Three Party Credit Card Transactions: Legal Rights And Duties

I. INTRODUCTION: COMMERCIAL REALITY LOOKING FOR A Viable DEFINITION

Today the credit card has become one of the pre-eminent forms of commercial transaction in the United States.¹

A review of statistical information on the present status of the industry is appropriate at this time. Total dollar volume for bank charge card programs in the U.S. in 1969 ... [approached] ... $4 billion compared to about $100,000,000 in 1959 ... Cardholder accounts will number some 24,000,000 at the end of this year compared with about 3,000,000 ten years ago.²

With these massive figures in mind, and with the current and possible future uses of the credit card reasonably within our perceptions, it is staggering to imagine that the rights of the parties involved in these types of transactions have not yet been clearly defined by the

¹In a discussion with a lawyer from the legal department of a prominent California bank, the possibilities of the future use of credit cards were explored. Already, it was determined, the functions of the bank credit card and the normal "checking" account are beginning to merge. The advent of the new check guarantee card allows one to cash a check in almost any commercial establishment. The use of "Instant Cash" procedures allows one to obtain cash from a bank and charge it to one's credit card. Thus, it is becoming increasingly difficult to discern a meaningful difference between the two devices in the context of transacting purchases. Indeed, it does not require the whimsical musings of a back office computer operator or the fantasies of Ray Bradbury to envision the cashless society with all commerce being transacted by credit cards and international systems of computer banks.

courts or legislatures. There have been frequent attempts to categorize the three party credit card agreement as either a letter of credit or a factoring arrangement. This distinction will be pursued and analyzed here in an attempt to put the credit card within the correct legal parameters because substantially different rights accrue to the interested parties depending upon which theory is applicable.

II. THE CREDIT CARD TRANSACTION

A. FOCUS: THREE PARTY CREDIT CARDS

The concern here is not the two party credit card where the issuer is also the seller of the product (e.g., Standard Oil or Macy’s credit cards). Rather we are dealing with a three party transaction where the issuer is, ostensibly, only providing a credit service. The three party

3The Oregon Supreme Court in Union Oil Co. v. Lull 220 Ore. 412, 349 P2d 243 (1960), indicated its predilection toward an assignment principle applicable to the three party credit card relationship. The court states at 349 P2d 252:

If the card is presented at a service station of an associated company with whom plaintiff has an agreement to make reimbursement for sales made through the use of plaintiff’s credit card, then, although the law of agency is not applicable, plaintiff’s right to recover for such sales is, nevertheless, no greater than the right of the dealer who made the sale. It is possible to regard plaintiff as the assignee of the dealer’s claim against the card owner, in which case plaintiff would take the assignment of the claim subject to the infirmities with which it was encumbered in the hands of the dealer—assignor.

However, in the case of United States v. Golden, 166 F. Supp. 799 (S.D. N.Y. 1958) the United States District Court can be interpreted to have stated its recognition of a direct obligation theory in this type transaction. This was a criminal case involving a leased automobile. The question was whether the taking was embezzlement or larceny. The importance of the resolution of this problem was that if it fell under the latter category prosecution under the Dyer Act (18 U.S.C. § 2312) could be sustained. From the court’s statements pertaining to the alternate theories one can infer its predilection for a direct obligation concept. It stated at page 802:

But even if the credit of the Diner’s Club was fraudulently obtained, it does not support a finding that the car obtained on that credit was obtained with intent to deprive the owner of the rights and benefits of ownership.

Had the defendant obtained a loan in cash and paid Hertz, the fact that the loan was obtained by fraud would not sustain a conviction under the act. In my opinion the use of the Diner’s Club card to obtain the Ford car at a time when the card had not expired and when it was still good presents precisely the same situation.

4Some have argued that something more is being offered by the issuing company. In 85 Banking Law Journal 941, 974, Bank Credit Cards And The Uniform Commercial Code by William B. Davenport, the author states: “A bank issuer of credit
credit agreement involves (1) the merchant, (2) the purchaser—cardholder, and (3) the bank-card issuer. The issue of who has what rights and against whom these rights devolve springs from the fact that no one has really declared just what this montage of legal theory represents in common commercial experience. "Indeed, there has been no attempt to formulate a comprehensive legal definition of the exact nature of the tripartite relationship found in the modern credit card transaction." If it is decided that this commercial arrangement represents a letter of credit, then the direct obligation theory is of immediate concern. If, on the other hand, these transactions are viewed in a factoring matrix, one will be forced to approach this problem from the principles of assignment. Yet, no matter in what legal terms one defines the mechanics of this transaction, its day-to-day workings are reasonably simple. The bank or independent credit card company, e.g., American Express or Carte Blanche, issues a credit card to the consumer who either expressly or impliedly agrees, by use of the credit card, to abide by certain rules and contractual obligations. The bank or independent credit card company also arranges by contract for numerous merchants to accept the credit card and discount the drafts resulting from sales made on the credit card with the respective bank or card issuing company. The third party in the arrangement is the consumer who obtains goods and/or services from cards must, and most do, also recognize that its cardholders regard it as an institution of esteem and good reputation and, therefore, reasonably believe and expect that it will not knowingly enlist as merchant members of a credit card plan organizations not of reputable character."


Either approach leads to the impression that legal technicians are allowing the symmetry of legal form to take precedence over the practicality of commercial substance.

The question of unconscionability aside, the holder—consumer and Bank of America—issuer agreement provides that the "holder agrees (1) to assume responsibility for credit extended by Bank of America . . . on the basis of the BANKAMERICAN; (2) to pay . . . obligations evidencing such credit, and finance charges where applicable . . . including a reasonable attorney's fee in the event of suit; (3) to notify Bank promptly in writing of loss of . . . [card] . . . (6) to waive and release Bank from all defenses, rights and claims holder may have against any merchant of company honoring the BANKAMERICAN . . . ." Bank of America, California, APPLICATION FOR BANKAMERICAN, form #TPL. 850 SF 9/70, [hereinafter cited as APPLICATION].

Bank of America, California, FACTS ABOUT BANKAMERICAN, 1970 [hereinafter cited as FACTS]. In this pamphlet at page 3 the bank tells perspective holders what the card has to offer. "Because of its wide variety of merchant members, BankAmericard offers cardholders the opportunity to use their cards in nearly every type of purchase situation, whether it is of a retail, service, travel or entertainment nature." At pages 12 and 13 of the same pamphlet is a list of 178 types of goods and services available by charge on their charge card.
the merchant by offering the credit card as his consideration and promise that payment will be forthcoming. The merchant then discounts the sales draft so obtained to the bank or other issuing company which then (pursuant to its agreement with the consumer) asks the purchaser to pay for what he has charged. Thus, the mercantile circle is complete and the legal maze of the parties' rights is left to be unraveled.

B. BENEFITS DERIVED AND OBLIGATIONS OWED BY THE THREE PARTIES

The credit card is perhaps best described as laminated cash. It permits the holder to be relieved of the necessity of carrying large sums of money and makes his personal bookkeeping a more manageable task. The card also allows the holder to purchase, presently, numerous items with wealth represented by earnings or savings not now liquid or within his immediate possession. Rather, it allows him to purchase items with wealth represented by earnings and savings soon to be accrued—hopefully by the time the bill comes due. However, the benefits are not limited to the consumer. The merchant is protected from bad debt problems and assorted bookkeeping expenses; and too, the bank derives substantial income from its credit charges and services.

Of course, it is too simple to consider the charge card as cash in a different form because, as will be discussed below, one will not find the same or as many responsibilities residuary to a cash sale as there

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9This is at best a questionable virtue for it is quite easy for an individual to lose track of his spending; it is all too easy to spend beyond one's means with a credit card. See note 10, infra.

10Apparently things are not working out precisely as planned for many of this country's non-corporate residents. In 1969 alone there were approximately 185,000 bankruptcy cases filed in the United States. U.S. Bureau of the Census, Statistical Abstract of the United States at 485 (91st. ed. 1970).

11FACTS ABOUT BANKAMERICARD, supra note 8, at page 9 states the following: "Credit cards normally collect a discount on their sales from participating merchants. Banks generally charge from one percent to six percent, of the sale price . . . The average is probably three percent or four percent, although some non-bank cards have been known to charge considerably higher percentages." And too, banks charge interest to card holders for allowing them to defer their payments. Though it may vary according to the bank or credit card plan involved, the "finance charge" normally approximates as follows: (1) up to $1,000 outstanding balance bears an interest rate of one and one-half percent per annum, (2) that portion of the outstanding balance between $1,000 and $2,500 bears an interest rate of one percent per annum, and (3) that portion of the outstanding balance above $2,500 bears an interest rate around 9.6% per annum. Also, not to be overlooked, is the frequent requirement that the merchant maintain a commercial checking account in the bank which issues the card he is honoring.
are to a three party credit card charge relationship. In the typical credit arrangement of this type each of the three parties carries heavy burdens even after the initiating sale has been transacted. The buyer has the obligation to transform his promise to pay into actual payment. The seller must take the steps demanded by the bank in order to turn the sales draft into cash, and the bank must discount the draft and collect money due from the purchases.

C. CONFLICTING THEORIES

The different theoretical matrixes which may be applicable can cause the burdens of responsibility to be carried by very different participants. The remainder of this discussion will concern itself with the application of letter of credit and factoring concepts to the hybrid world of the three party credit card. The major question is whether this type of credit card transaction involves a direct obligation theory or an assignment theory, or perhaps, a degree of both approaches.

III. LETTERS OF CREDIT, FACTORING AND CREDIT CARDS: THEIR MECHANICS

A. LETTERS OF CREDIT: MECHANICS

The modern letter of credit developed for the purpose of allowing a merchant to draw a draft on an institution of known solvency rather than on the purchaser of unknown solvency. It was primarily used in foreign commerce. The obvious advantage, and one which continues to make the letter of credit a contemporary instrument of domestic as well as foreign trade, is that the seller can consummate the sale and receive immediate assurance of payment and thus obviate the problem of credit risk. This is done without overburdening the buyer. In almost every commercial sales transaction there are to be found two conflicting interests: (1) the seller's desire for immediate payment, and (2) the buyer's desire to postpone payment as long as possible. To compel the buyer to send cash with the order or to pay cash against shipping documents would often put an impossible burden upon his capital. His desire to postpone actual payment is met when he sends his own note...; however... where the maker is

12B. Kozolchyk, COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS 9 (1966) [hereinafter cited as Kozolchyk].
not known, the paper is not marketable. When the note . . . of a third person, usually a bank, is given, the seller has commercial paper of greater marketability, but, on the other hand, the buyer has had to pay the bank cash for the paper or has had to give security.13

A letter of credit may take one of many forms.14 Essentially, however, it will always provide that a known credit institution will accept and purchase any draft properly drawn on it for the benefit of the buyer. This institution is normally the writer or its correspondent in another domestic or foreign city. This instrument is a major factor in facilitating long distance trade. Assuming the issuer is a well-known and secure institution, it gives the merchant instant assurance of payment, and it frequently gives the merchant instant cash. To obtain his money, the merchant need only take the required documents to the designated institution, and by the promise to pay within the letter, the receivable will be discounted. At the same time the buyer will not have to pay until the time specified in his contract with the institution which wrote his letter of credit.15 Further, by being able to make a purchase on credit which, without this documentary guarantee, normally would not be advanced, the buyer receives the added benefit of having mitigated his cash flow and liquidity concerns. Thus, transactions are facilitated by the letter of credit because the letter’s value lies in its acceptance by all parties concerned as a tool for protecting their respective rights.

The issuer writes the letter of credit upon the behest of the buyer. Pursuant to their contract, the issuer then issues the letter of credit which, when accepted by any merchant or a specified merchant, becomes a binding contract between the bank and this merchant. This second contract is not a supplement to the original issuer-buyer contract; it is, in a legal sense, a separate transaction.

A letter of credit is a promise by a bank to accept or to purchase drafts or to pay cash upon the performance of certain conditions. It is not, therefore, a promise to pay if the buyer does not pay, a promise made collaterally to the buyer’s obligation, as further

13McCurdy, Commercial Letters of Credit, 35 Harv. L. Rev. 539, 541 (1921).
14Id. at 545-563. Among those enumerated in this article are: (1) letters written by the buyer, (2) Authority to purchase drafts, (3) Indirect import letter of credit, and (4) Direct export letter of credit.
15Kozolchyk, supra note 12, at page 200. “. . . [T]he right of reimbursement technically arises at the time of issuance . . . Usually the exact period is fixed by United States banks at a date not later than one business day prior to the maturity of the draft.” This practice is codified in § 5114 (3) of the Uniform Commercial Code which states: “Unless otherwise agreed an issuer which had duly honored a draft or demand for payment is entitled to immediate reimbursement of any payment made under the credit and to be put in effectively available funds not later than one day before maturity of any acceptance made under the credit.”
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security to the seller of the goods. The bank is neither a guarantor nor a surety.\(^{16}\)

On the basis of its letter, the issuer will and must honor all drafts which meet the requirements set forth on the letter's face. This is the only concern of the bank. It must pay on the basis of the letter despite any problems arising on the contract between buyer and seller.

The question between the customer and the vendor is the one whether the goods comply with the contract, and if they do not, the former has his appropriate right of action. The question between the customer and the bank which issues the letter of credit is whether the documents presented with the draft fulfill the specific requirements, and if they do, . . . the bank has the right to pay the draft no matter what may be the defects in the goods which have been shipped. The bank is not obliged to assume the burdens of a controversy between the vendor and vendee.\(^{17}\)

The issuer has no interest in any other coincident contract. Its only obligation is to pay in accordance with the letter of credit it issued. Its only concern is for this contract. If the underlying buyer-seller contract is fraught with problems, those are issues to be worked out by the buyer and the seller. The issuer's business is in the documents not in the underlying contract of sale.\(^{18}\) The issuer also has a binding relationship with the buyer at whose request the letter of credit was issued. In consideration for the bank's issuing a letter of credit and performing the duties pursuant thereto, the buyer promises to reimburse the bank. This obligation arises despite any impediment which may develop by virtue of the underlying buyer-seller contract.

Thus, the letter of credit represents two direct obligations. One such obligation flows from the issuer to the merchant, and a separate and distinct direct obligation flows from the buyer to the bank. Both duties of payment are independent of the sales contract itself and are, therefore, independently enforceable. It is with this theory of direct

\(^{16}\)H. Finkelstein, Legal Aspects Of Commercial Letters Of Credit 32 (1930).


\(^{18}\)Uniform Commercial Code § 5114 (1). “An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary. The issuer is not excused from honor of such a draft or demand by reason of an additional general term that all documents must be satisfactory to the issuer, but an issuer may require that specified documents must be satisfactory to it.” Official comment #1 to this section goes on to explain that “[t]he letter of credit is essentially a contract between the issuer and the beneficiary and is recognized by the Article as independent of the underlying contract between the customer and the beneficiary . . . In view of this independent nature of the letter of credit engagement, the issuer is under a duty to honor the drafts or demands for payment which in fact comply with the terms of the credit without reference to their compliance with the terms of the underlying contract.”
obligation that some have attempted to equate the three party credit card transaction, and there are substantial similarities between these two types of commercial tools. However, it seems an unwarranted and perhaps unrealistic extension to attempt to make the letter of credit, developed to aid trade between participants sophisticated in the ways of business, fit into the modern realities of the household consumer.

B. FACTORING: MECHANICS

. . . A commercial factor does not lend against accounts receivable. He buys them outright, with no recourse to the client. If the account goes bad the factor is the loser—not the [one] . . . whose accounts have been factored. In order to assure this risk the factor must, of course, pass on all credits. He also does his client's accounts receivable bookkeeping, and does the collection. As shipments are made, the client is credited with all but a small reserve which is temporarily set up to absorb returns, allowances for faulty merchandise, and the other contingencies which arise. . . .

As indicated above, the factor provides a substantial number of services. He buys the accounts receivable, thus furnishing immediate cash flow to the merchant. He normally takes accounts without recourse, thus insuring the merchant against bad debts. To protect himself, and as a consequence providing protection for the merchant, he performs extensive credit checks on all the merchant's customers whose accounts the factor is willing to purchase or discount. He bills and collects on the accounts. Indeed,

[W]hen a business concern becomes the client of a factor, it eliminates the credit, collection, and bookkeeping expenses and is protected against bad debts losses. In addition it converts its non-productive accounts receivable to cash.

It is important at this point to recognize that factoring is just one

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20R. A. Freeman, Accounts Receivable Financing, COMM. ON THE CONTINUING EDUCATION OF THE BAR, STATE BAR OF CALIFORNIA, 3 CALIFORNIA COMMERCIAL LAW § 7.4 (1966). "Since factoring gives no right of recourse against the account assignor, the factoring concern assumes the full credit risk of the account debtor's nonpayment, necessitating extensive credit investigation of the account debtors . . . The assignee purchaser of the accounts will want the assignor to warrant that there are no defenses, offsets, or other matters affecting the collectibility of the accounts . . . there is an outright purchase rather than a loan . . ."
21C. Moore, Factoring — A Unique and Important Form of Financing and Service, 14 BUSINESS LAWYER 703, 708 (1959).
of many ways to finance a business. It is, much like a loan, a way of increasing cash flow. Factoring also provides a convenient means of reducing expenditures which is a slightly more oblique way of increasing cash flow. It is a convenient way of financing sales on short term credit to customers whose credit reliability can be easily assessed.

The rights of the parties under a factoring arrangement are based on an assignment theory. The accounts receivable do not represent negotiable instruments, but they do represent assignments of interests. As such, the factor is liable to any defenses which can be asserted against the merchant from whom the accounts were factored; this is so despite any notice the purchaser of the goods may have of the factor. The import of this, of course, is that if there is a default of some kind by the merchant on the sales contract of which the account receivable is representative, the buyer need not pay the factor if he would not have had to pay the merchant. On the other hand, if the purchaser defaults, although the factor can pursue him to obtain payment, the merchant is freed of any such burden since all his rights have been assigned upon the sale of the account. Thus, he no longer has any standing to sue the purchaser.

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22R. Johnson, Financial Management, 373-374 (1966). "Factoring as opposed to other forms of borrowing, is especially desirable when we need the services that the factor provides. In a highly seasonal business it is frequently uneconomical to maintain a credit department that will work overtime during a portion of the year and loaf the rest of the time. Because a factor serves many different industries he is able to operate more economically without wide seasonal swings in volume of activity. In industries such as the textile trades, the risks of credit loss are fairly high and credit extension takes considerable skill . . . When money is scarce and dear, many concerns turn to factoring and find it a very satisfactory means of financing."

23Uniform Commercial Code § 3104 defines a negotiable instrument as follows: "(1) Any writing to be a negotiable instrument within this division must (a) Be signed by the maker or drawer; and (b) Contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this division; and (c) Be payable on demand or at a definite time; and (d) Be payable to order or to bearer . . ."

24" . . . accounts receivable are purchased under a factoring arrangement on a notification basis . . . Notification is a distinctive feature of factoring . . . The direct contact which is established with each customer through notification permits the factor to obtain the detailed and current information which is essential to the liberal extension of credit and the assumption of any resulting credit losses." 14 Business Lawyer, supra note 21, at 723.

25The essence of the factor’s agreement with the merchant is that he will assume the position of an assignee. Among other things, this means he is subject to all valid defenses against the merchant in favor of the purchaser.

26Of course he really would not want to sue the purchaser. He has already received payment and really has no further interest in the transaction after completing performance of his obligations under the sales contract.
C. THE THREE PARTY CREDIT CARD TRANSACTION: MECHANICS

To the retail buyer is extended the opportunity of buying goods and services from merchants on the credit of the card issuer. . . . The seller, on the other hand, is able to take advantage of services of the card issuer that are similar to those offered by a firm that ‘factors’ or purchases accounts receivable.27

Indeed, the credit card represents a hybrid world of commerce. The issuer takes on responsibilities that, when viewed in total, are neither those solely of a factor nor those solely of an issuer of letters of credit. Yet, many writers have insisted upon viewing them as one or the other. In the final analysis, the credit card is chameleon-like, assuming the permutations of that commercial setting to which he who is viewing the transaction is most accustomed.

From the issuer to the merchant who allows his sales to be charged on the credit card, there flows a bundle of responsibilities and duties. One of these is the maintenance of proper bookkeeping records. A major selling point used by issuers in dealing with merchants is that it will be able to relieve the retailer of many of the costly bookkeeping chores which the issuer can do more efficiently.28 Another duty is represented by the issuer’s promise to buy all of the credit slips representing sales charged on its card.29 As a consequence the merchant need not attend to billing these sales.30 From this relationship naturally arises the corollary guarantee that the drafts will be purchased without recourse, and therefore, the issuer will make all the collections.31

The credit card represents to the retailer an inexpensive way to handle its bookkeeping and increase its cash flow without any collection or bad debts costs. The merchant benefits, because, at least

27Maffly and McDonald 48 Calif. L. Rev., supra note 5, at 465.
28See footnote #48 infra.
29BANKAMERICARD MERCHANT AGREEMENT, #TPI 901 10/70 (REV.), at 17 [hereinafter cited as AGREEMENT]. “Except as heretofore provided, all credit extended pursuant to the terms hereof will be at the sole risk of Bank and other BankAmericard issuers.”
30In fact, the merchant specifically promises not to do any billing. For example, the merchant agrees with Bank of America that the “[b]ank will have sole right to receive payment on Sales Drafts . . . Merchant agrees not to sue or make any collections thereon.” FACTS, Id. at 8.
31AGREEMENT, supra note 29, at clause 10(e). The bank generally guarantees to buy all drafts and assume full risk thereon. This clause allows the bank to sell back certain drafts representing sales in which “the cardholder disputes the sale, quality, or delivery of merchandise or the performance or quality of services covered by the Sales Draft.” This clause can be interpreted as indicating that Bank of America recognizes the entire credit card arrangement as an assignment.
theoretically and probably as a practical reality, the credit card induces people to make more purchases. Also, given the fact that people carry and use the credit card so frequently, they are more apt to purchase from one who will accept the credit card they possess.32 Arguably, therefore, his sales are increased. Of equally significant importance is the fact that this credit arrangement saves certain business expenses. Not only does the merchant avoid the expenses of billing and maintaining an accounts receivable ledger, but he is also saving the substantial costs of credit checks, collections and bad debts.33 To these time and money saving advantages is added his ability to realize immediately cash on his sales. The time span required to turn a consummated sale into readily useable cash is the time necessary to deposit the charge card drafts at the bank or send them to the non-bank issuer. Thus, it is the issuer who must carry the extended credit, and it is the merchant who gets nearly immediate use of the revenue while obtaining relief from the substantial burden of financing his customers through carrying their credit.34 If this is where the substance of the credit card transaction ended, we could

32Prestbo, "Consumers, Retailers Fight Over Bid To Cut Charge — Account Rates". The Wall Street Journal, (Pacific Coast Edition), March 4, 1971, at 1, col. 6 [hereinafter cited as Prestbo]. According to this article, approximately 30% of retail sales made in this country in 1970 were made on revolving charge accounts of the type used by most bank charge cards. This is such a large portion of the sales that no retailer could, seemingly, afford not to accept charge cards. The article explains that "[l]ast year's retail sales, excluding automobiles, groceries and liquor, amounted to $198.3 billion. About half that was bought on credit, it's estimated. Of that bought on credit, nearly 60% was bought on revolving credit accounts. Thus, using those figures, about $59 billion was charged on revolving charge accounts . . ."

Mezines, Basil J., The Role Of The Federal Trade Commission In Charge Card Operations, in the FEDERAL TRADE COMMISSION, at 15 (1970). This article explains that " . . . open end credit represents approximately 10% of all outstanding consumer credit — that is about 12 billion of the total of 120 billion dollars . . ." The article goes on to point out that of that $12 billion, bank credit cards represent approximately $800 million.

33Prestbo, supra note 32. "Even under the best of circumstances there isn't a retailer around that makes nearly the return on investment from credit that would be realized by putting the money into some other business enterprise . . . ."

A Report of Subcommittee No. 5 to the Committee on Small Business, 91st Cong., 2nd Sess., HOUSE REPORT NO. 91-1500 (1970). " . . . [I]n 1969 . . . [it was] indicated that providing credit in the department store field was a costly undertaking . . . [It was stated at the hearings] . . . that total credits from all stores included in this study exceeded their $36.3 million total service charge revenue by $14.7 million."

34This also relieves him of having to borrow as much money to finance his operation. This advantage can be substantial to the small merchant. His ability to carry credit for a billing period (usually thirty days) may be greatly impaired by a relatively small cash flow. The benefit of not having to carry this credit burden is welcomed by most merchants, large or small, as it does release for their immediate use a great amount of cash.
probably conclude that, indeed, this type of arrangement is simply a refined form of factoring. However, unlike a factoring arrangement, the credit card transaction requires the involvement of another party. The other party is the buyer.

The essence of the credit card, and presumably the reason for its wide acceptance, is its function as a catalyst for trade. By recognizing its obligation to pay its cardholders' bills the issuer insures the merchant that payment will be received. This obligation is the essence of the holder-Issuer contract.

The bank guarantees the holder that it will pay for all purchases made on its card and duly signed by the purchaser. In consideration for assuming this obligation the issuer guarantees the issuer that he will pay for any amounts so extended. This promise, too, becomes effective upon the holder's signature on the draft. Though there may be some question as to whether this signature represents a promise to the merchant, there is seemingly little if any question that such a signature is recognition of the above discussed benefits and burdens.

The third area of general responsibilities flows between the cardholder buyer and the merchant. Between the two there is a contract independent of any other credit agreement. The purchaser's consideration is either a promise to pay the bank or a verification that the bank has approved his credit and, therefore, will honor his drafts. The seller has given consideration for this contract in the form of goods or services provided to the buyer. This means, for example, that even if the three party transaction should be considered as a letter of credit, the buyer retains any defenses against the merchant he has as a result of the sale. Thus, the direct obligation theory requiring the buyer to pay the issuer has no effect on any claims asserted by the buyer directly against the merchant.

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35 Supra note 13. See, BankAmericard Merchant Agreement, supra note 29, at 17.
36 Supra note 11.
37 Webster, J., and Davis, Bank Credit Plans: In Consumer Financing, 1 Loyola Of Los Angeles L. Rev. 58 (1968-1969) "If, however, the purchaser's signature also operates as a promise to the merchant to pay the bank, refusal to perform would be a failure of consideration and would afford the merchant a direct cause of action for breach of contract."
38 Id. "If purchaser promises the seller to pay the bank, his promise would be the seller's consideration."
39 These rights lose much of their meaning, however, if one must pay the issuer and wait a long period of time to obtain a recovery from the merchant. They are especially meaningless when the merchant has gone bankrupt. This problem is mitigated, however, if the bank requires the merchant to purchase back any draft under which a dispute has arisen.
IV. LETTERS OF CREDIT, FACTORING AND CREDIT CARD TRANSACTIONS: THEIR RELATIONSHIPS

A. LETTERS OF CREDIT AND CREDIT CARD TRANSACTIONS ARE NOT THE SAME

Although the primary purposes of credit card and letter of credit transactions appear similar . . . it is difficult to say that the nature of the obligations incurred by the parties to the two transactions are alike.40

The purchaser’s signature on the agreement with the card issuer and his subsequent signature on purchase drafts act as direct promises to pay the issuer.41 This, of course, is precisely what one does when obtaining the services of a lending institution in the form of a letter of credit. Like the letter of credit, the credit card relationships only take on significance when the underlying sales contract is negotiated and consummated. And too, like the letter of credit transaction, the credit card transaction in no way affects the basic liability of merchant to consumer. These rights are a result of their sales contract and are in no way affected by the subsidiary contract providing for the mode of payment. Thus, a dispute about payment between the purchaser and the issuer has no effect on the rights and liabilities of the merchant and the consumer derived from their sales contract. This means that, among other things, expressed and implied warranties remain valid. This is precisely the situation which is found in a letter of credit transaction.

There is, in this triangular credit affair, also an agreement between the issuer and the seller. This is, like its counterpart in a letter of credit transaction, a separate and distinct agreement. However, its independence from the underlying transaction is the very question being probed by this discussion. The issuer-merchant agreement provides for the merchant to accept the issuer’s credit card and for the issuer to discount the drafts resulting from such sales.42 The agree-

40Maffly and McDonald, 48 CALIF. L. REV., supra note 5, at 467.
41APPLICATION FOR BANKAMERICARD, supra note 7. “Holder agrees (a) to assume responsibility for credit extended by Bank of America . . . on the basis of the Bank-Americard . . . .” This obligation is also recognized on the draft itself. For instance, the Master — Charge.draft reads as follows: “Cardholder — Acceptee shall pay to the issuer of the charge card identified hereon, or order; The amount shown as the total hereon (Together with other charges due thereon) in accordance with the charge card agreement between cardholder — Acceptee and said issuer.”
4285 BANKING LAW JOURNAL, supra note 4, at 980. The member agreement cited in this article indicates that it is subject to the underlying contract. It provides under § 12 that “. . . [the bank] may refuse to accept any sales slip, or revoke its prior acceptance thereof . . . in any one or more of the following circumstances . . . (b) The card-
ment provides only that the merchant take due care in accepting a card by making a reasonable attempt to verify the signature as genuine and the card as valid. Thus, it appears that the issuer-merchant agreement is not quite like its counterpart in the letter of credit since it is subject to some defenses based on the underlying contract. In fact, this is not the most important point of differentiation between the credit card and the letter of credit transactions. At the very outset of the incipient transaction there are differences between these two forms of payment. The letter of credit is a buyer instigated transaction. It is the buyer who goes to the letter issuer and obtains a letter in order to make a purchase. As previously stated, the credit card is a method used by the merchant to increase his sales. Indeed, it is more convenient for the buyer to carry a card than a discommodious amount of cash. Also, the purchaser gains the substantial benefits of deferring his payment. Thus it is reasonable to assume that he will very likely shop at a store which accepts a card. He may even be induced, by this convenience, to buy more than he otherwise would without the card. The real impetus for transactions of this form comes from the seller who uses the card as an advertising device to draw customers and increase his sales as well as to increase his convenience and bookkeeping efficiency.

The letter of credit is a device used by the mercantile world between businessmen, whereas the credit card is used by the household consumer world between consumer and merchant. In the former case one is dealing with those of at least some, and probably substantial, business sophistication. These people are likely to realize the independence of the contracts in this type of transaction. In the latter case one is dealing with those having less sophistication and with those having no intention to engage in separate arrangements which have liabilities independent of each other. Thus, though the transactions

holder of the Midwest Bank card used in such sale disputes his liability to the issuer on any one or more of the following grounds: (i) that the merchandise or services covered by such sales slip were returned, rejected or defective in some respect, or Member has failed to perform any obligation on its part in connection with such merchandise or services, and amount ...” AGREEMENT, supra note 29, at #6. This agreement states, “Merchant hereby agrees to indemnify and hold Bank harmless from any claim relating to any Sales Draft paid for by Bank as may be made by way of defense, dispute ... or affirmative action of cardholder.” At #10 the agreement states, Merchant agrees to pay Bank the total face amount of any Sales Draft ... in any situation relating to such Sales Drafts where ... (e) the Cardholder disputes the sale, quality, or delivery of merchandise or the performance or quality of services covered by the Sales Draft ...”

4385 BANKING LAW JOURNAL, supra note 4, at 981 (#4).
441 LOYOLA OF LOS ANGELES L. REV., supra note 37, at 59 n.52. Because the participants in a letter of credit transaction are usually businessmen, they realize that compliance with one contract is not a condition precedent to the enforceability
may on their face look similar, the major differences of the commercial context in which they arise and the different intentions of the participants makes the analogy tortuous and questionable.

The form of the two transactions look deceivingly similar, but their respective substances are very different. The credit card is very much like the letter of credit in that it seemingly substitutes the credit of a well-known institution for the lesser known consumer. It falters on the weakness of the analogy between the very important technical aspects of the transaction.

If the courts were to interpret the credit card transaction as one of the letter of credit gender, it would mean that despite the merchant's default, the consumer would still have to pay the bank on the basis of the draft. This would be so despite the differences in the transactions discussed above and despite the intentions of at least one party to the transaction: the consumer. In fact, the duty of payment in a credit card transaction could arise prior to delivery of the merchandise—an infrequent happening under a letter of credit transaction.

Perhaps, however, if this transaction is not analogous to a letter of credit, the rights of the parties may be determined as those arising from factoring. The argument has often been posited, though it does have weaknesses, that it is just this service of factoring which the credit card issuer is performing for the world of commerce.

B. FACTORING AND CREDIT CARD TRANSACTIONS ARE SIMILAR, BUT THEY ARE NOT THE SAME

One is impressed by the striking similarity between credit card transactions and factoring. The issuer's inducements and services to the merchant are much the same as would be the factor's inducements and services. For instance, Bank of America tells its prospective merchant members that,

Merchants who wish to make credit available to their customers of another. Most bank credit cardholders are retail consumers — a large proportion are housewives — and it is doubtful that many realize signing a sales draft operates a promise to pay the issuing bank irrespective of having received satisfactory performance from the merchant."

45I say "seemingly substitutes credit" because, as has been discussed throughout this article, the transaction may be less a substitution of credit than a recognition of the assumption of certain credit and billing functions by the bank.

46Payment would be required unless the bank recognized this default as one of its reasons for not accepting the drafts or selling them back to the merchant. See note 44, supra.

47See the discussion on the purposes of the letter of credit in the text accompanying footnotes 13-15 supra.
may do so without the problems and cost of credit checking... billing, collections and credit losses. Often, the discount they pay to the bank is less expensive than would be the cost of handling their own credit.48

Like the factor, the card-issuer will buy all the accounts receivable it has approved. This approval is represented by all the charges it has allowed to be made on its charge card. By issuing the credit card and by guaranteeing to purchase all drafts representing its use, the issuer is taking the credit risk and assuming the responsibility of checking the consumer's credit. This relieves the merchant from the burdensome commercial necessity of credit risk evaluation. The issuer, like the factor, does all the collections on these accounts; this, of course, reduces the work load of the merchant in the collection arena. Also, like the factor, the issuer relieves the merchant of bad debt losses since "[a]ll sales properly made on...[a charge card]...are final for the merchant. He receives the full amount of the sale less discount regardless of whether the cardholder pays his...bill."49

The courts or the legislature may decide that these similarities are so overpowering that the credit card transaction belongs within those legal doctrines used to reconcile disputes involving factoring. If so, they will have to view the issuer-merchant portion of the transaction as an assignment. Therefore, the issuer would be subject to any defenses available to the buyer against the merchant. Though, like the factor, the issuer could return the purchased drafts if they did not represent the implied or expressed warranties accompanying assignments, it would have to remain subject to the purchaser's defenses.50 In other words, the issuer could not force the buyer to pay his bill if the buyer would not have to pay the merchant.

The problem discussed here seems, on its face, to be not so much a real stumbling block as one of a purely theoretical nature. However, when class action suits become a significant reality in the courts of the United States, and when credit card charges become freely used for purchases of major monetary significance or possibly replace cash transactions entirely, the respective rights of the parties will become of extreme import.51 There will come a time when the buyer or buyers

48FACTS, supra note 8, at 4.

49Id. "Non—Recourse: All sales properly made on BankAmericard are final for the merchant. He receives the full amount of the sale less discount regardless of whether the cardholder pays his BankAmericard bill."

50RESTATMENT OF CONTRACTS, American Law Institute (1932), § 175. "An assignor...warrants to the assignee...[b] that the right, as assigned, actually exists and is subject to no limitations or defenses other than those stated or apparent at the time of the assignment..."

51CAL. CIV. CODE § 1781 (b) (West 1956). See also, Vasquez v The Superior Court ___CAL. 2d___ (1971).
will not want to pay for what they consider defective merchandise and the seller will not admit to such merchandise being defective. There will come a time when the Bank's boiler plate clauses will be questioned on the grounds of unconscionability.\(^5\)\(^2\) When that happens, it is extremely important to know if and to whom the buyer must pay. If the merchant will not accept the drafts back on the grounds that he has not breached his agreement with the issuer, the issuer may attempt to demand its payment from the buyer. Whether he can do so depends upon the legal matrix in which the credit card is placed.

V. CONCLUSION: A HYBRID OF COMMERCIAL REALITIES DEMANDS A HYBRID OF LEGAL THEORY

In order to determine the legal gender of the credit card, it is not sufficient to consider how much similarity exists between two types of transactions. Rather, one must be concerned with what is actually happening within the transaction and with related social policies which are worthy of fostering. With this in mind, it seems that the pivotal question goes to the function the issuer assumes. Is the issuer buying receivables or is it advancing credit to and at the instigation of the consumer who has a specific purchase in mind? Is it advancing credit to the merchant? The credit card transaction represents a little of both functions. Therefore, it becomes incumbent upon those attempting to define the transaction's theoretical and legal basis to find one which recognizes the realities and substance of this mode of commerce.

In pursuance of this end, it is of great importance to discuss any non-traditional responsibilities assumed by one or more of the three parties attributable to peculiarities found in credit card transactions. It appears, however, there are none. The purchaser's only responsibility is to pay for what he has received. Though he sends remittance to the bank rather than the merchant, it is nevertheless fair to assume that he recognizes only the merchant as the one who is to provide him with goods, services, warranties and guaranties. The merchant, of course, maintains his traditional responsibilities. He must provide the goods or services and fulfill warranties and guaranties. For such consideration he alone is entitled to payment, but payment is contingent upon performance of these forms of consideration. The issuer is providing the services of one which has been recognized as a factor in other commercial contexts.

\(^{52}\)See footnotes 5 and 41, supra.
Whatever the relationship between the three parties is determined to be, it is clear that two of the three contracts would have no commercial relevance or existence alone. Indeed, all three are interdependent. It may be the correct view to see all the agreements as contingent upon one another so as to make a complete, enforceable contract only when all three find their nexus at the same point—the consummated sale. With a letter of credit a buyer obtains a contract with a lender so he may make a purchase. The credit is received before the purchase is made. Factoring occurs after the sale is consummated, but the sale can be made without factoring. However, the sale by credit card is such that all three agreements are dependent on one another. Arguably, even the sale would not take place without the credit card.\(^5\)

Perhaps, all credit card transactions should be considered as simple transactions between buyer and seller with the issuer being considered a facilitator or catalyst which has rights to payment only upon completion of the underlying sales contract. This would mean it would have no rights to payment if there were a legitimate reason for non-payment by the buyer to the seller.

The fact is, the buyer buys expecting service from the seller, and no interpretation should relieve the seller of these duties. At the same time the issuer must be insured payment when the underlying contract is fulfilled. Since the issuer facilitates trade and commerce, it demands assurance of payment for its services. It is only with this assurance that it will continue to provide its funds. However, the consumer should not be asked or forced to carry the full burden of this guaranty and the corollary risks involved.

If one is forced to analyze the transaction within existing legal theory, the credit card transaction may be called a factor's relationship. The function performed by the issuer is more closely analogized to the traditional functions of the factor than to any other commercial device. It provides the commercial community with ready cash and cost savings. Unlike the factor, however, the issuer has direct relations with the consumer. It provides him with convenience and additional buying power. Indeed, the credit card may induce sales—something not ever contemplated by the factor.

When factoring became a significant commercial reality the legislature and the courts responded by defining the rights and liabilities of all the parties involved. When letters of credit became a pervasive commercial tool the legislature and courts likewise responded; indeed, today both these responses have been refined in the Uniform Com-

\(^5\)\textit{FACTS, supra} note 8, at 4. "Merchants who accept BankAmericard automatically increase their potential customers, drawing on a large number of persons who are cardholders."
mmercial Code. The impact of the credit card on the commercial world is already ubiquitous. What is needed is either judicial or legislative definition of the rights, duties and liabilities of the parties involved. Any such definition must go to the substance rather than the form of the transaction, and any such foray should be made with awareness that the tripartite credit card transaction is neither a letter of credit nor a factoring arrangement. Its purposes are different from those of either transaction to which it is analogized. It is a hybrid of both these transactions developed to fill the needs of contemporary commercial society. It must be controlled by a modern enunciation of the law.

Such a statement emanating either from the courts or the legislature must take cognizance of the functions the credit card performs. The law must foster ease of commercial relationships while promoting responsibility among the participants. Nothing will impede the free flow of commerce more rapidly than parties' to commercial transactions avoiding responsibility for their activities.

Recognition of the issuer's function is of primary importance. If one accepts the premise that the entire transaction remains one primarily between buyer and seller despite the interposition of the issuer as a facilitator, it is reasonable that the issuer should not have to bear the burden of buyer-seller disputes. Merely because the issuer discounts drafts in good faith does not inexorably lead to the conclusion that the seller is free from all responsibility. To the contrary, he is still primarily responsible for the sale. If disputes arise between the buyer and himself he, and not the issuer, should accept the responsibility for such a dispute. Thus, a dispute should result in the seller redeeming the draft representing the sale in question, either by force of the issuer-merchant contract or by force of judicial or legislative order.

Perhaps a more difficult question is, who bears the burden if the merchant responsible for the sale has become insolvent subsequent to the bank's purchase of the sales draft. The question really calls for a determination of whether, as a matter of public policy, the purchasing public should be insured against this type of seller's insolvency. Traditional commercial theory provides no such assurance. However, the three party credit card presents a new situation. In a disputed two party credit sale ultimately decided in favor of the purchaser, the purchaser's obligation to pay would be adjusted accordingly. There seems to be no good reason why, in a three party credit card transaction, the purchaser should be required to pay the full price without adjustment merely because the issuer discounts the drafts. Though the issuer should not be called upon to insure the sale, it can be called
upon to insure the purchaser against liabilities which he would not encounter in a simple two party credit transaction. If the issuer discounts drafts, it is not unreasonable to expect it to verify the merchant's willingness and ability to stand behind his sale or repurchase the draft. The responsibility for failure to use good commercial sense in discounting credit card drafts from irresponsible and insolvent merchants must fall squarely on the issuer.

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