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Kentucky Law Survey: Commercial Law and Consumer Credit

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Commercial Law and Consumer Credit

By Harold R. Weinberg*

The most significant development during the past survey year was the demise of the holder in due course doctrine and other related doctrines which insulated creditors financing consumer sales from consumer claims and defenses. As a result of this development, consumers will now be able to assert claims or defenses arising out of the sale financed against the financer under certain circumstances. Other developments also surveyed herein relate to the Uniform Commercial Code statutes of frauds and prejudgment creditors' remedies.

I. The Demise of the Holder in Due Course and Related Doctrines

Late in 1975 the Federal Trade Commission promulgated a trade regulation rule, effective May 14, 1976,¹ which operates

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¹ 16 C.F.R. § 433.1 (1975) provides:
(a) Person. An individual, corporation, or any other business organization.
(b) Consumer. A natural person who seeks or acquires goods or services for personal, family, or household use.
(c) Creditor. A person who, in the ordinary course of business, lends purchase money or finances the sale of goods or services to consumers on a deferred payment basis; Provided, such person is not acting, for the purposes of a particular transaction, in the capacity of a credit card issuer.
(d) Purchase money loan. A cash advance which is received by a consumer in return for a "Finance Charge" within the meaning of the Truth in Lending Act and Regulation Z, which is applied, in whole or substantial part, to a purchase of goods or services from a seller who (1) refers consumers to the creditor or (2) is affiliated with the creditor by common control, contract, or business arrangement.
(e) Financing a sale. Extending credit to a consumer in connection with a "credit sale" within the meaning of the Truth in Lending Act and Regulation Z.
(f) Contract. Any oral or written agreement, formal or informal, between a creditor and a seller, which contemplates or provides for cooperative or concerted activity in connection with the sale of goods or services to consum-
to preserve claims and defenses against creditors who finance many types of common consumer transactions, and authorizes monetary recoveries from these creditors under certain circumstances. The Kentucky General Assembly enacted legislation²

§ 433.2 provides:
In connection with any sale or lease of goods or services to consumers, in or affecting commerce as "commerce" is defined in the Federal Trade Commission Act, it is an unfair or deceptive act or practice within the meaning of Section 5 of that Act for a seller, directly or indirectly, to:
(a) Take or receive a consumer credit contract which fails to contain the following provision in at least ten point, bold face, type:

Notice
Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained pursuant hereto or with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder.

or, (b) Accept, as full or partial payment for such sale or lease, the proceeds of any purchase money loan (as purchase money loan is defined herein), unless any consumer credit contract made in connection with such purchase money loan contains the following provision in at least ten point, bold face, type:

Notice
Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder.

2 KY. REV. STAT. § 367.600 (1976) [hereinafter cited as KRS] provides:
As used in KRS 367.610:
(1) "Person" means an individual, corporation, or any other business organization.
(2) "Consumer" means a natural person who seeks or acquires goods or services for personal, family, or household use.
(3) "Creditor" means a person who, in the ordinary course of business, lends purchase money or finances the sale of goods or services to consumers on a deferred payment basis, provided such person is not acting, for the purposes of a particular transaction, in the capacity of a credit card issuer.
(4) "Purchase money loan" means a cash advance which is received by a
during its 1976 regular session which addresses some of the same matters included within the FTC rule. The Kentucky Act, however, exempts from its coverage consumer credit contracts which comply with the FTC rule or other federal administrative regulations relating to the preservation of consumer claims and defenses in credit transactions. Both the FTC rule and the Kentucky legislation will be discussed after a brief review of the consumer sales finance practices at which they are directed.

A. Smiling Creditors, Caponized Debtors

The law has traditionally provided the means for a creditor to arrange the financing of a sale transaction so that the creditor will be legally entitled to payment in full even if the buyer has a legitimate defense arising out of the transaction financed. One approach was through the holder in due course doctrine which historically developed to protect good faith purchasers of commercial paper. Under this doctrine, the transferee of a negotiable instrument, such as a promissory note, is insulated consumer in return for a finance charge, which is applied, in whole or substantial part, to a purchase of goods or services from a seller who (a) refers consumers to the creditor or (b) is affiliated with the creditor by common control, contract, or business arrangement.

(5) "Consumer credit contract" means any instrument which evidences or embodies a debt arising from a "purchase money loan" transaction or in which credit is extended by a seller or lessor in connection with a sale or lease to a consumer.

KRS § 367.610 provides:

(1) With respect to any consumer credit contract taken in connection with any purchase money transaction, an assignee of the rights of the seller or lessor is subject to all defenses of the buyer against the seller or lessor arising out of the sale or lease notwithstanding an agreement to the contrary, but the assignee's liability under this section may not exceed the amount owing to the assignee at the time the defense is asserted against the assignee. Rights of the buyer or lessee under this section can only be asserted as a matter of defense to or set off against a claim by the assignee.

(2) This section shall not apply to any consumer credit contract taken in connection with any purchase money loan or any sale or lease of goods or services which is in compliance with any trade regulation issued or promulgated by the federal trade commission or any regulation of the board of governors of the federal reserve system or similar federal agency having jurisdiction relating to preservation of consumer claims and defenses in credit transactions.

from all but a few relatively unusual types of defenses of any party to the instrument with whom he has not dealt. To invoke the doctrine, however, it required that the instrument have been taken for value, in good faith, and without notice that it was overdue, dishonored, or of any defense against it or claim to it.4

The holder in due course doctrine could come into play in the consumer credit arena as follows. A consumer would purchase goods such as a food freezer or services such as the installation of aluminum siding on credit, and would execute a promissory note for the unpaid balance plus a finance charge. The promissory note would contain an unconditional promise to pay.5 The seller of the goods or services would then negotiate the note, containing the promise to pay, to a sales financer who would pay the seller the face value of the note minus an agreed discount.6 The financer, as a holder in due course, could enforce the promise to pay even if a defense arose for the consumer because the freezer failed to freeze or the aluminum siding fell off the house.

The same sort of insulation from defenses could be achieved by the creditor if, rather than accepting a note, it purchased from the seller an installment sales contract containing a waiver of defense clause. Such clauses, which are

4 See KRS §§ 355.3-302 and -305 (1958). Even a holder in due course will be subject to the "real" defenses of
(a) infancy, to the extent that it is a defense to a simple contract; and
(b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and
(c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and
(d) discharge in insolvency proceedings; and
(e) any other discharge of which the holder has notice when he takes the instrument.
KRS § 355.3-305 (1958).
5 See KRS § 355.3-104 (1958).
6 The seller would be willing to accept the discounted amount for a variety of reasons. For example, the seller would obtain it immediately rather than the larger amount in installments over a period of time and would avoid the administrative cost of carrying and collecting the consumer installment obligation. The discount transaction might also be a part of a floor planning arrangement in which the seller is able to attract inventory financing from a financer at a relatively low interest rate by transferring his consumer paper, representing consumer debt at a higher interest rate, to the same financer.
recognized by Kentucky law,\textsuperscript{7} would contain language such as the following:

Buyer hereby acknowledges notice that the contract may be assigned and that assignees will rely upon the agreements contained in this paragraph, and agrees that the liability of the Buyer to any assignee shall be immediate and absolute and not affected by any default whatsoever of the Seller signing this contract; and in order to induce assignees to purchase this contract, the Buyer further agrees not to set up any claim against such Seller as a defense, counterclaim or offset to any action by any assignee for the unpaid balance of the purchase price or for possession of the property.\textsuperscript{8}

Thus, a creditor engaged in consumer sales financing might also achieve his freedom from defenses by the means of an agreement not to assert defenses by the buyer.

The third way in which a sales financer could achieve freedom from defenses was by making a direct loan which would enable the consumer to purchase goods or services in a subsequent transaction with a seller. If the goods or services purchased proved to be defective, the consumer could not rely on any resultant defense or claim against the seller as a defense against paying the creditor because the loan was considered for legal purposes to be a separate and distinct transaction from the sale.

Of course, occasions arose in which the consumer goods or services purchased were not satisfactory. Even if the seller could be located and was solvent, the consumer might find that without being able to utilize the leverage of withholding payment, the seller could not be persuaded to satisfy a legitimate claim. The value of the claim or defense would often be insufficient to justify retaining an attorney. Moreover, cases arose in which the seller had disappeared or was insolvent. In these situations the consumer was required to pay for defective goods or services with no effective recourse available against anyone.

This result might have been justifiable, despite its harshness, if it had been adequately supported by some significant

\textsuperscript{7} See KRS §§ 355.2-210 and 355.9-206 (1958) and note 10 infra. See also KRS §§ 371.320 (1962) and 371.325 (1974).

\textsuperscript{8} This particular clause was held to be contrary to public policy in Unico v. Owen, 232 A.2d 405, 408 (N.J. 1967).
public policy. For example, if the consumer had actually bargained for cut-off defenses, the result might have been sustained on the basis of freedom of contract. Or, if the consumer and the seller were strangers to the financer and the financer needed holder in due course protection to make his sales-finance business possible, then the result might have been sustained by policies in favor of protecting purchasers of commercial paper or facilitating such paper's marketability. The sanctity of direct loans might have been sustained on the principle that the lender ought to be free from claims or defenses arising out of a contract to which he was not a party, since making the lender responsible for the quality of the goods or services would go beyond the lender's or consumer's expectations or intent. However, such policy support often broke down in light of the facts. Consumers do not normally read through paragraphs of boiler plate in installment sales agreements to find waiver of defense clauses, nor do they normally understand them if they have the fortitude or good fortune to discover them. A lender who is accepting a substantial portion of a seller's consumer paper will have more than a nodding acquaintance with the seller, his business practices, and the credit worthiness of the seller's customers. The "separateness" of a direct loan becomes less self-evident when the seller directs the consumer to the financer to arrange the loan prior to the sale and the financer cooperates by providing favorable loan terms.

The arguments against permitting sales financers to be insulated from consumer defenses were accepted in varying degrees by many state courts and legislatures prior to the developments of the Kentucky holder in due course legislation and the FTC rule. While some sales financers may still sincerely believe that the promulgation of the FTC rule was akin to dropping "an A-bomb to kill a fly,"11 exposure to consumer defenses for such creditors appears to be here to stay.

9 See generally R. Rohner, Holder in Due Course in Consumer Transactions: Requiem, Revival, or Reformation? 60 CORNELL L.R. 503, 515-17 (1976).
10 For discussions of the Kentucky judicial developments concerning freedom from defenses, see Rohner at 515-24; Comment, 58 KY. L.J. 850 (1970).
B.  The FTC Rule

Few consumer sellers or sales financiers can afford to ignore the FTC rule. It is based on the conclusion that the use of promissory notes, waiver of defense clauses, or direct loans in situations where the seller and lender are acting in concert in consumer credit sale transactions is an unfair or deceptive act or practice within the meaning of section 5 of the Federal Trade Commission Act.\(^\text{12}\) It would be unwise for any seller to assume he need not comply because his business is local. The Act was amended in 1975 to broaden the FTC's jurisdiction from matters "in" to matters "in or affecting" commerce.\(^\text{13}\) Thus, the Commission's reach extends to intrastate transactions which have the requisite effect on interstate commerce, and is coextensive with federal constitutional authority.\(^\text{14}\) Although in its present form the FTC rule may be violated only by sellers, creditors cannot ignore it. Its effect will be to make lenders subject to many of the claims and defenses which the


Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are declared unlawful.


The F.T.C. considered the following reasons for deciding that some consumer sales financiers should be exposed to consumer claims and defenses:

1. he engages in many transactions where consumers deal infrequently;
2. he has access to a variety of information systems which are unavailable to consumers;
3. he has recourse to contractual devices which render the routine return of seller misconduct costs to sellers relatively cheap and automatic; and
4. the creditor possesses the means to initiate a lawsuit and prosecute it to judgment where recourse to the legal system is necessary.

See FTC Policy Statement at D-2, D-3.


consumer-debtor could assert against the seller. It will also have this impact on banks even though they are not subject to direct regulation by the FTC. And under a proposed amendment to the FTC rule, creditors may be included as potential violators of the rule in the future.

1. **Scope of the Rule**

The scope of the rule is delineated by its definitions. The definition for "consumer" indicates that the rule applies to sales or leases to a natural person of goods or services for personal, family, or household uses, but not to consumer transactions involving only realty or intangible personal property. Unlike the Truth in Lending Act, the FTC rule does not apply to transactions in which goods or services are acquired primarily for agricultural purposes and the amount financed is $25,000 or less. The FTC rule's definitions for "financing a sale" and "purchase money loan" expressly incorporate the limitations of the meaning of the words "credit sale" and "finance charge" used in the Truth in Lending Act and its regulations. As a result, a financed sale is "any sale with respect to which consumer credit is extended or arranged by the

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16 The proposed FTC amendment provides:
§ 433.1 (This section is unchanged by the proposed amendment. See supra note 1.) § 433.2 . . . In connection with any Purchase Money Loan (as that term is defined in § 433.1) or any sale or lease of goods or services, in or affecting commerce as "commerce" is defined in the Federal Trade Commission Act, it constitutes an unfair or deceptive act or practice within the meaning of Section 5 of that Act, for a seller or a creditor, directly or indirectly, to take or receive a consumer credit contract which fails to contain the following provision in at least ten point, boldface type:

**NOTICE**

Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained pursuant hereto or with the proceeds hereof. Recovery hereunder by the debtor shall be limited to amounts paid by the debtor hereunder.

16 C.F.R. § 433 (1975).


seller'' and includes open end credit plans which do not involve a "credit card issuer" and contracts in the forms of bailments or leases if they are "disguised" sale arrangements. Also, a purchase by a consumer involving an expenditure of more than $25,000 is not within the rule.

It must also be noted that credit card transactions are exempted from the FTC rule through the definition of "creditor." Preservation of claims in the credit card context is dealt with by special federal legislation. In addition, the most important scope questions under the rule are likely to be those concerning transactions which may involve a "purchase money loan."  

2. *The Rule and Discount Transactions*

The mechanics of the FTC rule in discount transactions are not difficult. It is a violation for any person who sells or leases goods or services to consumers in the ordinary course of business to, directly or indirectly, take or receive, any instrument which evidences or embodies a debt arising from a "financed sale" unless it contains the following legend in the requisite type face:

> Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained pursuant hereto or with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder.  

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12 Id.
14 See infra section I(B) and (C).
16 C.F.R. § 433.2 (1975). Concerning placement of notice:

In the event that more than one written instrument contains or embodies the rights and duties of the buyer and seller, the Rule does not require redundant placement of the Notice. The Notice need appear once, in any location which renders it a clear term or condition of the written credit agreement. Incorporation by reference in multiple credit documents is appropriate and satisfies the Rule as long as the documentation makes it clear to both the consumer and any holder that the consumer's written credit obligation is subject to the Notice.

In practical terms, this means that there is no need for re-execution of outstanding open-end credit contracts. It is sufficient if consumers are informed through a notation on sales slips or bills, and if the master files are
The claims or defenses relating to the goods or services referred to in the legend arise under law external to the rule and include state law causes of action for breach of warranty, fraud in the inducement, failure of consideration, and negligence. No “new” claims or defenses are created by the rule. As a result of the legend, one who finances sales through discounting or other “holders” of the consumer credit contract become subject to claims and defenses. In addition, the consumer is entitled to set his defenses off against the creditor’s claim, and may claim an affirmative recovery for amounts already paid.

Several aspects of the rule in regard to discount financing merit further discussion. First, the means chosen by the Federal Trade Commission to make creditors subject to claims or defenses does not render this form of sales financing illegal or prohibit the use of promissory notes or installment sales agreements. Rather, it requires that consumer credit contracts contain a precise reproduction of the legend which becomes a part of the agreement between the consumer and the seller. As a result, creditors cannot rely on any contractual means, such as a waiver of defense clause, to cut off claims or defenses. Conceivably, a seller might attempt to include both the legend and a waiver of defense clause or some more limited qualification concerning the assertion of defenses in an installment sales agreement. However, it is unlikely that any court will ever have to interpret such language because its insertion would be a violation of section 5 of the Federal Trade Commission Act. Although those persons financing consumer sales through dis-

tagged in any way sufficient to put a subsequent holder on notice under state law.

FTC Staff Guidelines, BNA ANTITRUST AND TRADE REG. REP., Release No. 764 (1976) at G-3 [hereinafter cited as FTC Staff Guidelines]. The guidelines were not formally reviewed or adopted by the FTC, and do not alter or amend either the rule or the FTC Policy Statement. Compare KRS § 355.1-201(10) (1958).

See generally Rohner at 511-15.

See FTC Staff Guidelines at G-1, G-2.

“Holder” is not limited by the rule to its commercial paper meaning of a “person who is in possession of . . . an instrument . . . drawn, issued or indorsed to him or to his order or to bearer or in blank.” KRS § 355.1-201(20) (1958). This term is not specifically defined by the rule. “Creditor” is defined to include a person who “finances the sale of goods or services to consumers on a deferred payment basis.” 16 C.F.R. § 433.1(c). See note 52 and accompanying text, infra.

See FTC Staff Guidelines at G-2.
counting can still take promissory notes, the legend is clearly effective to prevent such persons from claiming holder in due course status.28

Second, as a result of the rule, discount sales financers will "stand in the shoes" of sellers in so far as their right to enforce payment on consumer credit contracts is concerned, but in a position not fully analogous to that of an assignee of a contractual right to receive payment. Such an assignee is subject to defenses, but not to affirmative claims by the debtor.29 Under the FTC rule, the required notice must state that recovery by the debtor is limited to amounts paid by the debtor under the consumer credit contract and is intended to indicate that the consumer may assert by way of an affirmative claim, as well as by defense, the right not to pay all or any part of the outstanding balance owed the creditor pursuant to the contract.30 A creditor need not be concerned about exposure to consequential damages greatly in excess of the price of the goods purchased because of these limitations. However, creditors will take no solace from the arguable operation of the rule to make them disgorge payments made pursuant to a consumer credit contract but not received by the creditor such as an initial down payment made directly to the seller. Nor will creditors welcome the fact that the rule does not expressly limit the time during which consumers may assert their rights against financers to a period shorter than that provided by extra-rule statutes of limitations. Such statutes apparently continue to control transactions under the rule, with the result that the financer may remain liable to the consumer even after he has been paid in full.31 Also, the rule does not require that any steps be taken by the consumer to obtain satisfaction from the seller before the consumer may assert claims or defenses against the financer.32


29 See Rohner at 554.

30 See FTC Staff Guideline at G-2. One might argue that the financer should cease to be liable to the consumer after the term of the consumer credit contract has expired. See Statement of U.S. League of Savings and Loan Ass'n, BNA ANTITRUST AND TRADE REG. REP., Release No. 780 at A-8 (1976).

31 Id.

32 Law extrinsic to the rule may require the consumer to take certain steps or lose his claim or defense against the seller. See KRS §§ 355.2-607(3)(a); 355.2-714(1) (1958).
Finally, the required legend indicates that the holder of a consumer credit contract "is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained pursuant" to the contract. This provision leaves considerable room for interpretation. Suppose, for example, a consumer purchases a stereo for cash on November 1. The next day he purchases a color television on credit from the same seller, executing a consumer credit contract which is discounted to a finance company. The television set performs satisfactorily, but the stereo is defective and raises a claim for breach of warranty. The FTC rule could be interpreted to permit the consumer to assert the stereo breach of warranty as a claim or defense against the finance company seeking payment on the television paper under typical permissive rules of civil procedure in regard to counterclaims.\textsuperscript{33} Fortunately, the FTC has indicated that such an interpretation would go beyond the rule's underlying intent.\textsuperscript{34} In the words of the FTC, the holder's obligations are intended to be limited to those "arising from the transaction which he finances."\textsuperscript{35} Questions concerning the scope of a particular "transaction" might also be resolved through reference to the policy analysis which underlies the FTC rule.\textsuperscript{36}

3. The Rule and Direct Loan Transactions

The Federal Trade Commission determined that a failure to include direct loan sales financing within the scope of the rule would facilitate avoidance of its effect, and would amount to a failure to deal with a method of consumer sales financing in which, under certain circumstances, the lender should be subject to claims or defenses of the consumer.\textsuperscript{37} As a result, the rule was drafted to force sellers to insure that direct loan creditors would include a legend preserving claims or defenses in consumer credit contracts. The legend, which becomes a part

\textsuperscript{33} See KRS § 355.2-210 (1958); Ky. R. Civ. P. 13.
\textsuperscript{34} See FTC Staff Guidelines at G-2.
\textsuperscript{35} Id.
\textsuperscript{36} See supra note 12. The law of assignments may also provide some guidance, although it must be noted that such state law may be preempted by the FTC rule to the extent it is inconsistent with it. See note 57 infra.
\textsuperscript{37} See FTC Staff Guidelines at G-3.
of the contract between the consumer and the lender, makes any holder of the contract subject to all claims or defenses which the consumer could assert against the seller and permits the consumer to recover amounts paid. It is a violation of Section 5 of the Federal Trade Commission Act for a seller to accept the proceeds of a loan within the rule unless the consumer credit contract made in connection with the loan contains the legend. The proposed amendment to the rule would make it a violation of the Act for creditors to take a consumer credit contract which does not contain the legend.

Determining which direct loan creditors should be subject to the rule, and then drafting the rule to include only these financers, proved to be a difficult problem. In its present form, the rule relies on the definition of "purchase money loan" to perform this line-drawing function. This definition narrows the rule's scope to direct loans in which the seller "refers" consumers to the creditor or is "affiliated" with the creditor. Concerning this definition, the FTC has stated in its recent Statement of Enforcement Policy that:

The affiliation test applies where the lender and seller are part of the same business entity, or where there is a preexisting formal or informal contractual agreement or business arrangement to engage in concerted activity in connection with the financing of consumer goods and services. The referral test does not contemplate a preexisting agreement of this type. It encompasses relationships in which the lender and seller cooperate to channel purchases on a continuing basis.

38 Compare KRS § 355.9-107 (1958).
39 An earlier version of the rule utilized a definition of "related creditor" and a listing of enumerated fact situations which showed a sufficiently close relationship between the seller and financer to raise a rebuttable presumption that the rule should be imposed. See FTC Policy Statement at D 5-6. These fact situations were:
1) relation by blood or marriage between seller and creditor;
2) and 3) relation due to preparation of forms used in processing credit;
4) common control or affiliation of seller and creditor;
5) joint venture;
6) payment of consideration by creditor to seller;
7) guarantee of loan by seller;
8) five or more loans;
9) relation by knowledge of seller misconduct.
The present rule is designed to encompass all of the enumerated situations except the ninth, which the FTC decided raised too many problems of proof. Id.
Such a course of conduct results in a de facto or implied relationship. If the seller is sending buyers to a creditor without the express or implied agreement of the creditor or without any concerted or cooperative activity between the seller and creditor in connection with the financing of consumer sales, the transaction is not within the Rule. It is important to note that such agreement or concerted or cooperative activity must relate to the actual financing of the sale and not to ancillary conduct such as perfecting a security interest.40

It is apparent that the two standards will overlap when applied to many fact situations. It may prove difficult to draw a line between a preexisting "informal business arrangement" under the affiliation test and a "course of conduct" which results in a "de facto or implied relationship" under the referral test. However, the more important line drawing will occur in separating those relationships which are covered by at least one of the tests and those situations which are not covered by either test. The following hypothetical cases should be of some assistance.41

The affiliation test would be met in the following cases, therefore requiring the consumer credit contract to contain the legend.

1. A seller has an agreement with a creditor to maintain loan application forms in the seller’s office. When a buyer requests financing, the seller assists the buyer in filling out the forms.
2. A seller regularly sends his customers to a particular creditor. The creditor, in turn, agrees to provide a favorable financing arrangement for the seller's inventory or directly or indirectly provides some other consideration.
3. A seller regularly sends his customer to a particular creditor. The creditor agrees that as long as the seller continues to refer his customers, their loan applications will be processed or approved on an expedited basis where the borrower meets certain lending criteria but before a full credit check

41 Some of the hypothetical cases are taken from or based upon examples given in the FTC’s Statement of Enforcement Policy.
is completed.

4. Seller regularly discounts consumer paper to creditor.

According to the FTC, cases 1 and 2 are examples of situations in which there is a preexisting agreement rising to the level of a contract as defined by the rule. As a result, there is "affiliation" between the seller and creditor. In case 3, there is a business arrangement which also constitutes an "affiliation." In all three of the cases there is the type of cooperative activity on a continuing basis which justifies application of the rule.42

Case 4 is also a situation in which the FTC apparently intends to require sellers to make certain that any consumer credit contract made in connection with a purchase money loan from the creditor contains the legend.43 This is the case even if the direct loan to the consumer is an isolated occurrence and there are no other facts demonstrative of an agreement or concerted or cooperative activity between the seller and creditor with respect to direct loan financing. This may be overly burdensome on sellers (and might also be burdensome on creditors if the amended FTC rule is adopted)44 who have no direct loan affiliation with any creditor and who rely on discounting. Such sellers would seemingly be required to determine where the consumer obtained his funds and, if it turns out that they were obtained from a discount financer with whom the seller does business, would then have to ask the creditor and consumer to execute a new set of loan papers which contain the legend. The FTC has attempted to ameliorate some of the harshness in such situations by stating that when the objective circumstances surrounding the transaction between a consumer and seller do not indicate the source of the proceeds or do not provide reason to believe that the proceeds may be from a purchase money loan, there is no obligation to investigate the source of the proceeds further.45 An objective "reasonable seller under

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42 See FTC Statement of Enforcement Policy at G-2; FTC Staff Guidelines at G-4.
43 See FTC Statements of Enforcement Policy at G-1.
44 See 16 C.F.R. § 433 (1975).
45 FTC Statement of Enforcement Policy at G-2. This will benefit sellers in other situations as well. For example, a seller might have a direct loan relationship with a financer but be unaware that a particular consumer unilaterally borrowed funds from the financer prior to making a purchase.
the circumstances" test is contemplated.\textsuperscript{46} For example, if a consumer pays for a purchase with cash and there are no other facts which would reasonably suggest the possibility of a purchase money loan, the seller has no duty to investigate further. On the other hand, there would be such a duty if the consumer paid with a bank draft payable jointly to the seller and the consumer which is drawn on a bank with a discounting arrangement with the seller.\textsuperscript{47} Once a seller is on notice, he should not rely on the consumer to learn whether the notice was included in the consumer credit contract. His best course of action would be to go directly to the creditor.

It should be noted that there is an "affiliation" when there is common control. A common control situation would exist when the same holding company owns all the shares in brother-sister seller and sales financing corporations. The two corporations are deemed affiliated by the FTC even if there is no evidence of actual concerted activity with respect to consumer sales financing. Common control becomes less clear when an individual or group of shareholders owns shares in both companies, but there are also shareholders who own shares in only one company or the other. According to the FTC, this would constitute common control if the two companies are owned by substantially the same individuals.\textsuperscript{48} A parent seller with a wholly owned subsidiary finance company would also present a common control situation.

Cases in which there is no affiliation would include the following:

5. Seller maintains a checking account at creditor bank. Creditor bank holds the mortgage on seller's business premises.

6. Creditor has loaned money to seller and has taken a floating lien in seller's inventory of consumer goods as security. Seller periodically supplies creditor with information concerning the state of its inventory and permits creditor to periodically inspect the inventory.

\textsuperscript{46} Id.

\textsuperscript{47} The FTC has indicated that there is no duty to inquire further if a buyer pays for a seller's product or service with a personal check and there are no other circumstances which point to a purchase money loan. See FTC Statement of Enforcement Policy at G-3.

\textsuperscript{48} See FTC Statement of Enforcement Policy at G-1.
If a consumer borrows money from the creditor described in situation 5 and utilizes the proceeds to purchase consumer goods from the seller, the seller should have no duty to require the presence of the legend in the consumer credit contract executed by the buyer and delivered to the creditor. Although the creditor and seller in each case are related through business dealings, these dealings are not sufficiently related to consumer sales financing for there to be an affiliation.49

Situation 6 could be considered an indirect form of consumer sales financing since the creditor’s inventory financing enables the seller to sell to consumers. However, given no other facts, there is not sufficient concerted or cooperative activity relating directly to the actual financing of individual consumer sales.50 This would apparently still be true if case 6 were amended to state that the creditor’s security interest also covered the accounts receivable arising when inventory was sold on sale credit to consumers who did not obtain direct loan financing.51 However, if the accounts receivable were evidenced by consumer credit contracts entered into by the consumer and seller, the FTC rule would literally require that the contract contain the legend even though the creditor would have to foreclose on the seller to become a “holder” of the consumer credit contracts.52

The following case illustrates the type of “referral” which is contemplated by the definition of purchase money loan.

7. A buyer asks a seller for credit information. The seller suggests a creditor, calls up the creditor to determine whether the creditor will lend money to the particular buyer, and then sends the buyer to the creditor. Seller and creditor have no agreement, formal or informal, to refer customers.

A referral relationship requires a course of conduct. Therefore, situation 7 does not reflect a referral as that word is used in the definition of purchase money loan. However, the relationship would be created if such channeling continues.53 It should be

49 Id.
50 Id.
51 Id. See KRS § 355.9-306 (1958).
52 See supra § I(A); KRS § 355.9-502.
53 See FTC Statement of Enforcement Policy at G-2.
noted that a referral relationship can exist in the absence of any specific quid pro quo for the seller making the referrals. The following are examples of situations in which there is no "referral."

8. A buyer asks a seller for credit sources. Seller provides a list of lenders in the area and provides information on the availability of credit from them as an accommodation to his customers. The seller does not contact a creditor to arrange credit for the customers.

9. A seller routinely suggests that customers in need of credit go to a particular source or sources of financing. While the creditor is aware that seller is sending some of his customers, the creditor does not provide any tacit or explicit quid pro quo, and seller and financer have no relationship that would constitute an affiliation. Seller and creditor do not otherwise cooperate except insofar as may be necessary to arrange payment, perfect a security, or otherwise finalize the transaction.

In case 8 there is no referral because there is no concerted or cooperative activity. Seller is merely providing information. The FTC has indicated that there is also no referral in situations like case 9 because of the lack of some further affirmative act by the seller to promote the consumation of the loan. A simple suggestion is not a referral no matter how often it is repeated.

C. The Kentucky Legislation

The recent Kentucky holder in due course legislation is a statute with a limited sphere of application. First, it does not apply to consumer credit contracts which are in compliance with the FTC rule or regulations promulgated by other federal agencies with jurisdiction relating to the preservation of consumer claims and defenses in credit transactions. Second, the FTC rule itself may have preemptive effect under the supremacy clause of the federal constitution. Given its broad reach

54 Id.
55 Id.
56 Concerning the constitutionality of Kentucky legislation which delegates legislative power to other state or federal legislative bodies, see Commonwealth v. Associated Industries of Kentucky, 370 S.W.2d 584 (Ky. 1963).
to transactions "affecting commerce," most sellers will be required to comply with the FTC rule and, if they do so, will be able to ignore the Kentucky legislation safely. However, the Kentucky legislation is briefly analyzed below for those sellers or creditors who may be subject to it.

The Kentucky legislation, as does the FTC rule, utilizes definitions to outline its scope. There are few departures in the Kentucky definitions from their counterparts in the FTC rule. The rule uses the phrase "financing a sale" to describe the types of vendor credit extensions subject to the rule, and incorporates by reference the Truth in Lending Act's definition of "credit sale." The Kentucky legislation uses the phrase "in which credit is extended by a seller or lessor in connection with a sale or lease to a consumer" for the same purpose. Surprisingly, the Kentucky legislation contains a definition for "purchase money loan." Its presence is an anomaly since the Act does not actually affect direct loan transactions.

The Kentucky legislation is intended to cover discount financing utilizing negotiable instruments or installment sales contracts containing waiver of defense clauses. It makes the "assignee" of the rights of the seller or lessor subject to all defenses of the buyer against the seller or lessor arising out of the sale or lease. The word "assignee" must be intended to refer to creditors who are defined by the Act as including persons who, in the ordinary course of business, finance the sale of goods or services to consumers on a deferred payment basis. However, there is no "assignee" in the context of a direct loan to a consumer. In sharp contrast with the FTC rule, the Kentucky act limits the assignee's liability to the amount owing to the assignee at the time the defense is asserted against him, and states that the defense can only be asserted as a matter of defense to or set off against a claim by the assignee. The general approach of the Kentucky act is also different. Rather than requiring the insertion of a legend which makes it impossible for holder in due course status to arise or for an installment

58 See note 5 supra.
60 The Kentucky legislation also excludes credit card issuers from the definition of creditor. No other Kentucky statute covers freedom from defenses in the credit card context. See generally KRS § 434.560 (1970).
contract to contain language which could be interpreted as containing an agreement waiving defenses, the Kentucky act merely states that an assignee is subject to defenses. As a result, an assignee might find himself subject to defenses pursuant to the Kentucky act despite the complete silence of a consumer credit contract on the matter in violation of the FTC rule.

II. Other Developments

There were a number of other commercial law and consumer credit developments during the past survey year which, though not as far reaching as the FTC rule, may be of significance to Kentucky practitioners. The purpose of this section is to note two of them in summary fashion.

A. Uniform Commercial Code Statutes of Frauds

In the case of Shpilberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc. the Supreme Court of Kentucky considered the U.C.C. Article VIII statute of frauds which applies to investment securities transactions. In particular, the Court considered the portion of the statute of frauds which provides:

(1) A contract for the sale of securities is not enforceable by way of action or defense unless . . . within a reasonable time a writing in confirmation of the sale or purchase and sufficient against the sender under paragraph (a) has been received by the party against whom enforcement is sought and he has failed to send written objection to its contents within ten (10) days after its receipt. . . .

The Article II statute of frauds for the sale of goods contains a similar provision. The Shpilberg Court decided that the failure of a party in receipt of a written confirmation of a contract

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61 535 S.W.2d 227 (1976).
63 Between merchants if within a reasonable time a writing confirmation of the contract and sufficient against the sender is received and the party receiving it has reason to know its contents, it satisfies the requirements of subsection (1) against such party unless written notice of objection to its contents is given within ten (10) days after it is received.

KRS § 355.2-201 (1958).
to object within 10 days, not only satisfies the requirements of the statute of frauds, but also conclusively proves the existence of the contract itself. Speaking of the effect of retention of the confirmation for 10 days, the Court stated: "[I]f the writing clearly shows the existence of a contract, it is conclusive evidence of that fact to the extent that it cannot be contradicted simply by parol evidence that there was no agreement." 4

While the Court recognized that its decision appeared to conflict with the official comment to the statute of frauds section of the Code's sales article and decisions previously handed down in other states, 5 the Court based its decision on what it described as "the traditional Statute of Frauds." 6 In arriving at this rule, the Kentucky Court attributed a conclusiveness to a party's failure to object to a confirmatory memorandum in the face of contrary declarations by other courts 7 and commentators. 8 Thus, while the Court in Shpilberg specifically limited its ruling to those instances when the written memorandum contains all the essential elements of a contract, it must be recognized that the Kentucky Supreme Court's view of this matter deviates markedly from the rule as generally stated.

B. Prejudgment Creditors' Remedies

There were significant occurrences during the past survey year with respect to Kentucky's statutory prejudgment remedies. Those which do not involve an exercise of "state action," as well as those which do should be noted. 9

In Murphy v. General Motors Acceptance Corp., 70 the Kentucky Supreme Court gave consideration for the first time

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4 535 S.W.2d at 230.
6 535 S.W.2d at 230.
9 For a discussion distinguishing these two statutory types, see Weinberg, Kentucky Law Survey-Commercial Law, 63 Ky. L.J. 727 n.2 (1975).
10 No. 73-919 (Ky. March 5, 1976).
to a claim that the Commonwealth's self-help repossession statute\footnote{KRS § 355.9-503 (1958).} violated fourteenth amendment due process requirements set forth in \textit{Fuentes v. Shevin}.\footnote{407 U.S. 67 (1972).} The trial court in \textit{Murphy} had granted the defendant's motion for a summary judgment based upon a finding that there was no "state action" present, and therefore the fourteenth amendment notice and hearing requirements as set forth in \textit{Fuentes} were inapplicable. In a memorandum opinion \textit{per curiam}, the Kentucky Supreme Court affirmed the trial court, and stated that since the repossession involved no "judicial process," no "state action" took place and the \textit{Fuentes} decision did not apply. The Kentucky Court thus took a position consistent with that previously espoused by the Sixth Circuit in \textit{Gary v. Darnell}.\footnote{505 F.2d 741 (6th Cir. 1974).}

While Kentucky's Supreme Court affirmed the constitutionality of the state's existing "self-help" repossession statute, Kentucky's General Assembly rewrote the law concerning prejudgment remedies which \textit{do} involve "state action." The legislation was enacted to bring those statutory provisions within the dictates of the United States Supreme Court.\footnote{Senate Bill 23 (codified in various sections of KRS chapter 425). For a discussion of these new statutory provisions, see Mapother, \textit{Kentucky's New Prejudgment Seizure Law}, Ky. \textit{Bench and Bar} 20 (1976).}