

CREDIT CARDS—A PRELUDE TO THE CASHLESS SOCIETY

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I. INTRODUCTION

The credit card has existed for over fifty years, but is so new in its legal implications that little is known about it. There are few law review articles, little case law, and only one statute which treat its civil aspects. Only a few of the eventual legal problems are visible, and with most of them one can do little more than speculate. This article will consider two of these problems: (1) apportionment of the loss caused by the unauthorized use of a lost or stolen credit card; and (2) regulation of the cardholder's assertion against the issuer of any personal defenses he might have against the merchant who honored the card.

Credit cards originated as credit coins, small pieces of metal with the holder's account number engraved on them, which served as identification of charge customers in large department stores.¹ In the 1920's, oil companies began issuing courtesy cards which were honored by all their dealers. Since most of the oil companies were regional, they entered into reciprocal arrangements in order to make their cards useful nationally.

The founding of Diners' Club in 1950 began a new credit-card era. Unlike its predecessors, Diners' Club sells no goods. It provides the credit and collection services for merchant members of the plan and makes it possible for a card holder to purchase goods and services on credit at a large number of retailers without a prior arrangement with each merchant. Diners' Club and its direct competitors, American Express (which entered the credit-card field in 1958) and Carte Blanche (which was launched by the Hilton Hotel chain in 1959), are primarily used by travelers in hotels and restaurants. In 1959 the Bank of America and Chase Manhattan initiated all-purpose credit-card plans for use in ordinary consumer purchasing.² These differ from the travel plans primarily in that a larger percentage of the merchants who accept the card sell ordinary consumer goods.

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¹ The first case was *Wanamaker v. Megary*, 24 Pa. Dist. 778 (Munic. Ct. Phil. 1915).

² As will be seen later, it may be of great legal significance that the issuers are banks. Carte Blanche is presently owned by the First National Bank of New York.

Another big breakthrough appears to have occurred in 1966. Not only have established plans greatly increased their volume,³ but the number of consumer credit-card plans has increased to about 1,000.⁴ Some of the new plans are vastly more ambitious than their predecessors, which had been primarily local or regional in their operation, seeking a high level of acceptance by merchants in the area. The Midwest Bank Card system was organized in November 1966 by five Chicago banks, each of which issues its own credit card. All of the 20,000 merchants in the Chicago area who have joined the plan accept any Midwest Bank Card. The sales slips are cleared between the banks by a procedure similar to that used in clearing checks. By the end of 1966, nearly 600 banks in Illinois, Indiana, and Michigan had joined the system. Some issue their own cards; others have agreed to issue cards from one of the five Chicago banks. In January 1967 a similar, nationwide system was formed by eight large banks each of which issues its own cards locally.⁵ At the time of this writing, they had entered into discussions with the Midwest Bank Card system and with a California group. If the plans go as hoped, by mid-1967 a nationwide system will be in operation.

II. LOST OR STOLEN CARDS

A. *The Problem*

The liability of a holder for the unauthorized use of his credit card has been the only legal issue of the significant judicial cases and law review comments.⁶ One's use may be unauthorized if (1) he is

³ The Bank of America reported that the number of holders of its BankAmericard in California increased 50% from 1,250,000 in 1965 to 1,900,000 at the end of 1966. The number of merchants honoring the card increased from 50,000 to 61,000. The gross sales on the card increased from \$185,990,000 to \$228,305,345. During 1966, seven banks in other states began issuing BankAmericards under licensing agreements and have signed more than 1,000,000 holders and 20,000 businesses. Wall Street Journal (Midwest Edition), Jan. 12, 1967, p. 3, col. 2. Two months later BankAmericard was advertising that it was issued by 15 banks, that more than 90,000 businesses and services belong to the plan, and that by May 1, 1967 there would be more than 4,000,000 holders. Wall Street Journal (Midwest Edition), March 1, 1967, p. 13.

⁴ In 1964, there were only about 70 such plans. Wall Street Journal (Midwest Edition), Jan. 17, 1967, p. 1, col. 8.

⁵ Ibid. The banks are the Marine Midland Corporation, New York; Valley National Bank, Phoenix; Citizens and Southern Bank, Atlanta; Bank of Richmond, Virginia; Pittsburgh National Bank and Mellon National Bank & Trust Company, Pittsburgh; First Wisconsin National Bank, Milwaukee; and Seattle-First National Bank, Seattle.

⁶ The only major article is Macaulay, *Private Legislation and the Duty to Read—Business Run by IBM Machine, The Law of Contracts and Credit Cards*, 19 Vand. L. Rev. 1051 (1966). Student contributions include Comment, *The Lost Credit Card: The Liability of the Parties*, 30 Albany L. Rev. 79 (1966); Comment, *The Tripartite Credit Card Transaction: A Legal Infant*, 48 Calif. L. Rev. 459 (1960); Comment, *Applicability of Exculpatory Clause Principles to Credit Card Risk-Shifting Clauses*, 22 La. L. Rev. 640 (1962); 43 N.C.L. Rev. 416 (1965); Note, 35 Notre Dame Law. 225 (1960); 109 U. Pa. L. Rev. 266 (1960).

a thief who has simply stolen the card, or (2) he has been entrusted with the card for limited purposes and exceeds his trust. The reported cases include unauthorized use by employees, by a roomer, and by a divorced or separated wife.⁷

The magnitude of the problem is unknown. Estimates of the yearly monetary loss have ranged from *Time's* \$1,195,000 (in 1962)⁸ to the Better Business Bureau's \$20,000,000⁹ and *Kiwanis Magazine's* \$30,000,000.¹⁰ This enormous monetary loss has been represented in the courts by only twenty reported cases,¹¹ but the annual number is increasing. Seven occurred between 1915 and 1945, and the remainder since 1960; this represents a change from one every six and a half years (for 1915-1959) to nearly two a year.¹²

The amount at issue in the post-1960 cases has ranged as high as \$7,104.21.¹³ While this figure does not approach the large sums of money that may be lost in commercial transactions, it must be remembered that these losses are usually occasioned by a picked pocket or a lost wallet. The effect is that each credit-card holder always carries with him several thousands of dollars in currency. For some the potential liability from a stolen card is greater than their annual salary. It has been reported that "most major credit-card companies grimly absorb these losses themselves,"¹⁴ but the standard contracts of most issuers provide that the holder will be liable for all charges, at least until notice of loss or theft, although a few have recently limited the holder's liability to \$50 or \$100. In addition, eight of the plaintiffs in the thirteen cases reported since 1960 involving lost or stolen cards were

⁷ See notes 22 and 36 *infra*.

⁸ *Time*, June 19, 1964, p. 53.

⁹ News Release, Better Business Bureau, October 1966. Further inquiry revealed that "the \$20,000,000 loss figure is a projection based upon meager statistics available from industry sources plus an estimate compiled by law enforcement agencies. Many with whom I have spoken in the latter category consider the figure to be conservative." Letter from Mr. Martin R. Pollner to the author, Nov. 23, 1966.

¹⁰ Renner, *Crime and the Credit Card*, *The Kiwanis Magazine*, Summer 1966, p. 20. Mr. Renner also estimated that 300,000 credit cards were stolen and used fraudulently in 1965, an average loss of \$100 per card. More conservatively, *Time* estimated, "Of the 70 million credit cards in circulation in the U.S., no fewer than 1,500,000 are lost each year, and of these 60,000 have been stolen. Illicit charges run up on a stolen card are estimated to average \$500." *Time*, June 19, 1964, p. 53.

¹¹ See pp. 488-97 *infra*.

¹² For a discussion of the criminal aspects of the unauthorized use of credit cards, see Katz, *Federal Prosecution for the Interstate Transportation of Stolen Credit Cards*, 38 U. Colo. L. Rev. 323 (1966); Comment, 57 Nw. L. Rev. 207 (1962); 7 St. Louis U.L.J. 158 (1962). For a summary of the state criminal statutes, see *Retailers Manual of Laws and Regulations* 351 (17th ed. 1966).

¹³ *Sinclair Ref. Co. v. Consolidated Van & Storage Cos.*, 192 F. Supp. 87 (N.D. Ga. 1960). Only one case involved less than \$500. *Abraham & Straus v. Teller*, 37 Misc. 2d 797, 236 N.Y.S.2d 435 (1962) (\$210.33).

¹⁴ *Time*, June 19, 1964, p. 53.

major card issuers.¹⁵ Thus it may be questioned how much of the burden is in fact "grimly absorbed" by the issuers.

B. *The Cases*

The method by which losses from unauthorized use are apportioned between the card holder and the issuer is governed by the contract between them. In the reported cases, these contracts have taken three basic forms. The earliest cases, and a few of the later ones, involved no written contract, and courts were forced to determine the terms of the parties' agreement by implication. A second group involved contracts which placed on the holder liability for all purchases made until surrender of the card to the issuer. Finally, the modern cases have generally involved a contract term placing liability on the holder until he notifies the issuer of loss of the card. Because of this reliance on private agreement rather than on public law, any analysis of the reported decisions must be made in light of the type of agreement involved in each case.

1. *No Written Contract.* The lost-card problem first arose with the credit coin. There was no formal contract between issuer and holder defining the holder's liability for unauthorized purchases made with his coin, and the courts found it difficult to determine the nature of this new device. In *Wanamaker v. Megary*,¹⁶ the first reported case, a Pennsylvania trial court analogized the coin to a bearer negotiable instrument, which a good-faith purchaser from a thief takes free from others' claims even if he was grossly negligent. As a second ground for a decision in favor of the issuer, the court said that the unauthorized purchases were made possible by the holder's negligence in keeping in an insecure place her coin and visiting cards containing her name and address. Eight years later another Pennsylvania court decided in favor of the same issuer in a case in which the testimony showed that the holder had applied for and received the coin "with the understanding that . . . any one presenting the token and giving the name of the defendant could purchase goods upon her credit."¹⁷ In both cases the transmissibility of the coin was emphasized by the court.

In 1923, the New Jersey Supreme Court rejected any analogy to a negotiable instrument in *Lit Bros. v. Haines*.¹⁸

[T]he coin was given merely as an identification card

[I]t has none of the requisites of a negotiable instrument, for title to it cannot pass by delivery like securities payable to

¹⁵ See notes 22 and 36; pp. 489-90, 494-97 *infra*.

¹⁶ 24 Pa. Dist. 778 (Munic. Ct. Phil. 1915).

¹⁷ *Wanamaker v. Chase*, 81 Pa. Super. 201, 205 (1923).

¹⁸ 98 N.J.L. 658, 121 Atl. 131 (1923).

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bearer . . . [I]n the absence of any proof of an agreement between the parties that it was to have any other effect it is limited to that purpose . . .¹⁹

Since the parties had stipulated that the holder took the coin with no knowledge that it could be used by anyone else, the court dismissed the action.

A different legal principle was relied upon in *Gulf Ref. Co. v. Plotnick*,²⁰ another Pennsylvania decision. The automobile in which the holder kept his card was stolen on August 27, 1933, and the thief used the card from August 28 to October 13. Although the holder received monthly bills for these charges, he did not notify the oil company of the theft until some time in October or November. The court implied from the relationship between the issuer and holder a contractual duty that the card would be "used or honored properly and with due care."²¹ This it felt the holder had not done, and it denied his motion for judgment n.o.v.²² The court did not make clear whether the holder's lack of due care lay in keeping the card where it might be stolen, as had been suggested in *Wanamaker v. Megary*, or whether it lay in failing to notify the oil company of the theft.

Finally, there is *Thomas v. Central Charge Serv., Inc.*,²³ which is unique among the post-1960 cases, because it is clear that there was no written contract. The holder had used his card only once and had not signed it before it was stolen. When bills for more than \$500 were presented to the issuer, it telegraphed the holder notifying him of the unusual activity. On the following day, he went to the issuer's office, where he denied having made more than one purchase. The court said that "whatever the rule should be when a customer expressly binds himself by contract to promptly report a lost or stolen credit card,"

¹⁹ Id. at 659-60, 121 Atl. at 132.

²⁰ 24 Pa. D. & C. 147 (C.P. 1935). By this time, written contracts allocating loss were in general use, but the court did not mention one between the parties.

²¹ Id. at 150.

²² Using the same reasoning, the Louisiana Court of Appeals arrived at the opposite result in *Humble Oil & Ref. Co. v. Waters*, 159 So. 2d 408 (La. App. 1963). Although it is difficult to believe that there was no notice clause binding the parties in 1959, the case was decided without reference to any written contract between the parties. Miss Waters had lent her card to her roomer, but refused to give him the 1960 replacement card. He called plaintiff's credit office and said the replacement card had not arrived, whereupon they sent another, which he stole from Miss Water's mailbox. He also stole five months' statements. When Miss Waters finally received one, it totaled more than \$2,000. The court based its opinion on the finding that the holder had not been negligent and that the issuer's action in sending a credit card in response to an anonymous telephone call without verifying the identity of the caller "constituted, at least, carelessness and in all probability, negligence. For this, defendant is not responsible." Id. at 410.

²³ 212 A.2d 533 (D.C. Cir. 1965). As a result of losing the case, Central Charge Service has put a notice clause on the application form and on the card.

he had no such obligation in this case.²⁴ No promise to pay for unauthorized purchases, even those made prior to notice, could be implied from the relationship between the parties. The court found that "at most it may be said by implication that Thomas agreed to exercise due care in the use of his card. And while he perhaps failed in that agreement, it is plain that such failure is insufficient to support this action."²⁵ Why it was insufficient was not stated, although the court's determination was presumably based on the lack of "proximate cause." There were no special circumstances on the part of either issuer or holder. The court apparently felt that the holder's liability could be based only on an express contract.

It is unquestionably dangerous to attempt to draw any general conclusions from these cases, since only four jurisdictions are represented and the cases are widely separated in time and dissimilar in fact. It may be suggested, however, that the courts have now firmly fastened on the principle of negligence when there is no written contract governing the issuance and use of a credit card. Precisely what will be done with that principle is not clear, since the burdens are not always placed on the party blamed for the loss, but at least the litigant is furnished with a theory with which to approach the court.

2. *Surrender Clause*. Realizing the dangers of leaving the creation of contract terms to the courts, issuers began to include specific contract clauses placing on the holder the risk of unauthorized purchases. In *Magnolia Petroleum Co. v. McMillan*,²⁶ the contract provided that the holder was "responsible for all purchases made by the use of this card, prior to its surrender to the issuing company, whether or not such purchases are made by the named holder or into the car described."²⁷ The unauthorized purchases in question were made after the holder had instructed two friends to return the card which he had loaned them, but prior to any notice to the issuer. In reversing the trial court's judgment for the holder, the Texas Court of Civil Appeals relied on the contractual promise to pay for all purchases made by use of the card and, even though there was no contractual obligation, on the failure to give notice. It did not purport to rely on the fact that the card had originally been voluntarily transferred to the wrongdoers by the holder himself. On the other hand, it did not mention, except in its recitation of facts, that the card was nontransferable, and that the signatures on the credit slips showed that the purchases were not made by the holder personally.²⁸

²⁴ Id. at 534.

²⁵ Ibid.

²⁶ 168 S.W.2d 881 (Tex. Civ. App. 1943).

²⁷ Ibid.

²⁸ The credit slips were signed with the holder's name "by M. A. Carter" or "by C. H. Clark." Ibid.

Only one other case has been reported which may be regarded as having involved a "surrender" clause—*Gulf Ref. Co. v. Williams Roofing Co.*,²⁹ a significant case in the history of the law governing credit cards. Printed on the card was a clause, which the court assumed bound the holder; this clause provided that the holder "assumes full responsibility for all merchandise, deliveries or service obtained on credit by any person by its presentation."³⁰ The holder was also required to notify the issuer of loss of the card. The issuer argued that the effect of this clause was to make the holder liable for all purchases made with the card, until it had been returned; because of the treatment it gave the case, the court did not reach this issue. Gulf had issued eight of these credit cards to a roofing company for the use of its drivers. On the face of each one the holder had typewritten "Good for Trucks Only." One of the cards was inadvertently left by a driver at a gas station, and an employee of the gas station "embarked on a 90-day orgy of buying from Gulf dealers in Mississippi towns by presentation of the stolen card and forgery of the name of Gerald Huckaby as 'Gerald Huckaby.'"³¹ The attitude of the dealers from whom the wrongdoer bought was incredible. In the words of the court:

Some of the dealers knew the forger and he had lived in several of the towns where purchases were made. Tires were sold for a passenger automobile and in some cases of a different size than was required by the vehicle the forger was driving. One dealer sold him two radios, one for his car and the other for his house, which were charged as tires and gasoline and the house radio was never delivered. Charges were made for 20 gallons of gasoline when the capacity of the car the forger was driving was only 15 gallons. In several instances cash was delivered upon false invoices made out for merchandise. Most of the invoices had a fictitious license number written in by the dealer which was different from the license number upon the automobile driven by the impostor.³²

The collusion of the merchants was sufficient to decide the case in favor of the holder. The issuer as assignee "took the invoices subject to all equities and defenses existing between [the holder] . . . and the various dealers, although [the issuer] . . . may well [have been] . . . a *bona fide* purchaser for value without notice of such equities or defenses."³³ To the allegation that the holder was bound by the contractual provision to pay for all goods purchased by use of the card,

²⁹ 208 Ark. 362, 186 S.W.2d 790 (1945).

³⁰ Id. at 369, 186 S.W.2d at 794.

³¹ Id. at 365, 186 S.W.2d at 792.

³² Ibid.

³³ Id. at 367, 186 S.W.2d at 794.

the court replied that he had the right to limit its use by placing on its face "Good for Trucks Only." The holder had notified the issuer at the time of application that the cards were for the use of trucks. Even if he had not, the dealers "were guilty of gross carelessness in selling items for use of a passenger automobile contrary to this provision of the card."³⁴ The court went on to say that "it is necessarily implied from [the holder's broad promise to pay for all goods purchased by use of the card] . . . that the person extending credit must do so in good faith, in accordance with the provisions of the card and subject to any limitation appearing on the face of the card."³⁵ Under the circumstances, the court observed, it was doubtful if the loss would in fact fall on the issuer. The gross carelessness of the various dealers limited the issuer's obligations to them, and the culprit was known and had not been shown to be insolvent.

3. *Notice Clause.* The surrender clause does not seem to have played a very significant part in the history of credit cards. Perhaps because issuers realized the ill effect such a broad clause would have on the judicial attitude toward credit-card issuers, or perhaps because holders resisted undertaking such an enormous obligation, issuers have virtually abandoned the use of this clause in favor of clauses providing that the holder is liable for all purchases made with the card until he notifies the issuer that it has been lost. Decisions construing these clauses are the only ones with any significant degree of vitality today. Although not every recently issued card contains a notice clause, all the large issuers use one. Its legal import has been analyzed in only four recent cases.³⁶

³⁴ Id. at 368, 186 S.W.2d at 794.

³⁵ Id. at 369, 186 S.W.2d at 794.

³⁶ Eight other cases have been reported in which notice clauses were involved, but the court did not, for one reason or another, construe the clause. In the earliest, *Jones Store Co. v. Kelly*, 225 Mo. App. 833, 36 S.W.2d 681 (1931), the court was concerned only with whether the card was transferable and had been voluntarily transferred. On remand, the jury was to be permitted to consider the existence of the clause and the holder's failure to give notice.

Abraham & Straus v. Teller, supra note 13, considered procedural aspects of the problem and resulted in judgment for the holder. The court held that the issuer is required to process the notice within one day of receipt, no matter how large its operation, comparing the situation to a stop-order on a check.

In *Uni-Serv. Corp. v. Frede*, 50 Misc. 2d 823, 271 N.Y.S.2d 478 (N.Y. City Civ. Ct. 1966), plaintiff's application form and contract provided that the contract would be accepted only by mailing the applicant a card. Defendant never received his card, and the court found that it had not been mailed with a proper address. Therefore, there was never any contract between the parties, and the defendant was not liable for purchases totaling \$2,342.08. In passing, the court remarked that, since plaintiff had placed a \$250 limit on the credit available to the defendant, it should not have permitted the charges on his card to exceed that limit. Thus, defendant would in no event be liable for more than \$250.

In three cases, the holder had entrusted his card to a party who bore some special relationship to him, which was sufficient to make him responsible for the party's use of

The card involved in *Union Oil Co. v. Lull*³⁷ was stolen six weeks before its expiration date, at the time the holder received a replacement card for the following year. Using the still valid original card, the thief made fifty-five unauthorized purchases totaling \$1,454.25. Because he had the replacement card, the holder did not know of the card's loss until he received his monthly statement, at which time he notified the issuer. The issuer sued, relying on a contract clause³⁸ which provided:

The customer to whom this card is issued guarantees payment within 10 days of receipt of statement, of price of products delivered or services rendered to anyone presenting this card, guarantee to continue until card is surrendered or written notice is received by the company that it is lost or stolen.³⁹

The trial court had taken the position that the holder would be excused from performance of the contract provisions if, in his possession and use of the card and in giving notice of its loss and unauthorized use, he had acted as a reasonable man. The Oregon Supreme Court disagreed and remanded. The contract provided for liability until notice and not simply the exercise of due care by the holder. However, the clause was drafted as a guarantee of payment by the holder rather than as a direct and primary obligation. Since the only benefit accruing to the holder was the convenience in using the card, the guarantee was "essentially gratuitous." From this and the fact that the guarantor-holder had no control over the acts of the principal debtor (the wrongdoer), the court concluded that the contract embodied an

the card. *Sinclair Ref. Co. v. Consolidated Van & Storage Cos.*, supra note 13 (employee); *Kane v. Standard Oil Co.*, 108 Ga. App. 602, 133 S.E.2d 913 (1963) (employee); *Neiman-Marcus Co. v. Viser*, 140 So. 2d 762 (La. Ct. App. 1962) (estranged wife). *Contra*, *Socony Mobil Oil Co. v. Greif*, 10 App. Div. 2d 119, 197 N.Y.S.2d 522 (1960).

Finally there is *Read v. Gulf Oil Corp.*, 114 Ga. App. 21, 150 S.E.2d 319 (1966). A letter to the author from Mr. Thomas Elliott, Esq., attorney for Mrs. Read, dated January 19, 1967, indicates that Mrs. Read first gave notice by telephone and was told "not to worry about it—that Gulf Oil would take care of this." A few days later she confirmed the notice by certified mail. However, she was the owner of two Gulf cards and in the letter gave notice to cancel the wrong card. Gulf contended that it had not been effectively notified of the loss. Without mentioning this problem, the appellate court reversed the trial court's grant of a new trial and reinstated a verdict for Mrs. Read. This raises the question of the quality of notice to be given the issuer. Cf. U.C.C. § 4-403. This problem has not been discussed by any commentator.

³⁷ 220 Ore. 412, 349 P.2d 243 (1960).

³⁸ Lull argued that he was not bound by this clause, since it was not referred to in the application form he signed. The clause was printed, in small type, on the back of a card which was 1¾ inches by 3¼ inches. But the issue was lost because it was not raised in the pleadings; if properly raised, it would have been a jury question. *Id.* at 419, 349 P.2d at 247.

³⁹ *Id.* at 416, 349 P.2d at 245.

implied promise by the indemnitee-issuer to exercise due care to protect the guarantor-holder, citing, *inter alia*, *Williams Roofing Co.*⁴⁰

In the new trial, it was logical that the issuer should have the burden of proving its exercise of due care, since it was the plaintiff, and since it was the only party that could testify to the care taken (through its gas station attendants). As a practical matter, this meant that the holder would undoubtedly win, since it is unlikely that an attendant could remember what he did in an individual transaction which occurred some months or years earlier.⁴¹ Nor could the issuer rely on the routines of gas station attendants, which are far from standardized.

The issuer had better luck in *Texaco, Inc. v. Goldstein*.⁴² That court held the holder liable for the charges incurred before notice, finding the agreement eminently fair.⁴³ This contract provided for a sharing of the risk of a lost or stolen card, the holder bearing the risk until notice and the issuer bearing the risk thereafter.

In *Diners' Club, Inc. v. Whited*,⁴⁴ the back of the credit card contained a clause reading as follows: "If this credit card is lost or stolen, original holder is liable and responsible for all purchases charged through use of this card until [he gives] . . . written notice of its loss or theft." In a suit for \$1,622.99 against the holder for charges incurred before notice,⁴⁵ the trial court held for the plaintiff issuer. In reversing the decision on appeal, the Los Angeles Superior Court agreed with *Williams Roofing Co.*⁴⁶ and *Lull*⁴⁷ that the issuer and merchant each owe to the holder a duty of due care to see that irregular charges are not incurred. It also agreed that as assignee of the merchants' rights, the issuer was subject to the holder's defenses against the merchants, and that as plaintiff, the issuer had the burden of proof as to the exercise of due care. This would normally have necessitated reversal and remand for a new trial.

The holder attempted to avoid a new trial by arguing that he

⁴⁰ Supra note 29.

⁴¹ Whether plaintiff must prove due care or defendant its absence, the party so burdened finds itself—in the circumstances of the instant case—defeated: it would be highly improbable that a service station attendant would be able to recall his actions in regard to any particular transaction, whether or not due care was in fact exercised; and the costs of locating the proper witnesses and taking depositions would exceed the amount in controversy. The Oregon court has, then, cast upon the oil company all losses that occur as a result of misuse of its credit cards.

109 U. Pa. L. Rev. 266, 268 (1960).

⁴² 34 Misc. 2d 751, 229 N.Y.S.2d 51 (Munic. Ct. New York City 1962), *aff'd mem.*, 39 Misc. 2d 552, 241 N.Y.S.2d 495 (Sup. Ct. 1963).

⁴³ The contract was printed only on the back of the card. See pp. 498-501 *infra*.

⁴⁴ Civ. No. A 10872, Los Angeles Super. Ct., Aug. 6, 1964.

⁴⁵ Another \$285.26 in charges were incurred after notice.

⁴⁶ Supra note 29.

⁴⁷ Supra note 37.

should not be liable for the unauthorized use of his card. His agreement with the company provided that the card was not transferable and would "be honored only when properly signed and presented by the authorized holder." While the court found "much merit to this argument," it did not consider it further, since there were other grounds on which to reverse without remand, and, said the court, the problem was without general significance because the issuers could avoid the problem in the future by properly drafting the contract, by eliminating the need for a signature, and by making the card transferable.⁴⁸

The court decided not to remand, because the issuer suffered no damages. Its contracts with the merchants called for the purchase of all "valid" charges represented by a sales slip containing the "signature" of the holder, which was required to be "the same" as that on the card. Obviously these conditions had not been met. To keep the goodwill of the merchants, Diners' Club had paid all of the invoices even when they knew they were paying on forgeries. This, the court said, "is promotion, not damages, and should be charged to that account."⁴⁹ The court recognized, however, that Diners' Club could change this result in the future by assuming in advance the responsibility to pay merchants on forged invoices or if due care had been exercised.

The most recent case reported is *Allied Stores v. Funderburke*,⁵⁰ which is unique in having been decided under a statute governing credit cards.⁵¹ The plaintiff, a department store, issued credit cards entitling patrons to \$200 credit (or more, by special arrangement) at its store. Defendant holder apparently lost her card sometime in June 1965; by July 13, someone had used it to make 237 purchases totaling \$2,460. Because she had been out of the city, the holder did not discover her loss until July 14, when the issuer requested to see her concerning this unusual activity.

The application form which the holder had signed contained a provision obligating her "to pay for all purchases made by any person presenting the identification plate which Seller will lend me, until Seller receives my notice by certified mail that same has been lost or stolen."⁵² The court determined that this contract, which it found to be binding on the holder,⁵³ "does not expressly provide that the holder assumes all risk occasioned by loss or theft of the credit card where the

⁴⁸ The court cited *Texaco, Inc. v. Goldstein*, supra note 42, to show that the result might be different if the issuer did not require a signature on the card or restrict transfer.

⁴⁹ Civ. No. A 10872, at 6. But cf. *Carlyle v. Humble Oil & Ref. Co.*, 114 Ga. App. 115, 150 S.E.2d 299 (1966).

⁵⁰ 277 N.Y.S.2d 8 (N.Y. City Civ. Ct. 1967).

⁵¹ N.Y. Gen. Bus. Law § 512 (McKinney Supp. 1966).

⁵² 277 N.Y.S.2d at 10.

⁵³ See pp. 499-501 *infra* for a discussion of the notice requirements of § 512.

credit card holder is unaware of such facts and thus is unable to give the required notice."⁵⁴

The court then construed Section 512 of the General Business Law, which provides that "a provision to impose liability on an obligor for the purchase or lease of property or services by use of a credit card after its loss or theft is effective . . . only until written notice of the loss or theft is given to the issuer." Feeling that neither the statute nor the contract established any rule governing this situation, the court held that its decision must be based on the common law, which has for centuries "been founded on the principle that there can be no liability without fault."⁵⁵ On this basis, the court found the holder not liable. The mere fact that a thief had acquired the holder's card did not show any negligence on her part. On the other hand, the issuer's conduct had contributed to the loss, since such a large number of purchases were permitted to occur, and credit exceeding the store's \$200 limit was extended. The fact that the issuer did not discover these facts until the sales slips had been run through its data-processing equipment was no excuse. However necessary electronic data-processing equipment may be, "it is manifestly unfair to shift the burdens of its inadequacies or failures to the innocent consumer."⁵⁶ The court distinguished *Texaco* and *Lull* (which it seems to have misread as placing the burden of proving negligence on the holder)⁵⁷ on the basis that this was a "modest two-party arrangement entitling the user to credit at the plaintiff's store and no other."⁵⁸ For this reason there was no difficulty in placing a duty of due care on the issuer. The issuer's alternative argument based on the transferability of the card was rejected by treating it as an agency problem: The holder did not authorize anyone to use her card nor ratify its use by knowingly neglecting to notify the issuer of its loss; therefore, she could not be liable for the actions of the user.

Although it must be observed once again that there have not been enough decisions in the area to draw any very secure conclusions, it is clear that both surrender and notice clauses have fared surprisingly poorly. In only two cases has such a clause been unequivocally upheld;⁵⁹ in *Williams Roofing Co.*, *Lull*, and *Diners' Club*, the courts read into the contract an implied obligation of due care on the part of the issuer in the acceptance of the card for goods or services; in *Funderburke*, the clause was limited even more severely. Moreover these courts required the issuer to show the use of due care by merchants who

⁵⁴ 277 N.Y.S.2d at 11-12.

⁵⁵ *Id.* at 13.

⁵⁶ *Id.* at 15.

⁵⁷ See *id.* at 14.

⁵⁸ *Ibid.*

⁵⁹ *Texaco, Inc. v. Goldstein*, *supra* note 42; *Magnolia Petroleum Co. v. McMillan*, *supra* note 26.

were not its agents but were independent contractors. When this issue was first raised in *Williams Roofing Co.*, the court stated:

If these dealers were independent contractors and not agents of appellant, it necessarily follows that they were assignors of the forged invoices upon which appellant seeks to recover [A]ppellant, as assignee, acquired no greater right than his assignors It is well-settled that the assignment of a non-negotiable instrument passes the rights of the assignor subject to all defenses that would be available if the assignor brought suit direct on the instrument. . . .⁶⁰

The same result was reached in *Diners' Club* and in *Lull*, which quoted extensively from the *Williams* case. In *Diners' Club*, the court referred to the theory, developed in a comment in the California Law Review, that the holder's obligation in a three-party credit-card transaction may be directly to the issuer rather than by assignment from the merchant,⁶¹ although the language of the merchant-issuer contracts before the court called for an assignment. A simple change in these contracts might well have led the court to recognize a direct obligation from holder to issuer, but the court agreed with the conclusion of the author of the comment that even if the obligation were direct, it "should be construed as being conditional upon the merchant's fulfillment of his obligations under the contract of sale."⁶² Thus, even a direct obligation might have been considered to be conditioned on the merchants' duty to exercise due care, and consequently unenforceable as a practical matter.

C. Regulation of Holder-Issuer Contracts

The problems involved in holder-issuer contracts, which are, of course, drafted solely by the issuer, merit some general consideration. There is no need to discuss contracts of adhesion in detail at this point. The phenomenon of private legislation through unilateral contract-drafting is well understood.⁶³ That such contracts bring uniformity and certainty to modern business affairs is indisputable. Their use by businessmen when dealing with each other should be encouraged. But the legal system should exercise great vigilance when a substantial portion of an industry unites on a contract clause to be adhered to

⁶⁰ 208 Ark. at 367, 186 S.W.2d at 793-94.

⁶¹ Comment, The Tripartite Credit Card Transaction: A Legal Infant, 48 Calif. L. Rev. 459 (1960).

⁶² Id. at 487.

⁶³ The classic discussions are in Isaacs, The Standardization of Contracts, 27 Yale L.J. 35 (1917), and Kessler, Contracts of Adhesion—Some Thoughts About Freedom of Contract, 43 Colum. L. Rev. 629 (1943). Of particular relevance to credit cards is Macaulay, Private Legislation and the Duty to Read—Business Run by IBM Machine, The Law of Contracts and Credit Cards, 19 Vand. L. Rev. 1051 (1966).

by consumers. The consumer's only alternatives are to abstain completely from dealing in the field or to attempt to find one of the few businessmen who does not rely on such contracts. As the form contract moves toward universal adoption (which seems to be the case with the notice clause), the consumer has little choice left.

If a prospective holder is to decide intelligently whether use of credit cards is worth the risk of liability-until-notice, he must be aware of the potential consequences. It cannot be said that the issuers have been eager to inform him of them. Sometimes the clause imposing liability is found on the application form, sometimes on the back of the card, sometimes in the literature accompanying the card, and often in small type.⁶⁴

Whether a holder is bound by such provisions on the back of his credit card when he disclaims knowledge of them was discussed for the first time in *Union Oil Co. v. Lull*.⁶⁵ The application form contained no reference to the holder's liability for unauthorized use of the card by another person, and the printing on the back of the card was small. Unfortunately these issues had not been properly raised at trial. If they had been, said the court, there would have arisen a jury question as to whether the printed conditions formed part of the contract.

The question was properly raised in the trial court in *Texaco, Inc. v. Goldstein*,⁶⁶ where the notice provision, again absent from the application form, was printed in the middle of a paragraph on the reverse side of the card. The face of the card provided that its use constituted acceptance of the provisions on the back. The court dismissed the application form as a mere invitation to do business. "The issuance of the card to the defendant amounted to a mere offer on plaintiff's part, and the contract became entire when defendant retained the card and thereafter made use of it. The card itself then constituted a formal and binding contract."⁶⁷ Although not without support, this proposition is questionable. The application form and the back-of-the-card provisions (and the literature accompanying the card, if any) can be regarded as parts of an integrated contract,⁶⁸ leaving open the question of whether

⁶⁴ For a particularly good discussion of the degree of notice given by the oil industry, see *id.* at 1086-98.

⁶⁵ *Supra* note 37.

⁶⁶ *Supra* note 42.

⁶⁷ *Id.* at 754, 229 N.Y.S.2d at 54.

⁶⁸ According to *Goldstein*, the application form is an offer to do business, the sending of the credit card with a liability-until-notice clause is a counteroffer with inconsistent terms, and retention and use of the card by the holder is acceptance of the counteroffer. Counteroffers to nonmerchants to be accepted by silence border on deception. As between merchants, cf. U.C.C. § 2-207(2).

Offer and acceptance are even less obvious in the retention of an unsolicited card. In the first several months of the Midwest Bank Card system, 4,000,000 unsolicited cards were distributed. One man was reported as having received eighteen cards

the holder has a duty to read every word of all three writings for possible contract language.

The events litigated in *Goldstein* occurred prior to the enactment of Section 512 of the New York General Business Law, but the case was decided subsequent to enactment. The statute declares that any provision placing on the card holder liability for unauthorized use must appear on the card, on a writing accompanying the card when issued, or on the application form in eight-point or larger type. The statute assumes that the provision is binding so long as adequate notice has been given. The *Goldstein* court used the enactment of section 512 to show that "the Legislature acknowledged the validity of the agreement between the parties to the action as it existed on the date when the credit card was issued by the plaintiff to the defendant . . .,"⁶⁹ but it dismissed Texaco's use of five- or five-and-one-half-point type by saying that the requirement of eight-point type was only for "subsequent credit cards."⁷⁰

A recent study of oil-company credit cards concluded that the notice provision was somewhat more prominently set out in their 1966 application forms and cards than in those of 1963.⁷¹ In part this was attributed to the New York legislation and the hint in *Lull* that the notice in that case was not sufficient. However, the practices of the issuers still leave a great deal to be desired. Standard Oil Company of Indiana has recently made significant alterations in the holder's obligation for unauthorized use by changing the conditions on the back of the card.⁷² The literature accompanying replacement cards points out only

personally, with others going to his sons aged 11, 13, and 15. Another man reported that his three-year-old boy had received two cards. Wall Street Journal (Midwest Edition), Jan. 17, 1967, p. 1, col. 8.

⁶⁹ 34 Misc. 2d at 755, 229 N.Y.S.2d at 56.

⁷⁰ Although it is not crucial to the court's opinion, the statute does apply to credit cards issued prior to its passage, but not, of course, to transactions which had occurred prior to its effective date. Section 512 provides, in part:

Such a provision either in a credit card issued prior to the effective date of this article, or in a writing accompanying such a card when issued, or in the obligor's application for such a card is effective, on or after the effective date of this article, only if the issuer mails to the obligor, properly addressed, written notice of the provision conspicuously written or printed in a size at least equal to eight point type.

What constitutes fair notice does not change by the date of the card's issuance, but the court was overriding any argument in the holder's favor.

⁷¹ "In sum, there has been some improvement in visibility and understandability, but there is room for more." Macaulay, *supra* note 63, at 1099.

⁷² Standard Oil added the following provision to its cards: "No card which customer has voluntarily permitted another party to use shall be considered as lost or stolen, regardless of difficulty in securing its return. Customer's approval of all purchases by such other party is conclusively presumed." It would appear that this clause is intended to reverse the result of *Abraham & Straus v. Teller*, 37 Misc. 2d 797, 236 N.Y.S.2d 435 (1962) and *Socony Mobil Oil Co. v. Greif*, *supra* note 36. If the first sentence is taken literally, a holder would be liable for the charges incurred by a thief of his wife's

that the card is "new"—the holder's address has been left off so that if he moves he can continue to use it at his new address without difficulty. An application form for Diners' Club, which this author acquired in a Washington, D.C. hotel in December 1966, contained no reference to the holder's liability for unauthorized use. Furthermore, the entire agreement of Illinois Bankcharge, a major consumer card in use in the Chicago area, is printed in small blurry type squeezed into the top third of the rear of the application form, leaving the remainder empty.⁷³

In spite of this poor record on the part of the issuers, there is little question that many holders, maybe even most, know they should notify the issuer if their card has been lost. This may reflect merely an intelligent appraisal of the use to which a finder or thief could put the card, or it may be the result of the many articles on credit cards discussing the potential liability of the holder which have appeared in the public press in the last few years. Certainly the advertisements of the insurance companies offering credit-card insurance, and those of some issuers such as American Express and Diners' Club which limit liability to \$100, have had some effect. Nevertheless, adequate notice by the issuer should be a minimum requirement before any liability is placed on the holder. It costs the issuers nothing except the possibility that, apprised of their contractual obligation, some consumers would decide not to enter the contract. While the issuers would suffer a real loss, it is not one of which they can legitimately complain.

There are three elements to adequate notice. First, the language must be reasonably understandable by its recipient. A provision, for instance, that says "I promise to pay all charges" is not likely to convey to the average holder that this may include charges incurred by a thief of the card.⁷⁴ Second, the notice must be in a location where it is likely to be read prior to the prospective holder's decision to apply for or keep the card. The face of the application form is the logical place if notice is truly intended. Some issuers already do this, and there is little doubt that the form can always be drafted so as to accommodate the one sentence necessary. What does present some difficulty is giving notice with respect to an unsolicited card. There is no reason to expect the receiver to read every word on the card and in all of the advertising literature which is sent with it. Perhaps the difficulty can be resolved by requiring the issuer to show that the location of the clause is

card even after notice. The second sentence may limit the holder's obligation to those purchases made by "such other party."

⁷³ It is also printed in large clear type on page 62 of the 64-page Merchant Directory which accompanied the unsolicited Illinois Bankcharge card sent to the author in 1966 at a former Illinois address.

⁷⁴ A December 1966 Carte Blanche application form provided: "If this application is accepted and a charge card issued, I promise to pay all charges incurred and agree to the terms and conditions accompanying the card."

calculated to bring it to the holder's attention. Finally, the type size and style and the layout must be such as to make it likely that the provision will be read. Specifying the type size is not sufficient. Even though printed in the largest type which could reasonably be required, the likelihood that the provision will be seen can be reduced by the use of closely set lines of equally large or larger type and by burying the provision in question in the middle of a long paragraph.⁷⁵

Measured by these standards, the New York statute is grossly inadequate. It requires that eight-point type be used and that the provision be somewhere on the application form, the credit card, or the accompanying literature. The effect of such a limited regulation is likely to be that courts will look only to the formal requirements of the statute without questioning the adequacy of the notice in fact, even though the statute requires that the provision be "conspicuously" printed.⁷⁶ This was the attitude of the municipal court in *Goldstein*. It would be a better policy if the statutory requirement were simply one of adequate notice. It is not difficult for an issuer to meet this standard, and it would eliminate the necessity for a legislatively determined method of presentation.

D. *Statutory Apportionment of Loss*

As the law stands at present, neither issuer nor holder can be sure of his rights and obligations. Although the factual patterns are repetitive and not complex, the few cases go in too many directions, and only one of the post-1945 cases emanates from a state supreme court.⁷⁷ It seems likely that issuers who actively enforce the liability clause do collect from their holders a very large percentage of unauthorized charges without litigation. It is also very likely that many people who are shown what appears to be a binding contract holding them liable will not know enough to turn to a lawyer, but would be inclined to pay the entire bill.

Statutes such as the one recently enacted in New York provide only a partial solution to the problem of apportioning the loss engendered by the unauthorized use of credit cards. The consumer needs protection not only against deceptive practices by issuers but also

⁷⁵ Possibly the term "conspicuous" should be used to cover type size, location, etc. U.C.C. § 1-201(10) defines "conspicuous":

A term or clause is conspicuous when it is so written that a reasonable person against whom it is to operate ought to have noticed it. A printed heading in capitals (as: NON-NEGOTIABLE BILL OF LADING) is conspicuous. Language in the body of a form is "conspicuous" if it is in larger or other contrasting type or color Whether a term or clause is "conspicuous" or not is for decision by the court.

⁷⁶ See *Texaco, Inc. v. Goldstein*, supra note 42. But see *Allied Stores v. Funderburke*, supra note 50.

⁷⁷ That case is *Union Oil Co. v. Lull*, supra note 37.

against unfair contract provisions forced upon him by the issuer's superior bargaining power. Of course, all contracts are subject to the law under which they are drawn, and most jurisdictions refuse to enforce "unconscionable" clauses, but what is needed is a solution specially adapted to the needs of credit-card transactions. Because of the national scope of the problem, this solution ought to be a uniform one.

1. *Uniform Commercial Code*. One method of solving the unauthorized-use problem would be to decide that *bank-issued* credit cards are letters of credit under Article 5 of the Uniform Commercial Code.⁷⁸ They appear to be within the scope of section 5-102(1)(a), which provides that Article 5 applies "to a credit issued by a bank if the credit requires a documentary draft or a documentary demand for payment" According to section 5-103(b), a documentary demand for payment "is one honor of which is conditioned upon the presentation of a document or documents. 'Document' means any paper including document of title, security, invoice, certificate, notice of default and the like." Since payment to the merchant is conditioned on the presentation of the sales slip or invoice, this criterion is met.⁷⁹

If the issuer of a letter of credit has duly honored a demand for payment, it has the right to reimbursement from its customer (the holder) even though the documents were forged or fraudulent or there was fraud in the underlying transaction.⁸⁰ The issuer may even honor

⁷⁸ Non-bank issuers could bring themselves under Article 5 by conspicuously placing the words "Letter of Credit" or an equivalent identification on their cards. If a non-bank issuer did so, the remainder of this discussion would apply equally to it. See U.C.C. § 5-102(1)(c). A not-very-helpful definition of "bank" is given in U.C.C. § 1-201(4).

⁷⁹ It is possible that, in order to have their credit cards regarded as letters of credit under Article 5, banks would have to make a special effort. If § 5-103(a) is combined with § 5-104(1), it can be argued that a written promise to honor merchants' demands for payment would have to be placed on the card itself. Alternatively, the merchant-issuer contracts may be thought to serve this purpose.

Several law review articles have rejected the suggestion that the credit card be analogized to the letter of credit. Comment, *The Lost Credit Card: The Liability of the Parties*, 30 Albany L. Rev. 79, 87 (1966); Comment, *The Tripartite Credit Card Transaction: A Legal Infant*, 48 Calif. L. Rev. 459, 465 (1960); 35 U. Cinc. L. Rev. 424, 430 (1966). Contra, 35 Notre Dame Law. 225, 226 (1960). None of these articles discussed the scope note in § 5-102 or the significance of a bank as the issuer. This author has been told that some bank issuers believe their cards are letters of credit under Article 5.

⁸⁰ U.C.C. § 5-114(2)(b). The relevant portions of § 5-114 provide:

(2) Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a security (Section 8-306) or is forged or fraudulent or there is fraud in the transaction

(a) the issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a

the demand for payment despite notification from the customer of fraud, forgery, or other defect not apparent on the face of the documents if the issuer does so in good faith.⁸¹ In fact, the issuer would be required to honor if the invoice had been presented to an intermediary bank for collection and that bank had, in good faith and without notice of any defect, "given credit available for withdrawal as of right . . . whether or not the credit is drawn upon and whether or not there is a right of charge-back."⁸² This probably describes the standard method of collecting charges due on bank-issued credit cards.

Good faith⁸³ might not permit the issuer to demand reimbursement for payments made to a merchant on sales slips *known* by the bank to be forged at the time of initial payment, unless the terms of the credit did not condition payment on the genuineness of the customer-holder's signature. But Article 5 would require reimbursement for all payments made while the issuer had a good-faith doubt as to whether the signature had been forged⁸⁴ or was unaware of the forgery, even though the merchant had been negligent.

Actually, to apply Article 5 of the Uniform Commercial Code to bank-issued credit cards would be a misapplication of sound doctrine. Defects in the documents supporting a letter of credit, or fraud in the underlying transaction, are the fault of the seller with whom the buyer chose to do business and with whom the issuing bank need have had no contact. On the other hand, the fraud in a credit-card case is perpetrated by an impostor posing as the holder-buyer. The rightful card holder in most cases has had no contact with the merchant from whom the impostor purchased the goods or services. But the merchant was enlisted by the issuer and is subject to a fair degree of control. Merchant-issuer contracts often provide for charge-back of sales made by the use of stolen cards on the "hot list" and (as seen in *Diners'*

document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a security (Section 8-302); and

- (b) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor.

(3) Unless otherwise agreed an issuer which has duly honored a draft or demand for payment is entitled to immediate reimbursement of any payment made under the credit and to be put in effectively available funds not later than the day before maturity of any acceptance made under the credit.

⁸¹ *Ibid.*

⁸² U.C.C. § 4-208(1)(b). To reach this conclusion, it is necessary to relate four sections of the Code: Section 5-114(2)(a) refers to § 3-302, which is explained by § 4-209, which is, in turn, given meaning by § 4-208.

⁸³ "Good faith" is defined in U.C.C. § 1-201(19) as "honesty in fact in the conduct or transaction concerned."

⁸⁴ U.C.C. § 5-114, Comment 2.

Club)⁸⁵ sometimes provide for charge-back if the signature on the sales slip deviates markedly from that on the application form. Since the merchant is more nearly the agent of the issuer, the issuer, and not the holder, should assume responsibility for his negligence and fraud.⁸⁶

2. *Liability-Shifting Proposals.* A solution which would be preferable to classifying credit cards as letters of credit would be to share the risk—shifting the risk from the holder when notice is given, when the loss reaches a certain amount, or when the first of those events occurs. This solution has the advantage of widespread acceptance. No reported case has ever gone beyond the point of liability-until-notice in giving judgment for the issuer, and even those courts which have found an implied duty of due care on the part of the issuer and merchant have recognized the validity of notice as a risk-shifting event.⁸⁷ Notice clauses are used by nearly all the major issuers, although American Express and Diners' Club have recently adopted the use of clauses limiting the holder's liability to \$100. Finally, the only statute which regulates the field, enacted in New York in 1962, goes no further than to outlaw contract provisions imposing liability on the holder after he has given to the issuer notice of loss.⁸⁸

The purpose of dividing the risk of loss between the holder and the issuer is, at least partly, to induce each party to exercise care to prevent such losses. At a minimum, the holder should keep his card reasonably safe from theft and loss, and should promptly discover and report any mishap. The issuer should exercise control over its merchants and insure that they exercise care in accepting cards; it should also see that they are promptly notified about lost cards.

The use of notice as the risk-shifting event has been said to result in a reasonable allocation of the loss,⁸⁹ and appears to serve this purpose efficiently. On close examination, however, this is doubtful

⁸⁵ See p. 495 *supra*.

⁸⁶ It is possible to conceive of a merchant or his employees deliberately forging invoices in a holder's name and absconding. Article 5 would require the holder to bear the risk of this as against the issuer, even though he had neither lost his card nor contributed to the practice in any way.

As bank-issued credit-card systems expand from local to regional and eventually to national systems, the issuer will lose contact with the selling merchant. Nevertheless, it will remain true that the holder will have had no contact with the merchant and that the merchant was chosen to participate in the system by a member bank. Letter-of-credit doctrine will be no more appropriate to the allocation of loss from the unauthorized use of national bank-issued credit cards than from local ones.

⁸⁷ See *Diners' Club, Inc. v. Whited*, *supra* note 44; *Union Oil Co. v. Lull*, 220 Ore. 412, 421, 349 P.2d 243, 247 (1960).

⁸⁸ N.Y. Gen. Bus. Law § 512 (McKinney Supp. 1966).

⁸⁹ *Union Oil Co. v. Lull*, *supra* note 87, at 421, 349 P.2d at 247, said the bargain was "not an unreasonable one," and *Texaco, Inc. v. Goldstein*, *supra* note 42, thought it highly reasonable.

in many cases. The only purpose of notifying the issuer is to permit him to inform merchants not to accept the card. Some issuers take up to thirty days to do this, and others have completely abandoned the practice of circulating "hot lists" because of the cost. Notification to these issuers is a meaningless act. To use it as the event shifting liability merely results in an arbitrary allocation of the loss. On the other hand, notification is a significant event to those issuers who pass it on to their merchants promptly, and, if liability is to be shifted, doing so at that time is reasonable.

It has been argued that the \$100-deductible rule is as effective as the liability-until-notice rule in inducing holders to exercise care, and is preferable because it rids the holder of a potentially onerous burden.⁹⁰ Issuers may be moving in this direction because of competitive pressures.⁹¹ If all issuers were to go to a deductible system, the liability of the holder would be so small that lost-card litigation would be rare, and the social problem negligible. But it is unlikely that the oil companies and many of the other card issuers will be pushed by competition to this result. Most issuers can be expected to continue to contract for full liability-until-notice, unless forbidden to do so by law.

3. *A Suggested Approach.* The arguments in favor of both liability-until-notice and the \$100 limitation are based on the premise that the holder can reduce the loss from unauthorized use by guarding his cards more carefully and by notifying the issuer once they are lost or stolen. The courts in *Gulf Ref. Co. v. Williams Roofing Co.*,⁹² *Union Oil Co. v. Lull*,⁹³ and *Diners' Club v. Whited*⁹⁴ recognized that the loss could also be caused in part by the failure of the merchant to exercise due care in accepting the card. What has been overlooked is the fact that the loss is largely caused by the issuers' business decision to use a form of card which contains no identification of the holder except his name and possibly his address and a space for his signature, and to permit use of the card by the holder's relatives and friends.⁹⁵ It would not be difficult to increase the amount of identification on a card. Each card would have to be individualized and nontransferable, with additional individualized cards issued for the wife, children, em-

⁹⁰ Macaulay, *supra* note 63, at 1116.

⁹¹ A full-page advertisement in the Chicago Daily News, Dec. 30, 1966, p. 4 announced a \$50-deductible card under a bold headline "Now FirstCard is the only Midwest Bank Card that protects you against loss, theft or unauthorized use."

⁹² 208 Ark. 362, 186 S.W.2d 790 (1945).

⁹³ *Supra* note 87.

⁹⁴ Civ. No. A 10872, Los Angeles Super. Ct., Aug. 6, 1964.

⁹⁵ The cases indicate that the holder is more likely to be held liable if the card is transferable than if it is nontransferable. This should not be the case. It is the issuer who decides that the card will be transferable. He should bear the risk that the merchant will have no means of doubting the presenter's authority.

ployees, or other persons who are to have charge privileges to the holder's account. Simple forms of identification which could be embossed on present style cards are sex, height, eye color, etc., with which all are familiar. Oil-company cards might have the license numbers of the holder's cars. Pictures can be laminated into the card. It has been suggested that the card of the future will contain a machine-language profile of the holder's voice which will be automatically compared with that of the presenter.⁹⁶

Only an engineer can say to what extent and at what cost cards can be individualized so that busy, untrained sales personnel can make positive identification. At the present time, the cards are purchased in bulk from the manufacturer at prices as low as one or two cents per unit, when purchased in large quantities. The issuer embosses the holder's name, address, and account number on the card. This individualized operation substantially increases its cost, but it remains a relatively inexpensive operation. To add personal data such as sex, height, weight, eye color, etc. to the card would probably not increase the cost very much. But using pictures or voice recordings would demand the time of the applicant and special manufacture of each card. Perhaps more importantly, means of identification which demand sophisticated equipment at the point of sale may be useful only where there is a high dollar volume, although it has been suggested that the availability of such equipment may be radically extended by the use of specialized telephone equipment.⁹⁷

The point is not whether there are at present economically feasible means of identifying card holders; rather, it is that such technical innovations will be developed and used only if large-volume issuers are sufficiently interested. Their interest is diluted when the holder bears a major portion of the loss. Therefore, recognizing that the principal contributing factor to the unauthorized use of lost or stolen cards is the ease of use by a thief or finder, the issuer should bear the entire loss as between it and the holder, absent special circumstances. This is not a radical suggestion. Credit cards could be governed by the same rules which now govern check collection. The mechanical processes involved are closely similar. In the bank-sponsored credit-card plans, a merchant deposits his sales slips in his local bank and receives immediate credit for his deposit less a discount, which is typically five per cent. The slips are then transmitted to the sponsoring bank for payment in the same manner as are checks. It is difficult to see any reason to distinguish a forged sales slip from a forged personalized check.

A bank which is presented with a forged check is not required to

⁹⁶ Livingston, *Banking's Role in a Credit Card Economy*, *Banking*, Sept. 1966, pp. 111, 112. Mr. Livingston is a vice-president of Bankers Trust Company.

⁹⁷ *Id.* at 113.

pay, and, if it does pay, the bank can neither charge its customer's account⁹⁸ nor recover the payment from a holder in due course or a person who in good faith has relied on the payment.⁹⁹ The customer's account can be charged if his negligence substantially contributed to the making of the forged signature,¹⁰⁰ but loss or theft of checks personalized with the customer's name, address, and account number does not necessarily constitute negligence, and the customer has no duty to notify the bank of such loss or theft.¹⁰¹

Once the forged or altered items are sent to the customer with the statement of account, however, he "must exercise reasonable care and promptness to examine the statement and items to discover his unauthorized signature or any alteration on any item and must notify the bank promptly after discovery thereof."¹⁰² His failure to do so permits the bank to charge his account for the item, if it can show that such failure caused it to suffer a loss. The bank may also charge the account for any forged or altered items which are paid by the bank more than a reasonable time (not exceeding fourteen days) after the statement was available to the customer and prior to his notification of the wrongdoing. However, the bank may not charge the account if the customer establishes lack of ordinary care on the part of the bank.¹⁰³

The card holder should be held to a similar duty of care. *Gulf Ref. Co. v. Williams Roofing Co.*¹⁰⁴ illustrates the holder's duty. The holder, a small company, paid Gulf bills for the months ending September 25 and October 25, 1939, which included forged invoices amounting to \$275. It notified Gulf of the forgeries on December 6, 1939. Under the proposal suggested above, the holder would be liable for forged invoices in the September 25 statement and for those executed within fourteen days after the statement was received, but only to the extent that Gulf could show that it suffered a loss by reason of the holder's two-month delay in notification.¹⁰⁵ In the instant case Gulf probably would not have prevailed since "the culprit who committed the forgeries

⁹⁸ U.C.C. § 4-401(1) provides: "As against its customer, a bank may charge against his account any item which is . . . properly payable. . . ."

⁹⁹ U.C.C. § 3-418.

¹⁰⁰ U.C.C. § 3-406.

¹⁰¹ *Leff v. Security Bank*, 93 Misc. 139, 157 N.Y. Supp. 92 (Sup. Ct. 1916); *Pure Oil Pipe Line Co. v. Columbia Nat'l Bank*, 275 Pa. 547, 119 Atl. 607 (1923); 2 Paton, *Digest of Legal Opinions* 1818 (1940); Annot., 126 A.L.R. 613 (1923). But see *Frankini v. Bank of America Nat'l Trust & Sav. Ass'n*, 12 Cal. App. 2d 298, 55 P.2d 232 (1936), holding it to be a jury question whether the drawer negligently caused the forgery by leaving blank checks, the green ink he always used, and his protectograph on his desk in his home.

¹⁰² U.C.C. § 4-406(1).

¹⁰³ U.C.C. § 4-406(2), (3).

¹⁰⁴ *Supra* note 92.

¹⁰⁵ It seems only reasonable to measure the holder's responsibility by the date of execution to the merchant rather than payment by the issuer.

seems to be well-known and may be solvent."¹⁰⁶ No proof of loss would be necessary for Gulf to recover on the forged invoices executed after the fourteen days. The holder could defend only by establishing lack of due care on the part of the issuer or merchant in accepting the card. In the instant case, evidence of such lack of due care by the merchants was abundant. Indeed, there was outright collaboration in the fraud. Nevertheless, it would be necessary for the holder to show lack of due care in regard to each invoice, since carelessness or dishonesty by one dealer would not necessarily indicate carelessness or dishonesty by any other.

There is little doubt that, as between the holder and the issuer, the issuer must be held responsible for the lack of due care of the merchant. In spite of the denial of the court in *Texaco, Inc. v. Goldstein*,¹⁰⁷ the issuer has substantial control over the merchant, particularly in the case of oil-company cards. This control is enforced by charging back the loss if the merchant negligently accepted the card or if the signature on the credit slip does not reasonably conform to that on the holder's original application for the credit card.¹⁰⁸ This control raises the inference that issuers will be able to avoid the loss sought to be placed upon them by forcing the merchants to absorb it. However, the merchants are better able to resist pressure from the issuer than are holders. It is important to the issuer that his cards be accepted by all the major merchants (airlines, hotels, department stores, etc.) and by a large number of smaller merchants. Although it is also important to the merchants to be able to accept credit cards, they ought to be able to bargain effectively with the issuers.

Social engineering does not always work, and there is no assurance that placing the loss on the issuer would improve identification on credit cards.¹⁰⁹ But unauthorized use of lost or stolen cards will increase unless some action is taken. A \$50 or \$100 maximum liability on the holder

¹⁰⁶ Supra note 92, at 370, 186 S.W.2d 795.

¹⁰⁷ 34 Misc. 2d 751, 229 N.Y.S.2d 51 (Munic. Ct. New York City 1962), aff'd mem., 39 Misc. 2d 495 (Sup. Ct. 1963).

¹⁰⁸ See the discussion of *Diners' Club v. Whited*, p. 495 supra. These rules have created some dissension among the merchants.

[T]he "ungodly" who now make a big business of the misuse of credit cards have developed quite a number of very effective and quick ways of altering the cardholder's signature on the credit card. As a result, in all too frequent cases the employee honoring the card will have compared the signatures and have found them to be alike and will not, in any way, have realized that the card has been altered.

Letter from Mr. D. K. Usher, Manager—Traffic Procedures, Pan American World Airways, to the author, Dec. 22, 1966. But cf. *Carlyle v. Humble Oil & Ref. Co.*, 114 Ga. App. 115, 150 S.E.2d 299 (1966).

¹⁰⁹ Macaulay, supra note 63, after a very thoughtful study, concludes that we do not know enough about the operations of the credit-card business or the probable impact of a change in the rules to warrant legislative action.

may indeed induce some notification to the issuer of loss or theft of the card, which would not otherwise be forthcoming, but it is hard to believe that greater liability has any positive effect. Only action by issuers and merchants can reduce the losses, and they should be encouraged by the legal system to take those actions or suffer the consequences of their inaction.

III. ASSERTION OF PERSONAL DEFENSES AGAINST ISSUER

The conflict between the defrauded or disappointed buyer and the finance company which is a holder in due course of his obligation to pay is classic. A new aspect of this problem has appeared with consumer credit cards, which may be used to purchase expensive consumer goods, such as stoves and refrigerators, and not merely toothbrushes and airline tickets. In his contract with the issuer, the holder normally promises to pay for all goods purchased with the card, without regard to any disagreement he may have with the merchant. Often he also contracts for the issuer to extend him credit on a revolving basis.¹¹⁰ It has yet to be decided whether these contracts may be enforced literally.

A. *Technical Arguments*

Although the courts refer to the credit card as new and unique, they are likely to apply traditional rules of law to the new device. This suggests that the issuer's rights against the holder will be based on one of four traditional theories: (1) assignment from the merchant; (2) the holder's direct promise in consideration of the merchant's extension of credit; (3) the issuer's status as "payor bank" under Article 4 of the Uniform Commercial Code; or (4) the issuer's status as issuer of a letter of credit under Article 5 of the Uniform Commercial Code.

1. *Assignment and Direct Promise.* Of the four possible theories upon which the issuer may claim rights against the holder, the two simplest are (1) assignment from the merchant who sold the goods, and (2) a direct obligation arising out of the issuer-holder contract, completed by the merchant's sale of the goods or services. In three stolen-card cases, it has been held that the issuer was an assignee of the merchant and was therefore required to show the merchant's exercise of due care in accepting the card from the thief.¹¹¹ In one of the cases, *Diners' Club v. White*,¹¹² the court suggested that it was immaterial whether the issuer's claim arose out of an assignment or out

¹¹⁰ As with two-party revolving credit, the holder may pay the entire balance within twenty-five days of his monthly billing and avoid paying any service charges. Although details vary from one plan to another, typically he may pay as little as 10% of the outstanding balance monthly with a service charge of 1% to 2% added to the outstanding balance not paid within the twenty-five days.

¹¹¹ See pp. 491-95 *supra*.

¹¹² *Supra* note 94.

of a direct obligation. If it arose out of an assignment, the issuer was subject to defenses good against the merchant; if from a direct obligation, it "should be construed as being conditional upon the merchant's fulfillment of his obligations under the contract of sale."¹¹³

The characterization as assignment or direct obligation, although of no consequence in *Diners' Club*, becomes important when the holder-issuer contract contains an agreement to pay in spite of a dispute with the merchant. This agreement, though made directly with the issuer, rather than with the merchant as in traditional agreements not to assert defenses, is subject to Section 9-206 of the Uniform Commercial Code if the issuer's claim arises out of an assignment of accounts. If the issuer's claim arises out of a direct obligation, it is not subject to this section. Section 9-206 provides that:

(1) Subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods, an agreement by a buyer or lessee 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.¹¹⁴

This provision changes the prior status of the law in two important respects as concerns its possible application to consumer credit cards. First, statutes which allow the consumer to raise claims and defenses against a holder in due course or good-faith assignee of chattel paper are made a legitimate expression of commercial-law policy. No longer can they be treated as "bleeding-heart" legislation destructive of the legitimate needs of the money market. Second, the provision is a legislative statement to the courts that they may distinguish between consumers and nonconsumers. It is doubtful, however, if many courts will be willing to make such an open and radical break with tradition.

¹¹³ The quotation is from Comment, The Tripartite Credit Card Transaction: A Legal Infant, 48 Calif. L. Rev. 459, 487 (1960). The court itself said only that "we agree with such other theories" developed in the California Law Review comment when there is no assignment present in the case. The main alternative theory developed by the comment was the direct-obligation theory.

¹¹⁴ Section 3-305 describes the rights of a holder in due course: "To the extent that a holder is a holder in due course he takes the instrument free from . . . all defenses of any party to the instrument with whom the holder has not dealt . . ." It is arguable that the issuer has "dealt" with the holder and is therefore subject to any defense that the latter can raise to payment.

The only appellate court to which the argument has been raised rejected it, saying: "While this section provides that either the legislature or the courts may establish a different rule, we view this as a legislative function, the exercise of will rather than judgment, and we are reluctant to change the prior decisional law."¹¹⁵

In addition, there is little likelihood that any of the current installment sales acts invalidate the agreement not to assert defenses. Installment sales acts were enacted to provide some substitute regulation over installment sales contracts, which had been exempted by the courts from the application of the usury laws through the "time-price doctrine."¹¹⁶ Since the doctrine applies only between buyer and seller, installment sales acts are drafted in terms which restrict their application to buyer-seller agreements. As a result, neither the limitations on interest or service charges found in these acts, nor the limitations on agreements not to assert defenses found in some of these acts, apply to three-party credit cards.¹¹⁷

New York has modified its act so as to cover some three-party financing arrangements by adding a new Section 413.11 to the Personal Property Law, extending the law's coverage to three-party "retail installment credit arrangements." However, section 403.3, which limits the effect of agreements not to assert defenses, applies only to "contract[s] and obligation[s]." "Contract" is defined by the act as an agreement by which a security interest in the goods sold is reserved,¹¹⁸ which is not the case with the consumer credit card.¹¹⁹ "Obligation" is defined to exclude, *inter alia*, "retail installment credit agreements,"¹²⁰ the only three-party financing agreements subject to the act.

Although the current draft of the proposed Uniform Consumer Credit Code prohibits agreements not to assert defenses, it will not

¹¹⁵ First Nat'l Bank v. Husted, 57 Ill. App. 2d 227, 233, 205 N.E.2d 780, 783 (1965).

¹¹⁶ See Littlefield, Parties and Transactions Covered by Consumer-Credit Legislation, pp. 463-69 *supra*.

¹¹⁷ Only nine states limit agreements not to assert defenses in installment sales contracts other than for the sale of automobiles. Curran, Trends in Consumer Credit Legislation 312-22 (1965).

The problems of applying the installment sales acts to three-party credit cards are discussed in Comment, *supra* note 113, at 494-98; Note, Regulation of Installment Credit Cards, 35 U. Cinc. L. Rev. 424, 434-45 (1966); Note, Regulation of Consumer Credit—The Credit Card and the State Legislature, 73 Yale. L.J. 886, 898-901 (1964).

¹¹⁸ N.Y. Pers. Prop. Law § 401.6 (McKinney Supp. 1966).

¹¹⁹ The card issuer can insist upon a security agreement covering after-acquired property purchased through the use of the credit card as a prerequisite to the issuance of the card or the increase of the credit authorized. U.C.C. § 9-204(4)(b) invalidates after-acquired security interests in consumer goods only "when given as additional security unless the debtor acquires rights in them within ten days after the secured party gives value." If such a security agreement is used in New York, and if it is read in connection with the basic issuer-holder contract, including the agreement not to assert defenses, § 403.3 of the Personal Property Law applies.

¹²⁰ N.Y. Pers. Prop. Law § 401.7 (McKinney Supp. 1966).

apply to credit cards. The Second Tentative Draft of the Credit Code provides that

with respect to a consumer credit sale a transferee of the seller's rights is subject to all claims and defenses of the buyer against the seller arising out of the sale notwithstanding an agreement to the contrary, but the transferee's liability may not exceed the amount of the debt at the time the transferee acquires his rights.¹²¹

The drafters, however, do not consider the three-party credit card transaction to be a "consumer credit sale," but a "loan," and lenders are, of course, not subject to the borrower's defenses against the seller of goods purchased with the borrowed money. Section 3.102 of the Second Draft provides:

(1) "Loan" means . . .

(c) the creation of debt, pursuant to a letter of credit, credit card, or other preexisting arrangement between the lender and the debtor,

(1) by the lender's honoring of drafts or similar instruments for the payment of money drawn on the lender;

(2) by the lender's payment or agreement to pay obligations of the debtor; or

(3) by the lender's purchase from the obligor [obligee] of obligations of the debtor . . .

It may be worthwhile to contemplate the implications of this section as presently drafted. If a three-party credit card is a "loan," as is clearly intended, the lender (issuer) becomes so either by honoring "drafts or similar instruments" or by paying "or agree[ing] to pay obligations of the debtor." If issuers are said to pay or agree to pay obligations of the debtor (holder), it would seem that those obligations were at first owed to the merchant. The payment and transfer of the claim to the issuer would be an assignment of the claim, and, even though the Credit Code will not render null the agreement not to assert defenses in the issuer-holder contract, the court would be free to do so under Section 9-206 of the Uniform Commercial Code.

2. *Bank Collection and Letters of Credit.* When banks first entered the credit-card field, some attempted to fit the traditional negotiable instrument into the transaction. In several early bank plans, the merchant drew on the holder a negotiable draft payable to the issuer twenty-five days after demand.¹²² Normally the holder accepted

¹²¹ Credit Code § 2.404 (Tent. Draft No. 2, 1967).

¹²² See Robinson, *New Developments in Retail Financing*, 8 Kan. L. Rev. 554, 567-74 (1960).

the draft at the time of sale, but in at least one plan he simply "agree[d] to accept all drafts drawn on [him] . . . for charges incurred by or in [his] . . . behalf."¹²³ The merchant indorsed the draft and negotiated it to the issuer bank, which presented the drafts monthly to the drawee-holder for payment within twenty-five days. The procedure might easily have been varied to approximate more closely a clean letter of credit. To accomplish this, the draft would have had to have been drawn by the holder on the issuer bank payable to the order of the merchant, and presented to the bank for payment. The bank would have been reimbursed by the card holder at the time provided in their agreement.

The current system of payment to the merchant by bank credit-card plans is not radically different from this hypothetical system. One copy of the sales slip acts as a receipt to the buyer-holder. A duplicate is put in a deposit envelope on which is detailed the total amount of sales slips being deposited, less the issuer's discount. The balance is entered on the merchant's deposit slip and credited to the merchant's account. The slips are then forwarded to the respective issuers for collection. If the credit card is considered to be a letter of credit, the issuer is now bound to pay and the holder to reimburse him.¹²⁴ If not, the slips may be considered as "items," to be paid by the issuer-bank as provided in Article 4 of the Uniform Commercial Code. Under this theory, the holder is not yet committed. He may stop payment by phone call or letter, provided his order is "received at such time and in such manner as to afford the bank a reasonable opportunity to act on it prior to any action by the bank with respect to the item . . ."¹²⁵ Practically, this means that the holder will have to act within one to three days to be safe.

B. Policy Arguments

The major argument in favor of relieving the finance company or card issuer of the debtor's defenses is one of cost. Finance companies are geared to the smooth flow of repayments. Any controversy which interrupts the receipt of the monthly check increases the administrative costs. But set in context this does not appear to be a major problem. Most buyers are satisfied with the goods and services they have purchased.¹²⁶ When they are not, in almost every case the merchant is able to remedy the defect or satisfy the customer's complaint by crediting his account for the returned merchandise or for a price adjust-

¹²³ *Franklin Nat'l Bank v. Kass*, 19 Misc. 2d 280, 281, 184 N.Y.S.2d 783, 785 (Sup. Ct. 1959).

¹²⁴ See pp. 502-03 *supra*.

¹²⁵ U.C.C. § 4-403(1). See U.C.C. § 4-303.

¹²⁶ See Kripke, *Chattel Paper as a Negotiable Speciality Under the Uniform Commercial Code*, 59 *Yale L.J.* 1209, 1215-16 (1950).

ment. A problem exists only if (1) the merchant does not intend to give satisfaction whether or not the complaint is justified; (2) the merchant does not feel the goods are defective and refuses to accede to the customer's demand; or (3) the merchant has become insolvent or moved away.

The first alternative is not one which demands intellectual energy struggling for a solution. Even though this attitude is confined to only a few merchants, it exists, and it seems to exist in undue concentration in lower-income areas. If consumer credit cards did not penetrate extensively into these areas, this aspect of the problem would be of little importance to holders or issuers. But they do penetrate this market,¹²⁷ and this is a good argument for not allowing the issuers to aid unethical merchants to mulct the public, particularly since issuers actively encourage their holders to patronize merchants which accept the card.¹²⁸

Allowing the holder to assert the alleged breach of warranty as a defense to the claim may determine whether or not he has an effective remedy. The matter may be only procedural, since the buyer can in any case sue the seller for the alleged breach of warranty, but an immediate cash outlay to pay the issuer, and a further cash outlay to pay an attorney before there is any possibility of recovery from the seller, is more than many can afford. Lower-income buyers in particular may be forced to allow their legal rights to lapse. As the amount of the obligation arising out of the sale decreases, the pressure from this double cash outlay also decreases. But at the same time the smaller monetary value of the claim reduces the worth to the buyer of breach-of-warranty litigation.

Having paid the account, the buyer no longer has bargaining leverage with the merchant who does not wish to recognize the alleged defect. If the buyer can resist payment to the issuer, his leverage with the merchant is vastly increased, since it is to the issuer's benefit to encourage merchants to satisfy their customers. If the customers remain dissatisfied, the issuers can and will increase the discount to cover the added bad-debt expense, or take the accounts on a recourse basis backed by a sufficient dealer reserve as in typical consumer financing.¹²⁹

¹²⁷ "[Travel credit] cards . . . are issued mostly to relatively high-income consumers, and are used largely to charge airline tickets . . . and similar things. Bank cards are issued largely to lower-income consumers, who use them mostly to charge purchases at retail establishments, many of which are small." *Wall Street Journal* (Midwest Edition), Jan. 17, 1967, p. 1, col. 8.

¹²⁸ Issuers commonly participate in merchant newspaper advertising if the card symbol is used in the advertisement. They distribute various forms of point-of-sale advertising matter. Most importantly, they commonly send to the holders directories indicating those merchants which accept the card. These directories urge the holders to use their card "wherever you see this sign."

¹²⁹ After the New Mexico Supreme Court, in *State Nat'l Bank v. Cantrell*, 47 N.M. 389, 143 P.2d 592 (1943), held that a transferee finance company of a negotiable note

In the long run, if the issuers cannot enforce claims arising out of fraudulent sales or sales of defective merchandise, they will cut off those merchants who habitually engage in such tactics.

The problem is somewhat different if the merchant does not feel the goods are defective and refuses to accede to the customer's demand. There is no policy reason to favor the merchant or the buyer, either of whom may be in the right. Normally the issuer will favor the merchant whose goodwill is more important to it than the goodwill of any particular holder. This is especially true in these early stages of consumer credit cards, as the issuers attempt to persuade merchants that the increase in sales will more than compensate for the three to five per cent discount taken from the sales price by the issuer.¹³⁰ The issuers already return sales slips arising out of the unauthorized use of a card if it was on the "hot list" of lost or stolen cards. The addition of returned claims which cannot be collected because of an alleged breach of warranty or fraud in the transaction, which the merchant denies, may be sufficient to cause him to drop the plan. Many merchants did not previously sell on credit and joined credit-card plans on the assurance that the issuer takes all the credit risks, and they would consider it to be a credit risk if the holder alleged a breach of warranty which they deny.

However, credit-card holders are also regular customers of the issuer and are looked to for a steady stream of purchases. This may mean that issuers will become more interested in retaining the holder's goodwill than that of the merchant, especially if the plans for nationwide credit cards are successful. Under these plans a merchant who agrees to accept any one card, agrees to accept any card issued by a member of the plan. This means that the issuer knows the holder to whom it issued the card, but need not know the merchant with whom the card was used any more than it need know the merchant to whom a check was drawn to pay for the purchase of goods.

It is difficult to judge whether the size and type of credit-card purchases make customer complaints over the quality of the goods purchased more or less of a problem to credit-card issuers than to other consumer financiers. The average size of a credit-card purchase is considerably less than the average size of chattel paper. Although refrigerators can be purchased with some cards, more often cards are

and conditional sales contract was not a holder in due course, the only real change in consumer financing was that the finance companies increased the amount of the dealers' reserve. Vernon, *Priorities*, *The Uniform Commercial Code and Consumer Financing*, 4 B.C. Ind. & Com. L. Rev. 531, 547-48 (1963).

¹³⁰ *Diners' Club v. Whited*, *supra* note 94, is a good example. *Diners' Club* was not required by its contract with the merchants to pay them for charges incurred by use of a stolen card. When it did so anyway, the appellate court dismissed *Diners' Club's* action against the card holder, saying that the payments constituted promotion of its goodwill with the merchants and not damages.

used for small daily purchases. Ten alleged defects in \$4 pillows may cause as much or more administrative cost than one complaint about a \$4,000 automobile or \$400 refrigerator and still involve less money. With an automobile, or even a refrigerator, the amount of money involved may make it worth the time of the finance company to conduct at least a cursory investigation and attempt to resolve the complaint. But the value of the pillow is not worth more than a few minutes of the issuer's time. Furthermore, nonpayment of a \$4 or \$40 claim does not hurt as much as the nonpayment on a refrigerator.

Insolvency of a merchant who has sold defective goods raises all of the considerations which have been written about so extensively.¹³¹ The risk of loss involved can be seen either as a mercantile risk (the goods will be defective but not repaired by the seller) which should be borne by the purchaser, or as a financial risk (insolvency of the seller) properly borne by the finance company. In point of fact it is both. Yet only an engineer or chemist can verify the quality of many modern consumer goods until they have been used and found defective, while the finance company or credit-card issuer can conveniently investigate the solvency of the merchant. As regional and national credit-card plans go into effect, however, the issuers may not be able to make such investigations much longer. The individual issuer will lose contact with the merchants who accept its card and will have no reason to know of the solvency of those it has not personally induced to join the plan.

It would seem, therefore, that so long as the consumer credit cards are local, or the issuer has encouraged the merchant to join the plan, the issuer should be subject to the defenses which are good against the merchant himself. Its close relationship with the merchant, the opportunity it has to investigate the merchant's solvency and business ethics, the added leverage which the buyer would have in dealing with unethical merchants, the issuer's encouragement to holders to patronize those merchants which accept the card, and the issuer's ability to protect itself through recourse against the merchant and through the institution of a dealer's reserve all point in this direction. However, once the credit-card plans have become regional or nationwide, and the issuer has not dealt with the merchant who sold the goods, it is considerably more difficult to see the policy grounds on which the issuer should be subject to the holder's defenses.

¹³¹ E.g., Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 *Yale L.J.* 1057, 1093-102 (1954); Kripke, *supra* note 126; Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 *So. Cal. L. Rev.* 48 (1966); Sutherland, *Article 3—Logic, Experience and Negotiable Paper*, 1952 *Wis. L. Rev.* 230, 235-40. The holder's ability to assert defenses and counterclaims against the issuer is considered with care in Comment, *supra* note 113, at 471-78, but the effect of agreements not to assert defenses is not discussed.

C. Conclusions About the Assertion of Contract Defenses

These ruminations over the card issuer's freedom from the card holder's contract defenses lead to no clearcut conclusion. The movement in recent years has been to expand the consumer buyer's right to assert his contract defenses against those who finance the sale, in spite of the buyer's agreement not to do so. Unless this principle is extended to the card issuer, the movement will come to naught to the extent that credit-card financing supplants the traditional forms of consumer financing.

On the other hand, as the consumer-credit plans become regional and then national, there will be a fundamental change in the relationships of the three parties: issuer, holder, and merchant. It is still true today that the card issuer can be considered as supplying the merchant with a substitute charge-account service. But the drafters of the Uniform Consumer Credit Code, at the present stage of their work, call the three-party credit-card transaction a loan. In the future, we may see in it the establishment by the card holder of a line of credit at a bank with payment to the merchant by a form of bank instrument alternative to the check.¹³² Once this happens, there will be little basis for allowing the card holder to assert his defenses against a card-issuer bank after payment of the instrument.

IV. CONCLUSION

The problems arising out of lost and stolen cards and the card issuer's freedom from contract defenses are only two of the many to be faced as credit cards replace cash, checks, and various forms of purchase-money financing. One obvious and unsolved problem is the application of usury laws or installment sales acts to credit-card financing. It has been suggested above that the current acts do not apply.¹³³ Happily, the drafters of the proposed Uniform Consumer Credit Code are aware of the problem and intend to cover credit-card financing either in a separate article of the Code or by inserting it within the article on consumer loans. But covering regular two-party loans and three-party credit-card loans in the same provisions will not be easy.

The relationship between merchant and issuer is completely unexplored. It is not satisfactory to fit it exclusively within the law of assignment, bank collection, letters of credit, or unadorned contract when it partakes of each to some extent. Nevertheless, some characterization will occur whether or not desired or desirable. For example, if

¹³² For a discussion of other forms of noncheck bank transfers, see Dunne, *Variation on a Theme by Parkinson or Some Proposals for the Uniform Commercial Code and the Checkless Society*, 75 Yale L.J. 788 (1966).

¹³³ See p. 511 *supra*.

the issuer acquires his rights against the holder by assignment of an account within the meaning of Article 9 of the Uniform Commercial Code, the issuer must file a financing statement to perfect its security interest. This is not the practice today. Eventually some creditor, or the trustee in bankruptcy of an insolvent merchant, will raise the question.

It is unfortunate that a current business practice, involving billions of dollars annually, exists in such legal uncertainty. However, the industry is changing rapidly. It is unlikely in the near future to settle on a form which clearly fits the existing legal categories. For the same reason, the industry is not ready for comprehensive legislation, and it is unlikely that there will be sufficient litigation on the total range of questions to provide a reliable means of airing the problems. The only alternative is to increase vastly the amount of consideration given to credit cards by the law reviews before we find ourselves in a cashless society with too few legal guideposts by which to operate.