

**THE FTC “HOLDER IN DUE COURSE” LANGUAGE:
WHAT’S YOUR LIABILITY?**

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Background

In many transactions, a retailer sells an automobile or other “big ticket” item to a consumer, enters into a retail installment contract with the consumer, and then assigns the contract to a finance company.

The simple assigning of the contract has legal significance. It may protect a finance company from many claims. As an assignee of the contract, a finance company is not equivalent to the original creditor under the Truth in Lending Act (“TILA”).

Under TILA, an assignee is liable “only if the violation [of TILA] . . . is apparent on the face of the disclosure statement.” 15 U.S.C. §1641(a). “In general, courts addressing the issue of TILA assignee liability have found that §1641(a) limits liability when there is no indication from the disclosure document that liability may arise.” Alexander v. Continental Motor Werks, Inc., 1996 U.S. Dist. Lexis 1849 at *16 (N.D. Ill. 1996).

The plaintiff’s bar frequently attempts to circumvent this TILA limitation, by relying on language in the contract required by the Federal Trade Commission (16 C.F.R. §433.2), which is sometimes called the “Holder in Due Course Rule.” The Federal Trade Commission requires certain language on all retail installment contracts. The requirement and the language provide, in part:

§433.2 Preservation of consumer’s claims and defenses,
unfair or deceptive acts or practices.

In connection with any sale or lease of goods or services to consumers, in or affecting commerce as “commerce” is defined in the Federal Trade Commission Act, it is an unfair or deceptive act or practice within the meaning of Section 5 of that Act for a seller, directly or indirectly, to:

(A) Take or receive a consumer credit contract which fails to contain the following provision in at least ten point, bold face type:

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.

16 C.F.R. §433.2. (40 Fed. Reg. 53506, Nov. 18, 1975; 40 Fed. Reg. 58131, Dec. 15, 1975). The plaintiff’s bar claims that this language overrules the limitation on assignee liability in Section 1641(a). The issue is currently being debated in Smith v. Guardian National (97-1208) and Taylor v. Quality Hyundai and Bank One (96-3658), which are two cases pending before the Seventh Circuit United States Court of Appeals. In the meantime, this is how the battle is being fought.

The First Line of Defense

Plaintiffs’ interpretation of the “Holder In Due Course” language can be resisted on at least two grounds. First, it can be argued that if the Rule which requires the language really did override TILA’s limitation on assignee liability, **it would render an essential element of TILA’s statutory framework a complete nullity.** No

administrative rule can or should override comprehensive federal legislation. Secondly, it can be argued that the Holder in Due Course rule is intended **only to preserve consumers' legal rights, not to create rights of action where none would otherwise exist.**

Several Federal decisions support our position. Federal Judge Charles Kocoras ruled in Alexander v. Continental Motor Werks, Inc., 1996 U.S. Dist. Lexis 6133 at *6-7 (N.D. Ill. 1996), that the Holder in Due Course language cannot override Section 1641(a) of TILA, stating:

The standard contractual provision at issue provides that any holder "is subject to all claims and defenses" which the consumer has against the seller, limited to the amounts paid by the consumer. The language is required by FTC rules to be included in all consumer credit contracts. [citation omitted] According to FTC commentary, the purpose of the FTC rule is to preserve a consumer's claims "to defeat or diminish the right of a creditor to be paid" where the seller has failed to keep his side of the bargain. [citation omitted] It is not the stated purpose of the rule to override the express language of federal statutes such as TILA, or to create claims for consumers that are otherwise precluded by statute.

In section 1641(a) of TILA, Congress expressly chose not to limit liability upon assignees who do not have notice of a TILA violation at the time of the assignment based on the documents assigned. [citation omitted] The RIC language on which plaintiffs here rely is present in every contract, and, accepting the plaintiffs' argument, would effectively impose liability upon an assignee regardless of whether the violation was apparent under section 1641(a). Such a result would be contrary to the congressional intent behind section 1641(a), effectively elevating an FTC regulation over the language of TILA and making that portion of TILA which pertains to assignee liability superfluous. [citation omitted] (emphasis supplied)

See also Lindsey v. Ed Johnson Oldsmobile, Inc., 1996 WL 411336 at *7 (N.D. Ill. 1996) (where Judge Kocoras again rejected plaintiffs' theory)

At least two other decisions have also harmonized the Holder in Due Course Rule with the limitation on assignee liability in TILA. In Vietnam Veterans of America, Inc. v. Guerdon Industries, Inc., 644 F. Supp. 951, 965 n. 10 (D. Del. 1986), it was held:

[T]he [FTC] Rule does not “create” rights that a consumer can assert, but rather ensures that available rights are not eliminated. See Smith, Preserving Consumers Claims and Defenses, 63 A.B.A.J. 1400, 1402 (1977).

Therefore, the question becomes whether RICO or TILA themselves impose liability on assignees of consumer credit contracts Under TILA, liability of assignees is governed by 15 U.S.C. §1641, which provides that a consumer may recover against assignees where the violation is apparent on the face of the disclosure statement. [citation omitted] Accordingly, it would appear that allowing recovery against holders of consumer credit contracts under . . . TILA through the vehicle of “Holder in Due Course” contract provisions would, in effect, amend these statutes to impose liability on persons that Congress did not intend to be covered by these statutes. (emphasis supplied)

Accord Sheppard v. Quality Siding & Window Factory, Inc., 730 F. Supp. 1295, 1301-02 n. 8 (D. Del. 1990) (unlikely that contractual language required by FTC Rule could or should override assignee liability provision of TILA -- Congress has determined consumer’s right to recover against an assignee under TILA).

Consistent with the observations of these courts are the FTC’s own Guidelines on Trade Regulation Rules Concerning Preservation of Consumers’ Claims and Defenses, published just prior to the effective date of the FTC Rule. Elaborating on transactions affected by the FTC Rule, as well as limitations on its applicability, the FTC states:

Additional limitations on affected transactions are present because the definitions of “Financing a Sale” and “Purchase Money Loan” expressly referred to in the Truth in Lending Act and Regulation Z, and thus incorporate the limitations contained in these laws.

41 Fed. Reg. 20022 (May 4, 1976). Thus, we argue that the FTC itself recognized that the applicability of the Holder in Due Course Rule is necessarily circumscribed by the

provisions of TILA and Regulation Z. Those provisions clearly limit a finance company's liability to only those TILA violations which are apparent on the face of the contract.

Finally, we have argued that “[r]egulations cannot trump the plain language of statutes.” Robbins v. Bentsen, 41 F.3d 1195, 1198 (7th Cir. 1994). In other words, a regulation like the FTC Rule “may not serve to amend the statute,” or “add to the statute ‘something which is not there.’” Iglesias v. United States, 848 F.2d 362, 366 (2d Cir. 1988), citing Koshland v. Helvering, 298 U.S. 441, 447 (1936); United States v. Calamaro, 354 U.S. 351, 359 (1957). Accordingly, the FTC Holder in Due Course Rule cannot “trump” the provisions of TILA, nor can it “amend” or “add to” TILA to provide assignee liability where none would otherwise exist. As the FTC itself states, “the Rule does not create new rights and defenses.” 41 Fed. Reg. 20022 (May 4, 1976).

A “Fallback” Position

Where plaintiffs do not state a claim for rescission, a finance company may have a “fallback” argument. Federal Judge James Holderman articulated this argument in Dees v. Bob O’Connor Ford, Inc., 1995 WL 441629 at *3 (N.D. Ill. 1995):

In promulgating the regulation codified at 16 C.F.R. §443.2, however, the FTC limited the situations where a consumer will be able to maintain an action against the assignee-creditor stating that consumers “will not be in a position to obtain affirmative recovery from a creditor unless they have **actually commenced payments and have received little or nothing from the seller.**”

Likewise, in Mount v. LaSalle Bank Lake View, 926 F. Supp. 759 (N.D. Ill. 1996), where homeowners brought suit against a financial institution to which their retail installment contracts were assigned based on the FTC “Holder in Due Course” language, Federal Judge Charles Norgle held, id. at 764:

Such relief was to be available only if the seller's breach was so substantial that rescission and restitution were justified under applicable state law principles. Therefore, a consumer may successfully maintain an action against an assignee-creditor for any sums paid on account of a breach of warranty on the seller's part warrants rescission of the sales contract under applicable state law. (citations omitted) (emphasis supplied)

While this position may be somewhat limited in scope, it does provide another layer of protection in some cases.

Collateral Defense

The plaintiff's bar consistently claims violations of various state laws in connection with alleged violations of TILA. Fortunately, finance companies can utilize both the absence of a TILA violation as well as the assignee liability provisions of TILA to ward off plaintiff's collateral attacks.

In the absence of a TILA violation based on the failure to make disclosures, there can be no state law violation. The Illinois Supreme Court has held that claims for non-disclosure of information based on Illinois state consumer credit statutes are preempted by TILA:

Because the Illinois consumer credit statutes requiring specific disclosures are met by compliance with the Truth in Lending Act, we believe that the Consumer Fraud Act's general prohibition of fraud and misrepresentation in consumer transactions does not require more extensive disclosure in the plaintiff's loan agreement than the disclosure required by the comprehensive provisions of the Truth In Lending Act. Rather, we perceive in the disclosure provisions of Illinois' consumer credit statutes a consistent policy against extending disclosure requirements under Illinois law beyond those mandated in the Truth In Lending Act, in situations where both the Act and the Illinois statutes apply. (emphasis supplied)

Lanier v. Associates Finance, Inc., 114 Ill. 2d 1, 17, 499 N.E.2d 440, 447 (1986). See also Hernandez v. Vidmar Buick Co., 910 F. Supp. 422, 427 (N.D. Ill. 1996); and Dees v. Bob O'Connor Ford, Inc., 1995 WL 441629 at *8 (N.D. Ill. 1995), citing Lanier.

Even if a TILA violation exists, a finance company may still be able to use the limited liability provisions of TILA. As discussed above in Dees and Mount, at most, an assignee can only be liable if a consumer states a claim for rescission. Thus, the limited assignee liability provision of TILA may provide additional protection from collateral attacks.

Plaintiffs' Position

Plaintiffs' attorneys suggest that finance companies purchase contracts and voluntarily accept the liability of the original credit sellers whether or not such liability would be directly imposed on them. In support of this theory they typically cite: Brown v. LaSalle Northwest Nat'l. Bank, 820 F. Supp. 1078 (N.D. Ill. 1993); Heastie v. Community Bank, 727 F. Supp. 1133 (N.D. Ill. 1989); Armstrong v. Edelson, 718 F. Supp. 1372 (N.D. Ill. 1989); Cox v. First Nat'l Bank, 633 F. Supp. 236 (S.D. Ohio 1986). Plaintiff's bar contends that whether the language is required by the FTC or not, it is in the contract and therefore must be given effect.

The effect of the "preservations of defenses" language is sufficient to wipe out the potential claim of the Finance Company that its TILA liability is limited, by the terms of 15 U.S.C. § 1641(a), to a violation which "is apparent on the face of the disclosure statement." Stewart v. Credithrift of America Consumer Discount Co., 93 B.R. 878, 888 (Bankr. E.D. Pa. 1988); see also Jefferson Bank & Trust Co. v. Stamatiou, 383 So. 2d

388, 391 (La. 1980) (contract provision described in FTC rule is effective when included in the agreement, even if the rule did not apply).

Moreover, another recent Federal opinion bypassed the limitations on assignee liability as prescribed by TILA. In Fairman v. Shaumburg Toyota, Inc., 1996 WL 392224 at *7 (N.D. Ill. 1996), it was simply stated that:

As a holder of the contract, Community Credit [the finance company] is subject to all claims and defenses.

The opinion seems to have relied on the FTC “Holder in Due Course” language, which was included in the plaintiff’s contract. However, it is unclear whether the finance company’s attorney argued the limited liability under TILA, since the opinion does not specifically mention, let alone rule on the applicability of that particular provision of TILA.

So, while theories based on the “Holder In Due Course” language have been rejected by numerous courts, they still seem to have some validity. They are aggressively pursued by plaintiff’s bar.

The Current Battles

We are involved in three groups of cases in which this issue has arisen.

The first group of cases arises from the dealer’s and finance company’s alleged failure to properly disclose the finance charge on the consumer’s retail installment contract. Consumers have alleged that the failure to disclose the amount of the discount at which a finance company purchases a consumer’s contract from the dealer violates TILA and various state statutes.¹ By this theory, the discount is a finance charge not properly disclosed in the contract. Accordingly, the contracts allegedly

¹These include, but are not limited to, a state’s Consumer Fraud Act, Retail Installment Sales Act, Motor Vehicle Installment Sales Act, and Sales Finance Agency Act.

overstate the amount financed, understate the finance charge, and understate the annual percentage rate (“APR”). We have argued that even if the dealer “separately imposed” on the consumer the discount at which the finance company purchased the contract, the finance company is only liable for this “hidden finance charge” if it is apparent on the face of the contract. Typically, the contract does not reveal such “separate imposition.”

In the second group of cases, consumers have sought to hold dealers and finance companies liable for the alleged misdisclosure of amounts paid to others on the consumer’s behalf, typically for insurance, auto clubs, and extended warranties. The price of these “extras” appears on the retail installment contract under the heading “Amount Paid to Others on Your Behalf.” As a matter of practice, some dealers retain a portion of the fee for these extras. The Seventh Circuit has recently ruled, in Gibson v. Bob Watson Chevrolet-GEO, Inc. on the question of whether a dealer may list the retail price under this heading without disclosing that it is retaining a portion of this fee. The Gibson decision is adverse to the dealer. It is not final, and a petition for further review will likely be filed. If, however, the decision stands, the “FTC/Holder in Due Course” issue could assume primary importance, from the finance company’s perspective.

The third group of cases involves simple warranty claims. In fact, the Magnuson-Moss Act has occasionally been pleaded as well.

Conclusion

Despite several decisions, including those cited above, which are adverse to plaintiffs’ attorneys, there are continuing claims that the FTC rule overrides the limited

assignee liability provision of TILA. The “final,” definitive word will only come from the Seventh Circuit, probably before this year is over. In the meantime, the fight goes on.

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