Federal Trade Commission

Staff Guidelines on Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses

(Holder in Due Course Rule)

Bureau of Consumer Protection
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PREFACE

Since 1945, consumer credit has grown substantially. One result has been a major commitment, on the part of credit institutions, to the retail consumer market. Credit has helped millions of families enjoy the fruits of our industrial society.

This dramatic increase in consumer credit over the past thirty years has caused certain problems. Evolving doctrines and principles of contract law have not kept pace with changing social needs. One such legal doctrine which has worked to deprive consumers of the protection needed in credit sales is the so-called "holder in due course doctrine". Under this doctrine, the obligation to pay for goods or services is not conditioned upon the seller's corresponding duty to keep his promises.

Typically, the circumstances are as follows: A consumer relying in good faith on what the seller has represented to be a product's characteristics, service warranty, etc., makes a purchase on credit terms. The consumer then finds the product unsatisfactory; it fails to measure up to the claims made on its behalf by the seller, or the seller refuses to provide promised maintenance. The consumer, therefore, seeks relief from his debt obligations only to find that no relief is possible. His debt obligation, he is told, is not to the seller but to a third party whose claim to payment is legally unrelated to any promises made about the product.

The seller may, prior to the sale, have arranged to have the debt instrument held by someone other than himself; he may have sold the debt instrument at a discount after the purchase.

From the consumer's point of view, the timing and means by which the transfer was effected are irrelevant. He has been left without ready recourse. He must pay the full amount of his obligation. He has a product that yields less than its promised value. And he has been robbed of the only realistic leverage he possessed that might have forced the seller to provide satisfaction - his power to withhold payment.

On November 14, 1975, the Federal Trade Commission addressed this problem by promulgating a final Trade Regulation Rule concerning the Preservation of Consumers' Claims and Defenses.* The Rule, also sometimes called the Holder-in-Due-Course Rule, becomes effective on May 14, 1976.

The staff of the Commission has received many inquiries about the interpretation and application of the Rule. This pamphlet attempts to answer as many of these as possible. The analysis is informal and advisory in that it has not been formally reviewed or adopted by the Commission. Nor does anything here alter or amend either the Rule or the official Statement of Basis and Purpose published with it. Nonetheless, staff of the Bureau of Consumer Protection believes this publication of staff views will help the public and will facilitate and encourage compliance with the Rule.

TEXT OF THE RULE

§ 433.1 Definitions

(a) *Person.* An individual, corporation, or any other .business organization.

(b) *Consumer.* A natural person who seeks or acquires goods or services for personal, family, or household use.

(c) *Creditor.* A person who, in the ordinary course of business, lends purchase money or finances the sale of goods or services to consumers on a deferred payment basis; *Provided,* such person is not acting, for the purposes of a particular transaction, in the capacity of a credit card issuer.

(d) *Purchase money loan.* A cash advance which is received by a consumer in return for a "Finance Charge" within the meaning of the Truth in Lending Act and Regulation Z, which is applied, in whole or substantial part, to a purchase of goods or services from a seller who (1) refers consumers to the creditor or (2) is affiliated with the creditor by common control, contract, or business arrangement.

* 16 C.F.R. 433.1 *et seq*; 40 F.R. No. 223, 53506 (Nov. 18, 1975).

(e) *Financing a sale.* Extending credit to a consumer in connection with a "Credit Sale" within the meaning of the Truth in Lending Act and Regulation Z.

(f) *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 or the financing thereof.

(g) *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.

(h) *Credit card issuer.* A person who extends to cardholders the right to use a credit card in connection with purchases of goods or services.

(i) *Consumer credit contract.* Any instrument which evidences or embodies a debt arising from a "Purchase Money Loan" transaction or a "financed sale" as defined in paragraphs (d) and (e).

(j) *Seller.* A person who, in the ordinary course of business, sells or leases goods or services to consumers.

§ 433.2 Preservation of Consumers' 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.

or, (b) Accept, as full or partial payment of such sale or lease, the proceeds of any purchase money loan (as purchase money loan is defined herein), unless any consumer credit contract made in connection with such purchase money loan contains 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 WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

PURPOSE OF THE RULE

In adopting this Rule the Commission determined that it constitutes an unfair and deceptive practice within the meaning of Section 5 of the Federal Trade Commission Act (15 U.S.C. 45) for a seller, in the course of financing a consumer purchase of goods or services, to employ procedures which make the consumer's duty to pay independent of the seller's duty to fulfill his obligations. In the course of public proceedings of the Rule the Commission 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 on the part of the 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 for buyers which separate the consumer's legal duty to pay from the seller's legal duty to keep his promises.

This separation of duties may be accomplished in three ways. First, the seller may execute a credit contract with a buyer which contains a promissory note. In the event that the promissory note is assigned to a credit company, the credit company takes it free of any claim or defense which the buyer would have against the seller. This is true unless the buyer can prove that the credit company is acting in bad faith or with notice of actual seller misconduct. Second, if a local statute prohibits the use of such promissory notices in credit sale transactions, the seller may incorporate a written provision called a "waiver of defenses" in the text of an installment sales agreement. A waiver of defenses is the consumer's written agreement that his installment purchase contract may be treated like a promissory note in the event that it is sold or assigned to a credit company.

Finally, a seller may arrange a direct loan for his buyer. Where a seller arranges a loan in this fashion, the lender is legally entitled to payment in full whatever the seller may do or fail to do in the sales transaction which accompanies the loan and for which the loan is obtained. In jurisdictions where efforts have been made to curtail the use of promissory notes and waivers of defenses, the Commission documented a significant increase in the use of arranged loans to accomplish the same end.

The Commission's Rule is directed at all three of the above situations. It is designed to prevent the widespread use of credit terms which 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.

MECHANISM 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 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.

In addition, 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:

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.

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 which 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 (1) sue to liquidate the unpaid balance owed to the creditor and to recover the amounts paid under the contract and/or (2) 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 downpayment were made under the credit contract, the consumer could recover the downpayment as well as other payments. Recovery of a downpayment would be possible under many installment sales contracts. It would not be possible in situations where a direct loan contract is used, because the downpayment 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 Commission. The phrase simply incorporates those things which, 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. Where a local jurisdiction imposes a rule analogous to laches or equitable estoppel, consumer claims and defenses would continue to be subject to such a limitation, and the consumer would have a duty to notify the potential defendant of his contention within a reasonable time.

The Rule does apply 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.

The vast majority of cases, in the staff's opinion, will involve a limited right of set-off against the unpaid balance. Most sellers do not do business in a way that creates a right to rescission or significant consequential damages. It is probable that the vast majority of disputes between buyers and sellers will be settled by means of informal mechanisms.

This is the case in most seller/buyer conflicts today. While the Rule preserves and protects the consumer's legal right to assert claims and defenses, it does not compel unjustified reliance on the legal system in individual cases, and will not promote frivolous or unsubstantiated claims.

CREDIT CONTRACTS WHICH MUST CONTAIN THE NOTICE

The Rule does not apply to all credit instruments. The Notice must appear in written obligations defined as "Consumer Credit Contracts" in the Rule. The definition includes any written instrument which under the Truth in Lending Act* and Regulation Z of the Federal Reserve Board,** constitutes a consumer credit contract and which is

* 15 U.S.C. § 1601 *et seq*.
** 12 C.F.R. 226.

used to (1) "Finance a Sale" as that term is defined in the Rule or (2) 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 counselling or placement, health spa membership, and similar agreements made with individuals for noncommercial purposes are covered.

Sales of goods or services for commercial use are not covered by the Rule. This includes the purchase of equipment for agricultural production, because such production is a commercial activity within the meaning of the Rule. Nor does the Rule apply when a purchase is made by or for an organization rather than a natural person. Finally, only purchases of goods and services are covered by the Rule. Sales of interests in real property are unaffected, as are purchases of commodities or securities. 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.

Additional limitations on affected transactions are present because the definitions of "Financing a Sale" and "Purchase Money Loan" expressly refer to the Truth in Lending Act and Regulation Z, and thus incorporate the limitations contained in these laws. As a result, even with respect to transactions involving a sale of consumer goods or services, a purchase involving an expenditure of more than $25,000 is not affected by the Rule. Public utility services are not affected by the Rule. Finally, only those leases which 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 within the Commission's jurisdiction extends credit to a buyer and takes a written credit contract from the buyer, in connection with an affected transaction. All such situations are covered by the Rule, and all contracts so executed, except credit card instruments, must contain the required Notice. Credit card instruments are specifically exempted from the Rule.

This section is intended to be comprehensive in its coverage. Besides the credit card exemption, the only limitation is that the agreement itself must constitute a contract under the law of the local jurisdiction. A casual notation of retail credit extended, made in a form that does not itself constitute a contract, is not covered. Such an instrument would not be a contract in itself (though it might be part of a contract or evidence of contract), and would not be assignable. There is thus no reason to try to cover it.

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.

In the event that more than one written instrument contains or embodies the rights and duties of the buyer and seller, the Rule does not require redundant placement of the Notice. The Notice need appear once, in any location which renders it a clear term or condition of the written credit agreement. Incorporation by reference in multiple credit documents is appropriate and satisfies the Rule as long as the documentation makes it clear to both the consumer and any holder that the consumer's written credit obligation is subject to the Notice.

In practical terms, this means that there is no need for re-execution of outstanding open-end credit contracts. It is sufficient if consumers are informed through a notation or sales slips on bills, and if the master files are tagged in any way sufficient to put a subsequent holder on notice under state law.

Purchase Money Loans

(1) *General Considerations*

The Rule states that a seller may not accept money which 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 Notice before he consummates the Sale.*

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

The Commission has concluded that consumer' 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 Commission 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.

* An amendment which would apply this obligation to the third party financer as well is now under consideration by the Federal Trade Commission.

The Commission also concluded that when a creditor and a seller are working together to finance sales by means of consumer loans, the creditor has, or should have, access to information, resources, and business procedures which place him in a position to assess the likelihood of seller misconduct and make appropriate provisions for dealing with it. The creditor has access to sources of commercial information not easily available to the average consumer buyer, and if he transacts business with the seller repeatedly over a period of time he knows from his own experience whether the seller is basically fair or not. A creditor who deals regularly with a seller is in a position to establish economic ways of shifting the risk back to the seller, through recourse or reserve arrangements.

Where there is no such established relationship between the seller and the lender these reasons for the Rule do not apply. The Commission concluded that the Rule should not cover the situation where a buyer obtains financing from a lender who neither receives referrals from the seller nor is affiliated with the seller by common control, contract, or business arrangement.

The intent of the Rule is to define as "purchase money loans" those consumer loans made for the acquisition 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 which 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.

In reaching its conclusions about the scope of the Rule, the Commission was aware of the argument that a Rule preserving consumers' claims and defenses in purchase money loan situations could make lenders hesitate to finance purchases from unfamiliar sellers, and that this might reduce the diversity of credit sources available to consumers. It recognized that a lender who places the required Notice in loan agreements may feel compelled to keep himself abreast of the seller's practices and, perhaps, to police those practices to some extent. While the costs of such efforts might be small, it is clear that some costs and risks will be involved and that a creditor may choose not to incur them when he is unfamiliar with the seller involved. Since it is in the public interest to insure that consumers have a multiplicity of credit sources available, the Commission established a Rule that would not apply in contexts where the lack of connection between seller and lender would create difficulties. Thus the Rule applies only

when the seller is arranging credit, through either an established pattern of referrals or affiliation.

The complexities of the consumer credit market make it impossible to enumerate all situations in which a seller and lender may be engaging in "purchase money loan" financing, but the questions should be clarified by the above discussion and by the following elaboration of the common-sense purpose of the "purchase money loan" provision and its application to typical situations.

(2) *Specific Purchase*

The definition of "Purchase Money Loan" refers to "a purchase" and reaches only those consumer loans which are primarily or exclusively applied to a discrete purchase of goods or services from a particular seller. Where a consumer obtains a loan and uses the proceeds for multiple purchases from different sellers the Rule dues not apply.

The specific purchase requirement implicit in the definition of "Purchase Money Loan" has the effect of exempting most "open-end" loan agreements with lenders who are not sellers. For the most part, check overdraft accounts and other types of open lines of credit are not applied to a specific purchase at the time of the initial extension of credit. While one could take the view that credit is extended only when the open line is drawn upon, the staff does not believe that such a technical interpretation would serve the public interest. For all practical purposes, the extension is completed when the line is approved.

This interpretation raises some possibility that open-end credit arrangements could be used in an attempt to evade the Rule. It would be possible for an affiliated lender to set up his agreement in the form of an open-end credit transaction and simply make the first extension of credit an amount sufficient to complete the relevant purchase. In such a situation the substance rather than the form of transaction would govern and the Rule would apply.

Receipt by the consumer of some surplus loan proceeds does not, of itself, remove a loan from the "Purchase Money Loan" category. The test is whether the loan is applied in whole or substantial part to a specific purchase. While the "substantial part" clause creates a slight area of uncertainty, it is necessary to have such a qualification to close what would otherwise be a gaping loophole. If the Rule required that the entire advance be applied to the purchase it would be easy for a related lender to exempt himself simply by advancing a few dollars extra.

(3) *Relation between Creditor and Seller*

Once the criterion that the loan be applied to a specific purchase of goods or services has been met, the Rule imposes a further requirement before a consumer loan is classified as a purchase money loan. The specific seller who receives the proceeds of the loan must be engaged, in the practice of referring loan customers to the lender or he must be affiliated with the lender by common control, contract or business arrangement.

(a) *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.

Where the seller suggests that there are loan outlets in the community or immediate vicinity which 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 pre-designated 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, provided the specific purchase test is also met. Conversely, it means that an occasional referral which is not part of a business routine of the seller does not trigger the Rule.

(b) *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 financer's lending resources and vice versa.

The first type of affiliation is common control. The Commission has concluded that when a creditor and a seller are functionally part of the same business entity loans made by the lender for the financing of purchases from the seller should be subject to the Rule. This applies if the two companies are owned by a holding company or by substantially the same individuals, if one is a subsidiary of the other, or if they are under common control in any other way.

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 which 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 which 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, nor is a commercial credit agreement between the seller and a credit institution which has no relationship to consumer sales activities or the financing thereof. A commercial lease, the factoring of accounts receivable, 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 or a contract; the definition of "Creditor" specifically excludes credit card transactions.

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 loan contracts with consumers who use the proceeds at the seller's establishment must contain the required Notice. This is true provided the specific purchase requirement is met, whether or not a particular loan is directly attributable to the affiliation.

PLACEMENT OF THE NOTICE

The 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 more than one document is used to consummate a subject to the Rule, duplicative placement of the Notice is not required. Insertion in one document only, plus incorporation by reference where necessary, is appropriate. The Rule requires only that the documentation is used to make clear to both consumer and holder that the consumer's obligations under the contract are subject to the Notice.

Application of the Rule to seller open-end credit plans and series of sales plans has been discussed above. With respect to those plans which are covered, the staff believes that extensions of credit made after May 14, 1976, pursuant to agreements in existence before that date are covered by the Rule. This creates a logistical problem with respect to such pre-existing agreements. For future consumer accounts the Notice may be included in the master contract between the consumer and the seller. However, it would be wasteful to amend or rewrite existing master agreements to conform with the Rule.

For this reason the staff believes that it will be sufficient if consumers are notified once, in a monthly statement, that with respect to future purchases made pursuant to the existing master agreement the required Notice will become a term or condition of the consumer's credit obligation. Thereafter, the existing master agreement between the consumer and the seller may be tagged or marked to make it clear that the text of the Notice is incorporated by reference therein for the purposes of transactions occurring after the May 14, 1976 effective date of the Rule. Any method sufficient to put an assignee on notice under state law is acceptable.

EFFECTIVE DATE

The Commission promulgated its Trade Regulation Rule concerning Preservation of Consumers' Claims and Defenses on November 14, 1975. An initial period of six months was specified to permit sellers to incorporate the required Notice in their forms prior to the effective date of the Rule. The Rule becomes effective on May 14, 1976.

PROPOSED AMENDMENT

On the same day that the Commission adopted the Rule, it proposed an amendment thereto for consideration in informal rulemaking proceedings pursuant to the Federal Trade Commission Improvement Act.

The proposed amendment would not alter the purpose of the Rule, nor would it extend or restrict the transactions covered by the Rule. The proposed amendment would impose a duty of compliance directly on creditors as well as sellers in the transactions to what the present Rule applies.

The final Commission decision on the proposed amendment will be announced in the *Federal Register.*

ADVISORY OPINIONS

Under the Rules of Practice of the Federal Trade Commission, any person, partnership, or corporation may seek a formal advisory opinion with respect to a course of action the requesting party proposes to pursue. For details of the procedure to be followed see Sections 1.1 to 1.4 of the Commission Rules (16 C. F. R. § § l.l-1.4).

Informal requests for advice will be answered by the staff of the Commission. Inquiries should be directed to:

Assistant Director for Compliance
Bureau of Consumer Protection
Federal Trade Commission
Washington, D.C. 20580

Federal Trade Commission	ftc.gov
1-877-FTC-HELP	For The Consumer