NOTES

PROTECTION OF BORROWERS IN DISTRIBUTION FINANCE*

GOVERNMENTS have long attempted to shield the borrowing public from exploitation by lenders. Usury statutes in all states impose ceilings on interest rates for loans of money.[1] But borrowers in similar credit transactions are often left without protection.[2] Financing distribution of consumers' durables,

*Klett v. Security Acceptance Co., 223 P.2d 299 (Cal. App. 1950).

1. "Usury is characteristically defined as a loan or forbearance of money or something circulating as money, repayable absolutely with an exaction in excess of interest allowed by law, and made with an unlawful intent." Horack, *A Survey of the General Usury Laws,* 8 LAW & CONTEMP. PROB. 36, 39 (1941). Interest rate limitations are imposed because "[u]sury laws have recognized that he who is under economic necessity is not really free. To put no restriction on the freedom of contract would logically lead not to a maximum of individual liberty but to contracts of slavery, into which, experience shows, men will 'voluntarily' enter under economic pressure." Cohen, *The Basis of Contract,* 46 HARV. L. REV. 553, 587 (1933). See further RYAN, USURY AND USURY LAWS 14 (1924).

Maximum permissible interest rates have varied from zero in biblical times and the Middle Ages to infinity in the "commercial" 19th century. See generally RYAN, *supra;* Berger, *Usury in Instalment Sales,* 2 LAW & CONTEMP. PROB. 148 (1935). The American tradition of usury controls originated in England with 37 HENRY 8, c. 9 (1545), and 12 ANNE, c. 16 (1714). See GALLERT, HILLBORN & MAY, SMALL LOAN LEGISLATION 11 (1932); Horack, *supra,* at 37. Today every state limits interest charges on money judgments, matured obligations, and loan contracts where parties have not agreed upon specific rates to 5%-8% per year, with 6% most common. However, most states permit higher interest rates when expressly contracted for by the parties. Rhode Islands allows up to 30%. Parties may contract without limits in Colorado, Maine, Massachusetts, and New Hampshire. See generally Horack, *supra,* at 48-53 and statutes and cases there cited; WORLD ALMANAC 693 (1951).

For a summary of the remedies and penalties provided by these statutes, see Horack, *supra.* For the elements of usury, see DEXTER, CALIFORNIA USURY LAW 10-16 (1930). For comprehensive bibliographies consult BARRETT & ULRICH, ON REGULATION OF CONSUMER INSTALLMENT LENDING AND ON USURY LAWS (1948); HUBACHEK, ANNOTATIONS ON SMALL LOAN LAWS (1938).

2. Common law courts labeled certain transactions "sales" rather than "loans" to circumvent usury statutes that might have inhibited expansion of commercial credit. See Ecker, *Commentary on "Usury in Installment Sales",* 2 LAW & CONTEMP. PROB. 173, 174 (1935). Thus profits from sales on time were distinguished from interest on money loans. Freedom of contract was invoked to give "sellers" unrestricted rights to name their own price for property sold on credit. Berger, *supra* note 1, at 149.

This distinction mainly benefits installment "sellers." They are exempt whether operating under "conditional sales contracts", see Note, 48 YALE L.J. 1102 (1939), EAGER, CHATTEL MORTGAGES AND CONDITIONAL SALES § 315 (1941 and Supp.), or under "purchase" money mortgages. *Id.* at § 64-a. Their profits escape usury controls, whether taken by the original parties, Whiting v. Mill Engineering & Supply Co., 106 F.2d 473 (6th Cir. 1939), or by a financier who "purchases" the paper evidencing the original a billion dollar credit flow,[3] is generally exempt from usury limits.[4] Consequently, borrowing retailers and consumers may have no legal safeguards where sales finance companies[5] impose exorbitant charges.

"credit sale," General Motors Acceptance Corp. v. Weinrich, 218 Mo. App. 68, 262 S.W. 425 (1924). In other cases the distinction between "purchases" and "loans" permits unlimited profits to the buyer of commercial paper while curbing the original creditor's profit under the usury statute. Valley Mortgage Co. v. Patterson, 30 Ala. App. 492, 8 So.2d 213 (1942). See Horack, *supra* note 1, at 42-3.

The consequences of the verbalistic loan-sale distinction are often absurd. See Failing v. National Bond & Investment Corp., 168 Misc. 617, 621, 6 N.Y.S.2d 67, 71 (City Ct. 1938) noted, 48 YALE L.J. 1102 (1939): "If it is the needy individual whose protection usury laws are enacted to guard, is the need of him who borrows that he may buy for cash, greater than he who purchases on credit?"

Courts occasionally pierce the labels and employ usury controls to avoid unjust results. See, *e.g.*, People v. Silverberg, 33 N.Y. Crim. Rep. 46, 160 N.Y. Supp. 727 (Ct. Sp. Sess. 1915) (conditional "sale" of a $180 diamond ring for $295 held usurious as disguised loan of money at illegal interest). Even where the parties have used all the trappings of a "conditional sale" contract, courts have searched underneath legal form for an illegal intent to evade usury statutes. Benton v. Sun Industries, 277 App. Div. 46, 97 N.Y.S.2d 736 (1st Dep't 1950); Nazarium v. Lincoln Finance Corp., 78 A.2d 7 (R.I. 1951). See generally EAGER, *op. cit. supra*, § 315; DEXTER, *op. cit. supra*, note 1 at 14-15.

Nevertheless the exception from usury statutes for goods sold on credit continues the most popular method of avoiding usury statutes, Collins, *Evasion and Avoidance of Usury Statutes*, 8 LAW & CONTEMP. PROB. 54, 58 (1941), in the teeth of proof that usury statutes were designed to protect all seekers of credit regardless of form, Berger, *supra* note 1, at 170-1, and despite the economic unreality of any distinction between loans and sales. See Note, 39 YALE L.J. 408, 412 n.25 (1930).

3. At the end of August 1949, the total value of installment sales contracts assigned by retailers to finance companies for automobiles alone reached $2,700,000,000. Address by Thomas W. Rogers, Executive Vice President of the American Finance Conference, at Notre Dame University, Nov. 28, 1949, copy on file in Yale Law Library.

4. See note 15 *infra*. Transactions in which consumers and retailers obtain credit—*i.e.*, conditional sales contracts and trust receipt agreements—are generally classified as "sales" rather than "loans". See note 2 *supra*.

5. Approximately 1,400 finance companies operate in the United States. Moss, *Sales Finance Company Operations in 1947*, 34 FED. RES. BULL. 781 (1948). As a group they serve an important economic function. "By purchasing from dealers installment contracts arising from sales of automobiles and other durable goods, the sales finance group extends credit indirectly to consumers through retailers; by financing transactions at the wholesale level, it constitutes a link between manufacturers and retailers; and by obtaining working funds very largely from commercial banks, it serves as an intermediary between the banking system and the ultimate users of credit." *Ibid.* The finance companies have often been affiliated with manufacturers. See FTC, REPORT ON MOTOR VEHICLE INDUSTRY 921-2 (1939); United States v. General Motors Corp., 121 F.2d 376 (7th Cir. 1941). They operate with funds derived from capital stock and surplus, sales of bonds and debentures, and loans obtained from commercial banks by pledging masses of "purchased" installment contracts. FTC, REPORT ON MOTOR VEHICLE INDUSTRY 945-6 (1939). The industry is highly concentrated. Three finance companies at one time held over half of the industry's capital and did three-fourths of the total business. Cavers, *The Consumer's Stake in the Finance Company Code Controversy*, 2 LAW & CONTEMP. PROB. 200, 201-2 (1935). The largest companies hold over

In *Klett v. Security Acceptance Co.*,[6] however, a court held that usury statutes might control distribution finance charges. A retailer had ordered furniture from the manufacturer, and a finance company put up 90% of the invoice price. In return, the retailer agreed to pay a monthly "flooring"[7] charge of 1% of the money advanced. And to guard against the retailer's insolvency, the company required him to execute trust receipts[8] covering the goods. As a result, the retailer held the goods "in trust" for purpose of sale, while the finance company could repossess without legal process upon his failure to pay the flooring charge.[9] When the retailer defaulted, the

$10,000,000 in receivables. Moss, *supra*, at 785. For the view that the operations of sales finance companies have generally been free from abusive practices, see Myerson, *Practical Aspects of Some Legal Problems of Sales Finance Companies*, 2 LAW & CONTEMP. PROB. 244, 252-3 (1935); Ecker, *supra* note 2, at 182.

6. 223 P.2d 299 (Cal. App. 1950).

7. "Flooring" is the trade name for supplying wholesale finance assistance to retailers. It enables retailers to purchase inventory on credit, where suppliers do not extend credit directly. Finance companies buy the goods and place, or "floor", them in the retailer's store. The "floor plan" or "flooring contract" fixes the terms of the agreement and the rights of the parties. See generally, FTC, REPORT ON DISTRIBUTION METHODS AND COSTS, PART IV, 93-6 (1944); FTC, REPORT ON MOTOR VEHICLE INDUSTRY 787, 921-3 (1939); United States v. General Motors Corp., 121 F.2d 376, 389-90 (7th Cir. 1941); Oil City Motor Co. v. C.I.T. Corp., 76 F.2d 589 (10th Cir. 1935), noted, 35 COL. L. REV. 1322 (1935); People v. Van Wyke, 91 Cal. App. 2d 839, 206 P.2d 53 (1949); Commercial Credit Co. v. Barney Motor Co., 10 Cal. 2d 718, 76 P.2d 1181 (1938).

8. "[W]henever anyone *who is not a consumer* needs *temporary possession* of goods or securities theretofore in the hands of a financier who holds security interest in them, the trust receipt or some instrument like it is being used and needs to be used." MCGOWAN, TRUST RECEIPTS 9 (1947). The trust receipt device was first used by banks to finance imports without becoming involved in domestic selling. While the importer received "possession", the bank retained legal title to give it top-priority in the event of the importer's insolvency. See Gilmore, *Chattel Security II*, 57 YALE L.J. 761-2 (1948); MCGOWAN, *supra*, at 9-14.

The security afforded by trust receipts made possible finance of mass automobile distribution. Finance companies bought "legal title" from manufacturers and "floored" the automobiles with retailers. Manufacturers thus obtained working funds immediately, and retailers received expensive cars on credit. See FTC, REPORT ON MOTOR VEHICLE INDUSTRY 108-9, 920-1 (1939). In the credit distribution of other expensive goods and manufacturers' incoming stock the device has proved equally successful. Gilmore, *supra*, at 765; FTC, REPORT ON MOTOR VEHICLE INDUSTRY 946 (1939). See Dunham, *Inventory and Accounts Receivable Financing*, 62 HARV. L. REV. 588-9 (1949). Another advantage of trust receipts over chattel mortgages or other security devices is the liberality of recording requirements. See Hanna, *Trust Receipts*, 19 CALIF. L. REV. 257, 273 (1931); General Motors Acceptance Corp. v. Berry, 86 N.H. 280, 167 A. 553 (1933). See further EAGER, *op. cit. supra* note 2, § 647; FTC, REPORT ON DISTRIBUTION METHODS AND COSTS 95-6 (1944).

9. Klett v. Security Acceptance Co., 223 P.2d 299, 300 (Cal. App. 1950). "[T]he entruster [financier] shall be entitled as against the trustee [retailer] to possession of the goods, documents, or instruments on default . . . without legal process, whenever that is possible without breach of the peace." UNIFORM TRUST RECEIPTS ACT § 6. The

company simply carted the furniture away. Claiming the flooring charge to be usurious 12% annual interest, the retailer sued to recover the goods and statutory penalties. A trial court instruction that a trust receipt transaction could not be a loan of money under the usury statute was reversed on appeal,[10] thus inviting extension of usury statutes to distribution finance.

But the *Klett* ruling covers only half of the distribution finance problem. Retailer credit arrangements, such as the *Klett* court brought within the range of usury controls, are but one phase in financing the flow of goods from factory to consumer. At least two borrowers are involved: the retailer, who needs credit to get inventory into his store,[11] and the consumer, who

financier may then give notice of intent to sell the goods repossessed, proceeds of the sale to satisfy the retailer's indebtedness. *Ibid.* On the entruster's absolute power of repossession upon default of the trustee, see McGowan, *op. cit. supra* note 8, at 88; Bogert, Cases and Materials on the Law of Sales 283-4 n.2 (2d ed. 1947). The Uniform Trust Receipts Act has been adopted, with some variation, by the leading commercial states. See Gilmore, *supra* note 8, at 765 n.12; Bogert, *op. cit. supra*, at 883 n.1.

10. Klett v. Security Acceptance Co., 223 P.2d 299, 303-4 (Cal. App. 1950). Under orthodox common law trust receipt doctrines, there could not have been a loan of money to the retailer. A "trust receipt" was valid to secure the entruster's interest against claims of other creditors only if he obtained his interest in the goods from a third party. This required the finance company to send money to the factory directly, and did not permit its lending funds to the retailer to enable him to buy direct from the factory. But under the Uniform Trust Receipts Act, a trust receipt is valid for security purposes whether "title" comes to the financier from manufacturer or retailer. See Gilmore, *supra* note 8, at 763; Eager, *op. cit. supra* note 2, § 632; U.T.R.A. § 2. As a result, the statutory or "liberalized" form of trust receipt may or may not involve a loan of money, depending on whether retailer or manufacturer initially gets the financier's money.

In the following states that have adopted the Uniform Trust Receipts Act, trust receipt transactions may involve loans: Arizona, California, Connecticut, Illinois, Indiana, and Oregon. In other states, a retailer who buys directly from the factory must obtain working capital by chattel mortgage rather than trust receipt. Communication to the Yale Law Journal from X Sales Finance Company, on file in the Yale Law Library.

The appellate court might also have reversed upon the ground that the usury statute invoked by plaintiff specifically exempts "flooring contracts" from its provisions. Calif. Pers. Prop. Brokers Act, 2 Deering's Gen. Laws, Act 5825 (2d), §§ 3, 4 (Supp. 1949). But the Act does not define "flooring contracts" and the court avoided having to do so by reversing on the ground of error in the trial court's instruction. Klett v. Security Acceptance Co., 223 P.2d 299, 303 (Cal. App. 1950). See letter from defendant's attorney on file in Yale Law Library.

11. Since sales on time tie up working capital in installment accounts, the retailer's turnover would be stymied were investments in installment contracts not freed by external financing. See FTC, Report on Motor Vehicle Industry 920-1 (1939). The contracts are generally "sold" to finance companies rather than commercial banks because retailers require credit for longer periods than the ordinary commercial banks can or will extend. See FTC, Report on Distribution Methods and Costs 94 (1944). As much as 90% of sales financed by the companies were in the automobile retail field. Cavers, *supra* note 5, at 201. However post-war competition in retail automobile financing is intensified. Commercial banks now acquire retail paper directly. Moreover, many retailers have improved their financial position so that they can carry more of their own paper. See Moss, *supra* note 5, at 782.

buys the goods on time. Finance companies supply the funds for both.[12] Typically, a company not only extends inventory credit to the retailer, but also takes up his installment contracts with consumers.[13]

Financing consumers' installment buying, long beyond the reach of usury statutes,[14] is the finance companies' bonanza.[15] They vie for this lucrative

12. "[T]he arrangement of greatest convenience is that in which the same finance company finances both the distributor's motor-vehicle 'floor plan' purchases and his installment sales. Opportunities to becloud titles are eliminated; and proceeds of installment contracts can be applied to liquidation of the distributor's indebtedness on wholesale account." FTC, REPORT ON MOTOR VEHICLE INDUSTRY, 925 (1939).

Sales finance companies typically derive income from three sources. First is the "flooring charge," or interest charged for wholesale finance. See note 7 *supra*. But this makes up a relatively insignificant part of their total returns. See note 17 *infra*. Second, the companies profit from financing consumers' retail purchases on time to the extent that they do not share these profits with retailers. See notes 15 and 16 *infra*. Finally, finance companies operate a booming business insuring goods for consumers who buy on time. See generally Moss, *supra* note 5, at 785; FTC, REPORT ON MOTOR VEHICLE INDUSTRY 946 (1939). The insurance business may be the most profitable source of their income. *Id.* at 926. The finance companies violently opposed proposed legislation that would require a separate statement of the insurance charge for the benefit of installment buyers. See Gilmore, *The Secured Transactions Article of the Commercial Code,* 16 LAW & CONTEMP. PROB. 27, 37-8 (1951).

13. Inventory finance is big business. In the month of September 1950, 124 finance companies financed almost $492 million of inventory for automobile distributors and over $15 million for retailers of other consumers goods (furniture, radios, pianos, refrigerators, etc.). REPORT OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM ON SALES FINANCE COMPANIES, Nov. 15, 1950.

But inventory financing, despite its volume, represents a small percentage of the companies' total business. Generally the larger finance companies hold a greater proportion of their receivables in the form of wholesale paper. But in 1947 even the largest held only 18.1% of their receivables in this form. A remaining 68.1% consisted of retail installment paper "purchased" from retailers. Moss, *supra* note 5, at 785. On retail installment sales financing generally, see FTC REPORT ON DISTRIBUTION METHODS AND COSTS 96-100 (1944).

14. See note 2 *supra*.

15. "[F]inancing institutions rely almost completely for their profit upon the retail time sale transactions they buy." Communication to the YALE LAW JOURNAL from X Sales Finance Company, in Yale Law Library. See note 17 *infra;* Dunham, *supra* note 8, at 606. The carrying charge for the time-sale of an automobile at one time reached an equivalent interest rate of 132.15% per annum. See FTC, REPORT ON MOTOR VEHICLE INDUSTRY 1065 (1939). See also Gilbert v. Hudgens, 92 Colo. 571, 22 P.2d 858 (1933) (35.6%). Carrying charges have run as high as 106.1% on auto tires, 93.3% on radios, 103.7% on men's suits, and 51.8% on refrigerators. Berger, *supra* note 1, at 150 n.17. Most of these charges, however, were added by the retailer for his own benefit, the dealer's "pack." In 1936, carrying charges on automobile time-sales averaged 11½% per annum on the monthly unpaid balance of the cash purchase price. FTC, *supra,* at 1064. Some of this profit was rebated to the retailer by the finance companies. See note 16 *infra*. But even after allowing for this rebate and for less profitable inventory financing, see note 17 *infra,* in 1936 the companies' average rate of net profit reached 9.44% of total capital employed. *Id.* at 947.

trade with special inducements to retailers. A "kickback" often gives the retailer a slice of their profits from installment sales finance.[16] And low-cost inventory finance under trust receipts further attracts the retailer to the finance company.[17] Inventory credit ensures his flexible operations through

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Finance companies often make the carrying charge look smaller than it really is. Installment buyers are told that they pay the reasonable interest rate of 6% per year. But this is not "simple" or "true" annual interest, because it is computed as though the entire principal were outstanding during the life of the installment contract. If computed on unpaid balances, the 6% "discounted" carrying charge amounts to a simple interest rate of 11-12%. On the other hand, wholesale finance "flooring" charges represent simple interest. See note 17 *infra.*

Finance companies are not the only lenders gilding their rates of return by quoting maximum rates as though the entire principal were always outstanding. For the view that half the banks' personal loan departments openly mock usury statutes in this manner, see Collins, *Evasion and Avoidance of Usury Laws,* 8 LAW & CONTEMP. PROB. 54, 56 (1941).

16. The practice of "cutting in" retailers on carrying charge profits developed as a compensatory device for retailers who had to repurchase worthless conditional sales contracts when their customer defaulted. But the rebate (known as a "dealer's loss reserve" or "participation in the carrying charge") grew to twice the amount that would compensate retailers for this recourse liability. No longer indemnity but "gravy", generous rebates competitively wooed retailers' business. United States v. General Motors Corp. 121 F.2d 376, 391 (7th Cir. 1941): "Out of [a] $30 finance charge, $6 would be set aside as dealer's reserve." And see generally FTC, *op. cit. supra* note 15, at 925.

Similar inducements are (1) the "dealer's bonus," where rebates are given although recourse liability against the retailer is waived; (2) the "dealer's pack," or "special reserve," where the retailer simply adds to the carrying charge an arbitrary amount figured from rate charts furnished by the finance company. See, generally, *id.* at 932, 1023, 1052; Cavers, *supra* note 5, at 202-10.

17. "Generally floor plan financing provides little profit. All finance companies offer floor plan facilities as a service and an inducement to the dealer to sell his retail time-sale paper to the financing institution. . . . Competition is the chief limitation upon floor plan charges. . . ." Communication to the YALE LAW JOURNAL from X Sales Finance Company, in Yale Law Library. To keep wholesale finance charges attractively low, manufacturers even have subsidized affiliated or subsidiary finance companies. See Cavers, *supra* note 5, at 215-16; FTC, *op. cit. supra* note 15, at 817. This practice has been outlawed as impeding competition by state Retail Installment Sales Acts. See, *e.g.,* Ind. Stat. Ann. § 58-924 (Burns 1943). See note 26 *infra.*

At present one of the largest finance companies charges $1.50 per car and an interest rate of 4%. Communication to the YALE LAW JOURNAL from Y Sales Finance Company, on file in the Yale Law Library. Since the retailer repays the loan in a lump sum when he sells the car for cash, this flooring charge figure of 4% does not conceal interest actually higher. Compare note 15 *supra.*

However low cost inventory financing alone may not be enough to insure retailers' cooperation in assigning conditional sales contracts. Consequently many finance companies attempt to force the retailer to "sell" his retail paper to them as a condition of inventory credit. See Dunham, *supra* note 8, at 606-7. These "tie-in agreements" may be illegal under antitrust laws. *Id.* at 607 n.38.

greater financial liquidity [18] and permits him to shift in part the risks of business failure.[19] But for the finance company, credit to the retailer is only the means to an end—tapping the profits from consumer credit by financing later installment sales.

For that reason, policing finance companies' rates on retailer credit alone may still leave the consumer unprotected.[20] Rarely are inventory finance charges above usury limits.[21] Rate restrictions, therefore, can not substantially lower the retailer's cost of business or cut into the finance company's profits. In any event, whatever the retailer gains from lower rates the finance company can readily take away by reducing its kickbacks to him.[22] Consequently the *Klett* ruling can tamper with the process of sharing sales profits but cannot control the size of the shares. And no matter how finance company and retailer

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18. Only rare retailers can pay cash for expensive consumers durables inventory. See FTC, REPORT ON DISTRIBUTION METHODS AND COSTS 94 (1944). Customarily they use trust receipt financing and furnish only 10% of the required capital independently. See FTC, REPORT ON MOTOR VEHICLE INDUSTRY 921 (1939). Finance companies put up the rest after trust receipts have insulated the merchandise from other creditors' claims. See note 8 *supra*. This procedure was followed in the *Klett* case. Klett v. Security Acceptance Co., 223 P.2d 299, 300-1 (Cal. App. 1950). Even the retailer's "equity" in goods floored under trust receipts still unsold is subject to the finance company's claims on goods already sold to consumers. See Dunham, *supra* note 8, at 603-4.

19. Since business can be carried on largely with the finance company's money, the retailer is not forced to bear the entire risk of failure in the highly competitive field of mass distribution. Assistance from finance companies diminishes the risk of failure particularly in the auto retailing field. Without outside sources of capital, the dealer's frozen funds melt away in rapidly depreciating used cars. See FTC, REPORT ON DISTRIBUTION METHODS AND COSTS 94 (1944).

20. The retailer generally does not need protection. His bargaining position is strengthened by the fact that he can offer his lucrative refinancing of installment sales to the finance company that extends the lowest rates for inventory credit or the largest rebate from installment sales profits. But the credit purchaser, seriously needing the goods he buys on time and generally from a low income bracket, is fair game for exploitation.

21. See note 17 *supra*. Retailers have argued that, even though the flooring charge alone stays within usury limits, the combination of flooring and carrying charges violates the usury statutes where finance companies require assignment of retail paper as a condition to wholesale finance. *Ibid.* But this argument has been rejected on the ground that, whatever the total rate of the two charges, trust receipt financing is an unregulated "sale of credit" rather than a "loan of money" subject to usury limits. Oil City Motor Co. v. C.I.T. Corp., 76 F.2d 589 (10th Cir. 1935), noted, 35 COL. L. REV. 1322 (1935). But see note 29 *infra*.

22. The finance companies could also compensate for losses on wholesale financing by raising carrying charges to consumers. See Cavers, *supra* note 5, at 212 n.55: "Unduly low wholesale rates must be reflected in higher retail rates." And factory-owned or affiliated finance companies can get higher subsidies, if not held unlawful. See note 17 *supra*. But subsidies, added to factory prices, would hit consumers as hard as higher retail finance rates. Cash rather than credit consumers would foot the bill. See Cavers, *supra* note 5, at 215-16.

slice up the total profit, the consumer, unprotected by statute, may continue to pay the same high charges.[23]

Even if usury statutes were extended to cover the entire process of distribution finance, they might not prove the most satisfactory method of control. A rigid and uniform ceiling on credit charges was found inadequate even for simple money loans.[24] To encourage small loans by legitimate lenders, statutes permitted higher rates to compensate for smaller volume and greater risk.[25]

23. Competition among finance companies offering attractive rebates to retailers does not benefit the consumer. In fact, "with the introduction of the dealer reserve and the retaliatory bonus [see note 16 *supra*], the trend toward lower finance charges which had been in process theretofore came to an end and thereafter . . . economies in financing operations were reflected, not in lower finance charges to the car purchaser, but in larger payments by the finance companies to the dealer." Cavers, *supra* note 5, at 211.

24. Usury ceilings were so low that legitimate credit institutions lent only in large amounts to established customers. Greater collection and accounting costs and increased risk of default made small loans at ceiling rates unprofitable. See REPORT OF THE VIRGINIA ADVISORY LEGISLATIVE COUNCIL ON SMALL LOANS, SEN. DOC. No. 4, 13 (1943); GALLERT, HILLBORN, & MAY, *op. cit. supra* note 1, at 11-12. As a result, usury statutes often drove small borrowers to loan sharks. Illegal rates grew more oppressive by reason of their illegality. Money-lenders added extra charges to cover "added risk and social stigmata that attach to an illegal undertaking." *Id.* at 12; Horack, *supra* note 1, at 44. See further Nugent, *The Loan-Shark Problem,* 8 LAW & CONTEMP. PROB. 3 (1941); Ewart, *California Leads the Way in Small Loan Legislation,* 20 So. CALIF. L. REV. 172 (1947).

Aside from licensees under small loan acts discussed at note 25 *infra,* usury statutes permit pawnbrokers, credit unions, personal loan departments of banks, and building and loan associations to charge more than the statutory interest ceiling. See, generally, Neifeld, *Institutional Organization of Consumer Credit,* 8 LAW & CONTEMP. PROB. 23 (1941); Collins, *supra* note 15, at 61-2; WORLD ALMANAC 693 (1951). They also exempt certain transactions. See, *e.g.,* CALIF. PERS. PROP. BROKERS ACT, 2 Deering's Gen. Laws, Act 5825 (2d), §§ 3, 4 (Supp. 1949) (conditional sale contracts, "flooring contracts"; see note 10 *supra*); COLO. STAT. ANN., c. 88, § 23(b), (Supp. 1950) ("commercial loans made to dealers upon personal property held for resale.")

25. To facilitate legitimate loans, most states enacted small loan statutes permitting higher rates. All except Kansas, Missouri, Montana, North Dakota, South Carolina, and South Dakota have small loan statutes. Ten jurisdictions (Alabama, Arkansas, Delaware, Georgia, Mississippi, North Carolina, Tennessee, Wyoming, and the District of Columbia) have inoperative small loan acts. See Hubachek, *The Development of Regulatory Small Loan Laws,* 8 LAW & CONTEMP. PROB. 108, 123-5, 134-6 (1941); Foster, *The Personal Finance Business under Regulation,* 8 LAW & CONTEMP. PROB. 154, 156-68 (1941); WATMAN, INSURANCE COVERAGE UNDER SMALL LOAN LAWS (1949). In states without legislation or with dead-letter acts, loans can be made only within usury statute limits. *Ibid;* note 1 *supra.* For the history of small loan legislation, see Hubachek, *supra;* GALLERT, HILLBORN & MAY, *op. cit. supra* note 1. See further Bogert, *The Future of Small Loan Legislation,* 12 U. OF CHI. L. REV. 1 (1944); Kelso, *Social and Economic Background of the Small Loan Problem,* 8 LAW & CONTEMP. PROB. 14 (1941); HUBACHEK, *op. cit. supra* note 1.

The statutes typically require lenders to secure licenses and post bonds and impose other administrative controls. *Id.* at 34-65. Loans of up to $300 usually qualify for small loan rates. For the contention that this limit is unduly low, see Ewart, *supra* note 24, at 207.

Obviously, iron-clad interest rate limits are even less adaptable to complex modern credit transactions.

Curbs on distribution finance abuses [26] must not dry up the flow of goods to installment buyers.[27] Adequate protection of both the flow and the borrowers demands a flexibly administered system of adaptable controls.[28] Rigid statutes

Setting maximum rates to protect borrowers must take account of conflicting considerations. Rates must at the same time be high enough to attract honest lenders and low enough to make usury statutes meaningful as a socially desirable control. Foster, *supra* at 169. In practice, ceiling rates under small loan acts are graduated to permit higher rates for smaller loans, because (1) a flat ceiling might concentrate licensed lenders in more profitable larger loans, abandoning small loans to the loanshark; (2) small loans are costlier to administer, and a flat ceiling would penalize the larger borrower. "While it may not be socially desirable that very small loans bear their full share of operating costs, it has seemed proper to provide a less inequitable distribution of these costs than was possible under a flat maximum rate." Uniform Small Loan Law (draft 6), Explanatory Note 14, quoted in Hubachek, *The Development of Regulatory Small Loan Laws,* 8 LAW & CONTEMP. PROB. 108, 145 (1941).

26. Thirteen states have enacted statutes to regulate abuses in consumer financing. See Gilmore, *The Secured Transactions Article of the Commercial Code,* 16 LAW & CONTEMP. PROB. 27, 37 (1951). For the most part these are "disclosure statutes," requiring retailers to inform consumers of the elements that go into the time price. *Ibid.* See also Donaldson, *An Analysis of Retail Installment Sales Legislation,* 19 ROCKY MT. L. REV. 135 (1947). Similarly the Federal Trade Commission now requires itemization of costs in the installment sale of automobiles. FTC Trade Practice Conference Rules, 16 FED. REG. 1059 (1951). One draft of the proposed Commercial Code, strongly opposed by finance companies, note 12 *supra,* required explicit itemization of cash price, carrying charge, amount of down payment and an estimate of insurance charges. UNIFORM COMMERCIAL CODE § 9-205 (September 1950 Revision).

But the disclosure type of statute may not be enough to protect the consumer. "[T]he only workable solution is the establishment of state administrative agencies with licensing and rule-making powers, with funds sufficient to allow continuing supervision of consumer financing and with authority to revoke or suspend licenses for violations." Gilmore, *supra* at 45. See generally Donaldson, *supra;* Gilmore, *Chattel Security II,* 57 YALE L.J. 761, 773 (1948); Cavers, *supra* note 5 at 216, n.76.

27. Opportunity to buy expensive but necessary goods on time is vital to the consumer. "[T]he chief advantage is that it enables him to obtain the goods he wants immediately and to use them while he is paying for them out of his income." Evans, *Consumer Credit Regulation in a Garrison Economy,* 36 FED. RES. BULL. 1437 (1950).

The wisdom of installment buying is a subject of controversy both in times of deflation, see Berger, *supra* note 1, at 149 n.6, and inflation, see *Recent Developments in Installment Credit,* 36 FED. RES. BULL. 1427 (1950). For the effects of mass credit buying in reducing the proportion of consumers who do or can save, see *1950 Survey of Consumer Finances,* 36 FED. RES. BULL. 1441, 1445; Isaacs, *Installment Selling: The Relation Between its Development In Modern Business and the Law,* 2 LAW & CONTEMP. PROB. 141, 144 (1935). See generally Greene, *Better Business Bureau Activities in Aid to the Time Purchaser,* 2 LAW & CONTEMP. PROB. 254 (1935); Risk, *Installment Sale Contracts in the Detroit Conciliation Court,* 2 LAW & CONTEMP. PROB. 269 (1935).

28. Applying old usury statutes to time purchases might impose such low interest rates on finance companies that installment sales financing would no longer be profitable for honest companies. See note 24 *supra.* The argument that usury statutes futilely attempt to fix the market rate of interest without regard to factors that influence the

and stray decisions by courts are ill-designed to ensure the consumer's interest. State administrative commissions, alert to market and credit conditions, could effectively supervise both retailer and consumer financing charges and practices.[29] Within the broad framework of national credit policy,[30] coherent state control of all segments of distribution finance [31] can best safeguard borrowers in modern credit transactions.

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market led to repeal of general usury laws in twelve foreign countries and Massachusetts during the 19th Century. See Horack, *supra* note 1, at 38-9. The variability of economic factors determining fair retail installment finance charges may explain opposition of groups concerned with protecting the consumer to finance charges fixed by law in any form. See Ecker, *supra* note 2, at 188.

29. The Indiana Commission might serve as a model. See IND. STAT. ANN. § 58-901 through § 58-934 (Burns 1943). The Indiana Act authorizes the Department of Financial Institutions to enforce its provisions. IND. STAT. ANN. §§ 58-901, 58-925 (Burns 1943). The Act is directed specifically against practices preventing competition that would benefit consumers. See, *e.g.*, §§ 58-922 to 58-924, making illegal coercive tie-in agreements, see note 21 *supra,* and factory subsidies, see note 17 *supra.*

In addition to licensing, suspension, and inspection powers, the Department has extensive rule- and rate-making powers. IND. STAT. ANN. § 58-926 (Burns 1943) authorizes the Department to determine and fix fair maximum finance or carrying charges that may be contracted for in any retail installment contract. The legal limit varies according to the classification of contract, depending upon the amount of the outstanding unpaid purchase price. In Rule 58-926-1, the Department carefully analyzed permissible charges in terms of both true or simple interest on the declining unpaid purchase price. Compare note 15 *supra.*

Pursuant to IND. STAT. ANN. § 58-926 (Burns 1943), the Department promulgated Rule 58-926-1 limiting "Dealer's Participation in Finance Charges" to 2%-5% of the total carrying charge paid by the consumer. See HORACK, 2 INDIANA ADMINISTRATIVE CODE 4403-4 (1941). This marks a sharp curtailment of competitive rebating that mounted as high as 20% of the finance charge, see note 16 *supra.* In addition, Rule 58-926-1 imposes stringent regulation on insurance charges. See notes 12, 26 *supra.*

A possible defect in the Indiana Retail Instalment Sales Act is that it does not empower the Department to regulate inventory finance charges. This would seem to be an unfortunate omission, in view of the close economic relation between wholesale and retail finance costs.

30. See, *e.g.*, *Recent Developments in Installment Credit,* 36 FED. RES. BULL. 1427 (1950) (discussing the effects and history of Regulation W, which sets size and time limits for consumer credit).

31. For persuasive argument that all controls on consumer borrowing, including small loan acts, usury laws and exceptions to usury laws be regulated together with consumer finance under a single statute, see Gilmore, *supra* note 26, at 45; Bogert, *The Future of Small Loan Legislation,* 12 U. OF CHI. L. REV. 1, 25 (1944).