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THE FTC LEGEND IN LOUISIANA

The Federal Trade Commission enacted the Preservation of Consumers Claims and Defenses Rule¹ in response to perceived abuses of the holder-in-due-course doctrine² in consumer transactions. The usual example of such abuses involved a buyer who would sign a negotiable note in connection with his purchase of consumer goods. The seller would transfer the note to a third-party lender. If the buyer refused to pay, even for good reason, the lender would invoke his holder-in-due-course status to block the assertion of any claims or defenses. Thus, a buyer who received defective goods or who otherwise had a defense to payment as against the seller was nevertheless forced to render payment to the seller's transferee.

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1. 16 C.F.R. 433 (1987). Pertinent portion reads as follows:

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.

16 C.F.R. 433.2 (emphasis added).

2. Under La. R.S. 10:3-302 (1983) a "holder in due course" is defined as "a holder who takes the instrument (a) for value; and (b) in good faith; and (c) without notice that it is overdue or has been dishonored or any defense against or claim to it on the part of any person." "Instrument" is defined by La. R.S. 10:3-102(1)(e)(1983) to mean a *negotiable* instrument.

The FTC rule requires insertion of a notice in all consumer paper.³ The effect of this mandatory incorporation of a notice should be to preclude the subsequent transferee of the paper from acquiring the rights of a holder in due course.⁴ Consequently, a consumer should now be able to raise legitimate claims and defenses notwithstanding the seller's transfer of the note. Although this FTC regulation has been in effect since 1976,⁵ it is evident from Louisiana case law that problems continue with respect to its enforcement.

Code of Civil Procedure Article 424

One of the problems concerns the interpretation of negotiability under Louisiana Code of Civil Procedure article 424.⁶ This article deals with the assertion of a cause of action as a defense. As a general rule, the assertion of a cause of action as a defense is allowed, even though it has otherwise prescribed. However, the article specifically disallows the assertion of a prescribed defense of redhibition in connection with the enforcement of a negotiable instrument. Because this limitation applies to negotiable instruments only, its application turns on whether an instrument containing the FTC notice retains its negotiable character.

One of the requirements of negotiability is an "unconditional promise or order to pay."⁷ The language of the FTC notice could be construed

3. The Rule (16 C.F.R. 433) uses the term "consumer credit contract" and defines it as "[a]ny instrument which evidences or embodies a debt arising from a 'Purchase Money Loan' transaction or a 'financed sale' . . ."

4. Under state law, a paper bearing the FTC notice no longer contains an "unconditional promise to pay" and should not be considered "negotiable." La. R.S. 10:3-104(1)(b) (1983). One must be the holder of a negotiable instrument to acquire the rights of a holder in due course. Therefore, the effect of the FTC notice, and the interaction of state law, is to preclude the subsequent transferee from acquiring the rights of a holder in due course. The scope of this article is limited to a discussion of the court's failure to analyze the negotiability issue thoroughly. The use of the FTC regulation to give the holder of consumer paper a potential cause of action against a subsequent transferee is beyond the scope of this article.

5. See supra note 1.

6. La. Code Civ. P. art. 424:

A person who has a right to enforce an obligation also has a right to use his *cause of action as a defense*.

Except as otherwise provided herein, a prescribed obligation arising under Louisiana law may be used as a defense if it is incidental to, or connected with, the obligation sought to be enforced by the plaintiff. A prescribed cause of action arising under The Federal Consumer Credit Protection Act may not be used as a defense even if it is incidental to, or connected with, the obligation sought to be enforced by the plaintiff.

However, in connection with the enforcement of a *negotiable instrument* the defense of redhibition *may not be used if it has otherwise prescribed*. (emphasis supplied).

7. La. R.S. 10:3-104(1)(b)(1983).

as making the promise or order to pay "conditional." If so, an instrument containing the notice would not be considered negotiable,⁸ thus avoiding the application of the exception in article 424. Certain Louisiana cases, however, have concluded otherwise.

In *General Motors Acceptance Corporation v. Johnson*,⁹ the buyer executed a promissory note in connection with his purchase of an automobile. When the buyer ceased making payments on the note, GMAC, the holder, instituted executory process and subsequently filed suit for deficiency judgement. The buyer asserted redhibition as a defense under Louisiana Code of Civil Procedure article 424. If the paper were not negotiable, the limitation in Louisiana Code of Civil Procedure article 424 would be inapplicable, and the buyer could go forward with his defense.

Initially, the court noted the presence of the required FTC notice. With the notice present, the defense of redhibition was available against GMAC.¹⁰ In the court's view, it was the FTC notice itself, not the nonnegotiability of the instrument, that allowed the defense as an initial matter. The court, however, went on to state that "the note itself meets all the requirements of negotiability."¹¹ This finding led to the conclusion that the limitation in Louisiana Code of Civil Procedure article 424 was applicable. Because the defense of redhibition was asserted more than one year after the sale¹² or discovery¹³ of the alleged defects, the claim had prescribed, and in light of the court's conclusion of negotiability, the defense could not be raised.

If the court had analyzed the issue properly, it may have found that the promise contained in the instrument was made conditional by the presence of the notice, making the note nonnegotiable. The court added: "[T]he federal regulation cannot avail the [consumer] since, under state law, redhibition (once prescribed) is not an available defense against

8. See J. White and R. Summers, *Handbook of the Law Under the Uniform Commercial Code 14-8*, at 572 (1980). See also Hersbergen, *Developments in the Law—Private Law: Banking Law*, 41 *La. L. Rev.* 313, 315 (1980), in particular footnote 6, for an excellent discussion on the possible destruction of negotiability when the FTC notice is included.

9. 426 So. 2d 691 (La. App. 1st Cir. 1982), writ denied 433 So. 2d 151 (1983).

10. *Id.* at 695.

11. *Id.*

12. La. Civ. Code art. 2534: "The redhibitory action must be instituted within a year, at the farthest, commencing from the date of the sale"

13. La. Civ. Code art 2546:

In this case, the action for redhibition may be commenced at any time, provided a year has not elapsed since the discovery of the vice.

This discovery is not to be presumed; it must be proved by the seller.

the seller."¹⁴ Therefore, the finding of negotiability compelled the conclusion that the buyer's defense was barred by the operation of article 424.

The language of *Johnson* suggests certain policy considerations that may have influenced the court.¹⁵ The court found the purpose of Louisiana Code of Civil Procedure article 424, when construed against the federal regulation, to be as follows: "[T]o increase the merchantability of negotiable instruments by limiting the defenses assertable against the seller." The defense of redhibition, in certain circumstances, is limited by the exception in Louisiana Code of Civil Procedure article 424. The more broadly this exception is defined, the less the risk associated with the purchase of negotiable instruments. The reduction of risk leads to a decrease in the discount rate, which should result in an increase in merchantability of the paper.¹⁶ Thus, the court seemed to be interested in making consumer paper more valuable by limiting the effect of the federal regulation. In a footnote, the court added, "[T]he enactment of 16 C.F.R. 433 does not prevent Louisiana from limiting defenses available against sellers and holders alike, since determination of rights and liabilities of sellers and purchasers is a matter of state law."¹⁷

Even assuming the validity of the state's power in this area, it is the court's haphazard reasoning that is so disturbing.¹⁸ Despite the importance of the question, this court failed to analyze the issue thoroughly. If Louisiana courts wish to use article 424 to enhance the value of consumer paper, they must first address the negotiability question head-on. Instead of simply stating that the note retains its negotiable character despite the inclusion of the FTC notice, the court defining the scope of article 424 must explain its actions fully. Why is the note negotiable? Doesn't the inclusion of the notice render the promise "conditional"?¹⁹ If not, why not?

14. 426 So. 2d at 696.

15. *Id.* at 697.

16. *Id.*

17. *Id.* n. 4.

18. See *First Homestead Federal Savings v. Dent*, 459 So. 2d 689 (La. App. 4th Cir. 1984) (*Johnson* cited with approval).

19. A more fundamentally sound analysis is offered by the Maryland court in *Thompson v. Ford Motor Credit Co.*, 429 A.2d 277 (Md. Ct. Spec. App. 1981). *Thomas* involved a retail installment contract assigned to Ford Motor Credit Co. Under the facts of the case, the insertion of the notice became a part of the contract. However, the court recognized that with respect to negotiable paper, "[t]he language of the notice deprives the paper of its negotiability in that it becomes a conditional promise to pay a sum certain; one requirement for asserting the rights of a holder in due course is that one must be the holder of negotiable paper."

Failure of Certain Appellate Courts to Acknowledge the Regulation

A related problem deals with the outright failure of courts to discuss the relevance of the FTC regulation. In *Associates Financial Services Company v. Ryan*,²⁰ a secured lender sought to enforce payment of a note executed in connection with the buyer's purchase of a truck. The buyer filed a reconventional demand against the lender alleging the existence of redhibitory defects. The third circuit, in dismissing the reconventional demand, concluded that the buyer's claim was "totally without merit." The court focused on the fact that the lender did not act as a seller or manufacturer. The lender's role, said the court, was restricted to financing the purchase of the truck.²¹ The court, however, made no mention at all of the FTC regulation and the possible effect of the notice.

Perhaps the factual circumstances justify the result in the case. Unfortunately, the court fails to provide a clear statement of such facts. The court does not discuss whether the seller labelled the note pursuant to the federal regulation, so one explanation would be the absence of the legend on the note in question. In a case of noncompliance with the federal regulation, the seller would be subject to sanction for committing an "unfair trade practice."²²

Another explanation for the court's silence on such an apparently pertinent issue goes beyond the negotiability question. Proving the "honesty in fact"²³—required of a holder-in-due-course—could be a difficult burden for a sophisticated lender that received consumer paper not containing the FTC notice. It is at least arguable, then, that the holder-in-due-course status of this lender would be jeopardized by its lack of "good faith,"²⁴ so that even if the paper were not labelled properly, the consumer could raise his defense against the note holder.

A better explanation may be found in the nature of the underlying transaction. For the regulation to apply, the buyer must be a "consumer." Federal regulations define a consumer as "[a] natural person who seeks or acquires goods or services for personal, family, or household use."²⁵ In *Ryan*, the item purchased was a "Mack" truck. If this issue had been properly addressed, it is likely the court would have

20. 382 So. 2d 215 (La. App. 3d Cir. 1980).

21. *Id.* at 220-21.

22. J. White and R. Summers, *Handbook of the Law Under the Uniform Commercial Code* 14-8, at 1142 (1980). See La. R.S. 51:1405 and related jurisprudence illustrating what constitutes unfair trade practices under the statute.

23. La. R.S. 10:3-302(1)(b) (1983).

24. La. R.S. 10:1-201(19) (1983).

25. 16 C.F.R. 433.1 (1987).

concluded that a consumer transaction was not involved. Hence, the FTC regulation would have been inapplicable in the first place.²⁶

While the outcome of the case may not have changed, it is the court's refusal to address the pertinent issues that is most troublesome. What about the applicability of the FTC regulation? Did the court overlook the FTC regulation, or did it intend to override the FTC? If the court intended the latter, why was this not adequately explained? Instead, the court's use of such broad, sweeping language in its abrupt dismissal of the buyer's demand presents a misleading statement of the law.

In *General Motors Acceptance Corporation v. Sims*,²⁷ the buyer financed the purchase of a used car through GMAC. When the buyer failed to make any payments on the promissory note, GMAC instituted suit to seize the vehicle. In response, the buyer filed a reconventional demand against GMAC asserting the existence of redhibitory defects.

The Louisiana Fifth Circuit affirmed the dismissal of the buyer's reconventional demand. The court refused to hold GMAC liable because the company served only as a lender and neither as a seller or manufacturer. The court cited *Associates Financial Services Co. v. Ryan* in support of this conclusion.²⁸

This decision lends credence to concerns over the broad language used by the third circuit in *Ryan*. There is no discussion in *Sims* about the inclusion of the FTC notice and the effect, if any, of that notice. More troubling is the identity of the lender in *Sims*. There can be no doubt that GMAC was aware of the consumer origin of the transaction.

CONCLUSION

The purpose of this article is to implore the courts to stop ignoring the existence of the FTC regulation. The issues must be discussed expressly by the courts and dealt with in a carefully reasoned and candid manner. While the courts may not feel compelled to effectuate the intended result of the FTC regulation, they cannot simply avoid the issue. Courts should first recognize the existence of the FTC regulation. Then, a clear statement of the facts should be given, specifically noting whether the FTC notice was included. Instead of blindly ruling on the negotiable character of the paper, the court must go to the core of the problem, whether the inclusion of the notice renders the paper "conditional" under state law. The court should then determine the nego-

26. See *Jefferson Bank and Trust Co. v. Stamatiou*, 384 So. 2d 388 (La. 1980).

27. 472 So. 2d 111 (La. App. 5th Cir. 1985).

28. *Id.* at 114.

tiability of the paper on those grounds. If the courts continue ignoring the problem, their slackardness can only lead to more confusion among the circuits.

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