

Protecting and Improving the Best Thing The FTC Has Ever Done: The Holder Rule

Submitted by Jonathan Sheldon, Carolyn Carter, and Deanne Loonin, National Consumer Law Center
7 Winthrop Square, Boston MA 02110, www.consumerlaw.org; 617-542-9595
jsheldon@nclc.org; ccarter@nclc.org; dloonin@nclc.org

The Holder Rule Is the FTC's Most Effective Tool against Fraud

The TRR Concerning Preservation of Consumers' Claims and Defenses ("Holder" Rule), 16 CFR 433, is the most effective action the FTC has ever taken to prevent and remedy consumer fraud. The Rule requires all types of sellers of goods or services to include a clause in their credit contracts that makes any assignee or holder of the credit contract responsible for claims the consumer might have against the seller, up to a cap.

Before the FTC adopted the Holder Rule in 1975, sellers and creditors exploited commercial law to create a perfect system to profit from fraud. A fraudulent seller would sell faulty goods or services to a consumer on credit, and then assign the credit contract to a creditor (or arrange a purchase money loan from a creditor). The assigned contract would waive the consumer's right to raise assignor-related defenses against the assignee.

As a result, the consumer was legally bound to pay the creditor the full price of the goods plus all the finance charges *even though the goods were defective or never delivered or the transaction was procured by fraud*. With profits from fraudulent sales assured, creditors had no incentive to police the sellers whose transactions they financed. Moreover, it was usually impractical or impossible for the consumer to bring an affirmative action to recover from the seller.

The FTC Holder Rule dramatically changed these relationships. Now, in all types of transactions, consumers can raise seller-related claims against the holder. The consumer has a practical means of obtaining redress, by simply stopping payment on the portion of the debt representing fraud. The creditor in turn has an incentive to police its sellers to avoid losing money on its loans. In the case of a loss, the creditor is in a much better position than the consumer to recoup this loss from the seller.

There are tens of billions of significant consumer transactions every year in the United States and no federal, state or local agency or private litigation can hope to compensate all victims of consumer fraud. The FTC Rule instead enlists creditors and the consumers themselves to help police sellers.

Two Examples of What Happens without Holder Rule Protections

- Throughout the 1980s, the Holder Notice was *not* included in guaranteed student loans and the Department of Education argued that students could *not* raise school-related fraud as a defense on their student loans. The result was fraud on a scale hard to comprehend as over a thousand scam vocational schools eventually closed and millions of the most vulnerable students were ripped off, with no remedy. Students now can raise school-related defenses on their government backed loans. Not surprisingly, the area of greatest vocational school abuse

today involves loans outside the federal program where the Holder Notice is often (illegally) absent from the loan documents.

- The most telling example of what happens when holders are insulated from origination fraud involves an area where the Rule does not currently apply. Mortgage loan brokers and loan originators earlier this decade were given the green light for fraud on a scale never before seen in this country because the parties financing the mortgage loans claimed immunity from liability for the origination fraud and had no incentive to police it.

Ten Ways the FTC Can Protect and Improve the Holder Rule

Because of the Rule's importance, the FTC should give high priority to ensuring the Rule is properly understood and enforced. We urge the FTC to take the following steps to clarify and improve the Rule:

1. Issue a Commission Opinion stating that the Rule allows a consumer to recover payments made in a fraudulent transaction regardless of whether the consumer has the right to rescind the transaction. Many courts require, as a precondition to an affirmative recovery, that the consumer could have legally rescinded the transaction, relying on language taken out of context from the Rule's Statement of Basis and Purpose. The FTC Staff in 1999 issued two letters indicating this approach was contrary to the Rule's intent, contradicts the Notice's clear language, and misinterprets the Statement of Basis and Purpose. But numerous courts continue to ignore these staff interpretations.

2. Revise the 1976 Staff Guidelines, which mistakenly say that the Holder Rule does not apply to transactions over \$25,000, exempting many car sales today.

3. Revise the Rule itself, or issue a Commission Opinion stating that the Rule covers leases. Ambiguously, the Rule applies to a "sale or lease," but only to "consumer credit contracts" which are defined to exclude leases. Unlike the 1970's, automobile leases now are a major concern, but courts find the Rule does not apply to them.

4. Revise the Rule to provide that lenders share responsibility for complying with the Rule. Courts often rule the consumer has no remedy against the lender where the Holder Notice is improperly omitted from the loan documents, since only the seller, not the lender is responsible for inserting the Notice in the loan documents. That is, lenders (particularly national banks making loans for students to go to scam vocational schools) argue for special immunity from valid claims because their notes are illegally drafted. The FTC should amend the Rule to require that lenders share the responsibility with sellers to comply with the Rule's Notice requirements. Once the FTC acts, the banking agencies should be urged to adopt parallel requirements for lenders outside the scope of the FTC Rule.

5. Revise the Rule to provide that it is unfair or deceptive for creditors to misrepresent consumer rights under the Rule or to include contract terms contradicting the Holder Notice. Creditors frequently mislead consumers by claiming no responsibility for seller-related abuses. Creditors also try to circumvent the Rule by inserting in credit agreements either a direct or indirect waiver of the consumer's rights under the Notice. Once the FTC prohibits these

practices, we will urge the banking agencies to adopt parallel requirements for lenders outside the scope of the FTC Rule.

6. Bring enforcement actions against sellers who fail to arrange for the Notice to be inserted in the note. We continue to see a disturbing pattern of sellers in certain industries violating the Rule by failing to insert or arrange for the insertion of the Holder Notice in credit agreements. A prominent example is private student loans to attend proprietary vocational schools.

7. Issue a Commission Opinion stating that the Rule operates independently of state law rules about holder liability. The Eighth Circuit has misread the Statement of Basis and Purpose to require use of state law to determine *when* seller-related claims can be brought against the holder, as opposed to *what* claims are available against the seller (and thus available against the holder). The Eighth Circuit ruled the Holder Rule did not apply because state law did not allow consumers to raise seller-related claims against assignees. Of course, the Holder Rule was enacted to overcome just such state laws.

8. Issue a Commission Opinion stating that the Truth in Lending Act's limit on assignee liability only affects liability for TIL violations, not liability under the Holder Rule for state law claims. Several courts have wrongly held to the contrary.

9. Issue a Commission opinion interpreting the Rule to allow a consumer to recover attorney fees from a holder, in addition to recovering the amount paid under the contract. Under the Rule, the consumer's maximum recovery from a creditor is the amount paid under the contract. The Rule is unclear and courts are divided whether attorney fees, when recoverable under state or federal law, are part of the amount capped. Where the lender engages in a scorched earth litigation defense, the consumer's litigation expenses should not be part of the capped amount

10. Expand the Rule to allow consumers to raise against holders claims and defenses that they could raise against the loan originator or arranger (and not just against the seller). Holders' insulation from loan origination fraud is the major cause of the subprime mortgage crisis and also limits consumers' ability to raise loan fraud as a defense to loan repayment. The current crisis teaches us that the holder-in-due course doctrine must be further narrowed to meet the realities of the modern marketplace. Holders are already liable for all claims that the consumer could raise against the originator of HOEPA loans. We urge the FTC to expand the Holder Rule to apply this principle to all mortgage loans, or at least to a broader segment of the mortgage market, such as "higher priced mortgage loans," as now defined by Regulation Z. Once the FTC acts, we will urge the banking agencies to adopt parallel requirements for lenders outside the scope of the FTC Rule.