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James W. Bowers

SOME ECONOMIC INSIGHTS INTO APPLICATION OF PAYMENTS DOCTRINE: *WALKER-THOMAS* REVISITED

JAMES W. BOWERS*

I. INTRODUCTION: HUMAN HETEROGENEITY, CONFLICTS OF INTEREST, AND CONTRACTING

Human heterogeneity motivates contracts. We are all individuals, differing from each other in our natural and economic resource endowments, our tastes, talents, wants and aspirations. Heterogeneity creates opportunities to capture social gains from trading, by, among other ways, creating competitive advantages and disadvantages. I love flowers but find spading my flower garden exhausting because I am uncoordinated and weak. You are strong and skillful with a shovel, and can spade in a couple of hours what it would take me a day or two to complete. Our differences then likely lead to a mutually advantageous contract for you to spade my garden.

Heterogeneity can also create conflicts of interest. Of course, I might spade my own garden, but when I deal with you, like most buyers I desire to pay you a low price for the service. You, like most sellers, on the other hand, desire higher compensation. We can avoid having to deal with this conflict by refusing to contract; the cost of refusal is the loss of potential gains from trade that refusal foregoes. We owe contract *law* partially to our desire to resolve those conflicts. The basic contract law solves the problems of conflicts of interest which heterogeneity produces by enforcing the conflict resolutions to which the parties have heterogeneously agreed . Thus, in the usual case, no uniform contract rule requires "garden spaders shall be paid $15.30 per week" or "$18.00 for each twelve feet of soil cultivation adequate to prepare it for zinnia plantings." Contract law will enforce the heterogeneous compensation levels specified by each individual contract. Because the traders are heterogeneous, contract rules will be difficult to

* Professor of Law, Appalachian School of Law; Oliver P. Stockwell Professor, Emeritus, Louisiana State University Law Center. B.A. 1964, LL.B.1967 Yale. An early version of this project was supported by a research stipend granted by LSU Chancellor, Jack Weiss. I am also grateful for helpful comments on earlier drafts by participants at the UNLV contract law conference, and at an LSU faculty workshop. Professor Sarah Jenkins led me to some valuable research material, and provided helpful editorial suggestions as well, for which I thank her. That I failed, despite all this assistance, to plug any remaining holes, confirms the generality of Murphy's Law.

justify unless they carry out the parties' own differing interests or resolve conflicts among those interests in ways the parties themselves have chosen.

That premise compels suspicion that a concept such as "aberrant contract" is a redundancy. "Aberrant" means deviating from what is normal or from a standard.[1] Contracts exploit, and contract law works to assuage the effects of human idiosyncrasy and uniqueness. Contracting permits traders to form personalized responses to their opportunities to make gains from exchanges, as well as to resolve their conflicts when they use contracts. I may order from you, and you might agree to sell me a chartreuse pickup truck with purple and orange polka dots. That aberrant transaction captures the very essence of why we desire to make contracts and need contract law to enforce them. The definition of aberrant developed for use in this symposium simply takes certain common credit-granting devices, even though they are quite widespread and commonly used and in a move toward newspeak assigns them this label.

Ex ante agreements do not actually solve all parties' conflicts of interest. The conflicts arise only post contract, and parties may not have foreseen before concluding their agreement. Ex ante, the conflict—deemed so unlikely to arise—may not seem worth the costs of the resolution. Another function of the contract law, accordingly, has been to resolve the unforeseen conflicts that only become salient to the parties ex post. A substantial fraction of the body of contract law consists of so-called "default" contract terms that answer the question of how to answer a conflict-of-interest question not solved by the express agreement itself.

This study seeks to use this intellectual foundation to examine a particular set of long lived, but recently abandoned, contract rules for certain species of transacting parties, what has long been classified by lawyers as the problem of application of payments.

II. The Application of Payments Problem

Payments satisfy and discharge debt obligations. After receiving payment, a creditor will no longer have any legal recourse available because of the discharge. Debt obligations may arise in a single transaction, the archetype being a loan advanced by a bank to the signer of a note in its favor. However, small partial payments made to the bank on account of that loan transaction will leave outstanding loan balances, for which the creditor bank can sue to recover. This, the most elementary law school hypothetical, seems obvious even to non-lawyers.

1. The Oxford English Dictionary 21 (J.A. Simpson & E.S.C. Weiner, eds., 2nd ed. 1989).

Some debt obligations, on the other hand, grow from multiple transactions between the debtor and a single creditor. Typical examples include multiple meals charged on a single bankcard, or multiple charges from our cell phone providers for several phone calls. The patient makes several visits to the same doctor, or has several conferences with her lawyer, and owes additional sums for each visit or conference. Every month we receive our bankcard or telephone account statement, or our doctor's or lawyer's bills detailing several separate charges made for several purchases of goods or services during that period. Each meal, call, doctor visit or lawyer charge we might say, created a separate debt obligation. Typically, however, a monthly or periodic statement of account bills for the aggregate amount of the separate charges for each doctor or lawyer visit, phone call, or credit card-swipe.

Even though in the bankcard and telephone bill cases there really were multiple credit transactions (meals charged, office visits or phone calls), the debtor has no obvious systematic gain from choosing which transactions should be discharged by a partial payment should the debtor choose to make one. Nor does the creditor stand to capture systematic gains from any other choices. The parties' interests simply do not conflict. As in the archetypical bank loan, partial payments will still leave balances due and owed. The creditor doctor, lawyer, bankcard or phone company will rarely have an occasion to care which charges are satisfied by the partial payment, but will instead view the unpaid balance as a single remaining debt for which they expect to receive future payment. Typically, the debtor mailing in the partial payment is also indifferent about which charges she wants deemed paid in full, and which she prefers to remain outstanding and unpaid. She remains obligated for the unpaid balance in any case.

Cases arise, however, in which the obligations created by each transaction carry differing legal remedies. Suppose, for example, the separate credit charges making up the total debt bear interest but at differing rates. In that case, a welfare-maximizing debtor prefers that the creditor apply the partial payment to satisfy the highest interest debts first, leaving only the low rate debts unpaid. The creditor, for obvious reasons, rationally harbors the reverse preferences. This case illustrates a real conflict of interest about how to apply partial payments. If the parties' express contract does not resolve the conflict, the courts must resort to the default provisions of our basic background contract law to settle the dispute.

III. *WALKER-THOMAS*, AN ILLUSTRATIVE CASE.

Another context where application of partial payments might matter occurs when the items purchased on credit become collateral, subject to a "purchase money" security interest securing the unpaid portion of the purchase price. Some pieces of collateral will be more valuable than others. The debtor will want partial payments applied to the valuable collateral, permitting her to retain those items, leaving the creditor with the right to repossess only the collateral worth relatively less. The creditor will have the opposite preference for how to apply the partial payments. He wants partial payments applied first to debts secured by low value collateral, leaving him with the right to repossess the highest valued. One might expect the contract to settle this conflict as well. If the contract does not expressly deal with the application of partial payments on account, the common law, not unexpectedly, developed a set of default provisions which would govern absent the parties own contractual resolution. This study argues that in deciding whether to enforce an application of payments clause contracted for by the parties, a court ought also to consider the impact of that common law default doctrine. Consider a famous case in which that inquiry should have but never was made.

Williams v. Walker-Thomas Furniture Company[2] is probably the case that jumps first into a student's mind upon hearing the phrase "aberrant contracts." The case introduced the last two generations of American law students[3] to the most innovative provision in modern American contract law: the unconscionability defense.[4] The defense was first promulgated in this form to American law as Section 2-302 of the Uniform Commercial Code:

> (1) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made, the court may refuse to enforce the contract, or it may enforce the remainder of the

2. 350 F.2d 445 (D.C. Cir. 1965).

3. In a fair sample of popular and long-lived law school contracts casebooks, the case either leads the unit on unconscionability or is prominently printed and featured in that unit. *See, e.g.*, STEVEN J. BURTON, PRINCIPLES OF CONTRACT LAW 244 (Thompson/West ed., 3d ed. 2006); JOHN P. DAWSON ET AL., CONTRACTS CASES AND COMMENTS 693 (Thompson/Foundation Press ed., 9th ed. 2008); E. ALLEN FARNSWORTH, ET AL., CONTRACTS CASES AND MATERIALS 497 (Thompson Reuters/Foundation Press ed., 7th ed. 2008); LON L. FULLER & MELVIN A. EISENBERG, BASIC CONTRACT LAW 34 (Thompson/West ed., 8th ed. 2006); CHARLES L. KNAPP ET AL., PROBLEMS IN CONTRACT LAW CASES AND MATERIALS 586 (Aspen Publishers ed., 6th ed. 2007); EDWARD J. MURPHY ET AL., STUDIES IN CONTRACT LAW 538 (Foundation Press ed., 6th ed. 2003); ROBERT E. SCOTT & JODY S. KRAUS, CONTRACT LAW AND THEORY 56 (LexisNexis ed., 3d ed. 2003).

4. Modern unconscionability doctrine was first adopted by the enactment of section 2-302 of the Uniform Commercial Code applying it to contracts for the sale of goods. Subsequently the doctrine was extended to contracts generally. RESTATEMENT (SECOND) CONTRACTS § 208 cmt. a (1981).

> contract without the unconscionable clause, or *it may so limit* the application of any unconscionable clause as to avoid any unconscionable result.[5]

The subject of the contract clause *Walker-Thomas* found potentially unconscionable governed the application of a series of monthly installment payments to multiple debts.[6] This study is the first peek using economic theory to develop an understanding of the common law default application of payments doctrine. *Walker-Thomas* provides a prototypical illustration.

The court in *Walker-Thomas* overlooked the effect of knocking an unconscionable clause out of the contract—it left the parties in the common law default position. Economic theory predicts that under such default terms, consumers like plaintiff Williams will likely be worse off. So viewed, the offending contract clause was relatively more fair than its detractors have claimed.

In *Walker-Thomas*, two consumer-appellants, Ms. Williams and Mr. and Mrs. Thorpe appealed to the U.S. Circuit Court of Appeals for the D.C. Circuit, from District of Columbia Court of Appeals judgments.[7] Their cases had been consolidated for appeal. The District of Columbia Court of Appeals had affirmed trial judgments granting the plaintiff furniture store writs of replevin to repossess household goods purchased by the consumers on credit from the store.[8] The plaintiffs pledged repossessed household items as collateral to secure the unpaid balances of their purchase prices.[9] The legal aid office in D.C. represented both appellant consumers, one of whose lawyers later conceded that its goal was to shape the matter into a

5. U.C.C. § 2-302 (2002) (emphasis added).

6. 350 F.2d at 450 ("Because the trial court and the appellate court did not feel that enforcement could be refused, no findings were made on the possible unconscionability of the contracts in these cases. Since the record is not sufficient for our deciding the issue as a matter of law, the cases must be remanded to the trial court for further proceedings.").

7. Williams v. Walker-Thomas Furniture Co., 198 A.2d 914 (D.C. App. 1964).

8. *Id.* at 916.

9. Technically, the D.C. Circuit found the household goods were the subject of lease/purchase contracts under which payments took the form of rent payable until the purchase price had been entirely amortized at which time title to the purchased items would pass to the purchaser. *Walker-Thomas*, 350 F.2d at 447. Under the then existing law the contracts would have been characterized not as leases but rather as conditional sales. The classic description, history and analysis of that device are found in 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY, ch. 3 (1965). Under Article 9 of the Uniform Commercial Code, which had been adopted by Congress to govern in the District, but to take effect only at a date after the trial of this case, the contracts would have likewise been re-characterized as creating Article 9 security interests. U.C.C. § 1-201 (2011):

> Whether a transaction creates a lease or a security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and [there follows a list of other provisions which ask whether the goods have expected value after the expiration of the lease term, and which provide the lessee with the opportunity to capture that value for nominal consideration.

test case on a pure question of law.[10] Many factual details in the underlying cases were, accordingly, unaddressed. Fortunately, for researchers, that lawyer wrote an article shortly after the case, which contains information not recoverable from the submissions of the parties, some of which are generally available from the National Archives.[11] From the material available, this study begins by reconstructing the events that led to the appeal.

The Thorne and Williams cases were tried separately. The repossessing seller was the same in both cases, as were the terms of the various credit contracts both consumers signed so the cases were consolidated on appeal.[12] The first, for whose name the case became famously remembered, was that of defendant Ora-Lee Williams. Ms. Williams signed fourteen separate credit contracts over a five-year period.[13] The size of her monthly relief payment ($218) was known to the furniture store because the name of her social worker and the amounts of the monthly relief checks were annotated on the contract for a stereo she purchased as well as several of the other instruments she signed.[14] There was some disagreement about what to make of these annotations, however. The furniture company's brief suggests that the relief check may not have been Ms. Williams' *sole* source of income.[15] Apparently, from those annotations alone, however the D.C. Court of Appeals concluded that the relief check was the *sole* means for both herself and her seven children.[16]

Whether or not Ms. Williams was living only on the relief check may have been less important to the defendant furniture company than one might suppose, however. Other researchers have examined the furniture store's business methods, which included sending a collection agent to the homes of debtors on the expected delivery day of the relief checks.[17] The

10. Pierre S. Dostert, *Appellate Restatement of Unconscionability: Civil Legal Aid at Work*, 54 A.B.A.J. 1183, 1185 (1968) ("We did not demand a jury trial in these cases since we felt it preferable to strive for precedent in terms of law rather than isolated findings of fact."). In any case, U.C.C. section 2-302 supports a conclusion that unconscionability will never be a jury question. U.C.C. § 2-302 cmt. 4 (2011).

11. Dostert, *supra* note 10, at 1183.

12. *Walker-Thomas*, 350 F.2d at 447

13. Williams v. Walker-Thomas Furniture Co., 198 A.2d 914, 915 (D.C. 1964).

14. *Id.*

15. *See* Brief for Appellee at 25, Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965) (Nos. 18,604 & 18,605) ("Mrs. Williams . . . attempted to create the illusion of a poor innocent person of limited education, on relief with seven (7) children - not once disclosing the source and amount of additional income, reference to which has been obviously omitted in her brief at page 9, but which is stated clearly in her testimony. (Tr.54)."). The various appellate briefs cited hereinafter are on file with the author and the Chicago-Kent Law Review.

16. *Walker-Thomas*, 198 A.2d at 915.

17. *See* David I. Greenberg, *Easy Terms, Hard Times: Complaint Handling in the Ghetto, in* NO ACCESS TO LAW: ALTERNATIVES TO THE AMERICAN JUDICIAL SYSTEM 380, 382 (Laura Nader ed., 1980).

agent came prepared to cash the relief check, retaining the amount of the monthly payment, but would turn over the balance in currency to the debtors.[18] The effort to find a check-cashing service in the ghetto where this process functioned was not inconsequential; as were the risks of mugging, since outlaws were aware of the date the checks arrived as well. Other sources of income whose arrival dates were less predictable would have been less relevant to the creditor using this very expensive collection technique to deal with these high risk borrowers.

In his American Bar Association Journal article describing the case, Ms. Williams' lawyer discloses that the replevin writ in her case authorized the seizure of twenty-two items or sets of household goods.[19] Out of orderly habit, the lawyers applying for the writ were likely to have listed those items in order of their acquisition, and that order conforms to what economic theory predicts about relationships such as that between Ms. Williams and the furniture store. Consumers' counsel sought a decision on a pure question of law, so his case did not stress factual details about the underlying transactions.[20] The furniture company's theory was that all of the purchased items served as collateral for a single consolidated aggregate debt, and so its brief does not discuss the number or details of the separate underlying credit purchases either. The initial transaction between Williams and the store, the signing of a printed form on January 22, 1957, was for the credit purchase of two pair of draperies for a stated consideration of $12.95.[21] Another set of scholars who apparently had access to the trial record in the case describe the initial transaction only as "item one" but report its purchase almost a year later on December 23, 1957, for an initial purchase price of $45.65.[22] The first items listed in the writ of replevin, presumably because they were the earliest purchases, were one wallet, two pairs of draperies, one apron set, and one potholder set.[23] Since fourteen contracts were executed, but the replevin writ lists twenty-two separate items or sets of items to be seized, multiple items must have been purchased under some of the contracts. Since each succeeding contract consolidated the previously owed debt with the new credit extended for the new purchases, it is not surprising trying to link each item of collateral with its

18. *Id.*

19. Dostert, *supra* note 10, at 1183 (listing items).

20. *Id.* at 1185 ("We did not demand a jury in these cases since we felt it preferable to strive for precedent in terms of law rather than isolated findings of fact.").

21. *Id.* at 1183.

22. Robert H. Skilton & Orrin C. Halstad, *Protection of the Installment Buyer of Goods under the Uniform Commercial Code*, 65 MICH. L. REV. 1465, 1477 (1965).

23. Dostert, *supra* note 10, at 1184.

underlying transaction is confusing. The consumer's counsels' legal strategy, however, pivoted on the *order* in which items were purchased.[24] They emphasized their clients' subjective understandings that once having made a sufficiently large number of payments, title to the earliest purchased merchandise should have passed to them.[25] As we shall soon discuss, however, this strategy was unfavorable to their clients' interests in important respects,[26] so it is understandable that they were imprecise in describing each transaction. Reasonable conclusions about what actually occurred are justifiable because the case represents predictable behaviors and the pattern in the case confirms those predictions.

At the onset of a credit relationship, a profit-maximizing credit seller will predictably minimize the risk it assumes for credit extended to impoverished consumers by selling only inexpensive items. Once the debtor proves she can, and reliably will, make the payments she promised, the creditor ought to be willing to increase its credit exposure by agreeing, later in the relationship, to sell larger and more expensive items. Our assumption that the replevin writ lists the items of claimed collateral in their acquisition order bears out this economic prediction. Reliable performance under a series of credit transactions creates an economic asset for the consumer, a reputation—a form of intangible human relational capital evidenced by an increase in the borrowing power, even for impoverished consumers. The items listed in the replevin writ, were, in order:[27]

One wallet
2 pairs of draperies
1 apron set
1 potholder set
1 set rugs
1 pair of draperies
1 2x6 folding bed
1 chest
1 9x12 linoleum rug
2 pairs of curtains
4 sheets

24. *See* Skilton & Halstad, *supra* note 22, at 1487 & n.65.

25. The opinion of the D.C. Court of Appeals indicated that the appellants were arguing for a "first-in-first-out" application of payments. Williams v. Walker-Thomas Furniture Co., 198 A.2d 914, 916 (D.C. 1964). Appellant testified she understood the agreements to mean that when payments on the running account were sufficient to balance the amount due on an individual item, the item would become hers. *Id.* at 915.

26. *See infra* Part VIII.

27. Dostert, *supra* note 10, at 1184 n.1.

1 ws20 portable fan
2 pairs of curtains
1 Royal portable typewriter
2 gun and holster sets (presumably toys)
1 metal bed
1 inner spring mattress
4 chrome kitchen chairs
1 bath mat set
1 set shower curtains
1 Speedqueen washing machine
1 Admiral stereo

The pattern here conforms to our predictions that poor credit risk consumers must first demonstrate their dependability on small extensions of credit, but that when they do, creditors will eventually begin to enlarge the amount of credit risk they are willing to undertake. Ms. Williams, in fact, purchased household goods with an aggregate credit price in the neighborhood of $1500 over a five-year period and successfully made payments totaling $1056.[28] She was able to purchase the larger and more costly items of furniture and appliances only after she had successfully kept her commitments to make the payments on the lower priced items such as aprons, potholders, wallets, and curtains.

The Thorne case, consolidated with Ms. Williams', does not demonstrate that pattern, but for understandable reasons. Big-ticket items were randomly scattered in the presumed purchase order listed in their replevin writ, with smaller items.[29] The reason, not noted by the D.C. Circuit in its opinion, however, could well have been that the Thornes had been customers of the furniture store for twenty years, not just the five which Ms. Williams had been a customer.[30] Over the first fifteen years, they had successfully amortized the debts they accumulated. The Thornes therefore, likely entered into the last five years of the consumer/store relationship preceding this litigation already possessing the reputation for creditworthiness that Ms. Williams was required to build during that period.

28. Skilton, *supra* note 22, at 1477.

29. Their writ authorized the seizure of the following, again presumptively, in the order of their acquisition: 1 DuMont television, 1 antenna, 1 chenille bedspread, 2 pairs of draperies, 1 Crosley refrigerator, 1 7-piece breakfast set, 1 9x12 linoleum rug, 1 embassy antenna, 1 Gibson freezer, 1 daveno, 2 step tables, 1 cocktail table, 2 table lamps, 1 9x12 living room rug. Dostert, *supra* note 10, at 1184 n.2.

30. Brief for Appellee, *supra* note 15, at 8 ("For more than twenty years [Thorne] had engaged in a course of dealing with appellee.").

The courts' opinions do not discuss the facts in the Thorne appeal, the education levels, number of children supported, or which of the items they had purchased on credit and actually successfully repossessed, and similar personal details that it found relevant in the consolidated matter with Ms. Williams. The D.C. Circuit would have been aware, however, that since they were represented by the legal aid office, their income level at the time of the litigation, although not necessarily at the time the purchases were made, would have had to have been low enough to meet that office's eligibility requirements.

All of the credit purchase contracts signed by Ms. Williams and the Thornes contained the following clause:

> If I am now indebted to the Company on any prior leases, bills, or accounts, it is agreed that the amount of each periodical installment payment to be made by me to the Company under this present lease shall be inclusive of and not in addition to the amount of each installment payment to be made by me under such prior leases, bills or accounts; and *all payments now and hereafter made by me shall be credited pro rata on all outstanding leases, bills and accounts due the Company by me at the time each such payment is made*.[31]

The D.C. Circuit's opinion, which supplied the above emphasis to a sentence in the contract, has been understood to address that sentence alone as raising the suspicion of being unconscionable. The opinion infers from that sentence that "as a result, the debt incurred at the time of purchase of each item, was secured by the right to repossess all of the items being purchased."[32]

The D.C. Court of Appeals reached the same conclusion using stronger language:

> [E]ach [of the separate credit contracts] contained a long paragraph in extremely fine print. One of the sentences in this paragraph [seemingly the one emphasized by the D.C. Circuit Court] provided that payments, on all purchases after the first purchase, were to be prorated on all purchases then outstanding. Mathematically, this had the effect of keeping a balance due on all items until the time balance was completely eliminated. It meant that title to the first purchase remained in the appellee until the fourteenth purchase, made some five years later, was fully paid.[33]

For purposes of analysis here, I make one other inference from the above not discussed by the courts. It seems very likely that once a consumer made an initial purchase on credit, they agreed to an initial *payment period*. During that period, the consumer might discover some other want and

31. Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 447 (D.C. Cir. 1965) (emphasis added).

32. *Id.*

33. Williams v. Walker-Thomas Furniture Co., 198 A.2d 914, 915 (D.C. 1964).

attempt to satisfy it on credit with the store. A new purchase would require a new payment period, of course. It is highly likely that the payment period for the later items would extend beyond the terminal date of the agreed earlier payoff schedules on the previous purchases. Thus, when the contract for each later purchase consolidated the later debt with the former, it *also adopted the payment schedule for the later purchase, which inevitably had the effect of extending the payoff period for earlier purchases*. This, it seems clear, was the intent of the first half of the challenged contract clause which provided that going forward from the last purchase, future installment payments would be inclusive of and not in addition to the payments promised under previous contracts. The consumer, who had demonstrated the ability to make, say weekly payments of $15, could continue to make the similar modest payment but over a longer period in order to acquire new merchandise. Even if the monthly payments increased somewhat with new purchases, the increase would not have been adequate to pay in full for both the earlier and later purchases at the time the last payment on the earliest contracts became due. The clear purpose of contractually consolidating the debts was to enable the consumer to obtain new merchandise while continuing to pay both for the older and the newer purchases, with the obligation to pay ceasing only when the payment period for the last purchase expired. Another way, then, of looking at the requirement that all fourteen contracts be paid off before title to the collateral passed to the consumer, is not that it is a mathematical requirement. Rather, the requirement results from the consumers' requests to extend the period for making payments to the conclusion of the payment period provided for in the last purchase contract. For the first purchases to have remained unpaid, after a fourteen-contract cycle, the request to extend the time for nonpayment to last was renewed and granted at least thirteen times.

The consumers nevertheless testified that they believed their payments would always be credited to the earliest purchases.[34] It follows that they must have thought when they made new purchases they would not be required to make any payments on them for some time, because all payments would be applied to earlier purchases until they were paid off.[35] A contractual expectation of free use of depreciating collateral, like kitchen furniture and appliances, without making any payments on them probably would be unreasonable. Indeed, had the consumers' sufficient market power to have

34. *Id.*

35. *Id.* When several items were purchased at the same time under the same contract, which must have been the case with several of them, it is a mystery, for example, whether Ms. Williams thought the early payments applied first to the wallet or to the curtains. *Id.*

actually imposed such a term on the store, that term would likely be unconscionable itself. If it were unconscionable to apply any part of any future payments to satisfy the debt for the latest purchase, it is unlikely new sales would ever be made until the early items were completely paid off. Perhaps the world is a better place if the law makes Ms. Williams wait to buy a washing machine until she pays off her potholders, even if she opted to postpone the final payment date for the potholders at the time she bought the washer so she could obtain the washer earlier. That determination, however, would completely wipe out the value of the relational reputational asset her performance on previous promises had created.[36] Since borrowing power they have worked hard to create is likely to be significantly important to poor consumers, it seems, at minimum, ungenerous for the law to take it away from them.

None of the lawyers or judges seemed to realize that the vulnerability of the consumer collateral to repossession in the case was as much due to grants by the furniture store of time extensions postponing the final payment due dates of the debts owing on the earlier purchases as it was to the pro rata payment application clause. They are simply two sides of the same coin. The replevin theory, which justified repossession of the merchandise by the furniture store, requires that ownership in the chattel remain with the seller until the buyer fully repays the purchase price, at which time title passes to the buyer. If there is a default in the payment stream, the continued possession of the chattel by the buyer becomes wrongful, and repossession or replevy becomes warranted. The reason that the full purchase price cannot be deemed to have been fully paid logically follows from the fact that the time for completing the payments on *every* purchased item was being continuously extended into the future with each new purchase. The consumers had the choice to pay off the early items before purchasing the later ones, but when offered the opportunity to extend the payment schedules for the old purchases to the due dates of the new ones, they had to understand that they were postponing the event, full payment, which would result in a transfer of title to them. Supposing the contract had provided that payments would first be applied to the cloth chattels and only later to the metal ones, a clause which presumably would not be unconscionable per se. If under such an application clause, final due dates on all credit pur-

36. She might buy her washing machine on credit from another merchant and begin making two separate streams of payments, supposing that she can transfer her reputation as a reliable paying credit customer from one merchant to another without any additional transaction costs or delays. Such transaction costs, which surely exist and are positive, would still diminish the value of the economic asset her past credit performance had generated in her former credit relationship. Technically an economist would conclude that the reputational asset was specialized to the particular seller.

chases were nevertheless extended into the future when a new credit purchase was made, replevin of all of the items would still have been warranted. It was the grant of extra time in which to complete paying, rather than the pro-rata application of payment clause, which kept the right to replevy alive. In that sense, then, the payment application scheme is independent of the time extension grant. If the contractual plan leaves all of the collateral subject to replevy because the time for full payment has been continuously extended into the future, and a future repossession of the earliest purchased items is unconscionable, the agreement extending the time for final payment for all the items is as culpable for the result as is the pro rata application of payments clause. A doctrine that discourages credit sellers from granting additional time to welfare mothers for paying off their purchases also has unpleasant distributive overtones.

Perhaps the court felt a five-year extension of time to complete paying for her potholders so she could more easily make the payments on a new washing machine was so ungenerous that it was unconscionable, but that sounds unlikely. A claim that the consumers did not really understand that they were postponing full payment for every item they had purchased and thus did not subjectively consent to the purchase terms is harder to credit than a claim that they simply did not understand a pro rata payment application clause. However, counsel for Walker-Thomas did not make this argument, and the D.C. Court of Appeals dismissed the failure of consent defense based on the duty of the buyer to read and understand his or her contracts before signing them.[37]

The D.C. Circuit, on the other hand, seemed to credit the possibility that the store had not obtained true consent from the consumer to unfair terms and, if not, that a finding of lack of such consent could trigger an unconscionability inquiry:

Ordinarily, one who signs an agreement without full knowledge of its terms assumes the risk that he has entered into a one-sided bargain. But when a party of little bargaining power, and hence little real choice, signs a commercially unreasonable contract with little or no knowledge of its terms, it is hardly likely that his consent, or even an objective manifestation of his consent, was ever given to all the terms. In such a case the usual rule that the terms of the agreement are not to be questioned should be aban-

37. *Walker-Thomas*, 198 A.2d at 916 ("We have stated that one who refrains from reading a contract and in conscious ignorance of its terms voluntarily assents thereto will not be relieved from his bad bargain.").

doned and the court should consider whether the terms of the agreement . are so unfair[38] that enforcement should be withheld.[39]

IV. UNCONSCIONABILITY

Consumer counsel did not resort to the unconscionability defense at the trial or during its first losing appeal. The consumers resisted enforcement of the pro rata clause on grounds which generally fall into two categories: First they claimed that consumers cannot be held to contract terms they say they never personally, understood, because true subjective contractual intent is lacking. Second, they argued that the furniture company's contract was void for violation of (some) public policy.[40] To this list of classic (even if also classically unsuccessful) consumer defenses, however, the D.C. Circuit considered a new theory, based upon the then recent adoption by Congress of Article Two of the Uniform Commercial Code applicable to the District of Columbia, albeit with an effective date well after time of the trial of the case.[41] They concluded that the application of payments clause in the contract need not be enforced because enforcement would be unconscionable under the newly enacted U.C.C. section 2-302.[42] The D.C. Circuit, as a preliminary matter, also must have felt the tension between adopting the dangerously overbroad defensive theories of the consumer appellants, and the desire to modify the purchase contracts so as to conform them to what consumers would expect or deem fair. Accordingly, the D.C. Circuit took the unusual step of appointing a prominent D.C. lawyer as amicus curiae. The amicus submitted a brief devoted entirely to the application of the new unconscionability article, and the D.C. Circuit's ultimate opinion tracked the recommendation of the amicus very closely.[43]

Appellants and amicus argued that unconscionability doctrine applied because the new U.C.C. simply restated the common law.[44] Since the D.C. Circuit and the courts of the district were empowered to adopt common law doctrine effective in the district, and Congress had, in the prospective statute, indicated its policy preference that an unconscionability defense be

38. That the D.C. Circuit thought the pro rata application clause, and not the time extension clause was the source of the unfairness can be inferred from the way it initially characterized the facts of the case in the opinion. *See* Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 449 (D.C. Cir. 1965).

39. *Id.* at 450.

40. *See Walker-Thomas*, 198 A.2d at 915.

41. *Walker-Thomas*, 350 F.2d at 448.

42. *Id.* at 447-48.

43. *See generally* Brief Amicus for Gerhard Van Arkel, *id.* (Nos. 18,604 & 18,605).

44. *Walker-Thomas*, 350 F.2d at 449.

adopted, the courts were free to recognize the defense in this case.[45] One might have expected an argument analogizing replevin, an old common law writ[46] which permits involuntary physical transfer of the possession of goods, with specific performance of a promise to permit repossession. A court recognizing the closeness of the analogy might exploit the occasion to expand the envelope of the ancient equity unconscionability doctrine to encompass replevin actions as well.

To summarize the case, the consumers obtained several different household goods at several different points in time from the appellee furniture company on secured credit.[47] After each credit purchase, the consumers signed identical credit contracts, each of which provided for a single monthly payment not only to amortize the credit cost of the new purchase but also to reduce the unpaid balances remaining due on previous purchases.[48] The contract clauses provided that the single monthly installment payment made pursuant to the latest contract be applied to discharge that and all the previous multiple debts pro-rata.[49] The merchant creditor had long distributed each payment among the multiple contracts in the proportions the balances remaining due for each purchase bore to each other.[50] Thus, no matter how many installment payments the consumer made, an unpaid balance remained due on every purchased item until the consumer paid off the aggregate debt on all items. Under the conditional sale theory employed at the time, then, the condition for title to pass for *any* of the purchased items would not occur until payment in full was made for *all* of them, and thus all the objects would be subject to replevin (repossession) if the consumer defaulted on any part of the overall payment obligation.[51]

45. *Id.* ("In fact in view of the absence of prior authority on the point, we consider the congressional adoption of Section 2-302 persuasive authority for following the rationale of the cases from which the section is explicitly derived.") (footnote omitted).

46. 1 DAN B. DOBBS, LAW OF REMEDIES § 5.17(1), at 917 (West Publishing Co. ed., 2d ed. 1933) ("In rare cases, the plaintiff might seek equitable relief to secure the return of a chattel. More commonly, the claim for recovery of the chattel was pursued at common law under forms of action such as detinue or replevin.").

47. Actually, under lease-purchase contracts, which then existing law as well as Article 9 of the current U.C.C. re-characterizes it as a security interest. *See supra* note 33 and accompanying text.

48. *See infra* Part III.A.

49. *See Walker-Thomas*, 350 F.2d at 447; Williams v. Walker-Thomas Furniture Co., 198 A.2d 914, 915 (D.C. 1964).

50. *Id.*

51. The court might have noted that not only had the UCC sales of goods article, Art. 2, but also its secured transactions article, Art. 9 had been enacted by Congress, although with an effective date subsequent to the trial of these cases. By the same reasoning that enabled it to apply the provisions of article two, even though it had not yet become effective, the court might also have adopted the limitations on repossession of collateral found in the newly enacted Art. 9. Under Art. 9, the secured party must dispose of the collateral in a commercial reasonable manner. For some of the earlier purchased items, the court then might have been able to conclude that disposing of the collateral could never have

The D.C. Circuit Court of Appeals found this pro-rata application of payment clause potentially unconscionable under the recently enacted (but at that time not yet effective) section 2-302 of the Uniform Commercial Code,[52] and therefore remanded for the lower court to make the ultimate determination.[53] The case settled before the lower court could act on the remand so we have yet to discover whether or not pro-rata application of payments clauses are, in fact, unconscionable in the District of Columbia.

Common wisdom in consumer advocate circles nevertheless regards the issue the case remanded as completely settled despite the absence of a determination on remand. After the case, the National Commissioners on Uniform State Laws drafted a Uniform Consumer Credit Code (1968),[54] directing the application of payment strategy, urged by consumers' counsel in *Walker-Thomas*, mandatory. For example:

> **§ 2.409. Debt Secured by Cross Collateral**
>
> (1) If debts arising from two or more consumer credit sales . . . are secured by cross collateral (Section 2.408) or consolidated into one debt payable on a single schedule of payments, and the debt is secured by security interests taken with respect to one or more of the sales, payments received by the seller after the taking of the cross collateral or the consolidation are deemed, for the purpose of determining the amount of the debt secured by the various security interests, to have been first applied to the payment of the debts arising from the sales first made. To the extent debts are paid according to this section, security interests in items of property terminate as the debts originally incurred with respect to each item is paid.[55]

We consider below whether this application of payments strategy is actually likely to be in the interests of rational consumers in states that have adopted this mandatory clause for consumer credit contracts. Furthermore, for states not adopting this legislation, the study will argue that, prima facie, the *Walker-Thomas* clause was actually more in the interests of in-

been commercially reasonable, U.C.C. § 9-610(a) (2012), inasmuch as the cost of repossession and resale would have exceeded the amount recoverable.

52. *Walker-Thomas*, 350 F.2d at 448.

53. *Id.* at 450.

54. UNIF. CONSUMER CREDIT CODE §§ 1.101-9.103 (1968), adopted by seven states: Colorado, COLO. REV. STAT. ANN. §§ 5-1-101 to 5-9.5-109 (West 1971); Indiana, IND. CODE ANN. § 24-4.5-1-101 to 24-4.5-7-414 (West 1971); Oklahoma, 14A OKLA STATS. ANN. §§ 1-101 to 9-101 (1969); South Carolina, S.C. CODE ANN. §§ 37-1-101 to 37-6-415 (1976); Utah, U.C.A. 1953 70C-1-101 to 70C-9-102 (1985); Wisconsin, WIS. STAT. § 421.101 to 427.105 (1972); and Wyoming, WYO. STAT. ANN. §§ 40-14-101 to 40-14-702 (1971). A subsequent edition of this legislation, UNIFORM CONSUMER CREDIT CODE §§ 1.101-9.103 (1974) has an identical provision in Section 3.303. The 1974 version has been adopted in four other states: Idaho, IDAHO CODE ANN. §§ 28-41-101 to 28-49-107 (1983); Iowa, IOWA CODE §§ 537.1101 to 537.7103 (1974); Kansas, KAN. STAT. ANN. §§ 16a-1-101 to 16a-9-102 (1973); and Maine, ME. REV. STAT. tit. 9, §§ 1-101 to 10-401 (1973).

55. UNIF. CONSUMER CREDIT CODE § 2.409 (1968).

stallment buyers than the default provisions of the law which at that time would have replaced the stricken *Walker-Thomas* provision, so that declaring the *Walker-Thomas* provision unconscionable, and resorting to the default doctrine would have adversely affect rational credit consumers in those states. This analysis should also be of interest in light of the adoption by all states of the latest version of Article Nine of the Uniform Commercial Code which authorizes courts to develop an entirely new default application of payments doctrine insofar as the payments might apply to consumer debts secured by purchase money security interests.[56]

V. CONSUMER ASSETS: FINANCING OF CONSUMER PURCHASES

Why do consumers buy goods and how much do they value them? Conceptually, an asset owner has the exclusive right to the services of that asset over its useful life, and, accordingly, the present value of the asset to the owner is simply the discounted value of the stream of future services the asset is expected to provide, net of the discounted value of the stream of future other marginal costs it will be necessary to expend in order to obtain those services and the present worth of any future salvage value. These values and costs will vary by asset. Lawn mowers provide valuable services by maintaining your landscape over their useful lives, but they do require the user to bear the costs of future gasoline, parts, and maintenance necessary to keep those services coming. This insight teaches that consumer asset purchases are partially consumptive and are partially investments. You will consume the first year of your lawn mower's life during its first mowing season, but will have remaining the unspent values of the services it promises to provide over the coming growing seasons as well. Over the asset's life, the initial purchase price will eventually convert from a future investment into a present consumption cost. Rational consumers will thus buy consumer goods whenever the discounted value they place on the asset's services exceeds the value of the marginal consumer in the market (whose value determines the market price of mowers in a competitive market), and the lower their internal discount rates, the more they will be willing to pay.[57]

56. U.C.C. § 9-103(e)(h) (2012).

57. There is considerable opinion that many if not most consumers have so many cognitive deficiencies that they cannot be regarded even for policy purposes as rational. *See, e.g.*, Oren Bar-Gill, *Seduction by Plastic*, 98 NW U. L.REV. 1373 (2004); John A.E. Pottow, *Private Liability for Reckless Consumer Lending,* 2007 U. ILL. L.REV. 405 (2007). This is thought to be particularly true about their decisions to borrow in order to over consume what rational consumers might not have consumed. M. Keith Chen & Alan Schwartz, *Intertemporal Choice and Legal Constraints*, YALE LAW SCHOOL WORKING PAPER No. 381 (2009), *available at* http://ssrn.com/abstract=1396333.

Consumers also face budget constraints on their ability to purchase assets and thus control the future services those assets will provide. A rational consumer facing such constraints is thus likely to seek financing for the purchase. In any given period, if the value of the services the asset provides exceeds the sum of future costs and the amount due in installment payments, the consumer is made better off in each such period over the state of the world in which he cannot procure any financing and so must forego the services entirely. The issue raised in *Walker-Thomas* can thus be restated: Supposing a consumer has made a credit purchase in the past, will the opportunities to make future purchases still have value to that consumer? There is much in the law from which one can infer policy makers believe the answer is "yes." The states which closely regulate consumer credit transactions by adopting the Uniform Consumer Credit Code, for example, still encourage *purchase money* credit transactions by explicitly authorizing the pledge of any equity in collateral purchased on secured credit to secure the debt incurred in the purchase of that new item of consumer collateral.[58] The FTC rule, which prohibits the taking of consumer goods as collateral for loans, permits taking consumer goods as collateral in such *purchase money* transactions.[59] The Bankruptcy Code, permits debtors to avoid security interests in exempt property, but withdraws that permission if the debtor created the security interest to obtain the collateral.[60] Whether to prohibit a merchant from bargaining for favorable application of payment clauses in future credit contracts will thus have some social importance if the lost transactions would have been valued by the consumer. The judicial requirement that all payments in Ms. Williams's case be credited entirely to the potholders and toys requires the furniture store to make delivery of the beds, kitchen chairs, and washing machine without being able to ask for a stream of payments to begin at the time of delivery for those items. The conscionable contract is thus likely to require the Ms. Williams of this world to completely pay off the earlier debts before the market will likely be willing to offer them future opportunities to acquire the services of new assets on credit. The more budget constrained the consumer, the longer the time of postponement necessitated and the larger the loss in consumer welfare to budget constrained consumers.

58. UNIF. CONSUMER CREDIT CODE § 2.408 (1968); *id.* § 3.303(1) (1974).
59. 16 C.F.R § 444.2 (2013).
60. *Id.*; 11 U.S.C. § 522(f)(1)(B) (2012).

A. Consumer Goods as Collateral

At the time of Ms. Williams' transactions, it was permissible under the Uniform Commercial Code for consumers to pledge their household goods as collateral securing repayment of loans.[61] In 1985, however, the Federal Trade Commission adopted a Trade Regulation Rule Concerning Credit Practices that prohibits the taking of a *non-purchase-money* security interest in household goods.[62] The fact that purchase money security interests are still encouraged both by state and federal law and regulations is powerful evidence that the services identified in the foregoing analysis are of significant value to consumers such that outlawing the credit acquisition of household goods via secured credit would be on balance harmful. It is also highly likely that the FTC Rule would not have affected either Ms. Williams or Mr. Thorne. The credit extended to them by the furniture store was entirely used to permit them to acquire the collateral, which makes the store's security interests in their household goods purchase money security interests[63] permitted by that rule.

Indeed, to the extent the application of payments clause worked to preserve the purchase money status of all of the store's security interests under the then existing law, the clause served consumers very well. Under Article 9 of the Uniform Commercial Code, purchase money security interests in consumer goods are "perfected" and thus made effective against some purchasers of the collateral as well as against other creditors of the debtors, without requiring the giving of public notice by the filing of a financing statement.[64] Were the security interests to lose their purchase money status, they would become unperfected unless the store were to pay a filing fee to file a financing statement describing the items involved in each specific secured transaction.[65] It is likely that most, if not all of the extra filing fees, would have been passed along to the consumer, as are all the other costs of making the credit sales. Maintaining the purchase money character of the consumers' security interests not only saves them from the FTC prohibition on using consumer goods as collateral, but also saves Ar-

61. That this preexisting result was the status changed by the application of 2-302 is implicit in the opinion of the D.C. Circuit. *See also* Dostert *supra* note 10, at 1185 ("We had transmitted the details of the Thorne case with the request that the conduct of Walker-Thomas Furniture Company be investigated . . . The Commission concluded that after investigation of the case further action was not warranted.").

62. 16 C.F.R § 444.2.

63. U.C.C. § 9-103(a), (b)(1) (2012).

64. U.C.C. § 9-309(1) (2012).

65. U.C.C. §§ 9-310(a), 9-516(a) (2012).

ticle 9's filing fees.[66] Some doubt remains whether or not consolidating the debt incurred in purchasing the initial set of curtains with the later obligation to pay for the stereo, for example, caused the curtains to lose their status as purchase money collateral.[67] In the Williams case, however, this may not have been significant, as the actual collateral repossessed did not include much of the earlier, arguably refinanced, collateral.[68]

B. Purchase Money Collateral

Whether or not the security interests created in the earliest collateral sold to Ms. Williams had been satisfied and discharged by her payments may have been irrelevant because most of the earlier purchased (and thus presumably "paid for") collateral was not, in fact, actually repossessed.[69] The court's impulse to outlaw the contract payment application scheme might have its source in the rationale for which the FTC outlawed the use of household goods as (non-purchase-money) collateral.[70] Household goods are subject to a significant problem of information asymmetry, which creates the well-known "lemons" problem.[71] The consumer will likely be well informed about the condition and the history of any item of household goods used in the household. A repossessing creditor, and more particularly, a potential buyer at a foreclosure sale, on the other hand, will have very little information. To the extent that with any asset, information about its latent, difficult or expensive to observe feature might affect its

66. One might hypothesize that only an initial filing fee might be required to perfect a security interest in all of the collateral if the initial filing simply describes the collateral for the filing as "current and future household goods purchased on credit from us," or another similar generic categorical term. However, Article Nine itself will not give effect to after-acquired property clauses granting security interests in consumer goods, U.C.C. § 9-204(b)(1) (2012), and thus requires multiple separate future filings for each future consumer non-purchase money credit transaction. None of the courts or commentators who have evaluated the Walker-Thomas contract strategy has noted that it saved substantial filing fees and thus might even be preferred by consumers when they were evaluating whether or not the scheme was unconscionable or not.

67. *See* JONATHAN SHELDON & ROBERT A. SABLE, NATIONAL CONSUMER LAW CENTER, REPOSSESSIONS §§ 3.4.1-3.4.4 (2d ed. 1988) (providing a detailed discussion the effects of loan consolidation). Many of the arguments in favor of loss of purchase money status were probably reinforced or preserved when the latest revision of article nine expanded the reach of purchase money status only in non-consumer goods transactions, leaving the final determination of that status up to future courts when consumer goods are collateral. U.C.C. § 9-103(f), (h) (2012).

68. Brief for Appellee, *supra* note 15, at 6 ("Of the items sought to be replevied, only the chest, folding bed, washing machine and stereo were recovered—the remaining chattels having been eloigned.").

69. *Id.*

70. 16 C.F.R § 444.2 (2013); *see also* FEDERAL TRADE COMM'N, ECONOMIC REPORT ON INSTALLMENT CREDIT AND RETAIL SALES PRACTICES OF DISTRICT OF COLUMBIA RETAILERS (1968).

71. George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

value, a rational potential buyer will protect itself against the possibility of unobserved but damaging qualities by lowering the amount it will bid to obtain the used item. Sellers of used merchandise can normally agree to protect potential buyers by offering an accurate description of the condition of the asset and backing up the accuracy of their description by issuing a warranty of that accuracy. In the case of repossessed household goods, however, the owners will not be issuing warranties as they are not the sellers of the goods, nor will the uninformed foreclosing secured party be able to guarantee their quality. Indeed, buyers of repossessed goods will likely presume that some defect in the asset was among the causes of the default that led to the repossession and sale, and thus discount their bids at that sale accordingly.

The lemons problem means used, repossessed household goods likely have substantial but hard to credibly verify value to the debtor, but will bring only a heavily discounted recovery to the repossessing creditor. Since the losses to the consumer will thus outweigh the gains by the creditor, repossessions, and resales are economically inefficient viewed ex post. If so, preventing their occurrence (the effect of the FTC rule) can be justified on efficiency grounds. The loss from the repossession of an item of purchase money collateral should be, in principle, the same as for non-purchase-money collateral, but it is not forestalled by the FTC rule. The FTC may have reasoned that if they permitted the credit purchase of consumer goods, the prospect of facing a lemons loss would motivate consumers not to exercise the discretion they have to take actions that increase the risk of default. Since the gains to consumers empowered to finance purchase money assets are so large, and the lowering of the costs of moral hazard to the creditor is so substantial, the joint gains to consumers and creditors from the many *purchase money* credit sales successfully paid for can be expected to outweigh the few losses from the repossession of purchase money collateral for the few defaulters. Thus, the purchase money exception to the FTC rule can be explained. Whether benefit to other creditors should be taken into account in deciding whether the repossession power is conscionable for any given debtor, however, raises a different issue. The existing cases do not address whether or not a clause which is harsh on Consumer A can be saved from unconscionability by virtue of its benefits to consumers B, C, D . . . N, however.

VI. MEASURING DEBTS AND COUNTING THEM

To begin framing the area of law to be governed by the payment doctrines in question, one must assume that something called multiple debts exist which are addressed by single or partial payments. As soon as you flip on your electrical switch your electric meter begins to record a continuous increase in the debt you owe your power company. One might arbitrarily select some time period to be used in defining and measuring the size of a single debt, say a second's worth of power, so that at the end of a minute with the lights on, you owe sixty debts of kilowatt-seconds each to the utility. Alternatively, one might similarly break down the amount owing by allocating various time periods to varying uses of the electricity. For two hours, the current powered a TV, for thirteen minutes the washing machine, and for ten a floor lamp, leaving you with a TV debt, a washing machine debt, and a floor lamp debt. Common law civil procedure ignored these possible ways of making many debts out of a series of borrowings or purchases, however, by entertaining a cause of action "on an account stated" (or sometimes, an "account annexed" to the writ), one of the useful "common counts" of common law pleading.[72] Individual purchases and installment payments were simply ignored in that action and judgment awarded on the net balance due after debiting all of the charges and crediting all of the payments.[73] This theory probably still dominates in the collection of many kinds of lines of credit transactions, from American Express cards to gasoline and department store cards and country store charge accounts, to hourly charges by lawyers for legal services. There is no reason to try to associate any part of the debt with the underlying transaction which created it, so to save transaction costs, the aggregated debt is treated as a single obligation, even if the amount of the debt is computed by summing up the total of numerous credit transactions or sales events.

When legal remedies begin to depend on the facts of an underlying transaction, on the other hand, then there is good reason to decompose the total debt into its component parts, since each part might give rise to a different remedy. When the total owed is summed from obligations bearing differing remedies, a conflict may arise between the borrower and the lender. The borrower will prefer that all payments be applied to the debt bearing the most onerous legal consequences, say for example those which bear the highest interest rates or permit the seizure of the most valuable collateral,[74] so that he is left, should circumstances necessitate an eventual de-

72. RESTATEMENT (SECOND) CONTRACTS § 282 (1979).

73. *Id.*

74. Recall our previous theory that predicts credit sellers will not sell valuable items in its initial transactions, but rather delay extending that kind of credit only to borrowers who have acquired the reputation for being trustworthy payers. *See supra* notes 25-36 and accompanying text. The most valuable collateral, on that assumption, then is likely the latest to be acquired and the debt for which rational consumers want payments to apply first. *See supra* notes 26-28 and accompanying text. Ms. Williams

fault, facing an array of the least onerous remedial obligations, those, in the example, bearing lower rates or risking the loss only of the least valued collateral. For the same reason, the lender will desire the payments be first applied to the obligations bearing the least onerous remedies so that if default occurs, the debtor will face an array of the most seriously burdensome remedial duties. This prospect is likely to minimize moral hazard, the incentive of the debtor to default in the first place.

VII. THE ECONOMIC FOUNDATIONS OF THE CONSUMER DEBT REMEDY

The principle affect of any credit contract is that, ultimately, the borrower agrees to subordinate all of his interests in his property or seizable assets to the interests of the seizing creditor.[75] Why do creditors ask for and why do debtors grant such subordinations? The debt contract itself is a product of information asymmetry. At the time of extending credit, the creditor knows that there is a possibility the debt will not be repaid. Future defaults can be categorized into two classes.

First, the circumstances leading to the default may be endogenous to the debtor, or explained by decisions the debtor makes and actions he takes within his or her control. It would be prohibitive to spell out in a credit contract how the debtor agrees to make all of his or her life decisions after the grant of the credit so as to minimize the risk that those post-credit decisions and actions might necessitate a default on the debt. Consequently, credit contracts do not constrain debtor behaviors very explicitly, and thus grant them considerable discretion in how they can conduct their lives. This discretion gives rise to a significant economic transaction cost which economists label "moral hazard." The debtor will be empowered by the discretion left him in the credit contract to make many life decisions and to engage in many life activities without taking into account the possibility that those decisions and activities might result in an eventual loss to the creditor. As an example, the debtor may resign from an unpleasant job, risking that new and more pleasant substitute employment can be quickly obtained. When the risk that the substitute employment will not be quickly offered materializes, one result may be default by the debtor in her mortgage payments. More commonly, the debtor might decide to spend money

may have preferred to give up her potholders and keep her washing machine, the result made least likely by a FIFO application of payments requirement.

75. This argument needs to be qualified to the extent the state exempts certain assets from creditor seizure, as all states do, but it nevertheless does apply to nonexempt assets. *See* James W. Bowers, *Security Interests, Creditors' Priorities, and Bankruptcy*, in 5 ENCYCLOPEDIA OF LAW AND ECONOMICS, 270-272 (Boudewijn Bouckaert ed., 2nd ed. 2010).

on some other activity when the expenditure increases the risk that the debtor will be too illiquid to make the monthly payment that becomes due after the expenditure.

The second category of causes of debtor default may be classified as exogenous or general forces that will act on all debtors. The business cycle might enter into its periodic declining phase and the debtor might suffer unemployment resulting from the shrinkage in employment generally. Frequently, since exogenous causes for default are, by definition beyond the control of the parties, the most efficient technique for dealing with them is to engage in some kind of insuring or loss spreading strategy. In the case of merchant/consumer credit contracts, there is good reason to suspect that the party with the better loss spreading opportunities will be the merchant. On this basis, one might expect to find allocations of risk in credit contracts that address possible endogenous risks of default and assign them to the consumer debtor, and which likewise define the exogenous risks and assign them to the merchant creditor.

In fact, consumer contracts that classify and assign risks along these lines are infrequent if nonexistent. Partly this is because the categorical border between those causes of default is a fuzzy line. The economy may become difficult, but the default probability may still be affected by the debtor's ability or willingness to anticipate and adjust to the possibility of that difficulty. Thus, even exogenous causes of default may have a large endogenous component. The endogenous category of causes of payment default is thus likely the more important of the two categories of causes. Efficient contracts are likely to assign risks endogenous to a party to that party.[76] Because the risk or large portions of them fall within his control, the contractual placing of those risks upon him generates an efficient incentive for him to use his power to control to protect not only himself but the creditor as well. The stronger those incentives to behave in ways which minimize the prospect that losses will be suffered by the creditor the lower the cost of the moral hazard inherent in the debtor/creditor relationship, and presumably, the lower the cost of credit to the consumer.

The uninformed creditor is also naturally concerned that the debtor has maximal incentives to avoid defaulting, but is aware that rational debtors will resist repaying once the goods have been delivered or the loan disbursed.[77] The debtor's promise to repay, thus, is not a credible promise

76. Robert E. Scott, *Conflict and Cooperation in Long Term Contracts*, 75 CAL. L. REV. 2005, 2018-19 (1987).

77. Arthur Allen Leff, *Injury, Ignorance and Spite – The Dynamics of Coercive Collection*, 80 YALE L.J. 1, 5 (1970) ("Under the American Law of Contracts, after the other party has fully performed his obligations, it is absolutely irrational for you to perform yours.").

unless accompanied by an offer to subordinate to the creditor in the event of nonrepayment. The default understanding of any debt obligation is that the debtor has agreed to subordinate his rights to any of his assets to the creditor in the event of default. Nonrecourse contracts are the exception, not the rule.

VIII. THE MECHANISMS OF DEBTOR SUBORDINATION

Agreeing to subordinate is an expensive proposition for a debtor. One imagines the creditor showing up at the debtor's place after a default and selecting the most dearly loved or valuable of the debtor's assets. This prospect provides a powerful incentive not to default in the first instance, of course, and the agreement to risk this adverse consequence in the event of default adds great credibility to the debtor's expression of willingness to repay. The default subordination agreement provides a significant bonding function between the debtor and the creditor. The interest that lenders show in what assets the debtor owns is similarly explained. A promise to subordinate my interest in an asset to your claim is highly sensitive to the qualities of the asset.

In addition, the default subordination policy is subject to some significant limitations. Creditors may not simply appear and take what they want; instead, they are required in the first instance to give due process to the debtor. The subordination that takes place occurs only when sheriffs or marshals seize assets collecting judgments or when assets are sold at legally authorized non-judicial sales. During the time it takes the creditor to sue and obtain judgment against the debtor, the debtor can select which, among their collection of assets, are least valuable to them, liquidate those assets, and use the proceeds to pay off the debt.[78] Every jurisdiction also provides protection to particular types of assets which are likely to be very valuable to debtors but not to creditors by exempting them from seizures.[79]

Debtors can influence creditor choices of assets to seize, and accordingly the choice of which assets in which to be subordinated, by granting security interests in them to other creditors. The expense of disentangling

78. *See generally* Bowers, *supra* note 75.

79. ELIZABETH WARREN AND JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 169 (5th ed. 2006) ("The law in every state makes at least some property exempt from execution and other legal process so that no debtor can be reduced to absolute destitution."). At least one state permits the debtor to select the assets in which he will be subordinate ex post by permitting him to select which assets the sheriff must seize first. *See, e.g.*, TEX. PROP. CODE ANN. § 42.003 (2011) ("DESIGNATION OF EXEMPT PROPERTY. (a) . . .If the number or amount of a type of personal property owned by a debtor exceeds the exemption allowed by Section 42.002 and the debtor can be found in the county where the property is located, the officer making a levy on the property shall ask the debtor to designate the personal property to be levied on.").

the interest of the secured creditor from the interest being seized causes creditors to prefer seizing unencumbered assets first.[80] Thus, the law permitting the creation of security interests can be explained, in part, as a device to efficiently select the assets in which the debtor will be subordinat-subordinating to his other creditors,[81] just as the debt contract under which the agreement to subordinate occurs can be justified as a device to lower the transactional costs that moral hazard imposes on lenders and borrowers.

IX. CONSUMER PREFERRED APPLICATIONS OF PAYMENT

Initially, consumer preferences about which among multiple debts will be satisfied by any payment need to be subdivided into two temporal categories, ex ante and ex post.

A. Ex Ante: The Impact of Statutes of Limitation

Is there any reason why a debtor will care which of a series of future but yet to be incurred unsecured debts will be discharged by future payments? Arguably, there is for a single reason, the passage of time, and the running of statutes of limitations. Ceteris paribus, a hypothetical rational debtor will prefer to have all payments credited to the latest debts first, leaving unpaid only those about to be rendered unenforceable by the passage of time.[82] This economic inference makes the strategy pursued by consumers' counsel in *Williams*, to establish that consumers desire to have installment payments first amortize the early debts, at minimum uninformed if not irrational.[83]

On the other hand, if there is some possibility that the future credit transactions will involve the granting of security interests, the rational

80. For a detail elaboration on this point James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27, 57-67 (1991).

81. Although the FTC rule that prohibits consumers from using security interests in their consumer goods could be judged, on this ground, inefficient for consumers. *See supra* notes 69-75 and accompanying text.

82. Recall for example that the course of dealing between the consumers in *Williams* took place over a five-year period while the statute of limitation for causes of action arising under contracts for the sale of goods under Article 2 of the Uniform Commercial Code is four years. *See* U.C.C. § 2-725 (2012). Probably, however, the continuing extension of time in which to pay the early debts would tend to keep them renewed and within the four year period.

83. Interestingly enough, however, the eight states adopting the Uniform Consumer Credit Code have mandated that payments on multiple debts must be applied to the oldest purchases first, and that once that debt has been completely amortized, any security interest in the asset must then terminate. UNIF. CONSUMER CREDIT CODE § 3.303 (1974). Non-uniform Retail Installment Acts in other states often provide analogous regulation. *See* SHELDON & SABLE, *supra* note 67, at 87 n.266 (collecting citations).

debtor also has an ex ante preference for being able to speculate against the creditor by being permitted to select, ex post, which debts previous payments will be deemed to have discharged. This provision permits him to select ex post to have payments applied to those debts secured only by the most valuable collateral, limiting the creditor's foreclosure rights to only that collateral which, after the fact, is known to have the least value. If the market value of an asset serving as collateral rises, the debtor can thus capture the increase, and likewise impose the losses in collateral whose value has declined on the creditor.

Had the furniture store credit contracts not contained the clause directing how single payments would be applied to multiple obligations, but remained silent on the matter, debtors would have the right to designate the application of each payment ex post, as the payment is made under the existing default contract doctrine which governs in the absence of a contrary agreement. The default doctrine is laid out in sections 258 through 260 of the Restatement (2d) of Contracts:

> **§ 258. Obligor's Direction of Application:**
>
> (1) [A]s between two or more contractual duties owed by an obligor to the same obligee, a performance is applied according to a direction made by the obligor to the obligee at or before the time of performance.[84]

Since this default doctrine for the application of payments permits debtors to effectively speculate against lenders ex post, lenders should be reluctant to enter into credit arrangements which do not provide for an agreed application ex ante rather than overlooking the problem and relying on the default doctrine to resolve any future questions. Some incentive like this undoubtedly explains the presence of the application of payments clause in the Walker-Thomas furniture store credit contracts.

Once the application of payments clause is stricken from the credit contract on unconscionability grounds, however, the contract is left with a default term which permits the debtor to engage in ex post speculation against the creditor, putting debtors into a "heads I win, tails you lose" posture. The interesting question is, however, given this power by the de-

84. RESTATEMENT (SECOND) OF CONTRACTS §§ 258-260 (1981). A similar plan is adopted by the Uniform Commercial Code, but only for non-consumer goods transactions, U.C.C. § 9-103(e) (2012):

> **[Application of payment in non-consumer-goods transactions.]** In a transaction other than a consumer-goods-transaction, if the extent to which a security interest is a purchase-money security interest depends on the application of a payment to a particular obligation, the payment must be applied:
>
> (1) in accordance with any reasonable method of application to which the parties agree;
>
> (2) in the absence of the parties' agreement to a reasonable method in accordance with any intention of the obligor manifested at or before the time of payment . . . .

Id.

fault application of payments doctrine, consumers freed from having to comply with a contracted-for application of payments scheme will in fact be able and willing to include a specific payment application direction with every monthly check. Given their testimony that they believed the payments would be applied "first-in, first out" it is unlikely that either consumer in Williams made the authorized default directive at the times they made their payments. If a consumer overlooks the opportunity to make that direction with the payment in any month, the default regime then shifts from one of debtor choice to one of creditor choice.

Restatement of Contracts (2d) § 259:

> (1) [I]f the debtor has not directed application of a payment as between two or more matured debts the payment is applied according to a manifestation of intention made within a reasonable time by the creditor to the debtor.[85]

It seems reasonable to believe that as between a consumer who overlooked the giving of a payment direction and a professional merchant, the latter is more likely to be aware of the importance of exercising the power to make such a direction, and to use it to apply payments in the manner most favorable to the merchant and least favorable to the consumer. The parties' briefs do not consider whether the appealing consumers made application directions when they delivered their payments, which leads one to suspect that Ms. Williams and the Thornes did not do so. On the other hand, the furniture store's appellate brief asserts that because the store gave receipts to the consumer for every payment that might have manifested the store's intent to apply the payment pro-rata, in accordance with the contract clause.[86] There is also no evidence to the effect that either consumer objected to any application actually made by the creditor. In short, eliminating the pro rata clause from the credit contracts as the Williams decision seems to contemplate is likely to place consumers into a default regime in which they are unlikely to take the protective steps of making application directions, and consequently being left vulnerable to an application decision which permits the creditor to speculate against them. Indeed, however, in the Williams and Thorne cases the store did not exploit this opportunity. Instead, the store gave notice by issuing a receipt at the time of each payment that it would apply the payment pro rata to all debts. Striking the pro rata clause from the contracts and throwing the parties back into the general default regime would produce the same outcome the clause produced in states not adopting the U.C.C.

85. RESTATEMENT (SECOND) OF CONTRACTS § 259 (1981).
86. *See* Brief of Appellee, *supra* note 15, at 24-27.

B. Ex post: The Impact of Depreciation

Contracts that contain agreed upon methods for applying future payments to multiple debts almost always by definition represent the exercise of ex ante choices.[87] Systematically, there is one other fact of economic life that might influence the ex ante preferences of a debtor for application of any future payments among a series of secured debts. That fact of life is the existence of real economic depreciation. All other things equal, an older piece of collateral is likely to be worth less than a newer one, and hence less valuable. That too leads the debtor to prefer a last-in-first-out application of payments, discharging as much debt on the newer more valuable assets first, and leaving the creditor with only the older, less valuable depreciated collateral. Correlatively, the creditor will have the exact contrary set of preferences, preferring the payments to be credited against the heavily depreciated property, leaving only the newer undepreciated assets available when the creditor has to resort to default remedies. The effect of the existence of real economic depreciation on the application of payments preferences in merchant/consumer contracts, however, is muddied by the fact that the preferences being provided for will be the result of future transactions. A consumer can protect against the risk of being left with only depreciated collateral at the time of default by refusing to make credit sales of rapidly depreciating property in the first instance. If the debtor could validly agree to apply payments in such a way as to leave undepreciated property vulnerable to seizure upon the happening of a default, the merchant may be willing to make the future credit transaction. On the other hand, if the only conscionable contract term which the court will enforce leaves the merchant with collateral of low or zero depreciated value, the credit sales will not take place. We have already determined that value to consumers of the opportunity to conduct purchase money acquisitions of consumer goods seems to be both recognized by the existing law and economic theory. That value, however, would likely be heavily discounted or even lost in a regime that mandates the payment application exclusively to the most heavily depreciated assets first. Notably, this general theory of how consumers would prefer to have their payments applied is completely opposed to the applications prayed for by the consumer lawyers in the Williams case, and adopted by the states enacting the UCCC, or installment

87. Note that only one contract terms in the Williams cases is disclosed or discussed in the courts' opinions, probably due to the above discussed litigation strategies of the parties. However, the reasonable assumption from the facts we do know is that some of the impact of the terms of the successive contracts the consumers signed, particularly the terms which extend the payment amounts and deadlines would be, with respect to the initiation of the merchant/consumer relationship, ex post.

loan acts requiring payments applied to the oldest debts first, not only because the oldest debts will be for the least valuable collateral for consumers without established credit reputations, but also because the first items purchased will have depreciated the most.

X. CONCLUSION

This study has argued that consumers on the edge of poverty will not be initially permitted by credit sellers to buy valuable assets on credit. Instead, rational credit sellers will transact initially primarily through sales of consumer goods which do not have high value to the customer, but the loss of which poses a low risk of loss to the credit seller. Poor consumers will be enabled by markets to buy valuable assets which provide them valuable and long-lived services, but only after they have built up a strong reputational asset as reliable debt payers. In *Williams*, the seminal opinion which launched the modern unconscionability doctrine, the D.C. Circuit blessed a theory which might have protected the consumer's established reputation by applying his payments to debts incurred to acquire valuable assets, but instead dictated that those payments be applied to the purchase of the earliest purchased and thus least valuable assets. The court's opinion, which invited the trial court on remand to adopt the theory of the defending legal aid society counsel to grant the consumer ownership of the used curtains but to potentially deny her ownership of the washing machine, cannot be credited with representing the interests of rational consumers facing binding budget constraints. It reduces the value to them of using their curtain contract to develop a valuable reputational asset so that eventually they could hope to obtain a continuing stream of services from a washing machine with seller financing.

Finally, the study also argues there are additional reasons why consumers would likely prefer to have their property interests protected in the last purchased collateral, in addition to the argument based on the equilibrium struck between a credit seller and a high risk credit buyer in a series of purchases. First, application of payment to the latest debt in time increases the likelihood that the passage of time will operate to convey interests in the earlier purchases to the buyers. In the case of knowledgeable sellers, the potential advantage is admittedly small. Sophisticated sellers will manage in their later contracts to obtain waivers of statutes of limitation, perhaps at the addition of some transaction costs which themselves might be passed back to buyers.

Nevertheless, there is a final reason consumer buyers would probably prefer that payments be applied to their latest purchases first. Most consumer assets are rapidly depreciating so that, *ceteris paribas*, the payment application scheme would result in the consumer obtaining ownership of the least depreciated and therefore most valuable items in his or her collection. The payment scheme mandated by consumer statutes based on the Williams case, on the other hand, requires that the payments retire the debt and thus confer complete ownership to the buyer on the least valuable, most depreciated assets first.

If these conclusions are defensible, a mystery arises. Why did the furniture store itself not bargain to have payments applied to the earliest purchases first? By hypothesis, the store had bargaining power sufficient to obtain terms that were maximally unfavorable to consumer buyers, and in Williams, both buyers testified that they understood, and even preferred, the first in time payment application scheme. The pro rata payment application formula is favorable to buyers who contemplate the benefits of making a series of purchases because each new purchase extends the time limits for paying off of earlier ones. The first contract in which the offending clause was found would not have been unfavorable to the consumer, as there would have been no other debts to which payments might be applied, pro rata or otherwise.

Moreover, recall that Section 2-306 measures unconscionability ex ante, from the time of the formation of the contract.[88] From the standpoint of the time of the first contract, the pro rata clause had only a contingent potential effect. It would operate only in the event that the consumer made later purchases from the same merchant. When the later purchase is made the pro rata clause in the second contract operates to postpone final payoff of the debt from the first and from the second contract. How much it does so, however, is partially a function of the level of the newly agreed-to monthly payment. If the new payment level is high enough, the early debt might be paid off at the time it was originally scheduled to be paid so that a consumer expecting to own the potholders in July 1970 might in fact own them then, subject to another contingency: that the consumer does not default on the new level of payments. Since we cannot determine at the time of the second contract whether or not a future default will occur, it is difficult to conclude that the second contract is unconscionable at the time it was made. On the other hand, if the second contract does not set the new payment level at a high enough level to guarantee that the total debt will be

88. U.C.C. § 2-302(1) (2012) ("If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable *at the time it was made*, the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.") (emphasis added).

paid off by the time the debt on the first purchase was scheduled to be paid off, the second contract ipso facto must contain an assent from the debtor to postpone and extend the due date for the payoff of the earlier debt. A consensual postponement of the ownership date between the merchant and the consumer is harder to characterize as unconscionable, particularly if looked at from the time the second contract was made. The customer wished to extend the time until the first purchase is completely paid for and wished to postpone the occurrence of that event to enable her to acquire a more valuable asset and to exploit the new relational capital her payment history had produced.

Finally, the biggest mystery in the case is why neither counsel nor any of the courts was able to recognize that the contract term upon which they were focusing could be explained by a typical appreciation of contracting parties in installment credit cases that an application of payment problem might arise. The furniture store could have simply omitted the clause being objected to and relied upon the background contract rule for payment application. If the store guessed that consumers would be unaware of their default option to choose how their payments were to be applied ex post, they might have gained the right to make the ex post designation themselves. In all likelihood, they were prepared to do so since they gave notice of the pro rata application after receipt of each payment. That they probably had the opportunity to use their power under the default rules for application of payments to speculate against the consumers ex post, but chose instead to abide by a pro rata scheme which was less favorable to them than the default rule regime is strong evidence that they were not motivated to extract all the advantages the law might have granted them, but rather were willing to abide by an arrangement which postponed the due dates for old debts, and accordingly kept those debts open and unpaid longer than initially contemplated. The benefits of the time extensions, one must surmise, were worth so much to the consumers that they were likely to make future purchases from the same merchant in order to capture them. Those benefits may have disappeared, however, for consumers in the District of Columbia as a result of the holding in the case. Focus on creating broad idealistic legal precedent by the legal aid lawyers distracted them from attending to the factual patterns in their own clients' cases. Their failure to realize how markets, even in impoverished areas, create opportunities for the poor to develop relational capital with their vendors, which eventually allows them to acquire valuable assets on credit, led them to seek a judicial doctrine likely to impair that market function, harming not only their specific clients, but also the clients for whom they took implicit responsibility for by seeking the kind of ruling they did. The common law legal tradition that urges lawyers to represent their individual clients by attending closely to the facts in their cases is strengthened once this kind of case is realized to be a counter example.

There may be many consumers unhappy with the market options they have. It may stem from their desire to avoid charges based on the historical risk profile, or from the harshness of the remedies, the merchants bargain for, which tend to reduce those risks. In spite of such unhappiness, citizens living with liquidity constraints are actively seeking credit devices, which this symposium defines as "aberrant," demonstrating the value of these grants of credit to illiquid consumers. No studies ask whether, given the budget constraints consumers faced at the time they made purchases, they would have preferred no extension of credit over expensive credit. For one thing, it is difficult to locate and survey persons who thought about buying and decided not to, even though that option is always available. By defining the objectionable credit devices as aberrant, the law would tend to make them unavailable. Even poor people are able to finance the purchase of assets, which deliver a stream of valuable future services to them. Legally eliminating these expensive credit devices homogenizes all consumers into stereotypes of the unhappy consumer who does not value having the benefits any of these devices confer. That may not be an accurate characterization of our economy's consumers. Contract law owes its social value to permitting persons with heterogeneous tastes, wants, and aspirations to fulfill them in contracts suitable for the market conditions they face. The devices under scrutiny here may in fact meet many important needs of poor consumers. Calling them aberrant in order to outlaw them requires us to find ways of accommodating consumer heterogeneity. As of now, no one has sought to develop a solution for this problem. The traditional application of payments doctrine seemed to accommodate those needs. The difficulty with a mandatory "first payment applies to first debt" solution is that it leaves us in the dark about why the term must be mandatory and what kinds of payment application procedures will ever pass muster. For easy to understand reasons having to do with the short life spans of personal property, it also takes away the consumer's first option, which is to contract for the right to designate the application of every payment. Without that option to develop the value of her credit reputation in order to eventually obtain the services of the assets she wants, Ms. Williams will be stuck having to pay in full for her napkins but disabled from developing the value of her reputation in order to buy her washing machine.