right to assert collateral defenses into the underlying agreement, is an undue strain of legal concepts.¹⁵⁷ Consequently, construing "defenses" in the applicable statute as excluding collateral defenses would leave the consumer unprotected with respect to them, except when specific circumstances establish his asserted right.

152. Such an agreement may be binding even when made orally. See U.C.C. §§ 1-201(3), (11), 2-202(b); note 43 *supra*.

153. See note 67 *supra*.

154. See note 45 *supra* (last sentence).

155. See, e.g., *Model Act*, note 47 *supra*, § 2.502(1) (defining "warranty").

156. See note 155 *supra*; U.C.C. §§ 2-312 through -315. See also the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act, 15 U.S.C. § 2301 (6),(7) (Supp. V 1975).

157. Likewise, it is hard to see the obligation of the seller under the collateral transaction as a condition precedent for securing his rights upon the underlying contract. See generally U.C.C. § 3-306(c).

IV. CONCLUSION

The goal set forth in this article was the exploration, examination and elaboration of the principles of law which determine the question of subjecting purchasers of consumer paper to collateral defenses. These are consumer defenses which arise against the seller out of a separate and independent transaction from the financed contract for sale, but which are nevertheless available against the claim of the seller upon the financed contract. The discussion was based upon the provisions of the Uniform Commercial Code and consumer credit legislation dealing with the status of purchasers of consumer paper, general principles of law and policies which prevail in the consumer law field. It was argued that consumer paper retains its identity as an instrument and that the question of the subjection of its purchaser to collateral defenses should be disposed of according to the law which governs rights upon instruments. Obviously, the scope of the inquiry was limited to instances where a purchaser of consumer paper is not a holder in due course thereof.

It was suggested in this paper that according to the U.C.C. a holder not in due course might be held to take commercial paper subject to collateral defenses. Assuming that this proposition was rejected, alternative techniques for asserting collateral defenses based on theories dealing with questions of title were examined. The situation under consumer credit legislation which was discussed afterwards basically involved the issue dealing with the nature of consumer paper in relation to commercial paper covered by the U.C.C. Subsequently a reference was made to the possibility of viewing the right of the consumer to raise defenses stemming from other transactions as being incorporated into the underlying sales agreement.

The conclusion of this article is that as long as the use of consumer paper is permitted, present commercial and consumer credit legislation, whether adopted or proposed, may be interpreted as subjecting purchasers of consumer paper to collateral defenses. This is true even though the question was ignored by most legislative schemes.

As for the extent of the permissible collateral defenses, once the principle of their availability against financiers is recognized, that

is subject to determination by the various state laws.¹⁵⁸ As such the issue is beyond the scope of this article. It is submitted here, however, that a uniform determination of the range of these collateral defenses might be desirable.**

158. *See generally* CLARK, CODE PLEADING §§ 679 *et seq.* (1947); CORBIN, *supra* note 43, §§ 896-97. For citations to the various state statutes dealing with assignment and defenses against an assignee see RESTATEMENT, *supra* note 79, at 322 *et seq.*

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