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Commercial Transactions and Consumer Protection

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The opinions expressed in this article are those of the author and do not necessarily represent the views of the office of the Attorney General of the State of California.
I. Introduction

Because the preceding edition of this publication did not contain an article on trends in commercial transactions or consumer protection in California, this article will discuss selected decisions and developments in those fields during the years 1968 and 1969.¹ The principal focus of this article will be the significant decisions made during this period that interpret or relate to the principal statutes in the two fields: the California Commercial Code,² the Rees-Levering Automobile Sales Finance Act, and the Unruh Retail Installment Sales Act. These legislative enactments establish a comprehensive statutory pattern for regulation of all aspects of commercial law in this state.

1. Due to publication deadlines, no decisions subsequent to October 1, 1969, are included within the scope of this article. It should also be noted that the article's scope does not include a discussion of federal statutes that affect commercial activity within this state. Thus, the Truth-In-Lending Act (Public Law 90–321, 82 Stat. 146, 15 U.S.C.A. 1601 et seq.) and its significance is omitted from discussion. The interested reader is referred to the already voluminous literature on this subject, including: Butler, Truth and Confusion in Lending, 55 American Bar Assn. Journal 27 (Jan., 1969); Barrett, An Introduction to Truth in Lending, 14 Practical Lawyer 83 (Dec., 1968); and Attorney's Guide to Truth in Lending, California Continuing Education of the Bar (1969).

Also beyond the scope of this article are the substantial number of California decisions concerning real property transactions and secured interest in real estate, including Connor v. Great Western Saving & Loan Association, 69 Cal.2d 850, 73 Cal. Rptr. 369 (1968) and Hellbaum v. Lytton Savings & Loan Association, 274 Cal. App. 2d —, 79 Cal. Rptr. 9 (June, 1969).

2. The Uniform Commercial Code, commonly known as the U.C.C., was enacted with numerous amendments in 1963 by the California legislature, and became effective on January 1, 1965. The California version of the U.C.C. is commonly known, and will be referred to in this article, as the California Commercial Code or Cal. Com. Code. The official text of the U.C.C. was accompanied by the comments of its drafters, and the California Commercial Code is similarly interpreted with the aid of the California Code Comments. Hereafter, references to the two commentaries will be made as U.C.C. Comment to (e.g.) section 3419, or Cal. Code Comment to (e.g.) section 415. The two sets of Comments can be found in Deering's Annotated Commercial Code immediately following the section to which they relate.

For a reason unknown to the author, the California legislature, in enacting the California Commercial Code, chose to label the nine major sections of the code as Divisions, whereas the U.C.C. labels the same nine major sections as "Articles." Thus Division 2 of the California Commercial Code is the enactment, with some amendments, of Article 2 of the U.C.C.
The amendatory activity of the state legislature, which was a principal subject of Professor Levy's article on Commercial Transactions in the 1967 edition of this publication, virtually ceased in the years 1968 and 1969 with regard to the California Commercial Code. However, as will be hereafter noted, the California legislature has been quite active in regard to the Rees-Levering and Unruh Acts. In general, the case law development regarding these three statutes has been beneficial during the years in question, and a number of difficult decisions, particularly in the field of negotiable instruments, have been determined by the Courts of Appeal. The primary contribution of the California Supreme Court during this period was a single decision, the importance of which can hardly be overstated. This article concludes with an extended discussion of that decision, *Morgan v. Reasor*, and the opinion rendered therein by Justice Tobriner.

II. California Commercial Code

A. Liabilities of Banks in Paying or "Cashing" Checks

The attention of the courts of this state was often directed, during 1968 and 1969, to the subject of the liability of banks in dealing with their customers and persons to whom their customers have issued checks. While the California Commercial Code contains various sections that deal with this subject, the cases under discussion here presented fact situations that are not resolved by the explicit terms of the code. As used in this discussion, the term "drawee bank" refers to the bank on which the check in question has been drawn, and the term "collecting bank" refers to any bank other than the drawee bank that has handled the check. Usually, the collecting bank is the first bank to which a check is transferred in the collection process; in layman's terms, the bank in which the

6. See Cal. Com. Code § 4105(b) and U.C.C. Comment 2 to that section.
check is "cashed." In the sense that the word is used both in this article and in the code, only the drawee bank can "pay" a check, since it is the only bank that is ordered to make such a "payment" by the terms of the check.  

In Indiana Plumbing Supply Company v. Bank of America, the Court determined that a joint payee on a check whose indorsement is forged by a fellow joint payee in cashing the check has a cause of action against the collecting bank to recover the amount of the check. The Court adopted the reasoning and resolution of the issue previously announced in Harry H. White Lumber Co. v. Crocker Citizens National Bank. Both decisions declare that the precode California case law permitted such a recovery, and that the code contains no indication that the prior California rule is altered in any way. Courts in other jurisdictions have also reached the related conclusion that nothing contained in the Uniform Commercial Code controls on the liability of a collecting bank that has cashed a check on a forged indorsement to the drawer of the check. It is worth noting in this context that at least some commentators feel that the code did effect a change in the prior California law in giving the payee a direct right of action against the drawee bank that pays a check on a forged indorsement.

Another major question relating to a collecting bank’s liability when it cashes a check on a forged indorsement is unresolved by the code. The question is whether the drawer of the check can assert a direct cause of action against the collecting bank that cashed the check on the basis of the forged indorsement. By way of background, it is clear that the payee

8. While the word "pay" is not defined in the code, this is the obvious meaning given to the word by the statute. See Cal. Com. Code §§ 3401(1)(b), 3104 (2)(a), (b).


of the forged check may sue either the drawee bank or the collecting bank. It is also clear that the drawee bank cannot charge the drawer's account after paying the forged check. If the drawee bank cannot charge the drawer's account, it would appear to be saddled with the loss. However, in such a situation, the code established the right of the drawee bank to recover the amount of the check from the collecting bank on the theory that the collecting bank has breached its warranty of the validity of all indorsements necessary to give it "good title."

None of the liabilities and rights of action mentioned in the preceding paragraph, considered individually, resolves the issue of the drawer's right of action against the collecting bank. Further complicating the matter is the fact that the drawee bank's liability to the drawer for paying a check on a forged indorsement is subject to a time limitation. The drawer must examine his checks and report the forgery to the drawee bank within 1 year from the time he receives the bank statement and canceled check. Failure on the drawer's part to report the forgery within 1 year bars him, pursuant to section 4406(4) of the code, from suing the bank. The public policy in favor of prompt examination of bank statements and canceled checks to discover forgeries supports the imposition of the section 4406(4) requirements.

It is obvious that permitting a drawer to sue the collecting bank directly avoids circuity of actions, a wholly worthwhile goal. However, a drawer, barred by the limitations period

15. See Cal. Com. Code § 3419(1)(c) in regard to the drawee bank's liability in such a situation, and the discussion of Indiana Plumbing Supply Co. v. Bank of America, supra, concerning the collecting bank's liability.


18. See Cal. Com. Code § 4406(4). The official text of the U.C.C., on the other hand, would allow the drawer to report the forgery to the drawee bank within a 3-year period.


20. Two recent cases demonstrate the salutary effect of the statutory codification of the law regarding the banking process in division 4 of the California Commercial Code. By relying on the well-drawn definitions of such terms as "collecting bank" and "documentary draft," two recent California decisions resolve difficult and
established in section 4406(4) from an action against the drawee bank, might be able to circumvent the statutory policy encompassed in this section if he is entitled to sue the collecting bank. A concern for this aspect of the problem led the Supreme Judicial Court of Massachusetts to deny the drawer a right of recovery based on a conversion theory against the collecting bank in Stone & Webster Engineering Corp. v. First National Bank & Trust Company.¹

In July, 1969, the Court of Appeal rendered the first decision in this state subsequent to the passage of the California Commercial Code on the liability question.² In Allied Concord Financial Corporation v. Bank of America,³ the Court, concluding that the enactment of the code provided an opportunity to consider the liability issue on a new basis, held that the drawer was entitled, on third-party beneficiary principles, to the benefit of the warranties of proper indorsement that the collecting bank makes by implication to the drawee bank.⁴

complex fact situations in a clearly correct manner. (See Frontier Refining Co. v. Home Bank, 272 Cal. App.2d 630, 77 Cal. Rptr. 641 (1969), which applied the definition of “collecting bank” at Cal. Com. Code § 4105(d), and Valenzuela v. Bank of America, 272 Cal. App.2d 673, 77 Cal. Rptr. 609 (1969), in which the Court applied the definition of “documentary draft” as defined in Cal. Com. Code § 4104(f), in decisions exonerating the banks involved from liability.) At least on the evidence of these two decisions, the optimistic belief of the drafters of Article 4 of the U.C.C. that a codification of the rules regulating this complex and often arcane area would greatly benefit the banking industry, the commercial bar, and the courts, seems justified. (See U.C.C. Comment to Cal. Com. Code § 4101. Article 4 of the U.C.C. was, of course, enacted, with some amendments to conform with existing California banking practice, as Division 4 of the Cal. Com. Code.) Article 4 was designed by its drafters to replace the American Bankers Association Bank Collection Code, several “deferred posting” statutes, and decisional law in the various states. (See U.C.C. Comment to Cal. Com. Code § 4101.) In California, the adoption of article 4 replaced Financial Code sections 1010–1019. These former sections of the Financial Code constituted one of the few comprehensive state bank collection statutes. (See Introductory Comment to division 4 of the Cal. Com. Code.)


2. The precode rule in California had been that the drawer had no right of action against the collecting bank. See California Mill Supply Corp. v. Bank of America, 36 Cal.2d 334, 223 P.2d 849 (1950); Metropolitan Life Insurance Co. v. San Francisco Bank, 58 Cal. App.2d 528, 136 P.2d 853 (1943).


The decision, for support, notes that the West Virginia Supreme Court recently resolved the same issue in a similar fashion.\(^5\)

On the issue that had troubled the Massachusetts Court in *Stone & Webster, supra*, the Court of Appeal resolved the question by imposing the 1-year statute of limitations contained in section 4406(4) on any action that the drawer might bring against the collecting bank relating to a forged indorsement.\(^6\) Thus, the Court gives the collecting bank the advantages of all the defenses available to the drawee bank in an action by a drawer whose account is charged for a check paid on a forged indorsement. The Court concludes its decision by rejecting the claim of the drawer to a right of action against the collecting bank based on a conversion theory.\(^7\) The *Allied Concord* decision is clearly correct and constitutes a valuable addition to the body of decisions interpreting the Uniform Commercial Code.

A related issue came to the attention of the Court in *Blackmon v. Hale*.\(^8\) In that case, the drawer of a check sought recovery from the drawee bank for paying a check on which "Adams & Hale Trust Account" was the payee. The check was indorsed "Adams and Hale Trust Account, by J. C. Adams" and "Adams, Hale and Lee Trust Account."\(^9\) The drawer claimed that the check had not been effectively indorsed and that his bank was therefore liable for charging it against his account. The Court of Appeal held that the check had been validly indorsed because it had the Adams, Hale and Lee Trust Account indorsement.\(^10\)


\(^8\) 273 A.C.A. 780, 78 Cal. Rptr. 569, hearing granted July 30, 1969. After this article had been completed, the California Supreme Court handed down a decision in the case, 1 C.3d 548, 83 Cal. Rptr. 194, 463 P.2d 418.

\(^9\) J. C. Adams was an attorney whose law firm originally maintained the "Adams & Hale Trust Account." The firm added Lee and changed its trust account designation to "Adams, Hale and Lee Trust Account." See 273 Cal. App.2d —, 78 Cal. Rptr. 572.

\(^10\) 273 Cal. App.2d —, 78 Cal. Rptr. at 573.
The trial court had concluded that the check was "bearer paper," since it was payable to an account and not to an individual, and thus needed no indorsement for negotiation. The reviewing Court rejected this ground on the basis of the rule expressed in California Commercial Code section 3110 (1)(e). 11 The Court went on to state that since Adams was the "representative" of the trust account, his indorsement of the check, which was "order paper," was an effective indorsement. Unfortunately, some question is raised as to the validity of the decision on the basis of the facts stated therein, for Adams was not authorized to make withdrawals from the trust account on his own signature alone. The signature card of the bank that held the trust account required either Hale's signature by itself or Adams' and Lee's signature jointly for proper withdrawals. Thus, perhaps Adams was not the "representative" of the Adams, Hale and Lee Trust Account for purposes of section 3110(1)(e). However, there is no question that the Court's resolution of the "bearer paper" or "order paper" issue is correct. 12

The only decision in this area during this period that appears on its face to be clearly in error was rendered in September, 1969, in the case of Wright v. Bank of California. 13 In Wright, the plaintiff, as the result of misrepresentations by Feinberg, his cojoint venturer, was induced to write a check on the joint venture account in a substantial sum payable to March Construction Co. After obtaining the check, Feinberg gave it to a confederate who posed as a representative of

11. Cal. Com. Code § 3110 lists those types of instruments that are deemed to be "order paper" requiring an indorsement for negotiation. Among the types of order paper listed are those instruments that "... may be payable to the order of ... an estate, trust or fund, in which case it is payable to the order of the representative of such estate, trust or fund or his successors ... ." Although § 3110(1)(e) was not applicable to the transaction before the Court, since the effective date of the Cal. Com. Code was January 1, 1965, and the transaction occurred in 1961, the Court was of the opinion that the rule expressed therein was sound law and should be followed.

12. The section was intended by the U.C.C. drafters to change the law in those states that considered checks drawn payable to someone other than a named individual as "bearer paper." See U.C.C. Comment 2 to Cal. Com. Code § 3110(2).

March and took it to the drawee bank. The confederate forged an application for a cashier’s check payable to March, gave the application and the unindorsed check to the drawee bank, and received a cashier’s check in the same sum as the original check, payable to March. Through further efforts, Feinberg and his confederate were able to cash the cashier’s check at a second bank. The drawee bank on the original check charged the joint venture account for its amount, and Wright sued to have the charge restored. He relied on a number of theories in his complaint, including negligence, conversion, and a common count for money had and received.

The trial court upheld the drawee bank’s general demurrer to the complaint and, although the Court of Appeal reversed on other grounds, the appellate decision upheld that trial court’s determination that the drawee bank incurred no liability for the mere act of “paying” the original check without requiring any indorsement. The reviewing Court’s reasoning was that whereas negotiation requires an indorsement under California Commercial Code section 3202, presentment of a check to a drawee bank for payment is an act distinct from negotiation. Thus, for effective payment, there was no need for the drawee bank to obtain an indorsement of the instrument, and the bank therefore incurred no liability when it charged the drawer’s account.

This portion of the Court’s opinion is clearly in error. If nothing else, the internal inconsistencies in the decision demonstrate this fact. In determining, in the second portion of the opinion, that the bank may have been negligent in drawing the cashier’s check without determining the identity or authority of the applicant, the Court noted that the “fictitious payee” rule, which is, in essence, stated in California Commercial Code section 3405, is not applicable as a shield to the drawee bank’s possible liability for negligence. The Court

14. The issuing of the cashier’s check by the drawee bank was clearly “payment” of the original check.


16. Cal. Com. Code § 3405(1)(b) and (c) makes an indorsement by any person in the name of a named payee “effective” if the drawer of the check, or the employee of the drawer who supplied
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made the determination that section 3405 does not apply, on the ground that there was no indorsement on the check.\footnote{17} The Court might well have asked itself why the drawee bank would have been protected, if, under section 3405, a forged indorsement would have been “effective.” The reason is that without the fictitious payee doctrine, the bank could not legitimately charge the drawer’s account, since it is basic negotiable instruments law that a drawee bank that pays a check upon a forged payee indorsement cannot charge the drawer’s account.\footnote{18} This rule is based on the primary duty of a drawee bank to pay the check as ordered by the drawer. If the drawee bank pays the check to someone other than the actual payee, or a subsequent legitimate “holder” of the check, the bank has

him with the name of the payee, intended the payee to have no interest in the instrument. The “fictitious payee” rule applies to shift the burden of loss in situations where a dishonest employee, with either the authority to draw checks on his employer’s account or to make up such checks for the signature of a superior, causes the drawing of a check payable to a person, fictitious or not, whom the dishonest employee never intends to receive the check. After the check is drawn, the dishonest employee takes the check to a bank, poses as the named payee, forges the named payee’s signature, and converts the proceeds of the check to his own use.

Without the application of the fictitious payee rule, the bank would stand the loss in such a situation. This is unfair since the employer, by hiring a dishonest employee, placed such an employee in a position to work his mischief. The fictitious payee doctrine, as stated in the code, validates the forged indorsement. Thus, the bank is entitled to charge the employer’s account, and the loss is shifted to the employer. (See Cal. Code Comment 2 to Cal. Com. Code § 3405; Uniform Commercial Code Handbook, American Bar Association, pp. 114–116) (1964 Edition); The Uniform Commercial Code, a Special Report by the California State Bar, 37 Journal of the State Bar, pp. 157–159 (1962), and, generally, Abel, The Imposter Payee, or Rhode Island was Right, 1940 Wis. L. Rev. 161.


18. See The Uniform Commercial Code, a Special Report by the California State Bar, 37 Journal of the State Bar, pp. 155–156 (1962); Britton, Bills and Notes, section 142 (1961); Security First National Bank of Los Angeles v. Bank of America, 22 Cal.2d 154, 137 P.2d 452 (1943); Ryan v. Bank of Italy, 106 Cal. App. 690, 289 P. 863 (1930). Although not clearly stated in the code, all commentators agree that this very basic rule has been carried forward under the U.C.C., principally in the form of Cal. Com. Code § 4401, which authorizes a bank to charge a customer’s account for checks that are “properly payable.” See 2 Smith, California Commercial Law, Continuing Education of the Bar, section 8.22; Bunn et al., An Introduction to the Uniform Commercial Code (1964 Edition), pp. 224–225.
not made payment on the check in accordance with the "order" of the drawer. In *Wright*, a person posing as the payee obtained payment of the check from the drawee bank. Obviously this does not accord with the order of the drawer of the check, and the fact that the imposter did not forge the payee's indorsement should be of no significance.

Since the decision in *Wright v. Bank of California* called for a remand of the case to the trial court for further proceedings, the decision, with its glaring error, may remain uncorrected for some time until the California Supreme Court has an appropriate opportunity to disapprove or otherwise negate the decision. 19

B. Liabilities of Signers of Negotiable Instruments

During the period under review, California courts rendered two noteworthy decisions that may have future significance concerning the liability of those who sign negotiable instruments. Twenty years ago, the California Supreme Court, in *Hamilton v. Abadjian* 20 announced that courts of this state will not lend their process to the collection of gambling debts in situations where the debt takes the form of checks cashed by casinos to enable customers to gamble. Relying on the rule expressed in *Hamilton*, the Court of Appeal in *Lane & Pyron, Inc. v. Gibbs* 1 refused to affirm a judgment enforcing the liability of the drawer of a number of checks payable to Nevada gambling casinos on the ground that the trial court record contained no substantial evidence showing that the proceeds of the checks were not used by the drawer in gambling activities at the casinos. The collector-assignee of the checks had argued that because the casinos cashed the checks with no limitation on where the proceeds could be spent, and because the casinos offered a number of goods and services other than gambling opportunities, the *Hamilton* rule should not apply. The Court of Appeal disagreed and applied the *Hamilton*

19. A petition for rehearing was filed in the case on October 14, 1969, and denied by the Court of Appeal on October 23, 1969.


1. 266 Cal. App.2d 61, 71 Cal. Rptr. 817 (1968).
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Although the plaintiff in Lane & Pyron, Inc. was not a holder in due course, being merely an assignee for collection, the decision can be fairly read to imply that the results would be the same even if the plaintiff had been a good-faith purchaser of the checks without notice of the circumstances of their original issue or transfer. Holders in due course of negotiable instruments can enforce them against drawers or makers without the necessity of meeting so-called "personal" defenses such as failure of consideration, nonperformance of a condition precedent, etc. However, holders in due course do take instruments subject to those "real" defenses listed in California Commercial Code sections 3305 (2)(a) through (e). Among the "real" defenses listed is "... illegality of the transaction, as renders the obligation of the party [meaning the maker or drawer] a nullity ..." The judicial attitude reflected in Lane & Pyron, Inc., will, it can be assumed, result in future decisions holding that a check transaction that produces proceeds known by the payee to be earmarked for use in illicit activity, be a "real" defense under California Commercial Code section 3305(2)(b).

While noting that the defendant in First Western Bank & Trust Co. v. Bookasta was not, in the first instance, liable on a promissory note made by a corporation on which his signature did not appear, the Court held that if the corporation could be shown to be merely the "alter ego" of the defendant, the plaintiff would be entitled to enforce the note against him on that basis. This decision opens the door to plaintiffs to enforce negotiable instruments according to their terms against individuals who use alter ego corporations for business purposes.

C. Decisions Interpreting Division 9

In the period under consideration, the courts demonstrated a familiarity and aptitude for working with the provisions of Division 9 of the California Commercial Code. Judicial attention to explicit exclusions from the operation of the Division and to the definitions of terms set forth in the statute produced decisions that are consistent with the statutory pattern. In *Morris Plan Company of California v. Moody*, the Court resolved the issues before it by attending to California Commercial Code section 9103(4), which establishes that the method of perfecting a security interest in motor vehicles is governed exclusively by California Vehicle Code sections 6300 and 6301. In determining the applicability of Division 9 to security interests in promissory notes that were in turn secured by deeds of trust on real property, the Court in *Riebe v. Budget Financial Corp.* noted that while Division 9 does not apply to liens on real estate, the Division does apply to security interests in obligations that are, in turn, secured by real estate liens.

A federal Court, applying California law, also easily disposed of a case before it by focusing on the precise wording of section 9401(1)(a). That section establishes the office of the County Recorder in the county of the debtor’s residence as the proper place for filing a financing statement to perfect a security interest in equipment used in farming operations. The section, quite correctly, was held applicable to the issue of whether a security interest had been perfected in harvesting combines used by a “contract harvester” who owned no farming property of his own.

III. Consumer Protection

A. In General

The Rees-Levering Automobile Sales Finance Act\(^\text{12}\) and the Unruh Retail Installment Sales Act\(^\text{13}\) establish a statutory pattern for the regulation of virtually all consumer sales transactions involving goods or services in the State of California.\(^\text{14}\) During the period under investigation, legislative attention to these statutes in the politically sensitive consumer protection area was intense.\(^\text{15}\) While case law development regarding

\(^{12}\) Civ. Code §§ 2981–2984.3.

\(^{13}\) Civ. Code §§ 1801–1812.10.

\(^{14}\) The Rees-Levering Act, by its explicit terms, applies only to the sale of motor vehicles, whereas the Unruh Act controls consumer sales of all other “goods,” meaning tangible chattels, and, with some exceptions, all services. (See §§ 1802.1 and 1802.2.)

\(^{15}\) During the last three years, approximately 13 additions to or amendments of the Rees-Levering Act have been passed by the California legislature. Some of the more significant changes include the addition of section 2982.1, prohibiting “referral selling” selling practices in regard to motor vehicles; the addition of section 2982.5, regulating, in some instances, certain aspects of “secondary financing” for motor vehicle purchases; the addition of section 2982.7, requiring the refund of down payments made by buyers of motor vehicles in the event that the purchase contract is not executed; the amendment of section 2983 to enable the buyer to recover the fair market value of his “tradein,” or the value assigned to it in the motor vehicle purchase contract, whichever is greater, in the event that the seller violates certain disclosure provisions contained in section 2982.

During the years 1967 through 1969, the Unruh Act has been the subject of 37 amendments, deletions, or additions. Among the most significant are the following: the addition of section 1801.4, which abrogates a portion of the decision in Morgan v. Reasor (see extended discussion, infra); the deletion from section 1803.2 of the requirement that “referral selling” inducements made to the buyer be set forth in the consumer sale contract; the repeal of section 1803.9; the addition of section 1803.10, prohibiting “referral sales” inducements in the sale of consumer goods; the addition of section 1804.2, which is noted in the discussion of Morgan v. Reasor, infra; the addition of section 1812, requiring that an affidavit for a writ of attachment obtained in an action enforcing a consumer sale contract must state facts showing that the suit has been commenced in a proper court for the trial of the action. (This amendment, effected by Statutes 1969, Ch. 669, § 1, is perhaps of lessened significance in the light of the United States Supreme Court decision in Snaidach v. Family Finance Corporation, 395 U.S. 337, 23 L.Ed.2d 349, 89 S.Ct. 1820 (1969), which held prejudgment wage garnishments to be violative of procedural due process and the amendment to section 1812.10, making the venue requirements for court enforcement of consumer sale contracts jurisdictional. The Office of the California Attorney General issued an opinion in 1968 (51 Ops. Cal. Atty. Gen. 179) construing
the Rees-Levering Act was minimal, judicial interpretation of the Unruh Act produced the most significant California decision treated in this article.

B. The Rees-Levering Act

During the last two years, a series of five decisions relating to the Rees-Levering Act appeared. The cases primarily demonstrate application of the terms of the statute. The Court in *Hughes v. Nashua Manufacturing Co.*\(^\text{16}\) ruled that a "cutoff" clause, by which an automobile purchaser waived any right to assert claims he might have against the seller on the conditional sales contract against an assignee of the contract, was ineffective because the assignee failed to give the buyer notice of the assignment as required by section 2983.5.\(^\text{17}\) Although a portion of a conditional sales contract covering the sale of a vehicle, and many other items, did not comply with section 2982, the Court in *Ryan v. Mike-Ron Corporation*\(^\text{18}\) held that the portion of the contract concerning the sale of the motor vehicle was severable and that the seller could therefore enforce the remainder of the contract against the buyer.\(^\text{19}\) In *Zmack v. Arata Pontiac*,\(^\text{20}\) the Court affirmed a trial court decision of an automobile conditional sales contract on the basis of three clear violations of the provisions of section 2982.


\(17\). Section 2983.5 provides that written notice of the assignment must be given to the buyer by the assignee. The buyer then has a 15-day period after the mailing of the notice in which to inform the assignee of any facts giving rise to any claim or defense he may have against the seller. The section provides that if the notice is not given, the buyer may assert any right of action that he has arising out of the contract against an assignee of the contract, regardless of the existence of a contractual cutoff clause.


\(19\). If a motor vehicle's conditional sales contract does not contain the items specified in section 2982, the contract is rendered unenforceable against the buyer. (See section 2983.) Thus, if the buyer chooses, he may rescind the contract. Of course, if the buyer wishes to keep the motor vehicle, he will be liable for the value of the vehicle to the seller.

\(20\). 265 Cal. App.2d 689, 71 Cal. Rptr. 506 (1968).
An automobile lease under which the lessee was to pay rent in a sum equivalent to the value of the automobile with a $1 purchase option at the end of the lease term was denoted a conditional sales contract by the Court in Klein v. Leatherman. A buyer who successfully cross complained against his seller in an action by the assignee of an automobile conditional sales contract was awarded attorneys' fees as the "prevailing party" pursuant to section 2983.4 in Golden West Credit Corporation v. Maury.

C. The Unruh Act and Morgan v. Reasor

Other than noting two minor decisions, a discussion of decisional developments under the Unruh Act must focus on the California Supreme Court decision in Morgan v. Reasor Corp. Because of its direct holdings, discussion of the realities of commercial and consumer financing, and statements of judicial attitude and intendments, the decision in Morgan is certain to become an oft-cited landmark.

On October 14, 1962, plaintiffs Morgan agreed to purchase a house to be constructed by the predecessor in interest to Reasor Corporation on a lot owned by plaintiffs. In connection with the agreement, the plaintiff buyers executed a contract entitled "Lien Contract and Deed of Trust." By the


3. People v. George, 257 Cal. App. 2d 805, 65 Cal. Rptr. 368 (1968), involved a conspiracy conviction of two defendants who had engaged in activities prohibited by section 1812.6 of the Unruh Act, which provides that persons who willfully violate the act shall be guilty of a misdemeanor. In James Talcott, Inc. v Gee, 266 Cal. App.2d 384, 72 Cal. Rptr. 168 (1968), the court rejected an argument that the Unruh Act applied to the transaction before it. The case involved the lease of a printing press for use in the lessee's business. The court pointed out that the Unruh Act, which prohibits deficiency judgments, applies only to credit purchases or leases of goods and services for personal, family, or household use. Thus, the lessee businessman was held liable for a deficiency judgment on the printing press lease.

4. 69 Cal.2d 881, 73 Cal. Rptr. 398, 447 P.2d 638 (1968). For further discussion of this case, see Bernhardt, REAL PROPERTY, in this volume.
terms of this contract, Reasor Corporation sold the labor, management, and goods necessary to construct a particular model of house on the buyers' property, and the buyers conveyed their real property, and subsequent improvements, to a trustee, to be held as security until the buyers completed payment for the house. At the same time, buyers executed a note in favor of the seller, Reasor Corporation, for $19,398.12, $11,844 of which represented the cost of the house with a "time price differential of $7,554.12." The note required the plaintiffs to make 71 monthly installments of $116.06 each, with a final installment of $11,157.86.

Within three months, seller assigned the contract and note to Midwest Homes Acceptance Corporation. Midwest took the assignment with knowledge that the note and contract arose simultaneously out of the same transaction and with full knowledge of all the terms and conditions of the contract and note.

As established by a settled statement of facts entered into between the parties for purposes of appeal, the contract and the promissory note were at no time encompassed in a single document. The contract, at the time of execution by the buyers, contained blank spaces that were later filled in without fraudulent intent by either seller or Midwest, and the note was undated at the time it was executed by the buyers.6

The buyers brought up a threshold issue when they sued seller and Midwest for, among other things, a declaration that they had no liability for the obligation to pay the time-price differential of $7,554.12, because the above mentioned defects were violative of the Unruh Act.7 The defendants

5. "Time-price differential" was defined in the Unruh Act at § 1802.10 as being essentially equivalent to the meaning that a layman gives to the word "interest." The phrase was struck from § 1802.10 by the 1969 legislature, and the phrase "finance charge" was inserted as a replacement. This change was one of many made in the statute by the legislature in order to make the terminology of the Unruh Act conform to that used in the federal Truth-in-Lending Act. (See footnote on legislative developments, supra.)


7. All three of the "defects" in the transaction mentioned above are viola-
argued that the Act was not applicable to the transaction, and the alleged defects were therefore of no legal consequence.

The resolution of this threshold issue by the courts had been anticipated by an opinion issued by the California Attorney General in 1962. That opinion concluded that the labor and materials furnished by a general contractor, pursuant to a contract to construct a private residence, constituted “services” and “goods” as those terms were defined in the Act. The trial court, Court of Appeal, and State Supreme Court all reached the same conclusion. Although of academic inter-
est, the reasoning and result of the Court of Appeal and the Supreme Court on this specific issue have been rendered moot by the addition of section 1801.4 to the act by the legislature in 1969.  

Notwithstanding the fact that the specific kind of contract involved in Morgan v. Reasor is exempted from coverage under the Unruh Act by section 1801.4, the effect of the Court’s reasoning with respect to the close connection rule will obviously apply to those contracts within the purview of the Unruh Act. Therefore, an examination of the contracts involved in Morgan v. Reasor merits our attention. As previously indicated, when the Reasor contract was regarded within the Unruh Act, the trial court ruled that Midwest was entitled to recover the time-price differential provided in the note and contract accruing after June 2, 1966. On that date, Midwest, acting under court order, provided the buyers with a completed copy of the contract. Both the Court of Appeal and the State Supreme Court disapproved this portion of the trial court judgment on the ground that section 1812.7 provides that in the event the act is violated, the violator or a knowledgeable successor in interest “is barred from recovery of any time price differential or service charge . . . .”

The buyers, as plaintiffs, were awarded attorneys’ fees by the lower court, pursuant to the court’s reading of section 1811.1. The Court of Appeal held the attorneys’ fees award

11. See Statutes 1969, Ch. 554, section 1. The 1969 amendment provides that the Unruh Act shall not apply to any contract for the construction, sale, or construction and sale of an “entire residence” or all or part of a commercial or industrial building [see section 1801.4]. The second section to the bill, which added section 1801.4 to the Act, reads: “This Act is intended to abrogate any contrary rule in Morgan v. Reasor Corp. 69 Cal.2d 881, 73 Cal. Rptr. 398, 447 P.2d 638.” (See Statutes 1969, Ch. 554, section 2.)


14. Section 1811.1 of the Unruh Act provides: “[R]easonable attorneys’ fees and costs shall be awarded to the prevailing party in any action on a contract or installment account subject to the provisions of this chapter regardless of whether such action is initiated by the seller, holder or buyer.”
to be error, reasoning that because the action was essentially one for declaratory relief to determine the applicability of the Act to the contract and note, there was no action "on a contract" as required by section 1811.1. The State Supreme Court affirmed this portion of the trial court judgment on the basis that the phrase "on a contract" is to be liberally construed in accordance with expressed legislative intent. The legislative purpose of section 1811.1, the Court noted, was to encourage attorneys to accept cases from buyers who had valid defenses and rights of action, but lacked private capital to pay the necessary attorneys' fees. Since an action for declaratory relief is the only practical option available to a buyer who owes a number of installments that include a time-price differential factor and that are to fall due in the future, the Court concluded that the legislature intended no limitation on the type of action covered by section 1811.1, so long as the subject matter of the litigation involved a contract to which the Act applied.

The Court of Appeal decided to reverse the trial court decision so that the lower court could take evidence on the question of whether Midwest acquired the contract and note with knowledge of their noncompliance with the Act. The trial court had failed to consider this issue, which is clearly critical, since Midwest, as an assignee, would be barred by section 1812.7 from recovering the time-price differential only if it had acquired the documents with knowledge that they violated provisions of the Act.

The State Supreme Court held that the trial court decision need not be reversed for the taking of evidence on the issue

15. 67 Cal. Rptr. 577, 583 (1968). The Court announced its determination of the issue without the explicit reasoning upon which it is based.


18. 67 Cal. Rptr. 577, 582–583.

19. See section 1812.7 of the Unruh Act, cited and quoted supra.
because Midwest, on the agreed facts of the case, had the requisite "knowledge" required for the application of section 1812.7.20

On the point of Midwest's status in regard to section 1812.7, Justice Tobriner's opinion establishes a new criterion for the future application of the section. Specifically, the decision establishes that "constructive" knowledge is sufficient to constitute "knowledge" under section 1812.7. Thus, when Midwest acquired the note and contract as two separate documents from the seller, the fact that the documents were separate should have led it, according to the standard applicable to a "reasonable man," to inquire as to whether the note and contract had originally been contained in a single document. A cursory inquiry, in the Court's view, would then have revealed to Midwest that the Unruh Act provisions requiring a "single document" had been violated.1

In adopting the theory of "constructive knowledge," the Court rejected an analogy offered by Midwest to the law of negotiable instruments, and sets forth an extremely significant judicial attitude as well as giving a clear indication of judicial intentions in the consumer financing field. This portion of the opinion merits careful study and consideration by all members of the bar of this state.

The Court first states that the implementation of the Act, with its avowed aim of protecting consumers from credit abuses, requires that the standards for "knowledge," as that word is used in section 1812.7, should not be established to be so stringent as to permit easy avoidance of the section's consequences by financiers who purchase the commercial paper generated by retail installment sales to consumers. The economic function of section 1812.7, and the consequences of its application in the case of a seller inclined to frequently violate the Act, are then noted. Such a retailer will be forced to sell his commercial paper at a greater discount than a merchant who steadfastly complies with the Act, since financing

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agencies will feel reluctant to buy commercial paper that contains service charges that are unenforceable. This will, in turn, cause the frequently violating retailer to charge a higher price for his goods, and eventually customers will thereby be deterred from dealing with him.²

Furthermore, the Court's liberal interpretation of the knowledge requirement of section 1812.7 will properly allocate the financial loss arising from the unfair practices and credit abuses prohibited by the Act. The impact of such violations will, as a result of the Court's interpretation, be borne “. . . not by a few consumers unable to pass on the loss or in any way 'insure' against the effect of a harsh contract, but by the finance companies that buy large numbers of notes.”³ The Court, in this regard, notes the obvious fact that consumer sales financiers are obviously better able to bear the loss of an occasional “bad deal” than are individual buyers.

In connection with this discussion of the "knowledge" issue, the Court states:

Finally, strict enforcement [of the Act] will give finance companies, with the knowledge and economic leverage required effectively to police against Unruh Act violations, an incentive to do so.⁴

Thus, the decision recognizes the great value in enlisting one of the most powerful and sophisticated elements in the private sector of the economy in the task of policing the marketplace and preventing consumer abuse.

The Court recognized that its liberal interpretation of section 1812.7 will have some adverse effect on the negotiability and free flow of commercial paper. However, the Court does

². 69 Cal.2d 881, 890, 73 Cal. Rptr. 398, 404, 447 P.2d 638, 644.
³. 69 Cal.2d 881, 890, 73 Cal. Rptr. 398, 404, 447 P.2d 638, 644. Perhaps the Court's prediction in this regard is overly optimistic, for one might well have doubts as to the number of consumers who will have the necessary knowledge and energy to enforce their rights under the Unruh Act against finance companies holding their notes. In any event, the theory is quite sound, and the author's reservation on this point is based upon the lack of widespread and effective consumer education, a problem over which the court obviously has no control.
⁴. 69 Cal.2d 881, 890, 73 Cal. Rptr. 398, 404, 447 P.2d 638, 644.
not deem this a serious problem and notes that the negotiability of consumer paper has previously been limited "without apparent ill effect" by statutes in a number of states, including California.\(^5\) The decision tellingly indorses the thought on this subject expressed by the Florida Supreme Court in \textit{Mutual Finance Company v. Martin}.\(^6\) This decision declared that if a limitation on negotiability in consumer paper worked an increased burden on the finance companies, it would merely be a clear indication that the prior free negotiability of such paper had previously worked a corresponding injustice on retail purchasers.\(^7\)

The Court notes that the rule announced in \textit{Popp v. Exchange Bank}\(^8\) has been repealed for all intents and purposes by the legislature through the enactment of the 1967 amendment to section 1804.2. Therefore, the Court rejected the reasoning of that case as a valid analogy in construing the word "knowledge" in section 1812.7.\(^9\) In keeping with the

5. See 69 Cal.2d 881, 891, 73 Cal. Rptr. 398, 404-405, 447 P.2d 638, 644-645. Section 1804.2 of the Unruh Act, as amended by Statutes 1967, Ch. 1294, section 2, provides that an assignee of the seller's rights in a retail installment contract is subject to all claims and defenses that the buyer might have against the seller arising out of the sale, notwithstanding the existence of a cutoff clause in the sales contract. The assignee's liability in this regard is limited to the amount of the debt owing to the assignee at the time the defense is asserted. However, this limitation will not affect a buyer's right to recoup service charges previously collected by a seller or his assignee on a contract that violates the Act, because section 1804.2 provides an exception for the operation of section 1812.7. The subject of cutoff clauses, which are enforceable in nonconsumer sales in California pursuant to Cal. Com. Code § 9206(1), is mentioned in the decision of James Talcott, Inc. v. Gee, 266 Cal. App.2d 384, 387, 72 Cal. Rptr. 168, 170-171 (1968).


8. 189 Cal. 296, 303; 208 P. 113 (1922). The rule, as stated by the court, is that a holder in due course does not bear a duty to investigate suspicious circumstances when he acquires commercial paper. (69 Cal.2d 881, 891, 73 Cal. Rptr. 398, 404-405, 447 P.2d 638, 644-645.)

9. The basis of the Popp rule, to wit, that a holder in due course of a negotiable instrument does not lose his preferred position when he acquires the paper under suspicious circumstances if, in fact, he had no subjective knowledge of a defect in the transaction that produced the paper, is carried forward in the definition of "holder in due course" contained in Cal. Com. Code Section 3302(1). (See Cal. Com. Code Comment 2 to section 3302 and Cal. Com. Code section 1201(19).) Thus, Popp
indications contained in the portion of the decision concerning the frequently violating seller, his financier, and section 1812.7, the Court concludes its discussion of the "knowledge" issue with a statement that, in some situations, prior complaints against a seller might provide the "needed suspicious circumstance" to charge the financier or purchaser of retail installment sales contracts with "knowledge" of facts that he would have learned if he had made inquiry. Thus, it is quite clear that the California Supreme Court intends to impose liability for Unruh Act violations on financiers who continue to deal with retail sellers who have a history of non-compliance with the Act. All financial institutions are clearly put on notice, direct and not constructive, of this significant event in California commercial law.

D. Morgan v. Reasor and the Close Connection Rule

The portion of the Morgan v. Reasor decision discussed above would establish the case as truly significant. However, a later portion of the opinion, clearly obiter dictum, overshadows the foregoing in its significance and potential. The Morgan decision will, in all likelihood, be principally remem-
bered because the Court chose this case as an opportunity to offer a discussion concerning the problem of the third-party financier who has a "close connection" with a sales transaction. The Court's statements regarding this subject deserve the attention of all students of commercial law.

Other courts have recognized the artificiality involved when distinguishing between a seller and his financier who buys the seller's commercial paper, if the financier has entered into a direct or close connection with the particular sales transaction that generates the commercial paper. Rather than give the financier in such situations the status of a holder in due course, who is free from defenses and rights of action that the buyer would have against the seller, courts have occasionally treated the financier as a party to the original transaction rather than a third-party holder in due course. The Court notes that the close connection rule, with the resultant denial of holder-in-due-course status to the third-party financier, was applied by it in Commercial Credit Corp. v. Orange County Machine Works, and states that the "gravamen" of the Commercial Credit case or rule is that the seller extends credit and accepts the buyer's note as, in essence, an agent for the financier. In support of this reading of its prior decision, the Court quotes a legislative committee report recommending passage of the Unruh Act that discusses the evolution of installment sales financing, starting with the original situation in which a businessman handled the entire credit sale transaction himself without contemplating the transfer of the buyer's account receivable or promissory note to a third person. The report goes on to note that in present-day consumer financing, the seller generally has no intention of extending credit; but, in accordance with previous arrangements, the account receivable or note is treated as an asset that can be sold.


12. Certainly a casual, or even close, reading of Commercial Credit would not disclose that the Court in that decision was consciously proceeding on an agency theory. However, as the Morgan v. Reasor decision notes, the reading that it gives to Commercial Credit has been "suggested by other courts." 69 Cal.2d 881, 894, 78 Cal. Rptr. 398, 406-407, 447 P.2d 638, 646-647 (1968).
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receivable or promissory note will be immediately sold to a financier. 13

With the foregoing as an introduction, the Court chooses to take this opportunity to specify the standards that it will henceforth require for the application of the close connection rule. For that rule to apply, the buyer must show that the seller contemplated that the credit for the transaction would be advanced, and that the note would be held by the particular financier who did, in fact, eventually receive and hold the buyer's note. This proof, since it amounts to a "demonstration of ratification of an undisclosed agency," is sufficient to remove the shield of holder-in-due-course status from the financier since, as a principal with an agent directly involved in the sales transaction, the financier is on notice of all that occurs in connection with the transaction. 14 The Court then states that the agency theory, which it asserts was the basis for the close connection rule applied in the Commercial Credit decision, will apply to negate a financier's claims either to be a holder in due course or to be ignorant of violations of the Unruh Act in consumer sales situations.

The Court concludes this startling dictum by stating that there is no adequate information in the fact situation before it to determine what the seller contemplated in regard to the eventual transfer of the buyers’ note at the time of the sale. 15 The decision then notes the following circumstances that might give rise to an application of the close connection agency principle: if there has been a "substantial number" of previ-


15. 69 Cal.2d 881, 895, 78 Cal. Rptr. 398, 407–408, 447 P.2d 638, 647–648. However, in footnote 18 on page 893 of the opinion, the Court notes that the fact that the paper was assigned to Midwest within a few weeks after its execution by the buyers, the fact that Midwest knew that the note and contract were executed simultaneously and arose out of the same transaction, and the fact that the seller left blank spaces in a contract for Midwest to complete, are items that suggest a close connection between the financier and seller in the case before it.
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ous accounts receivable or promissory note purchases by a
given financier from a given seller;\(^\text{16}\) if the financier's name
appeared on the promissory note at the time it was executed
by a buyer; if the financier has inquired into the buyer's credit
rating;\(^\text{17}\) or if the commercial paper was assigned to the finan-
cier on the day it was executed by the buyer.\(^\text{18}\)

The sweep of the close connection rule as announced by the
Court will obviously include a vast percentage of all trans-
actions in which a seller transfers notes and accounts generat-
ed by retail installment sales to his financier. Certainly, once
an arrangement has been entered into between a retailer and a
particular financier calling for the transfer by the retailer of
commercial paper generated by his sales, all future assign-
ments or transfers of such paper between the retailer and finan-
cier will come under the close connection rule. Thus, the
"knowledge" requirement for the application of section
1812.7, will be satisfied in the vast majority of consumer sales.

It is also quite clear that since this portion of the opinion
deals with principles contained in the general law of commer-
cial transactions and negotiable instruments, such as holder-
in-due-course status, the Court has effectively ended the
viability of that concept in the vast bulk of nonconsumer sales
financing transactions.\(^\text{19}\)

Another aspect of the decision that might well be pondered
by the commercial bar is the possible application of the
Morgan close connection rule in third-party financed com-
mercial purchase transactions in which the buyer has signed
an agreement containing a "cutoff" clause. It would appear
that under the reasoning in Morgan, no true "assignment"
takes place when the seller transfers his rights to a "contem-

\(^{16}\) The Court notes this would be a
factor that would "weigh heavily." (69
Cal.2d 881, 896, 78 Cal. Rptr. 398,
408, 447 P.2d 638, 648.)

\(^{17}\) Presumably, prior to the seller
entering into the sales contract.

\(^{18}\) 69 Cal.2d 881, 896, 78 Cal.
Rptr. 398, 408, 447 P.2d 638, 648
(1968).

\(^{19}\) In this connection, it should be
noted that the Commercial Credit Co.
case, on which the Court relies so heav-
ily, involved the financing of a noncon-
sumer sale transaction. (See 34 Cal.2d
766, 767-768, 214 P.2d 818, 819-820
(1950).)
plated” third-party financier, because, in that situation, the seller is merely the agent of the financier. Thus, the scope of section 9206(1), and the validation of cutoff clauses contained therein, may well be restricted to those assignments of contracts or accounts by commercial sellers to financiers who were not contemplated as assignees by the seller at the time of the sale. While section 9206(1) is, pursuant to its terms, subject only to statutes that negate cutoff clauses in consumer goods purchases, the restrictive effect of the Morgan decision on the section’s scope predicted in this article does not contradict the wording of the section or the intent of the legislature in passing it. The section specifically makes cutoff clauses enforceable by any assignee “. . . who takes his assignment for value, in good faith and without notice of a claim or defense. . . .”—under the Morgan reasoning, the financier, as the principal, has “notice” of claims or defenses to the same extent as his “agent,” the seller. Thus, the specific wording of the section does not conflict with an application of the Morgan precedent in situations involving cutoff clauses and commercial sales transactions. Furthermore, the legislative history, which is extensively noted in the California Code Comment, discloses that the intention of the legislature in passing the section was to overrule the decision in American National Bank of San Francisco v. A. G. Sommerville, Inc.,20 which held cutoff clauses to be invalid as a matter of law. The legislature did not, as far as can be determined, consider the close connection rule, as originally stated in Commercial Credit, as being affected by the passage of section 9206(1).1

One can argue with the statement in the Morgan decision that the Court is merely specifying the standards and clarifying the bases for the rule that it previously announced in the Commercial Credit in 1950. In Commercial Credit, the court went to some pains to specify the application of the close connection rule in terms specifically related to the facts before it.2 The

focus of the Court's opinion in that case was a transaction in which the financier "actively participated," and this feature of the transaction was stressed in the Court's decision. It would appear that "active participation" is a far different test for the application of the close connection rule than that announced in *Morgan v. Reasor*, i.e., did the seller "contemplate" that the note or account involved in the transaction would be transferred to a particular financier? Furthermore, by making it clear that the close connection rule, resting on an agency theory, will apply in cases involving issues other than the alleged holder in due course status of a third-party financier, the Court again goes well beyond its previous decision in *Commercial Credit*. Whether adequately based in precedent or not, the close connection rule as enunciated in *Morgan v. Reasor Corp.* will, it is safe to say, be of lasting and major importance to commercial lawyers in the State of California.

"When a finance company actively participates in a transaction of this type from its inception, counseling and aiding the future vendor-payee, it cannot be regarded as a holder in due course of a note given in the transaction and the defense of failure of consideration may properly be maintained."