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New Jersey Retail Installment Sales Act

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LEGISLATIVE NOTES

NEW JERSEY RETAIL INSTALLMENT SALES ACT

The New Jersey legislature recently passed a bill designed to protect purchasers of goods under retail installment contracts.[1] This bill, amending the Retail Installment Sales Act of 1960,[2] eliminates the use of the holder in due course doctrine and waiver of defenses clauses in retail installment sales. Under the holder in due course doctrine,[3] if certain conditions are met,[4] a finance company[5] that purchases a note and retail installment sales contract from a seller[6] can demand full payment on the note notwithstanding any defenses the buyer might have been able to assert against the seller on the underlying installment contract.[7] When a buyer enters into a retail installment sales agreement which con-

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[1] N.J. STAT. ANN. §§ 17:16C-1, 17:16C-38.1 to -38.4 (7 New Jersey Session Law Service 1692 (1971)) [hereinafter referred to in text as Retail Installment Sales Act]. The Act, signed by the governor of New Jersey on January 11, 1972, became effective on April 9, 1972.

[2] *Id.* § 17:16C-1 (1960).

[3] *Id.* § 12A:3-302 (1962) [the Uniform Commercial Code is contained in N.J. STAT. ANN., tit. 12A, hereinafter cited as UCC].

[4] UCC § 3-302 provides that a holder in due course must:

1) be a holder as defined in UCC § 1-201(20);
2) hold an instrument that under UCC § 3-102(1)(e) is negotiable, as defined in UCC § 3-104;
3) take the instrument for value as defined in UCC § 3-303;
4) take the instrument in good faith as defined in UCC § 1-201(19); and
5) take the instrument without notice, as defined in UCC § 3-304, that it is overdue or has been dishonored, or of any defense against or claim to it on the part of any person.

[5] The term "finance company" is used in this note to mean any financial organization which frequently purchases consumer notes from retail sellers. This definition includes commercial banks and credit unions as well as finance companies.

[6] Statistics compiled for the Federal Reserve Banks demonstrate the widespread use of this practice. Of the total installment credit outstanding in the United States as of October, 1970, retail sellers provided only 13 percent, while commercial banks extended 42 percent, and finance companies extended 31 percent. These last two figures include direct as well as indirect (assigned) loans and so must be regarded with caution. *See* 56 FED. RES. BULL. A54 (Dec. 1970).

[7] UCC § 3-305 permits a holder in due course to take the instrument free from all claims (generally claims of title) to it and all defenses of any party to the instrument with whom the holder has not dealt (excepting the "real defenses" set forth in UCC §§ 3-305(a)-(e)). In contrast, a mere holder under UCC § 3-306 takes the instrument subject to all valid claims to it and to most defenses available to the defending party.

UCC § 3-305 does not prevent the retail buyer from asserting any claims he may have on the retail installment sales contract against the retail seller. A problem usually develops, however, when the seller becomes bankrupt or leaves the jurisdiction after signing the contract but before performing completely.

tains a waiver of defenses clause,[8] he waives his right to assert some or all of the defenses he might have had to a claim for payment of the unpaid balance on the installment contract held by the assignee-finance company, irrespective of whether the finance company qualifies as a holder in due course.[9]

The effect of the enactment of the New Jersey bill is that a "retail buyer"[10] may now assert against an assignee of the installment contract or subsequent "holder"[11] of the negotiable note any defenses he has against the retail installment seller. The new law would appear to be one of the most comprehensive laws of its type to be enacted.[12] However the draftsmen apparently left a significant loophole, appropriately termed the "specious cash sale,"[13] which, if exploited, could negate the intended effect of the new law. This note will analyze the bill, compare it with the relevant provisions of the National Consumer Act (NCA)[14] and

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[8] Subject to other state law, UCC § 9-206 recognizes the validity of such clauses except as to defenses of a type which may be asserted against a holder in due course. The assignee, to invoke such a clause, must take the assignment for value, in good faith, and without notice of a claim or defense. While these conditions parallel those under UCC § 3-302 for the holder in due course, the waiver of defenses clause is designed to cover those cases not subject to the holder in due course doctrine, as, for example, where the buyer signs a non-negotiable note.

The courts have split on the question whether such clauses are against public policy. For a compilation of cases on both sides, *see* Gilmore, *The Commercial Doctrine of Good Faith Purchase,* 63 YALE L.J. 1057 (1954); Jordan & Warren, *The Uniform Consumer Credit Code,* 68 COL. L. REV. 387 (1968).

[9] A typical clause reads:

> 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 a 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.

Unico v. Owen, 50 N.J. 101, 106, 236 A.2d 405, 408 (1967).

[10] N. J. STAT. ANN. § 17:16C-1(d) (7 New Jersey Session Law Service 1692 (1971)) defines "retail buyer." It is important to note that to be a retail buyer one must purchase goods from a retail seller "not for the purpose of resale." The import of the above restrictions is that the goods must be used for a personal purpose before their sale will fall within the scope of the New Jersey law. Purchases of goods for the purpose of building or maintaining an inventory for later resale or commercial use are not covered by the New Jersey law. Note also that definition of "goods," *id.* § 17:16C-1(a), also limits the definition of a retail buyer.

[11] "Holder" is defined in *id.* § 17:16C-l(m).

[12] In N.Y. Times, Jan. 12, 1972, at 1, col. 5, it was reported that a survey made by the New Jersey Banking Association revealed that, through 1970, seventeen states had enacted similar laws. According to the Banking Association, none of these laws, however, went as far as the new law in New Jersey.

[13] For a discussion of the specious cash sale and of the New York Specious Cash Sales Act, *see* Legislative Note, *New York Specious Cash Sales Act,* 5 U. MICH. J.L. REF. 145 (1971).

[14] NATIONAL CONSUMER LAW CENTER, NATIONAL CONSUMER ACT (First Final Draft 1970) [hereinafter cited as NCA].

the Uniform Consumer Credit Code (UCCC),[15] and will discuss the loophole and the ways it can be closed.

I. ANALYSIS OF THE RETAIL INSTALLMENT SALES ACT

A. The Scope of the Act.

The scope of the Retail Installment Sales Act is limited to a specified range of consumer transactions. The Act does not apply to sales of services, but applies only to sales of "goods."[16] Goods by definition do not include real property, money or choses in action, goods sold for commercial or business use, or personal property having a cash price greater than $7,500.[17] The scope of the Act is narrower than that of both the NCA, which applies to sales of services and money as well as personal property,[18] and the UCCC, which applies to sales of certain interests in land as well as personal property.[19] That the Act excludes sales of services may be particularly significant in light of the fact that sales of services are frequently intermingled with sales of goods.[20] It is possible that such sales may be excluded from the scope of the new law even though the nature of these transactions may parallel the nature of those covered by the Act.

The Act is further limited to those of the above consumer transactions involving a "retail installment contract."[21] This contract must be entered into in New Jersey and must involve a "retail seller"[22] and a "retail buyer."[23] The contract must also evidence an agreement to pay the "retail purchase price of goods or any part thereof in two or more installments over a period of time."[24] Neither the NCA nor the UCCC limits its scope solely

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[15] UNIFORM CONSUMER CREDIT CODE (Final Draft 1968) [hereinafter cited as UCCC]. For a comparison of the UCCC and the NCA provisions regarding negotiability, *see* Note, *Limitations on Sales Agreements Under the Uniform Consumer Credit Code and the National Consumer Act*, 56 IOWA L. REV. 171 (1970).

[16] N. J. STAT. ANN. §§ 17:16C-38.1 to -38.2 (7 New Jersey Session Law Service 1693-94 (1971)) limits the Act to transactions involving a "retail installment contract." Such a contract must be for the sale of "goods." *Id.* § 17:16C-1(b).

[17] *Id.* § 17:16C-1(a).

[18] The scope of the NCA is limited to a "consumer credit transaction" as defined in NCA § 1.301(10).

[19] The UCCC applies to a "consumer credit sale" as defined in UCCC § 2.104(1).

[20] Examples of such sales include the sale of memberships to health clubs, contracts for the delivery of milk, and repair contracts which include the installation of new parts.

[21] *See* note 14 *supra*.

[22] N.J. STAT. ANN. § 17:16C-1(c) (7 New Jersey Session Law Service 1692 (1971)) defines "retail seller."

[23] *Id.* § 17:16C-1(b). The definition of "retail buyer" is discussed in note 10 *supra*.

[24] *Id.*

to installment sales.[25] Thus, a purchase price payable in whole in ninety days and subject to a finance charge would be covered by the NCA and the UCCC but would not be subject to the New Jersey law.

Significantly, the term "retail installment contract" may cover transactions which, although not legally classifiable as sales of goods, appear in substance to be identical to such sales. These transactions include a contract for bailment or a lease where the bailee or lessee agrees to pay as compensation a sum substantially equivalent to the value of the goods and where the bailee or lessee has the option of becoming the owner of the goods upon full compliance with the terms of the agreement.[26] An important exception here is, however, that the New Jersey law does not cover consumer loans executed in connection with a retail sale.[27] The Retail Installment Sales Act in this sense parallels the UCCC,[28] but appears to be more restrictive than the NCA provision which defines a "consumer credit transaction" to include sales involving "consumer credit sales, consumer leases, and consumer loans."[29]

B. Statutory Provisions

The Retail Installment Sales Act focuses on eliminating the use of waiver of defenses clauses included in retail installment contracts and on precluding a finance company's reliance on the holder in due course doctrine to defeat the retail buyer's defenses on the contract. According to the New Jersey law "no retail installment contract shall contain *any* provision relieving the holder, or other assignee, from liability for any civil remedy sounding in contract which the retail buyer may have against the retail seller."[30] Thus, the New Jersey law, like the NCA,[31] provides an

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[25] Under NCA § 1.301(10), the contract must be an "obligation which is payable in installments or for which credit a finance change is or *may* be imposed" (emphasis added). Under UCCC § 2.104(1)(d) the contract obligation must be payable in installments or must involve a finance charge.

[26] N.J. STAT. ANN. 17:16C-1(b) (7 New Jersey Session Law Service 1692 (1971)).

[27] The definition of "goods" expressly excludes "money or choses in action." *Id.* § 17:16C-1(a). Furthermore, although the definition of "retail installment contract" includes contracts for lease or bailment of goods, it does not include contracts involving consumer loans. *Id.* § 17:16C-1(b).

[28] UCCC §§ 2.403-.404 cover a consumer credit sale or a consumer lease but make no mention of consumer loans. Neither the definition of "consumer credit sale" in UCC § 2.104(1) nor the definition of "consumer lease" in UCC § 2.106 includes consumer loans.

[29] NCA § 1.301(10).

[30] N. J. STAT. ANN. § 17:16C-38.2 (7 New Jersey Session Law Service 1693-94 (1971)).

[31] NCA § 2.406.

absolute ban on the use of waiver of defenses clauses in any contract which falls within the scope of the Act.[32]

In dealing with negotiable notes executed in connection with a retail installment contract, the Retail Installment Sales Act prevents the application of the holder in due course doctrine to the holder of the note by adopting an absolute ban on the use of negotiable notes in retail installment sales.[33] Since the holder in due course doctrine can only apply to negotiable instruments,[34] the Act in effect destroys the finance company's ability to shield itself from a retail buyer's complaints by means of the holder in due course doctrine.

Moreover, the Act attempts to ensure that the consumer recognizes that he is signing a note and that this note entails certain financial obligations. The Act requires that any note executed with a retail installment contract contain the words "consumer note" in large bold type.[35] In addition, the note may not contain security agreements which are not normally found on a negotiable note.[36] Since the retail seller does not have to provide a note which comports with the requirements of negotiability,[37] the seller could conceivably include promises on the face of the note which might otherwise appear in the sales contract.[38] While the Act does not place an absolute ban on the use of additional terms in the note, it does expressly prohibit the creation of a security interest in the note.[39] However, it would appear that the seller can still create this security interest in the installment contract.[40] Thus it can be argued that the impetus of the above requirement is to

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[32] The Retail Installment Sales Act has a much broader effect than the UCCC. UCCC § 2.404, Alternatives A and B. For a discussion of UCCC § 2.404 and how it compares to NCA § 2.406, *see* Note, *supra* note 15, at 180-81.

[33] N. J. STAT. ANN. § 17:16C-38.2 (7 New Jersey Session Law Service 1693-94 (1971)). This parallels the prohibition embodied in NCA § 2.405.

[34] *See* note 4 *supra*.

[35] N. J. STAT. ANN. § 17:16C-38.2 (7 New Jersey Session Law Service 1693-94 (1971)).

[36] *Id.*

[37] Under the Act the use of negotiable notes in retail installment contracts is no longer permissible. *See* notes 33-34 and accompanying text *supra*.

[38] Under UCC § 3-104 an instrument, to be negotiable, must contain an "unconditional promise or order to pay a sum certain in money and *no other promise, order, obligation or power* given by the maker or drawer except as authorized in this Article" (emphasis added). The exceptions are listed in UCC §§ 3-105 and 3-112. Once the instrument is made non-negotiable by operation of law, the seller is no longer bound by UCCC § 3-104.

[39] N.J. STAT. ANN. § 17:16C-38.2 (7 New Jersey Session Law Service 1693-94 (1971)).

[40] That part of the Act prohibiting the creation of a security interest in the note deals solely with the note and does not apply to the retail installment sales contract. *Id.* The terms of the contract are covered in *id.* § 17:16C-38.1. There is no restriction on the creation of a security interest in that section.

ensure that the consumer is not deceived by the placement of the terms of a security agreement in an unusual place.

Unlike a recently enacted New York law,[41] the New Jersey Act does not provide that a buyer can assert his contractual rights against an assignee only as a defense to or set-off against a claim made by an assignee thereby limiting the buyer's claim to the amount due on the note.[42] Under the New Jersey Act, like the NCA,[43] a buyer can not only assert his claim affirmatively against the assignee but can claim damages which exceed the amount due on the note as long as the damages claimed do not exceed the "time sales price" under the contract.[44] However, the New Jersey law states that the buyer can only assert those rights which arise "out of the retail installment contract or any seperate instrument executed in connection therewith."[45]

Finance companies violating the Retail Installment Sales Act are subject to two sanctions. First, a criminal fine may be levied for each offense.[46] Second, the finance company may be barred from recovering "finance, delinquency, collection, repossession, or refinancing charges" in any action based on a contract which violates the New Jersey law.[47]

II. THE SPECIOUS CASH SALE

A. The Problem

As has been mentioned, the Retail Installment Sales Act does not cover consumer loans.[48] This failure permits a retail seller and finance company to engage in a transaction described as a "specious cash sale"[49] or "interlocking loan."[50] In a specious cash sale

[41] N.Y. PERS. PROP. LAW § 403.6 (McKinney Supp. 1970).

[42] Under N.J. STAT. ANN. § 17:16C-38.2 (7 New Jersey Session Law Service 1693 (1971)) a "subsequent holder of a consumer note is subject to *all claims and defenses* of the retail buyer against the retail seller" (emphasis added).

For example, when a buyer has paid $600 on a $1,000 note executed in connection with a retail installment sale, he is limited under New York law to asserting his rights defensively and his claim is limited to $400 even if the damages he has suffered are larger. In New Jersey, this same buyer does not have to wait until the finance company sues before he can assert his rights and the amount he can recover is not limited to the unpaid balance on the note.

[43] NCA § 2.406.

[44] N.J. STAT. ANN. § 17:16C-38.2 (7 New Jersey Session Law Service 1693 (1971)). It should be noted that the New Jersey law specifically excepts sales of new motor vehicles. In these sales the buyer may seek only "the time balance," that is, the amount owing at the time the claim or defense is asserted against the assignee. *Id.*

[45] *Id.*

[46] *Id.* § 17:16C-38.3. The fine is to be not more than $500 for each offense.

[47] *Id.* § 17:16C-38.4.

[48] *See* notes 27-29 and accompanying text *supra*.

[49] *See* Legislative Note, *supra* note 13.

[50] *See* NCA § 2.407, entitled "Interlocking Loans and Sales."

the retail seller does not extend credit directly to the buyer but engages in a two-part transaction with the aid of a finance company. In the first part of the transaction the finance company makes an installment loan to the retail buyer. The buyer then takes the cash obtained from the loan and purchases the goods from the retail seller. When the dealer directs the consumer to a "willing" lender he "just happens to know" and especially when the dealer provides the loan forms and helps the consumer fill them out, such a transaction closely resembles a retail installment sale. Nevertheless, as long as the sale is for "cash," the sanctions and restrictions of the New Jersey Act are arguably inapplicable, and the holder in due course doctrine or a waiver of defenses clause may apply to the sale.[51] Simply by making a paper work adjustment, the finance company can deny the consumer the protection that the Act would otherwise have provided.[52]

Although no empirical data are available to indicate the extent to which retail sellers and finance companies utilize the specious cash sale, there is some reason to believe that they do engage in this type of transaction when it appears to be the only means of protecting themselves from contractual claims of the buyer. In jurisdictions that have enacted consumer protection laws similar to the New Jersey Act, studies reveal a decided upswing in consumer loans distinct from retail installment sales.[53] While the resort to legitimate direct loans seems to be a beneficial side-product of this trend,[54] the use of the specious cash sale has, in fact, presented serious problems.[55] The draftsmen of the NCA,

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[51] *See* notes 21-24 and accompanying text *supra*.

[52] *See* Note, *supra* note 15, at 181.

[53] A study made in Massachusetts by the staff of the *Wisconsin Law Review* indicated that more than 40 percent of the responding financial institutions felt that the new Massachusetts consumer protection laws (MASS. GEN. LAWS ANN. ch. 255, § 12C, and ch. 255d, § 10(6) (1968)) caused a shift toward direct loans. *See* Comment, *Consumer Protection—The Role of Cut-Off Devices in Consumer Financing*, 1968 WIS. L. REV. 505, 542-45 n.98 (1968).

A study of the home improvement loan business in Connecticut after the passage of the Connecticut Home Soliciation Sales Act of 1967 (CONN. GEN. STAT. ANN. § 42-134 to -143 (Supp. 1968), providing that the obligation to pay arising from a home solicitation sale cannot be evidenced by a negotiable instrument) indicated that many financing institutions have switched to the use of direct loans to the consumer, rather than indirect loans through the dealer. One bank was reported to have shifted its resources to advertising for consumers rather than soliciting dealers and found that the change had increased its direct loan business while decreasing the number of defaults. *See* Note, *A Case Study of the Impact of Consumer Legislation: The Elimination of Negotiability and the Cooling-Off Period*, 78 YALE L.J. 618, 642 (1969).

[54] *See* Note, *supra* note 53, at 654-55.

[55] *See* statement by New York Governor Nelson Rockefeller in McKinney's Session Law News of New York No. 5, A.258-59 (1971). The governor states in part:

> Since [the enactment of the New York consumer protection law], however, a number of unscrupulous merchants and finance companies, partic-

in light of the above, included a provision to remedy the matter.[56] In addition, because of what it considered to be extensive and abusive use of the specious cash sale, the New York legislature, which had previously enacted statutes similar to the New Jersey Act,[57] found it necessary to enact a further law to remedy the problem.[58] In spite of the New York experience, it appears that the New Jersey Retail Installment Sales Act fails to account for the problem presented by the specious cash sale.

B. Possible Responses to the Problem

In order to determine the severity of the problem created by the specious cash sale, it is necessary to examine initially the underlying goals of legislation such as the New Jersey Act and, thereafter, to determine the effect of the specious cash sale upon them. Three major goals have been suggested for legislative enactments limiting the use of negotiable notes and waiver of defenses clauses in retail installment contracts: to force finance companies to screen retail sellers more cautiously before extending credit;[59] to increase the bargaining power of the buyer in retail installment

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ularly in poverty areas, have managed to get around the intent of the 1970 law through the use of the so-called "specious cash sale."

Id. at 258. *See also* Legislative Note, *supra* note 13, at 145–46.

[56] NCA § 2.407.

[57] N.Y. PERS. PROP. LAW § 403.3(a) (McKinney Supp. 1970) makes waiver of defenses clauses in retail installment transactions unenforceable. *See* note 41 *supra* for the law eliminating negotiability of consumer notes executed in connection with retail installment sales.

[58] N.Y. GEN. BUS. LAW §§ 252–255 (McKinney's Session Law News of New York No. 5, Ch. 605 (1971)). For a discussion of this law, *see* Legislative Note, *supra* note 13.

[59] The argument here turns on the fact that the finance companies are the most able to regulate retail dealers. Most consumers do not understand that legal implications of the language contained in the contract. *See* Kripke, *Consumer Credit Regulation: A Creditor-Oriented Viewpoint*, 68 COL. L. REV. 455, 472 (1964), and Shuchman, *Consumer Credit by Adhesion Contracts II*, 35 TEMP. L. REV. 281, 287 (1962).

Furthermore, the organization of consumer interests into a meaningful bargaining unit which can bargain with, much less police, the retail merchant is at a very rudimentary stage. *See* Littlefield, *Preserving Consumer Defenses: Plugging the Loophole in the New UCC*, 44 N.Y.U.L. REV. 272, 281 (1969).

On the other hand, the finance companies seem to have a greater ability to investigate and evaluate the reliability of their seller-assignors and they possess the potent economic weapon of granting or refusing to grant credit. *See* Jordan & Warren, *The Uniform Consumer Credit Code*, 68 COL. L. REV. 387, 436 (1968); Murphy, *Lawyers for the Poor View the UCCC*, 44 N.Y.U.L. REV. 298, 320 (1969); and the Uniform Commercial Code Commentary, *Judicial and Statutory Limitations on the Rights of a 'Holder in Due Course' in Consumer Transactions*, 11 B.C. IND. & COM. L. REV. 90, 91 (1969).

An empirical study was undertaken in Connecticut to see if, in fact, tighter policing had resulted from the passage of a law eliminating the holder in due course doctrine in home solicitation sales. The study showed that some policing had in fact occurred but that the criteria used may not have been too relevant to the competency of the seller-dealer. The criteria cited included the size of the business and the number of years the business had dealt with the finance company. *See* Note, *supra* note 53.

contract disputes;[60] and to shift the initial contract loss to the party who is best able to bear it.[61]

The use of the specious cash sale could seriously impair the effectuation of all three of these goals. The "consumer loan" exclusion allows a finance company to avoid the responsibilities imposed under the Retail Installment Sales Act and, in effect, allows the company to drift back into the posture that created the problems the New Jersey legislature was trying to solve: the company would not have to police those dealers to whom it extended credit because it would be protected from loss; the consumer would still face the holder in due course doctrine and the waiver of defenses clause impediments to his right to sue on the contract; and the consumer, not the finance company, would bear the initial contract loss caused by the retail dealer's default or bankruptcy.

While the New York state legislature enacted a statute to close the loophole, the New Jersey state legislature perhaps need not go as far. Several courts have recently held that if the finance company has had a fair degree of involvement with the retail dealer, the consumer may attack the finance company's position as a holder in due course.[62] Although a majority of jurisdictions have

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[60] The policy here is to encourage consumers to exercise their private rights against retail sellers and finance companies and thereby to increase regulation of such companies. The value of private rights to the consumer is no greater than his ability to assert them in a court of law. The problem is that the use of default judgments coupled with the restrictions placed by the holder in due course doctrine and the waiver of defenses clauses has all but led to a breakdown of the private remedy. As an empirical study indicates, the creditor can expect the defendant to default in the majority of suits filed. *See* Projects, *Resort to the Legal Process in Collecting Debts from High Risk Credit Buyers in Los Angeles—Alternative Methods for Allocating Present Costs,* 14 U.C.L.A.L. REV. 879, 879-80 (1967).

By forcing the finance company to answer to the defenses or claims of the buyer against the seller and by providing monetary rewards to those who pursue their remedies, the consumer laws attempted to re-establish the effectiveness of the private remedy. *See* Uniform Commercial Code Commentary, *supra* note 59, at 107-08.

[61] It is generally recognized that the finance company is more able to avoid the loss by exercising extensive regulation of the dealers to whom it extends credit or by a mere threat to cut off all sources of credit to the dealer. Furthermore, if initial loss must be borne by a particular party, the finance company is most able to bear that loss without disastrous effects. *See* Kripke, *supra* note 59, at 472, and Note. *Consumer Financing, Negotiable Instruments, and the Uniform Commercial Code: A Solution to the Judicial Dilemma,* 55 CORNELL L. REV. 611, 613 (1970).

Moreover, fairness dictates that the part receiving the benefit—the profits—of the credit market should also bear the burdens encountered. *See* Littlefield, *supra* note 59, at 284. However, it is possible that the loss will eventually be passed from the finance company to the consumer if the finance company charges higher rates or restricts the flow of credit.

[62] *See* Kennard v. Reliance Inc., 257 Md. 654, 264 A.2d 832 (1970); Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967); International Finance Corp. v. Rieger, 272 Minn. 192, 137 N.W.2d 172 (1965); Mutual Finance Co. v. Martin, 63 So.2d 649, 44 A.L.R.2d 1 (Fla. 1963); Commercial Credit Corp. v. Orange County Mach. Wks., 34 Cal.2d 766, 214 P.2d 819 (1950); and Consumer Credit Corp. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940).

not followed the "close connectedness" doctrine outlined in *Consumer Credit Corp. v. Childs*,[63] in *Unico v. Owen*[64] the New Jersey Supreme Court considered this issue[65] and wrote what is generally considered to be the strongest opinion on behalf of the doctrine. In *Unico* a retail buyer contracted for the purchase of a large number of record albums. The record albums were to be delivered over a five-year period, while the installment price was to be paid over a three-year period. The retail dealer subsequently became insolvent, and soon after delivery of the albums ceased the retail buyer refused to make any more installment payments. The finance company, Unico, sued to collect on the note it had purchased from the dealer. The court, in a two-pronged decision, ruled that waiver of defenses clauses in retail installment sales were void as against public policy,[66] and that the finance company was too closely connected with the sale to qualify as a holder in due course.[67] Even if the Retail Installment Sales Act does not apply to a specious cash sale, the New Jersey courts, by invoking

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Although many of these cases were decided before the enactment of the UCC, it can be argued that the result should be the same. First, under UCC § 3-302(1)(b) the assignee must take in good faith in order to be a holder in due course. It is arguable that "good faith" precludes the finance company from participating in the underlying transaction:

> In the field of negotiable instruments, good faith is a broad concept. The basic philosophy of the holder in due course status is to encourage free negotiability of commercial paper by removing certain anxieties of one who takes the paper as an innocent purchaser knowing no reason why the paper is not as sound as its face would indicate. It would seem to follow, therefore, that the more the holder knows about the underlying transaction, and particularly the more he controls or participates or becomes involved in it, the less he fits the role of a good faith purchaser for value . . . .

Unico v. Owen, 50 N.J. 101, 109-10, 232 A.2d 405, 410 (1967). Second, under UCCC § 3-305(2), a holder in due course can take the instrument free from the defenses of any party only if the holder has "not dealt" with that party.

[63] 199 Ark. 1073, 137 S.W.2d 260 (1940).

[64] 50 N.J. 101, 232 A.2d 405 (1967).

[65] *See* Littlefield, *supra* note 59, at 275-77. For a listing of other cases, *see* note 62 *supra*.

[66] 50 N.J. 101, 125-26, 232 A.2d 405, 418 (1967).

[67] The court specifically held:

> For purposes of consumer goods transactions, we hold that where the seller's performance is executory in character and when it appears from the totality of the arrangements between dealer and financer that the financer has had a substantial voice in setting standards for the underlying transaction, or has approved the standards established by the dealer, and has agreed to take all or a predetermined or substantial quantity of the negotiable paper which is backed by such standards, the financer should be considered a participant in the original transaction and therefore not entitled to holder in due course status.

50 N.J. 101, 122-23, 232 A.2d 405, 417 (1967).

Although the Retail Installment Sales Act merely codifies the *Unico* holding with respect to waiver of defense clauses, it extends *Unico's* restrictions on the application of the holder in due course doctrine in retail installment sales. *Unico* only bars the use of the holder in due course doctrine where the relationship between the retail seller and buyer meets the close connectedness test; the Act imposes an absolute bar to the use of the doctrine in retail installment sales.

Unico, could still deny the application of the holder in due course status to a finance company involved in such a sale.

When the court is confronted with a possible specious cash sale case, it should resolve two issues with regard to the status of the finance company: whether the transaction is a specious cash sale, and if so, whether the holder in due course doctrine applies. The factor that distinguishes a legitimate direct loan from a specious cash sale is the degree to which the finance company is involved in the transaction for the sale of the goods.[68] It seems to follow, therefore, that the use of the close connectedness test could provide a valid method for resolving the first question.[69]

There is, however, an inherent ambiguity in the close connectedness test. If, for example, a prospective automobile buyer is referred to a finance company by the dealer, it is uncertain whether the objective circumstances surrounding the referral should govern or whether the dealer's intent should govern the sale. *Unico* seems to adopt the objective standard approach[70] but the answer is by no means clear and, as a result, commentators and draftsmen have split widely on the issue.[71] No matter which standard is followed, the close connectedness test still seems to provide a viable method for determining the presence of a specious cash sale.

If the close connectedness test indicates that the transaction is a specious cash sale, then it can be argued under *Unico* that this same test requires that the finance company be denied the holder in due course status.[72] Although it is arguable that *Unico* does not

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[68] *See* Legislative Note, *supra* note 13, at 149.

[69] It is interesting to note that the law presently enacted (*see* note 58 *supra)* and the proposed model provisions dealing with the specious cash sale (*see* NCA § 2.407 and Littlefield, *supra* note 59, at 293-94) speak in terms of "close connection," "direct relation," or "direct participation." The drafters have apparently turned to the language and standards that have evolved in the courts to determine whether a person claiming to be a holder in due course is in fact such a holder. The comments to NCA § 2.407 go as far as to adopt expressly the precedents developed by the courts.

[70] *See* note 67 *supra*.

[71] On the one hand, the NCA apparently adopts objective standards. NCA § 2.407(2) lists factual situations which are to be taken as *conclusive proof* that "the creditor participated in or was directly connected with" the sale.

The New York law, *see* note 53 *supra*, lists factual situations meant to serve as *rebuttable* presumptions of close connection. In this light, the New York law seems to follow the objective standards approach. However, the New York law's scope is not limited to the factual situations listed and other relevant evidence may be introduced either to show "close connection" or to rebut the presumption of "close connection." In this manner, the New York law could conceivably permit the use of subjective standards for determining "close connection."

On the other extreme, a professor who has written extensively in the area proposed an amendment to the UCCC which largely adopted subjective standards. *See* Littlefield, *supra* note 59, at 293-94.

[72] *See* note 67 and accompanying text *supra*.

apply to the specious cash sale because it does not apply to a retail installment sale in which a finance company has given a "direct" loan, the court should still be able to go behind the form to view the substance of the transaction.[73] If the loan is, in fact, direct and if the participation of the retail seller is minimal, the court should hold that the transaction is a loan, not a retail installment sale. Conversely, where the retail seller plays a critical role in securing the credit, the court should find that the transaction is, in fact, a retail installment sale.

If the New Jersey courts refuse to solve the problem of the specious cash sale, it is unlikely that the Act will afford much protection for the retail buyer.[74] Moreover, in a state that does not follow *Unico* the only solution is for the state legislature to enact legislation dealing specifically with the specious cash sale.

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[73] The courts have demonstrated already that they will go behind the form to view the substance of a retail installment sale. For example, where the finance company has directed the transaction between the lender and the maker of the note from its inception, the finance company is not held to be a bona fide purchaser of the negotiable note, but is regarded as a party to the original agreement. Its holder in due course status is thereby negated. *See* Nassau Discount Corp. v. Allen, 44 Misc. 2d 1007, 255 N.Y.S.2d 608 (City Ct. 1961), *rev'd on other grounds*, 262 N.Y.S.2d 967 (App.T. 1965); Mutual Finance Co. v. Martin, 63 So.2d 649, 44 A.L.R.2d 1 (Fla. 1953); Commercial Credit Corp. v. Orange County Mach. Wks., 34 Cal.2d 766, 214 P.2d 819 (1950); Citizens Loan Corp. v. Robbins, 40 So.2d 503 (App. Ct. La. 1949); and Buffalo Industrial Bank v. De Marzio, 162 Misc. 742, 296 N.Y.S. 783 (City Ct. 1937), *rev'd on default*, 6 N.Y.S.2d 568 (Sup. Ct. 1937).

[74] It could be argued that even if the specious cash sales were allowed to defeat the purpose of the new act, the fact that the finance companies and retail sellers would be forced to use the specious cash sale to avoid losing their holder in due course status would in effect defeat the "time-price" doctrine which allows the participants in a retail installment contract to escape the reaches of the state usury laws. If the specious cash sale is not viewed as a retail installment sale it must be viewed as a direct loan transaction, and such transactions are not usually covered by the "time-price" exception. Nevertheless, the policies of the Act itself would still be defeated.