COMMENTS OF MFY LEGAL SERVICES, INC., LINCOLN SQUARE LEGAL SERVICES, INC., AND FORDHAM LAW SCHOOL FEERICK CENTER FOR SOCIAL JUSTICE
To
THE FEDERAL TRADE COMMISSION
In the Matter of
HOLDER RULE REVIEW, FTC FILE No. P164800

By notice published on December 1, 2015, the Federal Trade Commission ("FTC") requested public comments on the efficiency, costs, benefits, and impact of the Holder Rule, "which protects the rights of consumers who make a purchase using credit obtained through a merchant."[1] MFY Legal Services, Inc. ("MFY"), Lincoln Square Legal Services, Inc. ("LSLS"), and Fordham Law School's Feerick Center for Social Justice ("Feerick Center") submit these comments and recommendations to ensure that the vital legal protections afforded by the Holder Rule to consumers continue and are strengthened where gaps exist.[2]

Our organizations are uniquely qualified to comment on the importance of the Holder Rule with regard to consumer protection. For over 50 years, MFY has provided free legal assistance to residents of New York City on a wide range of civil legal issues, prioritizing services to vulnerable and under-served populations, while simultaneously working to end the root causes of inequities through impact litigation, law reform, and policy advocacy. MFY provides advice and representation to more than 10,000 New Yorkers each year. MFY launched its Consumer Rights Project in 2005 in response to its clients' growing demand for legal representation and advice about consumer issues. It runs a weekly hotline and participates in courthouse clinics where its attorneys interact with low-income consumers and hear their stories firsthand.

LSLS is the nonprofit law firm through which Fordham University School of Law operates its in-house clinical program. Through its Consumer Litigation Clinic, LSLS provides direct legal services to low-income clients as defendants in debt collection actions, and as plaintiffs in affirmative cases against lenders and merchants engaged in unfair and deceptive practices. LSLS clients include victims of merchant misconduct sued by related creditors or their assignees, whose right to relief relied on the FTC Holder Rule.

The Feerick Center helps administer limited-scope legal clinics for economically distressed consumers in the Bronx, New York (Manhattan), and Richmond (Staten Island) Counties of New York City. Starting in 2008, these clinics have served over 8,000 consumers during nearly 14,000 consultations. The vast majority of consultations involve limited legal advice and assistance to consumers in connection with debt collection actions. In the Feerick Center's experience, defendants often raise fraud defenses, particularly in cases involving industries with documented and systemic fraudulent practices, such as used-car dealers and for-profit scam trade schools.

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[1] Press Release, Fed. Trade Comm'n., FTC Seeks Public Input in Review of Holder Rule (Nov. 25, 2015), https://www.ftc.gov/news-events/press-releases/2015/11/ftc-seeks-public-input-review-holder-rule.

[2] In particular, these comments respond to the following specific questions set out in the FTC's request for public comment: "(1) Is there a continuing need for the Holder Rule as currently promulgated? Why or why not? (2) What benefits has the Holder Rule provided to consumers? What evidence supports the asserted benefits? (3) What modifications, if any, should the Commission make to the Holder Rule to increase its benefits to consumers? . . . (13) What modifications, if any, should be made to the Holder Rule to account for changes in relevant technology or economic conditions?" *See* Rules and Regulations Under the Trade Regulation rule Concerning Preservation of Consumers' Claims and Defenses, 80 Fed. Reg. 75,018, 75,019 (proposed Dec. 1, 2015) (to be codified at 16 C.F.R. pt. 443).

I. Introduction

Since it took effect in 1976,[3] the Preservation of Consumers' Claims and Defenses (the "Holder Rule") has functioned as a cornerstone of consumer anti-fraud protection. The rule requires sellers of goods and services to include clauses in credit contracts subjecting lenders to any claims or defenses the consumer might have against the seller.[4] This extension of liability, albeit with a cap of how much the consumer has paid under the contract, contravenes the common law Holder in Due Course doctrine.[5] It is essential to protecting consumers from unscrupulous sellers who could otherwise easily avoid legal responsibility for their misconduct.

II. Background

Between 1950 and 1971, installment-based consumer debt increased five-fold to $137.2 billion.[6] During this period, sellers and creditors made widespread use of the common law Holder in Due Course doctrine, which provides that holders of debt are immune from many of the claims and defenses that the debtor has against the seller, including the right to withhold payment for a defective product or fraudulent inducement.[7] Consumers in these cases thus often found themselves without effective legal remedies. The FTC observed that the common law rule, which had emerged in the context of commercial transactions, effectively forced consumers to enter the commercial paper market.[8] It issued the Holder Rule in 1975 in order to stymie this wave. In doing so, it reasoned that "[b]etween 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 financer is in a better position both to protect itself and to assume the risk of a seller's reliability."[9]

III. The Current Landscape

Developments since the Holder Rule's adoption illustrate that it remains vital to protecting consumers from fraud. As of November 2015, consumers had $3.5 trillion dollars of outstanding consumer credit, an increase over the $2.7 trillion held in 2011.[10] Since 2011, as the economy has improved from the financial crisis in some sectors, outstanding consumer credit has steadily increased, growing by 7% in

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[3] Preservation of Consumers' Claims and Defenses, Unfair or Deceptive Acts or Practices, 40 Fed. Reg. 53,506 (Nov. 18, 1975) (codified as 16 C.F.R. §§433.1–.3 (2015)) [hereinafter Holder Rule].

[4] *See* 16 C.F.R. § 433.2.

[5] For this reason, the Holder Rule is also known as the "Anti-Holder Rule."

[6] 40 Fed. Reg. at 53,507.

[7] *See id.* The Holder in Due Course doctrine is also encoded in Article Three of the Uniform Commercial Code. *See* U.C.C. § 3-302 (AM. LAW INST. & UNIF. LAW COMM'N 2002). While it is impossible to track precisely the scale of the problem, abundant anecdotal evidence suggested it was far reaching. For example, a 1971 survey commissioned by the FTC of 59 legal services projects across 39 states and territories found that holder in due course cases comprised 7.7 percent of the total caseload between April 1970 and May 1971. *See* Holder Rule, 40 Fed. Reg. at 53,510. Furthermore, a Cook County, Illinois Circuit Court judge testified to the FTC that he heard over 3,000 cases involving creditor actions from September 1970 to April 1971 and that the "vast majority" of plaintiffs in such cases took advantage of the holder-in-due-course doctrine. *See id.*

[8] *See* Holder Rule, 40 Fed. Reg. at 53,507–53,508 ("The average consumer would hardly expect that his sales agreement will receive the same treatment as a sight draft on the Bank of England, in the event that his seller fails to perform as promised.").

[9] *Id.* at 53,509.

[10] BD. OF GOVERNORS OF THE FED. RESERVE SYS., FEDERAL RESERVE STATISTICAL RELEASE (Dec. 2015), http://www.federalreserve.gov/releases/G19/Current/g19.pdf (Consumer Credit Outstanding (Levels)).

2014 alone.[11] In the third quarter of 2015, household debt service payments constituted 15.3% of consumers' personal income.[12]

While many consumer credit transactions take place without incident, seller misconduct, fraud, and defects arise with some frequency, particularly in troubled industries that prey on vulnerable consumers. Today, seller misconduct presents as significant a concern for consumer protection as it did in 1975 when the FTC promulgated the Holder Rule—if not more so.[13] The Consumer Financial Protection Bureau ("CFPB") and the FTC both collect and analyze consumer complaint data. The FTC's 2015 Consumer Sentinel Network Databook reported that, in 2014, the agency received over 2.5 million complaints (excluding do-not-call complaints), of which 60% involved fraud—more than any other category.[14] In a 2015 report, the CFPB reported that within the complaint category "other financial services complaints," 49% dealt with fraud or scams;[15] among prepaid card complaints, 24% dealt with fraud or scams;[16] and among money transfer complaints, 43% dealt with fraud or scams.[17]

Thus, many of the factors cited by the FTC in 1975 as rationales for the Holder Rule exist even more strongly today: post-recession consumer credit is burgeoning and seller misconduct, defects, and related problems continue to plague consumers. Moreover, many Americans continue to be economically distressed notwithstanding the economic recovery: according to the CFPB, approximately 35% of adults, or 77 million of the 220 million Americans with consumer credit files, have debts in collections.[18] The debt collection industry has grown tremendously since 1975 and today generates $13 billion dollars in revenue a year—a third of it from debt buyers[19] with all of the attendant problems that debt buyer cases present.[20] Equally important, debt collection now involves litigation to a much greater degree, making the stakes for consumers ever higher and often more dire.[21] Because consumers enjoy the Holder Rule's protection as a

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[11] *See id.* The Consumer Financial Protection Bureau has reported on the expansion of the consumer credit markets:

> Consumer Credit is expanding in response to changes in economic conditions, with industry projecting continued growth for the next five years. Consumer credit, excluding mortgages is $615 billion higher than pre-2008 levels. While revolving debt continues to grow, non-revolving debt, driven largely by student loans, is almost 45% higher than pre-recession levels. Against a backdrop of overall growth, the market is changing in significant ways.

CONSUMER FIN. PROT. BUREAU, FAIR DEBT COLLECTION PRACTICES ACT: CFPB ANNUAL REPORT 2015 8 (Mar. 2015), http://files.consumerfinance.gov/f/201503_cfpb-fair-debt-collection-practices-act.pdf [hereinafter CFPB 2015 FDCPA Report] (citations omitted).

[12] FED. RESERVE BD., HOUSEHOLD DEBT SERVICE AND FINANCIAL OBLIGATIONS RATIOS (Dec. 28, 2015), http://www.federalreserve.gov/releases/housedebt/.

[13] *See* Holder Rule, 40 Fed. Reg. at 53,507.

[14] FED. TRADE COMM'N., CONSUMER SENTINEL NETWORK DATA BOOK FOR JANUARY – DECEMBER 2014 4 (Feb. 2015), https://www.ftc.gov/system/files/documents/reports/consumer-sentinel-network-data-book-january-december-2014/sentinel-cy2014-1.pdf.

[15] CONSUMER FIN. PROT. BUREAU, REPORT OF THE CONSUMER FINANCIAL PROTECTION BUREAU PURSUANT TO SECTION 1017(E)(4) OF THE DODD-FRANK ACT 62 (Dec. 31, 2015), http://www.consumerfinance.gov/reports/report-of-the-consumer-financial-protection-bureau-pursuant-to-section-1017e4-of-the-dodd-frank-act/.

[16] *See id.* at 60.

[17] *See id.* at 58.

[18] CFPB 2015 FDCPA Report, at 7.

[19] *See id.* at 7-8.

[20] FED. TRADE COMM'N., THE STRUCTURE AND PRACTICES OF THE DEBT BUYING INDUSTRY (Jan. 2013), https://www.ftc.gov/sites/default/files/documents/reports/structure-and-practices-debt-buying-industry/debtbuyingreport.pdf.

[21] *See* HUMAN RIGHTS WATCH, RUBBER STAMP JUSTICE: US COURTS, DEBT BUYING CORPORATIONS, AND THE POOR (2016), https://www.hrw.org/report/2016/01/20/rubber-stamp-justice/us-courts-debt-buying-corporations-and-poor; NAT'L CONSUMER LAW CTR., THE DEBT MACHINE: HOW THE COLLECTION INDUSTRY HOUNDS CONSUMERS AND OVERWHELMS COURTS (July 2010), www.nclc.org/images/pdf/pr-reports/debt-machine.pdf.

defense to debt collection, this burgeoning modern debt collection industry highlights its continued relevance.

Our experience confirms these trends. Consumers in New York City are repeatedly victimized by sales of defective products and outright fraud. Worsening the problem is the increased frequency with which these sales are conditioned on financing agreements that either are executed with the seller and immediately assigned to third parties, or are concurrently executed with third-party financers. These third-party financing arrangements are now common with sales of cars, student loans, and furniture. Consumers who enter these transactions generally expect that if the seller fails to deliver on its promises, they will not be required to continue paying.

Now, even with the Holder Rule, consumers' options for relief from seller misconduct are limited. The sellers may be fly-by-night scammers or insolvent businesses that shirk responsibility once the contracts are sold. When consumers turn to the lender—the company currently demanding payment—they are repeatedly told that they can only seek relief from the seller and must continue to make payments. Indeed, we see lenders routinely disclaim any liability for the sellers' misconduct; beyond lacking any sort of investigative interest or capacity, they often lie to consumers that they have no rights, claims, or defenses. Even consumers who are made aware of the right to withhold payment are intimidated from asserting it by the likely consequences—negative credit reporting and a resource-consuming lawsuit. In our experience, the lenders continue to do business with these unscrupulous sellers, ignoring complaints of misconduct and providing the financing that keeps them afloat. As a result, our marketplace loses an opportunity to eliminate bad actors, as the businesses in the best position to police them and recoup their losses have little incentive to do so.

The explosion of debt buying and consumer credit litigation in the past decade noted above worsens this already bad situation. As these options have become more cost-efficient for creditors, there is little downside to financing questionable transactions and then pursuing every single account, rather than selecting the most meritorious. Consumers are the ones who end up paying.

Specific examples from our clients illustrate the gravity and pervasiveness of the problem. Seller misconduct is still widespread. S.R. is permanently disabled, with limited English proficiency, and on a fixed income. A car dealer lured him to visit the lot with persistent mailings and calls claiming that he had won a prize. The touted "prize" never materialized, but the offer to purchase a used car did. Despite his protests that he did not need and could not afford a car, the dealer employed an unconscionable and well-orchestrated scheme of fraudulent misrepresentations to trick S.R. into buying and financing a car at $32,000—204% of its Kelley blue book value of $15,650, with $642 monthly payments. While the dealership was under investigation (and eventually successfully sued) by the New York Attorney General, the lender repossessed the car and dunned S.R. for the $15,000 deficiency. Only because of the Holder Rule was S.R. able to assert his fraud and unconscionability defenses against the lender.

Another client, S.H., was victimized by an unscrupulous seller working closely with the lender. He obtained a purchase money loan to pay for tuition at a training program. The program steered him to a lender whose officers overlapped and were largely family members. As part of the agreement, S.H. tendered a $2,500 City voucher to the program, which he was promised would be applied to the loan. Reasonably believing the voucher had been applied, S.H. enrolled in and completed the program. Years later, the lender sued S.H for the amount claimed due on the loan, failing to credit him for the voucher. The lender argued that the Holder Rule did not apply because the program had failed to include it in the contract.

In addition to rampant seller misconduct, our clients report that lenders routinely deny their liability under the Holder Rule. Another consumer with limited English proficiency, A.G., purchased a car that was supposed to be new from a dealer. Within a few months, it started having significant mechanical problems. He brought the car back to the dealer several times for repairs, but the problem was never fixed. After he complained, the lender towed the car. Believing he had returned the defective vehicle, A.G. stopped making payments. Months later, he was sued for a deficiency of over $15,000. Unbeknownst to him, the finance company had treated the towing as a repossession.

Another client, S.T., visited a dealer because he needed a car to bring his chronically ill daughter to the hospital. The dealer promised him that, after six timely payments, he could automatically refinance his loan so the payments would drop from $433 to an affordable $128 for the remaining 54 months. When he got home, he discovered he had unknowingly signed documents that obligate him to the higher payments for 72 months—over $10,000 more than he had agreed to. Among these documents was a contract he had specifically refused to sign. He realized he had been defrauded and immediately called the lender. The lender told him he was required to continue making payments. Two days later, it wired the dealer the money for the contract. Even though the employee who arranged the deal pleaded guilty to automobile-lending-related theft, and the lender had been informed of the fraud before finalizing the transaction, the lender continues to hold S.T. liable for the full amount of the loan. This matter is currently in litigation, where S.T. has asserted holder liability against the lender.

Our clients' experiences indicate that the Holder Rule not only serves a necessary role in protecting consumers, but also should be strengthened in order to fulfill its purpose.

IV. Our Proposals

Any weakening of the Holder Rule would be devastating to consumers. The persistence of misconduct notwithstanding its strong protections underscores its continued relevance and necessity. As in 1976, it is still the case that "the obligation to pay for goods or services is not conditioned upon the seller's corresponding duty to keep his promises."[22]

For this reason, we recommend strengthening the Holder Rule to ensure that lenders proactively and meaningfully respond to consumer complaints. This goal can be accomplished, first, by clarifying their obligations to consumers. Lenders should be required to ensure that the Holder Rule clause is included in the underlying contract. Currently, only sellers are responsible for including this language. In particular, it is often missing in private student loan agreements with proprietary vocational schools, leaving consumers like S.H. with limited options in certain jurisdictions.

In addition, the FTC should require lenders to inform consumers, not just in the contract but also when they report complaints of seller misconduct, that their claims and defenses against the seller are preserved. Now, without such a requirement, lenders fail to mention these rights and even affirmatively misrepresent them, telling consumers they cannot withhold payment. Although disputes as to the underlying facts may persist, consumers can make better decisions when they understand, and know the lender understands, their legal rights.

Second, the FTC should specify necessary protocols for investigating consumer complaints about sellers. Currently, at best, the lender may make a half-hearted attempt to ask the seller to purchase the contract. If the seller refuses to do so, the lender simply holds the consumer responsible for payments. In our experience, fraud complaints are so rarely investigated that lenders can only process merchandise returns through their repossession departments; they often lack a corresponding unit for handling lawful returns.

[22] FED. TRADE COMM'N., STAFF GUIDELINES ON TRADE REGULATION RULE CONCERNING PRESERVATION OF CONSUMERS' CLAIMS AND DEFENSES 1 (1976), https://www.ftc.gov/system/files/documents/rules/holder-rule/760504hidcrule.pdf.

This fact evinces an utter disregard for the Holder Rule. Among other features, these protocols should include cross referencing consumer complaints about businesses and individuals, reviewing law enforcement actions, and "secret shopping" the businesses they finance.

Third, robust enforcement actions are necessary to ensure compliance with these requirements.

Finally, financial incentives must be realigned to encourage early investigation of consumer complaints. Currently, lenders have no incentive to do so because their liability is capped at the amount of the payments made. Instead, they make the business decision to aggressively pursue collection and litigation, which intimidates consumers and can, in and of itself, have devastating consequences for victims of fraud and undermines the Holder Rule's effectiveness. The consumer stands to lose by way of penalties, increased fees, destroyed credit, and, if the lender pursues litigation, missed days of work, childcare expenses, and attorney's fees. The worst-case scenario for the lender, on the other hand, is to return the payments improperly received.

Eliminating the Holder Rule's liability cap ensures that lenders respond meaningfully to early complaints of fraud and cease doing business with repeat bad actors. It also ensures consumers are made whole, as many of their damages for fraud and breach of contract exceed payments made (*e.g.*, cash deposits, cash payments for add-on products, out-of-pocket losses for repairs, attorney's fees, and lost wages) and could have been avoided had the lender heeded their complaints.

V. Conclusion

For these reasons, we recommend strengthening the Holder Rule to encourage lenders to proactively respond to consumer complaints.

To further discuss these comments, please contact Ariana Lindermayer of MFY at 212-417-3742, Marcella Silverman of LSLS at 212-636-6934, or Dora Galacatos of the Feerick Center at 212-636-7747.