

SUBJECT: FTC Rule on Preservation of Consumers' Claims and Defenses

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EXECUTIVE SUMMARY

The Federal Trade Commission (FTC) Rule on Preservation of Consumers' Claims and Defenses applies to state and federal credit unions. This rule, which is frequently referred to as "The Holder-in-Due-Course rule," affects credit unions that provide financing to consumers when they purchase property:

- From the credit union, or
- From a seller who refers customers to the credit union or who has a formal or informal contract or business arrangement with the credit union.

Thus, the rule applies to financed sales of repossessed collateral or credit union equipment. It also applies to indirect lending and any other arrangement that credit unions may have with dealers and service providers.

In essence, the rule prohibits a seller from taking or receiving a consumer credit contract that does not contain a special FTC notice. This FTC notice is actually a contract clause that preserves the consumer's claims and defenses in the event that the contract is negotiated or assigned to a third party creditor. Thus, the WBA 431 S forms, which are used for indirect financing of vehicles, contain the required FTC notice.

In addition, the rule provides that the seller may not accept the proceeds of a purchase money loan unless the evidence of the loan contains another version of the FTC notice, described later in this release, preserving against the lender whatever claims and defenses the consumer may have against the seller.

Omission of the FTC notice by the seller, or acceptance by the seller of the proceeds of the purchase money loan where the evidence of the loan does not contain the notice, constitutes an unfair or deceptive practice within the meaning of Section 5 of the Federal Trade Commission Act (15 U.S.C. § 45).

While the rule is aimed at sellers, it will also affect credit unions. Under the rule, credit unions that purchase consumer paper containing the FTC notice required of sellers will no longer be able to avail themselves of the holder-in-due-course doctrine. Also, credit unions that make purchase money loans containing the FTC notice will be subject to all claims and defenses that the consumer could assert against the seller.

Credit unions should not accept any consumer paper that fails to contain the FTC notice required of sellers, since they may be considered to be a participant in the seller's violation of the rule. In addition, credit unions making credit sale loans should include the FTC notice in their contracts.

The FTC notice makes the credit union liable for any type of legal claim the member may have against the dealer: fraud, discrimination, unfair trade practices, defective goods, failure to honor warranties, lemon law, etc. The credit union can protect itself to a great extent by use of dealer agreements and assignment clauses that allow the credit union to assign loans back to dealer in the event of a consumer claim.

Credit unions may also negotiate a dealer reserve account to hold back a portion of the payments to the dealer to protect the credit union against such losses.

PURPOSE OF THE RULE

The FTC adopted this rule after it documented numerous cases where consumer purchase transactions were financed in such a way that the consumer was legally obligated to make full payment to a creditor despite breach of warranty, misrepresentation, and even fraud by seller.

Under ordinary contract law, the promises of the parties to a sale transaction are mutually dependent. A seller is entitled to payment provided he delivers what he promised to deliver. If the seller fails to deliver what was promised, the consumer's obligation to pay may be reduced or even eliminated. However, it is possible for a seller to arrange credit terms that separate the consumer's legal duty to pay from the seller's legal duty to keep his promises.

The FTC's rule is designed to prevent the widespread use of credit terms that compel consumers to pay a creditor even if the seller's conduct would not entitle the seller to be paid. It is designed to preserve the consumer's legally sufficient claims and defenses so that they may be asserted to defeat or diminish the right of a creditor to be paid, where a seller who arranges financing for a buyer fails to keep his side of the bargain.

CREDIT CONTRACTS THAT MUST CONTAIN THE NOTICE

The Holder-in-Due-Course rule does not apply to all credit instruments. The FTC notice must appear in written obligations defined as "Consumer Credit Contracts" in the rule. The definition includes any written instrument that constitutes a consumer credit contract used to:

- "Finance a Sale" as that term is defined in the rule; or
- In connection with a "Purchase Money Loan" as that term is defined in the rule.

Affected Transactions

The initial question is whether a sale constitutes a consumer transaction at all. The rule defines the term "consumer" to mean a "natural person who seeks or acquires goods or services for personal, family, or household use," and covers sales of all kinds of consumer goods or services for personal, family or household use. Purchases of appliances, automobiles, furniture, food, and any other product sold to individuals for non-commercial purposes are covered. Services such as home-improvement contracting, vocational training, employment counseling or placement, health spa membership, and similar agreements made with individuals for non-commercial purposes are covered.

Sales of goods or services for commercial use are not covered by the rule. Nor does the rule apply when a purchase is made by or for an organization rather than a natural person. Sales of interests in real property are not covered. However, the mere fact that a security interest in real property is taken does not mean that the sales transaction does not involve consumer goods or services. For example, home-improvement contracting, which does constitute a sale of goods or services, is often financed by credit secured by real property.

There are additional limits on "affected transactions" because the definitions of "Financing a Sale" and "Purchase Money Loan" expressly refer to the Truth in Lending Act and Reg. Z. As a result, those definitions incorporate the limits contained in these laws. Even for transactions involving a sale of consumer goods or services, a purchase involving an expenditure of more than [\\$73,400, effective Jan. 1, 2026 \(up from \\$71,900 in 2025\)](#) is generally not affected by the Holder in Due Course rule since it would be exempt from Reg. Z. See *ii Release No. B001* for details on the scope of Reg. Z coverage.

Finally, only those leases that constitute "credit sale" agreements under Regulation Z are affected by the rule. Regulation Z applies to those leases where a consumer contracts to pay a sum substantially equivalent to or greater than the value of the property leased and receives an option to become the owner of the property for no consideration or a nominal consideration.

Financing a Sale

This term is defined to include situations in which a seller extends credit to a buyer and takes a written credit contract from the buyer, in connection with an affected transaction. All contracts so executed, except credit card instruments, must contain the required FTC notice. Credit card instruments are specifically exempted from the rule.

Thus, the rule applies when the credit union sells credit union property on credit. Examples include sales of repossessed collateral or credit union equipment, if the credit union provides financing. The rule also applies when a dealer sells property and finances the sale. This is the case with WBA 431 S contracts, which a credit union may purchase in indirect lending. Thus, the WBA 431 S and The Leagues' Credit Sale form (WCUL #81101) include the required FTC notice.

The rule does apply to open-end credit extended by sellers, or to "series of sales" closed-end credit, when the credit is extended pursuant to a consumer credit contract. This includes those situations in which a master credit agreement is entered into at the outset of a buyer/seller relationship and extensions of credit for specific purchases are made later, through a charge slip, charge plate or similar device.

Purchase Money Loans

General Considerations

The rule states that a seller may not accept money for goods that a consumer obtained via a "purchase money loan," as that term is defined in the rule, unless the consumer credit contract made in connection with the loan contains the required provision preserving the consumer's claims and defenses. Where a "purchase money loan" is used to finance a sale, the seller is obligated to insure that the consumer's loan contract contains the required FTC notice before he consummates the sale.

The "purchase money loan" provisions of the rule must be read in the light of the FTC's Statement of Basis and Purpose. The FTC concluded that it is unfair for sellers to impose all risks of seller-misconduct on consumer buyers by arranging credit terms that insulate the creditor from claims and defenses. It has therefore required sellers to use the notice in credit contracts, which insures that the buyer's duty to pay remains subject to the seller's reciprocal duty to keep his promises.

The FTC has concluded that consumers' claims and defenses must also be preserved when sellers arrange financing for their customers by means of referrals to direct lenders, or where sellers and direct lenders are affiliated with each other, as well as when sellers take loan contracts and transfer them to third parties.

Failure to include purchase money loans would make avoidance of the rule both easy and inevitable. In the course of the rulemaking proceedings, the FTC learned that where the use of promissory notes and waivers of defenses in "indirect" consumer contracts has been prohibited by state law a marked increase in the use of direct loans to achieve the same ends has occurred. Whether direct or indirect financing is used, the basic problem of the separation of duties remains the same.

The intent of the rule is to define as "purchase money loans" those consumer loans made for the acquisitions of goods or services from a particular seller and consummated under circumstances where a seller and a lender have an established relationship or course of dealing with one another that is directed at financing sales. In such cases, and only in such cases, the rule requires the seller to insure that the consumer's loan contract contains the notice.

The FTC rule applies only if the seller who receives the proceeds of the loan is engaged in the practice of referring loan customers to the lender, or is affiliated with the lender by common control, contract or business arrangement.

Referrals. The rule requires a seller to insure that a consumer's loan contract contains the required notice when the seller refers consumers to the creditor. The word "refers" is intended to reach those situations where a seller, in the ordinary course of business, is sending his buyers to a particular loan outlet, or to particular outlets, for credit, which is to be used in the seller's establishment. In such circumstances, the seller is effectively arranging credit for his customers.

No specific number of referrals is specified in the rule. The key distinction is between those instances where a seller is merely passing along information about places where his buyers may obtain credit and those where a seller is acting as a conduit for financing and channeling buyer-borrowers to a particular lender or limited group of lenders.

The rule has taken a common-sense approach to the question of referrals. A seller "refers" consumers to the creditor when his conduct indicates that he is doing more than passively engaging in an information process.

Where a seller regularly names, or otherwise designates, a particular loan outlet as a source of credit to be used by his buyers, he is referring consumers to the lender. Where the seller contacts a credit outlet on behalf of his buyers he is engaging in referrals. Where a seller helps the buyer prepare the lender's credit documents he is engaging in referral.

On the other hand, where the seller suggests that there are loan outlets in the community or immediate vicinity that may handle consumer transactions, he is providing his customers with information and is not engaged in referrals. The same thing is true where a seller provides his buyers with a list of local credit outlets and takes no other action, provided the list is not furnished pursuant to a "contract" or "business arrangement" with the loan outlets. In short, where there is no communication whatsoever between a seller and a lender there is no referral unless the seller is actively steering his customers to a predestinated loan outlet for credit.

A seller does not engage in a passive information process merely because of buyer solicitation, however. If a seller responds to a buyer request for assistance with a specific referral, he is still making a referral.

Finally, the test is whether the seller routinely refers his customers to a lender or lenders. It is not whether a particular buyer was referred. This means that once a seller is referring his customers to a lender, all loan contracts between that

lender and buyers from that lender must contain the notice. Conversely, it means that an occasional referral, which is not part of a business routine of the seller, does not trigger the rule.

Affiliation. The alternative criterion for establishing the relationship necessary for a "Purchase Money Loan" is affiliation. The rule requires a seller to insure that the notice is used in a consumer's loan contract where the seller is "affiliated with the creditor by common control, contract, or business arrangement." This requirement is intended to cover the myriad situations where seller and lender are engaged in a mutually beneficial effort to promote the seller's sales through the use of the financier's lending resources and vice versa.

The first type of affiliation is common control, such as when the seller is a CUSO of the credit unions.

The other forms of affiliation are "contract" and "business arrangement." The rule defines these as follows:

- *Contract:* Any oral or written agreement, formal or informal, between a creditor and a seller, which contemplates or provides for cooperative or concerted activity in connection with the sale of goods or services to consumers of the financing thereof.
- *Business Arrangement:* Any understanding, procedure, course of dealing, or arrangement, formal or informal, between a creditor and a seller, in connection with the sale of goods or services to consumers or the financing thereof.

These definitions encompass all situations where a creditor and a seller are party to any agreement, arrangement, understanding, or mutually understood procedure that is specifically related to retail sales or retail sales financing. While the business arrangement or contract need not be formal in a legal sense, it must be ongoing, and clearly related to sales or sales financing. Cooperative activity on a continuing basis is what is specified by the rule.

It would be impossible to enumerate every conceivable example of the arrangements or contracts, which are reached by the rule's definitions. Examples would include:

- Maintenance of loan application forms in the office of the seller;
- Joint participation in the processing of loan documents;
- Creditors' referrals of customers to a sales outlet;
- Payment of consideration to a seller for furnishing loan customers or to a creditor for furnishing sales prospects;
- Floor-planning or inventory financing arrangements that include or contemplate the assignment of indirect paper or the referral of loan customers;
- Active creditor participation in a sales program;
- Joint advertising efforts;
- An agreement to purchase paper on an indirect basis.

It is also important to emphasize what is not included in the term "affiliation." The contract or business arrangement must be sales related; the rule is not intended to include the many possible business relationships that do not bear directly on the financing of consumer sales. For example, a commercial checking account is not an affiliation within the meaning of the rule. A commercial lease, a general business loan, or other similar commercial arrangement or contracts do not, by themselves, invoke the rule. By special provision, an agreement specifically dealing with credit card operations between a credit card issuer and a seller does not constitute a business arrangement.

It is also important to emphasize that the terms business arrangement and contract require some continuity over time. The fact that a creditor and seller must confer over a particular transaction does not in itself create an arrangement. Thus, for example, the mere fact that a creditor issues a joint proceeds check to a seller and a buyer in order to perfect the security agreement under the Uniform Commercial Code is not a business arrangement or contract.

Finally, where the lender and the seller are affiliated, all loans contracts with consumers who use the proceeds at the seller's establishment must contain the required notice. This is true whether or not a particular loan is directly attributable to the affiliation.

PLACEMENT OF THE NOTICE

The Holder-in-Due-Course rule imposes no requirement with respect to the location of the notice within the text of a consumer credit contract. It may appear anywhere. The rule is satisfied as long as the notice is clearly a part of the

contract. If the notice is not preprinted on the contract, it can be printed on Avery label(s), which should be affixed to each copy of the contract.

The rule requires only that documentation is used to make clear to both consumer and holder that the consumer's obligations under the contract are subject to the notice.

EFFECT OF THE RULE

The rule is designed to insure that consumer credit contracts used in financing the retail purchase of consumer goods or services specifically preserve the consumer's rights against the seller. It requires sellers to include the following provision, or notice, in at least ten point, bold face type within the text of any consumer credit contract, which they execute with a buyer:

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.

Thus, the above notice is included in The League's Credit Sale form (WCUL # 81101) and in the WBA 431 S forms used for indirect lending.

If a seller arranges direct loan financing for his customers, the rule prohibits the seller from accepting the proceeds of the loan as payment for a sale, unless any loan contract signed by the buyer and the direct lender contains the following provision in at least ten point, bold face type:

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.

This notice should be added to any regular credit union loan that is subject to the FTC Holder-In-Due-Course rule. A credit union could print it in ten point, bold type and place it on each copy of the member's loan – before it is signed.

For those consumer credit contracts in which the rule requires insertion of this specific contract provision, or notice, the notice will become a part of the agreement between the consumer and the creditor. The required notice will be treated in the same manner as other written terms and conditions contained in the agreement. For this reason, where use of the notice is required the notice must appear without qualification. The requirement that a contract "contain" the notice is not satisfied if the text of the notice is printed in the contract in conjunction with additional recitals, which limit or restrict its application. Where the text of the notice is qualified by additional language, the contract fails to "contain" the required notice.

While the rule provides for two different notices, depending on whether or not the consumer credit contract involved is an installment sales agreement or a loan obligation, both notices mean the same thing. They protect the consumer's right to assert against the creditor any legally sufficient claim or defense against the seller. The creditor stands in the shoes of the seller.

There is an important limitation on the creditor's liability, however. The wording of the notice includes the sentence "Recovery hereunder by the debtor shall be limited to amounts paid by the debtor hereunder." This limits the consumer to a refund of monies paid under the contract, in the event that an affirmative money recovery is sought. In other words, the consumer may assert, by way of claim or defense, a right not to pay all or part of the outstanding balance owed the creditor under the contract; but the consumer will not be entitled to receive from the creditor an affirmative recovery that exceeds the amounts of money the consumer has paid in.

Thus, if a seller's conduct gives rise to damages in an amount exceeding the amounts paid under the contract, the consumer may:

- Sue to liquidate the unpaid balance owed to the creditor and to recover the amounts paid under the contract and/or
- Defend in a creditor action to collect the unpaid balance.

The consumer may not assert against the creditor any rights he might have against the seller for additional consequential damages and the like. The same situation would exist where a seller's conduct would, as a matter of law, entitle a buyer to rescission and restitution. The consumer, relying on the required notice, could initiate proceedings to invalidate the credit contract and receive a return of monies paid on account. If a down payment were made under the credit contract, the consumer could recover the down payment as well as other payments. Recovery of a down payment would be possible under many installment sales contracts. It would not be possible in situations where a direct loan contract is used, because the down payment would not have been made pursuant to the loan contract.

The limitation on affirmative recovery does not eliminate any other rights the consumer may have as a matter of local, state, or federal statute. The words "recovery hereunder," which appear in the text of the notice, refer specifically to a recovery under the notice. If a larger affirmative recovery is available against a creditor as a matter of state law, the consumer would retain this right.

It is also important to note that the rule does not create new rights or defenses. The words "Claims and Defenses," which must appear in the notice, are not given any special definition by the FTC. The phrase simply incorporates those things that, as a matter of other applicable law, constitute legally sufficient claims and defenses in a sales transaction. Appropriate statutes, decisions, and rules in each jurisdiction will control, and the pertinent rules of law and equity, including rules of evidence, procedure, and statutes of limitations, will continue to apply.

For example, where a product is sold "as is" and there can be no warranty claim or defense, the rule would not create one. Where a local jurisdiction has a two-year statute of limitations on contract claims, such claims and defenses would be extinguished after two years.

The rule applies to all claims or defenses connected with the transaction, whether in tort or contract. When, under state law, a consumer would have a tort claim against the seller that would defeat a seller's right to further payments or allow the consumer to recover affirmatively this claim is preserved against the holder. This is, of course, subject to the limitation of recovery under this rule to the amounts paid in.

It is also possible for a consumer to have a claim or defense against a seller because of a separate transaction. The provision required by the rule would not allow him to assert such a claim or defense against the holder. The holder's obligations are limited to those arising from the transaction, which he finances.

INTERLOCKING LOANS

Wisconsin has an interlocking loan law, which is similar in some ways to the FTC Holder-In-Due-Course rule. The interlocking loan rule applies when a credit union's Wisconsin Consumer Act loan proceeds go to a dealer or merchant with whom the credit union has any of a number of relationships. Examples include payment of referral fees, having a recourse agreement, supplying loan documents to the dealer, etc. The law can even be triggered by the credit union having mere knowledge that the dealer fails to live up to its obligations to its customers.

The credit union is liable to the member for claims or defenses the member may have against the dealer. Rather than take the dealer to court to settle disputes, the member may simply stop making payments on the interlocking loan. The credit union's liability is limited to the outstanding balance of the loan at the time the credit union learns of the member's complaint.

RESTRICTIONS ON DEFICIENCIES

The Wisconsin Consumer Act restricts the borrower's personal liability for deficiency balances on credit sales and interlocking loans that are subject to the Act. Remember, credit sales include indirect loans ("dealer paper") bought by the credit union, as well as those the credit union originates to sell repossessed goods or credit union equipment. For such credit sales and interlocking loans the borrower is not liable for any deficiency on loans with an outstanding balance of \$1,000 or less at the time of default or voluntary surrender.

INDEMNIFICATION AGREEMENT

Credit unions may reduce the risk of loss under these rules by entering into business relationships only with reputable dealers, and by requiring an indemnification agreement of any dealer with which there is a relationship.

Whenever a credit union becomes involved in such a sales program, it should be convinced that the seller is reputable, financially sound and willing to cooperate in fulfilling its obligations to individual members.

The effect of the FTC notice is that the credit union agrees, as between itself and the consumer, that it can be held responsible for problems the consumer has with the dealer. The interlocking loan law has a similar result. Under the Wisconsin Consumer Act, there is the additional effect of relieving the borrower of liability for deficiencies of \$1,000 or less after voluntary surrender or repossession, regardless of whether or not the consumer was wronged by the dealer.

In order to protect themselves from liability for acts or omissions other than their own, many lenders require the dealer to sign an indemnification agreement, whereby they would be reimbursed for any resulting losses under the FTC Rule or Wisconsin's interlocking loan law.

The usefulness of the agreement depends ultimately upon the reputability and financial status of the seller involved.



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