Constructing a New Theoretical Framework for Home Improvement Financing

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Constructing a New Theoretical Framework for Home Improvement Financing

James Hogan told his story as follows:

In April of 1989 I was contacted on the phone by a representative of a company called Loan Originators. This person told me they could arrange to have repairs done to my house. . . . The repairs that were to be made on my house included roofing work on my house and carport and installing fascia boards. The cost was $6200.00.

. . . .

At the time we signed [the loan] documents, we owned our house and there was over $50,000.00 equity in our house. Though I signed the documents given to me by [the mortgage company], I did not understand them. The total loan was for $12,916.50. . . .

. . . . After we signed the documents, . . . some work was performed by the home improvement company. The work that was performed on our house was not completed and the work that was done was substandard and defective. As it turned out, we owed a great deal of money for little or no service. The representations made to me by the home improvement company that they would do a good job for me and make repairs to our house were false.

. . . . I was unable to keep up the mortgage payments and Fleet foreclosed on us in December of 1991. Fleet purchased the house at the foreclosure sale and was in the process of evicting me when I went to an attorney . . . . I still live in the
house even though it is now owned by Fleet.¹

Under current federal law, Hogan should not have lost his home to foreclosure. Hogan had a valid defense to payment of the debt based on the contractor’s failure to substantially complete the home improvements.² Had the issue been litigated, Hogan would not have been required to pay the debt nor would the lender have been permitted to foreclose. Unfortunately, most states currently put the burden on the homeowner to sue to prevent foreclosure by asserting defenses to payment. In addition, the homeowner must plead and prove nonperformance of the home improvement contract as a defense to payment.³

In this Article, I advocate modification of the law governing home improvement financing. In section I, I discuss the prevalence of home improvement scams, the dual system of home improvement financing available to affluent and poor homeowners, and the social cost of home improvement scams. Despite attempts by lawmakers to protect homeowners from unscrupulous home improvement contractors and lenders, home improvement scams remain a significant consumer problem. Most victims of such scams are poor, minority, and elderly homeowners. These homeowners obtain home improvements and home improvement financing through a system with tremendous potential for abuse. In this system, contractors and lenders use high pressure tactics and fraud to induce homeowners into disadvantageous home improvement transactions. Ultimately, victims of home improvement scams may, like the Hogans, lose their homes.

In section II, I discuss the application of negotiable instruments law to home improvement loans. The Federal Trade Commission adopted its Holder in Due Course Rule⁴ to ameliorate some of the harshness of negotiable instruments law in consumer transactions. Other state and federal measures are also designed to protect consumers who borrow to improve their homes. In

² See infra part II.B.
³ See infra part III.A. The homeowner has the burden of pleading as well as the burden of proof. However, because the burden of proof is a more significant burden than the burden of pleading, see infra note 117, I will refer only to the burden of proof in this Article except where a discussion of the burden of pleading is necessary.
sections III and IV, I explain why these measures have not been sufficient to eliminate abuse by home improvement contractors and lenders. In cases of abuse, a homeowner who has executed a promissory note to evidence the obligation to pay a home improvement loan must prove defenses to payment. In most states, the homeowner also must initiate a lawsuit against the lender to enjoin foreclosure because foreclosure without judicial hearing is permitted.5 The burden of initiating suit is particularly onerous because a suit to obtain an injunction is likely to be expensive and require the assistance of an attorney.6 Placing these burdens on the homeowner is not appropriate when a relationship between the contractor and the home improvement lender exists because this circumstance increases the likelihood of a defense to payment. Therefore, in section V, I recommend prohibiting promissory notes and power of sale foreclosure in home improvement loans made by lenders who have a relationship to the contractor. This measure would shift the burdens of proof and initiating suit to the lenders.

I

THE HOME IMPROVEMENT FINANCING DILEMMA

A. Home Improvement Scams

Home improvement scams have been a major consumer problem for decades.7 Consumer advocates have recommended solu-

5 See infra part IV.B.
6 See infra part IV.C.2.
7 See Preservation of Consumers' Claims and Defenses: Promulgation of Trade Regulation Rule and Statement of Basis and Purpose, 40 Fed. Reg. 53,506, 53,511 (1975) [hereinafter Statement of Basis and Purpose]; President's Commission on Law Enforcement and Administration of Justice, Task Force Report: Crime and Its Impact—An Assessment 50 (1967). In 1965, the National Better Business Bureau reported that fraud and deception in connection with home repairs or improvements had been its most frequent consumer complaint since 1953. Id. (citing National Better Business Bureau, Service Bulletin No. 363 (1965)). The National Better Business Bureau estimated that fraudulent and deceptive practices relating to home repairs and improvements cost consumers $500 million to $1 billion each year during that period. Id.

The news media have reported on the various scams and their victims over the years. See, e.g., Carol Agus, Nightmare, Not a Dream House, Newsday, Nov. 15, 1992, at 11; Mike McClintock, Right from the Start; The Most Important Remodeling Decision Comes Early, Wash. Post, Sept. 15, 1994, at T7; Ways Con Men Cash in on the Energy Crisis, U.S. News & World Rep., Aug. 8, 1977, at 58. A recent motion picture chronicled the antics of two "tin men" who used various fraudulent schemes to sell aluminum siding in the early 1960s. Tin Men (TriStar Pictures 1987).
tions, and both state and federal legislators and regulators have attempted to address the problem. Despite the work of consumer advocates and lawmakers, home improvement scams remain a major consumer problem today. In recent years, complaints about home improvement companies have made up a substantial portion of the complaints received by Better Business Bureaus around the nation. Furthermore, a recent survey of legal aid attorneys indicates that the incidence of home improvement and home improvement lending scams is significant.

Not all home improvement scams involve a home improvement loan; some perpetrators of home improvement fraud work only for cash. However, most homeowners must borrow to pay for significant home improvements. Lenders reporting under the Home Mortgage Disclosure Act originated more than one million home improvement loans in 1994 and just under one million home improvement loans in 1995. In 1993, congressional hearings addressed the problem of predatory lending, which is to a great extent a problem of home improvement lending.

8 See infra part II.
11 For example, a con artist may offer to seal cracks in a homeowner's driveway for a bargain price to be paid in advance, then may spread oil or water on the driveway and leave. Elliot H. McCleary, How to Avoid Home-Repair Rip-Offs, Consumers Dig., March 1993, at 30.
13 81 Fed. Reserve Bull. A68, tbl. 4.36 (Sept. 1995). Home improvement loans constituted more than 14% of reported home mortgage loans in 1994. Id.
14 82 Fed. Reserve Bull. A68, tbl. 4.36 (Sept. 1996). Home improvement loans constituted more than 16% of reported home mortgage loans originated in 1995. Id.
Contractors, finance companies, second mortgage companies, and mortgage brokers are the perpetrators of home improvement loan scams.\textsuperscript{17} Minorities, the elderly, and the inner-city and rural poor are most often the victims.\textsuperscript{18} Contractors, lenders, and mortgage brokers seek these particularly vulnerable homeowners. They may solicit door-to-door in low income neighborhoods, or they may target only the owners of homes that are in particular need of repair.\textsuperscript{19} Victims usually have substantial equity in their homes due to rising real estate values or reduction of purchase money debt but, because of their low or fixed incomes, must borrow to make needed home repairs.\textsuperscript{20}

Upon finding a likely target for a predatory home improvement loan, a contractor, lender, or broker may use high pressure tactics or outright fraud to induce the homeowner to enter a home improvement contract and abusive loan transaction.\textsuperscript{21} These parties may misrepresent the home improvements to be performed, the quality of the improvements, the price of the improvements, or the terms of the home improvement loan.\textsuperscript{22} They may pressure a homeowner to sign loan documents without reading them or with key terms left blank, or forge a homeowner's

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\textsuperscript{18} See Senate Banking Comm. Hearings, supra note 15, at 254 (statement of Scott Harshbarger, Attorney General, Commonwealth of Massachusetts), 315 (statement of Kathleen Keest, National Consumer Law Center).

\textsuperscript{19} See Mike Hudson, Stealing Home: How the Government and Big Banks Help Second-Mortgage Companies Prey on the Poor, 26 Clearinghouse Rev. 1476, 1478-79 (1993). Eva Davis, a San Francisco homeowner, believes she was targeted because the City of San Francisco placed a yellow tag on her house after it sustained damage in the 1989 earthquake. Senate Banking Comm. Hearings, supra note 15, at 291 (statement of Eva Davis).

\textsuperscript{20} Senate Banking Comm. Hearings, supra note 15, at 449 (letter to Sen. Donald W. Riegle, Jr. from William E. Morris, Director of Litigation, Southern Arizona Legal Aid, Inc.); see Senate Report, supra note 17, at 22.


\textsuperscript{22} See id.
signature. The loan documents often require the homeowner to pay an exorbitant interest rate and excessive closing costs, and they frequently include other unfair terms. Documents may even require larger payments than the homeowner's income can support. Finally, contractors often induce homeowners to sign completion certificates before work has even begun so that loan funds will be released immediately.

Home improvements performed by perpetrators of home improvement scams are often never completed. Those improvements that are completed tend to be substandard and contractors often use low-quality materials. In some cases the work may be so poor that it actually reduces the value of the home. Nevertheless, contractors may be paid for their substandard work when they sell the homeowner's payment obligation to a lender or when a lender advances funds directly to the contractor prior to satisfactory completion of the work. Once contractors have been paid in connection with a series of transactions, they often change their corporate identities or move to another state, making them difficult to sue. Lenders may ignore homeowners'

23 See id.
24 See House Consumer Credit Subcomm. Hearing, supra note 1, at 73-75 (statement of Bruce Marks, Executive Director, Union Neighborhood Assistance Corporation). Homeowners may pay interest rates in excess of 39%, Jack Meyers et al., Firm Wrote Loans at 39% Interest, B. HERALD, June 17, 1991, at 1, 20, reprinted in House Consumer Credit Subcomm. Hearing, supra note 1, at 116, and points totaling as much as 33% of the amount financed, Senate Banking Comm. Hearings, supra note 15, at 447 (letter to Sen. Donald W. Riegle, Jr. from Elizabeth Renuart, Managing Attorney, St. Ambrose Legal Services). Predatory home improvement loans may also have other unfair terms, such as high prepayment fees that make refinancing prohibitively expensive, House Consumer Credit Subcomm. Hearing, supra note 1, at 66-68 (statement of Steven D. Caley, Atlanta Legal Aid Society, Inc.), balloon payments that may be due within a year or two after the loan is closed, Senate Banking Comm. Hearings, supra note 15, at 309 (statement of Scott Harshbarger, Attorney General, Commonwealth of Massachusetts), and mandatory refinancing of existing first mortgages that carry lower interest rates, id. at 447 (letter to Sen. Donald W. Riegle, Jr. from Elizabeth Renuart, Managing Attorney, St. Ambrose Legal Services).
28 Id.
29 See Public Citizen, supra note 10, at 22.
complaints of unfinished or poor quality home improvements.\textsuperscript{30} Lenders may enforce a homeowner’s debt regardless of a defense to payment, and homeowners often know no better themselves. Ultimately, homeowners may pay for substandard or incomplete improvements or, worse, may lose their homes.

B. Dual Systems

While many poor homeowners are victimized by home improvement loan scams, more affluent homeowners obtain home improvements and home improvement financing through an entirely different system. While poor, minority, and elderly homeowners deal with door-to-door solicitors who offer an all-in-one package of improvements and financing, homeowners in middle or upper income neighborhoods are more likely to seek out reputable contractors, obtain several bids for the desired work, and independently secure financing on the best terms available. The advantages of the latter course are clear. By obtaining references and seeking bids from several contractors, homeowners are more likely to find a reliable contractor. When homeowners obtain financing from a lender with no relationship to the contractor, funds are less likely to be advanced unless the work is progressing. A home improvement lender can confirm that improvements are being performed as advances are made\textsuperscript{31}—something an independent lender is much more likely to do.

One reason this dual system exists is that homeowners targeted by scam artists lack sophistication.\textsuperscript{32} Another reason is that these homeowners lack the alternatives available to upper- and middle-income homeowners. While plenty of reputable contractors are willing to work in upper and middle income neighborhoods, less reputable contractors who solicit door-to-door predominate in low income communities.\textsuperscript{33} Mainstream lenders make home improvement loans in upper and middle income neighborhoods, but finance companies and second mortgage

\begin{itemize}
\item \textsuperscript{30} See, e.g., Agus, supra note 7, at 11.
\item \textsuperscript{31} See Senate Banking Comm. Hearings, supra note 15, at 316 (statement of Kathleen Keest, National Consumer Law Center).
\item \textsuperscript{32} Kathleen Keest, Some of the Poor Pay Even More: Is There a “Discrimination Tax” in the Marketplace, 27 Clearinghouse Rev. 365 (1993). Scam artists target the poor and minorities because they are perceived as being vulnerable. Id. at 366.
\item \textsuperscript{33} See Senate Banking Comm. Hearings, supra note 15, at 462-63 (report by New York City Dept. of Consumer Affairs). Some reputable contractors may even refuse to work in poor neighborhoods. Id. at 466.
\end{itemize}
companies that charge high interest rates are sometimes the only lenders who will make such loans in low income neighborhoods.\textsuperscript{34} Low income homeowners thus do not usually have the opportunity to obtain home improvements or home improvement financing from reputable companies.

\textbf{C. Social Cost of Home Improvement Scams}

Homeowners victimized by home improvement scams may pay for home improvements they do not receive or, if they refuse to pay, may lose their homes to foreclosure. When homeowners pay for substandard home improvements, they may sustain a substantial loss. Because home improvement costs tend to be high in relation to other expenses, a significant amount of money can be involved. Poor homeowners, who are the most frequent victims, are those least able to afford such a loss.

Homeowners who lose their homes as a result of home improvement scams may be both financially and psychologically devastated. Financially, a homeowner may lose remaining equity in a home, may face a deficiency judgment in some states, or both.\textsuperscript{35} In addition, homeowners must deal with intense psychological pressure. Homeowners facing loss of a home are more likely to confront physical and mental illness, suicide, crime, and family problems.\textsuperscript{36} Forced dislocation from a home, even without any corresponding financial difficulties, may result in sadness, depression, psychological distress, sleep loss, anger, and idealization of the lost home.\textsuperscript{37} Homeowners who lose their

\textsuperscript{34} Id. While mainstream lenders that lend money at market rates tend to shun inner-city neighborhoods occupied by poor and minority homeowners, these lenders have provided financing to predatory lenders or have purchased high interest rate loans from them. \textit{See Senate Banking Comm. Hearings, supra} note 15, at 308 (statement of Scott Harshbarger, Attorney General, Commonwealth of Massachusetts); Forrester, \textit{supra} note 17, at 421-22.

\textsuperscript{35} \textit{See infra} notes 178-80 and accompanying text.


\textsuperscript{37} \textit{See} Marc Fried, \textit{Grieving for a Lost Home: Psychological Costs of Relocation, in The Urban Condition} (Leonard J. Duhl ed., 1963), \textit{reprinted in Urban Renewal: The Record and the Controversy} 359, 359-61 (James Q. Wilson ed., 1966). This study dealt with urban slum dwellers displaced by urban renewal in Boston. The psychological effects on homeowners who lose their homes to foreclosure are likely to be at least as severe. While many of the slum dwellers in the study moved to better home environments, \textit{id.} at 370-76, homeowners displaced by foreclosure are likely to see a decrease in the quality of their housing.
homes because of foreclosure may end up homeless, but even for those who obtain alternative housing, the loss of their home is devastating.38

II

NEGOTIABLE INSTRUMENTS LAW AND CONSUMER CREDIT

Home improvement scams have a high social cost relative to other consumer problems,39 but the issues that arise in home improvement financing are, to a great extent, similar to other consumer credit issues. Sellers of goods and services to consumers on credit take advantage of legal rules designed for an entirely different setting. In many states, sellers may document a consumer’s payment obligation with a negotiable promissory note governed by Article 3 of the Uniform Commercial Code (UCC). A presumption of consideration thus arises and shifts to the consumer the burden to prove deficiencies in the seller’s performance.40 In addition, until 1976, sellers could transfer a consumer’s promissory note to a holder in due course41 who took the note free from personal defenses.42

A. Historical Perspective

1. Early History

A full understanding of negotiable instruments law requires some familiarity with the history of negotiable instruments. Bills of exchange, the first negotiable instruments, were used in international trade as early as the fourteenth century.43 By the late eighteenth century, bills of exchange were used as an unofficial currency among merchants because the only legal tender at the

38 Forrester, supra note 17, at 386-87. Homeowners who lose their homes also have psychological pressure resulting from the financial difficulties associated with foreclosure. See id.

39 See supra part I.C.

40 See infra notes 129-31 and accompanying text.

41 U.C.C. § 3-302(1) (1966). A holder in due course of an instrument is a holder who takes the instrument for value, in good faith, and without notice of certain matters, including a defense against it or a claim to it. U.C.C. § 3-302(a) (1990).

42 See infra notes 61-65.

43 James S. Rogers, The Myth of Negotiability, 31 B.C. L. REV. 265, 284 (1990). A bill of exchange, also called a draft, is an order or direction to pay made by a drafter upon a drawee. See U.C.C. §§ 3-103(6), 3-104(a), (e) (1990); U.C.C. §§ 3-102(1)(b), 3-104 (1966). For a discussion of other early uses of negotiable instruments see Rogers, supra, at 291.
time was coins. Bills of exchange permitted the assignment of debts at a time when contracts and debts were otherwise unassignable.

Courts recognized the negotiability of bills of exchange as early as the beginning of the eighteenth century. Characteristics of negotiability were transferability, a presumption of consideration, and the availability of holder in due course status for a holder. The latter two characteristics facilitated transferability of bills of exchange. Since bills of exchange passed from merchant to merchant in a series of transfers, the ultimate holders might have no knowledge of the original transaction or the earlier transfers. The holder in due course doctrine arose from the need to protect transferees of a negotiable instrument, even though the obligor or prior holders of the instrument might be harmed. The presumption of consideration served a similar purpose.

Promissory notes came into use much later than bills of exchange—near the end of the seventeenth century. Although promissory notes were frequently assigned in the eighteenth century, it was only in the nineteenth century that they were treated as fully negotiable in the United States. At the time of the development of negotiable instruments law, few notes were given as consideration for the purchase of goods and services.

45 Rogers, supra note 43, at 275-76 (quoting JOHN B. BYLES, THE LAW OF BILLS & EXCHANGE 2 (8th ed.)).
47 See 8 W.S. HOLDSWORTH, A HISTORY OF ENGLISH LAW 113-14 (1926); Rogers, supra note 43, at 275-76; James S. Rogers, Negotiability as a System of Title Recognition, 48 OHIO ST. L.J. 197, 199 (1987).
48 See Gilmore, supra note 44, at 612-13; Rogers, supra note 43, at 272, 275-76; Rogers, supra note 47, at 199.
50 Id. at 613.
51 HORWITZ, supra note 46, at 213-14. A promissory note is an unconditional promise to pay a fixed amount of money, with or without interest, that is payable to order or to bearer, is payable on demand or at a definite time, and does not state any other undertaking. U.C.C. § 3-104(a), (e) (1990).
52 HORWITZ, supra note 46, at 214.
53 Id. at 214-25.
54 Rogers, supra note 43, at 291. Bills and notes were used as a means of ex-
Therefore, issues relating to an underlying contract, typical of today's consumer credit purchase, rarely arose.  

2. Recent History

Prior to 1976, home improvement contractors, as well as other sellers of goods and services to consumers, could separate the consumer's obligation to pay from the seller's obligation to perform. As a result, a homeowner might remain obligated to pay for home improvements despite breach of contract by the home improvement contractor, breach of warranty, unconscionability, or fraud in the transaction. The homeowner's only remedy was to bring suit against the contractor, which was undesirable because the contractor might be difficult to locate or judgment proof. In addition, the cost of bringing suit might be prohibitive.

Contractors and other sellers separated their obligation to perform from the consumer's obligation to pay in one of three ways: (1) by requiring the consumer to execute a negotiable promissory note and selling the note to a lender having holder in due course status; (2) by including a waiver of defenses against assignees in the credit contract; or (3) by arranging for a lender to make a direct loan to the consumer. Under the first scenario, a note-holder could insist on payment even if home improvements were defective or never completed because a holder in due course takes a promissory note free from all personal defenses, including fraud in the inducement, failure of consideration, breach...
of warranty, and unconscionability. The second scenario, placement of a waiver of defenses in the credit contract, essentially gave holder in due course status to an assignee of the contract even if the assignee could not otherwise qualify for such status. The third scenario, a direct loan by a lender to a homeowner, was treated as independent of the contract for improvements even if the contractor had arranged the financing. Defenses arising under the improvement contract thus had no effect on the homeowner's obligation to repay the loan.

The Federal Trade Commission (FTC) found that sellers frequently used these mechanisms to effectuate unethical sales practices in consumer transactions. Home improvement contractors in particular often used schemes involving fraud or deception to induce homeowners to purchase aluminum siding or other improvements. Because the contractor's obligation to perform could be separated from the homeowner's obligation to pay, homeowners lost the right to stop payment when improvements were shoddy or uncompleted. Most of these schemes were directed at the poor; however, middle-class and affluent homeowners were also victimized, as evidenced by scams relating to the installation of swimming pools.

B. FTC Holder in Due Course Rule

Since 1976, the law has prevented home improvement contractors from separating the homeowner's duty to pay from the contractor's obligations under the contract. In 1975, the FTC
promulgated a trade regulation rule,\textsuperscript{71} commonly known as the 
Holder in Due Course Rule.\textsuperscript{72} The FTC intended the Rule to 
give consumers the right to assert claims and defenses against 
creditors in situations where a seller provides or arranges financ-
ing and then fails to perform his obligations.\textsuperscript{73} Specifically, the 
Rule requires sellers to include in most consumer credit contracts 
the following notice:

\begin{quote}
\textbf{NOTICE}

ANY HOLDER OF THIS CONSUMER CREDIT CON-
TRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES 
WHICH THE DEBTOR COULD ASSERT AGAINST THE 
SELLER OF GOODS OR SERVICES OBTAINED PUR-
SUANT HERETO OR WITH THE PROCEEDS HEREOF. 
RECOVERY HEREUNDER BY THE DEBTOR SHALL 
NOT EXCEED AMOUNTS PAID BY THE DEBTOR 
HEREUNDER.\textsuperscript{74}
\end{quote}

When the Notice is included in a consumer credit contract, an 
assignee cannot assert holder in due course status; thus, the con-
sumer may raise claims and defenses relating to the underlying 
contract. Furthermore, the Rule prohibits a waiver of defenses 
or other language in a consumer credit contract that limits the 
application of the notice.\textsuperscript{75} Finally, the Rule requires a similar 
notice if a direct loan is made by a lender affiliated with the seller 
"by common control, contract, or business arrangement" or is a 
lender to whom the seller refers consumers.\textsuperscript{76} The Rule is in-
tended to address all three methods sellers used to sever their 
contract obligations from consumers' payment obligations.\textsuperscript{77}

The FTC sought, with this Rule, to shift risks of seller miscon-

\begin{itemize}
\item \textsuperscript{71} Preservation of Consumers' Claims and Defenses, 16 C.F.R. §§ 433.1-.3 (1996); 
Statement of Basis and Purpose, \textit{supra} note 7, at 53,506.
\item \textsuperscript{72} Guidelines, \textit{supra} note 56, at 20,022-23.
\item \textsuperscript{73} \textit{Id.} at 20,023.
\item \textsuperscript{74} 16 C.F.R. § 433.2(a) (1996). The Rule makes it "an unfair or deceptive act or 
practice" for a seller to "[k]e or receive a consumer credit contract which fails to 
contain the . . . [Notice] in at least ten point, bold face, type." \textit{Id.} The Rule applies 
only to purchases by natural persons who purchase goods or services "for personal, 
family, or household use." \textit{Id.} § 433.1(b).
\item \textsuperscript{75} \textit{See} Guidelines, \textit{supra} note 56, at 20,023. If the Notice is included in the contract 
but additional language limits its application, the requirement that the contract 
"contain" the Notice is not met. \textit{Id.}
\item \textsuperscript{76} 16 C.F.R. § 433.1(d) (1996). The Rule makes it "an unfair or deceptive act or 
practice" for a seller to accept loan proceeds unless the required notice is included. 
\textit{Id.} § 433.2. However, the Rule imposes no penalty on the lender for failing to in-
clude the Notice.
\item \textsuperscript{77} Guidelines, \textit{supra} note 56, at 20,023.
\end{itemize}
duct to creditors who could either absorb the costs of misconduct or return the costs to sellers. Consumers usually are unable to evaluate the probability of seller misconduct in a given transaction, and they are generally unable to effectively shift costs of seller misconduct to the culpable party. Creditors, on the other hand, can better evaluate the likelihood of seller misconduct because they engage in more transactions and have access to more information. In addition, creditors can better return costs to culpable sellers because of their contractual arrangements with sellers and greater access to the legal system. Therefore, the FTC hoped creditors would prevent misconduct by controlling practices of sellers and would drive unscrupulous sellers out of the market by refusing to lend to their customers. The Rule was intended to minimize costs of seller misconduct and to internalize costs from remaining seller misconduct so prices of goods, services, and credit would reflect true transaction costs.

In most circumstances, the Rule gives consumers a very powerful weapon against unscrupulous sellers—the ability to withhold payment for the goods or services. Nonpayment forces the seller or the seller's assignee to sue the consumer for payment; and, if an assignee does sue, the Notice preserves defenses to payment based on seller misconduct.

C. Limitations of the Holder in Due Course Rule

While the FTC's Holder in Due Course Rule was designed to give consumers the ability to withhold payment where a seller fails to perform in a satisfactory manner, its effectiveness is limited. First, consumer rights provided by the Notice depend on seller compliance with the Rule. If the seller fails to include the Notice in a consumer credit contract, an assignee who purchases the contract in good faith and without notice of a claim or de-

79 Statement of Basis and Purpose, supra note 7, at 53,522-23.
80 Id. at 53,523.
81 Id.
82 Id.; Greenhalgh, supra note 78, at 827, 834.
83 Statement of Basis and Purpose, supra note 7, at 53,523. But see Greenhalgh, supra note 78, at 859-60 (arguing that the Rule does not achieve optimality).
84 See Guidelines, supra note 56, at 20,022; Statement of Basis and Purpose, supra note 7, at 53,509.
fense is a holder in due course with protection against claims and defenses by the consumer.\textsuperscript{85} Similarly, if the seller violates the Rule by including a waiver of defenses in the consumer credit contract, the consumer will not be able to assert defenses to payment against an assignee of the contract.\textsuperscript{86} Finally, the Rule places the burden on the seller, not the lender, to insure that loan documents between a lender and a consumer contain the Notice.\textsuperscript{87}

Another weakness of the Rule is its limitation on recovery by the consumer. The Notice provides that "[r]ecovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder."\textsuperscript{88} As a result, when a consumer seeks affirmative relief from the lender,\textsuperscript{89} the consumer may only recover the amounts paid under the consumer credit contract.\textsuperscript{90} The lender is not liable for additional damages caused by seller misconduct.\textsuperscript{91}

\textsuperscript{85} See Greenhalgh, supra note 78, at 853-54. The FTC recognized this limitation and proposed an amendment to the Rule that would have extended its applicability to lenders as well as sellers. 40 Fed. Reg. 53,530 (1975). The amendment was not ultimately promulgated.

\textsuperscript{86} See Blackmon v. Hindrew, 824 S.W.2d 85 (Mo. App. 1992). In Blackmon, a contractor agreed to do certain home improvements for $8,800 to be paid with interest over a term of five years. The contract contained the Notice but also included the following language: "Buyer agrees not to assert against the assignee of the holder of the note any claim Buyer may have against the Seller." \textit{Id.} at 86 (emphasis omitted). Upon completion of the improvements, the homeowner signed a certificate of completion, a promissory note, and a deed of trust, and the contractor assigned the note the same day. When the homeowner later discovered that the improvements were defective, she sued the assignee of the note and the trustees for the contractor. \textit{Id.}

The court in Blackmon held that the assignee was not liable to the homeowner because the qualifying language of the contract abrogated any protection given by the Notice. \textit{Id.} at 88-89. The homeowner was left dependant on state law for potential relief. \textit{Id.}

\textsuperscript{87} See 16 C.F.R. § 433.2 (1996).

\textsuperscript{88} \textit{Id.}

\textsuperscript{89} A consumer may want to sue the lender if some portion of the debt has been paid or if seller misconduct has caused damages beyond the amount of the debt. See, \textit{e.g.}, Perez v. Briercraft Serv. Corp., 809 S.W.2d 216 (Tex. 1991) (homeowner sued lender after siding fell off, windows fell apart, and improperly installed sewer vents caused foul odors in the house). Before promulgation of the Rule, the consumer had to sue the seller because the lender, as a holder in due course, was protected against defenses and claims. The consumer can now recover from the lender, but only to the extent of amounts paid.

\textsuperscript{90} See Guidelines, supra note 56, at 20,023. In those cases in which the amount paid under the contract is small, the cost of bringing suit may exceed potential recovery.

\textsuperscript{91} See Ford Motor Credit Co. v. Morgan, 536 N.E.2d 587 (Mass. 1989); Briercroft, 809 S.W.2d at 217 (Tex. 1991); Home Sav. Ass'n v. Guerra, 733 S.W.2d 134, 134-35
In this Article, I focus primarily on two additional limitations on effectiveness of the Holder in Due Course Rule. First, the Rule leaves the burden of proving defenses to payment on the consumer. Although the Rule abrogates the protection against claims and defenses ordinarily afforded the holder in due course of a negotiable instrument, it does not affect other aspects of negotiability.\(^{92}\) In a suit on a promissory note, the maker of the note has the burden to prove any defenses to payment.\(^{93}\) Therefore, a homeowner who executes a promissory note to evidence an obligation to pay for home improvements bears the burden to prove defects in the contractor's performance as a defense to payment.

Second, the Rule does not always preserve the consumer's most effective weapon—the ability to withhold payment if a seller has not adequately performed. Withholding payment is useless if a lender can foreclose on property securing a debt for goods or services without a judicial hearing.\(^{94}\) This scenario

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(Tex. 1987). Consumers have recovered additional damages from lenders by showing that the lender was involved in the fraud or that the contractor was acting as the lender's agent. See Union Mortgage Co. v. Barlow, 595 So. 2d 1335 (Ala. 1992), cert. denied, 113 S. Ct. 301 (1992); Knight v. International Harvester Credit Corp., 627 S.W.2d 382, 389 (Tex. 1982); Gene A. Marsh, Lender Liability for Consumer Fraud Practices of Retail Dealers and Home Improvement Contractors, 45 ALA. L. REV. 1 (1993).

\(^{92}\) See Rev. U.C.C. § 3-106(d) (1990). Under the prior version of Article 3, Professors White and Summers concluded that the effect of the Notice was to defeat negotiability of a promissory note by making the buyer's promise to pay conditional and therefore preventing an owner of the note from having holder in due course status. JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 14-8, at 638-39 (3d ed. 1988). Professor Sturley criticized this view as being inconsistent with the intent of the FTC. See Michael F. Sturley, The Legal Impact of the Federal Trade Commission's Holder in Due Course Notice on a Negotiable Instrument: How Clever Are the Rascals at the FTC?, 68 N.C. L. REV. 953 (1990). Article 3, as revised, resolves this issue with the following section:

> If a promise or order at the time it is issued or first comes into possession of a holder contains a statement, required by applicable statutory or administrative law, to the effect that the rights of a holder or transferee are subject to claims or defenses that the issuer could assert against the original payee, the promise or order is not thereby made conditional for the purposes of Section 3-104(a); but if the promise or order is an instrument, there cannot be a holder in due course of the instrument.

U.C.C. § 3-106(d) (1990). Therefore, in those states that have adopted the revised Article 3 the effect of the Notice is to preclude holder in due course status without precluding negotiability. See U.C.C. § 3-106 cmt. 3 (1990); Fred H. Miller, The Benefits of New UCC Articles 3 and 4, 24 UCC L.J. 99, 105 (1991).

\(^{93}\) See infra notes 128-30 and accompanying text.

\(^{94}\) The problem raised by non-judicial foreclosure is not limited to cases where a seller has assigned its right to payment under a consumer credit contract since the
arises with automobile loans, since automobiles can be repossessed by self-help under Article 9 of the UCC, and with home improvement loans, since many states permit power of sale foreclosure of real property. Although a homeowner may have a valid defense to payment and thus to foreclosure, the homeowner must bring suit to obtain an injunction against a power of sale foreclosure.

D. Other Federal Consumer Protection Measures

A number of other federal measures protect homeowners in home improvement loan transactions. Some federal measures are directed in particular at home improvement scams. For example, the Truth in Lending Act gives a homeowner the right to rescind a non-purchase money home mortgage loan for three days following the later of the closing of the loan or the delivery of the rescission notice and other disclosures required under the Act. Most home improvement loans are secured by a lien on the homeowner's home and are therefore subject to the three day cancellation right. The purpose of the cancellation right is to permit homeowners to reevaluate a transaction that creates a lien on their home. Lenders are not permitted to disburse loan proceeds, and contractors are not permitted to begin performance, prior to the expiration of the rescission period. If the homeowner exercises the rescission right, the homeowner is not liable

seller can foreclose a consensual lien without a hearing based on a homeowner's failure to pay for improvements in those states that permit non-judicial foreclosure.

95 U.C.C. § 9-503 (1990). Other consumer goods are likely to be located in the debtor's house and thus could not be repossessed without a breach of the peace. Id.

96 See infra note 166.


98 15 U.S.C. § 1635(a), (e).


100 See Regulation Z, 12 C.F.R. § 226.23(e).
for any amounts that would otherwise be due, and the lender must refund any amounts already paid.\textsuperscript{101} If the lender fails to comply with requirements of the Act, the right of cancellation is extended for as long as three years.\textsuperscript{102} This right of rescission does not, however, protect the homeowner who is given the required disclosures but discovers after the rescission period that home improvements are incomplete or substandard.\textsuperscript{103}

Congress recently amended the Truth in Lending Act to require additional disclosures and to prohibit certain unfair terms in home improvement and home equity loans with particularly high interest rates or points.\textsuperscript{104} One of the newly prohibited practices is the payment of advances under a home improvement loan directly to the contractor.\textsuperscript{105} A lender is permitted to make advances payable jointly to the contractor and homeowner.\textsuperscript{106} While this prohibition will prevent some abuses, it applies only to loans with particularly high interest rates.

While many federal measures protect home improvement borrowers, none specifically addresses limitations on the effectiveness of the Holder in Due Course Rule.\textsuperscript{107} Federal law leaves the

\textsuperscript{101} 15 U.S.C. § 1635(b).
\textsuperscript{102} Id. § 1635(f).
\textsuperscript{103} Some lenders and contractors have attempted to circumvent the three-day rescission period. Keest, supra note 99, at 417. A contractor may begin performance of the home improvements prior to the expiration of the cancellation period despite the prohibition of this practice. Id. The contractor may then tell the homeowner that the right of cancellation is not available because work has begun or that the homeowner must pay for the work already performed. Id. Another scheme involves separation of the contract for the home improvements from the loan. Id. at 418. The homeowner is not told the full cost of the improvements and financing until after the right of rescission for the home improvement contract has expired. The homeowner may want to cancel the loan, but the contractor must still be paid. Id. at 419. Courts have found in some cases that these schemes violated the delay of performance requirement and have therefore permitted a homeowner to rescind after the expiration of the three-day period. See Doggett v. County Sav. & Loan Co., 373 F. Supp. 774 (E.D. Tenn. 1973). The schemes are effective, however, where homeowners never learn of their rights under the Act or where they fail to take affirmative action to enforce their rights.

\textsuperscript{104} Home Ownership and Equity Protection Act of 1994, Pub. L. No. 103-325, tit. I.B, 108 Stat. 2190 (1994) (codified at 15 U.S.C. §§ 1601-1648 (1994)). The loans affected are those with an annual percentage rate more than ten percentage points greater than the rate on a Treasury security of comparable maturity or with points and fees exceeding the greater of eight percent of the loan amount or $400. Id. § 152(a), 108 Stat. 2190 (codified at 15 U.S.C. § 1602(aa)(1)).

\textsuperscript{105} Id. § 152(d), 108 Stat. 2190 (codified at 15 U.S.C. § 1639(i)).

\textsuperscript{106} Id.

\textsuperscript{107} See supra part II.C.
burdens of proof and initiating a lawsuit on a homeowner who is the victim of a home improvement scam.

E. State Law

Some states give consumers additional protection against unscrupulous sellers. State law may sometimes fill gaps left by the Holder in Due Course Rule. First, courts in most states apply the "close-connectedness" doctrine—a judicially created doctrine pre-dating the Holder in Due Course Rule—to abrogate the holder in due course doctrine where the assignor and assignee of a note have a close relationship. Under the close-connectedness doctrine, the relationship between an assignor and assignee may be used to impute notice of defenses or lack of good faith. The doctrine applies even in those situations where the seller fails to include the FTC Notice in a note. However, the doctrine does not apply where a lender with a relationship to the seller makes a direct loan to a consumer. The close-connectedness doctrine also does not affect allocation of the burdens of proof or initiating suit.

Second, a number of states have adopted either the 1968 or the 1974 version of the Uniform Consumer Credit Code (UCC), which may place the burden to prove a contractor's performance of home improvements on the lender. The UCC provides that a seller may not accept a negotiable instrument other than a check as evidence of a consumer's obligation. This section is intended to prevent assignees of consumer credit contracts from obtaining holder in due course status by prohibiting the use of negotiable instruments in certain consumer credit transactions. To the extent this section causes sellers to evidence a consumer's obligation to pay in such a way that the obligation is conditioned

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109 Id.
110 The doctrine was first recognized by the Arkansas Supreme Court in Commercial Credit Corp. v. Childs, 137 S.W.2d 260 (1940), before the FTC promulgated the Holder in Due Course Rule.
111 See Nelson & Whitman, supra note 62, § 5.29, at 352.
on seller's performance, it also prevents shifting the burden of proof to the consumer.\textsuperscript{115} In addition, the 1974 version of the UC\textsuperscript{3} prevents holder in due course status, regardless of seller compliance, by making an assignee subject to all claims and defenses the consumer could have raised against the seller.\textsuperscript{116} Even under the 1974 version, however, a homeowner must file suit to raise defenses if the lender can foreclose without judicial process.

Finally, some states prohibit foreclosure without a hearing, placing the burden of initiating suit on a home improvement lender. State judicial foreclosure requirements are discussed in Part IV.

III

BURDEN OF PROOF

Although the Holder in Due Course Rule preserves a homeowner's defenses against a home improvement lender when the lender has a relationship to the contractor, current law leaves the burden to prove any defense to foreclosure\textsuperscript{117} and, in many

\begin{itemize}
\item \textsuperscript{115} The section does not prohibit sellers from taking a promissory note which is not negotiable only because it is not payable to order or bearer. Under the prior version of the UCC, such an instrument is treated in the same manner as a negotiable instrument except that there can be no holder in due course thereof. U.C.C. § 3-805 (1966). There is no comparable provision in revised Article 3 except with respect to checks. See U.C.C. § 3-104 cmt. 2 (1990). Therefore, a promise not payable to order could not be a negotiable instrument, although some of the characteristics of negotiability could arise under ordinary principles of contract law. \textit{Id.}
\item \textsuperscript{116} U.C.C.C. § 3.404(1) (1974). Under the 1968 version of the UC\textsuperscript{3}, the seller's violation of the prohibition against taking a negotiable instrument affects an assignee lender only if the lender had notice that the instrument was issued in violation of the provision. U.C.C.C. § 2.403 (1968). Another limitation of the 1968 version of the UC\textsuperscript{3} is that it applies to consumer credit contracts originated by the seller and transferred to a lender, but does not apply where a seller arranges financing to be made directly by a lender. The 1974 version makes direct lenders subject to claims and defenses where a sufficient relationship between the seller and the lender exists. U.C.C.C. § 3.405(1) (1974). \textit{See infra} notes 221-22 and accompanying text.
\item \textsuperscript{117} The burden of proof is in fact two separate burdens: (1) the burden of producing evidence sufficient to establish the existence of an element in the first instance; and (2) the burden of persuasion to establish that, more likely than not, the element exists in view of all the evidence. \textit{See Edward W. Cleary, Presuming and Pleading: An Essay on Juristic Immaturity, 12 Stan. L. Rev. 5, 15-16 (1959).} Because the burden of producing evidence and the burden of persuasion generally go hand in hand, \textit{id.} at 16, the term "burden of proof" is sufficiently descriptive of both burdens for purposes of this Article. \textit{But see Alex Stein, Allocating the Burden of Proof in Sales Litigation: The Law, Its Rationale, a New Theory, and Its Failure, 50 U. Miami L. Rev. 335 (1996) (emphasizing the difference in the application of allocation rules).}
\end{itemize}
states, the burden to initiate a lawsuit on the homeowner. The burden of proof falls on the homeowner when her obligation to pay for home improvements is evidenced by a promissory note. The burden of initiating suit falls on the homeowner when a home improvement lender is permitted to foreclose by power of sale. Placing these burdens on the homeowner is inappropriate in circumstances in which defenses to payment are likely, such as when the contractor and lender have a relationship.

A. Burden of Proof: Construction Contract vs. Promissory Note

Allocation of the burden of proof in a suit to collect payment for home improvements depends upon whether the homeowner’s obligation to pay is evidenced by a promissory note. When a homeowner pays cash for home improvements, her obligation to pay is created by the construction contract between the contractor and the homeowner. Under the terms of the contract, the contractor promises to perform certain work and the homeowner promises to pay for these improvements. In the absence of a contract provision to the contrary, performance of services is required before payment for the services becomes due. With minor improvements, the contractor usually performs before the homeowner pays. With more complex improvements, the contract will typically provide for progress payments as work pro-

118 See E. Allan Farnsworth, Contracts § 8.11, at 611-15 (2d ed. 1990); Justin Sweet, Legal Aspects of Architecture, Engineering and the Construction Process § 22.01, at 460 (5th ed. 1994).
gresses. In the event the contractor fails to perform his obligations under the contract, the homeowner may simply refuse to pay the contract price. If the contractor brings suit against the homeowner, the contractor must prove the terms of the underlying transaction and that a breach occurred. Specifically, the contractor must establish substantial performance, and he will not prevail if he has not substantially performed. The homeowner must prove any relevant affirmative defenses, such as fraud or unconscionability.

The contractor may have a contractual lien or a mechanic’s lien securing the homeowner’s obligation to pay for home improvements. Most states require judicial foreclosure of a mechanic’s lien and some states require judicial foreclosure of a contractual lien. In a judicial foreclosure action, the contractor must prove the existence of a debt by establishing performance.

If home improvements are being financed and state law permits, the homeowner typically will be required to execute a promissory note containing an unconditional promise to pay the amount of the contract price. The promissory note may be payable to a third party lender if funds are being advanced by the lender, or may be payable to the contractor if the contractor intends to transfer the note to the lender. The promissory note is usually secured by a deed of trust or mortgage on the homeowner’s home. If the contractor fails to perform, the homeowner may stop making payments on the note. However, if the homeowner refuses to pay, the noteholder may accelerate and sue on the note or begin foreclosure proceedings. The note, although related to the underlying obligation on the construction contract,

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119 See Sweet, supra note 118, § 22.02, at 461.
121 See Sweet, supra note 118, § 22.06, at 476-83.
122 See Cleary, supra note 117, at 7; Zaretsky, supra note 120, at 633.
123 Nelson & Whitman, supra note 62, § 12.4, at 905.
124 See infra note 159 and accompanying text.
125 For example, in Texas a petition for foreclosure of a mechanic’s lien should recite that the contractor supplied labor or materials. 18 William V. Dorsaneo III & Larry Knippa, Texas Litigation Guide § 271.100[1] (1996).
126 Typically, contractors do not finance the improvements themselves but rely on a third party lender that is involved initially or when the contractor assigns the note.
provides a separate basis for enforcement of the payment obligation.  

Article 3 of the UCC provides for allocation of the burden of proof in a suit on a negotiable instrument.  

The maker of a promissory note has the burden to prove any defenses to payment, such as failure of consideration, breach of warranty, unconscionability, or fraud. Therefore, while a contractor must prove substantial performance in a suit brought on a contract for home improvements, the homeowner must prove deficiencies in performance as a defense to a suit on a note. The execution of a promissory note to evidence the homeowner’s obligation to pay for home improvements thus shifts the burden of proof on issues related to performance. Where a relationship between the home improvement contractor and the lender exists, placement of this burden on the homeowner does not comport with traditional notions of appropriate allocation of the burden of proof.

B. Allocation Rules

Certain factors are typically considered in allocating the burden of proof. These factors include the parties’ relative access to evidence, probability of the outcome, and policy. Access to evidence is a factor in the allocation of the burden because the party with superior knowledge of, or control over, evidence rele-

127 See Zaretsky, supra note 120, at 632.
129 U.C.C. § 3-308(b) (1990); U.C.C. § 3-307(2) (1966). The validity of signatures is deemed admitted unless they are specifically denied. U.C.C. § 3-308(a) (1990); U.C.C. § 3-307(1) (1966).
130 After a defense is established, a holder may seek to cut off the defense by establishing that he is a holder in due course. U.C.C. § 3-308(b) (1990); U.C.C. § 3-307(3) (1966).
131 See Rogers, supra note 120, at 941-42; Zaretsky, supra note 120, at 633. Even if a promissory note is not a negotiable instrument governed by Article 3, the maker has the burden to plead and prove defenses based on the underlying contract because the execution of a note turns a conditional obligation into an unconditional one.
132 JAMES ET AL., supra note 117, § 7.16, at 344-45. The same factors are usually considered in allocating the burden of pleading. FRIEDENTHAL ET AL., supra note 117, § 5.15, at 276; JAMES ET AL., supra note 117, § 3.11, at 159-61.
133 See JAMES ET AL., supra note 117, § 3.11, at 159-60; Cleary, supra note 117, at 11-13; Fleming James, Jr., Burdens of Proof, 47 VA. L. REV. 51, 60-61 (1961) [hereinafter James, Burdens of Proof].
vant to an issue should be required to prove that issue.\footnote{134} Probability is a factor because the burden should usually be placed on the party attempting to show that the case departs from the normal course of events.\footnote{135} Probability thus allows close cases to be decided correctly more often than not.\footnote{136} Finally, policy is a factor because the party with the burden of proof is handicapped to some extent.\footnote{137} Policy can provide the basis for determining which party should bear the handicap and lose a close case.

In an action against the maker of a promissory note, Article 3 places the burden to prove defenses to payment on the maker.\footnote{138} This placement of burden can be evaluated in light of the above allocation factors. First, evaluation will be based on an assumption that the promissory note evidences the maker’s obligation to pay a loan unrelated to any underlying contract for the purchase of goods or services.\footnote{139} Defenses that could arise in connection with this type of loan include lack of consideration (if loan funds were never advanced), prior payment of the note, and usury. Because the payee and maker should have equal access to evidence regarding such defenses, the burden of proof could be placed on

\begin{footnotes}
\footnote{134} See James et al., \textit{supra} note 117, § 3.11, at 160, § 7.16, at 344; Cleary, \textit{supra} note 117, at 12; James, \textit{Burdens of Proof}, \textit{supra} note 133, at 60. Professor Cleary calls this factor “fairness.” Cleary, \textit{supra} note 117, at 12. Professor Stein writes that access to evidence should be a factor in allocating the burden of producing evidence but not in allocating the burdens of persuasion. Stein, \textit{supra} note 118, at 335.

\footnote{135} See James et al., \textit{supra} note 117, § 3.11, at 160; Cleary, \textit{supra} note 117, at 12-13; James, \textit{Burdens of Proof}, \textit{supra} note 133, at 60-61; Lawrence B. Solum, \textit{You Prove It! Why Should It?}, 17 \textit{Harv. J.L. \\& Pub. Pol'y} 691, 701 (1994). Professor Solum describes this function of the burden of proof as follows:

[I]n a legal case, allocation of the burden may simply be a method or procedure for producing the best outcomes in the long run, or (in the language of decision theory) maximizing the expected utility of legal proceedings. Usually, this will be the most accurate outcome, but not always. For example, the burden of persuasion in a criminal case may be proof beyond a reasonable doubt, because the disutility of convicting an innocent person far exceeds the disutility of finding a guilty person to be not guilty: better that ten guilty persons go free than one innocent person be convicted. \textit{Id.} at 701.

\footnote{136} The difficulty with the probability factor is in determining the relevant group on which to base the calculation of probability. See Cleary, \textit{supra} note 117, at 13.

\footnote{137} See James et al., \textit{supra} note 117, § 3.11, at 160, § 7.16, at 345; Cleary, \textit{supra} note 117, at 11-12; James, \textit{Burdens of Proof}, \textit{supra} note 133, at 61.

\footnote{138} See \textit{supra} notes 128-30 and accompanying text.

\footnote{139} Examples include commercial loans, home purchase money loans, and consumer loans made for the purchase of goods or services by lenders with no relationship to the seller. See \textit{infra} part IV.D. for a discussion of these types of loans.
\end{footnotes}
either party if the note were not intended to be transferred. However, where a promissory note has been transferred to a third party, the maker of the note has superior knowledge of and control over evidence regarding defenses. Placing the burden of proof on the maker rather than on the transferee is therefore appropriate.

With regard to probability, defenses to payment tend to arise only in the unusual case. Typically, when a maker executes a promissory note, funds are advanced, and when a lender sues on a note, the note has not been paid. Thus, placement of the burden on the maker to prove the unusual case—that the maker never received loan funds or paid the note—is appropriate.

Finally, the strong policy of transferability of negotiable instruments arguably justifies placing the burden of proof on the maker of a note. A promissory note is more readily transferred if the transferee will not later be required to prove matters about which the original parties have superior knowledge. Therefore, the burden may appropriately be placed on the maker of a promissory note evidencing a loan unrelated to purchase of goods or services.

This allocation analysis changes with respect to a note evidencing the obligation of a homeowner to pay for home improvements performed by a contractor with a relationship to the lender. In this case, the homeowner can raise defenses based on the contractor's performance. As between the contractor and the homeowner, the contractor has superior knowledge of, and control over, evidence of substantial completion. As between the lender and the homeowner, the parties should have roughly equal access to evidence of performance because the lender should have obtained this evidence from the contractor prior to advancing funds. This factor therefore does not mandate placing the burden of proof on the homeowner.

Probability requires shifting the burden of proof to the lender only if valid defenses are more likely than not in the relevant set of transactions. The first step in applying the probability factor is to determine this relevant test group. While most home improvements are completed to the satisfaction of the homeowner, unsatisfactory completion occurs regularly in an identifiable set of transactions—those where the contractor and the lender have

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140 See infra part IV.D.
141 See supra note 136.
a relationship—because related lenders are less likely to police contractors by withholding loan funds until improvements are satisfactorily completed.\textsuperscript{142} Therefore, the test group should include only those cases in which the home improvement lender has a relationship to the contractor. In addition, the test group should include only those cases in which the lender is suing or foreclosing because of non-payment on the note.\textsuperscript{143} The homeowner may simply be unable to pay for the improvements, or she may be refusing to pay because of the contractor's failure to satisfactorily complete them.\textsuperscript{144} Although there is no empirical data, contractors fail to satisfactorily complete improvements in a significant number of transactions where there is a relationship between the contractor and the lender.\textsuperscript{145} In fact, in cases of home improvement loans made to poor or elderly homeowners—cases in which the lender and contractor tend to have a relationship—a fraudulent or abusive transaction may be the norm rather than the exception, and contractors in such transactions are unlikely to complete improvements in a satisfactory manner. Therefore, probability arguably weighs in favor of placing the burden of proof on the lender.

Policy most clearly requires placing the burden of proof on the lender. Policy favoring promissory notes' transferability should yield in the consumer credit context to policy that favors protecting a consumer's home.\textsuperscript{146} Negotiability of home improvement notes and other consumer paper is not necessary to foster the flow of commerce.\textsuperscript{147} Consumer paper is rarely transferred in a long series of assignments to a party without any relationship to or knowledge of the original payee.\textsuperscript{148} On the other hand, when a homeowner is handicapped in defending a suit on a home im-

\textsuperscript{142} See supra note 31 and accompanying text.
\textsuperscript{143} Cases in which a homeowner has paid for satisfactory improvements are not relevant. As Professor Cleary says: "The litigated cases would seem to furnish the more appropriate basis for estimating probabilities." Cleary, supra note 117 at 13.
\textsuperscript{144} The Hogans made payments despite the contractor's shoddy performance until James Hogan had to stop working because of a job-related injury. House Consumer Credit Subcomm. Hearing, supra note 1, at 55-56 (statement of James R. Hogan, Sr.).
\textsuperscript{145} See supra Part I.A.
\textsuperscript{146} See Forrester, supra note 17, at 406-09.
\textsuperscript{147} Rosenthal, supra note 44, at 401. The FTC found that "[t]he considerations which underpin the laws of negotiability have little or no application in consumer transactions where the integrity of the commercial paper market is not a concern." Statement of Basis and Purpose, supra note 7, at 53,507.
\textsuperscript{148} Rosenthal, supra note 44, at 378-79.
The theoretical framework for home improvement financing is crucial. The homeowner may pay for improvements that were not performed or, worse, may lose the home. The interest in avoiding such an outcome clearly outweighs the need for negotiability of the homeowner's note. Therefore, policy requires placing burden of proof in a suit for payment of a home improvement note on the lender if that lender has a relationship with the contractor.

The transformation of a homeowner's conditional obligation to pay for home improvements under a construction contract into an unconditional obligation to pay evidenced by a promissory note is simply inappropriate where the home improvement lender has purchased the obligation from the contractor or otherwise has a relationship to the contractor. The FTC determined that the holder in due course doctrine should not apply to consumer credit transactions, including home improvement loans. Similarly, the presumption of consideration created by a promissory note should not apply. Therefore, the law should not permit a lender to require that a homeowner's obligation to pay for home improvements be evidenced by a promissory note unless the lender is truly independent of the contractor.

IV

BURDEN OF INITIATING SUIT

The burden of initiating suit is a more significant burden to the victim of a home improvement scam than the burden of proof. As a general rule, allocation of the burden of initiating suit is determined by the circumstances giving rise to a claim. In any dispute involving property, the party without physical possession of the disputed assets has the burden of initiating suit.

The FTC's Holder in Due Course Rule was intended to give

149 See supra part I.C.
150 See Statement of Basis and Purpose, supra note 7, at 53,507, 53,511.
151 See infra part IV.C.2.
152 For example, in tort litigation, the injured party has the burden to sue. Under contract law, the burden to sue usually falls on the party claiming breach of contract unless that party can shift the burden by not performing.
154 For example, the law places the burden of initiating suit to recover disputed credit card amounts on financial institutions. Id. at 117 n.199. The cardholder may refuse to pay disputed amounts, and the financial institution is not permitted to set off the amount against other deposits of the cardholder. 15 U.S.C. § 1666h (1994).
consumers the power, based on a valid defense, to withhold payment for goods and services purchased on credit. In connection with purchases of most types of goods or services, the Rule shifts the burden of initiating suit away from the consumer. Prior to the Rule’s promulgation, a consumer could not raise valid defenses against the noteholder. As a result, a consumer was required to pay the noteholder and her only recourse to recover the sums paid was to bring suit against the seller. Since promulgation of the Rule, consumers have been able to raise valid defenses against noteholders. A consumer with a valid defense may withhold payment from the noteholder, thereby retaining the disputed assets and making a suit against the seller unnecessary. The Rule permits the consumer to withhold payment and removes the burden of initiating suit in cases where a lender may not repossess collateral without judicial action.

In states that permit power of sale foreclosure, the holder of a note secured by real estate may foreclose and apply sale proceeds from the debtor’s property against the debt without a judicial hearing. Thus, if a homeowner withholds payment on a home improvement loan, the lender can satisfy the debt by foreclosing on her home. To assert a valid defense to payment of the note, the homeowner either must continue to make payments and seek a declaratory judgment voiding the debt or must enjoin the foreclosure. A homeowner’s only mechanism to prevent foreclosure is through the courts. Power of sale foreclosure therefore shifts the burden of initiating suit to the homeowner.

A. Judicial Foreclosure

Approximately twenty states prohibit power of sale foreclosure. See Guidelines, supra note 56, at 20,022. Statement of Basis and Purpose, supra note 7, at 53,511-12. See supra part II.B. An optimistic view of the world would assume that note holders who know of a consumer’s valid defense to payment are unlikely to sue the consumer. It is only where a note holder is not aware of a defense or is not certain of its validity that the note holder is likely to actually initiate a losing lawsuit against the consumer. However, unscrupulous lenders may count on the consumer’s ignorance of defenses or on the consumer’s unwillingness to appear in court to assert them. See infra notes 194-97 and accompanying text.

The homeowner could also file bankruptcy to stay the foreclosure and raise the defense in the bankruptcy proceeding to prevent allowance of the lender’s claim. See 11 U.S.C. § 502(b)(1) (1994). Except as a vehicle to assert a defense or as a delay tactic, bankruptcy provides little protection to homeowners facing foreclosure. See Forrester, supra note 17, at 427-30.
sure, making judicial action the only means available to foreclose a mortgage lien. Judicial foreclosure requirements vary from state to state, but generally include the following steps: a title search to determine ownership interests in the land, filing a foreclosure bill of complaint, service of process, hearing, entry of the court's judgment, notice of sale, sale, judicial confirmation of the sale, distribution of sale proceeds, and determination of any deficiency judgment. The court oversees each of these steps, providing some safeguard against defects in the sale process.

The lender initiates the foreclosure action by filing a complaint that must comply with pleading requirements. In Texas, for example, the complaint must allege the existence of the indebtedness, default by the debtor, and the existence of a lien. The foreclosing lender must name as defendants all parties with an interest in the property that will be affected adversely by foreclosure and must provide adequate notice to these parties. In many cases, the borrower does not file an answer, probably because the borrower has no defense to payment. When the borrower does have a viable defense, there is usually a trial on the issues. If the borrower fails to answer or has no valid defense, the court will enter judgment for the lender and order a sale. After sale at public auction, most states provide for judicial confirmation to insure that the foreclosing lender complied with all statutory requirements for foreclosure.

B. Power of Sale Foreclosure

Most states permit a mortgage lender to foreclose by power of sale. Power of sale foreclosure has been criticized because notice requirements are frequently insufficient, because there is

159 See Nelson & Whitman, supra note 62, § 7.11, at 490.
161 Dunaway, supra note 160, § 12.05.
163 Dunaway, supra note 160, § 11.03(9)(g).
164 Id. § 12.06(1).
165 Id. § 12.13(7).
167 See David A. Leen et al., Due Process and Deeds of Trust—Strange Bedfellows?, 48 Wash. L. Rev. 763, 793-94, 800 (1973); David M. Madway, A Mortgage Foreclosure Primer, Part II, 8 Clearinghouse Rev. 250, 258, 265 (1974); David P. Cotellesse, Note, Nonjudicial Foreclosure Under a Deed of Trust: Some Problems of
no opportunity for a hearing prior to foreclosure,\textsuperscript{168} and because the foreclosure sale price is often below fair market value.\textsuperscript{169} After the United States Supreme Court held certain prejudgment remedies unconstitutional as violating debtors' procedural due process rights,\textsuperscript{170} commentators speculated about the constitutionality of power of sale foreclosure.\textsuperscript{171} Most state power of sale foreclosure schemes pass constitutional muster, not because of the adequacy of their notice and hearing requirements, but because of the absence of state action.\textsuperscript{172} However, constitutional-

\textsuperscript{168} See Leen et al., supra note 167, at 793-94, 797; Madway, supra note 167, at 258, 268; Delcambre, supra note 167, at 88-89; Turner, supra note 167, at 872.


ity does not ensure fairness nor does it establish that public policy should permit such schemes.

Foreclosure notice requirements vary from state to state in terms of notice periods, types of notice, and parties to be notified.\textsuperscript{173} Procedural due process, where applicable, requires that notice must be "reasonably calculated . . . to apprise interested parties."\textsuperscript{174} While most power of sale foreclosure statutes now require notice by mail or personal service rather than merely by publication,\textsuperscript{175} statutes may not require that notice be given to all parties with an interest in the property.\textsuperscript{176} Nevertheless, because adequacy of notice is not an inherent problem with power of sale foreclosure, I do not address it further.

Inadequacy of bid price has received a substantial amount of attention in recent years.\textsuperscript{177} A forced sale at foreclosure simply does not produce a price equal to fair market value. As a result, homeowners who lose their homes to foreclosure may lose their equity in the home,\textsuperscript{178} or may face a deficiency judgment if foreclosure proceeds fail to satisfy the debt.\textsuperscript{179} In some states, lend-

\textsuperscript{173}See Nelson & Whitman, supra note 62, § 7.19, at 534.
\textsuperscript{175}See Nelson & Whitman, supra note 62, § 7.19, at 534. A few states still require notice by publication only. See, e.g., GA. CODE ANN. §§ 44-14-162, 162.2, 162.3 (Harrison 1994) (applicable to nonresidential mortgages only); MISS. CODE ANN. § 89-1-55 (1991).
\textsuperscript{176}See, e.g., D.C. CODE ANN. § 45-715 (1990); MINN. STAT. ANN. § 580.03 (West 1988); TEX. PROP. CODE ANN. § 51.002 (West 1995).
\textsuperscript{177}See, e.g., Berger, supra note 169; Dietrich, supra note 169, at 316-28; Gover & West, supra note 169; Johnson, supra note 169; Nelson, supra note 169, at 248; Washburn, supra note 169; Wechsler, supra note 169.
\textsuperscript{178}See Johnson, supra note 169, at 966-67. Professor Johnson's hypothetical borrower, Karen Mortgagor, has $60,000 of equity in her home, but she is unlikely to receive any proceeds from a foreclosure sale of the home. See id. A borrower will typically lose any existing equity in a foreclosure because the lender has little or no incentive to bid more than the amount of the debt and because third parties rarely purchase at a foreclosure sale. Id. at 968-71.
\textsuperscript{179}Id. at 967. Many states impose limitations on the right of a mortgage lender to seek a deficiency judgment, with limitations ranging from procedural requirements to anti-deficiency statutes. See Nelson & Whitman, supra note 62, §§ 8.1-8.3. Anti-deficiency statutes may prohibit a deficiency judgment altogether under certain circumstances or limit the amount of a deficiency to the difference between the debt and the value of the foreclosed property. Id. § 8.3.
ers may buy a home at foreclosure for substantially less than its fair market value, sell the house for significantly more, and still maintain a deficiency suit against the borrower though the lender has been made whole.\textsuperscript{180} Borrowers, therefore, can face both loss of equity and a deficiency judgment. Nevertheless, because inadequacy of bid price is not unique to power of sale foreclosure,\textsuperscript{181} I do not address it further in this Article.

A homeowner’s lack of opportunity for a hearing shifts the burden of initiating suit onto the homeowner. This is the primary concern I address in this Article. Where state action makes procedural due process applicable to power of sale foreclosure, due process entitles the mortgagors to “a hearing at which [the mortgagors] could challenge . . . the legal right of [the mortgagee] to foreclose.”\textsuperscript{182} The mortgagor’s right to bring suit to enjoin a foreclosure probably does not satisfy constitutional requirements for opportunity to be heard.\textsuperscript{183} Most power of sale foreclosures are nonetheless valid because state action is absent.

C. Propriety of Power of Sale Foreclosure in Contractor-Connected Home Improvement Loans

Wholly apart from the constitutional issue is the issue of fairness. As a matter of public policy, should home improvement lenders who have purchased a loan from, or who have a relationship with, the home improvement contractor be permitted to foreclose on a person’s home without prior hearing? Answering this question requires balancing the benefits of the power of sale foreclosure remedy to such lenders against the costs to homeowners.\textsuperscript{184} First, the cost of power of sale foreclosure is less than

\textsuperscript{180} See Johnson, supra note 169, at 966-67. In states with anti-deficiency legislation or a statutory right of redemption, a lender has little incentive to make a “low-ball” bid. \textit{Id.} at 967-68.

\textsuperscript{181} See Nelson, supra note 169, at 248; Washburn, supra note 169, at 847.

\textsuperscript{182} Ricker v. United States, 417 F. Supp. 133, 139 (D. Me. 1976); \textit{see also} Turner v. Blackburn, 389 F. Supp. 1250, 1259 (W.D.N.C. 1975) (“[A]t a minimum due process requires the trustee to make an initial showing before the clerk or similar neutral official that the mortgagor is in default under the obligation; the mortgagor must of course be afforded the opportunity to rebut and defend the charges.” (citation omitted)).


\textsuperscript{184} While no such balancing has been performed with regard to power of sale
the cost of judicial foreclosure, although the cost differential is difficult to measure and varies from state to state. Lower foreclosure costs may be passed on to borrowers in the form of lower interest rates and increased availability of credit. These benefits may be outweighed if power of sale foreclosure imposes a substantial hardship on homeowners. The availability of power of sale foreclosure imposes costs on society if it permits lenders to foreclose in instances in which a homeowner has a valid defense to payment that she would raise in a judicial foreclosure hearing but not with a power of sale foreclosure. Since at least some instances of wrongful foreclosure would be avoided if judicial foreclosure were required, the question becomes the frequency with which these instances occur.

To evaluate the contribution made by power of sale foreclosure to the frequency of wrongful foreclosures, several questions should be considered. First, how often do lenders attempt to foreclose despite a homeowner's valid defense to foreclosure? Second, how often do homeowners with a valid defense fail to raise that defense by seeking to enjoin a power of sale foreclosure? Finally, how often would homeowners with a valid defense appear and raise that defense in a judicial foreclosure? While no concrete answers to these questions exist, a meaningful discussion of each is still possible.


185 Cost and Time Factors in Foreclosure of Mortgages, 3 Real Prop., Prob. & Tr. J. 413 (1968) [hereinafter Cost and Time].

186 Power of sale foreclosure may also impose costs on homeowners if it is less likely to result in a fair bid price. Judicial involvement in the judicial foreclosure process may increase the likelihood of a fair bid. However, anti-deficiency legislation and statutory redemption schemes adopted in connection with power of sale foreclosure can also increase the likelihood of a fair bid. Adequacy of bid price is not the focus of the Article.

187 These questions are based on similar questions asked by Professor White in his evaluation of the remedy of self-help repossession. See White, supra note 184, at 512.
1. Prevalence of Defenses to Foreclosure

Because homeowners do not always raise valid defenses to foreclosure of a home improvement loan, measuring the prevalence of such defenses is difficult. In some cases, homeowners may have defenses to payment based on the loan transaction itself. In addition, because of the FTC's Holder in Due Course Rule, homeowners are permitted to raise defenses based on the failure of the contractor to complete improvements in a satisfactory manner or based on fraud or unconscionability in the underlying home improvement contract. While anecdotal evidence indicates that defenses to payment are quite common, no empirical evidence is available. The number of complaints made to Better Business Bureaus about home improvement companies provides some indication that defenses to payment based on problems in the underlying transaction frequently arise. Furthermore, studies of consumers sued by their creditors show that a substantial number may have complete or partial defenses to payment.

2. Failure of Homeowners to Raise Valid Defenses

In jurisdictions in which a home improvement lender may foreclose by power of sale, the only means for a homeowner to
assert a defense to foreclosure is by bringing suit to enjoin the foreclosure. This burden creates a major obstacle for homeowners for a number of reasons. First, consumers tend not to assert their legal rights when doing so requires them to initiate litigation. Homeowners may not be sufficiently sophisticated to know that a valid defense will prevent a foreclosure, or they may be cynical about their own ability to prevail against the foreclosing lender. In addition, they may be intimidated by the legal process or by the prospect of hiring an attorney.

Second, the costs of initiating litigation may be prohibitive. A suit to obtain an injunction is not easily brought pro se, yet homeowners most often affected by home improvement scams are the very members of society who may have the least access to legal services. While middle or upper income homeowners may have the resources to retain an attorney to prevent foreclosure, less affluent homeowners are unlikely to be able to afford an attorney. Although the poor have access to free legal services in many communities, low income homeowners may have incomes too great to qualify for such services. Thus, homeowners facing foreclosure may be caught in the middle, with incomes too low to afford an attorney but too high to make them eligible for free legal services. Even those who would qualify for free legal services might not be aware these services are available. Furthermore, a suit to enjoin a foreclosure, even with a claim against the lender, is unlikely to produce damages which would

194 Cooter & Rubin, supra note 153, at 81, 116.
195 Id.
196 See White, supra note 184, at 528.
197 See Cooter & Rubin, supra note 153, at 81.
198 See generally id. at 80-81 (discussing the effect of litigation costs on a consumer's decision to pursue litigation); Marc Galanter, Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change, 9 LAW & SOC'Y REV. 95, 108-10, 119-24 (1974) (discussing the advantages in litigation that repeat players, such as finance companies, have over "one-shotters," such as consumer debtors).
199 See infra notes 204-08 and accompanying text.
200 The Legal Services Corporation establishes the maximum income levels for persons eligible for free legal assistance. Income Level for Individuals Eligible for Assistance, 62 Fed. Reg. 12,751 (1997). Generally, the maximum annual income for an individual to be eligible is $9,863 and for a family of four to be eligible is $20,063. Id. at 12,752.
201 Approximately half of the consumers interviewed by Sterling and Schrag had incomes too high for them to qualify for free legal services in Washington D.C. Sterling & Schrag, supra note 193, at 386-87 n.106.
202 Four of the fifteen consumers interviewed by Sterling and Schrag were not aware of the availability of free legal services. Id. at 386.
warrant an attorney's acceptance of the case on a contingent fee basis.\textsuperscript{203}

Finally, the nature of the injunction action creates problems for homeowners. To prevent a pending foreclosure, the homeowner must obtain a temporary restraining order (TRO), a preliminary injunction, or both. In addition, the homeowner must ultimately obtain a permanent injunction based on the invalidity of the debt. Most jurisdictions require a plaintiff seeking either a TRO or a preliminary injunction to post a bond or other security.\textsuperscript{204} The bonding requirement increases the cost of an already expensive action. In order to obtain a preliminary injunction or TRO, the homeowner must typically show irreparable harm and some probability that the homeowner will prevail on the merits.\textsuperscript{205} If foreclosure is imminent, a homeowner may attempt to obtain a TRO. While a TRO may be issued in an ex parte hearing, its typical duration is only ten days to two weeks.\textsuperscript{206} A preliminary injunction usually will be required to prevent a lender from foreclosing after expiration of the TRO and before a permanent injunction can be obtained. While a preliminary injunction survives until final judgment on the merits, unless dissolved earlier, securing a preliminary injunction requires an evidentiary hearing.\textsuperscript{207} If the homeowner is successful in obtaining a preliminary injunction, then the homeowner can avoid foreclosure until a hearing is scheduled for the permanent injunction. In an action to obtain a permanent injunction, the homeowner must prove a valid defense to the debt.\textsuperscript{208} Therefore, enjoining a foreclosure is likely to require two evidentiary hearings and at least some discovery to obtain evidence. If there is a dispute about the quality of the home improvements, the homeowner will probably need testimony from an expert witness. Obtaining injunctive relief to

\textsuperscript{203} \textit{But see} Union Mortgage Co. v. Barlow, 595 So. 2d 1335 (Ala.), \textit{cert. denied}, 113 S. Ct. 301 (1992) (holding a lender liable for over six million dollars on the basis that the contractor was acting as the lender's agent in perpetrating a fraud against the borrower); Marsh, \textit{supra} note 91, at 20-25 (discussing the \textit{Union Mortgage} case).

\textsuperscript{204} \textsc{Dan B. Dobbs, Law of Remedies} § 2.11(3) (2d ed. 1993). The cost of the bond is not refundable even if the homeowner ultimately prevails in preventing a foreclosure.

\textsuperscript{205} \textit{See id.} § 2.11(2).

\textsuperscript{206} \textit{Id.} § 2.11(1).

\textsuperscript{207} \textit{Id.} The hearing on a preliminary injunction is usually attenuated, with evidence by affidavit typically permitted. \textit{Id.}

\textsuperscript{208} The homeowner must also show that the legal remedy is not adequate. \textit{See id.} § 2.5(2). Typically, this showing is not difficult because each tract of land is assumed to be unique.
prevent a foreclosure is thus expensive and most certainly requires the assistance of an attorney. Because of the difficulty of asserting a defense to payment in this manner, homeowners may instead continue making payments despite the defense or, worse, may lose their homes to foreclosure.

3. Likelihood of Homeowners to Raise Defenses in a Judicial Foreclosure

The extra costs of judicial foreclosure should be imposed on lenders only if homeowners are more likely to appear and raise defenses in a judicial foreclosure action than they are to seek to enjoin a power of sale foreclosure. Studies show that a great percentage of consumers sued by their creditors fail to appear. Some commentators theorize that consumers who default have no defense to payment. However, other reasons explain the frequency of default. For example, consumers may default because they have not received a summons, because they do not understand the summons, because they are unable to miss work, or because they have been advised by a court clerk or the creditor's attorney not to appear. The propensity of consumer debtors to default when sued raises the question of whether homeowners would appear to raise a defense against a foreclosure. If homeowners are not likely to appear, then the extra costs imposed by judicial foreclosure are not warranted.

Despite the propensity of consumer debtors not to appear

209 See Caplovitz, supra note 193, at 201-11; Johnson, supra note 184, at 114 (citing a National Commission on Consumer Finance Press Release, May 5, 1972); Sterling & Schrag, supra note 193, at 361; see also Barbara Bezdek, Silence in the Court: Participation and Subordination of Poor Tenants' Voices in Legal Process, 20 Hofstra L. Rev. 533, 554 (1992) (finding that tenants defaulted in almost 85% of the eviction actions covered by the study); Robert W. Doggett & Stefan H. Krieger, “Don’t Bother Coming”: A Study of Eviction Court in Dallas County 88 (May, 1992) (unpublished manuscript, on file with the author) (finding that tenants defaulted in about three-fourths of the eviction actions covered by the study).

210 See, e.g., Johnson, supra note 184, at 114; White, supra note 184, at 528; see also Caplovitz, supra note 193, at 205:

A number of judges in these courts are well aware of the extraordinarily high proportion of default judgments in consumer actions . . . but they are not alarmed, for they reason that this indicates merely that the debtor knows he is at fault and sees no point of risking further court costs by making an appearance and asking for a trial. In fact, a number of consumers may have partial or complete defenses to payment. See supra notes 190-93.

211 Caplovitz, supra note 193, at 205; Sterling and Schrag, supra note 193, at 370.
when sued, more homeowners would appear at a judicial hearing to assert defenses than would initiate an action for an injunction. First, because a judicial foreclosure typically takes more time than a power of sale foreclosure, a homeowner will have more time to retain an attorney to raise defenses in a judicial foreclosure action. Second, a homeowner without an attorney is more likely to be able to defend a foreclosure action than to bring an action for an injunction. Therefore, those homeowners who cannot afford an attorney or qualify for free legal services would be more likely able to raise defenses. In addition, other costs associated with bringing an action for an injunction, such as filing and service fees and the cost of a bond, would not fall on the homeowner. Furthermore, other factors, such as ignorance of the availability of a defense or fear of the legal system, which tend to inhibit homeowners from initiating a lawsuit, could be minimized by safeguards built into the foreclosure procedure.

D. Distinguishing the Contractor-Connected Home Improvement Loan

The purpose of this Article is not to recommend the elimination of power of sale foreclosure. Foreclosure without a judicial hearing is appropriate in connection with loans made to sophisticated borrowers such as commercial real estate borrowers. It is reasonable to assume that these borrowers could hire an attorney to enjoin a foreclosure if necessary and that they would prefer the lower interest rates presumably available when lenders can foreclose in the least expensive manner.

Foreclosure without judicial hearing may also be appropriate in those circumstances in which defenses to foreclosure are rare. Home purchase money financing provided by an institutional lender is an example of such a situation. Since this type of lender has no relationship with from the seller of the home, any problems arising from the underlying purchase transaction are not appropriately raised against the lender. Defenses arise if the lender did not in fact lend the money, if the borrower is not in default, or if there is fraud or unconscionability in the loan trans-


213 See Nelson, supra note 169, at 33.

214 See infra notes 225-27 and accompanying text.
action itself. While these defenses do arise, they are probably rare.\textsuperscript{215} Even in home improvement financing, foreclosure without judicial hearing may be appropriate for lenders without any relationship to the contractor. Again, problems in the underlying transaction are not appropriate to raise, and other defenses are rare.

Power of sale foreclosure is inappropriate in those circumstances where a contractor is likely to be paid despite nonperformance or where there is a likelihood of fraud or unconscionability. The best indicator of these circumstances is the existence of a relationship between the lender and contractor, a relationship usually found in the system of home improvement financing available to many poor, minority, and elderly homeowners.\textsuperscript{216} Therefore, power of sale foreclosure should not be permitted when such a relationship exists.

\section{V \quad Shifting the Burdens}

The burdens of proof and initiating suit should be placed on the lender attempting to collect a home improvement loan through foreclosure if the lender has a relationship with the contractor. In order to shift the burden of proof, contractors and lenders should be prohibited from converting a homeowner’s conditional payment obligation under a home improvement contract into an unconditional payment obligation evidenced by a

\textsuperscript{215} A purchase money loan can also be distinguished from home improvement loan on the basis that a purchase money loan permits the purchase of the home in the first place. There are distinctions made in consumer finance between purchase money loans and non-purchase money loans. For example, creditors are no longer permitted to take non-purchase money security interests in certain types of household goods. \textit{See} 16 C.F.R. § 444.2(a)(4) (1996). While a home improvement loan has something of the characteristics of a purchase money loan, since loan proceeds are to be used to increase the value of the house, the lien not only attaches to the improvements but to the entire home. Therefore, a foreclosure of a home improvement loan permits a lender to take equity in the home that predated the home improvement loan.

\textsuperscript{216} \textit{See supra} part I.B. A sophisticated homeowner, who approaches several contractors for estimates and arranges financing independently, is unlikely to become the victim of a home improvement scam. \textit{See supra} note 31 and accompanying text. The FTC reached a similar finding when it considered extending the Holder in Due Course Rule to consumer loans made by lenders without any relationship to the seller of goods and services. \textit{See} 40 Fed. Reg. 53,506 (1975). The FTC determined there was not sufficient evidence of unfairness to consumers in connection with such loans to warrant extending the rule. \textit{See} 53 Fed. Reg. 44,456 (1988).
promissory note. If the homeowner's obligation were evidenced only by the home improvement contract, the homeowner's obligation to pay would be conditioned on the contractor's performance. In order to shift the burden of initiating suit, power of sale foreclosure by a home improvement lender with a relationship to the contractor should be prohibited. Home improvement lenders would then be required to foreclose judicially and to prove performance by the contractor in order to foreclose.

The burdens of proof and initiating suit should be shifted to the lender if the contractor originated the loan or if there is a relationship between the lender and the contractor. The FTC's Holder in Due Course Rule and the 1974 version of the UC3 each provide a model for defining the required relationship between the lender and contractor. The Holder in Due Course Rule applies where the seller "(1) refers consumers to the creditor or (2) is affiliated with the creditor by common control, contract, or business arrangement." This definition may be too broad. The UC3 lists the relationships that trigger its operation, but this list may be incomplete. For example, the UC3 would not apply where the seller arranges financing for the consumer but does not receive a commission or referral fee. A preferable approach would be a list similar to that in the UC3 but broadened to cover other situations in which abuse is likely. One factor that should make a loan contractor-connected is the lender's disbursement of loaned funds directly to the contractor without direction from the homeowner.

This prohibition would also shift the burden of pleading. See supra note 117 and accompanying text.


16 C.F.R. § 433.1(d) (1996). "Contract" is defined as "any oral or written agreement, formal or informal, between a creditor and a seller, which contemplates or provides for cooperative or concerted activity in connection with the sale of goods or services to consumers or the financing thereof." Id. § 433.1(f). "Business arrangement" is defined as "any understanding, procedure, course of dealing, or arrangement, formal or informal, between a creditor and a seller, in connection with the sale of goods or services to consumers or the financing thereof." Id. § 433.1(g).

See NELSON & WHITMAN, supra note 62, § 5.30, at 361 n.25 ("This language appears to be broad enough to cover virtually every purchase-money loan in which the lender knows what the use of the funds will be . . . .").

16 C.F.R. § 3.405(1)(a).

Without this factor, unscrupulous lenders would be encouraged to make direct loans to homeowners with equity in their homes and then to disburse funds to an unrelated contractor without regard to whether work was completed. Such loans
Shifting the burdens of proof and initiating suit would give homeowners substantially more protection against home improvement scams. A lender seeking to foreclose would have to commence a judicial foreclosure action against the homeowner. The homeowner would then receive notice of a hearing to determine the lender’s right to foreclose. At the hearing, the lender would be required to make a prima facie showing that the contractor had substantially performed. The homeowner could provide evidence to rebut the lender’s showing and would have the opportunity to raise defenses to payment such as fraud, unconscionability, or breach of warranty.

Certainly some homeowners with valid defenses to payment would fail to appear at the hearing and thus be subject to a default judgment. This problem could be minimized, however, by providing information to the homeowner and by tailoring the process to meet the needs of a pro se defendant. For example, the law could require that the summons be worded in plain English and be accompanied by a brochure containing information about valid defenses to payment. In addition, homeowners could be excused from filing a written answer and could be required to appear at the courthouse only once. These types of procedures would help eliminate factors such as fear of the legal system and ignorance of the availability of defenses that discourage consumers from appearing at a judicial hearing.

Without eliminating promissory notes and power of sale foreclosure altogether in home improvement financing, it would be impossible to shift the burdens of proof and initiating suit in every case. Some contractors and lenders would evidence contractor-connected home improvement loans with promissory

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Footnotes:

224 Although a foreclosure could proceed only if the lender made a prima facie showing of substantial performance, a default judgment could nevertheless be entered if the lender had fabricated evidence or if the homeowner’s defense was unrelated to performance. My proposal does not shift the burden of proof with respect to other defenses such as fraud or unconscionability.

225 See CAPOVITZ, supra note 193, at 208-09 (comparing the wording of summonses in different states).

226 Sterling and Schrag suggest a similar brochure in consumer debt collection actions. Sterling & Schrag, supra note 193, at 388-89.

227 See CAPOVITZ, supra note 193, at 201-02 (discussing the complexity of responding to a summons in some states); Sterling & Schrag, supra note 193, at 360 (discussing a simplified procedure).
notes despite a prohibition.\footnote{228 Some lenders do engage in prohibited practices. For example, although the Texas Constitution prohibits liens against homestead property for purposes other than purchase money, taxes, or home improvements, \textit{TEx. Const.} art. XVI, § 50, some lenders lend money to homeowners for other purposes and document their liens as being for purchase money or improvements. \textit{Public Citizen}, supra note 10, at 28 n.4.} Some lenders would proceed with power of sale foreclosures of such loans despite a prohibition. Only action by the homeowner, with the burden to prove the applicability of the prohibitions, would prevent foreclosure in such cases. This problem should, however, be minimal. While many home improvement contractors are small "fly-by-night" operations, frequently changing addresses, corporate identities, and even states in which they operate,\footnote{229 \textit{See supra} note 29 and accompanying text.} home improvement lenders, because of the nature of their business, are more likely to be highly capitalized institutional lenders operating on a statewide or even nationwide basis.\footnote{230 \textit{See Senate Banking Comm. Hearings, supra} note 15, at 308 (statement of Scott Harshbarger, Attorney General, Commonwealth of Massachusetts); \textit{Forrester, supra} note 17, at 421-23.} Small or local home improvement lenders generally obtain capital by selling their loans to large institutional lenders or by using the loans as collateral to borrow from the larger lenders.\footnote{231 \textit{See Senate Banking Comm. Hearings, supra} note 15, at 308 (statement of Scott Harshbarger, Attorney General, Commonwealth of Massachusetts); \textit{Forrester, supra} note 17, at 421-23.} While disreputable contractors may blatantly disregard the law, home improvement lenders and the purchasers of their loans are likely to operate within the letter of the law.

The problem of contractors or lenders disregarding statutory prohibitions against promissory notes and power of sale foreclosure could be minimized with strong punitive measures directed at lenders as well as contractors.\footnote{232 The FTC Rule, on the other hand, is enforceable only against sellers. \textit{See supra} notes 85-87 and accompanying text.} For example, the statute could include a provision for attorneys' fees and treble damages in the event of violation. A provision for attorneys' fees would increase the likelihood that homeowners could afford attorneys to help them enforce their rights. A treble damages provision would discourage lenders from violating the prohibition. In addition, any promissory note executed in violation of the statute could be void, regardless of whether home improvements were completed in a satisfactory manner. Finally, punitive measures
could be made applicable to subsequent holders of any loan made in violation of the statute, which would cause purchasers of home improvement loans to police the activities of the originating lenders.

A prohibition against promissory notes and power of sale foreclosure in contractor-connected home improvement loans would probably discourage these types of loans. Home improvement lenders would be encouraged to make direct loans to homeowners purchasing improvements from contractors without any relationship to the lender. Furthermore, lenders would be encouraged to make advances payable jointly to the homeowner and contractor rather than directly to the contractor,\textsuperscript{233} providing protection to homeowners against nonperformance by the contractor. Despite the disadvantages of maintaining a relationship with a contractor, some lenders would undoubtedly do so for marketing purposes. However, lenders that maintained relationships with contractors would be encouraged to police the activities of the contractors since foreclosure would require proof of substantial completion.

Shifting the burdens of proof and initiating suit to lenders would increase the costs to lenders of enforcing contractor-connected loans. Undoubtedly, some of the increased cost would be passed on to consumers in the form of higher interest rates. However, because of the frequency of abusive transactions in connection with home improvements and the tremendous loss to the homeowner who is the victim of a home improvement scam, the higher cost can be justified. Furthermore, the cost of loans made by lenders without a relationship to a contractor would not be affected.

**Conclusion**

Current law, which places the burden to prove defenses to payment on the maker of a promissory note and which permits power of sale foreclosure, seems to be based upon an assumption that defenses to payment are rare. This assumption may be correct with respect to an ordinary mortgage loan not related to any underlying home improvement contract. The assumption is not valid with respect to a home improvement loan made by a lender with a relationship to the contractor. Scams, like the one perpe-

\textsuperscript{233} See *supra* note 223 and accompanying text.
trated against James Hogan, occur too frequently to be ignored. When these scams do occur, they cause substantial harm to the homeowners affected. To protect vulnerable homeowners, promissory notes and power of sale foreclosure must be prohibited in contractor-connected home improvement loans.