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ASSIGNMENTS—Maker's Defenses Cut Off—Uniform Commercial Code § 9-206*—Merchants know that extensive use of time payment or installment purchase plans is commercially advantageous. Ready credit encourages the purchase, and the merchant can avoid tying up his liquid assets if he discounts the note or contract evidencing the debt to a third party, usually a bank or finance company specializing in credit financing. The amount by which the note must be discounted before sale to the financing party depends on several factors. Certainly, the risk of insolvency of the maker is one consideration; whether the maker can interpose defenses arising from the original transaction is another. The risk of loss to the finance company due to insolvency of the maker is decreased when the finance company is assigned a contract of sale because the purchased item then serves as collateral. The interposition of defenses may usually be forestalled if the finance company acquires a promissory note as a holder in due course. It is therefore common for the merchant to require a conditional sale contract, or similar security agreement, and a promissory note from the purchaser, both to be assigned to the finance company.

Because the maker's defenses are thereby cut off, this practice can be unfair. The courts have recognized this, and have adopted ways to curtail questionable practices. The New Mexico Supreme Court, in *State Nat'l Bank v. Cantrell,*1 struck down this practice, but the court did not distinguish between unscrupulous and reputable business institutions. Most other jurisdictions have taken a more moderate approach by examining the particular relationship between the merchant and the finance company to determine if the finance company is, in fact, a "true" holder in due course. The Uniform Commercial Code, now in wide acceptance, incorporates many of the limitations imposed by the majority of jurisdictions for transactions involving the purchase of non-consumer goods, and allows more stringent regulation on a state-to-state basis in the case of consumer goods.2 The focus of this Comment is on the question whether, in

1. 47 N.M. 389, 143 P.2d 592 (1943).

References to New Mexico's version will be designated "UCC" both in footnote and text, omitting the full statutory citation.
view of the *Cantrell* decision, the New Mexico Supreme Court will apply the more stringent regulation available under the UCC for transactions having their origin in the purchase of consumer goods.

In *Cantrell*, the merchant sold an air conditioning unit to the defendant, taking a down payment and securing the balance with a promissory note. The unit was for use in the defendant's restaurant; hence, under the UCC, it would be classified as non-consumer goods. At the time of sale a conditional sale contract was executed which provided, among other things, that the equipment was guaranteed for five years. Immediately thereafter, the plaintiff bank notified the defendant of the fact that it was about to purchase the note and contract from the merchant. The bank asked the defendant to sign and return a letter reciting that the equipment purchased "has been completely installed and is satisfactory" and promising to "make payments on the note in accordance with its demands, as due." The defendant signed and returned this letter after the installation of the unit, but before he had had time to actually use it. The next morning he discovered that the equipment was unsatisfactory. When the merchant refused to comply with the guarantee, the defendant had the unit removed from the restaurant at his own expense.

After the defendant's default in payment, the plaintiff bank brought suit on the promissory note, the defendant counterclaiming for breach of warranty. The trial court found against the plaintiff and awarded the defendant fifty-seven dollars on his counterclaim. The plaintiff appealed, contending that as a holder in due course he was free from the breach of warranty defense set up by the defendant's counterclaim and was therefore entitled to judgment on the promissory note. Upon appeal to the New Mexico Supreme Court, held, Affirmed.²

The supreme court recognized that, even though the bank knew the consideration for the note was an executory contract, this alone would create no right in the maker of the note to interpose the breach of an underlying contract as a defense.⁵ The supreme court also conceded that the promissory note was a negotiable instrument, and that the plaintiff was a holder in due course. Nevertheless, the plaintiff was also the assignee of the conditional sale contract, executed and transferred at the same time and as part of the same trans-

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3. For the UCC definition of consumer goods, see section 9-109, set out at p. 416 infra.
4. 47 N.M. at 394, 143 P.2d at 595.
action; the plaintiff, as assignee, was thereby possessed of the rights conferred by the contract and burdened with the obligations it imposed.6 By virtue of the New Mexico counterclaim statute,7 the defendant was "entitled to plead as a counterclaim the breach of warranty as 'a cause of action arising out of the contract or transaction set forth in the complaint as the foundation of the plaintiff's claim, or connected with the subject of the action' . . . or as 'any other cause of action arising also on contract and existing at the commencement of the action.' "8

The bank also claimed on appeal that the agreement in the letter signed by the defendant should estop the defendant from asserting his breach of warranty defense.9 The supreme court indicated that this question had not been properly presented at trial and should not be first raised on appeal. Regardless of this, the plaintiff's contention would not have prevailed. The supreme court could not find sufficient evidence showing that the plaintiff had relied on the letter in purchasing the note and contract. It further appeared that the defendant had signed the letter without full knowledge of the pertinent facts.10 Absent these essential elements, the doctrine of estoppel was inapplicable.

If Cantrell has a meaning beyond the interpretation of the counterclaim statute,11 it is gleaned from this statement by the court:

6. 47 N.M. at 392, 143 P.2d at 594, citing Zederman v. Thompson, 17 N.M. 56, 121 Pac. 609 (1912), and Doub v. Rawson, 142 Wash. 190, 252 Pac. 920 (1927).
8. 47 N.M. at 392, 143 P.2d at 595.
9. On the issue of estoppel, itself beyond the scope of this Comment, see Annot., 44 A.L.R.2d 8 (1955).
10. Full knowledge is an essential element of an estoppel, as pointed out in Dye v. Crary, 13 N.M. 439, 85 Pac. 1038 (1906). The first Cantrell appeal, State Nat'l Bank v. Cantrell, 46 N.M. 268, 127 P.2d 246 (1942), resulted in the supreme court remanding the case for the trial court to make certain findings of fact. One such finding was that the defendant did not know, until advised by a mechanic, that part of the equipment purchased was second-hand.
11. The counterclaim statute was determinative of the case. One of the plaintiff's contentions in a petition for rehearing was that Texas law should apply. The supreme court's opinion on rehearing stated that the court agreed with the correctness of the Texas cases cited because they were in accord with Azar v. Slack, 29 N.M. 528, 224 Pac. 398 (1924), which held that the holder of a promissory note is not precluded from being a holder in due course unless it is affirmatively shown that the breach of an underlying contract occurred prior to transfer of the note, and that the assignee had knowledge of the breach. The supreme court in Cantrell went on to say:

Where the plaintiff loses is not because of any difference in the law of the two states on the question presented but, rather, in failing to challenge successfully the defendant's right under our then controlling statute on counterclaims . . . or under the Texas statute as well as for that matter (Art. 2017, Vernon's
The defendant signed the letter on the assumption that, since the plaintiff was purchasing both the contract and the note, it would be under the same obligation to fulfill the terms of the contract as the original seller, its assignor.\(^\text{12}\)

This is at least some indication that the court was interested in protecting the reasonable expectations of a purchaser who had signed a promissory note.

The *Cantrell* decision announced this rule: If the purchaser of a negotiable instrument is simultaneously assigned a conditional sale contract, he is subject to all defenses arising from the contract, even though he is a holder in due course of the note. This formulation is known as the "single contract" theory.\(^\text{13}\)

The "single contract" theory renders a negotiable instrument non-negotiable, and, in doing so, may well be said to defeat the reasonable expectations of the finance company. For example, the finance company, having acquired the status of a holder in due course of the note, also acquires the additional security supposedly afforded by a sale contract, only to discover that it has not improved its position but has actually destroyed a large portion of the value of being a holder in due course. It has been suggested\(^\text{14}\) that the finance company could avoid this unfavorable result by either (1) taking the assignment of the sale contract at a later date, or (2) not taking an assignment of the sale contract at all, but entering into a trust agreement.\(^\text{47}\) N.M. at 394, 143 P.2d at 596.

12. *Id.* at 395, 143 P.2d at 595.

13. The single contract theory finds occasional support in other jurisdictions. First & Lumberman's Nat'l Bank v. Buchholz, 220 Minn. 97, 18 N.W.2d 771 (1945), reached the same result as *Cantrell* on almost identical facts, without reference to a counterclaim statute. Cooke v. Real Estate Trust Co., 180 Md. 133, 22 A.2d 554 (1941), used the single contract theory to limit the remedies of the financing institution to those contained in the conditional sale contract; the promissory note and conditional sale contract having been simultaneously delivered and assigned. In *Cooke*, the Maryland court distinguished between cases involving notice of an executory contract as consideration for the note and cases involving notice to the finance company, albeit in the sale contract, that liability was conditional. Cf. *Griffin v. Baltimore Fed. Sav. & Loan Ass'n*, 204 Md. 154, 102 A.2d 804 (1954).


agreement with the merchant providing that if the note becomes uncollectible because of the maker's insolvency, the finance company will be subrogated to whatever right the merchant has to repossess the property. The latter method, though not entirely satisfactory, at least would not impinge upon the finance company's remedy of suing on the note as a holder in due course.

The "single contract" theory has not met with wide acceptance because it shocks traditional notions of negotiable instrument law and can, at least theoretically, be easily circumvented. However, many courts, rejecting the conceptual basis of the "single contract" theory, invoke other rationales to reach similar results. The thrust of these rationales is generally directed toward unscrupulous business practices, rather than negotiable instrument law. For example, a contract of sale containing provisions purporting to give the contract negotiable characteristics has been struck down as an attempt to create a "new form of negotiable instrument." Alternatively, courts may feel that the relationship between the finance company and the merchant is such that they are, in effect, one and the same. The finance company could not then in good faith claim the benefits of holdership in due course; the finance company should be charged with full knowledge of the transaction underlying the creation of the note.

As a practical matter, the finance company can circumvent the rationale of the Cantrell decision simply by incorporating in the sale contract a clause providing that the maker will settle all claims against the merchant directly with the merchant, or by a clause

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15. In those jurisdictions finding the finance company not to be a holder in due course because of the closeness of association with the merchant, see notes 16, 25, & 26 infra, it is likely that such a trust agreement would only serve as an additional justification for denying the finance company the status of a holder in due course.


Conditional sale contracts by themselves are normally held to be non-negotiable. See e.g., Security Fin. Co. v. Comini, 119 Ore. 460, 249 Pac. 1054 (1926).

17. See, e.g., Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940), in which the contract of sale, prepared by the finance company, contained a printed assignment to the company on its reverse side. See also cases cited in notes 25 & 26 infra.

18. Mutual Fin. Co. v. Martin, 63 So. 2d 649 (Fla. 1953), 44 A.L.R.2d 1 (1955). In Martin, the Florida Supreme Court considered and rejected the idea expressed in Cantrell and other cases that negotiability could be affected by a simultaneous execution of a conditional sale contract and a promissory note. Regardless of this, the Florida court said that the finance company could not be heard to claim to be in good faith a holder in due course.
waiving the maker’s right to assert defenses to the contract against an assignee of the merchant. Under such a clause, the maker, unlike the defendant in *Cantrell*, cannot expect the assignee to be under the same obligations to fulfill the terms of the contract as the merchant.

The use of such a clause has several practical effects: (1) It places the risk of the possible insolvency of the merchant on the maker. (2) It places the burden on the maker to locate the merchant for suit on the breach of contract. (3) It deprives the maker of the possibility that by refusing to make payments on the note he could compel the merchant to comply with the terms of his contract—the maker must, under such a clause, bear the expense of instituting a separate action against the merchant for breach of contract.19

These clauses have met with varying degrees of success. Most jurisdictions have given them effect, in the absence of some special affront to public policy or public interest.20 Conversely, even those opinions most strongly upholding the duty of the maker to abide by his contract indicate21 that if his defense arises from conduct involving moral turpitude on the part of the merchant the clause would be a nullity.22 The trend23 is to more freely find a public policy

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19. Conversely, it can be argued that the purchaser should not be allowed to complain of these burdens because if he had borrowed directly from a finance company, made the purchase, and then given the finance company a security agreement with the purchase item serving as collateral, he could certainly not then interpose against the finance company defenses arising between himself and the merchant.


21. For example, see the qualifications placed on the holding in United States *ex rel. Adm'r v. Troy-Parisian, Inc.*, *supra* note 20.

22. Fraud and usury are examples of such affronts to public policy. The issue of fraud is the most frequently litigated. It is commonly said that the fraud that vitiates the contract also vitiates the waiver clause. See Equipment Acceptance Corp. v. Arwood Can Mfg. Co., 117 F.2d 442 (6th Cir. 1941); American Nat'l Bank v. A. G. Sommerville, Inc., 191 Cal. 364, 216 Pac. 376 (1921); Pacific Acceptance Corp v. Whalen, 43 Idaho 15, 248 Pac. 444 (1926); Progressive Fin. & Realty Co. v. Stempel,
involved, and therefore to refuse to give the clause effect. The trend is based on this philosophy:

It is difficult to conceive that such a clause could ever be suggested by a party to a contract, unless there was in his own mind at least a lingering doubt as to the honesty and integrity of his conduct. . . . Public policy and morality are both ignored if such an agreement can be given effect in a court of justice.²⁴

Many decisions indicate quite frankly that the burdens placed on the maker by the use of such a clause are too great to be tolerated. The burdens of a merchant’s insolvency and unscrupulous conduct should fall, regardless of the terms of the contract,²⁵ upon the merchant’s cohort,²⁶ the finance company. A partial justification for so

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²⁶ 25. The rationale is that the court should look behind the printed word in the sale contract to the relationship between the finance company and the merchant. If a “close enough” association exists, it, rather than the contract, is determinative. The problem is to decide what is “close enough.” Most courts feel that merely supplying the forms for the transaction will not vitiate the waiver clause unless the form supplied contains some reference to the finance company, as did the printed assignment on the back of the sale contract in Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940), or a reference to the name of the financing institution, Buffalo Indus. Bank v. De Marzio, 162 Misc. 742, 296 N.Y. Supp. 783 (Sup. Ct. 1937). In Allied Bldg. Credits, Inc. v. Miller, 7 Pa. D. & C.2d 438 (County Ct. 1956), the court reviews the decisions and concludes that something more than the supplying of the forms should be required in order to bar the plaintiff from holder in due course status. In the Miller case, the plaintiff had indeed gone much further. It appeared that the finance company had required the execution of the particular instrument in question as a condition precedent to the granting of the loan. The court in Miller quoted from Allied Bldg. Credits, Inc. v. Ellis, 258 S.W.2d 165 (Tex. Civ. App. 1953):

Appellant Finance Company, who purchased the note . . . not only had knowledge of the additional instrument, but actually caused it to be executed. Appellant by its course of action becomes an original party to the additional instrument; and forfeits what might otherwise have been its status as a holder in due course.


²⁶ 26. Buffalo Industrial Bank v. De Marzio, supra note 25:

[S]hould [the finance company] be unbound by the representations to the buyer made by the sales division of the joint business, representations, and promises at variance with the terms of the printed form, a printed form impossible of reading in the present instance save with a magnifying glass, and comprehensible only by a commercial lawyer? Should we thus throw the burden of
allocating the burden is that the finance company in its ordinary course of business can more easily protect itself from loss.\textsuperscript{27}

The UCC provision in this area is section 9-206, which provides:

Subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods, an agreement by a buyer that he will not assert against an assignee any claim or defense which he may have against the seller or lessor is enforceable by an assignee who takes his assignment for value, in good faith and without notice of a claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the Article on Commercial Paper (Article 3). A buyer who as part of one transaction signs both a negotiable instrument and a security agreement makes such an agreement.

An earlier draft of the UCC provided that in the field of consumer goods such an agreement could not be enforced.\textsuperscript{28} However, the interests of the financing institutions in the broad field of consumer goods financing was recognized in the draft eventually adopted, each state being allowed to design its own limitations.\textsuperscript{29} This flex-

\textsuperscript{27} A common procedure affording some protection is for the company to withhold a percentage of the total consideration paid for the note until the payments are completed by the purchaser. In Implement Credit Corp. v. Elsinger, 268 Wis. 143, 66 N.W.2d 657 (1954), the court pointed out that if such an arrangement were found to be sufficient to prevent the finance company from being a holder in due course this would lead to the abolition of dealer's reserve accounts and would therefore result in higher finance charges as an alternative method of protection.

\textsuperscript{28} UCC § 9-206(1) (1952):

An agreement by a buyer of consumer goods as part of the contract for sale that he will not assert against an assignee any claim or defense arising out of the sale is not enforceable by any person. If a buyer as part of one transaction signs both a negotiable instrument and a security agreement even a holder in due course of the negotiable instrument is subject to such claim or defense if he seeks to enforce the security interest either by proceeding under the security agreement or by attaching or levying upon the goods in an action upon the instrument.

\textsuperscript{29} The recognition of the validity of agreements to waive defenses against assignees in the UCC may serve as a deterrent to a casual, and perhaps needless, finding that such agreements are void as against public policy. Consider Walter J. Hieb Sand & Gravel, Inc. v. Universal C.I.T. Credit Corp., 332 S.W.2d 619 (Ky. 1959), dealing with non-consumer goods, in which the court rejected a contention that the waiver clause should be voided by pointing out that the UCC gave effect to such waivers.
ibility wisely permits appropriate judicial action if, and only if, purchaser protection is needed.\(^{30}\)

Section 9-109 defines goods as "'consumer goods' if they are used or bought for use primarily for personal, family or household purposes." In providing different rules for consumer and non-consumer goods, the UCC implies that the consumer is less able to protect his own interests than the purchaser of business goods. Although this view is arguable, the rationale breaks down when the item purchased could be classified as either consumer goods or as equipment—a physician's car or a farmer's jeep. Comment 2 to section 9-109 states that the classes of goods are mutually exclusive and that in such borderline cases the principal use to which the property is put should be considered as determinative; no distinction based on "expertise" is recognized.

What might thus be a doorway through the UCC allowing abusive or questionable financing practices in transactions involving goods other than consumer goods is partially closed by four conditions precedent: (1) the assignee must take in "good faith," (2) for value,\(^{31}\) (3) without notice of a claim or defense, and

\(^{30}\) It is arguable from a literal reading of section 9-206 of the 1958 and 1962 versions of the UCC that the clause "subject to any statute or decision which establishes a different rule" (emphasis added) refers only to those states which have such a statute or decision prior to the adoption of the UCC. This construction prevents the term "statute" in the clause from being a redundancy, i.e., the legislature could at any time take action to amend an offensive UCC provision. However, comment 2 to section 9-206 states that "this article takes no position on the controversial question whether a buyer of consumer goods may effectively waive defenses by contractual clause or by execution of a negotiable note." This comment implies that it is not the intention of the UCC to preserve the status quo in jurisdictions where judicial regulation may in the future be necessary or forthcoming, but not yet decided. The later interpretation of the UCC seems more logical and practical; rapid changes in financing techniques may necessitate judicial regulation now which would have been needless in the past.

\(^{31}\) "Value" is defined more restrictively in section 3-303, referring to the requirements for holdership in due course, than the general definition in section 1-201 (44) which is applicable to article 9. Thus, there exists a possibility under the UCC that an assignee not able to qualify as a holder in due course of an accompanying promissory note may still be able to cut off the buyer's defense under the section 9-206 assignee clause. This is similarly possible if the promissory note is overdue; under section 3-302(1) (c) notice that a note is overdue bars holdership in due course, but there is no comparable requirement for the assignee under article 9.

\(^{32}\) Section 1-201 (25) provides:

A person has 'notice' of a fact when (a) he has actual knowledge of it; or (b) he has received notice or notification of it; or (c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists.

It would require little effort to find the existence of "reason to know" when the association between the finance company and the merchant is very close, particularly so
(4) in no event are the so-called "real defenses" cut off. In view of these requisites, one may well conclude that the UCC simply incorporates the various theories created by case law for the protection of the purchaser.

Section 1-201 (19) defines "good faith" as "honesty in fact in the conduct or transaction concerned." This definition is made applicable to article 9 by section 9-105 (4). This definition has been said to open a Pandora's box of flexibility and interpretation—its meaning may well vary with its context throughout the UCC. How it will be construed in application to section 9-206 is yet to be seen. The meaning of good faith is, of course, of prime importance to finance companies that, in decisions prior to the adoption of the UCC, have had makers successfully interpose defenses because the finance company was not in good faith a holder in due course.

These decisions drew no distinction between purchasers of consumer or non-consumer goods. Rather, the decisions were based on what was regarded as a compelling public policy. It would not seem illogical for these same courts to find a "different rule" for consumer goods and to also be liberal in extending protection to the purchaser of non-consumer goods because the assignee did not take in good faith.

Section 9-206 expressly buries the single contract theory in New Mexico; by execution of a promissory note and a security agreement, the purchaser makes "such an agreement" not to assert defenses against the assignee of the contract. The question remains, however, whether a different rule can be found for purchasers of consumer goods. Section 50-7-1 of the New Mexico statutes provides:


33. The "real defenses" are enumerated in section 3-305. One of these is "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." Comment 7 to this section indicates that this defense extends to an instrument signed with knowledge that it is a negotiable instrument, but without knowledge of its essential terms. It recognizes, in short, the defense of "real" or "essential" fraud. This defense could apparently be maintained under circumstances in which the finance company has dealt with a patently dishonest merchant.


35. See notes 16, 17 & 24 supra and accompanying text.
Except as provided in the Uniform Commercial Code\textsuperscript{36} . . . the assignee has a right of action in his own name, subject to any defense or setoff, legal or equitable, which the maker or debtor had against any assignor before notice of his assignment.

In \textit{Quality Fin. Co. v. Hurley},\textsuperscript{37} the Massachusetts court recognized a very similar statute\textsuperscript{38} to be primarily a procedural statute\textsuperscript{39} designed to insure the right of an assignee to maintain an action in his own name. Nonetheless, that court gave weight to additional considerations (\textit{i.e.}, the waiver clause was a blanket provision and was set out in a long, closely-worded printed form) and held that a waiver clause like that contemplated by section 9-206 should be disregarded as contrary to the policy of the statute.\textsuperscript{40}

\textit{Hurley} may be construed as authority to find that section 50-7-1 establishes a rule different than contemplated by section 9-206 in New Mexico with regard to consumer goods. The \textit{Cantrell} decision further indicates a readiness to liberally apply statutes primarily procedural in nature to protect an unsophisticated purchaser. However, to predicate a statement that New Mexico does have a different rule for consumer goods solely on these two factors would be to do an injustice to the policy behind the UCC. The language of section 50-7-1 and the UCC, though strangely circuitous\textsuperscript{41}, does not demand such a conclusion.

What is intended by the UCC, in the interests of stable and predictable commercial transactions, is a positive judicial or legislative expression that \textit{consumer goods} transactions are to be specially regulated. The UCC provides adequate safeguards for the regulation of questionable financing practices; these safeguards are properly used to curtail only those practices, not to curtail financing activities indiscriminately, as the case would be if section 50-7-1 is construed like the counterclaim statute in \textit{Cantrell}. Section 9-206 buries \textit{Cantrell}; its ghost should not be allowed to restrain reasonable business practices.

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\textsuperscript{36} Amended to take in this exception by N.M. Laws 1961, ch. 96, § 11-106.
\textsuperscript{37} 337 Mass. 150, 148 N.E.2d 385 (1958).
\textsuperscript{39} See Universal Adjustment Corp. v. Midland Bank, 281 Mass. 303, 184 N.E. 152 (1933).
\textsuperscript{40} Contra, Jones v. Universal C.I.T. Credit Corp., 88 Ga. App. 24, 75 S.E.2d 822 (1953) (involving a similar statute).
\textsuperscript{41} Section 9-206 is, in the consumer goods area, expressly made subject to any statute or decision establishing a different rule. N.M. Stat. Ann. § 50-7-1 (Repl. 1962), expressly excepts provisions in the UCC.