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HOLDER IN UNDUE COURSE: THE FTC RULE PRESERVING CONSUMERS' CLAIMS AND DEFENSES

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The FTC's rule putting lenders in the shoes of sellers virtually abrogates the holder in due course rule of commercial instruments. This article analyzes all the requirements for compliance with the rule and gives special attention to the difficult problem of how to tell what transactions constitute purchase money loans under the rule.

Introduction

On November 14, 1975,¹ the Federal Trade Commission promulgated a Trade Regulation Rule on Preservation of Consumers' Claims and Defenses.² The Rule became effective on May 14, 1976.³ The primary purpose of the Rule is to prevent the use of credit terms in consumer credit transactions which allow creditors to take free of claims and defenses arising from the underlying sales transactions.⁴ This article analyzes the notice requirement, transactions subject to the Rule, parties subject to the Rule, and penalties for violation of the Rule.

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¹ 40 Fed. Reg. 53,506 (1975).

² 16 C.F.R. §§ 433.1-433.2 (1977).

³ 40 Fed. Reg. 53,506 (1975). The Commission has exempted open-end consumer credit contracts entered into prior to November 1, 1977, provided the contracts do not cut off consumers' claims and defenses. 42 Fed. Reg. 19,487, 40,426, and 46,509 (1977).

⁴ "Guidelines on Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses," 41 Fed. Reg. 20,022, 20,023 (1976) [hereinafter cited as Guidelines].

The Notice Requirement

The Rule requires that the following notice be included in all consumer credit sales contracts which arise from credit transactions subject to the Rule:

NOTICE

Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained pursuant hereto or with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder.⁵

The Rule also requires that the following notice be included in all consumer loan contracts which arise from credit transactions subject to the Rule:

NOTICE

Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder.⁶

The notice must be printed in at least ten-point, boldface type,⁷ but the notice is not required to be in a particular location.⁸ A creditor can comply with the Rule by affixing a stamp or sticker, or by attaching a separate paper.⁹

A conditional notice will not satisfy the notice require-

⁵ 16 C.F.R. § 433.2 (1977).

⁶ *Id.*

⁷ *Id.*

⁸ Guidelines, note 4 *supra*, at 20,026.

⁹ FTC Staff Advisory Letter, 5 CCH Cons. Cred. Guide ¶ 98,285 (Aug. 9, 1976).

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ment.¹⁰ An attempt to limit or restrict the notice will result in having a notice which fails to comply with the Rule.¹¹ Where the contract contains a paragraph in violation of the Rule, affixing a sticker containing the notice does not satisfy the Rule; there should have been a statement voiding the offending paragraph.¹²

When the notice is included in a contract, it becomes a part of the contract. With the notice in the contract, subsequent parties to whom the contract is assigned or negotiated take subject to defenses which the consumer could assert against the seller of the goods or services. Waiver of defense clauses cannot be included in contracts subject to the Rule. Promissory notes containing the notice are not negotiable instruments because the notice makes the promise conditional. For transactions subject to the Rule, the notice does away with the right to take free of claims and defenses arising from the sales transaction.

Transactions Subject to the Rule

General Considerations

Before a transaction will be subject to the Rule, the transaction must be in or *affecting* interstate commerce.¹³ This limitation, however, has little significance; under the current interpretation of the "affecting commerce" language, almost all economic activity affects interstate commerce.¹⁴ Therefore, there likely will be few credit transactions which are not subject to the Rule.

¹⁰ Guidelines, note 4 *supra*, at 20,023.

¹¹ *Id.*

¹² Note 9 *supra*, at ¶ 98,295 (Oct. 15, 1976).

¹³ Federal Trade Commission Act, 15 U.S.C. § 45(a)(1) (Supp. V 1975); FTC Trade Regulation Rule on Preservation of Consumers' Claims and Defenses, 16 C.F.R. § 433.2 (1977).

¹⁴ Gregory, "The Federal Trade Commission's New Powers and What They Mean to the General Practitioner," 48 Okla. B.A.J. 2135, 2136 (1977).

Another limitation on the application of the Rule is that only consumer transactions are subject to it.¹⁵ To qualify as a consumer transaction, the transaction must involve a natural person seeking to acquire goods or services for personal, family, or household purposes.¹⁶ The individual who obtains an automobile for personal use or who obtains an appliance for the home has entered into a consumer transaction; home improvement contracts, vocational training programs, and health club memberships are examples of service transactions that may constitute consumer transactions.¹⁷ Because of the definition of consumer transaction, the Rule does not reach commercial transactions; nor does it reach agricultural transactions. It also should be noted that the Rule does not cover sales of real property.

Credit Sales

The Rule covers two categories of consumer credit transactions: consumer credit sales and consumer sales financed by purchase money loans.¹⁸ Under the Rule,¹⁹ a consumer credit sale has the same meaning as the term "Credit Sale" in the Truth in Lending Act²⁰ and Regulation Z.²¹ By incorporating Regulation Z, the Rule excludes certain transactions. For example, if the amount financed exceeds \$25,000, the transaction is not subject to the Rule.²² On the other hand, under Regulation Z, certain transactions purporting to be leases are treated as credit sales, thus becoming subject to the Rule. A "lease" transaction is covered by the Rule where the lease amount is

¹⁵ 16 C.F.R. § 433.2 (1977).

¹⁶ *Id.* at § 433.1(b).

¹⁷ Guidelines, note 4 *supra*, at 20,024.

¹⁸ 16 C.F.R. § 433.1(i) (1977).

¹⁹ *Id.* at § 433.1(e).

²⁰ 15 U.S.C. §§ 1601 et seq. (1970).

²¹ Federal Reserve Board, Truth in Lending Act, Reg. Z, 12 C.F.R. §§ 226.1 et seq. (1977).

²² *Id.* at § 226.3(c).

“substantially equivalent to or in excess of the aggregate value of the property and services involved” and the “lessee will become, or for no other or for a nominal consideration has the option to become, the owner of the property” at the end of the lease term.²³

Purchase Money Loans

The “purchase money loan” provisions present the greatest difficulties for lawyers interpreting the Rule and attempting to determine what transactions constitute purchase money loans.

Frequently, consumers acquire goods or services by obtaining the purchase price from a creditor other than the seller. The proceeds of these loans provide the purchase money for the consumer, but not all of these transactions are purchase money loans under the Rule. Thus, it is necessary to determine which loan transactions are purchase money loans.

The Finance Charge Requirement

A loan to a consumer is not a purchase money loan unless it is subject to a finance charge within the meaning of the Truth in Lending Act and Regulation Z. Generally, a finance charge is the cost assessed by the creditor for the use of the funds advanced by the creditor.²⁴ The finance charge may include interest or discount, a service or activity fee, and a loan or finder’s fee.²⁵

The Specific Purchase Limitation

To be subject to the Rule, the proceeds of a loan must be used in whole or substantial part to obtain goods or services from only one seller. Use of the proceeds from one

²³ *Id.* at § 226.2(t).

²⁴ *Id.* at §§ 226.2(w), 226.4.

²⁵ *Id.* at § 226.4.

loan to make multiple purchases from different sellers is not covered by the Rule.²⁶ If the consumer borrows \$1,000 and applies the proceeds to the purchase of a used automobile, the loan will be a purchase money loan provided all other requirements for a purchase money loan are satisfied. Likewise, where the consumer applies the \$1,000 proceeds to the purchase of a refrigerator and a dishwasher from the same seller, the loan will be a purchase money loan if all other requirements are met. But the loan is not a purchase money loan if the consumer uses a part of the \$1,000 to buy a refrigerator from seller *A* and the remainder to buy a dishwasher from seller *B*. Sellers and lenders cannot avoid the Rule by having the lender advance a few dollars more than the purchase price of goods or services to be obtained with the loan proceeds.²⁷

Because of the "specific purchase" limitation, almost all open-end credit will be exempt from the coverage of the Rule. Open-end credit arrangements with the seller, however, are subject to the Rule.²⁸ Furthermore, sellers and lenders cannot avoid the Rule by setting up open-end credit for transactions that would otherwise be subject to the Rule. The substance, rather than the form, of the transaction will control.²⁹ For example, EZ Loan Company, a wholly owned subsidiary of Seller, establishes "open-end" accounts for customers of Seller, but the proceeds can be used only for purchases from Seller. These transactions are purchase money loans.

The Affiliation or Referral Requirement

Not all consumer loans used for a specific purchase are purchase money loans. A loan is not a purchase money

²⁶ Guidelines, note 4 *supra*, at 20,025.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

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loan unless the seller is affiliated with the lender or the seller refers consumers to the lender.³⁰

The Affiliation Requirement. The seller may be affiliated with the lender by common control, by contract, or by business arrangement.³¹ The seller is affiliated with the lender by common control when both seller and lender are owned by the same holding company, both are owned by substantially the same individuals, or either is a subsidiary of the other.³² An affiliation by contract occurs when there is an oral or written agreement, formal or informal, which contemplates or provides for cooperative or concerted activities by a seller and a lender in connection with the sale and financing of consumer goods or services.³³ A creditor's agreement to provide favorable financing for seller's inventory in return for seller's agreement to refer loan prospects to the creditor constitutes affiliation by contract.³⁴

The broadest basis for finding an affiliation between a seller and a lender is the affiliation by business arrangement. Business arrangement includes any understanding, procedure, course of dealing, or arrangement—formal or informal—between the seller and the lender, in connection with the sale and financing of consumer goods or services.³⁵ An arrangement for expedited processing or approval of loan applications in return for seller's regular referral of loan prospects results in an affiliation by business arrangement.³⁶

From this discussion, it can be seen that the Rule applies to all situations where a seller and a lender are par-

³⁰ 16 C.F.R. § 433.1(d) (1977).

³¹ *Id.*

³² Guidelines, note 4 *supra*, at 20,026; Statement of Enforcement Policy in Regard to Trade Regulation Rule on Preservation of Consumers' Claims and Defenses, 41 Fed. Reg. 34,594, 34,595 (1976) (hereinafter cited as Enforcement Policy).

³³ 16 C.F.R. § 433.1(f) (1977).

³⁴ Enforcement Policy, note 32 *supra*, at 34,596 (Example 2).

³⁵ 16 C.F.R. § 433.1(g) (1977).

³⁶ Enforcement Policy, note 32 *supra*, at 34,596 (Example 3).

ticipating in concerted or cooperative activity for the sale and financing of consumer goods or services. Following are some situations which constitute affiliations under the Rule: Seller keeps loan application forms for the lender; seller participates in the preparation or processing of loan documents; lender refers customers to the seller; lender pays seller for providing loan prospects or seller pays lender for providing sales prospects; floor plan or inventory finance arrangement which includes the assignment of indirect paper or the referral of loan prospects; active lender participation in the sales program; joint advertising efforts; and lender agrees to purchase paper on an indirect basis.³⁷

All arrangements between sellers and lenders are not subject to the Rule; the arrangement must be related to the financing of consumer sales. Thus, commercial lending arrangements for the financing of inventory, equipment purchases, working capital, or any purpose other than the financing of consumer sales do not result in affiliations within the meaning of the Rule. The maintenance of a commercial checking account with a lending institution is not an affiliation. An arrangement between a seller and a lender for the approval of personal checks is not an affiliation. Nor will the issuance of a check for the loan proceeds payable jointly to the buyer and the seller result in an affiliation.³⁸ Credit card arrangements for the financing of consumer sales are not covered by the Rule.³⁹

The Referral Requirement. One type of purchase money loan is the referral loan. Referral loans arise from situations where a seller refers consumers to a lender.⁴⁰ Referral means more than merely providing information about pos-

³⁷ Guidelines, note 4 *supra*, at 20,026; Enforcement Policy, note 32 *supra*, at 34,595.

³⁸ *Id.*

³⁹ 16 C.F.R. §§ 433.1(c), 433.1(h) (1977).

⁴⁰ *Id.* at § 433.1(d)(1).

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sible credit sources. It is not a referral prohibited by the Rule for the seller to provide a purchaser with the names of several creditors in the general area where the seller is doing business. To constitute a referral, the seller must name a specific lender or a limited group of lenders. Referral means routine, regular referrals on a continuing basis, not occasional referrals.⁴¹ Consideration is not required for a referral loan, but the Federal Trade Commission has indicated that the furnishing of the name of a creditor will not be treated as a referral unless the creditor provides some "quid pro quo" or the creditor and the seller cooperate in some way for their mutual benefit.⁴²

Parties Subject to the Rule

At the present time, the Rule operates against sellers only.⁴³ Sellers must include the notice in all credit instruments for credit sales which are subject to the Rule.⁴⁴ Sellers are prohibited from accepting the proceeds of purchase money loans unless the purchase money credit instruments contain the notice required by the Rule.⁴⁵ Thus the burden of assuring compliance with the Rule is placed upon sellers for purchase money loans as well as credit sales.

According to the Federal Trade Commission, where a seller and a lender are affiliated or where a referral relationship has been established between a seller and a lender, the notice must be included in all credit contracts with consumers who use the proceeds to buy goods or services from the affiliated or referral seller.⁴⁶ However, the seller

⁴¹ Guidelines, note 4 *supra*, at 20,025-20,026; Enforcement Policy, note 32 *supra*, at 34,596.

⁴² Enforcement Policy, note 32 *supra*, at 34,596.

⁴³ The Federal Trade Commission has proposed an amendment to the Rule that would make it applicable to purchase money lenders. 40 Fed. Reg. 53,530 (1975).

⁴⁴ 16 C.F.R. § 433.2 (1977).

⁴⁵ *Id.*

⁴⁶ Guidelines, note 4 *supra*, at 20,026.

may not know that the funds were obtained from the affiliated or referral lender. The seller is responsible for determining that the credit instrument contains the required notice only when the seller knows or has reason to believe that the funds being accepted are the proceeds of a purchase money loan.⁴⁷ If a purchaser uses a joint proceeds check from a referral or affiliated lender, the seller has actual knowledge that the proceeds are from a purchase money loan.⁴⁸ Likewise, the seller has actual knowledge if the purchaser states that the funds were obtained from a referral or affiliated lender.⁴⁹ The seller is put on inquiry notice if a purchaser uses a check or draft drawn by a referral or affiliated lender.⁵⁰ When the seller knows, or is put on notice, that funds are proceeds of a purchase money loan, the seller should verify with the lender that the credit instrument contains the required notice; the seller should not rely on the purchaser for this information.⁵¹ Where a purchaser uses cash or a personal check, the seller is not obligated to inquire about the source of the funds being used for the transaction.⁵²

Penalties for Violation of the Rule

Failure to comply with the Rule constitutes an unfair or deceptive act or practice under the Federal Trade Commission Act.⁵³ Thus, a violation of the Rule subjects the seller to the powers and remedies available to the Federal Trade Commission.

⁴⁷ Enforcement Policy, note 32 *supra*, at 34,596.

⁴⁸ *Id.* at 34,597 (Example 1).

⁴⁹ *Id.* (Example 3).

⁵⁰ *Id.* (Example 1).

⁵¹ *Id.* (Example 4).

⁵² *Id.* (Example 2).

⁵³ 15 U.S.C. § 57a(d)(3) (Supp. V 1975); 16 C.F.R. § 433.2 (1977).

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The Federal Trade Commission has a number of powers and remedies under the Act.⁵⁴ First, the Commission may obtain a temporary restraining order or preliminary injunction from a district court of the United States when it has reason to believe that the Rule is being, or is about to be, violated and that it would be in the public interest to restrain or enjoin the violation.⁵⁵ The Commission also has the power to issue cease and desist orders.⁵⁶ Violation of a cease and desist order can result in a civil penalty of not more than \$10,000 for each violation. For a continuing violation, each day of continuance constitutes a separate offense. This remedy is enforced in a civil action for the benefit of the United States. The action is brought in a district court of the United States by the Attorney General of the United States.⁵⁷

The Commission has the right to initiate a civil action in United States district court to recover a civil penalty for a violation of the Rule. For this remedy, the seller must have "actual knowledge or knowledge fairly implied on the basis of objective circumstances that such act is unfair or deceptive and is prohibited by such rule."⁵⁸ Similarly, the Commission has a civil action against a seller who engages in an act or practice declared unlawful by the Commission in a final cease and desist order if the seller has "actual knowledge that such act or practice is unfair or deceptive and is unlawful."⁵⁹ The civil penalty which may be recovered in these civil actions is not more than \$10,000 for each violation; for a continuing violation, each day of continuance is a separate offense.⁶⁰

⁵⁴ Federal Trade Commission Act, 15 U.S.C. §§ 41 et seq. (1970 & Supp. V 1975).

⁵⁵ *Id.* at § 53(b) (Supp. V 1975).

⁵⁶ *Id.* at § 45(b).

⁵⁷ *Id.* at § 45(1).

⁵⁸ *Id.* at § 45(m)(1)(A).

⁵⁹ *Id.* at § 45(m)(1)(B).

⁶⁰ *Id.* at §§ 45(m)(1)(A), 45(m)(1)(B), and 45(m)(1)(C).

Finally, the Commission has the authority to bring a civil action for the benefit of injured consumers. This action can be commenced for the violation of either a rule or a cease and desist order. The action may be brought in a United States district court or in any state court of competent jurisdiction. The court has the power to grant the relief necessary to redress the injury, including rescission or reformation of contracts, refund of money or return of property, and payment of damages.⁶¹ This section provides that exemplary or punitive damages shall not be awarded.⁶² There is a statute of limitations of three years for this remedy.⁶³

Conclusion

The Federal Trade Commission Trade Regulation Rule on Preservation of Consumers' Claims and Defenses⁶⁴ abrogates the right to take certain consumer credit obligations free of claims and defenses arising from the sales transactions being financed. Almost all consumer credit sales are covered by the Rule, but there are a number of requirements and limitations which restrict the coverage of purchase money consumer loans. Proceeds of the loan must be used for purchases from a single seller, and there must be an affiliation or a referral relationship between the creditor and the seller. An affiliation may result from common control, contract, or business arrangement. For a referral relationship, there must be regular and continuing reference of purchasers to specific lenders.

Consumer credit contracts subject to the Rule must contain a notice that the holder of the contract is subject to all claims and defenses which the debtor-purchaser might

⁶¹ *Id.* at § 57b.

⁶² *Id.* at § 57b(b).

⁶³ *Id.* at § 57b(d).

⁶⁴ 16 C.F.R. §§ 433.1-433.2 (1977).

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assert against the seller of the goods or services. The seller is responsible for making sure that the notice is included in all contracts subject to the Rule. Seller's failure to meet this obligation results in a violation of the Federal Trade Commission Act and could result in the imposition of substantial civil penalties against the seller.

In God We Trust—and Bankers

“Fraud and embezzlement take more money from banks than robbery does, and no one alive can accurately assess the claims of religion. Image, apparently, is everything. That seems to be the lesson of a Gallup Poll released last week that seems to show that, of nine American institutions, only organized religion and banking enjoy a high level of confidence.

“Organized religion came in first, with 60 percent of 1,500 adults in more than 300 localities expressing a ‘great deal’ or ‘quite a lot’ of confidence; banking got 55 percent; the rest went downhill, led by the military with 48 percent. Other institutions earned ‘quite a lot’ of confidence in these proportions: the public schools, 45 percent; the Supreme Court, 39 percent; big business, 27 percent; television, 21 percent; labor unions, 20 percent; Congress, 18 percent. Labor had the highest vote for ‘very little’ or ‘none,’ with 43 percent.”

—Tom Ferrell and
Virginia Adams
The New York Times
June 16, 1978