



Office of the Secretary

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

May 3, 2012

Jonathan Sheldon
Carolyn Carter
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7 Winthrop Square
Boston, Massachusetts 02110

Dear Mr. Sheldon and Ms. Carter:

This letter is in response to the National Consumer Law Center's request for a Commission advisory opinion regarding the Federal Trade Commission's Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses, 16 C.F.R. § 433, commonly known as the Holder Rule.¹ Specifically, you ask the Commission to affirm that the Holder Rule does not limit a consumer's right to an affirmative recovery to circumstances where the consumer can legally rescind the transaction or where the goods or services sold to the consumer are worthless. Your letter states that even though the plain language of the Rule is clear—which FTC staff confirmed in a 1999 opinion letter²—some courts continue to bar consumers from affirmative recoveries unless rescission is warranted.³

¹ Your letter requesting an advisory opinion is co-signed by representatives from Public Citizen, U.S. PIRG, the Center for Responsible Lending, and the National Association of Consumer Advocates.

² See Attachment, FTC Staff Letter (Sept. 25, 1999).

³ Your letter lists six cases that have been decided since the issuance of the 1999 FTC staff opinion letter that have held that a consumer may only obtain an affirmative recovery against a creditor under the Holder Rule when the seller's breach is so substantial that rescission and restitution are justified or where the goods or services sold to the consumer are worthless: *Rollins v. Drive-1 of Norfolk, Inc.*, No. 2:06cv375, 2007 WL 602089 (E.D. Va. Feb. 21, 2007); *Phillips v. Lithia Motors, Inc.*, No. 03-3109-HO, 2006 WL 1113608 (D. Or. Apr. 27, 2006); *Costa v. Mauro Chevrolet, Inc.*, 390 F. Supp. 2d 720 (N.D. Ill. 2005); *Comer v. Person Auto Sales, Inc.*, 368 F. Supp. 2d 478 (M.D.N.C. 2005); *Herrera v. North & Kimball Group, Inc.*, No. 01C7349, 2002 U.S. Dist. LEXIS 2640 (N.D. Ill. Feb. 15, 2002); *Bellik v. Bank of America*, 869 N.E.2d 1179 (Ill. App. Ct. 2007). You cite *Comer* as pointedly rejecting the FTC staff opinion letter. *Comer* notes that the staff letter is "not binding on the Commission." 368 F. Supp. 2d at 490.

The Holder Rule protects consumers who enter into credit contracts with a seller of goods or services by preserving their right to assert claims and defenses against any holder of the contract, even if the original seller subsequently assigns the contract to a third-party creditor. In particular, the Holder Rule requires sellers that arrange for or offer credit to finance consumers' purchases to include in their credit contracts the following 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.

A creditor or assignee of the contract is thus subject to all claims or defenses that the consumer could assert against the seller. The Holder Rule does not create any new claims or defenses for the consumer; it simply protects the consumer's existing claims and defenses. The *only* limitation included in the Rule is that a consumer's recovery "shall not exceed amounts paid" by the consumer under the contract.

Thus, the plain language of the Rule permits a consumer to assert a seller's misconduct (1) to defend against a creditor's lawsuit for amounts owed under the contract and/or (2) to maintain a claim against the creditor for a refund of money the consumer has already paid under the contract (*i.e.*, an affirmative recovery). Despite the Rule's plain language, however, some courts have imposed additional limitations on a consumer's right to affirmative recovery. Beginning with *Ford Motor Credit Co. v. Morgan*, 536 N.E.2d 587 (Mass. 1989),⁴ these courts have allowed affirmative recovery only if the consumer is entitled to rescission or similar relief under state law.⁵ Courts following the *Morgan* approach have not imposed any similar limitation on a consumer's right to raise the seller's misconduct as a defense in a lawsuit.

⁴ In *Morgan*, the court faced extensive consumer misconduct in connection with the financing of a car purchase. After experiencing problems with the car, the consumer concealed the automobile, removed the battery, removed or deflated the tires, and surrendered the automobile only after being found in contempt by the trial judge. He also delayed the sale of the automobile, during which time it was extensively vandalized, resulting in a total loss that was not recoverable due to the consumer's failure to obtain insurance. The creditor sued the consumer for the balance due under the contract, and the consumer filed a counterclaim based on the dealer's misrepresentations. Notably, in contravention of the one express limitation in the Holder Rule, the consumer sought recovery of an amount in excess of what the consumer had paid under the contract. The court ultimately held that the consumer was not entitled to any affirmative recovery, but he did not have to pay the remaining balance due. 536 N.E.2d at 588.

⁵ See, e.g., n.3, *supra*.

The Commission affirms that the Rule is unambiguous, and its plain language should be applied.⁶ No additional limitations on a consumer's right to an affirmative recovery should be read into the Rule, especially since a consumer would not have notice of those limitations because they are not included in the credit contract. Had the Commission meant to limit recovery to claims subject to rescission or similar remedy, it would have said so in the text of the Rule and drafted the contractual provision accordingly. It remains the Commission's intent that the plain language of the Rule be applied, which many courts have done.⁷

The purpose of the Holder Rule, as stated in the Rule's Statement of Basis and Purpose ("SBP"), supports this plain reading. The Commission adopted the Rule to provide recourse to consumers who otherwise would be legally obligated to make full payment to a creditor despite breach of warranty, misrepresentation, or even fraud on the part of the seller.⁸ The Commission found that "the creditor is *always* in a better position than the buyer to return seller misconduct costs to sellers, the guilty party,"⁹ and therefore concluded that "[s]ellers and creditors will be responsible for seller misconduct."¹⁰ Moreover, the Commission considered, but firmly rejected, a suggestion by industry representatives that the Rule be amended so that a consumer "may assert his rights only as a matter of defense or setoff against a claim by the assignee or holder,"

⁶ See *Qwest Corp. v. Colorado Public Utilities Comm'n*, 656 F.3d 1093, 1099 (10th Cir. 2011) ("We begin with the plain language of the regulation. . . . If the regulation's language is clear, our analysis ends and we must apply its plain meaning.") (internal citations and quotations omitted); *Lozada v. Dale Baker Oldsmobile, Inc.*, 91 F. Supp. 2d 1087, 1095 (W.D. Mich. 2000) ("No basis exists for referring to the commentary to understand the meaning of language that is unambiguous on its face.").

⁷ See, e.g., *Lozada*, 91 F. Supp. 2d at 1094-95; *Simpson v. Anthony Auto Sales, Inc.*, 32 F. Supp. 2d 405, 409 n.10 (W.D. La. 1998); *Riggs v. Anthony Auto Sales*, 32 F. Supp. 2d 411, 416 n.13 (W.D. La. 1998); *Beemus v. Interstate Nat'l Dealer Servs., Inc.*, 823 A.2d 979, 984-85 (Pa. Super. Ct. 2003); *Jaramillo v. Gonzalez*, 50 P.3d 554, 561 (N.M. Ct. App. 2002); *Scott v. Mayflower Home Improvement Corp.*, 831 A.2d 564, 573-74 (N.J. Super. Ct. Law Div. 2001).

⁸ See 40 Fed. Reg. 53506, 53507 (Nov. 18, 1975) ("The rule is directed at what the Commission believes to be an anomaly. . . . The creditor may assert his right to be paid by the consumer despite misrepresentation, breach of warranty or contract, or even fraud on the part of the seller, and despite the fact that the consumer's debt was generated by the sale.")

⁹ *Id.* at 53523 (emphasis added); see also *id.* at 53509 ("Between an innocent consumer, whose dealings with an unreliable seller are, at most, episodic, and a finance institution qualifying as 'a holder in due course,' the financier is in a better position both to protect itself and to assume the risk of a seller's reliability."); *id.* at 53523 ("We believe that a rule which compels creditors to either absorb seller misconduct costs or return them to sellers, by denying sellers access to cut-off devices, will discourage many of the predatory practices and schemes. . . . The market will be policed in this fashion and all parties will benefit accordingly.").

¹⁰ *Id.* at 53524.

finding instead that “[t]he practical and policy considerations which militate against such a limitation on affirmative actions by consumers are far more persuasive.”¹¹ For example, the Commission noted that some consumers may feel compelled to continue payments because of the threat of negative credit reporting and that “a stronger potential consumer remedy will encourage greater policing of merchants by finance institutions.”¹²

Thus, to give full effect to the Commission’s original intent to shift seller misconduct costs away from consumers, consumers must have the right to recover funds already paid under the contract if such recovery is necessary to fully compensate the consumer for the misconduct—even if rescission of the transaction is not warranted. Otherwise, whether a consumer is able to be fully compensated would depend on how much the consumer paid under the contract at the time of the dispute. For example, consider a consumer who finances the purchase of an automobile, later discovered to be defective, for \$10,000 and is entitled to compensation of \$3,000 based on the seller’s misrepresentations regarding the condition of the automobile. If the consumer has paid \$4,000 under the financing contract and still owes \$6,000, the consumer could withhold \$3,000 of the balance due and be fully compensated—a defensive posture sanctioned by *Morgan*. If, however, the consumer has paid \$8,000 and owes \$2,000, the *Morgan* approach would permit the consumer to withhold the remaining \$2,000 payment, but not affirmatively recover the additional \$1,000 that would be necessary to make the consumer whole.¹³ There is no basis under the plain language and the intent of the Rule for such an anomalous result.

Courts that have followed the *Morgan* approach have misinterpreted two isolated comments in the SBP that accompanies the Rule. In part, the SBP states that affirmative recovery by the consumer “will only be available where a seller’s breach is so substantial that a court is persuaded that rescission and restitution are justified”¹⁴ and that consumers “will not be in a position to obtain an affirmative recovery from a creditor, unless they have actually commenced payments and received little or nothing of value from the seller.”¹⁵ However, when read in context of the entire SBP, including the SBP language highlighted above, the two SBP comments cited by *Morgan* and its progeny do not undermine the plain language of the Rule. As explained by one court that rejected the *Morgan* approach, “[w]here one or more parts of the [SBP] fully comport with the text of the rule while another, read in a particular way, is at odds with the plain language of the regulation, there exists no basis for giving controlling weight to an

¹¹ *Id.* at 53526.

¹² *Id.* at 53527.

¹³ This example is drawn from Michael Greenfield & Nina Ross, *Limits on a Consumer’s Ability to Assert Claims and Defenses Under the FTC’s Holder in Due Course Rule*, 46 Bus. Law. 1135, 1140 (1991).

¹⁴ 40 Fed. Reg. at 53524.

¹⁵ *Id.* at 53527.

interpretation which narrows the language of the rule itself.”¹⁶ These statements should be read as practical observations or predictions, instead of as contradicting the Rule. In most instances where there is significant consumer injury associated with seller misconduct but rescission is not warranted, the consumer is likely to find out about the injury shortly after the transaction is consummated, and thus is likely to stop payments before the claim amount is larger than the balance due. In other words, affirmative recoveries will be rare in cases where rescission is not justified because such recoveries occur only if the consumer’s claim is larger than what the consumer still owes on the loan.¹⁷ When read in this context, the two SBP comments do not conflict with the rest of the SBP and the plain language of the Rule.

Thus, the Commission affirms the plain language of the Holder Rule and the intent of the Rule as discussed in the entire SBP. Specifically, the Rule places no limits on a consumer’s right to an affirmative recovery other than limiting recovery to a refund of monies paid under the contract. Further, the Rule does not limit affirmative recovery only to those circumstances where rescission is warranted or where the goods or services sold to the consumer are worthless.

By direction of the Commission.

Donald S. Clark
Secretary

¹⁶ *Lozada*, 91 F. Supp. 2d at 1096.

¹⁷ *See id.* at 1095 (noting that the SBP “is susceptible of being understood as a statement of agency prediction that affirmative recoveries will occur only when courts are persuaded that the equities so require and when damages exceed the amount due on the account”); *accord Jaramillo*, 50 P.3d at 561.