

Am I My Brother's Keeper? The Scope of Assignee Liability Under the FTC Holder Rule

STEVEN McCARTAN

This article explores the kinds of acts or omissions that are “apparent on the face” of financing documents so as to give rise to lender liability. Based upon this discussion, it concludes with some recommendations to lenders on minimizing the scope of liability under the FTC Holder Rule.

In recent years there has been an explosion of consumer fraud lawsuits related to fees charged in financing transactions. Generally, the party who prepares the underlying financing documents is separate from the finance company. The most prominent target for these suits has been the auto industry, but these suits have arisen in a number of consumer transactions. In these transactions, the party selling the consumer product has the most direct responsibility for making disclosures related to the fees underlying the transaction.

Once the creditor finalizes the paperwork, it is assigned to the finance company — or assignee — for approval. Although finance companies

Steven McCartan is a partner in the Business Litigation practice group of the Kansas City office of Lathrop & Gage, LLP. He regularly represents clients in litigated and non-litigated business disputes, including breach of contract matters, loan-enforcement actions, insurance disputes, regulatory matters, and business torts. His special emphasis is defending the financial services sector against consumer fraud class actions under state consumer protection statutes, the Truth-in-Lending Act, and the Fair Debt Collection Practices Act. Mr. McCartan can be reached at smccartan@lathropegage.com.

typically have no involvement in disclosing the fees to the consumer, they are frequently named in the lawsuits. In these suits, plaintiffs seek to hold the finance companies liable for the alleged misrepresentations and omissions of the party that prepared the paperwork that contained the fees. Under the common-law “holder in due course” rule, a lender without knowledge of misrepresentations or omissions could not be liable for them.

But in 1975 the Federal Trade Commission (“FTC”) changed the common law to make lenders liable for certain acts and omissions. This change, known as the “FTC Holder Rule,” subjected lenders to liability even in instances where they were unaware of the underlying fraud. In 1980, Congress amended the Truth in Lending Act (“TILA”) to narrow the scope of lender liability to instances in which the fraud was “apparent on the face” of the financing documents assigned to the lender.

This article explores the evolution of these legal changes and the kinds of acts or omissions that are “apparent on the face” of financing documents so as to give rise to lender liability. Based upon this discussion, it concludes with some recommendations to lenders on minimizing the scope of liability under the FTC Holder Rule.

THE HISTORY OF THE PRESENT FORMULATION OF THE FTC HOLDER RULE

The Common Law and UCC “Holder in Due Course Doctrine”

The common law holder in due course (“HDC”) doctrine generally holds that a finance company who receives assignment of commercial paper is not subject to separate claims that a buyer may have against the seller of the financed goods.¹ Despite its common law history, the HDC doctrine is also part of the Uniform Commercial Code (“UCC”).² To qualify for HDC status, a finance company must establish that it purchased the commercial paper (1) for value; (2) in good faith; and (3) without notice that the commercial paper has been dishonored or that there is a defense to its enforcement.³ If these three criteria are satisfied, the “maker” of the commercial paper cannot use its defenses against the seller (*e.g.*, fraud) to avoid having to pay the finance company.

Under this framework, the HDC doctrine “separates the buyer’s obligation to pay” (the finance company) “from the seller’s obligation to perform” (on its promises to the buyer) under the sales contract.⁴ The policy rationale for the HDC doctrine is to assure the liquidity of commercial paper, thus facilitating more consumer credit transactions and, in turn, increased sales of goods.⁵ As one lender put it: “[I]f enforcing warranties or guaranteeing product performance is to be forced upon financial institutions as a cost factor, you can rest assured that those additional costs will be passed on to the consumers of our products through increased consumer interest rates or through restrictions on the availability of consumer credit or both.”⁶

The FTC Holder Rule

But the HDC doctrine also led to some harsh results. In one instance, a health club went out of business, but the patrons still had an obligation to make monthly payments.⁷ Similarly, a consumer who purchased meat products needed to make monthly payments even though the meat was substandard and, later on, not even shipped.⁸ Based upon these and other stories, in 1975 the FTC enacted the FTC Holder Rule.⁹ Under this rule, a party is liable for “all claims and defenses which the debtor could assert against the seller of goods.”¹⁰ Under the FTC Holder Rule, each consumer-credit contract must contain the following boilerplate: “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.”¹¹

The logic behind the rule is that, “as between the consumer and assignee-lender, the latter was in the best position to protect itself against dealer misconduct.”¹² The hope was that finance companies would shun dishonest dealers of consumer goods and thereby drive them out of business.¹³ In other words, assignee finance companies would monitor their consumer products brethren to assure compliance with disclosure laws.

The Effect of the 1980 Amendment to TILA on the FTC Holder Rule

Five years later (in 1980), however, Congress amended Section 1641(a) of the Truth in Lending Act (“TILA”) for the purpose of (1) “narrowing ‘considerably the potential scope of assignee liability,’” (2) making “compliance easier for creditors,” and (3) limiting “civil liability for statutory penalties for only significant violations.”¹⁴ To accomplish these goals, Congress imposed “separate and distinct disclosure obligations on creditors and assignees.”¹⁵ Under the 1980 Amendment, creditors (*i.e.*, the sellers of consumer goods) are “primarily responsible for making the required disclosures and ensuring that they are accurate.”¹⁶ But the assignee’s duty is limited “to a review of the assigned documents themselves to determine if they contain violations that a reasonable person can spot on the face of those documents.”¹⁷

The specific language of this amendment states that an assignee may only be liable for the actions of a creditor where a violation is “apparent on the face of the disclosure statement.”¹⁸ This language creates an obvious conflict with the FTC Holder Rule, which imposes pure derivative liability.¹⁹ With rare exception,²⁰ in resolving this conflict courts have held that the FTC Holder Rule language is trumped by Section 1641(a).²¹

An illustration of this view is *Jackson v. South Holland Dodge, Inc.*, where plaintiff purchased a vehicle from a car dealership, which subsequently assigned the retail-installment contract to a finance company.²² Plaintiff alleged that the car dealership’s manner of disclosure violated the state deceptive-practices statute, with the finance company derivatively liable under the FTC Holder Rule.²³ The finance company moved to dismiss based upon Section 1641(a) and, on appeal, the Illinois Supreme Court upheld dismissal.²⁴ The court held that the contract language with the mandated FTC Holder Rule language was “not the subject of bargaining” and, as such, “must be read in light of other laws that modify its reach.”²⁵

Because Congress amended TILA in order to “limit assignee liability,” the “unmistakeable effect of the 1980 amendment is to trump the FTC’s holder notice.”²⁶ The FTC Holder Rule is preempted even if the plaintiff’s petition does not contain a TILA claim.²⁷

ACTS OR OMISSIONS THAT ARE “APPARENT ON THE FACE” OF FINANCING DOCUMENTS

Because consumer-credit violations must be “apparent on the face of the disclosure statement,” a key question revolves around when this standard is satisfied. According to the Seventh Circuit, “[o]nly violations that a reasonable person can spot on the face of the disclosure statement or other assigned documents will make the assignee liable under the TILA.”²⁸ Stated another way, “the word ‘apparent’ means that which is ‘obvious, evident, or manifest;...open to view, plain, patent.’”²⁹ The basis for this standard is that it would be “contrary to the goals of TILA” if an assignee were held liable under a contract “that appears perfectly compliant with the law on its face.”³⁰

Acts and Omissions That Are Not Apparent

In applying this standard, courts have found that a reasonable person would not be able to spot forged initials on an assigned agreement.³¹ Nor would a reasonable person be able to determine that an auto dealer had retained a portion of a customer’s payment for extended warranty coverage.³² Likewise, a finance company cannot be liable for not detecting that a car dealership failed to properly itemize a document preparation charge under a relevant state statute.³³ Similarly, a finance company is not charged with knowledge of a disclosure violation just because it “issued the checks and credits” and therefore had knowledge of the “true cost” of the warranty at issue.³⁴ Even if the consumer’s copy of the contract contains violations, the assignee has no liability so long as the assigned contract is free of violations.³⁵ These decisions are all consistent with courts’ refusal to enter any rulings that would “impose a duty of inquiry on financial institutions that serve as assignees.”³⁶

To try to escape this fixed rule, plaintiffs have argued that a defendant’s general knowledge makes it liable for an otherwise unseen violation. In *Taylor*, the Court rejected plaintiff’s argument that the finance company’s “awareness of the practices of some creditors” was tantamount to “knowledge that a particular disclosure on a particular TILA form is inaccurate or incomplete.”³⁷ Similarly, the court in *Ramadan v. Chase*

*Manhattan Corp.*³⁸ rejected an assertion that defendant's "experience in the field" gave rise to imputed knowledge of a disclosure violation.³⁹ Even where a finance company has "special knowledge" that would have enabled it to ascertain a disclosure violation, this knowledge is not actionable if the violation is not apparent on the document itself.⁴⁰ These holdings reflect the dominant view of this issue.⁴¹

Acts and Omissions That Are Apparent

Given the "strict" interpretation of what constitutes an "apparent" disclosure violation, there are fewer reported cases finding such violations. An illustrative case is *Aldrich v. Upstate Auto Wholesale of Ithaca, Inc.*,⁴² where the lender received assignment of a contract stating that "there *will* be an attorney's fee of 15% of the amount then due..." (emphasis added). Plaintiff argued that this statement was misleading because New York law only authorizes attorneys' fees on a quantum meruit basis up to 15 percent — as opposed to mandating that 15 percent be the assigned percentage.⁴³ The court agreed and, because this statement was apparent on the face of the assigned contract, the lender was found to be subject to liability.⁴⁴

Lenders are also liable where "a disclosure... can be determined to be incomplete..."⁴⁵ In *Shepard v. Quality Siding & Window Factory, Inc.*, for example, plaintiff alleged that the assignee-lender failed to disclose the schedule of payments, starting date for payments, and security interest in two loan agreements.⁴⁶ The court found that these omissions were "readily apparent" and therefore defendant was "liable for TILA disclosure violations."⁴⁷ These cases illustrate the kinds of disclosures and omissions that should be apparent to lenders.

Direct Liability for Assignees

The above discussion related to the FTC Holder Rule and TILA does not have any bearing on claims for direct liability against lenders. "A plaintiff would be entitled to maintain a cause of action... where the assignee's fraud is active and direct."⁴⁸ An example would be an instance where an "assignee met with [a] car dealer and concocted a scheme to put false statements on the financing statement..."⁴⁹ A real-world example

of this scenario is *Knapp v. Americredit Financial Services, Inc.*,⁵⁰ where defendant sought summary judgment on plaintiffs' unfair trade practices claim on account of defendant's status as an assignee.⁵¹ The court, however, denied summary judgment because "[p]laintiffs do not seek to hold [defendant] liable as an assignee.... Rather, the lender's liability is predicated upon the direct involvement of [defendant]'s employee and agent... in the planning and execution of a scheme involving false pay stubs, false downpayments, and an acquisition fee."⁵²

TECHNIQUES FOR MINIMIZING EXPOSURE UNDER THE FTC HOLDER RULE AND TILA

Assignee liability under the FTC Holder Rule and TILA hinges upon the relationship between the assignee and the creditor. The clear strategy for plaintiffs seeking to bind finance companies is to claim that the assignee and creditor worked together to defraud the plaintiff. In essence, plaintiffs will attempt to strip assignees of their protected status and turn them into creditors. Accordingly, to minimize exposure, assignees must be careful to maintain a clear line of separation with creditors. This wall should be established in several areas:

- *Marketing* — Assignees should refrain from joint marketing activities with creditors, as these activities could imply an agency relationship between the creditor and assignee.
- *Creditor Agreements* — Agreements between assignees and creditors should clarify that the assignee plays no role in the advertisement and sale of loans and that there is no agency relationship between the assignee and creditor.
- *Policy and Procedure Manuals* — To reinforce the language in the dealer agreements, assignees should provide policy and procedure manuals that inform creditors that they should refrain from using an assignee's name in marketing the terms of financing. These manuals should also define how creditors should characterize the assignee's role in the transaction.

- *Employee Training* — Assignees should train their employees to avoid engaging in any activities that create an appearance of the existence of an agency relationship with creditors. Although employees may need to provide some guidance to creditors on certain policies and procedures, they must repeatedly emphasize that the creditor has final authority over the individual customer transactions.
- *Customer Service Manuals* — Assignees should create manuals that train employees to inform customers on the difference between receiving assignment of a contract and actually creating that contract. Employees must be taught to refer transaction-related questions to the underlying dealership and respond only to questions that specifically concern the assignee.

CONCLUSION

The FTC Holder Rule provides a means of recovery against assignees of retail finance contracts. However, this theory has been severely curtailed by the 1980 amendment to TILA, which limits assignee liability to violations “apparent” on the face of the assigned documents. But this standard is inapplicable to claims asserting that the assignee and creditor conspired to harm a plaintiff. As such, assignees must make a concerted effort to ensure that they maintain a wall of separation from creditors.

NOTES

¹ Gene A. Marsh, *Lender Liability for Consumer Fraud Practices of Retail Dealers and Home Improvement Contractors*, 45 Ala. L. Rev. 1, 36-37 (1993).

² *Id.*

³ U.C.C. §§ 3-302(1)(a-c).

⁴ *Id.* at 37.

⁵ Timothy J. Grendell, *Let the Holder Beware! A Problematic Analysis of the FTC Holder in Due Course Rule*, 27 Case W. Res. L. Rev. 977, 979 (1976).

⁶ *Id.* at 980 n.18 (quoting Rohner, *Holder in Due Course in Consumer Transactions: Requiem, Revival, or Reformation*, 60 Cornell L. Rev. 503, 528 n.133 (1975)).

⁷ *Id.* at 980 n.20.

⁸ *Id.* at 980-981 n.20

⁹ *Id.* The FTC Holder Rule went into effect on May 14, 1976. *Id.*

¹⁰ 16 C.F.R. § 433.2(a).

¹¹ 16 C.F.R. § 433.1-3.

¹² Marsh, 45 Ala. L. Rev. at 42-43 (1993).

¹³ *Id.* at 44.

¹⁴ *Jackson*, 755 N.E.2d at 468 (citation omitted).

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.* (citation omitted).

¹⁸ *Id.* at 468-69 (citing 15 U.S.C.A. § 1641(a) (1994)).

¹⁹ 16 C.F.R. § 433.2(a).

²⁰ *See Cox v. First National Bank of Cincinnati*, 633 F.Supp. 236 (S.D. Ohio 1986) (despite the 1980 Amendment, contractual language summarizing the FTC Holder Rule preserves claim against assignee); *Perry v. Household Retail Servs., Inc.*, 953 F. Supp. 1370, 1376 (M.D. Ala. 1996) (even if the violation had not been apparent on the face of the contract, assignee was liable “by virtue of the claim preservation provision in the contract”).

²¹ *Jackson v. South Holland Dodge, Inc.*, 755 N.E.2d at 469.

²² *Id.* at 465.

²³ *Id.*

²⁴ *Id.* at 471-72.

²⁵ *Id.*

²⁶ *Id.* at 472; *Vickers v. Interstate Dodge*, 882 So.2d 1236, 1243 (La. Ct. App. 2004) (reversing judgment against assignee bank because “TILA preempts the [state consumer protection statute] with regard to an assignee’s liability....”).

²⁷ *See Psensky v. American Honda Finance Corp.*, 875 A.2d 290 (N.J. Super. Ct. App. Div. 2005) (“[W]e hold that [the finance company]’s compliance with TILA is a complete defense to the state claims being asserted against [the finance company]...even in the absence of a specific TILA claim in plaintiff’s complaint”).

²⁸ *Taylor v. Quality Hyundai, Inc.*, 150 F.3d 689, 694-95 (7th Cir. 1998).

²⁹ *Ritter v. Durand Chevrolet, Inc.*, 932 F.Supp. 32, 35 (D. Mass. 1996).

³⁰ *Psensky*, 875 A.2d at 293 (citing *Alexiou v. Brad Benson Mitsubishi*, 127 F.Supp.2d 557, 564 (D.N.J. 2000)).

³¹ *Vickers*, 882 So.2d at 1239.

³² *Jackson*, 755 N.E.2d at 469.

³³ *Psensky*, 875 A.2d at 297.

³⁴ *Ellis v. GMAC*, 160 F.3d 703, 709 (11th Cir. 1998).

³⁵ *In re Armstrong*, 288 B.R. 404, 416-17 (E.D. Pa. 2003).

³⁶ *Taylor*, 150 F.3d at 694; *see also Green v. Levis Motors*, 179 F.3d 286, 295 (5th Cir. 1999) (finance company's general knowledge and knowledge of non-assigned documents had no relevance to its liability under TILA).

³⁷ *Id.*

³⁸ 229 F.3d 194 (3rd Cir. 2000).

³⁹ *Id.* at 198.

⁴⁰ *Balderos v. City Chevrolet*, 214 F.3d 849, 853 (7th Cir. 2000) (noting that the law imposes a "strict" interpretation of TILA on issue of assignee liability); *see also Furge v. Evergreen Finance Co.*, 1998 WL 729624 (N.D. Ill. Oct. 16, 1998) (common ownership of finance and car company does not add to assertion of assignee liability, as that liability is predicated solely on the four corners of the assigned documents).

⁴¹ *See Jackson*, 755 N.E.2d at 469 (finance company need only review "the face of the assigned document"); *Ritter*, 932 F.Supp. at 35 ("[T]he mere allegation that [finance company] had general knowledge of the dealer's practice is not sufficient to find that [finance company] violated Section 1641(a)"). *But see Perry*, 953 F. Supp. at 1376 ("The court is highly persuaded by the plaintiff's contention that [assignee] was surely aware of all the facts and circumstances of its credit policy, and therefore the defects were apparent on the face of the agreement....").

⁴² 564 F.Supp. 390, 392 (N.D. N.Y. 1982).

⁴³ *Id.* at 393.

⁴⁴ *Id.*

⁴⁵ *Shepard v. Quality Siding & Window Factory, Inc.*, 730 F.Supp. 1295, 1302 (D. Del. 1990) (quoting 15 U.S.C. § 1641(a)) (emphasis added).

⁴⁶ *Id.* at 1299.

⁴⁷ *Id.* at 1302.

⁴⁸ *Jackson*, 755 N.E.2d at 470; *see also Psensky*, 875 A.2d at 296 (same holding);

⁴⁹ *Id.* at 470-71.

⁵⁰ 245 F.Supp. 841 (S.D. WVa. 2003).

⁵¹ *Id.* at 851.

⁵² *Id.* at 851.