CONSUMER CLAIMS AND DEFENSES

HEARINGS

BEFORE THE

SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE

OF THE

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE HOUSE OF REPRESENTATIVES

NINETY-FOURTH CONGRESS

SECOND SESSION

ON

A RECENTLY ENACTED FEDERAL TRADE COMMISSION RULE ON THE PRESERVATION OF CONSUMERS' CLAIMS AND DEFENSES, THE "HOLDER IN DUE COURSE" RULE

AUGUST 26 AND 31, 1976

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- Tobey, Robert E., on behalf of the.

Federal Trade Commission:
- DeLong, James V., Assistant Director, Special Projects.
- Rubin, Erik, Assistant Director, Bureau of Consumer Protection.
- Smith, Margery Waxman, Acting Director, Bureau of Consumer Protection.

Independent Bankers Association of America:
- Maddox, Charles O., president.
- Peterson, Richard W., legislative counsel.

National Automobile Dealers Association, John J. Pohanka, president.
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Neighborhood Legal Services Program, George J. Zweibel, consumer specialist.
Photo Marketing Association, James M. Goldberg, counsel.
Retail Jewelers of America, James M. Goldberg, counsel.
Western Home Furnishings Association, James M. Goldberg, counsel.

CONSUMER CLAIMS AND DEFENSES

FRIDAY, AUGUST 26, 1976

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 2:10 p.m., in room 2322, Rayburn House Office Building, Hon. John M. Murphy, chairman, presiding.

Mr. MURPHY. The subcommittee will come to order.

This afternoon, the Subcommittee on Consumer Protection and Finance opens 2 days of hearing on a recently enacted Federal Trade Commission rule on the preservation of consumers' claims and defenses, the holder in due course rule.

On November 14, 1975, the Federal Trade Commission promulgated a trade regulation rule abolishing the doctrine of holder in due course. The rule, became effective on May 14, 1976 [See p. 182.] A little more than a week ago, the Commission issued a Statement of Enforcement Policy to clarify some of the interpretations about the rule.

The Commission has spent more than 5 years on this rule, has had 3 sets of hearings and has accumulated about 10,000 pages of transcript over that time. The rule is complicated in its application to the marketplace, and has raised much controversy since it was finally promulgated.

The doctrine originally arose out of court suits involving commercial transactions between merchants with approximately equal bargaining power. If one merchant bought from another, paid for the article on an installment basis, and the seller of the article sold the debt obligation to a bank, the courts generally held that the buyer could not stop payment to the bank if the merchandise failed to perform as expected. The buyer could sue the seller, or could refuse to deal further with him. As between two innocent parties, the buyer and the bank—the rule did not apply if the bank had knowledge that the merchandise was faulty, the buyer was considered to be in a stronger position to deal with the seller and to solve his problem, or to cease dealing with him.

As applied to consumer transactions, however, the theory of equal bargaining power does not apply, and the consumer suffers. The consumer buys, for instance, a television set from a seller. He signs an installment contract, which the seller discounts to a finance company. The television set fails to function properly 2 weeks after purchase. The consumer cannot stop payment to the finance company, who is a holder in due course. The consumer is legally obligated to continue paying the creditor despite any breach of warranty, misrepresentation or even fraud by the seller. And a lawsuit against the seller is generally out of the question because of the expense and time required. Finally, because the consumer buys television sets very seldom, he cannot realistically threaten to stop doing business with the seller. He just has no leverage.

I have other remarks that I am going to include in the record at this point and ask Mr. McCollister if he has any opening remarks.

Mr. McCOLLISTER. I do, Mr. Chairman.

This subcommittee spent a great deal of time examining the wisdom of granting the FTC the authority to issue trade regulations rules defining the specific practices that would be considered unfair or deceptive acts or practices within the meaning of the Federal Trade Commission Act.

In November of 1975, the Commission issued its rule abolishing the holder in due course doctrine in several instances. This rule became effective on May 14, 1976. Although the rule was not specifically promulgated under the procedures set out in the Magnuson-Moss Act, I think that the rule does give us a good preview of how we can expect the FTC to operate in the future. And if this is true, Mr. Chairman, I, for one, would strongly urge that this subcommittee spend some time reexamining the whole question of whether the Commission should have this kind of quasi legislative authority at all.

The FTC spent 5 years promulgating the holder in due course rule. A number of hearings were held. Yet on the very day that the final rule was issued, the Commission proposed to amend it, to include creditors within the scope of the rule. Since the holder in due course rule became final, the Commission made no efforts to educate the effected public as to what the impact of the rule would be until May 4, 1976, just 10 days before the rule was to go into effect, when the FTC staff issued guidelines which attempted to explain more fully what the rule was designed to do. Unfortunately, the staff guidelines raised as many questions as they answered. Because questions still remained, the Commission just 2 weeks ago issued a statement on enforcement policy which further seeks to explain what the impact of the rule will be.

Mr. Chairman, I find it just incredible that the Federal Trade Commission would put a rule into effect while so many questions and ambiguities exist. This is essentially incredible since the FTC has been working on the rule since 1971.

In reading over the statement basis and purpose which accompanies the FTC's rule, I notice that the Commission did not consider what impact this rule would have on small business and, frankly, seemed to gloss over the impact which the rule would have on the cost and availability of consumer credit. Therefore, at the beginning of this month, I wrote to a number of bankers in the State of Nebraska asking them what their experience with the rule has been. To date, without exceptions, the response I have received have been extremely negative. Not one of the bankers has had anything good to say about the FTC's rule. In fact, a bank in Omaha wrote me:

> We have discontinued a customer relationship with at least eight smaller dealers in Omaha. As the smaller dealers seek credit accommodations they undoubtedly will be paying a higher price for funds which will be passed onto the consumer.

A North Platt banker writes: "I wish to advise you that the holder in due course regulations have nearly eliminated certain consumer credit requests." He goes on to say that he has also curtailed his financing of mobile homes for the same reason.

Finally, a banker in suburban Omaha told me about a new business which contacted him for financing. This banker states that he was told that with the rule as now in effect, we would not be interested in helping him. To my knowledge, he has still not found a bank willing to work with him. The banker goes on to observe that this hurts not only the small businessman, but also the customers with whom he deals.

These are just the three of the many examples I found just in the State of Nebraska illustrating that financial institutions have indeed changed the way they are doing business in this area. If the effect of the rule is that consumer credit becomes either unavailable or more expensive, I wonder whether the Federal Trade Commission has really done consumers such a favor?

Mr. MURPHY. Thank you, Mr. McCollister.

The committee's first witness this afternoon is one of the congressional experts in consumer affairs. He chairs the Committee on Consumer Affairs of the Full Committee on Banking and Currency, Hon. Frank Annunzio of Illinois.

STATEMENT OF HON. FRANK ANNUNZIO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS, ACCOMPANIED BY CURTIS PRINS, STAFF DIRECTOR, CONSUMER AFFAIRS SUBCOMMITTEE, COMMITTEE ON BANKING, CURRENCY AND HOUSING

Mr. ANNUNZIO. Thank you, Mr. Chairman.

Mr. Chairman, members of the subcommittee, it is truly a distinct privilege for me to appear before you today, and I deeply appreciate the honor of being the leadoff witness at these important hearings. I am accompanied this afternoon by Mr. Curtis Prins, the staff director of the Consumer Affairs Subcommittee of the Committee on Banking, Currency, and Housing.

Mr. Chairman, I am not here this afternoon to defend every sentence, every word, or every punctuation mark of the Federal Trade Commission's ruling repealing the holder in due course doctrine. I do feel that there are some clarifying provisions that need to be worked out with regard to the ruling, and the Federal Trade Commission has indicated that it is working toward that end. I am not willing for one moment, however, to suggest that the entire ruling should be scrapped, substantially reworked, repealed, or even delayed in its implementation. To do so would be to endorse a concept that has caused untold financial horrors, for far too many consumers.

The Federal Trade Commission's holder in due course ruling was not an overnight hit. The Commission spent some several years in both the hearings and the writing stage, and thousands of comments were devoted to the discussion of the proposed rule. Perhaps those who are opposed to the repeal are guilty of the far too common malady of only reacting when a crisis exists. I suggest that anyone who is unhappy with the FTC's action is like the criminal who refuses to offer a defense during his trial and then when the jury finds the criminal guilty, argues that he was not given an opportunity to tell his side of the story.

It is contended by those who opposed the ruling that the FTC should have promulgated it under the provisions of the Moss-Magnuson Act. I wonder, however, if those same champions of the Moss-Magnuson provisions would have felt as strongly if the FTC had come out with a regulation that left holder in due course virtually intact.

I am certain before these hearings are concluded that someone will suggest that the holder in due course doctrine should not be repealed because it has been a principle of commercial law since the 18th century. Of course, the question of whether or not it has been a good principle of commercial law will not be addressed. Instead, the only question that proponents of the status quo will raise is that the holder in due course should be maintained solely because it has been here for a long time. If that philosophy had been adopted, this country would still have slavery for, after all, slavery was in existence for a long time. And we would still deny the right to vote to women, a practice which existed in this country for a long time. Children would still work in mines and in sweatshops for pennies a day. That wasn't a good practice, but it existed for a long time.

We cannot endorse a principle merely by employing a calendar test. If the holder in due course doctrine is right and just, then it should be maintained, but if that doctrine is not just, as I believe it is not, then it must be struck down regardless of its longevity.

Mr. Chairman, shortly after the holder in due course ruling went into effect in mid-May, there was an immediate outcry from trade associations about the consequences of allowing the repeal to remain in effect. Just like Pavlov's dog, many of these trade associations are trained to react in a negative manner when anything that deals with consumer rights is raised.

The banking lobby was quick to attack the FTC ruling, and not far behind were the automobile dealers. On the same day that the president of the American Bankers Association made a speech condemning the holder in due course ruling, I heard an advertisement on a Washington area radio station urging borrowers to secure loans from a particular bank. In part the radio ad said, "Obtin your loan from us, or ask your dealer to finance your purchase with us."

Mr. Chairman, if the holder in due course repeal is causing as many problems as the bank lobby would like Congress to believe, why is a major banking institution in this area openly soliciting new business that would come directly under the new ruling? And why in the light of the banker protest has the American Bankers Association announced that its member banks have planned to substantially increase the finance of new automobiles for consumers. According to the ABA, not only is an increase planned, but not a single bank surveyed by the association plans to cut back the amount of money available for new car lending.

I know that many of the members of the subcommittee have received letters from businessmen concerning the holder in due course doctrine. For the most part, the letters that I have seen on this subject fall into the Chicken-Little-the-sky-is-falling category. Typical of the letters

was one that was referred to me from a small banker in the western portion of our country. The banker's cry of "wolf" read in part:

> Down payments of 50 percent or higher will be required on big ticket items such as automobiles to guarantee that a buyer has a large enough equity from time of purchase that he will not default on his contract because his cigarette lighter didn't work. With today's ridiculous prices for automobiles and a required down payment of 50 percent, guess how this will affect the auto industry.

Well, just as Chicken Little found that the sky did not fall, our banker friend is finding that virtually nothing has changed in the automobile financing area. Down payments are no higher, and according to the newspaper ads in almost every major city, it is still possible to obtain a no-down-payment financing.

Mr. Chairman, when the claims from various business groups that the repeal of the holder in due course doctrine would spell the end to the American business community began appearing, I decided to do a survey of my own rather than depend upon the manufactured horror stories being promoted in opposition to the holder in due course repeal. In order to determine the effects of the ruling, the Consumer Affairs Subcommittee staff called more than 100 automobile, furniture, and home improvement businesses in Washington, Maryland, and Virginia.

Of the more than 30 automobile dealers contacted, not a single one indicated any major problems with the new method of doing business. From the automobile dealers, the most common reply when asked about the new ruling was, "We haven't noticed any difference" or, "It hasn't affected us."

Several dealers claim that they never heard of the FTC action. And one Virginia dealer apparently was trying to use the FTC's action as a basis for steering customers away from Maryland dealers. The Virginia dealer told the staff that people with good credit had nothing to worry about and that the new regulations seem to affect Maryland banks more than those in Virginia.

Here are some typical quotes from Washington car dealers concerning the FTC ruling. A General Motors dealer said, "No problem at all." A used car dealer pointed out, "it is easier and cheaper for you to find your own financing." A luxury car dealership, said, "It depends on your credit rating; no problem at all." An import dealer said, "It will be a while before people start changing their policies." A used care operator said, "No problem whatsoever." A Chrysler product dealer responded, "Never heard of it." An import dealer said, "It is not difficult for us to finance cars at all." A luxury car dealership said, "No problem at all." Another luxury car dealership said, "No problem" and another GMC dealership said, "I haven't noticed any change at all."

The survey of furniture dealers, for the most part, paralleled the results obtained from car dealers with the exception that not as many furniture dealers financed purchases. Of 10 furniture dealers contacted in Virginia only 4 of them financed sales through a lending institution and all 4 indicated that there was no problem with the new ruling.

One salesman admitted, however, that he had never heard of the ruling and asked to have the staff explain it to him. At the end of the explanation the salesman responded, "We've been in business a long time, and we back our merchandise. We will have no problem with the ruling."

Similar reports about a lack of problems were received from furniture stores in Maryland and the District of Columbia.

One of the most universal comments received from furniture dealers was that as long as the company sold quality merchandise it would have no problem in obtaining financing for customers.

The responses received from home improvement firms were not for the most part, identical to the responses received from auto and furniture dealers. One company representative indicated that he was thoroughly knowledgeable with the new regulation because his bank had a meeting with all of the companies that financed with the bank to explain the rule. He indicated that the bank foresaw no problem for reputable companies.

One Washington contractor was upset with the FTC's action and labeled it as ridiculous. However, he did not indicate that the ruling had caused his company any problems at this time.

Following a press release describing the results of my study, I received letters from a number of consumer affairs offices throughout the country reporting on the result of similar studies they conducted in their areas. Every one of these studies indicated that while merchants might not like the repeal of the holder in due course doctrine they were not experiencing any changes in their business operations.

I note from your witness list, Mr. Chairman, that representatives of the automobile sales industry will be appearing before the subcommittee. As I noted earlier, this industry has been one of the most vocal in pushing for a return of a traditional holder in due course philosophy.

I have long been a supporter of the automobile sales industry in general and particularly in times when the energy shortage caused great problems for many smaller dealers. Despite this support of the auto sales industry, there is one aspect of the operation that troubles me greatly, and it is something that I hope this subcommittee will deal with in its oversight functions.

There may well be some move toward exempting arms-length financial transactions or the so-called "purchase money loans" from the new FTC ruling. But, Mr. Chairman and members of the subcommittee, there is no reason why this type of transaction, which many automobile dealers engage in with various financial institutions, should be exempt. I am referring here to the practice of financial institutions providing auto dealers, and in many cases other types of businesses, with a share of the income derived from the interest on the finance contract.

Under such an arrangement an auto dealer who finances individual car sales through a particular institution will receive either a set amount for each contract or in even more horrendous cases, the financial institution will set a base charge for interest rates and will tell the dealer that any interest that can be charged the consumer above this base charge belongs to the dealer.

I am convinced that this highly questionable, though long-standing practice is one of the reasons why I see so many automobile financing contracts with interest rates of astronomical proportions. The question here is not whether or not it is legal or ethical for dealers to get a piece of the action for directing financing business to a particular institution. The question is whether or not that relationship should be rewarded by exempting those transactions from the new Federal Trade Commission protection. It has been argued that by allowing a dealer to set the interest rate that a buyer will pay, the dealer becomes an agent of the financial institution. At the very best, there is clearly no arms-length transaction. Why then should there be any consideration given to this type of arrangement?

It is my feeling that what the automobile dealers want is to be able to continue their sweetheart arrangements with the financial institutions while gaining an exemption from, or a repeal of, the FTC's ruling. The automobile dealers not only want to have their cake and eat it too, they are asking the consumers to buy the cake for them.

In closing, Mr. Chairman, let me commend you and your subcommittee for holding these hearings and also for the fact that they are oversight hearings rather than trying to rush through a hastily drafted bill. You are dealing with a highly important issue, and thoroughness, not speed; quality, not quantity, in my opinion, is what is needed in dealing with this issue.

I therefore urge you and the members of the subcommittee to give the new ruling a fair treatment here. It has been in operation only slightly more than 90 days, and I do not think that is enough time to judge the merits of the ruling. Thank you very much for allowing me to appear here this morning.

I want to thank you, again, Mr. Chairman, and the other members of the subcommittee for allowing me to appear before your distinguished committee this afternoon.

Mr. MURPHY. Thank you, Congressman Annunzio, for a very fine and strong statement. This subcommittee is known not only for the quality of its legislation, but also the attendance of the committee and not for its quantity.

Mr. ANNUNZIO. If I may reply to that, Mr. Chairman. As one of those who is consistently opposed to reform, I want to say that this afternoon I view the attendance as a direct result of the reform.

Mr. MURPHY. Congressman Annunzio, on page 3 you indicate that the American Bankers Association announced that its member banks plan to substantially increase the finance cost of new automobiles for consumers. Did the ABA make this statement in a newsletter or a publication?

Mr. ANNUNZIO. Mr. Chairman, it appeared in a newspaper clipping, "Bankers plan more car loans" in the Washington Evening Star.

Mr. McCOLLISTER. I might add, Mr. Chairman, the automobile dealers will be testifying on Tuesday, so we can hear their side of the story.

Mr. MURPHY. Did the ABA make any correlation between its member banks' plans and the abolition of the holder in due course rule?

Mr. ANNUNZIO. No.

Mr. MURPHY. The committee is interested in the results of your survey of automobile, furniture and improvement dealers. Did your subcommittee categorize the answers it received and deduce the percentages reflecting the effects of the FTC rule?

Mr. ANNUNZIO. Mr. Chairman, the reason that we could not categorize for percentages was that we found no problems when we asked the question. Everybody said, "We are having no problem with it." And that is the reason I have been urging caution, more time, so that we can get more data in order—before arriving at a conclusion.

Mr. MURPHY. Are there any minor problems that surfaced? You indicated there were not many major problems.

M. ANNUNZIO. The problem with most regulations coming out of any agency is the fact people have a difficult time understanding the regulations.

Mr. MURPHY. Mr. McCollister.

Mr. McCOLLISTER. Referring to your survey, again, on page 4 of your written statement you quote an import dealer who says, "It will be a while before people start changing their policy." Also, another used car dealer responded, "Never heard of it." I am concerned by those kind of statements. They seem to indicate to me not that the rule is having no effect out there in the marketplace, but there are an awful lot of business people who are either living in blissful ignorance or are knowingly violating the law. Do you have a comment?

Mr. ANNUNZIO. I have my staff director here. I want him to comment, but I want to also comment. When you have answers of that type coming from these dealers, it is primarily because—the ruling has been in effect for a short time.

Mr. McCOLLISTER. When did you make that survey?

Mr. ANNUNZIO. We made our survey in about July. The ruling came out in May. We went to work on it in July.

Mr. McCOLLISTER. What part of July?

Mr. ANNUNZIO. The latter part, right after the Fourth of July.

Mr. PRINS. Mr. McCollister, if I might respond to that, you have a very valid point, sir, about the lack of understanding of the ruling. But I think the sword cuts both ways here. I think there has been a lack of getting all the information out on the part of the Federal Government, but I think industry has to share some of the blame. As an example, 3 days before the ruling went into effect, I played golf with one of the largest Ford dealers in the Washington area. It had nothing to do with this. He just happened to be on the golf course that day and I asked him about what he was doing about this ruling. "How is it going to affect you?" He said, "I called Ford Motor Credit this morning because I was concerned on what was going to happen." And he said, "I was told by Ford Motor Credit, they have no idea what they are going to do. They have no contingency plans." And he said, "I was told just to sit tight."

Here is a man who finances a great many of his cars with Ford Motor Credit. He calls them, and they cannot even give him an answer as to what he should be doing.

Mr. McCOLLISTER. Do you think their answer might in part be affected by the fact the FTC 3 days before they released the rule amended the nature of it?

Mr. PRINS. I think that is a consideration, but this thing had been kicked around, as you pointed out, a number of years, and I do think they ought to have some kind of contingency plan to protect the people——

Mr. McCOLLISTER. I wonder how many such regulations from every other area of government that impact on the Ford Motor Co. have also been kicking around over the years. I suspect they, like every other organization, are pretty busy trying to find ways to live with what is adopted, let alone those that are in inventory waiting to be released.

Mr. PRINS. I think the magnitude of this, sir, in my opinion——

Mr. McCOLLISTER. You are saying there is a magnitude, considerable magnitude about this?

Mr. PRINS. I think the very fact that Mr. Murphy has called these hearings indicates the magnitude of this, sir.

Mr. McCOLLISTER. Perhaps it is not quite like the comment that the dealer said you referred to in your survey. It wouldn't have any effect at all, or whatever.

Mr. PRINS. That is their comments, not mine, sir.

Mr. McCOLLISTER. I conducted a survey, too, and it is probably just about as valid as the one you conducted. For example, I have a letter here from a banker in a town of a couple thousand on the outskirts of Omaha. It says:

> I received your letter in which you expressed a concern for the abolishment of the holder in due course document. Our bank was about to begin increasing purchasing paper from business customers. However, now because of this ruling, we will not only not increase but will decrease purchasing accounts,

And so on.

I would say that it has a very substantial effect on consumer credit. I feel certain that the situation is not unique to Nebraska.

I would ask the gentleman from Illinois if he doesn't feel that this is going to have some effect on consumer credit simply because of the restrictions of credit.

Mr. ANNUNZIO. If it does, I think your administration has plenty to worry about after listening to President Ford the other night in his acceptance speech before the convention.

Mr. McCOLLISTER. I am not sure that was responsive to my question.

As you probably know, the Wharton School of Finance recently estimated that the collective impact of the FTC rule was likely to be somewhere around $2.2 billion of goods to be removed from the credit market this year and reduce the gross national product $1 to $2 billion. The study raises then, I think, a serious policy question, that is, the FTC, in its effort to protect consumers, may have issued a rule having a significant impact on the collective good health of the country. Is this really what the FTC is qualified to——

Mr. ANNUNZIO. All that I can say to my distinguished friend from Nebraska, their study is about as valid as yours and the study I conducted. They did not have enough time to get into the indepth effect. It was like when we were holding hearings on the Equal Credit Opportunity Act. And everybody then began to cry, and the bill was signed by the President. And about about two weeks after that bill was signed by the President, there was no discrimination because of race, color creed, nationality, age and so forth, the banks were doing more business, over $3 billion, in fact. In fact, it was that particular consumer credit and consumer lending that had saved many of the large banks in this country that were in trouble.

Mr. McCOLLISTER. Mr. Chairman, I do not have any more questions for the gentleman. I want to thank him for his contributions.

Mr. ANNUNZIO. Thank you.

Mr. MURPHY. Thank you, Congressman Annunzio. We thank you for being here.

Our next witness was to be Congressman Albert Johnson, but he is unable to be here because of official business in Pennsylvania, and without objection, the Chair wishes to place in the record, as though read, the statement submitted by Congressman Albert W. Johnson of Pennsylvania as well as a statement from Congressman W. Henson Moore of Louisiana.

STATEMENT OF HON. ALBERT W. JOHNSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Mr. JOHNSON. On September 19, 1974, I voted for H.R. 7917, the House version of S. 336 which was later passed into law as the "Magnuson-Moss Warranty—Federal Trade Commission Improvement Act". (Public Law 93-637)

What we are concerned with today is a Trade Regulation Rule which has been promulgated by the Federal Trade Commission pursuant to "Magnuson-Moss" and a proposed amendment to that Trade Regulation Rule. The rule requires that a prescribed notice be included in consumer credit contracts in order to foreclose the possibility of a creditor becoming holder-in-due course or an assignee or lender not subject to consumers' claims and defenses.

I have requested this opportunity to offer brief remarks because I believe the Commission has failed to adhere to Congressional intent both as to the manner in which the Preservation of Consumers' Claims and Defenses Rule was promulgated and to the rule's unlimited application.

When I voted in favor of H.R. 7917, I took into account the report of the Committee on Interstate and Foreign Commerce as well as some of the views circulated to fellow Members by Mr. Broyhill of North Carolina. Two areas of concern to me then were the rulemaking authority to be given to the Commission and the manner in which such rules would be applied.

Gentlemen, to refresh our memories please allow me to quote two paragraphs from the House Interstate and Foreign Commerce Committee Report on H.R. 7917. These paragraphs pertain to rule applicability and the Commission's jurisdiction to prevent use of unfair methods of competition and unfair or deceptive acts or practices substantially affecting Commerce.

> The expansion of the FTC's jurisdiction made by this section 201 is not intended to occupy the field or in any way to preempt State or local agencies from carrying out consumer protection or other activities within their jurisdiction which are also within the expanded jurisdiction of the Commission.
>
> Where cases of consumer fraud of a local nature which affect commerce are being effectively dealt with by State and local government agencies, it is the Committee's intent that the Federal Trade Commission should not intrude. [H.R. Rep. No. 93-1107, 93d Cong; 2 Sess. 45 (1974)]

Last November, I was surprised to learn that apparently it is the Commission's intent in promulgating this rule to override contrary State and local law. Within days of learning this, I joined Mr. Stuckey of Georgia and 20 other colleagues in cosponsoring House Concurrent Resolution 483. This House resolution stated Congress has not delegated to the Federal Trade Commission any authority to preempt the laws of the States and their political subdivisions in respect to the subject matter of this rule.

I believe that you, the members of this subcommittee, have an excellent forum in which to ask representatives of the Commission to clarify the question of whether the rule actually does preempt effective State and local consumer protection laws. If this is the case, we have yet another example of a regulatory agency with rulemaking authority creating a plethora of paperwork and regulations contrary to Congressional intent. Furthermore, it is another example of unknown non-elected individuals in Washington promulgating regulations which supplant effective State laws.

Prior to being elected to Congress, I served 17 years in the Pennsylvania Legislature. Pennsylvania has long been concerned with consumer protection and has legislated what I believe are effective and equitable regulations.

Under Pennsylvania's Goods and Services Installment Sales Act there is a 45 day complaint period for a purchaser to give an assignee of paper notification of the existence of defenses or rights of action toward the contract. The applicable section of that act reads as follows:

> No right of action arising out of a retail installment sale which the buyer has against the seller which would be cut off by assignment, shall be cut off by assignment of the contract to any third party whether or not he acquires the contract in good faith and for value unless the assignee gives notice of the assignment to the buyer as provided in this section, and within forty-five days of the mailing of such notice receives no written notice of the facts giving rise to the claim or defense of the buyer. . . . The notice of assignment shall contain the following warnings to the buyer:
>
> You have forty-five days within which to notify us of any claims or defenses which you might have against the seller. If you have any complaints or objections to make, you should notify us at this time. [1966, Special Sess. No. 1, Oct. 28, P.L. 55, Art. IV, § 402]

Under the Pennsylvania Home Impprovement Finance Act, the purchaser has a time frame of 15 days to give written notice of the existence of rights of action or defenses to an assignee of paper. (Aug. 14, 1963, Public Law 1082, Art II, § 208).

These laws after due consideration of relevant factors were enacted by the Pennsylvania legislature to provide Pennsylvanians ample opportunity to assert claims and defenses without disrupting the local consumer credit market. It is my understanding that although these laws have effectively achieved their desired results, the Commission's rule will preempt them. I submit when it comes to consumer protection procedures, elected representatives at the State level know consumer markets the best and can deal more effectively with local deceptive or unfair practices.

The second phase of my remarks today will address circumstances or events stressing that the rule may have a considerable impact upon segments of our economy. There is no question the rule as presently drafted will have a pervasive effect upon all participants in the consumer credit community of these United States. Adverse ramifications may abound for marginal and low-income consumers due to the fact that the financial institutions of this Nation may be exposed to inequitable and innumerable legal actions. These institutions may as a result refrain from extending credit. I am concerned about these consumers who frequently depend upon credit for purchasing appliances, automobiles, mobile homes or other necessities of life.

The ramifications of this rule should not be minimized. As you are aware, section 18(f) of the Magnuson-Moss Act requires the Board of Governors of the Federal Reserve System to promulgate substantially similar regulations proscribing acts or practices of banks substantially similar to acts or practices proscribed by any substantive trade regulation rule issued by the Commission within 60 days after the effective date of the Commission's rule. The Board does not have to issue such regulations if it finds that (i) such acts or practices of banks are not unfair or deceptive to consumers, or (ii) implementation of such regulations would seriously conflict with essential monetary and payment systems policies of the Board. Compliance with the regulations proscribed by the Board are enforced with respect to financial institutions over which they have regulatory authority by; the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation.

As I recall, at one point in debate of the House version of S. 356 there appeared some discussion as to the fact that banks as well as finance companies, retailers, consumer finance companies, and nonbank credit card companies should fall within the purview of the Commission. However, I believe the full House Committee on Interstate and Foreign Commerce voted unanimously for banks to be regulated as to unfair and deceptive practices by the banking agencies alone.

In view of its statutory obligation and the Commission's proposed amendment addressing creditors the Board of Governors of the Federal Reserve System issued a release on February 3, 1976, requesting comment at that time on the Preservation of Consumers' Claims and Defenses Rule. Based upon the comment letters received pursuant to that request, Chairman Burns of the Federal Reserve Board communicated by letter (May 5, 1976) with Chairman Collier of the Commission urging that the effective date (May 14, 1976) of the rule as adopted for sellers be deferred until the rule could be clarified and refined. Irrespective of this urgent plea the Commission failed to postpone the effective date.

In his statement before the full Committee on Banking, Currency and Housing on July 27, 1976, Dr. Burns in referring to this rule expressed concern:

> It may well be reducing somewhat the availability of credit to consumers and some retailers at the very time when a continued strong rise of consumer spending is needed to foster further gains in production and employment.

On August 3, 1976, as the ranking minority member of the full committee, I wrote to Dr. Burns voicing my concern and requesting him to amplify by letter why the Federal Reserve Board believes consumer credit may well decrease due to the Commission's "holder-in-due course" ruling. Dr. Burns responded by letter and amplified his remarks by stating:

> Data are not yet available to assess the impact of the rule on the economy. It seems clear, however, that the risks of seller nonperformance would tend to be shifted from buyer to creditor. Such an increased burden of risk would be transmitted in large part to consumers—through a higher price of credit, or through reduced credit availability or both. My concern is that the uncertain, but potentially broad, scope of the rule may disrupt the operations of some merchants and creditors beyond the extent appropriate to control the activities of unscrupulous merchants. These undesirable effects, in turn, could limit the recovery in consumer spending, and thus put a damper on over-all economic expansion.

We are all aware how controversial this rule has become, both as to the manner in which it was promulgated and the possible adverse effect it may have upon our Nation's consumer credit community. If the Commission had promulgated this rule with Congressional intent in mind and had followed the rulemaking procedures as outlined in section 18 of Magnuson-Moss we would not have to be at this hearing. Let me restate that I am an advocate of proper consumer protection laws and procedures. That is why I originally voted in favor of H.R. 7917. However, in this instance we find an independent regulatory agency of the Executive Branch turning its back on Congress and on many of the citizens of this great Nation. As elected representatives of the citizens of these United States we should view this action by the Commission with the utmost caution.

I believe Congress should rigorously examine in detail not only the Commission's action, but the rule's possible effect upon our Nation's economy. For this reason, I have joined Mr. Broyhill of North Carolina and Mr. McCollister of Nebraska in cosponsoring H.R. 15082. Since Mr. Broyhill is the second ranking minority member of the full Committee on Interstate and Foreign Commerce and Mr. McCollister is the ranking minority member of this subcommittee, I will defer to them any detailed explanation of this bill.

Briefly, H.R. 15082 will suspend, pending review, the effect of the Commission rule. The General Accounting Office is directed to examine the Commission's basis for issuing the rule, the effect of the rule on consumer credit markets and present avenues of consumer redress for grievances arising from consumer sales. GAO will then submit its written report to Congress and the Commission as to its findings and recommendations on the desirability of promulgating the rule. Having considered the report and followed appropriate rulemaking procedures, the Commission may repeal the rule or give it effect either in its present form or as amended.

Gentlemen, H.R. 15082 provides the "prudent gradualism" needed at this time. Mr. Chairman, I request that my extension of remarks of August 10, 1976, which appeared in the Congressional Record be included in the official record of these hearings. Thank you.

[The remarks referred to follow:]

[From August 10, 1976, Congressional Record]

STATEMENT OF HON. ALBERT W. JOHNSON OF PENNSYLVANIA

Mr. JOHNSON of Pennsylvania. Mr. Speaker, I am proud to cosponsor with the gentleman from North Carolina (Mr. Broyhill) the bill, H.R. 15082. This bill if enacted would suspend, pending review, the effect of the Federal Trade Commission's rule concerning limitation of the use of holder-in-due-course defenses in connection with the sale or lease of goods or services to consumers; would require the General Accounting Office to conduct a study of the effect of this rule on the consumer market; and would require formal rulemaking by the Commission respecting this rule.

My concern in respect to the Federal Trade Commission's Trade Regulation Rule on Preservation of Consumers' Claims and Defenses has long been of record. On November 18, 1975, I joined 21 of my colleagues in cosponsoring House Concurrent Resolution 483. This House resolution stated that Congress has not delegated to the Federal Trade Commission any authority to preempt the laws of the States and their political subdivisions in respect to the subject matter of this rule. This assertion is based upon the fact that the report of the House Committee on Interstate and Foreign Commerce—House Report 93-1107—on the Magnuson-Moss warranty-Federal Trade Commission Improvement Act stated that the amendments to the Federal Trade Commission Act made by title II of that act were not intended to preempt State and local jurisdiction. However, when the Federal Trade Commission issued this holder-in-due-course rule, the following statement was made "it is the Commission's intent in issuing this proposed rule to override contrary State and local law."

My principal concern over what the Federal Trade Commission has done is twofold. First, the Commission by rule has attempted to preempt numerous State laws which adequately protect the consumer and by such action has promulgated a rule contrary to the intent of Congress.

Second, the Commission has issued a rule whose terms in some instances are so loosely defined as to raise serious questions due to this ambiguity. One such term which comes to mind is that of a "purchase money loan."

This rule as presently drafted will have a pervasive effect upon all participants in the consumer credit community of these United States. Adverse ramifications may abound for marginal and low-income consumers due to the fact that the financial institutions of this Nation may be exposed to inequitable and innumerable legal actions. I am concerned about these consumers who principally seek credit in order to purchase an appliance, automobile, mobile home or recreational vehicle.

The Federal Reserve Board has received approximately 1,140 letters stating that this holder-in-due-course rule may have a disruptive effect upon the Nation's economy. On May 5, 1976, Chairman Arthur Burns of the Federal Reserve Board wrote Chairman Calvin Collier of the Federal Trade Commission conveying the Board's urgent concern in respect to this rule, urging that the effective date be deferred, and requesting the Commission to clarify and refine the rule. This appeal fell upon deaf ears and the rule pertaining to sellers went into effect May 14, 1976. On July 27, 1976, Chairman Burns stated before the Committee on Banking, Currency and Housing that this rule "seems to have come at an unpropitious moment" and may reduce consumer credit. On August 3, 1976, as the ranking minority member, I wrote Chairman Burns voicing my concern and requesting him to amplify by letter why the Federal Reserve Board is of the opinion that consumer credit may well decrease due to the Federal Trade Commission's "holder-in-due-course" ruling.

My colleagues, I urge each of you to review this rule which appears in the Federal Register, volume 40, number 223 at page 53506. After review I believe you will concur that this rule needs to be suspended, and that thorough study be conducted as to the effect this rule may have upon our Nation's consumer credit community.

STATEMENT OF HON. W. HENSON MOORE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. MOORE. Mr. Chairman, widespread objections to the May 14, 1976, holder in due course rule promulgated by the Federal Trade Commission merit immediate withdrawal of the rule together with preparation of accurate information on its impact on the availability of credit. I have cosponsored a bill (H.R. 14531) to this end. The Federal Trade Commission contends the availability of credit has not diminished while the Chairman of the Federal Reserve System, national retail trade associations, lending institutions, and many of my constituents who work with holder in due course on a day-to-day basis vigorously dissent.

Two conflicting private studies reveal an absence of substantive and uncontested data from which the May 14 decision should be objectively analysed. Such abundant disagreement between two Federal regulatory powers and inconsistency in testimony presented to this subcommittee leads me to urge the Interstate and Foreign Commerce Committee and Congress to force at least a suspension of the May 14 rule until all facts on its impact are known. Beyond this controversy, I believe the failure of the Federal Trade Commission to publish its

ground rules until May 4, just 10 days before the rule became effective, is inadequate warning for the business community.

The Federal Trade Commission points to 5 years of preparation, three separate sets of public hearings, and some 10,000 pages of transcript in justifying its holder in due course rule. At the same time, testimony given by the Commission on August 26 stated creditors and retailers failed to register their objections to the text of the rule until just before the May 14 deadline. The Commission further contended it was unaware of any problems the retail marketplace would have with the rule.

Mr. Chairman, according to my own records any claim by the Federal Trade Commission pleading ignorance to objections from retailers simply does not wash. I personally forwarded more than 20 written objections from my constituents to the Federal Trade Commission since November 25 of last year. In reply, the Commission informed me in writing it had received these objections and that questions raised would be answered well in advance of May 14. In addition, the Federal Reserve System announced on May 5 that it had received 1,080 letters commenting on the proposal with only 8 in favor of it. Such information had been passed along to the Federal Trade Commission in informal proceedings. In my opinion, the Federal Trade Commission cannot justify its delay in responding to questions raised months earlier only 10 days before the rule took effect.

The Chairman of the Federal Reserve System, Arthur Burns, has expressed his objections to the Federal Trade Commission on at least two occasions. On June 29, he was critical of the "potentially harmful effect which it could have on the flow of consumer credit, the viability of marginal retail firms, and more broadly, the upward thrust of retail trade." On August 26, the Federal Reserve System reported its fears were well founded. It discovered increased policing action by lenders over retailers have ended longstanding business or referral relationships with some retailers being forced to seek less preferred sources of finance at a higher cost to the consumer.

Marginal firms and many new firms are expected to be forced out of business due to the lack of credit availability, according to the Federal Reserve System. Consumers will also find little comfort in the report that some lenders have either cut their loan maturities or have put pressure on retailers to shorten product or service warranty periods. It concluded that competition has declined in product and credit markets with credit being more difficult to obtain at a reasonable cost. These deficiencies were found to far outweigh the anticipated benefit the consumer would receive.

Vast disagreement in the findings of two private studies on the availability of credit also justify immediate retraction of the rule. A survey recently completed for the Commission by the Yankelovich, Skelly and White firm lead the Commission to conclude "the rule has not had a significant dislocative impact on the consumer credit market." This is in sharp contrast to an assessment prepared by the Wharton School of Finance. It found the adverse impact of the regulation would be so severe that some $2.2 billion in goods would be removed from the credit market this year and our gross national product would decline by $1 to $2 billion. In my opinion, any regulatory action taken in the presence of such conflicting findings is premature.

Other uncertainties in the rule include the question of preemption of State holder in due course laws, a point of interest to my constituents as well as the Federal Reserve System. Legislation enacted by State governments to apply to unique local credit relationships should not be swept aside by appointed Federal regulators. Questions concerning application of the rule to charge accounts the consumer may have with the retailer, open lines of credit, and what happens if only part of a loan is applied to a purchase remain unanswered. Application of the Magnuson-Moss Act to an amendment to the rule but not to the rule itself has also generated questions of fairness.

Mr. Chairman, for all of these reasons, a lot of homework should have been done before the Federal Trade Commission unveiled its holder in due course rule. As it was not completed, I believe sufficient evidence exists to revoke or at least suspend the May 14 decision until questions raised by all sides are answered and hard and fast facts on the availability of credit are compiled. I strongly believe that this rule is not in the best interests of consumers or commerce.

Mr. MURPHY. Our next witness is Mrs. Margery Waxman Smith, Acting Director, Bureau of Consumer Protection of the Federal Trade Commission accompanied by James V. DeLong, Assistant Director for Special Projects, the Federal Trade Commission and Mr. Erik Rubin. Your position?

Mr. RUBIN. Assistant Director of the Bureau of the Consumer Protection.

STATEMENT OF MARGERY WAXMAN SMITH, ACTING DIRECTOR, BUREAU OF CONSUMER PROTECTION, FEDERAL TRADE COMMISSION, ACCOMPANIED BY JAMES V. DeLONG, ASSISTANT DIRECTOR, SPECIAL PROJECTS, AND ERIK RUBIN, ASSISTANT DIRECTOR, BUREAU OF CONSUMER PROTECTION

Mrs. SMITH. Good afternoon. Thank you, Mr. Chairman.

Mr. MURPHY. Mrs. Smith.

Mrs. SMITH. We appear today on behalf of the Commission to discuss the Federal Trade Commission's holder in due course rule. I have a shorter version of my statement which I would like to give orally although you have a more lengthy written version.

Mr. MURPHY. It is a pretty good version. Without objection, the entire Federal Trade Commission statement will be printed in the record, and you may proceed, but I would ask that you not cut important portions of the testimony.

Mrs. SMITH. As of May 14, 1976, the "holder in due course" trade regulation rule requires a seller who executes an installment sales agreement, or arranges loans for his buyers, to insure that the consumer credit contract contains a specific provision preserving the legal rights that are part of any normal bargain between buyer and seller.

This rule has a 5½-year history. It was first proposed on January 21, 1971. After an extensive period of initial comment and written submissions, three public hearings were conducted in Chicago, New York, and here in Washington. Based on the information presented during the comment period and the testimony offered in those hearings, the rule was revised and republished on January 5, 1973.

Further hearings were conducted in Chicago and in Washington. The public record was finally closed to written comments on June 11, 1973.

During the course of this lengthy public proceeding, every organization and individual who expressed an interest in testifying was given the opportunity to do so. The list of participants was extensive. A total of over 2,000 pages of transcript and over 7,000 pages of written submissions were received. These comments were received from all people interested in the rule, from retailers, financial institutions, trade associations, legal services attorneys, State and Federal law enforcement officials, judges, economists, academics, experts, consumers and consumer representatives.

Although the record closed in June 1973, the Commission did not publish its final rule until November of 1975. This was because of uncertainty over the Commission's rulemaking authority resulting from the National Petroleum Refiners litigation. This uncertainty was not removed until the court of appeals acted. The rule was finally adopted by unanimous Commission decision on November 11, 1975. Industry was given 6 months lead time in which to prepare compliance with the rule which took effect on May 14, 1976.

The Commission's holder in due course rule was one of three rules that was substantially completed when Congress passed the Magnuson-Moss Federal Trade Commission Improvement Act of 1975 and Congress explicitly provided that the new procedural requirements of the Magnuson-Moss Act were not applicable to such rules. Nevertheless, the proceedings that the Commission conducted in the holder in due course rule met the Magnuson-Moss procedural requirements. These proceedings were not simple notice and comment rule making but public hearings eliciting testimony on all sides of the question. All participants had the opportunity to give questions to witnesses and significant revisions of the rule were published for further hearings. Finally, as I said before, all available scholarly sources in law and economics were considered including the massive study of the National Commission on Consumer Finance.

The Commission throughout these proceedings listened carefully to what interested parties had to say and revised and improved the rule in accordance with the facts that emerged in the public proceedings. Therefore, while the rule was conducted prior to enactment of the Magnuson-Moss Act, all the major procedural rights ultimately required by that act were provided.

The fundamental principle embodied in this rule is simple and straightforward. It is that consumers who purchase goods or services on credit should not forfeit their legal rights merely because the seller assigns the note to a third party or find a lender who will work with him to finance retail purchases.

While the required contractual notice is phrased in technical language, the Commission's basic conclusion is plain. As the Commission said, it is unfair and deceptive for a seller to just contractual boiler plate to separate a buyer's duty to pay from a seller's duty to perform.

The public record leading to the rule document's countless varieties of retail transactions where seller's continually deprive consumers of any effective rates through use of negotiable instruments, whatever defense clauses or arranged loans. These devices were used to cut off buyer's remedies to sellers and force full payment to creditors regardless of whether the seller met or failed to meet his obligations.

In those cases in which the seller performed fully, the consumer lost nothing by these devices. In many other instances, however, consumer losses were serious. The record is full of situations where sellers took advantage of their ability to cut off consumer claims and defenses to profit from misrepresentation and fraud. To take a well known example, the committee may remember the *Monarch Construction* case in Washington during the 1960's.

Urban renewal was destroying whole streets of deteriorating rowhouses and homeowners were afraid the bulldozer would arrive at their house next. An organization was formed to sell what was called townhouse fronts to intercity residents. These townhouse fronts were aluminum appendages which appeared to improve the exterior of the house. Many were sold to lower income families of massive markups. Promisory notes were taken together with first, second and third deeds of trust. In most cases, the work was never performed. The deed instruments were sold to financial institutions in Washington and Philadelphia and the inventor of the scheme left town, leaving behind hundreds of families faced with foreclosure. Although he was ultimately convicted of fraud, the home owners could do nothing, could not use fraud as a defense to payment and their attempts to procede against this man were useless as he no longer had any assets.

The Commission's holder in due course rule should prevent this consumer nightmare from ever happening again. The purpose of the rule is to recognize the realities of the situation where consumers who are victimized by seller misconduct are compelled to pay third party creditors although consumers are not in a position to obtain redress for their injuries.

The mechanism of the rule is straightforward. Sellers as of May 14, 1976, have two duties. First, where they execute consumer credit contract with the buyer, they must insert within the written text of the form used a provision which expressly prevents the cutoff of buyer's legal rights. Second, where a seller works with the lender in connection with consumer sales, the seller may not accept the proceeds of purchase money loan unless the loan contract signed by the buyer contains a similar provision, generally preserving the buyer's legal rights.

The rule, as it now stands, applies only to sellers. It does not impose any duties directly on creditors. The Commission's proposed amendment, which was announced at the same time that the rule was announced in November 1975, would apply the rule to creditors. But the Commission recognizes that the situation between creditors and sellers may not be identical and that many issues must be analyzed before a final decision is made in applying the rule to creditors.

The required contract provisions simply preserves against the creditor any legal claims and defenses the consumer would have against the seller under applicable State law. It does not extend its claims or defenses in any other way since the object is to preserve existing substantive rights not to create new ones. Thus, contrary to some unfortunate news stories, the rule does not create any new right to withhold payment. A consumer who wrongfully refuses to pay does so at the same peril he faced before; no more, no less.

If the consumer has a warranty claim worth $60 based on cost of repair, and the State law only gives him a right of setoff up to this amount, he has only this right of setoff against the creditor. Nor does the rule extend rights in time. A 3-year warranty still terminates after 3 years. Autos are often sold with a 12-month warranty. After 1 year, any creditor holding a 36-month auto contract is no longer exposed to warranty claims and defenses. Consequently, we expect that under the rule, absent serious wrong doings by sellers, the creditor's exposure should be small.

In addition, creditors can protect themselves from the risk involved. Indeed, their ability to do so is an important consideration underlying the rule. Sellers and creditors have already devised numerous mechanisms, such as recourse and reserve arrangements to apportion the risk to consumer finance and these are readily adaptable to this new situation.

These are practical considerations with components of the approach taken by the rule. The market objective is to shift the cost of the seller misconduct in certain defined situations from consumers to those who regularly deal with sellers and who can, in turn, shift the risk back to sellers. Incentives are created to avoid problems and to resolve them chiefly where they occur. Naturally the circumstances differ where fradulent and unethical sellers are concerned. Creditors will have an incentive to avoid transactions where there is a high risk of major legitimate claims and defenses. As a result, we expect that certain sellers will find it difficult to do business to the advantage, I might add, of the vast majority of sellers who are honest and respectable.

We readily acknowledge that since the rule's promulgation, several areas of uncertainty have been brought to the attention of the Commission. We have tried, and I believe we have succeeded, to answer questions as they have arisen in an expedicious and forthright manner. The bureau staff has issued guidelines on some issues, and the Commission itself has promulgated an enforcement policy statement clarifying some of the most important issues, particularly those concerning purchase money loans. The Commission has also responded to requests for immediate advisory opinions when asked to do so.

In conclusion, I want to emphasize that the Commission does not believe its responsibility ends with the promulgation and enforcement of a rule such as this one. It has a continuing duty to monitor the responses to the rule. It must evaluate its impact, whether positive or negative, and respond rapidly to any problems that arise. The staff of the Federal Trade Commission is in close contact with other interested government agencies and with different parts of the private sector to obtain feedback on the operation of the rule as it operates in practice, not as it operates in theory.

Moreover, in order to fully assess the impact of the holder in due course rule, the Commission staff has undertaken a two part evaluative study, first, to identify any immediate problems that credit institutions are experiencing, and, second, to monitor on a longer term basis, the impact the rule may have on availability and price of consumer credit.

The first part of the study was conducted for us by the independent survey firm of Yankelovich, Skelly and White and their report which we just received this week was made available to the committee. The firm interviewed 120 lending institutions in four States—California, New York, Texas and West Virginia—using a questionnaire developed by them with extensive assistance from our staff. There are two major caveats to be considered in considering the results of this study. First, businesses are still in the process of adapting to the rule and the sample size and nature of the survey are such that the results are qualitative, not quantitative. This means they cannot be reliably extrapolated to the country as a whole. Despite these caveats, we believe the survey is by far the best available evidence of the immediate impact of the rule. Its conclusions are generally supportive of the proposition that the rule has not had a significant dislocative impact on the consumer credit market.

The survey is directed to the actual impact the rule has had. The questions that were asked were questions as to what the credit institutions are actually doing to protect themselves and to take care of the rule.

To date, credit institutions have replied that elimination of the holder in due course provision has had little impact on their consumer credit policies, practices and activities. Virtually no lending institutions have changed their interest rates on direct loans. Of those lender institutions which purchase dealer paper, almost all have set up recourse or indemnification agreements or stopped purchasing paper from a small number of dealers. These small number of dealers, the credit institutions have told us, are those they would describe as shady or fly-by-night operations.

In addition, the number of claims and defenses which consumers can exercise has not increased from levels existing prior to deduction of the rule. The survey has also showed problems in lender perceptions and attitudes to the rule. Particularly that many lending institutions perceive the rule as vague and are uncertain about the meaning of specific provisions. Much of lender concern about the rule stems from these confusions. We are very concerned about this and are taking efforts to get the rule and our interpretation of the rule out to all interested institutions.

Although the survey gives only a preliminary sketch of the impact of the rule, its conclusions indicate that the rule is not having an immediate impact in terms of raising the cost of consumer credit or restricting availability of consumer credit.

We intend as second part of the study a broader approach that will include those areas of confusion and individuals and groups that need more specific attention. The second part of the study will include dealers and consumer groups as well as credit institutions.

In summary, we believe that this rule defines a standard of conduct that is necessary and appropriate to protect consumers. It is not detailed or lengthy measure but a short and specific approach to a real and documented problem. Our goal was simplistic; an ease of compliance and the protection of consumers with the minimum possible disruption to the marketplace. We believe the Commission's holder in due course rule will accomplish this goal.

Thank you.

[Testimony resumes on p. 26.]

[Mrs. Smith's prepared statement follows:]

STATEMENT OF MARGERY WAXMAN SMITH, ACTING DIRECTOR, BUREAU OF CONSUMER PROTECTION, FEDERAL TRADE COMMISSION

Good morning. My name is Margery Smith. I am Acting Director of the Bureau of Consumer Protection at the Federal Trade Commission. I am accompanied this morning by James DeLong and Eric Rubin of the Commission staff.

We appear today to discuss the Federal Trade Commission's important new "Holder in Due Course" Rule. As of May 14, 1976, this trade regulation rule requires a seller who executes an installment sales agreement, or arranges loans for his buyers, to ensure that the consumer credit contract contains a specific provision preserving the legal rights that are part of any normal bargain between buyer and seller.

The rule was first proposed on January 21, 1971. After an extensive period of initial comment and written submissions, three public hearings were conducted—in Chicago, New York and here in Washington, D.C. Based on the information presented during the comment period and the testimony offered in those hearings, the Rule was revised and re-published on January 5, 1973. Further hearings were conducted in Chicago and Washington. The public record was finally closed to written submissions on June 11, 1973.

During the course of two and one-half years of public proceedings, every organization and individual who expressed a desire to testify was given the opportunity to do so. The list of participants was extensive. A total of 2,250 pages of transcript and 7,362 pages of written submissions were received from retail sellers, financial institutions, trade associations, legal services attorneys, state and federal law enforcement officials, judges, economists, academicians, experts, consumers, and consumer representatives. No individual or organization was foreclosed from participation in these proceedings. As a result, many different backgrounds, interests and points of view are reflected in the public record.

The record closed in June, 1973, but the Commission was not then in a position to move forward on the rule because of uncertainty over its rulemaking authority stemming from the National Petroleum Refiners litigation. That uncertainty was removed by enactment of the Federal Trade Commission Improvement Act in January, 1975. The rule was finally adopted by a unanimous Commission on November 14, 1975. Industry was given six months lead time to prepare for compliance with the rule, which took effect May 14, 1976.

This Rule was one of two[1] that were substantially completed when the Improvement Act was adopted. This law explicitly provided that its new procedural requirements were not applicable to such rules. Nonetheless, interested parties had more than five years notice of proposed Commission action in this area, together with a full opportunity to take advantage of a two and one-half year public proceeding. The proceeding was not simple notice-and-comment rulemaking. Five public hearings elicited testimony on all sides of the major questions. Witnesses were examined by the staff to assure disclosure of material information. All participants had the opportunity to question witnesses by submitting their questions to the presiding official. Significant revisions of the rule were published for further hearings. Finally, all available scholarly sources in law and economics were considered during the decisionmaking process, including the massive study by the National Commission on Consumer Finance. The Commission thus listened carefully to what interested parties had to say, and revised and improved the rule in accordance with the facts which emerged in public proceeding. While the proceeding was conducted prior to enactment of the Federal Trade Commission Improvement Act, all the major procedural protections ultimately required by that Act were provided.

The fundamental principle embodied in this Rule is simple and straightforward. It is that consumers who purchase goods or services on credit should not forfeit their legal rights merely because the seller assigns the note to a third party or finds a lender who will work with him to finance retail purchases. While the required contractual notice is phrased in technical legal language, the Commission's basic conclusion is plain. It said: "It is unfair and deceptive for a seller to use contractual boilerplate to separate a buyer's duty to perform his obligations from seller's duty to perform his own."

Part of the reasoning behind this conclusion is equity. As a matter of equity, protection of the consumer's legitimate expectation in the seller's performance

[1] The other is the proposed rule on franchising.

is important. In theory, of course, a consumer always has the right to sue a nonperforming seller. In reality, the costs of litigation are high enough so that removal of the consumer's right to withhold all or part of his own performance is tantamount to a removal of all rights. The record documents endless varieties of retail transactions where sellers routinely deprive consumers of any effective rights through the use of negotiable instruments, waiver-of-defense clauses, or arranged loans. If any of these devices is used a creditor who finances the consumer transaction enjoys legal rights which are superior to those of the seller. He is entitled to payment in full whatever the seller may do or fail to do with respect to his obligations.

In most cases, the consumer loses nothing by this because the seller performs fully. In other instances, the consumer's loss is limited, though annoying. He may have to pay extra repair bills or simply settle for an unsatisfactory product. In many cases, however, the losses are serious. The record is full of situations where sellers have taken advantage of their ability to cut off consumers' claims and defenses to profit from misrepresentation and fraud. Abuses were documented wherever sellers relied on installment credit to make sales. This was true in home improvement contracting, auto sales, vocational education, furniture and appliance transactions, freezer food plans, swimming pool installations, health spa and recreational programs such as health spa memberships . . . the list is endless.

To take a well-known example, the Committee may remember the *Monarch Construction* case in Washington during the 1960's. Urban renewal was razing whole streets of deteriorating row housing. Home owners were afraid that the bulldozers would arrive at their door next.

An individual formed an organization to sell "townehouse fronts" to inner-city residents. A towne-house front was an aluminum appendage affixed to the exterior of a home to improve its appearance. Many were sold to lower-income families at massive markups. Promissory notes were taken together with first, second, and third deeds of trust. The sales pitch was "make your home look better to passers-by or face the bulldozer."

In most cases the work contracted for was never completed. The instruments were sold to financial institutions in Washington and in Philadelphia. The inventor of the scheme ultimately left town, leaving behind him hundreds of families faced with foreclosure. Although he was ultimately convicted for fraud, the homeowners could not use the fraud as a defense to payment.

Sometimes regulatory agencies face conflicts between equity and economic efficiency. This is not true for the Holder-in-Due Course Rule, though, because the rule is also solidly based in economic considerations. An efficient free market requires that the costs and risks associated with an activity be internalized. In other words, a seller should bear the costs and risks of his own misconduct. Only if this is true will the market operate efficiently to reward those sellers who perform well and penalize those who do not.

The real issue is the mechanism by which these costs and risks are imposed on the seller. In theory, if a buyer knows that a seller is cutting off the buyer's claims and defenses, he will factor the added risk into his purchase decision and be willing to pay more or less depending on his appraisal of the seller. The holder of the credit obligation would not be concerned with the seller's conduct and would not have to make any estimate of the risks involved.

In times past, when sellers were fewer and consumer credit was less pervasive, it may have been reasonable to conclude that consumers could assess the risks of seller nonperformance more efficiently than a note purchaser. Under these conditions, a rule of law favoring holders-in-due course may have promoted economic efficiencies. But in today's complex credit-oriented economy of mass production and distribution, where buyers and sellers transact impersonally for standardized products, it may no longer be most efficient to place all the risks of seller nonperformance on the buyer. This is particularly true where the creditor has frequent dealings with the seller though common ownership, affiliation or a regular course of dealing. The Commission's rule, in short, carefully shifts some of these risks from consumers to those who have a better and more efficient means of assessing them, pricing them, and shifting them back to the seller.

The purpose of the rule is to recognize these realities. Consumers who are victimized by seller misconduct and compelled to pay a third-party creditor are not in a position to obtain redress for their injuries, thus shifting the costs back to the seller. The reasons for this situation are many. They revolve around the costs of taking time off from work, finding legal representation in a context which the

law would generally classify as a small claim, undertaking the costs of litigation, and meeting a rigid payments schedule whatever the ultimate result of such efforts may be.

Creditors, in those situations to which the rule applies, are in a position to shift the risk back where it belongs, either directly or through the price mechanism. They deal in volume while consumers deal once. Creditors enjoy ready access to commercial information which consumers cannot obtain. They have the leverage to return risks to the sellers they finance. They can spread information costs over many transactions. All together their comparative advantage here is incalculable.

The mechanism of the rule is straightforward. Sellers, as of May 14, 1976, have two duties. First, where they execute a consumer credit contract with a buyer they must insert, within the written text of the form used, a provision which expressly preserves the buyer's legal rights. Second, where a seller works with a lender in connection with consumer sales, the seller may not accept the proceeds of a purchase money loan unless the loan contract signed by the buyer contains a similar provision, again preserving the buyer's legal rights.[2]

The required contract provision simply preserves against the creditor any legal claims and defenses the consumer would have against the seller under applicable state law. It does not extend these claims or defenses in any other way, since the objective was to preserve existing substantive rights, not to create new ones. Thus, contrary to some unfortunate news stories, the rule does not create any new right to withhold payment. A consumer who wrongfully refuses to pay does so at the same peril he faced before—no more, no less. If a consumer has a warranty claim worth $60 based on the cost of repair, and state law gives him only a right of set-off up to this amount, he has only the right of set-off against the creditor.

Nor does the Rule extend rights in time. A three year warranty terminates after three years. Autos, for example, are often sold with a twelve-month warranty. After one year, any creditor holding a 36-month auto contract is no longer exposed to warranty claims and defenses.

The consumer, in all cases, is limited to the exact amount of legal damages. Only when a consumer's legal damages exceed the amounts he still owes a creditor under the contract will the consumer be in a position to seek a return of all or part of the monies he has already paid. If the state law would entitle a consumer to recission and restitution, for example in cases of nondelivery or fraud, this right could be asserted against the creditor also.

The consumers' rights are also subject to "legal" time limits in the jurisdiction. In addition to contractual time limits on things like the length of warranties, actions such as breach of contract, misrepresentation, and fraud are subject to statutes of limitations in every state. Equitable principles such as laches and estoppel also protect sellers, and hence creditors, from untimely and unreasonable claims.

The required provision does contain one express cautionary limitation on a creditor's exposure. The consumer may never recover consequential damages under the provision which exceed the amount of the credit contract.

To summarize the pratical effect of these considerations, in the absence of serious wrongdoing on the part of a merchant consumer claims and defenses will generally be a function of seller breach of warranty. The creditor will face liability where a seller refuses to honor his warranty. Warranty claims, which normally amount to the cost of a repair or adjustment, will almost never affect the major portion of an installment sales agreement. Reputable merchants honor their warranties, and they do not disappear from the market or enter bankruptcy court with no warning. In addition, most limited warranties will not last for the life of a related consumer credit. Absent serious wrongdoing, the creditor's exposure is small.

In addition, creditors can protect themselves from the risks involved. Indeed, their ability to do so is an important consideration underlying the Rule. Sellers and creditors have already devised numerous mechanisms, such as recourse and reserve arrangements, to apportion the risks of consumer finance, and these are readily adaptable to the new situation. Few sellers should be reluctant to indemnify the creditor who takes their paper against their own breaches of their

[2] The rule, as it now stands, applies only to sellers. It does not impose any duties directly on creditors. The Commission has proposed an amendment which would apply the rule to creditors, but it recognizes that the situations are not identical and that many issues must be analyzed before a decision on any such extension is made.

own sales agreements. The risk involved here is far smaller than the more general risk of consumer nonpayment. The liability created by the rule does not justify any creditor requiring more of a seller with whom he deals than an undertaking to hold the creditor harmless where there is a breach of a sales agreement.

Finally, even where the use of a formal agreement indemnifying a creditor against seller misconduct in consumer transactions is impractical, other indemnification routes are available. Creditors can ask a seller to sign a simple letter of intent with respect to seller breaches of sales agreements. They can rely on their common law right of subrogation to compensate them for an adjustment to a consumer's account where no arrangement is made with the seller in advance, or they can ask a consumer to assign a claim or a defense in return for an adjustment in the amount owed.

Nor is there any reason why the rule would increase litigation in consumer transactions. Where a creditor had a holder-in-due course defense against a consumer's claim, he always had an incentive to litigate and see if the defense was unheld on the facts. Under the rule, all parties—creditor, seller, consumer—share an incentive to resolve problems quickly and cheaply. This should rarely require the services of an attorney. An experienced loan officer, intimately acquainted with a particular consumer market and with practical understanding of the common terms of sales transactions, should be in an excellent position to determine whether or not a consumer claimant has any basis for his assertions. If there is breach of warranty, informal contact with the seller and the consumer should effectively resolve the problem.

These practical considerations are components of the approach taken by the Rule. The market objective is to shift the costs of seller misconduct in certain defined situations from consumers to those who regularly deal with sellers, who can in turn shift them back to the sellers. Incentives are created to avoid problems and resolve them cheaply when they occur.

Naturally, the circumstances differ where fraudulent and unethical sellers are concerned. Creditors will have an incentive to avoid transactions where there is a high risk of major, legitimate claims and defenses. As a result, certain sellers will find it hard to do business, to the advantage, I might add, of that vast majority of sellers who are honest and reputable. Before proceeding to a discussion of our efforts to evaluate and monitor the impact of the rule, let me touch upon one area which has caused some concern, the application of the rule to certain direct loan transactions. After the rule was first proposed, and in the course of the initial round of three public hearings, state law enforcement officials and others offered the Commission substantial evidence that where individual states had eliminated holder-in-due course, sellers had modified their procedures to achieve the same ends by arranging direct loans. In many cases, the very same creditors who had purchased paper from these sellers simply transferred their discount business to the loan booth.

As we studied the problem, we learned of an endless variety of formal and informal arrangements between sellers and lenders which were functionally no different from the conventional, indirect financing upon which sellers have historically relied. Sellers were furnished with loan applications by nearby loan outlets. They were invited to arrange loans by telephone, or to escort buyers to a loan office and stand by to receive the proceeds check. In some cases agreements were formal and in writing. In others sellers and creditors simply shared an understanding or a course of dealing with no formal agreement. The impact of these practices on consumers and on the market was identical to that found where credit instruments are assigned to the creditors.

Accordingly, the rule was revised and re-published with a provision which affected certain consumer loans. After further hearings, the Commission decided that a vendor-related loan provision was essential to the rule, and that the rule should apply to those consumer loans where a seller and a lender worked cooperatively in connection with sales transactions, whether the arrangement between seller and creditor was formal or informal. The Commission did not try to list all of the arrangements and procedures which would trigger this requirement. Instead, it articulated a standard: the rule would only apply to those loans where a seller and a creditor are affiliated with one another by a formal or informal arrangement, procedure, agreement or course of dealing which is directly connected to sales or sales finance.

Some have questioned the wisdom of establishing a standard of conduct instead of publishing a laundry list of fact situations to which the rule applies. Complaints of unnecessary uncertainty and unreasonable costs have been heard.

The problem is that the practical, everyday possibilities for creditor and seller cooperation are limitless. The Commission thought it preferable to articulate in its Statement of Basis and Purpose the general reasoning behind the rule as an aid to specific interpretation. Since the rule's promulgation, the Bureau staff has issued guidelines on some issues and the Commission itself has promulgated an Enforcement Policy Statement clarifying some of the most important issues concerning purchase money loans.

I would readily acknowledge that certain ambiguities in the loan provision of the rule have created problems. Some of these have resulted from efforts to force the rule to mean what it doesn't say. For example, the auto dealers trade association took the view that the rule applies to all transactions between a car dealer and consumers who obtain direct loans from a bank where the dealer has a checking account. This is inaccurate because the arrangements and agreements which trigger the rule must be sales connected, and a checking account is not. Other auto dealers asserted that the use of a dual proceeds check to perfect a security interest under the Uniform Commercial Code, where this is the sole cooperation between the lender and the seller, might trigger the rule. The Commission responded to the dealers' request with an immediate advisory opinion saying this was not so.

The official Statement of Enforcement Policy mentioned above was issued to clear up questions and problems which have been brought to our attention since enactment. This Statement resolves questions about the standard embodied in the vendor-related loan component of the rule. The Commission waited for three months to ensure that it could assess all the problems which developed in the transition period. In the loan area, as in the indirect paper area, the Commission chose a straight-forward approach to the problem of consumer claims and defenses. It focused on the text of loan contracts and required the use of a contract provision which harnesses state law. When a seller is regularly arranging credit for his customers from a lending source, or is affiliated with the lending source, the rule applies.

In conclusion, I should emphasize that the Commission does not believe its responsibility ends with the promulgation and enforcement of a rule such as this one. It has a continuing duty to monitor the responses to the rule, evaluate its impact—both positive and negative—and respond rapidly to any problems that arise. The staff of the Federal Trade Commission is in close touch with other interested government agencies and with different parts of the private sector to obtain feedback on the operation of the rule in practice. We are in the process of designing formal evaluation studies.

We have, of course, heard assorted dire predictions about the impact of the rule. They do not accord with the information presented in the course of the rulemaking proceeding, which included the recommendation of the N.C.C.F. that holder-in-due course be abolished, testimony concerning the impact of state law reforms, and analyses by academic experts. In the thousands of pages of the record there is no dependable evidence to support these dire predictions and we do not believe them.

Nonetheless, I can assure you that if the rule does have any serious adverse impacts, the Commission wants to be the first to know so that it can respond promptly and appropriately.

I believe this rule defines a standard of conduct that is necessary and appropriate. It is not a detailed and lengthy measure, but a short and specific approach to the problem. Our goal was simplicity and ease of compliance, with minimum possible disruption.

In 1954, Professor Grant Gilmore, the draftsman of Article Nine of the Uniform Commercial Code said:

It is hard, and it becomes each year harder, for counsel to explain convincingly why "the law requires that a hard pressed wage earner who has been bilked by a now insolvent seller into buying junk masquerading as a television set or a washing machine must pay the full price to a bank or a finance company whose own relationship with the fraudulent seller has been long-continued and profitable. [Gilmore, *The Commercial Doctrine of the Good Faith Purchase,* 63 Yale L.J. 1098 (1954)]

I only regret that it took the legal system 22 years to respond to Professor Gilmore's question.

I would be happy to answer any questions you have.

Mr. MURPHY. Thank you, Mrs. Smith.

The FTC contracted Yankelovich, Skelly, and White, as you have mentioned.

Mrs. SMITH. Yes.

Mr. MURPHY. Did you evaluate the Wharton study, or the impact, or validity of that study?

Mrs. SMITH. Members of our staff talked to people at Wharton, and they described the methodology they had used in coming up with their numbers, and that consisted of calling a few dealers and asking them what they expected would happen. It is not a study in terms of actual numbers—what was actually happening. It was a projection of expectations. We think that that projection, like some of the hypotheticals raised in the course of our very extensive record have yet to be tested, and that the Yankelovich study is an actual test of what is going on right now in the credit institutions.

Mr. MURPHY. What would the proposed modification to the rule change or how might it change the effective rule which requires only sellers of merchandise to include the notice in the transaction covered by the rule?

Mrs. SMITH. As the rule stands right now, it is an unfair practice for a seller to separate, by means of a form consumer credit contract, a buyer's duty to pay from a seller's duty to perform his promise. During the course of our hearings on this, we discovered that there were many situations in which the commercial practices of creditors were related to the practices of sellers in cutting off buyers' rights. Consequently, the Commission had reason to believe that the rule should be extended to cover those situations in which creditors were involved. It will make compliance with the rule far easier by putting sellers and creditors under the same standard of conduct. However, the rule will continue to cover the same transactions.

Mr. MURPHY. Is the proposed rule being conducted in accordance with the Magnuson-Moss Act?

Mrs. SMITH. Yes, it is.

Mr. MURPHY. Mr. McCollister.

Mr. MCCOLLISTER. Which proposed rule?

Mrs. SMITH. This is the amendment as it will affect creditors.

Mr. MCCOLLISTER. First, I have a number of questions, but first to pick up a few loose ends. Who was surveyed in the Yankelovich study? What was the size of those credit institutions?

Mrs. SMITH. In four States 127 credit institutions were surveyed, and they included large credit institutions and smaller credit institutions, large cities and smaller cities.

Mr. MCCOLLISTER. Can you tell me your definition of "small credit institution," or their definition?

Mr. SMITH. I think it is a definition they use, they did not supply us with, and we did not ask for the names of the credit institutions that were surveyed.

Mr. MCCOLLISTER. Their survey is quite at odds with the survey from small credit institutions in Nebraska.

I have a number of questions relating to procedure, that being my principal concern about this. Could you return, Mrs. Smith, to the early part of your summarized statement so that I can compare what you said in that statement with what you said on page 2 of the statement I have before me where you said, "This rule was one of two that were substantially completed when the Improvement Act was adopted. This law explicitly provided that its new procedural requirements were not applicable to such rules." How did you say that? I have the impression that you referred directly to an exemption in the Moss-Magnuson Act to your holder in due course rule.

Mrs. SMITH. In the first place, there were three rules that would have been substantially completed at the time the Magnuson-Moss Act was enacted, and the Magnuson-Moss Act says rules that were substantially completed——

Mr. MCCOLLISTER. I know what it says——

Mrs. SMITH. And it was understood by the drafters of the legislation that the three rules that were substantially completed were the holder in due course rule, the franchise rule and the mail order rule.

Mr. MCCOLLISTER. I understand.

I suppose it is a matter of the definition of "substantially completed." But in any case, might some of these questions relating to this rule have been avoided had there been a greater opportunity for cross-examination?

Mrs. SMITH. There was complete opportunity for cross-examination in the case of this record. Questions could be submitted to the presiding officer at anytime for cross-examination. So the same rights existed under this particular rulemaking as would exist under Magnuson-Moss.

Mr. MCCOLLISTER. Can you tell me what the commission perceives as the standard for judicial review of the rule?

Mrs. SMITH. The Magnuson-Moss Act is substantial evidence based on the record. The judicial review in the case of pre-Magnuson-Moss rules would be broader than that. A count could uphold the rule based on evidence outside the record as well as evidence considered by the Commission.

Mr. MCCOLLISTER. Was it the arbitrary, and capricious standard——

Mrs. SMITH. Right, it was a broader standard.

Mr. MCCOLLISTER. More difficult to overturn. So that the commission says, or you say, that your perception of the standard of judicial review is substantial evidence of the record taken as a whole?

Mrs. SMITH. That's a standard from the Magnuson-Moss Act.

Mr. MCCOLLISTER. I think you have just said that that was the standard that you believe applied to the holder in due course rule.

Mrs. SMITH. I believe we could uphold that standard in this particular case.

Mr. MCCOLLISTER. We are not talking about that. I want to know what the commission believes to be the standard that will apply.

Mrs. SMITH. The standard that existed before in the Magnuson-Moss Act—that the Commission was not arbitrary or capricious.

Mr. MCCOLLISTER. Although the holder in due course doctrine has been in effect for over 200 years, a number of States have abolished the doctrine or limited it to deal with problems unique to their individual State.

Why does the FTC feel it has more expertise with respect to the holder in due course doctrine than the individual State legislatures, the member of which are elected representatives of the people and are knowledgeable of the problems in their own State.

Mrs. SMITH. The rule was predicated on maintaining rights as determined under State law—that is, substantive rights as determined under State law. So we do not view the rule as preempting State substantive law. The only concern of the Commission was that buyers should not be cut off from these substantive rights by an old English doctrine, by legal boiler plate. The manner and procedure which buyers may assert claims and defenses continues to be governed by applicable State law. The record indicates that few States have effective rules to protect consumers from being cut off by holder in due course or waiver of defenses. Many States testified in the course of our proceeding. Some 16 States testified in favor of the rule. No States testified against it.

In addition, probably most importantly, the Commission is charged by the Congress with protecting consumers under the Federal Trade Commission Act. The record showed abuses nationwide on the violations of the Federal Trade Commission Act through the unfair practice of using legal boiler plate to cut off consumer remedies. The Commission must act under its congressional mandate to protect consumers.

Mr. MCCOLLISTER. I think that the legislative history, though, of the Magnuson-Moss Act makes it clear that we did not intend that the FTC rules and regulations preempt State law. It can be argued I suppose, if we had wished this rule we would have included a specific preemption provision, but further statements in both the committee reports, both the House and Senate, indicate that we did not mean for the FTC rules to be preemptive. The commission's recently issued statement of enforcement policy states: "The manner and procedure by which a buyer may assert claims and defenses is governed by the terms of any contractual obligation and by applicable State law."

What if a State has in effect a law that is inconsistent with the holder in due course rule? For example, what if a State would allow claims and defenses to be asserted only for a particular period of time? Does the FTC trade regulation rule preempt this type of State law?

Mrs. SMITH. Yes; it would.

Mr. MCCOLLISTER. How do you square that? When I was a part of those hearings for 4 years, it was the intent of the subcommittee, the intent of the full committee and in the intent of the House that you not preempt State law.

Mrs. SMITH. The record showed that unfair practices were being committed under the Federal Trade Commission Act and the Commission has been given authority by Congress to protect consumers under that act. We cannot deny consumers rights of protection.

Mr. MCCOLLISTER. At the same time, the FTC issued its final rule, it proposed an amendment to that rule designed to extend it to creditors. This apparently evidences as believed that the inclusion of banks and credit companies is necessary for effective enforcement. Why did the FTC issue you a final rule and propose a simultaneous amendment? Wouldn't it have been better not to issue any rule until you consider whether it should extend to banks and credit companies. Since you already spent 5 years considering this, time apparently was not of the essence. Wouldn't a rule that would apply to all segments of the consumer credit sector of the economy have been more effective and better received?

Mrs. SMITH. As you say, it took 5 years, and I think that is too long a period of time. Part of the reason why it took 5 years is that the Commission's rulemaking authority was in doubt as a result of litigation.

The proceedings themselves led the Commission to believe that creditors should be included under the rule. But we also think there might be situations in which creditors might have different problems than sellers, and so it was decided it would be better to amend the rule and hear all the comments as they involved creditors before we made a final decision.

Mr. MCCOLLISTER. You are aware of Chairman Burn's criticism of certain aspects of the FTC's rule. What does the FTC plan to do if the Federal Reserve Board either refuses to promulgate the holder in due course rule applicable to banks or make substantial changes in the rule prior to its promulgation with respect to banks?

Mrs. SMITH. We have been working with the Federal Reserve Board. We worked with them on our statement of enforcement policy, so they have been aware of what we have been doing. I do not expect we will have any problems of the kind you describe.

Mr. MCCOLLISTER. The FTC has just issued a statement of enforcement policy concerning the rule. Especially, the statement attempts to clarify the purchase money loan. Why weren't these clarifications made a part of the rule itself? I am concerned that many questions and ambiguities still remain in a rule which took the FTC 5 years to promulgate.

Mrs. SMITH. All parts of the industry, consumer groups, economic experts, and trade associations, participated in that 5-year proceeding. As a result we assumed there was more knowledge out in the industry than there actually was. We gave the industry a 6-month leadtime in which to come into compliance. During that 6-month time, we expected to get questions, and we did not get any until the very close of the period. As soon as those questions came in, we issued guidelines, and we began to answer the questions first by the staff and then by the Commission.

Mr. MCCOLLISTER. The FTC was silent during almost all of that 6 months until about 10 days before the rule was to go into effect.

Mrs. SMITH. We did not know what questions to answer until the questions were given to us. We understood how the rule worked. We expected that industry would come in, and that was the point of giving the 6-month leadtime.

Mr. MCCOLLISTER. What is the nature of the FTC's obligations to inform—educate.

Mrs. SMITH. I admit that we could have done a better job of informing if we had known there was some confusion out there. The problem was, we did not realize there was confusion. We expected after 5 years and several thousand pages of transcript and participation by all parts of the industry that there was no longer any confusion. I admit, we were wrong.

There is one other important thing to stress, which is, that this is a major piece of rulemaking, and it does have gray areas. It affects several industries nationwide.

We tried to make it as simple as possible, yet effective. We could not cover every possible situation. It is not like Internal Revenue

Service regulations which list countless transactions. We tried to set a standard of conduct which was relatively specific. We tried to keep the gray areas as small as possible, and we have tried to answer questions as fast as possible. But we cannot answer them all unless we get them.

Mr. McCollister. If the rule itself is not entirely clear on the point, certainly the staff guidelines make it clear that a creditor would be liable in tort for a product defect. As I am sure you are aware, the Congress, in the recently enacted Fair Credit Billing Act, specifically removed tort liability. In view of this clearly expressed congressional intent in a very closely related area, why did the commission include tort liability in its holder in due course rule?

Mrs. Smith. In the first place, the tort liability will be determined by the State law again. It would depend upon the liability of the seller in the State law. In many instances, many State laws include fraud and misrepresentation under the definition of tort, and we thought those categories of wrong doing had to be included. The liability, in the case of tort or in the case of other actions, extend only up to the amount that the buyer has paid under the contract, so the creditor is not opening himself up to a suit for $3 million when the contract is only for $300. There is also nothing magical about the word "tort." We all carry insurance of some kind, and there are ways for creditors to get insurance or to shift the risk of this and take care of it.

Mr. McCollister. That becomes a part of the credit cost then?

Mrs. Smith. I think it might become part of the credit cost. In fact, that is why we are continuing to monitor the cost of consumer credit. We are very concerned about whether the cost of credit will go up.

Mr. McCollister. In an explanation of the rule, there is a discussion of bank cards and acknowledgement of the existence of the Fair Credit Billing Act. The Fair Credit Billing Act, of course, abolishes the holder in due course doctrine with respect to bank cards in certain circumstances, and this act is primarily enforced by the Federal Reserve. I was struck by one sentence in this section of the explanation. The sentence is found on page 53517 of the Federal Register for November 18, 1975, and it reads: "The commission has no reason to believe that this legislation will not afford adequate protection to consumers at the present time."

Is the commission saying in this sentence that it believes it could have altered congressional intent expressed by the Fair Credit Billing Act if it had found or if it finds at some point in the future that this legislation is not providing adequate protection?

Mrs. Smith. No; I think it is simply saying there is no reason to inquire any further. I assemble that if the Commission found evidence of wrong doing in that area it could make a recommendation to Congress.

Mr. McCollister. But you could not fix it by rule?

Mrs. Smith. No; I do not believe so.

Mr. McCollister. In your statement on page 18 you say that, "Our goal was simplicity and ease of compliance with minimum possible disruption."

Considering the fact that since the rule was issued, the commission has issued a proposed amendment, has had to issue extensive staff guidelines and a statement of enforcement, I am not certain if you achieved that result. Please describe any mechanisms which you have now in place to monitor the affect of the rule.

As I indicated in my opening statement, bankers across the State of Nebraska have told me this rule is having very considerable impact on the way they do business these days. This has been just the last 2 weeks. We will be hearing from representatives of the banking community when these hearings continue on Tuesday, but I understand one of the banking associations did survey their members and found the rule has had a staggering effect on how their business is conducted. Would you have any comment under that seeming discrepancy and point of view?

Mrs. Smith. I think part is attributable to the failure of understanding or misapprehension on the part of credit institutions. I think to a great extent, when you ask them what they think the outcome of the rule will have upon their credit arrangements, they give you dire predictions. The study that we contracted with the Yankelovich firm was to find out what is actually happening. We are continuing to monitor the consumer credit market, using independent contractors. We expect and would like to see all the surveys that show up in the course of this proceeding as well as any others.

Mr. McCollister. Sometimes their predictions of difficulty are not exaggerated. I would refer you to RESPA, Real Estate Settlement Procedures Act, which turned everybody upside down, now only to banking, which did for a while until Congress remedied it, not only the banking, but the lending business.

Mrs. Smith. We are really concerned about this problem. That is part of our monitoring efforts as well. We do not want this rule to have an adverse impact on the consumer credit market.

Mr. McCollister. You state in justifying the rule that a creditor is in a better position than a consumer to assess the business reputation of a seller. How is a creditor, however, to deal with a new entrant into a particular business who has not established a reputation? Several banks in the survey that I conducted indicated that they would not consider extending credit to a new business. What about a firm that has enjoyed a good reputation but then suddenly experiences a flurry of complaints, how is the lender able to predict that this will not happen? What about a firm which did not enjoy a good reputation in the business community but, in the current vernacular, becomes a born-again christian and wants to mend his ways? It would appear that he would be cut out of the credit market. What about the minority business person operating in the inner city that has a number of customers who, because of a general economic down turn, stop payment alleging product defects. How can a lender reasonably deal with these kinds of situations?

Mrs. Smith. You have asked several questions.

Mr. McCollister. I have given you several situations, but the same question—the predictability of being able to judge the way that a seller is going to conduct his business.

Mrs. Smith. I think we have to first start out with the proper understanding that these risks also existed before, that goods were shoddy, merchandise undelivered or sellers insolvent. Before the rule, the risk was born entirely by consumers. Now the risk is born in some measure by the financial community. The financial community is in a better position to investigate reliability and performance. That is one aspect of it. The other aspect is they can arrange recourse type agreements which cast the risk back to the seller or they can bring in financially responsible suppliers to the sellers.

Mr. McCollister. Let's stop right there. They can bring in financially responsible sellers to meet with the buyer. In other words, the lender has to put his good housekeeping seal of approval on the seller, the ones to whom they direct the buyers to go to?

Mrs. Smith. In judging the financial responsibility of the seller, the creditor can take into account——

Mr. McCollister. Doesn't that put a severe hardship on a new seller just getting started in business? Doesn't it mean he is going to have a much more difficult time competing than he has even now when it is pretty difficult?

Mrs. Smith. You are right. New dealers have also had a harder time in getting credit because they have to establish themselves.

Mr. McCollister. And isn't it more difficult under this circumstance?

Mrs. Smith. We do not think it is going to be much more difficult. We think there has also been a screening process, and what the credit institution looks to is the financial stability of the individual company involved in setting up a new business, the capital structure, dozens of other factors. The rule, in any event, does not affect direct loans between creditor and new business. What it does is make it more difficult for the new business to have a referral relationship with the creditor——

Mr. McCollister. Has the Small Business Administration made any comment in its new rule as advocate for small business? Has it made any comment about the holder in due course doctrine?

Mrs. Smith. I do not think it has.

Mr. McCollister. Why don't we have them to do that. I have the extreme good fortune of not only serving on this subcommittee, but also serving on the Small Business Committee on which I am the ranking minority member of the subcommittee dealing with regulatory agencies, prominent among which in our concern is the Feedral Trade Commission.

Although the recently issued statement of enforcement policy generally clarifies some of the ambulgities that existed with respect to the rule, I am curious about the very last example given on page 9 of that statement. The example seems to say that a seller must assume that a buyer is not telling him the truth and, therefore, he has an obligation to communicate with the creditor in every instance.

This to me is some sort of a nonsensical result. Further, as a consumer, I would greatly resent this intrusion into what should be a private matter with my bank. And I have a letter to Senator Tower from one of his constituents who bitterly resents this. Let me just read some of it. He goes on at length, but States in part that:

> My considered opinion is that so long as the funds I utilize for the purpose of purchasing consumer goods or services, as long as those funds are acquired honestly and ethically, that it is neither the business of the seller of these goods or services nor the business of the Federal Trade Commission, nor the business of the U.S. House of Representatives, nor the business of the U.S. Senate, nor the business of the executive branch of the Federal Government as to the source of those funds.

Now, isn't that a reasonable comment? It seems to me if I were to take a check and lay it down in front of an automobile dealer for the purchase of a new car and he throws this form out which says, "A Federal Trade Commission rule prohibits sellers and leasers of consumer goods and services from accepting from a consumer the proceeds of a purchase money loan unless certain required disclosures were included in the contract entered into by the consumer and the lender. To assistance in complying with this new Federal rule the following information is required," the form has a space for, "I hereby certify that none of the funds used in payment for the below described vehicle were obtained as a result from a creditor," a place for signature and date, then another space with a spot for a signature, as well as the statement, "Funds for full or partial payment for the below described vehicle were secured from," "Creditor," space for writing the name of the creditor, and signature again.

Now, isn't that a pretty serious intrusion?

Mrs. Smith. The rule was made applicable to the overall relationship between lenders and sellers, not to specific transactions. And there are three reasons for this. First, having a test based on specific transactions would cause practical problems. Loan offices would have to evaluate the history of each purchase decision, whether you came to the seller first, whether you came to your bank first. It would just create enforcement problems. Our major concern was to have the rule apply to situations in which the lenders can economically learn about the sellers business arrangements and the lender can protect himself by means of recourse agreements. The short answer to your angry consumer, roughly, would be that he would be a lot more angry if the transmission fell out of his car and he had to continue making payments.

Mr. McCollister. That dealer had the same obligation to him whether he pays cash or if he borrows the money from the bank. The dealer has the same obligation.

Mrs. Smith. But you would not have to continue paying on your note if it turned out you had a legal defense against the seller.

Mr. McCollister. Even if the rule is having the desired effect of making the creditors police the marketplace, this result is also tightening up credit in areas such as mobile home sales and automobile sales. But th thing that bothers me is, if the Wharton model is correct, doesn't it put the FTC in an area of vast influence on this country's economic recovery that goes quite far beyond the FTC's charter.

Mrs. Smith. We do not believe that the Wharton model is correct.

Mr. McCollister. I understand you do not. I believe it because of some of the reaction I have had from my own State.

Mrs. Smith. I think the way to test that and the proper way at this point is to monitor the situation, see what is actually occurring in the consumer credit market. I think the study the Yankelovich firm conducted is exactly the kind of study we need, what is actually happening in the market. Until we can see since that the consumer credit market——

Mr. McCollister. How much of the FTC resources is it going to take to do that monitoring.

Mrs. SMITH. We are negotiating a contract right now, and I do not know how much it is going to cost us to do that.

Mr. McCOLLISTER. There is a statement made in the Federal Register on November 18, on page 53524 which reads as follows:

The commission also anticipates a substantial consumer education either on the part of its staff after announcement of this rule. We will direct our staff to take reasonable action, via the media, to publicize the existence of the rule and what it means to consumer buyers. Anouncements directed at the Spanish community will appear in the Spanish language as legal service offices, consumer groups and individual consumers test the rule by periodic lawsuits against the creditors and sellers and as the courts thus become more receptive and accustomed to considering competing equities in consumer sales transactions, the rule will enjoy increasing knowledge and use on the part of all consumers.

It is gratifying to know the Commission feels a responsibility to inform consumers as to the existence and effects of the rule. I am serious about that. But, I wonder why the Commission did not feel the same need to educate those who would be subject to the rule? Why did the Commission make no attempt whatever to explain the effects of the rule until May 4, 1976, just 10 days before the rule went into effect?

We have already talked about this somewhat. But can you explain further why the Commission sat on their public relation's hands for that long a period of time?

Mrs. SMITH. The Commission did not exactly sit on its public relation's hands. We sent out copies of the rule and the press releases to every trade association, every participant in the hearing. We sent it out to 5,000 people in an attempt to get the word out. We did everything we possibly could to find out what questions there were in the industry.

I think we were lulled into a full sense of security.

Mr. McCOLLISTER. Is it possible that the world out there is a good deal more complicated and diverse than the Federal Trade Commission has any idea of?

Mrs. SMITH. I do not think for this issue it is any more diverse than the financial institutions, retailers and trade associations that participated in the 5 years of hearings. At least from the point of a participant in the holder in due course rule proceeding, all the questions that have been raised since enactment of the rule were questions that were raised in the course of our 5-year proceeding. There really is not anything new here. It is the same question and the same people asking those questions and the same dire predictions we are attempting to answer.

Mr. McCOLLISTER. Cash purchases, of course, are not covered by the rule.

It is good social policy to encourage the use of credit in this fashion?

Mrs. SMITH. The rule was an answer to a very practical problem—there were documented instances, thousands of cases of sellers using holder in due course or waiver of defense to cut off buyers from their remedies.

The rule is a practical answer to that problem.

Mr. McCOLLISTER. Finally, Mr. Chairman, I would say, it is, indeed, disconcerting that a multi-headed monster, the FTC, is represented here by such competence, grace and charm. It is disconcerting to find that monster represented so ably.

Mr. MURPHY. It is very discerning.

Mr. McCOLLISTER. That is it.

Mr. MURPHY. We have a rollcall on.

I have about four questions Mr. McCollister didn't cover in the last hour, so the staff will submit them to you in writing right here. Perhaps we can complete the record.

We will take a 10-minute recess and come back and try to finish.

[Brief recess.]

Mr. MURPHY. The subcommittee will come to order.

Mrs. Smith, what did the Commission's evidence show to be the harm for consumers on a holder doctrine?

Mrs. SMITH. As I have stated before, we had a massive record, and was asked the Office of Economic Opportunity to do a survey of the neighborhood legal staffs to see what evidence they had of use of the holder in due course and waiver of defenses provisions. They showed a 14,000 indications of foreclosures of asserted claims and defenses and credit sales contracts in 1 year.

A hundred documented cases were put into our record. The OEO survey also showed 1 out of every 13 neighborhood legal staffs cases involving consumer injury resulting from application of the holder in due course doctrine.

In several States, several civil court judges testified that a vast majority of their cases involving credit actions raised holder in due course problems. State attorneys general also testified on behalf of the rule.

Mr. MURPHY. What States have comparable provisions and how long have they been in effect? What have the banks been saying nationally, what has been the response of the banking industry in these regulations or laws?

Mrs. SMITH. Five or six States have comparable provisions in effect since the early 1970's. The evidence shows that there has not been a reduction, at least as far as we know, in the availability of consumer credit or an increase in the cost of credit in these States which have such rules.

Mr. McCOLLISTER. Will the chairman yield?

Mr. MURPHY. Yes.

Mr. McCOLLISTER. I have a letter here addressed to our colleague from Pennsylvania, Albert Johnson, from the Mobile Home Manufacturing Institute which states that:

An example of this is in the State of Oregon which has had a State law imposed for some time. We find in that State at least three banks very greately curtailed their mobile home lending. U.S. National Bank of Oregon, the First National Bank of Oregon, the First State Bank of Oregon have all curtailed their lending, according to mobile home officials in that State.

Mrs. SMITH. I assume that letter is accurate. The sale of mobile home sales in general has gone down. There has been considerable evidence of shoddy merchandise in the mobile home industry, which we have investigated in other contexts as well.

Mr. MURPHY. Did the evidence show that any groups were particularly affected?

Mrs. SMITH. Yes: the evidence showed that poor people, inner-city residents were particularly affected. Sellers of shoddy merchandise were smart enough to get rid of their notes as soon as they could to cut off buyers from any remedies they might have against them.

There also was evidence affecting higher income people.

We had evidence of swimming pool sales—I assume swimming pools are only bought by higher income people—in which the same device was used to cut off buyers' rights.

Mr. MURPHY. What was the National Commission on Consumer Finance, and what data did they provide on the suggestion?

Mrs. SMITH. The National Commission on Consumer Finance recommended that the holder in due course doctrine be abolished, and their evidence is massive. We took that into account in our proceeding.

Mr. MURPHY. What is your reaction to the arguments that the cost of the cost of credit will rise as a result of the rule?

Mrs. SMITH. Those arguments, as I said before, were raised during the course of our hearings, as well.

We do not believe that they will be borne out. We do not believe the cost of credit has risen in those States which have similar provisions to the Federal Trade Commission rule.

There is another point to be made here. If, in fact, there is some small increase in the cost of credit, we think that is probably offset by the increase in the value of the product being bought. Now consumers in buying a product, can be sure the seller will stand behind the product, and, if not, you will have recourse if the note is discounted to a credit institution.

Mr. McCOLLISTER. Mr. Chairman, if you will yield once more?

Mr. MURPHY. Surely.

Mr. McCOLLISTER. In a speech given by James F. Smith, Senior Economist, Board of Governors of the Federal Reserve System, he said that:

> The effects on consumers of limiting the holder in due course doctrine when rate ceilings are inadequate for creditors to earn enough to pay for their cost of policing dealers has been demonstrated in Puerto Rico. There it was found that the median rejection rate among banks for applicants for loans to purchase cars reached 100 percent within 6 months of the enactmen tof the law limiting the holder doctrine.

Mrs. SMITH. I do not know what the rates in Puerto Rico are or what problems Puerto Rico might have.

We have indication in most States right now that rate ceilings have not yet been reached.

Mr. McCOLLISTER. But the point was that the cost of policing added something to the rates that were then in effect, pushing them up to the ceiling.

Mrs. SMITH. I guess that would depend upon how low the ceiling was in the case of Puerto Rico.

Mr. McCOLLISTER. In any case, if they could make loans before the holder doctrine was abolished and cannot now because of the added costs of it, it has an effect on consumers.

Mrs. SMITH. I do not know that Puerto Rico is an analagous situation. It really is not quite like the United States.

But, if there is some increase, small increase in the cost of credit, we believe that is more than offset by the fact you are now buying a package you can rely upon, warranties that you will be assured will be enforced.

Mr. McCOLLISTER. At least that is the premise.

Mrs. SMITH. Yes.

Mr. MURPHY. Mrs. Smith, can you or should you consider the cost of credit separate from the total cost of transactions including the price of the article and repairs, whether necessary or unnecessary, or replacements?

Mrs. SMITH. No; I think you have to view it as a package; cost of credit is just one part of the package.

Mr. MURPHY. Do you believe the rule would result in a decrease in the number of sellers of shoddy goods?

Mrs. SMITH. We expect that it will do that. In fact, the Yankelovich study shows that is what credit institutions have been doing. They have been dropping those dealers who are shoddy, fly-by-night operations.

Mr. MURPHY. Can you elaborate on the avenue creditors have taken or which you envision them to take to shift the potential reliability of the rule back on the seller?

Mrs. SMITH. We expect they will take several different avenues.

First, they can use recourse arrangements to shift the burdens or risks back on the sellers.

They can also use insurance arrangements.

There was an article in Forbes Magazine the first week in August which said that a Florida insurance company was offering insurance to cover exactly this kind of problem.

Mr. McCOLLISTER. Will the gentleman yield?

Mr. MURPHY. Yes.

Mr. McCOLLISTER. Did it also discuss the cost of that insurance?

Mrs. SMITH. The article does not discuss the cost of that insurance, but it said it was very successful. They were having great sales. I am told it was $4 per contract. I do not know. That is not in the article.

Mr. McCOLLISTER. Who pays the $4 ultimately?

Mrs. SMITH. I think ultimately that cost is spread in a way that it was not spread before the rule; the risk, which $4 represents, was borne entirely by the buyer.

Mr. McCOLLISTER. I suspect that the cost is borne entirely by the buyer now, maybe in the purchase.

Mrs. SMITH. That is right.

Mr. MURPHY. Counsel, Mr. Kinzler.

Mr. KINZLER. Mrs. Smith, when did the first proposed rule on this suggestion appear, first proposed holder in due course? In 1971?

Mrs. SMITH. 1971.

Mr. KINZLER. And when in 1971?

Mrs. SMITH. January of 1971.

Mr. KINZLER. Since then, you have five sets of hearings, in different cities, as I see from your testimony, close to 10,000 pages and written submissions.

Where in those 10,000 pages is the Federal Reserve's testimony?

Mrs. SMITH. I do not believe there is any testimony by the Federal Reserve Board.

Mr. KINZLER. None in there?

Mrs. SMITH. No; there is not any.

Mr. KINZLER. The rule was promulgated November 14, 1975. It went into effect, I recall, May 15.

Mrs. SMITH. May 14.

Mr. KINZLER. At what point did the Federal Trade Commission hear from the Federal Reserve?

Mrs. SMITH. I think we received a letter on May 4 or 5 of 1976.

Mr. KINZLER. Thank you very much.

Mr. MURPHY. Minority counsel, Ms. Nord.

Ms. NORD. You do not know of Federal Reserve staff informally submitting questions to FTC staff prior to May 5?

Mrs. SMITH. I think there have been informal contacts with the Federal Reserve and FTC staff.

Ms. NORD. Thank you.

Mr. MURPHY. Thank you very much.

Our next witness is Robert J. Hobbs of the National Consumer Law Center.

STATEMENT OF ROBERT J. HOBBS, STAFF ATTORNEY, NATIONAL CONSUMER LAW CENTER, INC.

Mr. HOBBS. Good afternoon. I am a staff attorney with the National Consumer Law Center in Boston, Mass. The Consumer Law Center is a nonprofit Massachusetts corporation providing assistance to lawyers representing low-income consumers and dedicated to improving laws directly affecting low-income consumers. The Consumer Law Center is primarily funded by the National Legal Services Corp. My statement reflects the views of the Consumer Law Center and myself but not necessarily those of the Legal Services Corp.

I began dealing with the holder in due course doctrine almost from the inception of my legal aid work in 1969. My experience with the doctrine has ranged from the context of client counseling to litigation to State legislation to Federal Trade Commission hearings. I wish to thank the committee for the opportunity to appear today and welcome the committee's inquiry into the conduct of the Federal Trade Commission regarding the Holder Rule.

The Federal Trade Commission promulgated its holder rule last November, only after years of voluminous and open hearings. All viewpoints were given a multitude of opportunities to be heard. The Holder Rule of last November was promulgated, consistent with both the letter and spirit of the procedures of the Magnuson-Moss Federal Trade Commission Improvement Act. Nothing would be accomplished by adding to the 9,612 pages of public comment and testimony accumulated over 4 years prior to November. Further hearings would only be dilatory. None of the legitimate criticisms of the holder rule would be served by further hearings at the taxpayers' expense.

My major concern is with the Federal Trade Commission's actions of the last several months. My impression is that the Federal Trade Commission is retreating and retrenching from its considered position of the holder rule of last November, not as a result of the open processes of the Federal Trade Commission Improvement Act, but as a result of pressure by powerful industry interest. My fear is that the last several months have witnessed a thwarting by industry of the purposes and spirit of the Federal Trade Commission Improvement Act at the Federal Trade Commission. I am sure that the pressure of the financial industry has been heavy on the Federal Trade Commission.

However, heavy industry pressure should not justify disregarding the years of scarce public resources which were devoted to the open hearings and open drafting of the Holder Rule. My concern is that the holder rule of last November has been rewritten under the label of "Guidelines" and "Enforcement Policy". This has occured without public and consumer participation, without regard for past public and consumer participation, and, I suspect, as a result of pressures by the industry to be regulated. I urge this committee to include this concern in its oversight inquiry.

To illustrate my concern, I would like to give two examples and depart from my prepared text.

One was a vocational school case that I dealt with in New Orleans around 1972 before I went to Boston. I was working for legal aid at the time; and a vocational school that was principally providing keypunch operation training mainly to low-income, black consumers, went out of business.

It just so happened that it had been conducting business on a floor above our main office. The morning they went out of business there was a sign there on their door that said, "Closed".

Many of the students showed up for their classes, and they started coming down to us. We were flooded. I was not in that particular office, but people called me and said, "Will you listen to these people and take their cases?"

I said, "Send them over."

We started interviewing students who kept on showing up all week as their classes became due at the vocational school which was closed.

The state of the law in Louisiana then was that the holder in due course doctrine was in full effect.

The financing for this particular vocational school was not provided by assigned contracts. It was provided by what I would call the arranged loan. One might ask why that happened. It was only some months later when we were in bankruptcy court and I was talking to the creditors that I found out why this had occurred.

The reason it occurred: When this vocational school started up some 6 or 7 months before they went out of business in New Orleans, the principals involved went around to finance companies and said, "Will you buy our contracts?"

And the finance compnaies after some type of investigation, I don't know what type, but some type of investigation—this is from finance company officials—uniformly refused to buy the contracts, the notes of this vocational school.

However, when a consumer came into that vocational school and usually, at least the clients that I dealt with on the most part were young, black, and at the time I dealt with them very disillusioned about our system, they were asked if they could pay the $300 or $400 or $500 for this vocational education, and they said, "No; we couldn't."

The vocational school people would then direct them to give a deposit, whatever they could get, and to "Bring your parents in and we will arrange financing."

The parents would come in. The vocational school people would ask the parents, "What finance company do you deal with?"

And the parents would say, "I deal with X, Y, or Z finance company".

And the school would say, "Let's go over there and see if we can get a loan to finance this education."

The school officials would then take this student and the parents over to a loan company. The loan company would then extend what was classified under Louisiana law as a direct loan.

In some instances, this was the same finance company that refused to buy the contracts of this vocational school when they investigated the vocational school but, because of the law at that time, they could feel free, in extending a direct loan, from any responsibility for what they feared would occur if they were buying the contracts directly from the vocational school.

Does the Federal Trade Commission rule solve this type of what I see as financer irresponsibility? It would have been a close case. It would have been one of the gray area cases under the rule that was promulgated last November.

As I see guidelines and enforcement policies coming out of the Federal Trade Commission, I become more worried that this type of financier irresponsibility is not going to be addressed by the Federal Trade Commission. I think it should as a policy matter.

Another short anecdote.

Shortly after that episode, I was in the Louisiana Legislature. We were considering credit legislation that would abolish or limit the holder in due course doctrine. I was not wholly in favor of that legislation because it had some loopholes that I was aware of.

One loophole that really had not coalesced, despite that experience I had some months before, was the arranged loan loophole, and it was not being closed by the legislation.

We thought we were winning victories in that committee meeting, but, on the way out in the hallway, an automobile dealer whispered to me and said, "All we have to do now is to take the consumer over to the loan company and we can get around the rule that you think you just passed."

I do not believe that everybody in the credit industry operates on the premise that they are trying to avoid this responsibility. In fact, I think most of the legitimate members of the industry handle consumer complaints in a responsible way.

Before continuing, I believe some perspective is necessary. First, it must be recognized that both sides have legitimate problems with the draftsmanship of the Federal Trade Commission rule of last November. To some extent, this is unavoidable as with any statute or regulation.

The proper balance between conciseness and detail is always difficult when drafting a law, particularly in such a complex field as consumer credit. The judgment of whether to leave unusual situations for later administrative or judicial interpretation is always delicate.

Second, the Federal Trade Commission Holder Rule of last November simply follows a pervasive legislative and judicial trend at both the State and Federal levels to abolish the anamoly of the use of the holder in due course doctrine in consumer transactions. Thirty-five states had modified the HDS doctrine by 1973 to protect consumers. More states have acted since then. In 1974 Congress limited the HDC doctrine with regard to credit cards in the Fair Credit Billing Act.

Third, the legal insulation of financers from the legal responsibilities of sellers has never been automatic. The common law placed an assignee in the shoes of the assignor. Later, the law merchant creating insulation for certain assignees, which was continued in the Uniform Negotiable Instruments Law and the Uniform Commercial Code, always had complex legal prerequisites. In recent years, State judges have become increasingly aware of the realities of consumer transactions and more insistent on strict compliance with the legal prerequisits of the UCC and the law merchant.

Fourth, the holder in due course insulation of financers from the legal problems created by sellers who depend upon the financers for their existence is a great anamoly in the consumer marketplace. In theory, holder in due course insulation of financers can only promote irresponsible financing of sellers. It has allowed bankers, finance company managers, and other creditors to be careless about which sellers and consumer credit transactions they finance.

During my participation in April in Federal Trade Commission hearings on proposed amendments to the Federal Trade Commission Holder Rule, one of my predominant impressions was that, despite their protestations, the finance industry witnesses possessed a tremendous sophistication which could have a sound impact if directed at policing the consumer marketplace. This policing by financers is precisely the purpose of any attempt to do away with the holder in due course doctrine. And, this policing is accomplished without the creation of another Government bureaucracy.

Now, I would like to turn to the industry criticisms of the Holder Rule with which I am familiar.

In the April Federal Trade Commission hearings, many industry witnesses objected in one form or another to the basic policy decisions already made by the Commission in the seller rule. Some took the position that financers should have no responsibility for seller-related claims and defenses unless the financers and sellers style the transfer of the consumer's obligation to pay as an assignment of the contract or as a transfer of a negotiable instrument.

It is my feeling that this committee should be very concerned about the legal labels on types of transactions. It should be more concerned about how responsible financers utilize their sophistication and knowledge to influence the way sellers behave.

A routine industry position in those hearings was that the rule would increase the cost of credit and diminish the supply of credit and that those effects would fall most heavily on low-income consumers.

In those hearings, none of the witnesses there undertook to support those assertions with even the crudest form of data. This was despite the fact that many of them were representatives of national organizations and had members and States which had laws going as far, and in other cases going nearly as far, as the Federal Trade Commission rule.

On the other hand, witnesses for the Credit Union National Association testified that they made several telephone inquiries which indicated that the legislation of Massachusetts, Maryland, Wisconsin, and one other State, which they could not recall at the time, had created no particular problem for credit unions in those States.

The problem with this type of generalized prediction without supporting data is that the witness may perceive the data supporting his testimony when, in fact, it may not.

There was an exchange in the record at those hearings by a representative of the Credit Thrift, which is a national finance company.

Before I quote, the question was:

"What is the effect of the interlocking loan statutes in the State of Massachusetts?"

Credit Thrift says:

It has limited our activities in the field to some extent, but we have made loans for those purposes in those offices.

Subsequently, a check of the banking commissioner's office in Massachusetts indicated that the volume of loans outstanding by Credit Thrift expanded every year after that law went into effect, except September 1975 when everybody else was suffering.

Unfortunately, that type of data is not available in most States.

Another thing that happened that was somewhat amusing was that we had members of the industry coming into those hearings predicting dire consequences as a result of the holder rule. But the consequences were not their predictions but predictions that their banker had told them or their dealer had told them would occur.

There was one man that came in to testify about what the consequences would be in Philadelphia where he was in the home improvement business, and he was saying it would be really tough on him but a lot of his fellow home improvers would go out of business.

He happened to mention that he was also doing business in Maryland, which has a law, probably stronger than the Federal Trade Commission law, and that law has been in existence for years and years. He was completely unaware of that law. It had no effect on his business.

Mr. MURPHY. The committee must recess for this vote.

We will be back in about 10 minutes.

[Brief recess.]

Mr. METCALFE [presiding]. The committee will come to order.

Mr. Robert Hobbs was in the midst of making his statement, and will you be kind enough to continue, Mr. Hobbs?

The chairman will be here momentarily. He is tied up on the floor.

Mr. HOBBS. I believe I left off in the Federal Trade Commission hearings in April, that there were many industry spokesmen predicting dire consequences as a result of the then proposed Federal Trade Commission rule.

I would like to emphasize that in those hearings, under cross-examination, those industry spokesmen were not able to substantiate their predictions with data, hard or soft.

I urge this committee to inquire into the basis of any such predictions. I would also like to point out, that, on the other hand, there were numerous witnesses who testified that those States with similar laws to the Federal Trade Commission rulings experienced little or no effect on credit supply or prices. I submit that regulation in this area is such a small factor in the overall economy that it has the slightest impact, if any.

Also, it should be noted that the diminution of supply of credit to irresponsible sellers or transactions is a very positive achievement.

My other predominant impression of industry criticisms of the Federal Trade Commission Holder Rule is that those criticisms, often legitimate in many cases, mask a desire for loopholes in the coverage of the rule. Just as in the area of tax law, lawyers representing industry in the area of consumer credit law have displayed ingenuity in taking advantage of any legal loopholes when it was advantageous to their clients.

The Federal Trade Commission Holder Rule of November was painted with a broad brush—perhaps too broadly in some instances, and too narrowly in other instances. I am deeply concerned that if the parade of Federal Trade Commission tinkering with the rule, labeled "Guidelines" and "Enforcement Policy," and so forth, continue, there will be loopholes aplenty.

In the April Federal Trade Commission hearings, many industry witnesses, when cross-examined on their willingness to police against the legal irresponsibility in the consumer marketplace, expressed their strong desire to avoid that responsibility. It is this policy—financer policing of the marketplace, in which they are a major force, which is the heart of the Federal Trade Commission Holder Rule. The rule is necessary to overturn the "empty head" attitude of some members of the financial community fostered by the Holder in Due Course Doctrine. It is this "empty head" attitude which resulted in the repeated instances of the financing of ill-advised consumer transactions by financers who probably would not have become involved if they had made the inquiries which the Federal Trade Commission Rule of last November requires of them.

Again, I wish to thank the committee for the opportunity to testify.

If there is any further information which I might provide, I will try my best to do so.

Mr. METCALFE. Thank you very much, Mr. Hobbs, for your very fine statement.

I do not know whether Chairman Murphy asked you, whether or not, according to your testimony, you indicated by 1973 35 States had modified the holder in due course doctrine.

Could you categorize the different types of State laws?

Mr. HOBBS. I could jolt my recollection and try to do so.

There is probably a major dichotomy in the types of legislation that could be called notice types of statutes versus statutes that did not have these notices. These notices usually provided a consumer could raise claims or defenses against a financier for a certain period of time ranging from, I believe, about 9 days to something over a year.

Other States simply said there are no negotiable instruments in consumer transactions or there is no holder in due course doctrine or there is no way for defense in consumer transactions.

A number of States, I believe five or six at present, as well, went the dditional step and closed the arranged loan loophole in some fashion 1 some transactions.

Mr. METCALFE. Do you know how many State laws, and could you ategorize them as equally or more restrictive than the Federal Trade Commission use rule?

Mr. HOBBS. Forty-nine States have the UCC which is the Uniform Commercial Code, and, in some ways, it is more restrictive than the Federal Trade Commission rule.

In the arranged loan area, Maryland says that any arranged loan in which the financier takes a security interest in is an arranged loan and that financier is subject to claims and defenses.

I believe Massachusetts has a referral rule, so there are a number of States, four or five, in some ways go beyond the Federal Trade Commission; 49 go beyond the Federal Trade Commission rule in other ways.

The traditional law has gone beyond the Federal Trade Commission law in some ways.

Mr. METCALFE. You say there are 49 States right now that fall in that category?

Mr. HOBBS. That have the UCC which, in some ways, goes beyond the Federal Trade Commission rule.

Mr. METCALFE. About how long those particular laws been in effect?

Mr. HOBBS. The UCC—the major momentum was the early 1960's; and the consumer protection momentum for restriction of holder in due course gathered in the late 1960's.

Most of those laws were passed, I would say, between 1968 and 1973. There certainly have been a handful that have been enacted since 1973.

Mr. METCALFE. Who would have the best information as to the effect of these laws, the State rules on such things as the cost and availability of credit and the effect on small and new businesses?

Mr. HOBBS. It is my poistion that there is no really good accurate data available. It is my position that the reason for that is simply because a rule of this nature is such a miniscule part of our overall economy that it is very, very difficult to measure statistically.

The best study that I am aware of would be technical studies No. 2 and 5 of the National Commission on Consumer Finance.

But there are problems with those studies in a statistical sense, I am told by the statisticians, and not from my own knowledge in the area of statistics.

Mr. METCALFE. Referring to the creditors, have those creditors, in fact, come forth with any information to support such negative effects?

Mr. HOBBS. Not that I am aware of at all.

It has been the consistent position of the National Consumer Law Center whenever we get involved in, let's say, a policy dispute of this nature with industry, to invite and ask industry to come forward with some hard figures to show us what the changes in, let's say, their gross volume of consumer credit has been before and after a similar law is passed. The industry has been very unwilling to do that.

Mr. METCALFE. In your testimony, you suggest that the diminution of the supplier of credit to irresponsible sellers or transaction is a positive achievement.

Could you please expand on this statement and suggest what you would see to be the proper factor for a cost-benefit analysis for the abolition of the holder in due course doctrine?

Mr. HOBBS. I think it is a very difficult thing to do to turn what is really a theory, a qualitative theory, that there will be some diminution in supply and that diminution is the supply of irresponsible sales. That would be a positive achievement.

I suspect that the industry is not 100-percent efficient, and we might lose some responsible transactions. But, then, again, because the industry is not 100 percent efficient, some members of industry are not going to even be aware of the rule. And, so, we are going to have a continuation of some irresponsible transactions.

I suspect you cannot measure the impact of this rule as of the day it went into effect or today or next week. It will gradually become enforced and more people will comply with it as they become more aware of it. That is true of any law.

Mr. METCALFE. Also in your statement you state that "If the parade of Federal Trade Commission tinkerings with the rule labeled 'Guidelines,' 'Enforcement Policy,' and so forth continue, there will be loopholes aplenty."

Could you please be more specific and cite interpretations that you think create those loopholes?

Mr. HOBBS. Yes.

I express that as my concern and my fear. I hope my fear and my concerns prove ill-founded.

In the rule, it provides that in the arranged loan situation that a loan is covered if there are referrals or—and I emphasize "or"— affiliation. In the guidelines, the requirement for referrals, I believe, was tinkered with and it was made referrals in the ordinary course of business. And "referral" was distinguished from a creditor or seller simply providing information to a buyer. That is probably correct in some instances.

In the enforcement policy, referral was further made a little bit harder to satisfy if you were a consumer trying to prove a referral took place because it became a referral and, I believe the language was "de facto or agreed pattern or cooperative activity."

The problem I was trying to illustrate with the vocational school example I gave earlier, it is very difficult to reconstruct a consumer transaction some months after it takes place and to find out what the actual relationship between the seller and the financier was and how the consumer got to the financer.

And the more the arranged loan provision is circumscribed to benefit industry, to obtain clarity, the more likely it is that those members of industry interested in doing so can come up with devices to avoid the definition that the Federal Trade Commission develops.

I think for the purpose of avoiding circumvention it is very necessary to paint with a broad brush.

Mr. METCALFE. Thank you very much, Mr. Hobbs, for your very excellent testimony.

I have no further questions.

Counsel, do you have any questions?

Mr. KINZLER. No.

Mr. METCALFE. Thank you very kindly.

The next witness is Mr. Michael Harper.

STATEMENT OF MICHAEL C. HARPER, ATTORNEY, WASHINGTON, D.C.

Mr. HARPER. Thank you, Congressman Metcalfe.

In the interest of time, I will read an abbreviated portion of my testimony in the hope that the entire statement will be inserted in the record.

I feel very honored to participate in your committee's consideration of the Federal Trade Commission's new preservation of consumer claims and defenses rule. I consider the new rule an outstanding example of the positive contribution which can be made to the development of legal policy by a Federal agency delegated broad rulemaking authority.

I predict that the congressional response to the new preservation rule will be a critical factor in determining how the Commission generally discharges its consumer protection rulemaking responsibilities under the Federal Trade Commission Act, as amended.

I recognize that it is often much easier for Congress to forge a politic compromise on some potentially controversial issue by granting broad discretion to a supposedly apolitical expert executive agency than by itself enacting detailed legislation which, if not meaningless, inevitably offends some focused political interest.

There is always a danger, however, that broad grants of authority to executive agencies which express a somewhat undefined commitment to the general public will not be aggressively implemented.

Congressmen and women may find it convenient to claim public applause for their support of a provision vesting important authority in an executive agency; but when general public attention has been directed toward other matters, these same legislators may be induced by offended industry representatives to undercut the agency's efforts to implement the provision.

This rule should be especially easy for this Congress to support because it is based on removing competitive imperfections in the operation of our Nation's credit markets.

As long as the holder in due course doctrine was effective, consumers who purchased on credit were not informed in advance by the price of the goods or of the credit that they would have to bear the costs of the seller giving them shoddy or defective merchandise.

Consumers who were sold bad goods on credit bore the costs of seller misconduct, but were informed of these costs only after they decided to complete their purchase. Unsophisticated consumers normally underestimated the real costs of the goods and services which they purchased on credit. And, more importantly, few consumers were in a good position to judge which sellers were more likely to transfer defective merchandise.

The Commission's "Preservation of Consumers Claims and Defenses Rule," however, conforms our motion's credit markets much closer to the traditional model of a "free-market" economy. The Commission's rule imposes the direct costs of seller misconduct on the creditor, whether the creditor be the seller or a third party.

If the creditor expects to maintain his traditional profit margin, it will be necessary to pass on these costs in some manner to the buyer-debtors. The buyer will thereby be informed in advance of his purchase of the costs of seller misconduct. The consumer will also be informed of the relative risks of misconduct by various merchants.

Creditors who deal regularly with certain merchants are in a much better position than infrequent consumers to calculate seller misconduct costs. The relative costs (or unavailability) of credit to purchase the goods of merchants with a particularly poor sales record will increase; the relative costs of credit to purchase the goods of more reliable merchants will decline.

Moreover, the Commission's new rule operates as an automatic insurance system to spread these risks between buyers. During the

"holder in due course" era, a buyer who was unlucky enough to obtain shoddy goods or services would have to incur all the costs of seller misconduct himself, unless, of course, he was able to bring an affirmative action against the seller.

By internalizing the misconduct costs, the Commission's rule will cause each buyer-borrower to purchase a de facto insurance policy from a creditor who is positioned to calculate risks and probabilities and to spread costs between his debtors as an actuary.

Many criticisms of the rule reflect a complete misunderstanding of its purposes. Some have charged that the rule is undesirable because it will make consumer credit more expensive.

The real question is whether the rule will make goods and services sold on credit more expensive. Of course, it will not. The rule will simply insure that the actual costs of goods and services are expressed in their credit price.

The rule probably will make consumers' credit more expensive in some instances, but any price increase of credit will simply express a cost which must be paid by consumers at some point anyway. Of course, there is no free lunch. But this rule will give credit consumers a menu with accurate prices before they order.

Some critics of the rule worry that it will place some small merchants out of business. But the only merchants who are threatened by this rule are those who have an established record of fraudulent sales. These are the merchants who will not be able to obtain purchases of their consumer credit paper. These are the merchants who won't find creditors willing to accept regular referrals of customers. Sellers of low quality, inexpensive goods and services will not be harmed by the rule.

New merchants without an established trade record also have little to fear from the rule.

It was pointed out earlier it is possible to purchase insurance contracts to cover the risk of seller misconduct costs. The fact of the matter is, creditors are in a much better position to insure themselves than buyers and the costs are going to be paid ultimately anyway. I have great faith in the American insurance industry to step in where there is a need to spread costs.

My own interest in the rule derives from my efforts on behalf of Consumers Union to monitor the Federal Reserve Board's discharge of their own rulemaking responsibilities under section 18(f)(1) of the amended Federal Trade Commission Act.

As part of this monitoring, we responded to Chairman Burns' letter to Chairman Collier on the eve of the effective date of the rule.

I request that my letter and Chairman Burns' response be inserted into the record. If this request is granted, I will not reiterate most of the points. [See p. 51.]

Mr. METCALFE. It will be entered into the record.

Mr. HARPER. The major concern expressed by Chairman Burns' letter and the accompanying staff memorandum is that creditors will be constrained to include the preservation notice in all of their consumer credit contracts.

We suggested to Chairman Burns how the concerns of creditors could be allayed without weakening the force of the Rule.

But the most important point for this committee to understand is that the definition of "purchase money loan" should not be narrowed so that it serves only to avert direct seller-creditor collusion without insuring the internalization of the costs of seller misconduct as explained above.

The broad definition of "purchase money loan" as now framed requires the preservation notice whenever the creditor knows that the consumer-borrower will use the loan proceeds to purchase goods or services from a seller which regularly refers consumers to the creditor or with whom the creditor is affiliated. Wen the creditor as such knowlor with whom the creditor is affiliated. When the creditor has such knowledge, he is in a position to internalize seller misconduct costs by charging more for the loan or by arranging recourse or repurchase agreements with the seller.

I must add that the Commission's recent statement of enforcement policy unfortunately suggests that the Commission may have lost sight of its primary rationale for the rule, the internalization of the seller-misconduct costs. The statement's example No. 4 indicates that a creditor need not include the notice in cases where the seller regularly suggests that borrowers go to the particular creditor if the seller has not had any prior contact or conversations or arrangements with the creditor.

Creditors should be able to make a judgment on the reliability of all sellers in their community which regularly refer customers to them.

With this caveat, I believe the Commission deserves a resounding resolution of support from this Congress.

There is a lot of talk about the need for more consumer advocacy in Washington. But much more than advocacy consumers need substantive action like that taken by the Commission. Congress response to such substantive action is the real test of its commitment to broadening the rights of consumers and giving them fair treatment.

Thank you.

[Testimony resumes on p. 54.]

[Mr. Harper's prepared statement and letter to chairman Burns with response follow:]

STATEMENT OF MICHAEL C. HARPER, ATTORNEY, WASHINGTON, D.C.

I feel very honored to participate in your Committee's consideration of the Federal Trade Commission's new Preservation of Consumer Claims and Defenses Rule. I consider the new Rule an outstanding example of the positive contribution which can be made to the development of legal policy by a federal agency delegated broad rulemaking authority. I believe it deserves this Committee's and Congress's support.

I predict that the Congressional response to the new Preservation Rule will be a critical factor in determining how the Commission generally discharges its consumer protection rulemaking responsibilities under the Federal Trade Commission Act as amended. As you are aware, the substantive rulemaking authority vested in the Commission under the FTC Act is defined only by the phrase "unfair or deceptive acts or practices." Clearly the extent to which the public will benefit from effective specific trade practice regulations will turn on how the Commission views its Congressional support.

I recognize that, given obvious constraints on Congressional resources, it is not possible for the legislative branch to spin out the detailed technical regulations necessary to address all issues, such as unfair commercial practices, which call for federal intervention. I recognize also that it is often much easier for Congress to forge a politic compromise on some potentially controversial issue by granting broad discretion to a supposedly apolitical expert executive agency than by itself enacting detailed legislation which, if not meaningless, inevitably offends some focussed political interest.

There is always a danger, however, that broad grants of authority to executive agencies which express a somewhat undefined commitment to the general public will not be aggressively implemented. Groups representing diffuse consumer interests may be able to marshall their forces for a large battle on Congressional Hill against more focussed special industry interests, but few have been able to advance effectively diffuse public interests before agencies on a continuing basis. Congressmen and women may find it convenient to claim public applause for their support of a provision vesting important authority in an executive agency; but when general public attention has been directed toward other matters, these same legislators may be induced by offended industry representatives to undercut the agency's efforts to implement the provision.

The Commission is undoubtedly looking to Congress now for an indication of whether the support for the Commission's rulemaking authority which Congress generally expressed in the Magnuson-Moss FTC Improvement Act is more than noncontroversial window-dressing.

Happily the Commission's new Preservation Rule is well framed and concerns an important issue to which it should not be difficult for the public to respond. Congress should have no difficulty expressing its appreciation of this rule and thereby underscoring its seriousness in supporting the Commission's rulemaking authority.

The Rule should be especially easy for this Congress to support because it is based on removing competitive imperfections in the operation of our nation's credit markets. By internalizing the costs of seller misconduct the Rule insures that consumers who purchase goods and services on credit will appreciate better the true costs of those goods and services. The Rule also presents consumers with an effective insurance system by which the risks of seller misconduct are spread amongst all credit consumers.

As long as the holder in due course doctrine was effective, consumers who purchased on credit were not informed in advance by the price of the goods or of the credit that they would have to bear the costs of the seller giving them shoddy or defective merchandise. Consumers who were sold bad goods on credit bore the costs of seller misconduct, but were informed of these costs only after they decided to complete their purchase. Unsophisticated consumers normally underestimated the real costs of the goods and services which they purchased on credit. And more importantly, few consumers were or are in a good position to judge which sellers were more likely to transfer defective merchandise. There was nothing in the cost of their credit to signal consumers that the risks of their having to pay seller misconduct costs were greater for the sales of particular merchants.

The Commission's "Preservation of Consumers Claims and Defenses Rule", however, conforms our motion's credit markets much closer to the traditional model of a "free-market" economy. The Commission's Rule imposes the direct costs of seller misconduct on the creditor, whether the creditor be the seller or a third party. If the creditor expects to maintain his traditional profit margin, it will be necessary to pass on these costs in some manner to the buyer-debtors. The buyer will thereby be informed in advance of his purchase of the costs of seller misconduct. The consumer will also be informed of the relative risks of misconduct by various merchants. Creditors who deal regularly with certain merchants are in a much better position than infrequent consumers to calculate seller misconduct costs. The relative costs (or unavailability) of credit to purchase the goods of merchants with a particularly poor sales record will increase; the relative costs of credit to purchase the goods of more reliable merchants will decline. The price system will thereby inform consumers of the relative risks of purchasing goods or services from various sellers.

Moreover, the Commission's new Rule operates as an automatic insurance system to spread these risks between buyers. During the "holder in due course" era, a buyer who was unlucky enough to obtain shoddy goods or services would have to incur all the costs of seller misconduct himself, unless of course he was able to bring an affirmative action against the seller. By internalizing the misconduct costs the Commission's Rule will cause each buyer-borrower to purchase a de facto insurance policy from a creditor who is positioned to calculate risks and probabilities and to spread costs between his debtors.

Of course some creditors may not wish to finance at any interest rate any purchases from particular untrustworthy sellers. Some sellers with a history of fraudulent practices may not be able to sell their consumer credit paper no matter what discount and recourse they offer. It is one of the Rule's purposes to make it difficult for certain merchants to hawk their wares with easy credit terms which hide the true costs of the purchase to the unwary and unsophisticated consumer. But Congress should not fail to appreciate that the Rule's purpose and effect is also to internalize all seller misconduct costs in credit transactions so that the credit buyers can make decisions informed of the actual cost of their contemplated purchase.

Many criticisms of the Rule reflect a complete misunderstanding of its purposes. Some have charged that the Rule is undesirable because it will make consumer credit more expensive. The real question is whether the Rule will make goods and services sold on credit more expensive. Of course it will not. The Rule will simply insure that the actual costs of goods and services are expressed in their credit price. The Rule probably will make consumers' credit more expensive in some instances, but any price increase of credit will simply express a cost which must be paid by consumers at some point anyway. There is no free lunch. But this Rule will give credit consumers a menu with accurate prices before they order.

Some critics of the Rule worry that it will place some small merchants out of business. But the only merchants who are threatened by this Rule are those who have an established record of fraudulent sales. There are the merchants who will not be able to obtain purchases of their consumer credit paper. These are the merchants who won't find creditors willing to accept regular referrals of customers. Sellers of low quality, inexpensive goods and services will not be harmed by the Rule. The Rule does not create new rights or defenses beyond those granted by the applicable state law: the Rule simply preserves rights and defenses which are otherwise legally sufficient.

New merchants without an established trade record also have little to fear from the Rule. As long as there is not something in the merchant's background to make an insurance company suspicious, creditors who are uncomfortable with a new merchant's paper could arrange for some low cost insurance to spread their own risk. Certainly creditors are in a much better position to insure themselves than are buyers. The misconduct costs of new sellers will be paid by consumers eventually. These costs should not be hidden from consumers in order to favor the establishment of new businesses.

My own interest in the Rule derives from my efforts on behalf of Consumers Union to monitor the Federal Reserve Board's discharge of their own rule-making responsibilities under Section 18(f)(1) of the amended Federal Trade Commission Act. As part of this monitoring, we responded to Chairman Burns' letter to Chairman Collier on the eve of the effective date of the Rule. I request that my letter and Chairman Burns' response be inserted into the record. If this request is granted, I will not reiterate most of the points which I set forth in my letter. However, I would like to respond further to two of the arguments raised by the Staff memorandum accompanying Chairman Burns' letter which I have heard in additional criticism of the Rule.

The major concern expressed by Chairman Burns' letter and the accompanying Staff memorandum is that creditors will be constrained to include the preservation notice in all of their consumer credit contracts. The memorandum stressed that a creditor can never be sure that a consumer-borrower, whatever his stated intention, will not use the proceeds of a loan to purchase goods or services from a seller who generally refers consumers to the creditor or who is affiliated with the creditor.

We stated in our response to Chairman Burns that even if the Preservation Rule is extended as proposed to apply to creditors' trade practices as well as sellers', creditors who in good faith did not require the preservation notice would not risk Commission enforcement action. The Commission could seek punitive damages against a creditor only where they could show that the creditor had or should have had knowledge that the conditions which invoke the preservation notice had all been met. We further suggested to Chairman Burns that the concerns of creditors could be allayed without weakening the force of the Rule. The following clause could be added at the end of the definition of "purchase money loan": "unless the creditor can show at the time of the loans it did not have knowledge and could not have obtained knowledge by making reasonable inquiry that the proceeds would be so applied."

The most important point for this Committee to understand, however, is that the definition of "purchase money loan" should not be narrowed so that it serves only to avert direct seller-creditor collusion without insuring the internalization of the costs of seller misconduct as explained above. The broad definition of

"purchase money loan" as now framed requires the preservation notice whenever the creditor knows that the consumer-borrower will use the loan proceeds to purchase goods or services from a seller which regularly refers consumers to the creditor or with whom the creditor is affiliated. When the creditor has such knowledge, he is in a position to internalize seller misconduct costs by charging more for the loan or by arranging recourse or repurchase agreements with the seller.

The other issue raised by the Federal Reserve Board which seems to have been particularly troublesome to some creditors is the Rule's nonexclusion of tort claims in the preservation notice. These creditors seem to be worried that they will have to obtain costly insurance to cover the possibility of large personal inquiry actions against them for the seller's or manufacturer's negligence. But the Rule could simply not be more clear that a consumer may not assert against the creditor any rights which he might have against the seller for consequential damages beyond the amounts which the consumer has already paid under the credit contract! The required Preservation Notice unequivocally announces: "Recovery Hereunder Shall Not Exceed Amounts Paid By The Debtor Hereunder." Only the cost of the merchandise, plus interest, can be recovered.

It is therefore not necessary to exclude tort claims. It also would not be appropriate, given the history of the common law development and convergence in various jurisdictions of the tortious strict liability and the contractual implied warranty causes of action.

I believe that the Commission deserves a resounding resolution of support from this Congress. There is a lot of talk about the need for more consumer advocacy in Washington. But much more than advocacy consumers need substantive action like that taken by the Commission. Congress' response to such substantive action is the real test of its commitment to making our economy operate in a fairer manner for all Americans.

CENTER FOR LAW AND SOCIAL POLICY,
Washington, D.C., June 8, 1976.

Hon. ARTHUR F. BURNS,
Chairman, Federal Reserve System,
Washington, D.C.

DEAR CHAIRMAN BURNS: On January 5 of this year I wrote to you on behalf of Consumers Union of United States, Inc.[1] concerning the extent of the Board's unfulfilled responsibilities to consumers under Section 18(f)(1) of the amended Federal Trade Commission Act. I suggested that the Board was merely responding to rulemaking initiatives of the Commission and had taken little, if any, independent action to discharge its Section 18(f)(1) responsibilities to protect consumers from unfair and deceptive bank practices. Your eleventh hour May 5 letter to Chairman Collier and your accompanying staff memorandum urging modification and deferral of the Commission's new Rule on "preservation of Consumers' Claims and Defenses" indicate that the Board not only does not fully understand its consumer protection responsibilities, but also intends to participate in Commission rulemaking only in the Board's traditional role of representative of the banking constituency which it regulates.

As you know, the Board will itself have mandatory rulemaking responsibilities regarding the preservation of consumers' claims and defenses when the Commission extends its new rule to cover creditors as well as sellers. We hope that the orientation of your letter and staff memorandum does not suggest that these responsibilities will not be discharged in accordance with Congressional intent.

With the exception of one technical problem discussed on page 21 of the memorandum, the arguments and analyses presented in your letter and the staff memorandum are addressed to alleviating the impact of the Commission's

[1] Consumers Union of United States, Inc. ("Consumers Union") is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide information, education, and counsel about consumer goods and services and the management of the family income. Consumers Union's income is derived solely from the sale of *Consumer Reports* (magazine and TV) and other publications. Expenses of occasional public service efforts may be met, in part, by nonrestrictive, noncommercial grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports*, with a circulation of almost 2 million, regularly carries articles on health, product safety, marketplace conomics, and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

Preservation Rule on creditors rather than making the Rule a more effective consumer protection device. The memorandum makes numerous arguments why the Rule should be restricted or even rejected completely. The memorandum does not generally attempt to suggest ways in which the Rule might be framed to acommodate some of the creditor concerns without sacrificing the Rule's purposes. The letter and memorandum pleaded for delay of the Rule's effective date because some of its boundaries might not be completely clear to creditors, even though: (1) the Rule as now promulgated is applicable only to sellers; (2) no punitive damages can be imposed unless knowledge or constructive knowledge of the deceptiveness of the particular practice is proven; and (3) realistically the Commission's limited enforcement staff can not be expected to initiate any formal actions against practices which are not clearly encompassed by the Rule's purposes as well as arguably by its technical terms.

A specific discussion of the staff memorandum highlights the extent to which the memorandum serves as a creditor advocate's brief against the Rule and fails to provide objective analysis of the consumer interests for which the Board is responsible.

The memorandum's, as well as your letter's, primary concern is with the Rule's definition of "purchase money loan." The memorandum argues that this definition, if read technically, will require creditors to include the preservation notice in all their personal loan contracts, and that such a strict definition is not necessary to serve the Rule's stated purposes. The memorandum stresses that a creditor can never be sure that a consumer, whatever his stated intentions, will not use the proceeds of a loan to purchase goods or services from a seller who generally refers consumers to the creditor or who is affiliated with the creditor. The memorandum concludes that a creditor must insert the preservation notice in all his personal loan contracts because of the chance that the loan will ultimately become a "purchase money loan" within the definition of the Rule. The memorandum argues that this is unresonable because the definition was only meant to avert collusion between sellers and creditors to circumvent the Rule.

Even if the memorandum is correct that the definitional terms of the Rule are technically more encompassing than necessary, the memorandum clearly over-responds to any problem raised by the Rule's technical breadth. First, a definition of "purchase money loan" which may be read to encompass more loans than it is the purpose of the Rule to cover should not prejudice creditors. Creditors who do not use the preservation notice when the consumer borrower does not know whether he will use the proceeds to purchase goods or services from a related seller will risk little. As indicated above, the Commission staff can not be expected to enforce the Rule in situations to which it is not clearly applicable. And even if they attempt to do so, no punitive damages can be imposed if the creditor does not and could not have had knowledge that the conditions of the preservation notice were all met. 15 U.S.C. § 45(m).

Second, the memorandum's statement of the purpose of the definition of "purchase money loan" is too restrictive. The Commission included purchase money loans within the new Rule not only to cover cases of seller-creditor collusion, but also to cover cases in which independent creditors "have the same access to information as discount creditors" and can "obtain equivalent guarantees and endorsements from sellers which embody a repurchase obligations." 40 Fed. 53506, 53525 (1975). Regardless of any collusive relationship, whenever the creditor knows that the consumer-borrower will use the loan proceeds to purchase goods or services from a seller which regularly refers consumers to the creditor or with which the creditor is affiliated, the creditor is a position to internalize the costs of the risk of seller misconduct. The creditor can, for instance, charge more for the loan or arrange general recourse or repurchase agreements with sellers which make regular referrals.

Third and most important, the memorandum's recommended response to what it alleges is an overly broad definition of "purchase money loan" weakens the Rule much more than is necessary to avoid the alleged overbreadth problem. The concerns raised in the memorandum under the headings "Definition of Purchase Money Loan", "Check Credit", and "Availability of Recourse Arrangements" could all be simply addressed by permitting creditors to show that they did not have knowledge and could not have had knowledge at the time the loan was made that the loan proceeds would be used to purchase goods of a related seller. This could be accomplished by adding at the end of the definition a clause such as "unless the creditor can show that at the time of the loan it did not have knowledge and could not have obtained knowledge, by making reasonable inquiry, that the proceeds would be so applied."

The staff memorandum recommends a narrowing of the definition of purchase money loan which would impose the notice requirement only on those loans made pursuant to some business arrangement or contract or pursuant to a referral which is itself made pursuant to such a business arrangement or course of dealing. Depending on the interpretation given to "course of dealing", this definition might permit sellers and creditors to avoid the preservation notice by tacit understandings, the existence of which it would be almost impossible to prove. Cerditors would have no incentive to seek some means of recourse from those sellers with which they have no formal association, but which nonetheless make regular referrals of consumers. Creditors could avoid the Rule simply by not questioning consumers concerning the intended use of the loan proceeds. The costs of seller misconduct would thus not be internalized in accordance with the Rule's purpose.

In sum, the staff memorandum suggests a major weakening of the practical force of the Rule in order to correct a problem which, given the purposes of the Rule and limited Commission enforcement authority and resources, is realistically of minor importance.

The memorandum's attention to and analysis of other issues also reflect a Board preference toward creditor representation rather than consumer protection pursuant to Section 18(f)(1). The memorandum recommends significant qualifications of the Rule which the Commission already has considered carefully and rejected as inconsistent with the Rule's underlying rationale and purposes. For instance, the memorandum recommends that consumers be required to "make a good faith attempt to resolve the problem with the seller prior to taking action against the creditor." This recommendatioon is inconsistent with the Commission's finding that creditors can better internalize the costs of seller misconduct. Acceptance of the recommendation would substantially affect the impact of the new Rule by conditioning the assertion of claims and defenses against creditors on what in most cases would be a very burdensome proof that a good faith attempt was in fact made. Noting this problem of proof and the usual consumer interest in making an initial attempt to obtain redress from the seller, the Commission explicitly rejected suggestions that the consumer be required to make written demand upon the seller before stopping payments. 40 Fed. Reg. 53506, 53528 (1975).

The memorandum also suggests limiting the time during which a creditor would be subject to claims and defenses, at least on large ticket items. However, the Commission, stressing the purposes of the Rule, has already rejected suggestions that limitations be placed upon the time in which defenses can be raised and upon the size of loans covered by the notice requirement. *Id.* at 53528. The memorandum's argument that time and size limits should be imposed reveals a complete insensitivity to the Rule's purposes. The memorandum emphasizes that a seller may go out of business during the lengthy term of a large loan leaving the holder of the credit contract the only guarantor of the goods or services. But seller disappearances occasion some of the most important situations in which consumers require the protection of the notice and in which the costs of seller misconduct are not internalized without the preservation of claims and defenses.

The memorandum advances other restrictions of the Rule without analysis of whether such restrictions would in any way weaken the Rule as a consumer protection resource. For instance, the memorandum simply assumes that agricultural credit is for some reason special and should not be included without a specific evidentiary record; no analysis of why the Rule's rationale does not apply to farm credit or of why the special treatment of farm credit under Truth-in-Lending is relevant to the Rule is set forth. Similarly, without supporting analysis, the memorandum pleads for a "clarification" of the coverage of leases which could act as a restriction of the Rule.

Finally, the memorandum seems to seek to confuse the meaning of the Rule and then argues that the effective date should be deferred because of this conclusion. The memorandum's discussion of the Rule's coverage of leases provides an example. In addition, the memorandum's suggestion that a "purchase money loan" may exist because of an arrangement between a creditor and a seller unrelated to the sale of goods or services to consumers is completely inconsistent with the definitional section of the Rule. A "business arrangement" is limited by definition to some arrangement "in connection with the sale of goods or services to consumers or the financing thereof." 15 C.F.R. 433.1(g). Notwithstanding any "[i]nformal discussions between the staffs of the Board and the Commission", "checking accounts" of "unrelated creditor loans to sellers" surely do not in themselves constitute a "business arrangement" under such a definition.

The Board should not of course be criticized for attempting to contribute to the development of a Rule which does not unduly disrupt this nation's credit industry. But it is surely inconsistent with the Board's responsibilities under Section 18(f)(1) of the amended FTC Act for that attempted contribution to be made in the form of creditor advocacy.

Sincerely,

MICHAEL C. HARPER,
Attorney.

CHAIRMAN OF THE BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., July 19, 1976.

MICHAEL C. HARPER
Washington, D.C.

DEAR MR. HARPER: I have received your letter of June 8 commenting on the Board's response to the Federal Trade Commission's Rule on Preservation of Consumer's Claims and Defenses. You refer particularly to my letter of May 5 to Chairman Collier of the FTC and the accompanying memorandum by the Board's staff outlining certain issues raised by the rule in its present form.

In the material submitted to the Commission, the Board and its staff expressed concern that the rule contains ambiguities that may render its implementation more difficult. The Board remains committed to minimizing the confusion and any adverse economic impact that may result from implementation of the rule.

The Board's concern for the impact of the rule on the credit industry in no way conflicts with its long-standing commitment to consumer protection. Indeed, the Board would not be adequately fulfilling its responsibilities to consumers if it failed to consider the economic consequences of the rule. If creditor uncertainty over the scope and application of the rule contributes to higher costs and reduced credit availability, a serious commitment to the needs of consumers would seem to dictate some modification in that rule.

I appreciate your sharing with me your concern regarding this rule and the Board's response to it. I can assure you that the Board will continue to do everything possible to fulfill its responsibilities for consumer protection and the economy in carrying out the mandates of the Federal Trade Commission Improvement Act.

Sincerely Yours,

ARTHUR F. BURNS, *Chairman.*

Mr. METCALFE. Thank you very much, Mr. Harper, especially for giving us a synopsis of your full statement. In your testimony, you state that the cost of credit alone, even if it rises as a result of the rule, does not give a fair evaluation of the rule's effect.

You suggest that the total cost of a transaction actually includes cost of credit, costs of the article and cost of any unnecessary repairs or replacement the buyer must bear because the seller refuses to perform as he has promised.

What evidence is there of comparing the total cost of the consumer transaction before and after the rule?

Mr. HARPER. I do not know of evidence, and the real question in my mind is how effective will the rule be? If it is very effective, it seems to me there will be some transferance of the cost from the payment by the consumer after he has found it shoddy or defective to the creditor and, therefore, the cost of credit, and if it is passed back to the seller, the cost of the goods.

Just in terms of economic analysis, however, Congressman, I cannot understand how this rule will make any difference in terms of total cost of the consumer of the goods and services he purchases. He has to pay before or later. He has to pay some time, assuming it does not detract from the creditor's market power, I do not see how the rule takes away from the creditor's total market power. So, the creditor is in just as good a position to maintain his profit margin as before.

Mr. METCALFE. Do you think they are about equal or just about spread around differently among consumers?

Mr. HARPER. What is equal or spread around?

Mr. METCALFE. Do you think that they are about equal?

Mr. HARPER. The cost?

Mr. METCALFE. Yes; just spread it around——

Mr. HARPER. I think that is a very good question because the relatively unsophisticated consumer is more apt to be—that is going to be the lower income consumer, of course—is more apt to be duped by sellers whose conduct is fraudulent or bordering thereon. He or she is more apt to bear the higher cost. Unfortunately, I do not think the costs are now spread around. Even beyond that, even if certain individuals may just be unlucky, whether they are lower or middle income or sophisticated or unsophisticated.

It is like any insurance premium. Spreading the cost is desirable because it avoids catastrophes longer. You buy a car and it breaks down. A used car dealer may be selling a warranty on cars. One out of five may be bad, but you may be the unlucky one. It is not spread unless you do something like this which operates an insurance.

Mr. METCALFE. How does that relate to the dishonest car sellers? Are they affected by this rule?

Mr. HARPER. Very much so.

I should qualify the answer to your first question in that you asked what effect there would be on total cost.

Mr. METCALFE. Right.

Mr. HARPER. I should qualify. I should have defended the rule more because, insofar as it puts out of business the dishonest seller and car dealer who cannot sell his paper to the creditors or cannot even give recourse and cannot get his goods financed, so far as it puts them out of business, I think the total cost of goods to consumers is going to be reduced.

Mr. METCALFE. Mr. Harper, I have one more question to ask you in light of the time factor. We have one more witness.

It has been argued that new businesses may have difficuty getting finance companies, banks and other creditors to buy their paper. Since they have no track record on which the creditor can base an estimate of his trustworthiness, do you have any evidence that insurance may be available for the new businesses to cover the period during which there is no such track record to back him up?

Mr. HARPER. The only thing I know about is the Forbes article that was already cited. But, as I said, I have great faith in American entrepreneurs to come into this area to make some money. If I want to make some money, and there is this need for insurance and creditors want to protect themselves, I will come in and say:

> Look, there are 100 new merchants in this community. It is true one or two may be bad guys and women and may be selling shoddy goods and may burn you, but if you buy the insurance policy and spread the risk, everybody will be a little bit better off.

of Congress general sentiment on the subject of holder in due course and similar devices.

The rule itself, at last, declares it to be an unfair and deceptive practice for a seller to use procedures which separate the consumer's legal duty to pay from breaches of the seller's legal duties, such as breach of warranty and fraud. It addresses all three of the devices used by creditors to accomplish this separation, by preserving claims and defenses to defeat or diminish the creditor's right to be paid. No new rights or defenses are created; only those already existing under local law apply.

Clearly, in my mind, the rule represents a giant step forward for the largest American silent majority, the consumer. Nonetheless, the credit industry, haunted by the specter of lost insulation from consumers' claims and defenses, has repeatedly called attention to a well-developed repertoire of evils said likely to follow enactment of the rule.

I have selected what I feel are the six leading arguments raised in opposition to the rule. I will briefly explain why each concern expressed, good intentions aside, is exaggerated.

The first matter I will address concerns the procedure of promulgation of the rule rather than its substance. This has been discussed previously, so I will not get into it very deeply. Of course, what I am referring to is the fact that there is some talk of requiring the FTC to reissue its rule, observing the strict legislative rulemaking proce-resources, and tax dollars. Where the presentation of data, views, and that are that provision embodies Congress' intent that substantially completed records need not be the subject of new proceedings using the new procedures, presumably in the interest of conserving time, resources, and tax dollars. Where the presentation of data, views, and arguments were substantially completed, as here, before the date of enactment thereof, promulgation of the sort which we see here was completely proper and permissible under the act.

Attacks have also been made on the quality of the record which led to promulgation of the rule. As stated in much more length by Mrs. Smith from the Federal Trade Commission, all interested parties were accorded many opportunities to file written data, views, and arguments at many junctures to the extent of compiling some 10,000 pages.

The public record compiled in such bulk pointed up the need for meaningful Federal intervention in this area. The suggestion that the rule be revoked now and repromulgated following more formal procedures is in clear contravention of the intent of section 202(c) (1). It also demonstrates callous disregard for the already overburdened taxpayer, in light of the astronomical costs likely to be incurred in repeating this whole process. Were I a legislator, I would not saddle my constituents with such a bill, particularly where in return I could offer only a return to the "bad old days" of consumer impotence at the hands of insulated creditors. Furthermore, the reprieve for creditors would in all probability be temporary, notwithstanding the loss of time and tax dollars in favor of nominal procedural niceties.

The next matter which has been discussed at some length today concerns the scope and applicability of the rule itself. It has been repeatedly suggested that creditors are unable to ascertain the scope and

applicability of the rule, to the extent that compliance will be difficult or impossible.

There is no uncertainty as to the requirement that sellers include the notice provision eliminating holders in due course and waivers of defenses. Therefore, any doubt concerning scope and applicability concerns which sort of loan transactions are also subject to the notice requirement.

Among the criticism in this regard is that the broadness of the definition of a "purchase money loan" is such that it may create uncertainties in some categories of credit. Confusion is also expressed as to what constitutes a cooperative agreement between a creditor and a seller. More correctly stated, these and similar concerns seek guidance as to what loopholes remain in the wake of abolition of the holder in due course and prohibition of defense waivers.

In issue here are the most fundamental policy decisions underlying promulgation of the rule. On the massive record described, it was determined that sellers must include in credit contracts the notice provision which would prevent separation of the buyer's promise to pay from the seller's duties. Similarly, claims and defenses must be preserved where sellers arrange financing for buyers through referrals to direct lenders or where seller and lender are affiliated with each other. It was recognized that failure to include purchase money loans would make avoidance of the rule easy and certain, as evidenced by a demonstrated increase in the use of direct loans, including "body dragging," in jurisdictions already limiting consumer promissory notes and waiver of defense clauses.

I also think it is relevant to repeat again that creditors are in a position to possess information concerning sellers with whom they deal which is not available to buyers. Creditors are deemed able to establish means by which to shift the risk back to the seller.

On the other hand, the rule is not all encompassing. It only regulates situations where the loan is made by a creditor who receives referrals from the seller or is affiliated with the seller by "common control, contract, or business arrangement."

In my opinion, the exemption of any device from coverage by the rule invites the shift of more questionable sales in that direction. I believe the rule, if anything, leaves too many loopholes open for such experimentation. I should also add that I fully share the concerns expressed by Mr. Hobbs as regards the recent retreat that appears to be underway at the FTC. This morning, for the first time, I read the "Statement of Enforcement Policy" which was printed on August 16, 1976, in the Federal Register, and my overall impression, without being able to supply a detailed analysis at this point, is that some of the transactions to be excluded may very well result in the channeling of industry's vast resources into loan devices of avoidance.

The next matter that I am going to discuss concerns effects on the cost and availability of credit. It has been said that the rule is going to open a virtual Pandora's box in the consumer credit area, the focus of which would be the drying up of the supply of credit accompanied by an increase of the cost of the credit which remains available.

To my knowledge, no hard evidence in support of such fears has come to light in the first 3 months during which the rule has been in effect.

I also note, in passing, the FTC study, which I heard about for the first time today, performed by an independent research group which also seemed to indicate that no significant impact on the availability of credit has as yet taken place following promulgation.

Of equal significance, I have no personal knowledge of data, on record or otherwise, which supports such fears in those States that already have laws substantively similar to the rule. This is significant, particularly in light of the fact that industry, perhaps alone, has access to such data. It logically seems to follow that industry's choice not to produce such data owes to the fact that it is simply not supportive of its position.

In summary, in light of all facts known to me, I feel it is safe to say, at least at this point in time, that the facts contradict the predictions of doom offered by the financers. I also believe it is important to note that the FTC sounds as if it is earnestly endeavoring to obtain additional independent study information to zero in on the problems which exist along this line, if they exist and as they occur.

Another issue which has been raised concerns what is perceived to be potential liability of indefinite duration under the rule, particularly in the context of the sale of large ticket items customarily financed over a long period of time, such as mobile homes and boats. According to this theory, it is contended that the creditor, who will be faced with continuing exposure to liability over several years for consumer claims and defenses assertible against the seller, will, of necessity, restrict the availability of credit for such purchases.

The retort to this argument is quite simple. The rule is explicit in subjecting a holder only to, and I quote:

> All claims and defenses which the debtor could assert against the seller of goods or services obtained with the proceeds.

Furthermore, the local statutes of limitations will naturally control as to when the claims and defenses will be extinguished. A creditor is therefore subject to a claim or defense for the same length of time as the seller would be and not for the full term of the loan. This, of course, becomes particularly relevant in the case of 5- or 10-year loans, such as the large ticket items that I have mentioned. The fears of industry in regard to the duration of liability are, therefore, in my opinion, also unfounded.

A similar fear has been expressed in regard to the extent of liability. The fear is that the rule will subject creditors to massive tort and other liability.

Again, however, the rule contains its own built-in limitation upon the liability of creditors, which must be included in the required notice. The consumer is thereby limited to a refund of the amount paid under the contract. This approach is not revolutionary, but merely codifies the existing law in most States which have addressed affirmative claims against third-party creditors. I might include the District of Columbia in that category.

Although a consumer may have a claim or defense against a seller arising out of a different transaction, that claim or defense may not be asserted against the holder.

It must also be realized that the holder is assuming certain benefits by his status. With these must come obligations. The hope is that creditors dealing with disreputable dealers will either sever such ties or indemnify themselves. The latter methods are preferable to denying the consumer any protection whatever, and, as stated, the recovery is, in any case, limited to what the consumer has already paid out of his pocket.

On balance, and in consideration of the interests of all affected parties, the formula arrived at by the FTC and incorporated in the rule, I feel, is a most reasonable one.

One last point I am briefly going to mention is the question of effects on small retailers.

Some segments of industry have said that they foresee adverse limitations upon the financing of unfamiliar sellers, thus erecting barriers to their entry into the consumer marketplace. As the argument goes, the uncertainty created by the lack of experience with their business practices would reinforce the preexisting fear of undue costs and risk inherent in the new rule. In my opinion, this represents a theory only, which overlooks the wording of the rule and is unsubstantiated by factual data.

The rule, as worded, does not apply where the lack of connection between a seller and lender would create undue difficulties. It applies only where the seller is arranging credit, either by an established pattern of referrals or affiliation.

I do not have statistics available, unfortunately, but I do feel the calamitous consequences predicted by the industry have not materialized in the five or six States already possessing laws substantially akin to the rule.

Whatever reputation is enjoyed by such a seller is likely to be considered by a creditor regarding his or its entrance into the retail market. There are known standards which can be applied for use in screening out undesirable investments, that is, those likely to generate consumer grievances. To the extent creditor scrutiny diminishes the supply of shoddy merchandise and practices, as Mr. Hobbs said, the rule is performing well for consumer and creditor alike.

I have just a couple of final remarks in conclusion. The industry's opposition to promulgation of the rule, as documented, and as heard throughout the course of the proceedings, has been long and hard. Examination of the merits raised reveals the conspicuous absence of substantiation, despite the industry's unique access to favorable data, if any in fact exists. What evidence there is, particularly from those States which have laws like the rule, seems to point the other way.

What we have before us is a good rule. It represents the first civilized and evenhanded attempt to return to the consumer of this country the right to pursue just claims and defenses, regardless of who receives the monthly payments, but only up to the amount actually paid by the consumer.

The removal of the financer's incentive under old law to maintain ignorance of the seller and his merchandise will have to be replaced by greater involvement, which must result in a higher quality of credit.

I am confident that once creditors elect to divert their tremendous resources and ingenuity toward assuring the integrity of sellers rather than avoiding the rule, we will observe a marked improvement in the quality of credit, to the shared benefit of consumer and creditor alike. Thank you.

[Testimony resumes on p. 69.]

[Mr. Zweibel's prepared statement follows:]

STATEMENT OF GEORGE J. ZWEIBEL, CONSUMER SPECIALIST, NEIGHBORHOOD LEGAL SERVICES PROGRAM

INTRODUCTION

My name is George J. Zweibel. I am an attorney in the District of Columbia, and am currently employed as a staff attorney by Neighborhood Legal Services Program for the District of Columbia, formerly funded by the Office of Economic Opportunity, now the Legal Services Corporation. Neighborhood Legal Services Program, like its counterparts across the country, is the primary provider of free legal representation to low-income consumers in Washington, D.C., and I appear today as the representative thereof. I have served in my present capacity for a period of about two years, during which time I have specialzed in consumer law. In addition to my admission to the bar of the District of Columbia, in January 1973, I am also admitted in Pennsylvania (May 1973). Prior to my present employment, I practiced for about two years in Pennsylvania, as a neighborhood attorney with Neighborhood Legal Services Association, in Pittsburgh, a similarly funded organization.

I consider it a great privilege to be afforded the opportunity to present my views to the House Subcommittee on Consumer Protection and Finance, and to address a very important matter, the recently enacted Federal Trade Commission Trade Regulation Rule Concerning the Preservation of Consumers' Claims and Defenses (hereinafter called "Rule").

Before discussing the Rule itself, I shall briefly examine the legal context within which the Commission deemed federal intervention necessary.

I. BACKGROUND

> More money is being taken from Americans at penpoint than by gunpoint and the pen often makes it legal.—Helen Nelson, former Consumer Counsel for the Governor of California

Miss Jones, who bought a television set on time from Dealer A, is totally unaware that if the set self-destructs one week later she may still be required to pay the XYZ Finance Company, which purchased her contract and note. One of the most difficult things for a lawyer to explain to a client such as Miss Jones is the continuing obligation of paying for goods which are nonconforming, defective, or even useless. And yet, such a duty continues to exist in many states.

Miss Jones has fallen victim, like hapless millions before her, to the holder in due course doctrine. Under that doctrine, if a financer buys the promissory note of a buyer from a seller of goods or services, in good faith, with no knowledge of consumer claims or defenses, the consumer must pay despite such defects, as if he had borrowed the money directly from the financer and then tendered it to the seller. That the goods are useless, no longer in existence, or even undelivered, is irrelevant. A holder in due course is insulated against all defenses or claims except those showing the note to be totally void.

The holder in due course doctrine constitutes the heart of the law of negotiable instruments. It was created by businessmen solely to regulate the free flow of commerce among themselves. In its more than 200 years of existence, the doctrine has, as intended, allowed liquidity and confidence in commercial paper. Over the years, the concept expanded to encompass the purchase of consumer goods and sevices on time as well. Consumers, however, are not in the same position as banks or other commercial paper users. In consumer transactions, the integrity of the commercial paper market is not a concern. Nonetheless, the use of promissory notes forces entry into this market. As a result, the holder of a negotiable instrument is free to sue a consumer on the basis of the instrument itself without regard for any aspect of the underlying transaction which gave rise to the instrument. Defeating holder in due course status in the courts has always been difficult, at best, and often impossible.

Except where barred by local law, provisions may also be included by the seller whereby the buyer agrees not to assert claims or defense against a subsequent assignee of the seller. In those jurisdictions which have eliminated the holder in due course, the waiver clause has often taken over, giving the assignee all the protections enjoyed elsewhere by the former. In those which have not, a holder unable to qualify as a holder in due course may still receive full insulated if such a clause is inserted. Another device for avoiding creditor exposure to consumer claims or defenses arising in the course of credit sales is the use of

vendor-related loans, such as referral to a lender after the customer has selected an item for purchase. The law generally treats prearranged loans of this sort as spontaneous transactions solicited by the borrower, rendering claims for payment wholly independent of sales agreements. The three devices described share the common purpose of subjecting consumers to collection actions while denying them the opportunity to defend. Used singly or in concert with each other, depending upon the local legal climate, they have been most effective in separating the debt from related claims and defenses.

As indicated at the outset, it is rather late in the game to assume that the consumer knows his legal rights and liabilities in the event of a post-sale legal conflict. Add to this the fact that consumers are regularly induced to purchase goods or services they neither need nor can afford, often by the use of high pressure tactics or misrepresentation. The years have witnessed schemes of consumer deception of monumental proportion, where a large number of consumers were defrauded in a short period of time, their accounts sold to insulated third parties, and the perpetrators escaped the jurisdiction with their ill-gotten windfall, to invest it in similar schemes elsewhere. In such cases, devices such as the holder in due course permitted the perpetration of fraud or other illegality upon all persons, not only those with sufficient quantities of cash to pay in full before the seller vanished. Not every consumer abuse is of the grand mal variety. Consumers frequently have complaints such as misrepresentation by the salesperson, tender of defective merchandise, nondelivery, and so forth. In either case, however, the consumer may share a common bond, the loss of his defenses and right to redress forever, without even knowing it.

In the context described, legislative bodies across the land have had to come to grips with the questions: When should a third party be able to enforce a consumer obligation without being subject to defenses relating to such obligation? When, and to what degree, should a third party be liable for the affirmative claims of a consumer arising out of the transaction? When, and to what degree, should a direct lender be subject to a consumer's defenses and/or claims arising out of the transaction financed by the loan?

Legislative responses have been almost as varied as they are numerous. To be sure, the use of holder in due course and other insulating devices, in the context of consumer credit, have been limited or eliminated to one degree or another in about 40 jurisdictions.[1] Some simply render the holder in due course doctrine inapplicable to consumer sales transactions, but impose no restriction upon the use of defense waiver provisions. Others restrict cut-offs of consumer rights for a stated period of time, during which the consumer must communicate sale-related grievances to the creditor in order to preserve the right to raise them later. Nonetheless, the holder in due course survives in several states, while insulating devices of one sort or another remain viable in most states, particularly those utilizing the vendor-related loan.

It is in this context of variant legislative treatment by the states, with loopholes aplenty, that the F.T.C. has attempted to establish a national standard to provide greater protection for consumers.

II. FTC TRADE REGULATION RULE CONCERNING THE PRESERVATION OF CONSUMERS' CLAIMS AND DEFENSES

On November 14, 1975, the Federal Trade Commission, following more than four years of study, including weeks of hearings and the compilation of nearly 10,000 pages of transcript and written comments, addressed what it found to be widespread public concern about the mechanical abrogation of the rights of consumers through the use of insulation devices. That date saw the final promulgation of the Trade Regulation Rule Concerning the Preservation of Consumers' Claims and Defenses,[2] which became effecive May 14, 1976.

On the effective date, the Cmmission released extensive staff guidelines regarding the Rule, in order to facilitate compliance. The release fully discussed the text, purpose, and mechanism of the rule, as well as which contracts must contain the required notice provision and the placement thereof. I will draw from portions of these guidelines, insofar as they relate the meaning of the Rule.

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[1] This figure, reported November 18, 1975, is contained in the Federal Trade Commission Statement of Basis and Purpose for the Trade Regulation Rule Concerning the Preservation of Consumers' Claims and Defenses. 40 F.R. 53506, 53508.

[2] 16 C.F.R. § 433.1 *et seq.*; 40 F.R. 53506.

In essence, the Rule declares it an unfair and deceptive practice, within the meaning of the Federal Trade Commission Act,[3] for a seller, in financing consumer goods or services, to use procedures which separate the consumer's legal duty to pay from the seller's legal duties regarding such matters as breach of warranty and fraud. As noted earlier, this separation of legal duties is usually accomplished in one of three ways:

(1) The seller executes a promissory note along with the credit contract. A subsequent assignment then establishes a holder in due course, insulated by operation of law under the Uniform Commercial Code.

(2) The seller incorporates a waiver of defenses provision in the contract. By this waiver, the buyer "agrees" that the contract will be treated like a promissory note in the event of assignment.

(3) The seller arranges a direct loan for the buyer. The lender is then entitled to payment regardless of what the seller has done. The Rule addresses all three of these devices, to the extent that buyer's claims and defenses against the seller will be preserved to defeat or diminish the right of an assignee (creditor) to be paid.

The Rule insures that the consumer credit contract will preserve the consumer's rights against the seller. This is done by requiring the insertion of a notice provision in the text of all such contracts executed with buyers, subjecting any holder to all claims and defenses the debtor could assert against the seller, up to the amounts paid by the debtor thereunder. Loan contracts under which the seller has arranged direct loan financing require a similar notice clause. By including such notice as part of the agreement, whether an installment sales or loan agreement, the ultimate creditor will stand in the shoes of the seller.

Significantly, the Rule creates no new rights or defenses. The "claims and defenses" referred to in the notice are only those already existing under applicable law in each jurisdiction.

What the new rule does is provide an important new protection to consumers. At long last, the consumer is protected against the selling of inferior products with third party financing later to find the creditor hiding behind the curtain of the holder in due course doctrine or a similar device. Such third parties are now equally responsible for defective products or services. Consumers buying products wearing out or breaking down too soon, for example, may now seek the same relief from third party creditors as was available from the original seller. Purchasers of credit accounts must live up to the claims made about the product at the time of purchase by the seller.

Despite the obvious improvement in the lot of the consumer, the finance industry had fought long and hard to obstruct promulgation of the Rule. I will next address and refute the most important of the arguments which have been made on behalf of the industry.

III. INDUSTRY ARGUMENTS REBUTTED

Banks and finance companies, haunted by the specter of lost insulation from consumers' claims and defenses, have, in concert with their supporters, repeatedly espoused a well-developed repertoire of evils certain to follow the enactment of such a rule. Burial of the holder in due course, at the ripe old age of 200-plus, will, according to the dogma, unloose frightening forces upon the already ailing economy, favoring neither creditor nor consumer.

Rhetoric aside, however, the concerns expressed are not of sufficient gravity to offset the benefits of the Rule. In the following discussion, I will enumerate the leading points raised in opposition to the Rule, and explain why each concern expressed, albeit well intentioned, is exaggerated.

1. Scope and applicability of the rule

It has been repeatedly suggested that creditors are unable to ascertain the scope and applicability of the Rule, to the extent that compliance will be difficult or impossible.[4]

There is no uncertainty as to the requirement that sellers include the notice provision eliminating holders in due course and waivers of defenses. Any doubt concerning scope and applicability therefore concerns which sort of loan transactions are also subject to the notice requirement.

[3] 15 U.S.C. § 45.

[4] *See, for example,* letter dated April 9, 1976, from Gerald M. Lowrie, Executive Director, Government Relations, American Bankers Association, to Calvin J. Collier, Chairman, Federal Trade Commission.

The Rule prohibits acceptance by a seller of money obtained through a "purchase money loan," unless the consumer's loan contract contains the provision preserving the consumer claims and defenses. Section 433.1(d) defines the term as follows:

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.

Chairman Burns, of the Federal Reserve Board, has indicated that the "broadness" of the definition may create uncertainty in some categories of credit, indicating, for example, the difficulties in learning whether a referral is involved.[5] The Independent Bankers Association has expressed confusion as to what constitutes a "cooperative arrangement" between a creditor and a seller.[6] More correctly stated, these and similar concerns seek guidance as to what loopholes remain in the wake of abolition of the holder in due course and prohibition of defense waivers.

Questions of the sort here raised concern the most fundamental policy decisions underlying promulgation of the Rule. Following several years of consideration and the accumulation of a massive record, the Commission concluded that it is unfair to sellers to impose all risks of seller misconduct on buyers through the use of insulating credit arrangements. As a policy matter, it was therefore determined that sellers must include in credit contracts the notice provision which would prevent separation of the buyer's promise to pay from the seller's duties. It was similarly concluded that claims and defenses must be preserved where sellers arrange financing for buyers through referrals to direct lenders or where seller and lender are affiliated with each other. It was recognized that failure to include purchase money loans would make avoidance of the Rule easy and certain, as evidenced by a demonstrated increase in the use of direct loans, including "body dragging," in jurisdictions already limiting consumer promissory notes and waivers of defenses.

The Commission additionally recognized that creditors have access to information concerning sellers with whom they deal which is not available to buyers. Such creditors are deemed able to establish means by which to shift the risk back to the seller, by recourse arrangements, requiring warranty insurance, subrogation, or the like.

On the other hand, the Rule is not all-encompassing. It only regulates situations where the loan is made by a creditor who receives referrals from the seller or is affiliated with the seller by "common control, contract, or business arrangement." Cognizant that the complexities of the consumer credit market would inevitably lead to questions as to the meaning of "purchase money loan" financing, the Commission pamphlet of staff guidelines on the Rule included seven pages of discussion of the scope of the Rule in most typical loan situations.

In my opinion, the exemption of *any* device from coverage by the Rule invites the shift of more questionable sales in that direction. If the finance industry is to earnestly assure the quality of its consumer credit, there should not even exist the temptation of shifting from one sort of lending scheme to another to shirk that responsibility. I believe the Rule, if anything, leaves too many loopholes open for such experimentation. But, so far as it goes, the Rule is reasonably explicit and, with the addition of the staff guidelines, should not cause significant confusion to lenders.

2. Effects on the cost and availability of credit

We are warned that the Rule will open a Pandora's box in the consumer credit arena. Among the predicted results are the drying up of the supply of credit, accompanied by an increase in the cost of the credit available. Some perceive a threat to the very growth of retail trade in this country. To my knowledge, no smidgen of evidence in support of such fears has come to light in the first three months during which the Rule has been in effect. More significantly, I know of no data on record which supports such fears in states with laws substantively similar to the Rule. This is significant, particularly in light of the fact that industry

[5] Letter dated May 5, 1976, from Arthur F. Burns, Chairman, Board of Governors of the Federal Reserve System, to Calvin J. Collier, Chairman, Federal Trade Commission.

[6] Statement by Charles O. Maddox, Jr., President, Independent Bankers Association, dated May 27, 1976, addressed to all members of the House and Senate Banking Committees.

has access to such data. It logically follows that industry's choice not to produce such data owes to the fact that it is not supportive of its position.

On July 2, 1976, Chairman Annunzio, of the House Consumer Affairs Subcommittee, addressed the House of Representatives concerning the claim that credit is "drying up" following implementation of the Rule.[7] The case was well-stated by Chairman Annunzio: "It appears to be just another case of the lobbying groups crying 'wolf' or doing a good imitation of Chicken Little's 'the sky is falling' routine."

Unlike the industry, however, Chairman Annunzio offered a factual basis for his conclusion. His staff had telephoned more than 100 automobile, furniture, and home improvement businesses located in the District of Columbia, Maryland, and Virginia, to inquire as to whether the new rule was causing any major problems. The overwhelming response was in the negative. Additionally, banks, as well as the American Bankers Association itself, had begun advertising their intention to substantially increase the financing of new automobiles for consumers, which loans would come squarely under the new rule.

In light of the foregoing, it is safe to say that the facts available contradict the predictions of doom offered by financers. The expressions and actions of the regulated themselves are to the contrary. No substantiation has been offered in support of the fears expressed.

3. Duration of creditor's liability.

Particular concern has been voiced over what is perceived to be potential liability of indefinite duration under the Rule, especially in the context of the sale of large ticket items customarily financed over a long period of time, such as mobile homes and boats. It is contended that the creditor, who will be faced with continuing exposure to liability over several years for consumer claims and defenses assertible against the seller, will simply restrict the availability of credit for such purchases. To remedy this, it is suggested that liability be limited to a "reasonable" number of years.

Illustrative of the industry position is a statement dated May 27, 1976, prepared by the president of the Independent Bankers Association, and addressed to all members of the House and Senate Banking Committees. It is there stated that lenders will "be liable for a produce long after the manufacturers' warranty has expired," citing the following example:

> For instance, mobile home loans, which account for 90% of all home loans under $20,000, generally have a term of 5–10 years. Yet the average manufacturer's warranty on a mobile home is 12 months. This means the lender is being forced to guarantee the product long after the manufacturer will no longer stand behind it. Surely this is unfair.

The retort to this argument is quite simple. The Rule itself is explicit in subjecting a holder only to "all claims and defenses which the debtor could assert against the seller of goods or services obtained with the proceeds." The lender is not subjected, for example, to providing a guaranty any longer than the manufacturer. Furthermore, the local statute of limitations will control as to when claims and defenses will be extinguished. The lender in the five-to-ten-year mobile home loan situation would only be subject to suit for breach of warranty for the statutory period governing contracts, usually two or three years from the date of the breach. The creditor is therefore subject to a claim or defense for the same length of time as the seller would be, and not the full term of the loan.

The fears of industry in regard to the duration of liability are therefore unfounded.

4. Extent of liability

Banks and finance companies have also expressed the fear that the Rule will subject them to massive tort and other liability. Remedial measures suggested include the exclusion of all tort claims from the rule or, alternatively, exclusion of such claims as personal injury or property damage arising from the goods and services purchased. It is felt by industry that the latter sort of claims have no relation to the unfair practices addressed by the Rule.

In response, it must be stressed that the Rule contains its own built-in limitation upon the liability of creditors, which must be included in the required notice:

> Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder.

In other words, in the event that an affirmative recovery is sought from a creditor, the consumer is limited to a refund of the amount paid under the contract. Such an approach is not revolutionary, but merely codifies the existing law in most states which have addressed affirmative claims against third party creditors.[8] Of course, the consumer may assert, by way of claim or defense, a right not to pay all or part of the outstanding balance owed to the creditor.

[7] Congressional Record—House, H7288, July 12, 1976.

In accordance with the foregoing, where a seller's conduct gives rise to damages exceeding what has been paid under the contract, the consumer may elect to sue to liquidate the unpaid balance and recover the amount already tendered or defend in a creditor collection action. In no instance can the consumer recover additional damages, of a consequential or punitive nature, for example.

Importantly, although a consumer may have a claim or defense against a seller rising out of a different transaction, that claim or defense could not be asserted against the holder. The holder's obligations pertain only to the transactions he finances.

As to the liability which is incurred, it must be realized that the holder is assuming certain benefits, including purchase at less than face value presumably. With these must come obligations. The hope is that creditors dealing with disreputable dealers will either severe such ties or indemnify themselves. The latter methods are preferable to denying the consumer any protection whatever and, as stated, the recovery is, in any case, limited to what the consumer has already paid out of his pocket.

On balance, in consideration of the interests of all affected parties, the formula arrived at and incorporated in the Rule is a most reasonable one.

5. Effects on small retailers

Some segments of the industry foresee adverse limitations upon the financing of unfamiliar sellers, thus erecting barriers to their entry into the consumer marketplace, as well as reducing the diversity of credit sources available to consumers. As the argument goes, the uncertainty created by the lack of experience with their business practices would reinforce the existing fear of undue costs and risk. In my opinion, this represents a theory only, which overlooks the wording of the Rule and is unsubstantiated by factual data.

In promulgating the Rule, the Commission recognized the need to insure the availability of multiple credit sources. It is for this reason that the Rule, as worded, does not apply where the lack of connection between the seller and lender would create undue difficulties. It applies only where the seller is arranging credit, either by an established pattern of referrals or affiliation.

The calamitous consequences predicted by the industry have not materialized in the states already having laws substantively akin to the Rule. On the contrary, this appears to be one more "Chicken Little" pronouncement of the sort usually encountered in excess in the face of any new consumer credit regulation. Despite the last decade's proliferation of credit regulation at every level, federal, state, and local, that period has witnessed an accompanying doubling of the value of consumer credit, including a disproportionate increase by commercial banks.[9] This occurred despite the recurrent doomsday predictions of creditors.

I also think it unlikely that whatever reputation is enjoyed by individuals who become new entrants into the retail market will not be compared to known standards for screening out undesirable investments, that is, those likely to generate consumer grievances. To the extent that creditor scrutiny diminishes the supply of shoddy merchandise and practices, the Rule is performing well for consumer and creditor alike.

6. Procedures used to promulgate the rule

The Independent Bankers Association has advocated requiring the F.T.C. to reissue its rule, observing the strict legislative rulemaking procedures of the Moss-Magnuson Act. Such a requirement is embodied in S. 642, which would revoke the Rule but allow subsequent promulgation in accordance with the new procedural requirements of the Act (15 U.S.C. § 57a). Unlike the previously discussed issues, this contention concerns the procedures utilized in promulgating the Rule, and not the substance thereof.

The Rule was promulgated pursuant to Section 202(c)(1) of the Act, which reads, in pertinent part, as follows:

[8] *See, for example,* D.C. Code § 28–3808 (1973 ed.).

[9] Federal Reserve Bulletin (August 1974).

> Any proposed rule under section 6(g) of such Act with respect to which presentation of data, views, and arguments was substantially completed before such date may be promulgated in the same manner and with the same validity as such rule could have been promulgated had this section not been enacted.

In light of the above provision, the decision of the Commission to promulgate the Rule, where the "presentation of data, views, and arguments was substantially completed" before the date of enactment thereof, was entirely proper and permissible under the Act. The cited provision embodied the intent of Congress to the effect that substantially completed records need not be the subject of new proceedings using the new procedures, presumably in the interests of conserving time, resources, and tax dollars.

Attacks have been made on the quality of the record which led to the promulgation of the Rule. In fact, all interested parties were accorded the opportunity to file written data, views, and arguments at many junctures following the initial publication of proposed rulemaking in 1971.[10] In addition to accepting written comments for some 2½ years,[11] public hearings were held in New York, Chicago, and Washington, D.C. in June through September, 1971, and in Chicago and Washington, D.C. in March and May, 1973, for a total of 17 days of hearings in all.[12] In the course of two rounds of hearings, every party who expressed a desire to present views was given an opportunity to do so. In all, 2,250 pages of transcript were taken, plus 7,362 pages of written comments, for a total record of 9,612 pages.

The public record elicited pointed up the need for meaningful federal intervention in the area under investigation. As a result, the Rule was promulgated November 14, 1975, with a length statement of basis and purpose, which thoroughly reviewed the information, data, and testimony received in the course of the proceedings, including a statement of purpose for each provision with the reasons for any revisions adopted.[13]

The suggestion that the Rule be revoked and re-promulgated following more formal procedures is in clear contravention of the intent of Section 202(c)(1). It also demonstrates callous disregard for the already overburdened taxpayer, in light of the astronomical costs likely to be incurred in such a venture. Were I a legislator, I would not need to deliberate very long in deciding whether to saddle my constituents with such a bill, particularly where in return I could offer only a return to the "bad old days" of consumer impotence at the hands of insulated creditors. Furthermore, the reprieve for creditors would in all probability be temporary, notwithstanding the loss of time and tax dollars in favor of nominal procedural niceties. I think that logic requires instead that we build upon a basically good rule, promulgated in response to a massive record of consumer exploitation without redress, smoothing the rough edges as they appear.

Conclusion

The industry's opposition to promulgation of the Rule has been long and hard. Examination of the merits raised, however, reveals the conspicuous absence of substantiation, despite the industry's access to favorable data, if any exists. What evidence there is, particularly from those states which have laws like the Rule, points the other way, as I have attempted to demonstrate.

What we have before us is a good rule. It represents the first civilized and even-handed attempt to return to the consumer of this country the right to pursue just claims and defenses, regardless of who receives the monthly payments, but only up to the amount actually paid by the consumer.

Logic also favors the Rule. It is designed to make it less profitable to engage in activities which create claims and defenses. The removal of the financer's incentive under old law to maintain ignorance of the seller and his merchandise will have to be replaced by greater involvement, which must result in a higher quality of credit. The hope is that the financer will shift the costs of seller-

[10] The proposed rule was published in the Federal Register for comments and hearings thereon on January 26, 1971 (36 F.R. 1121). As a result of the public record which followed, a revised version of the rule was proposed in the Federal Register on January 5, 1973 (38 F.R. 892).

[11] The closing date for the submission of written comments by interested parties was June 11, 1973 (38 F.R. 8600).

[12] See 36 F.R. 6592, 7465; 37 F.R. 8600.

[13] 40 F.R. 53506–53529.

related claims and defenses back to the seller. Even in instances where this cannot be done, which should be relatively few, it is still better that such costs be borne by the financer, and spread to his customers, than by the individual consumer.

I am confident that once creditors elect to divert their resources and ingenuity toward assuring the integrity of sellers rather than avoiding the Rule, we will observe a marked improvement in the quality of credit, to the shared benefit of consumer and creditor alike.

Mr. Metcalfe. Thank you, Mr. Zweibel. If you notice, that was the bell. I have to get over to the floor.

Mr. Zweibel. Certainly.

Mr. Metcalfe. Thank you very much. I appreciate it. I am sorry we have to cut it short, but we will submit these questions to you.

The subcommittee will stand recessed subject to the call of the Chair.

[Whereupon, at 5:35 p.m. the hearing was adjourned, subject to the call of the Chair.]

CONSUMER CLAIMS AND DEFENSES

TUESDAY, AUGUST 31, 1976

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE,
Washington, D.C.

The subcommittee met at 2:20 p.m., pursuant to notice, in room 2322, Rayburn House Office Building, Hon. William M. Brodhead presiding. [Hon. John M. Murphy, chairman.]

Mr. BRODHEAD. My name is William Brodhead. I'm a member of the subcommittee, the chairman is Mr. Murphy, and the ranking member is Mr. McCollister. They are appearing before the Rules Committee and are expected to be here shortly.

Today, the subcommittee will conduct its second and final day of oversight hearings on the Federal Trade Commission's rule on preservation of consumers' claims and defenses, the holder in due course rule.

The first day's witnesses made a strong case for the rule. The Federal Trade Commission witness, Margery Waxman Smith, Acting Director of the Bureau of Consumer Protection, was an extremely effective advocate for the rule, in the face of prolonged and demanding questioning by our ranking minority member.

Mrs. Smith pointed out that Commission procedures in promulgating the rule conformed to the dictates of the Magnuson-Moss Act, despite the fact that substantially completed rules, and the holder in due course rule in particular, were excluded from application of the Magnuson-Moss Act procedures. The Federal Trade Commission held five sets of hearings in different cities, during which all interested persons were permitted to submit questions to the hearing examiner so that he could cross-examine witnesses. The FTC compiled a record of oral and written testimony which runs almost 10,000 pages.

I might add that testimony from the Federal Reserve Board is conspicuously absent from the record. The FED, which has expressed some concerns about the rule, did not formally raise their objections until more than 5 years after the rule was first proposed and 5½ months after the rule was actually promulgated. To be exact, the FED didn't write to the FTC until 10 days before the rule became effective. Clearly, application of the Magnuson-Moss Act would not have helped the FED make its case.

During the first day of hearings, the subcommittee received a study from the independent firm of Yankelovich, Skelly and White, Inc., with which the FTC had contracted, and which revealed that the Commission's rule was having little or no impact on banks' willingness to extend credit under the new rule. While other less formal and detailed studies were alluded to in the first day of hearings, and more will be considered today, the Yankelovich study has particularly high credibility because it was not conducted in-house.

[The study referred to is printed as an appendix to this hearing, p. 211.]

Mr. BRODHEAD. Today's witnesses all raise questions regarding various aspects of the rule and its probable effects. I am hopeful that we can establish a dialog which will identify specific problems with the FTC's rule so that they can be remedied.

At this point I want to enter into the record, as though read, a statement of James T. Broyhill, Member of Congress, and member of the full committee. Without objection the statement will be entered into the record at this point.

STATEMENT OF HON. JAMES T. BROYHILL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA

Mr. BROYHILL. I would like to thank my colleagues for providing me an opportunity to express my views regarding FTC's Holder in Due Course rule and to explain the purpose of H.R. 15082, legislation sponsored by Mr. Johnson of Pennsylvania, Mr. McCollister, and myself.

The problems which are bing encountered with this legislation actually stem from two areas, the rule itself and the method of promulgation. While I shall not address content in great detail, I am of the opinion that there are several potential shortcomings of the FTC proposal which demand further inquiry.

My primary concern as a Member of Congress, however, is the method by which this rule was implemented. Through passage of the Moss-Magnuson Act in 1975, Congress explicitly laid out the criteria by which the Federal Trade Commission could promulgate regulations. Under the terms of section 18 of the act, the Commission may use no other authority but that contained in section 18 to write trade rules of general applicability. Section 18 rulemaking procedures were specifically written to clarify the FTC authority to write trade rules that have the force and effect of law. The FTC, however did not use the procedures spelled out in section 18 which require that FTC:

First, publish a notice of the proposed rule together with a statement of the particular reasons for the proposed rule.

Second, permit interested parties opportunity to submit written views on the proposed rule.

Third, provide an opportunity for public hearing and to permit cross-examination of witnesses if there are disputed issues of material fact and the Commission determines this is required for a full disclosure of such issues.

Fourth, accompany any final rule with a statement containing the conclusions of the Commission as to basis and purpose of the rule. Such statement shall include a statement as to the prevalence of acts and practices covered by the rule and the manner and context in which such acts or practices covered by the rule are unfair or deceptive. Also the

statement shall include the economic impact of the rule. taking into account the effect of the rule on small businesses and the consumers.

Fifth, in the event the rule is challenged in the courts, hold the rule unlawful if it is not supported by substantial evidence in the entire rulemaking record taken as a whole.

Mr. Chairman, these are the requirements mandated by Congress.

These procedures were not followed by the FTC presumably because a part of the rulemaking procedure had been completed prior to the passage of the Moss-Magnuson Act which recognized the problem of in-process rulemaking. What disturbs me is that the FTC, recognizing that considerable work yet remained to be done prior to adoption of the holder in due course rule and clearly aware of Congressional intent as expressed in the Moss-Magnuson Act, proceeded under the old rulemaking procedures which did not afford interested parties full opportunity to air their views and to assure that these views were acted upon. I believe that if the Commission had followed the procedures of the Moss-Magnuson Act which I have just outlined, this rule probably would have been adopted in an amended form. The predictions that were made—warning the FTC that this rule would drive up consumer costs, have a significant impact on small business, and dry up sources of consumer credit—are, I believe, coming true. There appears to be a mounting record of evidence both from the Federal Reserve and from constituents of several Members of Congress which documents the effects this rule is having. Even the Chairman of the Federal Reserve Board has asked for some extension so that further study could be conducted. This would not have happened if the Moss-Magnuson procedures had not been bypassed and Chairman Burns' warnings not ignored.

Mr. Chairman, I believe that if we establish guidelines for rulemaking we must see that those guidelines are followed. When experts predict damaging effects upon our Nation's credit system, and when evidence begins to accumulate supporting these predictions, we must give proper consideration to the consequences. We must show the Federal agencies that Congress has not delegated carte blanche authority to write or alter the law, especially in the midst of protests from those who are to be affected.

I and my cosponsors rise not in opposition to this rule, nor de we attempt to repeal it. Our legislation, H.R. 15082, will only suspend its effect pending adequate study and review of this rule and the consequences it will have upon consumers and creditors alike.

We ask that you permit the General Accounting Office to study the implications for a limited time, and then report back to Congress as well as to the FTC who will decide to revise, repeal, or reinstate the rule. This will not retract rulemaking authority already granted. It will, however, follow the spirit of the law and the intent of Congress as specified in the Moss-Magnuson Act.

Mr. BRODHEAD. Our first witnesses will be a panel representing the National Savings & Loan League and the U.S. League of Savings Associations.

Gentlemen, if you will come forward.

Now, would you identify yourselves for the record?

STATEMENTS OF BURLEIGH TRIMBLE, ON BEHALF OF THE U.S. LEAGUE OF SAVINGS ASSOCIATIONS, ACCOMPANIED BY J. WILLIAM BRENNAN, ASSISTANT WASHINGTON COUNSEL, AND DAVID E. DEVOL, ON BEHALF OF THE NATIONAL SAVINGS & LOAN LEAGUE, ACCOMPANIED BY HARDING WILLIAMS, GENERAL COUNSEL

Mr. TRIMBLE. My name is Burleigh Trimble and I represent the U.S. League and I have with me Mr. Bill Brennan, assistant Washington counsel for the U.S. League, Washington office.

Mr. BRODHEAD. I see. Welcome. And you are, sir?

Mr. DEVOL. David DeVol, senior vice president, San Diego Federal Savings & Loan and I am accompanied by the general counsel of the National League, Mr. Harding Williams.

Mr. BRODHEAD. Welcome. We're glad to have you with us. In view of the fact that the House is now in session I think that the most fruitful procedure for us to follow here today, will be for you to give a brief oral summary of your statement. Then we will enter your statement in full in the record, and it will be available and circulated to all the members of the committee.

Who is going to go first?

Mr. TRIMBLE. I can lead off, Mr. Chairman.

Mr. BRODHEAD. All right.

Mr. TRIMBLE. Mr. Chairman, my name is Burleigh Trimble and I am loan officer in charge of improvement loans for Iberia Savings & Loan Association, New Iberia, La. and I appear today at the request of the U.S. League of Savings Associations. We appreciate this opportunity to comment at your oversight hearing regarding the FTC's trade regulation rule entitled "Preservation of Consumer's Claims and Defenses."

Since the rule applies only to "purchase money loans" for the acquisition of consumer goods and services, its application to the savings and loan business is primarily in the area of mobile home and home improvement lending. To a much lesser extent, it would affect loans for educational purposes and consumer loans in those few jurisdictions where State chartered associations are permitted to make such loans.

With respect to the types of loans mentioned above, the RTC's new regulation would subject our associations to all claims and defenses which the debtor could assert against the seller when there is a continuing business arrangement between the seller and the association, or where the seller is deemed to be affiliated in some way with the association.

One of our chief problems with the new rule is that it exposes our institutions in those areas mentioned above to an open-ended type of liability up to the extent of the selling price of the merchandise which includes the face amount of the debt plus the down payment. Truth-in-Lending, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, the Fair Credit Reporting Act and the Employee Retirement Income Security Act are all closed ended because both the statutes and regulations exist on a Federal level and their effect on lenders and their customers can be viewed in the context of a statute with specific regulatory provisions. The new FTC rule, however, predicates liabiltiy on claims arising under any Federal law, State law, warranty, provision, etc. which, for our purposes, are related to the production, sale and financing of mobile homes, home improvements, consumer goods or educational loans. A good example of the potential extent of liability concerns a recent occurrence in Colorado involving attic insulation, promoted by a local public utility. Insulation, which was thought to be adequate, was placed in more than 1,700 homes before it was discovered that it did not meet thermal performance and fire safety standards and in fact, was responsible for several attic fires. Under the FTC's new rule, an association financing a number of home improvement loans involving this type of insulation would be exposed to significant liability for a defect which could only be ascertained by extensive tests or extensive technical knowledge beyond the purview of the association. Obviously, the FTC's rule can only cause a significant decrease in the availability of credit for these types of loans, as well as a significant increase in the cost of borrowing to the consumer.

In addition to exposing savings and loan associations to an unlimited basis for liability, the FTC's new rule contains no time limitation on the period which lenders may be liable other than the actual term of the loan. Federally chartered savings and loan associations are currently authorized to make loans on the security of mobile homes for a term of up to 15 years. Likewise, Federal associations are permitted to make loans for the purpose of home improvement, alteration, repair or equipping for a similar period. Under the FTC's rule, if the seller goes out of business at any time during the term of the loan, the lending institution which holds the contract becomes the sole guarantor of the goods. It is obvious that in many cases defects might result from the passage of time and even though he may not have the power to do so under the rule, the consumer may attempt to exert his rights by merely stopping payment on the obligation. In such case, the only way the lender can cause payments to be resumed would involve expensive court litigation. Toward the end of the 10- to 15-year obligation, the size of the remaining unpaid balance would not justify the expenses attendant to litigation.

Because of the long-term basis for most mobile home and home improvement loans, the effect of the FTC's rule will be to force savings and loan associations to deal with only the most financially sound mobile home dealers and home improvement specialists, and avoid dealing with new products and new sellers in the market even though this latter group may have good products and services to sell.

Another issue of concern to our business is that the FTC's rule would subject our institutions which hold the types of consumer credit contracts previously discussed to potential tort liability. Claims of this nature have no relationship whatsoever to the type of unfair practices which the FTC's rule addresses nor has the Commission produced evidence which would provide any valid reason for holding the lender liable for problems traceable to the manufacturer of the product.

The Commission's view is, of course, that the creditor stands in the shoes of the seller. However, this disregards the fact that regulated financial institutions are not in a position which enables them to assume the same risks as manufacturers and sellers. The latter are entrepreneurs in the strict sense and their shareholders risk their capital in return for potential profit. Financial institutions are not entrepreneurs to the same degree. They operate with other people's funds and must maintain a more conservative posture which is clearly set forth by the law and regulation which governs their operations.

Congress has in many instances provided specific exemption from tort liability; a good example being section 170 of the Fair Credit Billing Act. We feel that such an exemption is necessary here in order to maintain lending costs at reasonable levels.

In a related area, it should be noted that the Commission's regulations contain no requirement that a good faith attempt be made on the part of the purchaser to recover from the seller for a product defect before suing the holder of the contract. Such a requirement would be a more expeditious way to solve the consumer's problems. If this is not the case, many of our institutions will be forced to purchase expensive product liability insurance which will increase the financing costs to purchasers. The rule should be amended to limit holder liability to those instances where the consumer is unable to obtain satisfaction from the seller. It should also be noted that there is precedent for such rule in the Fair Credit Billing Act which requires a good faith effort by the consumer to make an initial effort to resolve his problems with the seller.

The Commission apparently intends that State law be preempted across the board. Unfortunately, there are many problems which stem from such preemption.

For example, it is very difficult to write a rule which fits into the broad framework of each State's statutory framework and causes no unintended problems. A good example, in the case of the FTC's rule, is that some States have small loan laws which prohibit a person from owing more than an established amount to a small lender.

The legislative history of the FTC Improvements Act of 1974 clearly indicates that it was not the intention of Congress that Federal Trade Commission trade regulations rule authority be so broad as to permit unilateral preemption of State laws.

The Commission's final rule, however, does not merely cover breach of warranties, misrepresentation and fraud, it covers all claims and defenses which a consumer might have against the seller. By going beyond its intended scope the rule greatly increases the potential for conflicts with States as well as other Federal laws. In fact, it is our understanding that the rule conflicts directly with the FHA title I mobile home lending requirements. Revisions are needed to confine the rule to the scope initially expressed by the Commission.

Our written statement discusses the economic impact of the FTC rule.

At the same time the FTC announced its rule affecting sellers, it proposed another rule which could require creditors who make purchase money loans to include in their financing agreements a similar notice to that required in sales contracts by the seller rule.

We oppose the FTC's new proposed rule for several reasons. First, the Commission has presented no compelling evidence which indicates that savings and loan associations or banks have engaged in unfair or deceptive practices. Next, our lenders are closely supervised by the Federal Home Loan Bank Board which is the Federal financial regulatory agency specifically charged by Congress with that responsibility. To add another layer of bureaucratic redtape to a business which is already adequately regulated is both unwarranted and unreasonable.

The financing of homes constitutes an entirely separate area that has been recognized by Congres and Congress action to create a special mechanism to supervise and monitor institution mortgage and home lending activities. The fact that the Commission apparently has found that unfair and deceptive practices exist in certain types of sales situations is not relevant in determining whether such practices exist with respect to loans financed by savings and loan associations.

Interpretative guidelines published just before the seller rule became effective indicated that sales of interests in real property are not within the scope of the rule. We assume that the same would be true of the proposed rule. However, the question of whether the rule covers home refinancings is left unanswered. At the very minimum we feel that all housing and housing related loans should be specifically omitted from the rule itself and that as federally regulated financial institutions, savings and loan associations should be treated equally with commercial banks.

I thank you very much, Mr. Chairman.

[Testimony resumes on p. 81.]

[Mr. Trimble's prepared statement follows:]

STATEMENT OF BURLEIGH TRIMBLE ON BEHALF OF THE UNITED STATES LEAGUE OF SAVINGS ASSOCIATIONS

Mr. Chairman: My name is Burleigh Trimble and I am Loan Officer in charge of Improvement Loans for Iberia Savings and Loan Association, New Iberia, Louisiana, and I appear today at the request of the United States League of Savings Associations.[1] We appreciate this opportunity to comment at your Oversight Hearings regarding the FTC's trade regulation rule entitled "Preservation of Consumer's Claims and Defenses." This rule specifies, among other things, that it shall be an unfair or deceptive act or practice for a seller to accept the proceeds of any "purchase money loan", unless the consumer credit contract made in connection with the loan contains a prescribed notice that the holder of the contract is subject to all claims and defenses which the consumer could assert against the seller. The term "purchase money loan" is defined to include a loan where the proceeds are used by the consumer to purchase goods or services from a seller who either refers customers to the creditor or is "affiliated with the creditor by common control, contract or business arrangement."

Application of the rule to savings and loan associations

Since the rule applies only to "purchase money loans" for the acquisition of consumer goods and services, its application to the savings and loan business is primarily in the area of mobile home and home improvement lending. To a much lesser extent, because of their dollar involvement, it would affect loans for educational purposes and consumer loans in those few jurisdictions where state-chartered associations are permitted to make such loans. In order to more accurately describe the involvement of savings and loan associations in such activities: as of December 31, 1975, our institutions had invested an aggregate of $2,243,000,000 in mobile home loans and $2,228,000,000 in home improvement loans. Educational and consumer loans totalled some $759,000,000.

[1] The United States League of Savings Associations (formerly the United States Savings and Loan League) has a membership of 4,600 savings and loan associations, representing over 98 percent of the assets of the savings and loan business. League membership includes all types of associations—federal and state-chartered, insured and uninsured, stock and mutual. The principal officers are: Robert Hazan, President, Portland, Oregon; John Hardin, Vice President, Rock Hill, South Carolina; Tom B. Scott, Jr., Legislative Chairman, Jackson, Mississippi, Norman Strunk, Executive Vice President, Chicago, Illinois, Arthur Edgeworth, Director—Washington Operations; and Glen Troop, Legislative Director. League headquarters are at 111 E. Wacker Drive, Chicago, Illinois 60601; and the Washington Office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006; Telephone (202) 785-9150.

With respect to the types of loans mentioned above, the FTC's new regulation would subject our associations to all claims and defenses which the debtor could assert against the seller when there is a continuing business arrangement between the seller and the association, or where the seller is deemed to be affiliated in some way with the association.

Rule provides "open-ended" liability

One of our chief problems with the new rule is that it exposes our institutions in those areas mentioned above to an "open-ended" type of liability up to the extent of the face amount of the debt plus interest. Truth-in-Lending, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, the Fair Credit Reporting Act and the Employee Retirement Income Security Act, etc. are all "closed ended" because both the statutes and regulations exist on a federal level and their effect on lenders and their customers can be viewed in the context of a statute with specific regulatory provisions. The new FTC rule, however, predicates liability on claims arising under any federal law, state law, warranty, provision, etc. which, for our purposes, are related to the production, sale and financing of mobile homes, home improvements, consumer goods or educational loans. A good example of the potential extent of liability concerns a recent occurrence in Colorado involving attic insulation. Insulation, which was thought to be adequate, was placed in more than 1700 homes before it was discovered that it did not meet thermal performance and fire safety standards and in fact was responsible for several attic fires. Under the FTC's new rule, an association financing a number of home improvement loans involving this type of insulation would be exposed to significant liability for a defect which could only be ascertained by extensive tests. Obviously, the FTC's rule can only cause a significant decrease in the availability of credit for these types of loans, as well as a significant increase in the cost of borrowing to the consumer.

Rule provides no reasonable time limit for lenders

In addition to exposing savings and loan associations to an unlimited basis for liability, the FTC's new rule contains no time limitation on the period which lenders may be liable other than the actual term of the loan. Federally chartered savings and loan associations are currently authorized to make loans on the security of mobile homes for a term of up to 15 years. Likewise, Federal associations are permitted to make loans for the purpose of home improvement, alteration, repair or equipping for a similar period. Under the FTC's rule, if the seller goes out of business at any time during the term of the loan, the lending institution which holds the contract becomes the sole guarantor of the goods. It is obvious that in many cases defects might result from the passage of time and even though he may not have the power to do so under the rule, the consumer may attempt to exert his rights by merely stopping payment on the obligation. In such case, the only way the lender can cause payments to be resumed would involve expensive court litigation. Toward the end of a 10–15 year obligation the size of the remaining unpaid balance would not justify the expenses attendant to litigation.

Because of the long term basis for most mobile home and home improvement loans the effect of the FTC's rule will be to force savings and loan associations to deal with only the most financially sound mobile home dealers and home improvement specialists, and avoid dealings with newcomers to the market even though this latter group may have good products and services to sell.

Rule provides no exemption for tort claims

Another issue of concern to our business is that the FTC's rule would subject our institutions which hold the types of consumer credit contracts previously discussed to potential tort liability. Claims of this nature have no relationship whatsoever to the type of unfair practices which the FTC's rule addresses nor has the Commission produced evidence which would provide any valid reason for holding the lender liable for problems traceable to the manufacturer of the product.

The Commission's view is, of course, that "The creditor stands in the shoes of the seller" (Federal Register 5/14/75, page 20023); however, this disregards the fact that regulated financial institutions are not in a position which enables them to assume the same risks as manufacturers and sellers. The latter are entrepreneurs in the strict sense and their shareholders risk their capital in return for profit potential. Financial institutions are not entrepreneurs to the same degree. They operate with other people's funds, and must maintain a more conservative posture which is clearly set forth by the law and regulation which governs their operations. In short, in most cases it would be illegal for a financial institution to accept the same degree of risk in any enterprise as would a manufacturer or a seller. Therefore, such regulated financial institutions should not be subjected to potential tort liability for injuries caused by defects in the products they finance.

Congress has in many instances provided specific exemption from tort liability; a good example being Section 170 of the Fair Credit Billing Act. We feel that such an exemption is necessary here in order to maintain lending costs at reasonable levels.

In a related area, it should be noted that the Commission's regulations contain no requirement that a good faith attempt be made on the part of the purchaser to recover from the seller for a product defect before suing the holder of the contract. Such a requirement would certainly not impose an unreasonable burden on the consumer and would seem to be the most expeditious way to resolve the consumer's problems. If this is not the case, many of our institutions will be forced to purchase expensive product liability insurance which will increase financing costs to purchasers. The rule should be amended to limit holder liability to those instances where the consumer is unable to obtain satisfaction from the seller. It should also be noted that there is precedent for such rule in the Fair Credit Billing Act which requires a good faith effort by the consumer to make an initial effort to resolve his problems with the seller.

Preemption of State law

Many states have laws which limit holder in due course status, however, none seem to be as comprehensive as the FTC's rule. The Commission apparently intends that state law be preempted across the board. Unfortunately, there are many problems which stem from such preemption.

First, it is very difficult to write a rule which fits into the Board framework of each state's statutory framework and causes no unintended problems. A good example, in the case of the FTC's rule, is that some states have "small loan" laws which prohibit a person from owing more than an established amount to a small lender. In the event a savings and loan association finances multiple home improvement loans for a borrower and concludes a recourse arrangement with the home improvement specialist, he may not be liable to the association for the aggregate amount which exceeds the small loan limit. Such law would prevent lenders in such states from protecting themselves by way of recourse agreements.

The most important point with respect to the issue of the right of preemption is that the legislative history of the FTC Improvements Act of 1974 clearly indicates that it was not the intention of Congress that Federal Trade Commission trade regulation rule authority be so broad as to permit unilateral preemption of state laws. As you know, this issue is now the subject of litigation brought against the Commission by the Automobile Dealers Association. Legislation has been introduced in the Senate which will lay to rest any lingering doubts on this point and we strongly support passage of this legislation.

Rule exceeds intended scope

The explanation provided by the FTC for the holder in due course rule appeared in the May 14 *Federal Register* at page 20023. According to the Commission, their investigation 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. The Commission's final rule, however, does not merely cover breach of warranties, misrepresentation and fraud, it covers all claims and defenses which a consumer might have against the seller. By going beyond its intended scope the rule greatly increases the potential for conflicts with state as well as other federal laws. In fact, it is our understanding that the rule conflicts directly with the FHA Title I mobile home lending requirements. Revisions are needed to confine the rule to the scope initially expressed by the Commission.

Economic impact

As we previously indicated, by placing an increased burden on lenders to police sellers and by exposing lenders to liability from product defects, the new FTC rule will obviously increase the cost of financing transactions which fall within its purview. Since the rule has only been in effect for a little more than three months, it is as impossible to assess what the ultimate impact will be on costs and availability of credit as it would be for proponents of the rule to quantify what they believe its benefits are to consumers. To make a prediction as to the ultimate outcome would be much the same as trying to predict the benefits of solar energy products. Short term effects, however, are more predictable and it should be noted that Wharton Econometrics Forecasting Associates have advised that the new rule could reduce our country's gross national product this year by more than two billion dollars. If this prediction is valid, we question whether it is the proper function of the FTC to promulgate a rule at cross purposes with existing Federal Reserve monetary policy (i.e., to encourage a recovery in consumer spending).

An area of very special concern to savings and loan associations is mobile home lending. In 1974 mobile home manufacturers shipped 329,000 units while in 1975 total units shipped decreased to 213,000 units. Much of the decline in production may be attributable to lack of available financing. For example, many of our associations have terminated their mobile home programs because of the increasing number of regulatory impediments in this area. To mention just a few, the FTC has recently proposed another trade regulation which, if adopted, would impose new requirements on manufacturers and sellers of mobile homes with respect to the warranties which they provide to purchasers. This rule would dovetail with the FTC's holder rule and serve to increase the liability of associations which finance transactions within the scope of the holder rule. In addition, the Department of Housing and Urban Development has promulgated mobile home construction and safety standards which are tighter than any previous code. These standards include such areas as body and frame construction, electrical work, fire, safety and thermal protection. HUD has also issued new enforcement regulations for construction standards. Flood insurance, truth in lending and Equal Credit Opportunity are other areas where new requirements have been issued within the past 18 months. The effects of the FTC's new holder rule simply adds to an already overburdened area and will certainly further reduce the availability of credit in this area.

Proposed rule

At the same time the FTC announced its rule affecting sellers, it proposed another rule which would require creditors who make "purchase money loans" to include in their financing agreements a notice similar to that required in sales contracts by the seller rule. In essence, the seller rule exposes lenders who engage in transactions covered by the rule to all claims and defenses which can be asserted against the seller by the purchaser. The proposed rule would go one step further and impose an affirmative burden on the lender to include the required notice in his financing agreements.

We oppose the FTC's new proposed rule for several reasons. First, the Commission has adduced no evidence that savings and loan associations or banks have engaged in unfair or deceptive practices. Next, the actions of our lenders are closely supervised by the Federal Home Loan Bank Board which is the Federal financial regulatory agency specifically charged by Congress with that responsibility. To add another layer of bureaucratic red tape to a business which is already adequately regulated and which is subject to the new requirements of RESPA, ECOA, ERISA, OSHA, Flood Insurance, and on-going amendments to the Truth-in-Lending regulations is both unwarranted and unreasonable.

It should also be noted that if one of our associations fails to include the provided notice in its financing agreement and is found to violate the rule, it would be subjected to a $10,000 per day civil penalty. We are at a loss to understand why our institutions should be subjected to such potential liability when no evidence has been adduced concerning wrongdoing by them. The financing of homes constitutes an entirely separate area that has been recognized by Congress and Congress' action to create a special mechanism to supervise and monitor institutional mortgage and home lending activities. Accordingly, the fact that the Commission apparently has found that unfair and deceptive practices exist in certain types of sales situations is not relevant in determining whether such practices exist with respect to loans financed by savings and loan associations.

The Commission has recognized the need for excluding certain areas from its rules and has in fact excluded credit cards. We feel strongly that a similar exclusion should be granted with respect to savings and loan activities in the area of home and home-related lending.

To summarize our position, let me say that there are several amendments which are necessary to make FTC's new rule a workable arrangement. Specifically, some limitations are necessary in order to confine the scope of the rule to the area of breach of warranty, misrepresentation and fraud which is the stated target of the FTC. Second, a reasonable time limit is needed for the period in which a lender might be liable for product defects. Third, tort claims should be specifically excluded from the scope of the rule. Fourth, lender liability should be limited to those instances where the consumer is unable to obtain satisfaction from the seller. Such limitation would obviously serve to hold down lending costs, insure a readily available supply of credit for consumer transactions and thereby restrain any potentially adverse impact on the nation's economic posture.

In addition, we are seriously concerned about the FTC's proposed new rule and feel that its application to savings and loan associations would be totally unjustified. We also are very much concerned that the FTC has exceeded its statutory authority by promulgating a rule which would preempt state law on a unilateral basis. We strongly support pending legislation which would return authority to the states concerning the holder in due course doctrine.

We appreciate this opportunity to make our views known on this matter.

Mr. MURPHY. Thank you, Mr. Trimble. Mr. McCollister and I were at the Rules Committee on another piece of legislation and couldn't be here for the opening of this session. If the gentlemen would identify themselves?

Mr. WILLIAMS. I'm Harding Williams, the general counsel of the National Savings & Loan League.

Mr. DEVOL. David DeVol, senior vice president, San Diego Federal Savings & Loan.

Mr. BRENNAN. Bill Brennan, assistant Washington counsel for the U.S. League of Savings Associations.

Mr. MURPHY. Mr. Trimble, your statement will be included in full in the record [see p. 77.]

Mr. DeVol, are you next?

STATEMENT OF DAVID E. DEVOL

Mr. DEVOL. Yes, sir. Thank you.

Mr. Chairman, and members of the subcommittee, my name is David E. DeVol. I am a senior vice president and the division manager of the consumer services division of San Diego Federal Savings & Loan Association, San Diego, Calif. I am appearing on behalf of the National Savings & Loan League, a nationwide trade organization for savings and loan associations.

Although the National League has submitted a technical statement, I felt, however, it would be most appropriate to make my presentation from an operator's standpoint on the effect the trade regulation rule would have on the day-to-day operation of an association and would provide an even better understanding of our concern.

San Diego Federal is a $1 billion statewide financial institution founded in 1885 and with an excess of $107 million in consumer loans outstanding, we rank among the three largest consumer lenders in the thrift industry.

The bulk of our consumer lending is in home improvements, mobile homes, and student loans. Last year, San Diego Federal was the largest home improvement lender in the entire savings and loan industry.

Approximately 90 percent of our consumer loan volume is in direct paper generated from dealer sources. As such we are most conversant with dealer/lender relationships and well acquainted with the Federal Trade Commission Regulation Rule on Preservation of Consumers' Claims and Defenses, the so-called holder in due course doctrine.

As you know, California has long been a leader in reducing the burden on the consumer by its legislative posture as to the holder in due course doctrine. I might add, however, that from the inception of my personal consumer lending experience 17 years ago, I have with the support of top management steadfastly recognized the legitimate expectations of the consumer and have not employed the due course doctrine. As lenders we now find ourselves legally bound by a ruling which we willingly accepted and implemented years ago.

Aside from the jurisdiction implications, we are concerned about several aspects of the recent FTC ruling. Most notably, we are opposed to the open ended nature of the ruling, wherein a borrower can bring a claim against the lender years after the loan origination, and for that matter, long after the loan is paid in full.

In this respect, Federal Reserve Board Chairman Arthur Burns expressed his concern to FTC Chairman Calvin Collier, commenting among other things, "About the absence of any time limit on the duration of the creditor's liability. This may make creditors hesitate to offer long-term loans to finance home improvement projects or mobile home purchases." Please bear in mind that many home improvement and mobile home loans extend to 10-, 12-, and even 15-year terms.

While we have long protected the consumer through sound and systematic underwriting of our dealer contractor relationships, the threat of defenses 5 or 10 years later is of significant concern. We feel that open ended liability for lenders will serve as a retardant to both consumer sales and consumer lending, and could lead to a growing tendency on the part of manufacturers to eliminate warranties.

As pointed out in greater detail in the National League's full statement, we would prefer that the rulemaking power on this subject be vested in the Federal Home Loan Bank Board. If such were the case, San Diego Federal would propose a time certain limitation to these defenses. For example, 24 or 36 months from loan inception. If legitimate claims as to workmanship are going to develop, most will occur within this most reasonable period.

May I quote from the Federal Register of May 14, 1976, page 20023. "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 sellers." The rule as published, however, does not cover merely breach of warranty misrepresentation and fraud, it covers all claims and defenses a consumer might have against the seller.

A recent issue of Insulation Reporter discusses a public utility sponsored insulation program using materials subsequently found to constitute a possible fire hazard. This provides any consumer participating in the program with a potential claim against the manufacturer of the product, the public utility, the contractors and subcontractors who did the work, and the lender who may hold a loan financing the home improvement. As one observer pointed out, the list of possibilities is endless.

Strict enforcement of this type will, in our opinion, severely restrict the entry into and development of good small contractors in the home improvement field. For the most part, the home improvement industry is dominated by thousands of small, yet capable and conscientious, independent custom builders. The FTC ruling may discourage lender-dealer relationships with many of these entrepreneurs, causing lenders in the process to concentrate their activity only among the giants of the industry. This would raise the cost to the consumer due to reduction of competition, at the expense of both the consumer and the small contractor.

A third area of concern deals with discouragement of innovative ideas, particularly in the area of nergy conservation. Several weeks ago, we were approached by a producer-distributor of solar heating devices. This contractor was soundly financed and appeared to have a high quality and desirable product. Due to the uncertainty of the FTC ruling and relative newness of the product in question, we were forced to decline an otherwise attractive relationship. This will undoubtedly be the position of other lenders, and in the long run is not in the public interest. We might otherwise have been inclined to pursue this relationship with a reasonable time-certain limitation to our potential liability. To a certain degree, we have been confronted with similar circumstances in our dealings with insulation contractors and heating and air-conditioning contractors.

In still other instances, we have heard of dealers who are seriously considering the elimination or reduction of all guarantees and warranties whatsoever, as opposed to the more generous terms now offered. Again, this is not in the public interest.

Mr. Chairman and members of the subcommittee, San Diego Federal is in basic accord with a change in the holder in due course doctrine as it affects legitimate consumer protection. We ask that enforcement be placed under the rightful jurisdiction of the Federal Home Loan Bank Board and that reasonable time limits be placed on implementation in order to avoid abuse and in order to assure the continued availability of consumer credit.

Thank you.

Mr. MURPHY. Do you have a prepared statement, Mr. Brennan?

Mr. BRENNAN. We're completed our statement, Mr. Chairman.

Mr. MURPHY. Mr. DeVol, is the difficulty you have in determining what transactions are those in real estate and which are not any different under this rule than in any other areas in which the real or personal property distinction is made?

Mr. WILLIAMS. Mr. DeVol now is subject to the Unruh Act in California which I believe spells out in greater detail the differences between what kind of real property transactions are covered and what are not. The problem we have had with the rule as promulgated by the Federal Trade Commission is that it's very vague and very uncertain as to what might be real property and what might not be. For example, the original Unruh Act did not specify whether certain loans were, or were not, realty so that a custom building situation was not covered. Under this rule I think counsel of the particular savings and loan association would have a hard time trying to distinguish what might and what might not be real property.

Mr. MURPHY. Aren't there fairly clear lines in common law that determine what is real property and what is not?

Mr. WILLIAMS. Yes.

Mr. MURPHY. You could always go to those distinctions.

Mr. WILLIAMS. That's true, but I believe State laws such as the Unruh Act is not always clear on this point especially in California. There were still a number of cases in which the Unruh Act itself did not cover and subsequent amendments to that act were necessary.

Mr. MURPHY. Since the rule is not intended to apply to real estate transactions, why should jurisdiction be transferred to the Federal Home Loan Bank Board?

Mr. WILLIAMS. Let me say first of all that we have only the FTC guidelines to reassure us that the holder in due course rule is not intended to apply to first mortgages on residential property. It's possible that this could be tested in court. And our point is on that question. If the Federal Trade Commission had intended to exclude real property transactions, it would have been simple to incorporate such exclusion in the rule. We believe that this would have been done had the rulemaking power been vested in the Bank Board under the original Magnuson-Moss Act.

Furthermore, there is nothing under the Magnuson-Moss Act rulemaking powers, under section 18, that would restrict the Federal Trade Commission from, in fact, making rules applicable to the savings and loan industry and applicable to real property transactions. It gives them a carte blanche in our industry as long as the rule comes under the umbrella of unfair or deceptive acts or practices.

Mr. MURPHY. Have you asked the Federal Trade Commission for a ruling on this?

Mr. WILLIAMS. Yes; we have.

Mr. MURPHY. What did they say?

Mr. WILLIAMS. We were told by the staff that the guidelines which came out in May would probably answer most of our questions we had on the application to real property. Again, our point is that we understand the preamble to that set of guidelines makes it very clear that this is a staff interpretation and not binding on the courts or the Commission.

Mr. MURPHY. Mr. McCollister.

Mr. MCCOLLISTER. Mr. DeVol, on page 2 of your statement you state that you object to a lender remaining liable for years after a loan is made. Wouldn't your liability end when the product warranty terminated? Your subsequent statement seems to imply that by the reference to the fact that you thought it would have an adverse effect on the length of a warranty?

Mr. DEVOL. Yes, sir; our house counsel has advised us it could possibly go beyond the term of the loan. In some cases we have had contractors who would offer guarantees or warranties that might be for the lifetime of the borrower or for as long as he owns the home. This could extend well beyond the term of our loan. For example, in California it's not unusual to offer a lifetime structural guarantee on a swimming pool and yet the swimming pool loans are generally limited to 10 to at the most 15 years. It is possible that our liability could extend beyond the maturity of the loan.

Mr. MCCOLLISTER. I'm concerned about what this does to the mobile home business because it is one of the most important sources of low-cost housing. Can you speculate what the effects of the rule may be, any of you gentlemen, on the local home industry?

Mr. TRIMBLE. Yes, sir; I can answer that. On the mobile home industry itself in the Southern States of Florida, Alabama, and Mississippi, the sales have been curtailed.

Mr. MCCOLLISTER. Is that what you call the cotton South?

Mr. TRIMBLE. The Sun Belt. The sales have been curtailed due to a lack of financing.

Mr. MCCOLLISTER. Sales have been curtailed?

Mr. TRIMBLE. Yes, sir.

Mr. MCCOLLISTER. Can you document that? Can you give us any better indication of the magnitude of it?

Mr. TRIMBLE. No, sir; I don't have the figures at hand but I would say sales have decreased at least a minimum of 33 percent.

Mr. MCCOLLISTER. I would ask counsel, do we have anybody from the mobile home industry coming to testify?

Mr. KINZLER. No one has requested to come.

Mr. MCCOLLISTER. Could you obtain some documentation of that decrease in mobile home sales for the record if we were to hold the record open?

Mr. TRIMBLE. Even in my own State of Louisiana, that particular area, there are only four lenders now in the mobile home financing area.

Mr. MCCOLLISTER. How many were there?

Mr. TRIMBLE. There were approximately 25 or 30 at one time and now there are only 4 of us left, 4 or 5 of us left that are still in, and as you say, it's a very valuable part of housing.

Mr. MCCOLLISTER. It would be hardly in the consumer's interest, the abolishment of the holder in due course doctrine, I mean.

Mr. DEVOL. Mr. McCollister, I was in the Florida panhandle yesterday and had the opportunity to talk to approximately eight dealers there. I don't hold myself out to be an expert in Florida certainly, but there is a problem with financing in that area. There are only two lenders who are active down there, neither one of which is local to that area. Whether this is directly related to the FTC ruling or not, I don't know, but financing is an extreme problem in that part of the country.

Mr. MCCOLLISTER. It's curious we've not had any requests from the mobile home industry to testify here if the rule has had that effect on financing of mobile homes.

Mr. MURPHY. Would the gentleman yield?

Mr. MCCOLLISTER. Yes.

Mr. MURPHY. Sales of mobile homes have decreased for the last 20 months which precedes the ruling, of course.

Mr. MCCOLLISTER. Maybe they can't afford the airplane ticket to Washington.

Do your experiences in States that have abolished the holder in due course doctrine bear out predictions of restrictions of credit for mobile homes and other—States that already have the holder in due course doctrine?

Mr. DEVOL. Speaking for California, it happened a good many years ago and the effect that took place at that time, frankly, I don't recall.

Of course, we do not consider it to apply to home mortgages. We have, for the most part, learned to live with the holder in due course but we would like some time certain limitations in that respect.

Mr. McCOLLISTER. The Federal Trade Commission in their testimony last week seemed to think that everybody would learn in time to live with it and that the bad effects that some of us feel are inherent in it, are just getting acquainted with the difficulties of it. You've expressed the California situation, what about Louisiana?

Mr. TRIMBLE. Well, Mr. McCollister, the effect right at the present time, in my own shop, we have cut off all direct deals originating from mobile home dealers who are not signed dealers with ourselves. That leaves the full recourse with the dealers.

Mr. McCOLLISTER. There is nothing to prevent me as a prospective mobile home purchaser from going to you as a lender and making our own arrangements on a loan and then taking the money you've given me and go down to the mobile home dealer? You do not then have a continuing liability as long as there is not a linkage between the lender and the dealer, is there?

Mr. TRIMBLE. Well, there is a difference of opinion on this thing. I've been to several sessions that were conducted and several statements were made whereby if you advertised that you made mobile home loans and a mobile home dealer knew that you made mobile home loans and the buyer came in to apply for a loan and you asked him where he's going to get a loan from and he says Joe Blow sends him down here to buy the mobile home, then this might create a sufficient relationship between the S&L and the dealer for the rule to apply. This was told to me in Atlanta. And to further this along a little bit, it's not as bad right now as it could possibly get if the amendment is enacted to the rule. If the amendment is enacted to the rule, it's going to really be rough.

Mr. McCOLLISTER. Then for the record would you care to specify the amendment that is being proposed?

Mr. TRIMBLE. Well, the proposed amendment, would require that lenders place a warning notice in their financing agreements. This would clearly operate to dry up credit sources. And in Louisiana we have—Chairman Murphy asked a while ago about real property. We do have a problem in Louisiana. A mobile home is purchased and brought in and moved on a lot and the wheels removed, it then becomes real property. So you have a gray area there. We don't really know.

Mr. McCOLLISTER. You folks in your industry have gotten rather well acquainted with the Congress of the United States in the last year or so. I'm concerned about the cumulative impact of many of the laws we pass. We have had the Real Estate Procedures Settlement Act, we've had the Fair Credit Billing, we've had Equal Credit Opportunity and now through the good graces of the Federal Trade Commission we have the abolishment of the holder in due course doctrine.

How does a small bank, or in your case a small savings and loan association keep up to date on what your obligations are under various Federal laws?

Mr. TRIMBLE. We do the best we can. At present I try to follow the Federal Register and the news coming out of the U.S. League and

also the National League. It is a rather difficult thing. The laws and regulations that are being promulgated at the present time put a tremendous burden on the small shop.

Mr. McCOLLISTER. Disproportionate, is it not, for the small shop?

Mr. TRIMBLE. Yes, sir.

As an example and this is not dealing with just FTC but RESPA cost our shop around $25,000 for 6 months. That amount came off the bottom line. The FTC rule which we are discussing today has already cost about $6,000 for the printing of new forms and applications. These expenses may ultimately be borne by the consumer in the form of higher interest rates. We talk about product liability insurance, we may be forced to go into this. This is going to be another additional going cost. There's only one source for such insurance now and I believe that it is Lloyd's of London. I think the rate is going to be about 1¾ percent. All of these developments mean that it's going to be really tough on the consumer.

I think chairman Murphy asked why do we support Federal Home Loan Bank Board regulations in this area as opposed to the FTC? Well, I'd like to take the opportunity to answer that. We are getting bombarded with all different types of Federal agencies. We don't really know who we come under anymore. Congress says the Federal Home Loan Bank Board was designed to regulate savings and loans and this is who we look to. Now the FTC comes in, Federal Reserve comes in, HUD comes in, FHA comes in; who do you answer to? I mean it is a problem and in a smaller shop it's really rough. I would dare say right now in my hometown that at least 95 percent of the dealers are in violation of the law because they didn't know about holder in due course and the FTC's rules.

Mr. McCOLLISTER. Well, could this possibly have anything to do with the relatively low regard the polls show the people have for the Congress?

That's a leading question. I know the answer to that question.

Mr. MURPHY. If the gentleman will yield for a moment.

Mr. McCOLLISTER. I yield.

Mr. MURPHY. The Congress through the years, of course, makes the laws and they are supposed to be implemented by the executive branch. That executive branch in many instances has been known and has been prone to a regulatory system whereby major interests are usualy heard and the small interests are not covered and protected and we find the implementors picking on smal businesses and the burden does go down to small business and that's why this Congress, the majority caucus implemented more oversight and this committee itself has undertaken far more oversight than at any other time in the history of this country and I would wager in the next Congress the oversight function of the Congress over those who are not carrying out the intent of Congress will be far more broadened in an effort to protect the very people you brought out.

Mr. McCOLLISTER. If the Chair will yield back, I was under the impression that the Federal Trade Commision was an arm of the Congress.

Mr. MURPHY. The Federal Trade Commision is an independent regulatory body.

Mr. McCOLLISTER. Referred to as an arm of the Congress.

Mr. MURPHY. Whose commissioners are appointed by the President.

Mr. McCOLLISTER. And confirmed by the Senate.

We've got a long list of witneses, Mr. Chairman, and you and I——

Mr. TRIMBLE. Mr. Chairman, I'd like to introduce one more statement. It's concerning the conflict between Federal agencies. FHA has an application form for the borrower and on the reverse side of that application form calls notice to the borrower that neither FHA nor the lender shall be responsible for workmanship or materials in this loan.

Now, here I sit in a shop trying to operate a home improvement loan program under FHA title I and FTC has a rule on one side that I'm getting from the dealer saying that I have to insert the paragraph and FHA says no, you're not liable for it. We don't know where we stand.

Mr. McCOLLISTER. Does Farmers Home have similar——

Mr. TRIMBLE. I don't know about Farmers Home. I brought this question up to the two attorneys for the two respective agencies and I have not yet received an answer.

Mr. McCOLLISTER. I want to wait until the automobile dealers get in here.

Mr. MURPHY. Mr. DeVol, do you favor abolition of the rule?

Mr. DEVOL. Yes, I would say so under the jurisdiction of the Federal Home Loan Bank and with the time certain provisions that we have suggested. The thing that concerns us is the open ended nature of this. The acountants have even raised the issue of how we are to carry that liability on our books. It could be a rather substantial liability. So we would like to see the time certain limitation and we would like to be under the jurisdiction of the Home Loan Bank Board.

Mr. MURPHY. But not the abolition of the holder in due course rule?

Mr. DEVOL. We feel we can live with that; yes, sir, under certain restrictions.

Mr. MURPHY. Mr. Trimble?

Mr. TRIMBLE. No, sir; not under the present circumstnces. It would have to be modified greatly to be able to live with it. It's a situation as I see it that we're being asked to police an industry or police loans and it's going to cause loan rejections and a lack of production. Why put more people out of work when you have the better business bureaus and the consumer agencies in the various States? They have a job to do too, and this should be their function.

Mr. BRENNAN. Mr. Chairman, if I might add something. I think we could live with the holder rule with certain modifications. One of these modification is some reasonable time limit on the period of the liability of the lender. A 5- to 12-month period perhaps would be reasonable.

Another thing that concerns us is that perhaps the rule has gone beyond the scope that was initially intended by the Federal Trade Commission. The rule was designed to prevent breach of warranty, fraud and misrepresentation situations and apparently has gone beyond that and is an open ended type of liability on the part of the lender at this particular point. These are the main objections that we have. As far as the proposed rule is concerned, we feel there should be a specific exclusion for savings and loan associations as far as housing and housing related loans are concerned. And it also very

much troubles us that the FTC has perhaps exceeded its congressional mandate with respect to preempting State law.

Mr. MURPHY. Counsel?

Mrs. FOLDES. You stated you would be faced with open ended liability on your loans and you discussed with Mr. McCollister the problem of warranty liability. Aren't most warranties limited to about 3 years?

Mr. TRIMBLE. Yes.

Mrs. FOLDES. What percentage of sales which this rule would affect involve long-term warranties or other liabilities which might exceed the term of the loan?

Mr. TRIMBLE. Well, the rule itself is silent on how long you're really liable for it. It makes no mention of a 1-year warranty or a 3-year warranty or the duration of warranty. There is no mention in the rule, just in the guidelines.

Now at a recent meeting I was told by the FTC that the guidelines were merely guidelines and that if we were caught, we would be tried on the basis of the rule, not the guidelines and it has to be specific in the rules.

Mrs. FOLDES. Who would bring a case against you if not the staff of the Federal Trade Commission who wrote the guidelines?

Mr. TRIMBLE. It could end up in different areas. I think it could end up in a different heading. This is my interpretation of it. Maybe Mr. Brennan may have a different interpretation of it.

Mr. BRENNAN. Well, the thing is the liability is open ended. You never know what's going to come down the pike in the next few years that might predicate liability. You can't just say that it's an expressed warranty. For example, the insulation case we mentioned previously, there was certainly no indication there that there was going to be a basis for liability. The only way you could have ascertained it would have been extensive tests which would certainly be beyond the purview of anything that either Congress or the Federal Trade Commission could expect of a savings and loan association.

Mr. KINZLER. Sir, are you saying the Federal Trade Commission is supposed to anticipate things that have not happened yet? That is the crux of your question.

Mr. BRENNAN. Well, that's the problem with the way they have written the rule.

Mr. KINZLER. Well, don't you think they're capable of adapting to a change in circumstance?

Mr. BRENNAN. That's exactly what we're suggesting, that the rule be modified in this respect.

Mrs. FOLDES. Do you now have any means to shift responsibility back on those sellers to whom you lend so that they will ultimately pay if the consumer fails to perform?

Mr. TRIMBLE. Yes, at this present time we're operating under full recourse agreements with the sellers.

Mrs. FOLDES. What is your ultimate liability then?

Mr. TRIMBLE. Supposing there is no seller, then you become the seller. You take the place of the seller.

Mrs. FOLDES. What percentage of the sellers that you deal with now under the rules are ones——

Mr. TRIMBLE. Well, at the present time we have two left that we're dealing with. The death rate among the rest in the last 2 years has been tremendous.

Mrs. FOLDES. Are these in mobile homes?

Mr. TRIMBLE. Mobile homes, right.

Mrs. FOLDES. Because the Federal Trade Commission at hearings the other day expressed no surprise that there was a pretty hefty attrition rate in lending to mobile home dealers because those dealers have, in a large number of FTC investigations, been shown to be particularly subject to these fraudulent problems.

Mr. TRIMBLE. I think that the rule needs to be more clearly defined as to what the limits of liability are.

Mrs. FOLDES. You indicate a possible unwillingness to deal with new business under this rule. We had a report from the FTC that there was insurance being offered by a Florida concern at a rate of about $4 per automobile transaction which amounts to about one-tenth of 1 percent. How does that square with your experience with Lloyds of London?

Mr. TRIMBLE. Well, that rate is fairly low compared to the rate I was quoted from Lloyds of London. I might mention this, in quoting the recent periodicals about insurance companies, unless they get a substantial premium for their risk, they will not be in the picture very long. In fact, we have several insurance companies going by the wayside.

Mrs. FOLDES. Because they have offered insurance in this area?

Mr. TRIMBLE. Yes and on hazard insurance on the mobile homes itself and this has placed another burden on the consumer.

Mr. DEVOL. It's also hard to insure against a risk that at this point is unknown. You can buy insurance but if the company is not prepared to back up that insurance, then you may end up with nothing and there has been no experience in this field.

Mrs. FOLDES. That's true of any kind of insurance, though. There is always a time period when a new insurance need arises during which you may not have all the figures to determine all aspects of risk. But I don't see how you could ever get around that problem other than by never changing anything.

How is your evaluation of credit worthiness of a new business different now than before the rule? Have you not traditionally made an evaluation of the financial soundness of the business and the character of its managers before you lend to them?

Mr. DEVOL. May I respond to that? We make a very careful analysis of our dealers and we feel that we're experts in analyzing that situation. We can sit down with the financial statement and we can pretty well determine the financial strength of the dealer. We have no way, however, of dealing with the problem that I mentioned of insulation that becomes a fire hazard. That's something we're not experts on and we have no way to deal with. If it was just simply a case of dealing with the financial statement of the dealer, we would have no problem whatsoever in this situation.

Mrs. FOLDES. What recommendation would you have for the new business problem?

Mr. DEVOL. Again, I think a time certain limitation. If we know what our risk is and the length of time involved, we can relate that to the financial strength of the dealer. We have to bear in mind that we're dealing generally with very small contractors. In many cases a home improvement contractor would just simply be a pickup truck. He's not necessarily out to defraud the public but he generally is a fairly unsophisticated type of businessman.

Mrs. FOLDES. Assuming the attic insulation kind of area, if you had some time limitation for the consumer to raise his claim of defense and he wanted to raise the defense 6 months and 3 days later when his attic caught on fire, you would, in effect, be saying that so long as the guy passed that 6 months, he can pass bad paper.

Mr. DEVOL. We're not suggesting that anyone pass bad paper.

Mrs. FOLDES. You were suggesting you can separate his right to payment from his duty to sell reasonable products.

Mr. DEVOL. We feel there should be a time certain; yes.

Mrs. FOLDES. Thank you.

Mr. MCCOLLISTER. One further question. The previous Congress, my Small Business Committee assignment included the committee having responsibility for oversight on the Office of Minority Business Enterprise and we've always been concerned about minority contractors having an opportunity to get started in business. It would seem to me that the abolishment of the holder in due course doctrine does further injury to the opportunity of minority contractors to get started in just the kind of business we're talking about, home repairs and home installation. What has been the experience in California where you've lived with the—with something approaching this same doctrine for some years?

Mr. DEVOL. Well, we're very careful in the contractors we aline ourselves with and we take the attitude that if they are allowed to finance through us, that we are, in effect, endorsing their product to a degree. But to answer more specifically your question, I would think it would definitely limit any small contractor, be he minority or otherwise, make it very, very difficult for a small contractor to get started.

Mr. MCCOLLISTER. That was my impression.

Mr. MURPHY. Gentlemen, thank you very much, we certainly appreciate having you here today.

Our next witness is Mr. Robert Tobey, first vice president of the National Bank of Detroit representing Consumer Bankers Association. Mr. Tobey.

STATEMENT OF ROBERT E. TOBEY ON BEHALF OF THE CONSUMER BANKERS ASSOCIATION, ACCOMPANIED BY DREW V. TIDWELL, LEGISLATIVE REPRESENTATIVE

Mr. TOBEY. With me today is Mr. Drew Tidwell, legislative representative of the Consumer Bankers Association and he may answer some of the questions that——

Mr. MURPHY. Why don't you sit over here?

Mr. TOBEY. I'll be glad to. Let me hasten to add this is not my testimony or we would be here awhile.

Mr. Chairman, as you've indicated, my name is Robert Tobey, first vice president of the National Bank of Detroit and head of the installment loan department. With me is Mr. Drew Tidwell, legislative representative of the Consumer Bankers Association. I am testifying to-

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day on behalf of the Consumer Bankers Association which represents the consumer lending departments in many of the Nation's commercial banks, large and small. At present our members extend to more than 50 percent of all consumer credit outstanding held by banks; national banks, commercial banks in the United States.

You are concerned with the Federal Trade Commission rule concerning the preservation of consumers' claims and defenses applicable to sellers which was promulgated on November 18, 1975, and became effective on May 14, 1976.

Mr. Chairman, attached to my statement are the following items which, with your permission, we would like to be made a part of the official record. The first is the Consumer Bankers Association testimony which was given before the Federal Trade Commission in 1971 when the thought of this rule was first approached. [See p. 95.] In addition to that, a letter dated March 11, 1976, to the Federal Trade Commission with a synopsis of testimony on behalf of the Consumer Bankers Association which was presented by Mr. Les Butler, senior vice president of the First Pennsylvania Bank. [See p. 101.]

In addition, the full statement of the Consumer Bankers Association before the FTC on April 8, 1976 [see p. 105], presented by Mr. Paul Stansbury, president of Consumer Bankers Association; and again, by Mr. Butler, a revised version of the rule proposed to the Commission as a possible area of compromise at a subsequent informal discussion which was held by representatives of Consumer Bankers Association with members or representatives of the Federal Trade Commission; and finally, an additional submission by the association to the Commission dated May 25, 1976 [see p. 114.]

Mr. MURPHY. Without objection, those exhibits will follow your testimony.

Mr. TOBEY. As you are very much aware, much of the argument and discussion surrounding this rule is very technical in nature. In addition, there is much speculation as to what may, or may not be the economic impact of the rule.

I might hypothetically state that there is evidence that this rule will lead to some reduction in consumer credit loans, the amount yet to be determined. Even the rule itself is in a state of flux since the Commission recently found it necessary to issue a statement of enforcement policy and invited comment from the public on whether further action might prove necessary. We appreciate the issuance of this enforcement policy as it does clear up several of the problems with which we have been confronted.

I would like to discuss briefly four items today in the brief time allotted to me. They are, one, to restate the position of the Consumer Bankers Association which throughout these proceedings has been one of cooperation with the Commission and the committee. Two, to highlight areas of concern to sellers and creditors which we find still impose undue compliance and liability burdens and which are not adequately covered by the statement of enforcement policy. Three, to give some brief examples of how sellers and creditors have so far been affected by the rule; and finally, to raise a question relative to whether or not the Commission may have exceeded its authority in promulgating the rule and whether both this subject and the broader issue is not more appropriate for Congress to address directly.

On November 18, 1975, the Federal Trade Commission promulgated the preservation of consumers' claims and defenses trade regulation rule applicable to sellers, which became effective on May 14, 1976. At the same time, a proposed amendment to the rule applicable to creditors was issued for comment. The Commission indicated that the question of the applicability of the rule to sellers was not to be considered with the amendments making the rule equally applicable to creditors. While the promulgated rule directly regulates sellers, it indirectly regulates, of course, creditors and impacts the value of installment paper and certain loan documents that are in the hands of creditors. The proceeding on the proposed credit rule was limited to questions of whether creditors participate with sellers in separating a consumer buyer's duty to pay on a credit contract from the seller's duty to perform as promised, whether it is unfair or deceptive for creditors to do so, and whether the rule could be more readily enforced if creditors were made subject to it. The Commission did not permit interested sellers, creditors, and consumers the opportunity to question the seller rule.

Because there was no other forum available at which critical issues of the seller rule could be publicly discussed the CBA took the position that, as the creditor rule would merely work as an amendment to the seller rule, relevant comment on the seller rule and its application to sellers as well as creditors were open issues in need of much discussion and clarification.

In this regard, we raised and discussed the applicability of the seller rule to leases, imposition of warranty claims and tort and product liability claims on creditors, and the necessity for creditors to use contracts of adhesion. We explored the fact that experience in consumer credit and access to information unavailable by normal means to consumers are less that useful to creditors because no viable means are provided in the rule to permit creditors to warn consumers of possible seller misconduct without the exposure of liability claims by creditors. We expressed concern with the Commission's apparent hand-washing attempt to place the responsibility for maintaining fairness in the marketplace with creditors and the fact that the rule provided absolutely no relief to consumers who purchased goods and services for cash.

The result, at least in part due to our efforts, was the release by the Commission of nonbinding staff guidelines which attempt to clarify what the staff believes is the intent and scope of the seller rule and the issuance of the recent statement of enforcement policy.

From the beginning, the Consumer Bankers Association has taken the position that were the regulation to concern itself solely with limiting the effectiveness of waiver of defense provisions and holder in due course rights, it could not only be accepted as a matter of routine business operation but would, in fact, probably be supported by our industry. And all along we have attempted to pursue a constructive course which would effectively protect the rights of consumers without unduly and adversely affecting the marketplace. We are not satisfied with the staff guidelines or the statement of enforcement policy because they continue to place, in our opinion, an undue risk of liability for noncompliance upon the dealers who discount contracts with banks or refer customers to banks for loans and adversely affect the value of such paper in our portfolio.

For example, one problem which is not, in our opinion adequately covered, even in the statement of enforcement policy involves the definition of purchase money loans found in Section 433.1(d) of the rule [see p. 120]. The seller rule requires the seller to insure that a specified notice appear on loan documents whenever the seller refers customers to the creditor or is affiliated with the creditor by common control, contract or business arrangement. As an example, if a bank financed the floor plan of a dealer's consumer goods and purchases third party paper from the same source and a customer of the bank borrows funds which were used to purchase goods and/or services from that dealer, the dealer could not, without violating the rule, accept such funds in full or partial payment unless the bank's loan note contained the notice specified by the rule. The problem is that neither the seller nor the bank may be aware that the transaction should be covered by the rule. Neither would seek to insert the required notice on the loan documents. The seller would, therefore, be committing an unfair and deceptive act or practice in violation of the rule. If the creditor rule is issued and the Federal Reserve Board then promulgates a rule making the creditor rule applicable to banks, the bank would also be in violation of the rule. In this kind of fact situation, the rule should not apply because the seller has not arranged the credit for the seller, regardless of what might appear to be another arrangement with the bank and the seller.

To insure that liability should ensue only when the seller arranges financing for the buyer, we have suggested that the rule be amended to accomplish this stated aim of the Commission.

On June 2 of this year, representatives of the Consumer Bankers Association were asked to meet with representatives of the Compliance Division of the Commission in order to informally discuss our concerns with the seller rule. At this meeting we submitted a revised version to the Commission which is attached to this testimony. The revised rule defines terms more precisely to insure transactions that should be regulated, are regulated and capable of enforcement. Liability to creditors was made similar to that of credit card issuers under the Fair Credit Billing Act. A creditor would be liable up to the amount outstanding at the time of the claim by but not for tort or product liability claims. Negotiable instruments and waiver provisions are made unfair and deceptive when used in consumer credit contracts. Most importantly, purchase money transactions would be limited to those in which the seller arranged financing for the buyer with the cooperation of the creditor.

Since promulgation of the rule, many banks, at least in part due to the rule, stopped discounting installment sales contracts on appliances. Some member banks have cut off all home improvement dealers and several banks have severely curtailed their acceptance of home improvement installment sales paper. Banks are refusing to put the notice on direct loan documentation, even if requested to do so by sellers or in connection with some affiliation or arrangement with the seller. Many banks are not accepting new dealers because of the lack of an established track record of consumer satisfaction and are looking with particular concern at the inherent danger and risk of uncollectability

based on the product or services offered by the seller. For example, a large east coast bank recently decided not to make related loans available to customers of orthodontists because of the high risk that dissatisfaction with orthodontist would render a note more difficult to collect and subject the bank to malpractice claims which the customer would have against the orthodontist. In fact, some banks have still not been able to find an insurer willing to cover all of the risks of the bank under the rule. Lastly, we know of one bank in which the rule has already been interposed as a defense to payment on at least four occasions.

Notwithstanding our attempts to cooperate with the Commission to develop a rule which would be fair to all concerned and would not unduly and adversely affect the ability of consumers to obtain credit and of small businessmen to obtain credit for their customers, we are also concerned that the Commission may have exceeded its authority in promulgating the rule. This is because the rule directly preempts the laws of many States and no congressional statute, in our opinion, gives the Commission the direct authority to preempt State law. In addition, because this rule so vitally affects the interests of consumers, sellers and creditors, we are somewhat surprised that it has not previously become the subject of congressional concern. In the last several years, Congress has acted on truth in lending, truth in leasing, garnishment of wages, equal credit opportunity, fair credit billing, fair credit reporting and the Congress is now considering passage of an Unfair Debt Collection Practices Act. I submit that the rule concerns itself with matters of as serious moment any of these act of Congress. For this reason, I suggest that the Congress take some action on the rule, whether by suspension or revocation, and take up consideration of the need for legislation regarding holder in due course and waiver of claims and defenses.

Thank you for your time and consideration.

[Testimony resumes on p. 121.]

[The documents referred to follow:]

STATEMENT OF LESLIE R. BUTLER, SENIOR VICE PRESIDENT, FIRST PENNSYLVANIA BANK, AND ALSO REPRESENTING THE CONSUMER BANKERS ASSOCIATION BEFORE THE FEDERAL TRADE COMMISSION—1971

My name is Leslie R. Butler, I am a Senior Vice President of First Pennsylvania Bank, N.A., Philadelphia, Pennsylvania, and am responsible for the various consumer lending activities performed at my Bank. Accompanying me here today is an associate Counsel of the Bank, Mr. Leonard S. Goodman. I am pleased to have this opportunity to speak on behalf of my employer and as a representative of the Consumer Bankers Association on this very important topic.

It is my firm belief that the F.T.C. and banks are both seeking to accomplish the similar aim of responding adequately to consumer needs for goods and services. Specifically, we see that aim as an effort to see that the goods and services perform as offered; are sold at a reasonable price; and that the businessman's right to compete and to earn a profit which allows him to continue offering the goods and services is maintained.

I submit that if the interests of everyone affected by the Rule are not given adequate consideration, the Rule may impact the marketplace in a manner which neither we nor the consumer will find desirable and, at the very least, will add unnecessary confusion and complication to that marketplace. As Mr. Starsbury indicated, we are here to express that we hope will be helpful views on the "proposed rule" and the implications that the rule may have on the competitive marketplace beyond what the Commission appears to have intended. Our reading of the "Statement of Basis and Purpose" suggests that, in at least some areas under discussion, we are in philosophic agreement. However, our concern is that the practical applications of the Proposed Rule may not be consistent with that philosophy.

According to research conducted for one of our member organizations, at least 39 jurisdictions, including Puerto Rico and the District of Columbia, have eliminated or limited the holder in due course doctrine with regard to consumer obligations. No fewer than 41 jurisdictions, including Puerto Rico and the District of Columbia, have eliminated or limited the effectiveness of waiver of defense provisions in contracts. The approach varies from complete elimination in all consumer transactions to the use of "time-notice" provisions. In addition, at least seven states have thus far subjected direct lenders to the same obligations and liabilities as sellers when they knowingly participate in the sale transaction. In Arizona, for example, the lender is subject to claims and defenses when the seller "arranges" the loan by receiving a commission or by assisting in preparation of the loan documents. The Maryland law provides that the lender is subject to claims and defenses when he knows the seller arranged the loan or when the lender, otherwise "knowingly participated" in the sale. Knowing participation involves such things as making the proceeds of the loan payable to the seller or taking a security interest in the goods sold. In Massachusetts, the knowing participation test is supplemented by the "directly connected with" transaction test.

Many of our members are therefore already operating with some form of limitation on waivers or the holder-in-due-course doctrine. We are not aware of any unusual burden created on lenders in these particular states or any vast exodus of lenders from the business. The reaction to the Proposed Rule among our members was generally consistent on one point:

Were the regulation to concern itself solely with limiting the effectiveness of waiver of defense provisions or holder in due course rights it could not only be accepted as a matter of routine business operation but would, in fact, be generally supported by our industry. In its present form, however, we feel the regulation goes well beyond this.

At First Pennsylvania we have been extending consumer credit since 1934 and are considered one of the pioneers in consumer credit among Banks. We conduct our business in a responsible and responsive manner. In our experience, bad business is not profitable and business which creates customer dissatisfaction, delinquency, disputes and suits is clearly bad business. We think banks nationally share these views and that our experience may, therefore, be representative of the way in which most banks offer consumer credit.

In Pennsylvania, the holder-in-due-course and waiver doctrines have been eliminated with respect to motor vehicle paper for many years. As a matter of fact, we do not accept any form of dealer installment sales paper containing negotiable instruments upon which the status of holder in due course could be claimed. However, we do dely on various State waiver laws at present, which provide buyers with a defined period in which to raise claims and defenses.

For example, in accordance with the provisions of the Pennsylvania Home Improvement Finance Act, the buyer has 15 days within which to give written notice to the assignee of the contract of the existence of any rights of action or defenses to the contract. Under the Goods and Services Installment Sales Act, the buyer has 45 days within which to give the assignee written notice of the existence of rights of action or defenses to the contract. Notwithstanding our reliance on such waiver laws, we stress customer satisfaction and require our dealers to make every effort to satisfy valid consumers claims. In short, as previously noted, we support limiting the effectiveness of waiver of defense provisions on holder in due course rights so long as that is the sole concern of the Rule.

I will comment on several aspects of the Rule where we feel the Commission has extended coverage beyond what is necessary to protect consumers and will make some recommendations on how the Proposed Rule might be modified to achieve fairness to consumers without unduly penalizing either creditors or sellers or consumers.

The Seller Rule which becomes effective on May 14, 1976, contains two sections: Section 433.1, Definitions; and Section 433.2, Preservation of Consumers' Claims and Defenses, Unfair or Deceptive Acts or Practices. The Proposed Rule would affect only Section 433.2 of the Seller Rule, which proscribes certain unfair or deceptive acts or practices of sellers in connection with purchase money loans or any sale or lease of goods and services. Even though the Commission has indicated that it will not, in this proceeding, reopen the question of

the applicability of the Seller Rule to sellers, I am concerned that applicability of the Proposed Rule, in any given fact situation, will depend on criteria found in the definitions contained in Section 433.1 of the Seller Rule. For example, as Mr. Stansbury has indicated, the definition of "purchase money loan" is vague because the terms "contract" and "business arrangement" are too broadly defined and the term "refer" is not defined.

Because it is so critical to our entire discussion, let me review in some additional detail Mr. Stansbury's comments with respect to purchase money loans.

The Seller Rule defines a "purchase money loan" as a cash advance the proceeds of which are applied, in whole or in substantial part, to a purchase of goods or services from a seller who refers consumers to the creditor *or* is affiliated with the creditor by common control, contract or business arrangement. The Statement of Basis and Purpose indicates that any seller who arranges financing for his customers should be prevented from cutting off claims and defenses by means of the financing so arranged.

I quote:

> "We have retained the 'referral' test originally proposed as one of the rebuttable presumptions. As proposed it specified five or more referrals to a creditor. Based on this record we are persuaded that while the act of referral is sufficient to justify imposition of the rule, *provided referrals are made in the course of some routine or arrangement*, there is no justification for choosing a specific number . . ." (Italics supplied.)

Because the Seller Rule does not cover referrals made "in the course of some routine or arrangement," but all referrals by a seller of a consumer to a creditor, even if there is no affiliation with the creditor, it is unclear what conduct is being regulated and what steps a lender can take to stop seller referrals should it decide not to accept them.

Webster's Seventh New Collegiate Dictionary defines "refer" to include, among other things, "to send or direct for treatment, aid, information or decision; to direct attention." The definition of purchase money loan, by use of the word "or" does not comprehend any routine course of conduct or arrangement. Thus, pursuant to the Seller Rule, whenever a seller recommends or suggests a particular creditor as the source of financing, the seller must insure that the loan documents provide the Notice specified in the Seller Rule.

Pursuant to the Proposed Rule, the lender would have the duty of including the specified Notice on the loan documents whenever the borrower was referred by the seller.

In many cases, the creditor will not be aware that the borrower was referred by the seller. Furthermore, unless there is some agreement between the creditor and seller, there is no possibility of a recourse arrangement which would be the most effective way to return seller misconduct costs to sellers. Recourse arrangements which frequently exist in three-party situations, are not present in two-party loan transactions even where there is a referral pursuant to some routine or arrangement.

The discussion leads us, of course, right back to the key point made by Mr. Stansbury, that the touchstone of this whole concept is a creditor's or lender's ability to control a seller, and "cut him off" if not satisfied with his honesty and responsiveness to legitimate consumer complaints. The referral concept is highly unworkable in its present form and needs to be totally eliminated or more closely defined since the lender has no effective means of control over the seller. For example, I suggest that in accordance with the Statement of Basis and Purpose, the Proposed Rule (and even the Seller Rule) should indicate that "a referral" is intended to cover only those situations in which the seller arranges the loan and does so in the course of some defined routine or contractual or business arrangement with the creditor. Thus, a "purchase money loan" could be radically redefined merely by changing "or" to "and"; as a loan, the proceeds of which are applied, in whole or substantial part, to a purchase of goods or services from a seller who refers consumers to the creditor and is affiliated with the creditor by common control, contract or business arrangement. This would parallel somewhat the developing case law that attempts to impose liability where a creditor has knowledge of seller wrongdoing *and* an ability to stop such wrongdoing.

"Business arrangement" is defined to include any understanding, procedure, course of dealing, or arrangements, formal or informal, between a creditor and a seller, in connection with the sale of goods or services to consumers or the financing thereof. While it is better to condition applicability of the Seller Rule on "referrals pursuant to some business arrangement" rather than on bare referrals by a seller, the definition of business referral is unnecessarily broad and uncertain of application. I would suggest that the definition of "business arrangement" be limited in accordance with Mr. Stansbury's suggestion.

The reference in the Seller Rule and the Proposed Rule to "lease" is particularly troublesome. The definitions contained in Section 433.1 refer to sales or loans and never refer to leases. It is unclear whether the Commission intends to regulate those leases which are the equivalent of extensions of credit or all true leases of consumer goods.

The definition of "financing a sale" in the Rule is based on the definition of "Credit Sale," as contained in Regulation Z of the Board of Governors of the Federal Reserve System and Truth in Lending. As defined in Regulation A, "credit sale" includes a lease if the lessee contracts to pay as compensation for use a sum substantially equivalent to or in excess of the aggregate value of the property and services involved and it is agreed that the lessee will become, or for no other or for a nominal consideration has the option to become, the owner of the property upon full compliance with his obligations under the contract.

If leases that are the equivalent to credit sales are the type of leases intended to be covered by the Seller Rule and the Proposed Rule, they are adequately described in the definition of Credit Sale contained in the Rule and the reference to leases should be deleted. On the other hand, if the Proposed Rule is intended to cover true leases, that is, leases which are not the equivalent of credit sales, I do not understand how the Proposed Rule would operate. This is because a transfer of ownership from the seller would be to the creditor lessor of the goods and not to the consumer lessee. In a true lease, the consumer lessee is not an and will not become the owner. As the Notice, by its terms, grants debtors certain rights against sellers, what rights would consumer lessees have against either the seller of the goods or the creditor from whom he leases such goods?

Let me turn your attention now to several other aspects of the Proposed Rule which give us some concern.

WARRANTY CLAIMS

In the Background materials contained in the Statement of Basis and Purpose several references are made to a seller's breach of warranty as one kind of dishonest practice which should give rise to a purchaser's ability to seek redress from the creditor who financed the transaction. I question whether the Commission has the authority to impose breach of warranty liability on any other person, including creditors, than the actual person making the written warranty.

The Magnuson-Moss Warranty—Federal Trade Commission Improvement Act—provides that while nothing in this Act shall invalidate or restrict any right or remedy of any consumer under State law or any other Federal law, a consumer who is damaged by the failure of a supplier, warrantor, or service contractor to comply with any obligation under the Act, or under a written warranty, implied warranty or service contract may bring suit for damages and other legal or equitable relief if the amount in controversy is in the amount of $25 or more, but that no action may be brought pursuant to the Magnuson-Moss Act, unless the person obligated under the warranty is afforded a reasonable opportunity to cure such failure to comply. For purposes of the Act, only the warrantor actually making a written affirmation of fact, promise, or undertaking is deemed to have created a written warranty, and any rights arising thereunder may be enforced under the Act only against such warrantor and no other person.

Because the Congress intended to improve the adequacy of information, prevent deception and improve competition in the marketplace it created a scheme to regulate all written warranties made in the United States or in any territory or possession of the United States. To this extent, the Magnuson-Moss Warranty Act preempts State and Federal laws regulating warranties. Thus, it seems to me that the Commission by means of the Seller Rule and the Proposed Rule is imposing a new Federal warranty liability on creditors, whether by reason of a set-off, counterclaim or suit for damages by a debtor, which is directly prohibited by the law and therefore beyond the Commission's rulemaking authority.

I would suggest that consideration be given to modifying the Seller Rule and the Proposed Rule Notices to indicate that they do not cover breaches of written warranties.

POLICING SELLER MISCONDUCT

One of the major themes, not only of this proposed regulation, but of other recently enacted legislation, is that of "Judicial Review by the Creditor." For example, the Fair Credit Billing Act grants to cardholders the right to withhold

payment to a third party credit card issuer pending the outcome of a merchant dispute so long as the amount in dispute is more than $50, the merchant is located in the same state or within 100 miles of the cardholder's residence, and the customer has made a good faith attempt to settle the claim. We are very concerned with this trend to continually interpose banks and other creditors between our customers and the various "sellers" with whom the customer chooses to do business.

The Commission has stated that the creditor is always in a better position than the buyer to return seller misconduct costs to sellers, the guilty party, and by reallocating the costs to the party that generated them such costs are reduced to a minimum. Some of the reasons given for passing this burden to creditors include: (1) experience of creditors in consumer credit; (2) access to information unavailable to consumers; (3) recourse to contractual devices which render the routine return of the seller misconduct costs to sellers relatively cheap and automatic; and (4) the creditor possesses the means to initiate a lawsuit and prosecute it to judgment where recourse to the legal system is necessary. In our judgment this line of reasoning will not prove effective in practice.

A creditor's access to information that is unavailable to consumers is useless as a tool to police the marketplace unless the creditor is given some viable means to use that information. In three-party situations, where a creditor buys existing credit contracts from sellers, the creditor can stop doing business with any sellers with whom he does not want to do business and, to this extent, such information is useful. But, when the dealer who always rendered good service to his purchasers dies, sells the business or runs into a customer who unreasonably refuses to accept actions by the dealer which would appropriately adjust the claim, the creditor is left with instalment contracts whose value is dependent on how the new owner runs the business. This is especially a problem in connection with long-term obligations such as home improvement paper where the maturity of the obligation may be 7, 10, or even 15 years away. A reserve or recourse arrangement might be totally inadequate to cover the losses sustained by a creditor if the succeeding owner proceeds to run the business into the ground.

Thus, a creditor's use of information to cull dishonest dealers from its ranks does not altogether reduce the creditor's risk. The Proposed Rule not only penalizes creditors who deal with sellers whose misconduct is known, but also penalizes those creditors who have made efforts to do business only with highly reputable merchants. Among other things, some effects of the Rule may be to cause a reduction in the terms available to consumers, a reduction in competition because of the creation of a new, artificial barrier to entry for new firms in the marketplace who will not be able to obtain financing for their customers and higher retail product costs to consumers due to additional recourse reserves required by creditors.

In the two-party situation, access to information about a seller's previous misconduct is of absolutely no help to the creditor, even were it avalaible.

If the consumer credit applicant is creditworthy, can a creditor, without risk of liability, advise the applicant for a purchase money loan that the dealer from whom the purchase is intended to be made has a prior history of unfair dealings with consumers? Because the rule grants no immunity to liability, a creditor who voluntarily takes it upon himself to advise a consumer that the dealer has a poor history of resolving complaints, or no such history, can expect to be held liable for such advice. And yet Regulation B of the Board of Governors of the Federal Reserve System requires that we tell applicants the reasons for a credit denial.

Even though the thrust of the Rule is to have creditors police sellers and thereby, minimize seller misconduct, in the two-party situation a creditor has no effective means of control over dealers. In fact, the creditor will find himself in violation of the Proposed Rule if he refuses to include the Notice whenever a dealer refers an applicant to the creditor for a loan. Because creditors would open themselves to suits for libel whenever they advised an applicant of a dealer's history of poor service to consumers, lenders cannot reasonably be expected to give such advice to loan applicants. Lenders are therefore unable to change the practices of the marketplace and must extend credit to creditworthy consumers. Notwithstanding this inability to advise applicants, creditors who continue to make purchase money loans will find themselves subject to claims of disgruntled borrowers because the Notice must be or should have been included on the loan documents. The alternative to this dilemma, that creditors stop making purchase money loans, is unattractive to all concerned.

I see the Proposed Rule as unfair to creditors and in need of substantial clarification. Contrary to the ability of a card issuer to charge back to a merchant the amount involved in any dispute under the Fair Credit Billing Act, there is no creditor recourse to sellers in a purchase money referral loan, as this transaction is defined in the Proposed Rule, and while creditors possess the financial means to sue for losses the consumer may have suffered as a result of seller misconduct, creditors are not the proper parties to bring suit. This is because the loan and the sale are *separate* transactions. Courts would invariably hold that, without the existence of some contract or other business relationship between the creditor and the seller, the creditor is without standing to sue a dealer who referred a consumer to the creditor in order to vindicate that consumer's rights.

Let us now look for a moment at the Commission's contention that "seller misconduct" costs will be translated by the creditor into "a more accurate price for consumer goods." Without the existence of the proposed rule, we already work closely with our dealers on customer satisfaction. It's good business for both of us. Unfortunately, we are finding a small but growing incidence of "professional consumers" who use the rules and regulations already in effect, the age of consumerism, and the probable cost of suit as a way to avoid legitimate obligations and to get more than they are entitled to. To protect its valid dealer relationships there will be occasions when alleged misconduct costs will not be passed back to the seller but will be absorbed by the creditor even though recourse is available.

The Commission says that there may be a "slight reduction in efficiency" with respect to "consumer misconduct" costs. I respectfully suggest that the price that all consumers must pay is higher costs of credit, reduced credit terms or even credit unavailability. As creditors absorb more costs which cut profit margins we must reduce the risk of loss by raising credit standards. Should we tell those consumers we turn away that the denial was as the result of a slight reduction in efficiency caused by the new FTC Holder-in-Due-Course Rule?

If policing the marketplace is the aim of the Proposed Rule and the Seller Rule, then the Commission is abdicating its trade regulating function in credit transactions by making sellers and creditors market policemen, and is taking *no* action whatsoever to protect cash customers who are just as subject to merchant misconduct. To the extent that credit customers are given additional rights not accorded cash customers the Rules discriminate unfairly against cash customers and have the effect of discouraging thrift.

ALTERNATIVE METHODS OF ACHIEVING THE SAME RESULT

Because I firmly believe that promulgation of the Seller Rule and the Proposed Rule may cause more harm to consumers than is intended, but that action must be taken to rid the marketplace of improper practices by sellers, I would suggest the following courses of action as viable alternatives to accomplish the Commission's aims. These alternatives would not penalize those creditors who seek to deal only with reputable merchants, would not affect the marketplace to the detriment of consumers, and yet would tend to rid the marketplace of those sellers and creditors who engage in improper practices:

(1) Review the definitions in the Rule and more carefully define the terms: "goods and services," "creditors," "credit card," "purchase money loan," "refer or referral," "continuing relationships," "lease," "control," and "business arrangement."

(2) Revise the rule so that it deals solely with the issue of making it an unlawful or deceptive act or practice for a seller to take a negotiable instrument or to include in any instalment sales contract waiver provisions in connection with the credit sale of goods or services to a consumer.

(3) Impose a reasonable time limitation upon the rights of a consumer to assert his defenses against the seller and/or the creditor. In this respect, we propose limiting the right to raise defenses to "the warranty period which covers the consumer goods or services or during the period up to three years from the date of the consummation of the credit contract, whichever is less."

(4) Prohibit practices such as "dragging the body" or the like, by sellers in order to avoid the provisions of the above rule and impose liability against creditors in those situations where the creditor knows, or should have known, that the seller engages in improper practices, or the creditor participates in the underlying sales transaction.

(5) Permit a creditor, by affirmative regulation, to advise prospective loan applicants of the bona fides of any dealer from whom the loan applicant intends to purchase consumer goods or services, in whole or in part, with the proceeds

of the loan. Require such advice when the creditor is aware, or should have been aware, of three (four? five?) instances of seller misconduct within a preceding one (or two, three) year period.

CONCLUSIONS

For all of the above reasons, I ask the Commission to review the Proposed Rule in order to reassess the benefits to some consumers against the costs all consumers must bear. Being a consumer finance officer, I know that creditors will have to take steps to minimize the risks of loss inherent in consumer paper which contain the prescribed Notice. While these steps may mean some belt tightening and restructuring of our present practices, we will not go out of the consumer finance business just because of the Proposed Rule.

The Rule is a half-way measure which discriminates against those persons who purchase for cash. It attempts to interpose the creditor as a policeman whenever credit is utilized to accomplish a consumer purchase, without giving the creditor the tools to exercise such authority and without relieving the creditor from liability that may result from suits by disgruntled credit applicants or sellers. The Rule will inhibit persons from going into business as sellers, because few creditors will buy instalment paper from a seller when the seller has no track record upon which to appraise the risk. Finally, it will be an added burden to those persons who would seek to become creditors, because it creates an additional compliance burden which, along with the other laws, rules and regulations affecting consumer credit, costs time and money for which creditors receive no compensation in return.

To the extent that the Rule places seller misconduct costs on creditors, whether fairly or unfairly, such costs must be made up in some way in order for creditors to maintain profitability.

FIRST PENNSYLVANIA BANK,
March 11, 1976.

Re Holder in Due Course—Synopsis of Oral Presentation.

WILLIAM D. DIXON,
Assistant Director for Rulemaking,
Federal Trade Commission,
Washington, D.C.

DEAR MR. DIXON: The following is a synopsis of those arguments I intend presenting to the Federal Trade Commission (the "Commission") at the hearings on the proposed amendment (the "Proposed Rule") to the Trade Regulation Rule on Preservation of Consumers' Claims and Defenses (the "Seller Rule") which are to be held in Washington early in April of this year. My comments will be presented in conjunction with those of Paul Stansberry on behalf of the Consumer Bankers Association (the "CBA") and represent the views not only of the CBA but of my employer, First Pennsylvania Bank N.A. (the "Bank"). At the present time, I am employed by the Bank as a Senior Vice President and I am directly responsible for all areas of consumer finance.

The Seller Rule which becomes effective on May 14, 1976 contains two sections: Section 433.1, Definitions; and Section 433.2, Preservation of Consumers' Claims and Defenses, Unfair or Deceptive Acts or Practices. The Proposed Rule would affect only Section 433.2 of the Seller Rule which proscribes certain unfair or deceptive acts or practices in connection with purchase money loans or any sale or lease of goods and services. Even though the Commission has indicated that it will not, in this proceeding, reopen the question of the applicability of the Seller Rule to sellers, I am concerned that applicability of the Proposed Rule, in any given fact situation, will depend on criteria found in the definitions contained in Section 433.1 of the Seller Rule. For example, as Mr. Stransberry will indicate, the definition of "purchase money loan" is vague because the terms "contract" and "business arrangement" are too broadly defined and the term "refer" is not defined. Furthermore, Section 433.1 does not contain a definition of "goods or services" so that certain real property transactions may inadvertently be covered by the Proposed Rule.

LEASES

I have an additional question with regard to "leases" of goods or services which are covered by Section 433.2. This term is not defined in Section 433.1 and it is unclear what kinds of leases are intended to be regulated. The definition of "financing a sale" is based on the definition of "Credit Sale" as contained in

Regulation Z of the Board of Governors of the Federal Reserve System, which was drawn pursuant to the Truth In Lending Act. As defined in Regulation Z, "credit sale" includes a lease if the lessee contracts to pay as compensation for use a sum subtantially equivalent to or in excess of the aggregate value of the property and services involved and it is agreed that the lessee will become, or for no other or for a nominal consideration has the option to become, the owner of the property upon full compliance with his obligations under the contract. If leases which are the equivalent of credit sales are what is intended to be covered by the Seller Rule and the Proposed Rule, they are sufficiently described in the definition of Credit Sales and the reference to leases should be deleted from Section 433.2 of the Seller Rule and the Proposed Rule. On the other hand, if the Proposed Rule covers true leases, that is, leases which are not the equivalent of credit sales, I do not understand how the Proposed Rule would operate. This is because a transfer of ownership from the seller, if such a transfer occurs, would be to the lessor and not to the lessee. In a true lease, the lessee is not and will not become the owner. As the Notice, by its terms, grants Debtors certain rights against Sellers, consumers who lease property would be confused by the provisions of the Notice.

WARRANTY CLAIMS

In the Background materials contained in the Commission's Statement of Basis and Purpose for promulgation of the Seller Rule several references are made to a seller's breach of warranty as one kind of dishonest practice which should give rise to a purchaser's ability to seek redress from the creditor who financed the transaction. I question whether the Commission has the authority to impose breach of warranty liability on any other person, including creditors, than the person making the written warranty.

The Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (the "Act") provides that while nothing in the Act shall invalidate or restrict any right or remedy of any consumer under State law or any other Federal law, a consumer who is damaged by the failure of a supplier, warrantor, or service contractor to comply with any obligation under the Act, or under a written warranty, implied warranty or service contract may bring suit for damages and other legal or equitable relief if the amount in controversy is in the amount of $25 or more, but that no action may be brought pursuant to the Act unless the person obligated under the warranty is afforded a reasonable opportunity to cure such failure to comply. For purposes of the Act, only the warrantor actually making a written affirmation of fact, promise, or undertaking shall be deemed to have created a written warranty, and *any rights arising thereunder may be enforced under this section only against such warrantor and no other person.*

Because the Congress intended to improve the adequacy of information, prevent deception and improve competition in the marketplace it created a scheme to regulate all written warranties made in the United States or in any territory or possession of the United States. To this extent, the Act preempts State and Federal laws regulating warranties. Thus, it seems to me that the Commission by means of the Seller Rule and the Proposed Rule is imposing a new Federal warranty liability on creditors, whether by reason of a set-off, counter-claim or suit for damages by a debtor, which is directly prohibited by the Act and therefore beyond the Commission's rulemaking authority.

I would suggest that, in order to comply with the Act, you consider modifying the Seller Rule and the Proposed Rule Notices as follows:

NOTICE

> Any holder of this consumer credit contract is subject to all claims and defenses, *other than for breach of written warranty*, which the debtor could assert against the seller....

POLICING SELLER MISCONDUCT

The Commission indicates that the creditor is always in a better position than the buyer to return seller misconduct costs to sellers, the guilty party, and by reallocating the costs to the party that generated them such costs are reduced to a minimum. Some of the reasons given for passing the burden to creditors include: (1) experience in consumer credit; (2) access to information unavailable to consumers; (3) recourse to contractual devices which render the routine return of seller misconduct costs to sellers relatively cheap and automatic; and (4) the creditor possesses the means to initiate a lawsuit and prosecute it to judgment where recourse to the legal system is necessary.

Access to information unavailable to consumers is useless as a tool to police the marketplace unless the creditor is given some viable means to use that information. In the *three party situations*, where the creditor buys an existing credit contract from a seller, the creditor can cut off those sellers with whom it has a record of poor experience, or refuse to do business with those with whom it has no experience. However, how does a creditor protect itself when the dealer who has always rendered good service to his purchasers dies, sells the business or runs into a customer who unreasonably refuses to accept actions by the dealer which would appropriately adjust the claim? This is especially a problem in home improvement paper where the maturity of the obligation may be 7, 10 or even 15 years away. A reserve or recourse arrangement might be totally inadequate to cover the losses sustained by a creditor if the succeeding owner proceeds to run the business into the ground. In this regard the Proposed Rule not only penalizes creditors who deal with sellers whose misconduct is known, but also penalizes those creditors who have made efforts to do business only with highly reputable merchants.

In the *two party situation*, access to information about a seller's previous misconduct is of *no* help to the creditor, even if it were available. If the applicant is creditworthy, can the creditor advise the applicant for a purchase money loan that the dealer from whom the purchase is to be made has a prior history of unfair dealings with consumers? Because the rule grants no immunity to civil or criminal liability, a creditor who voluntarily takes it upon himself to advise the consumer that the dealer is no good can expect to be held liable for such advice. Even though the thrust of the rule is to have creditors police and minimize seller misconduct, in the two party situation, the creditor has no effective control over the dealer. In fact, the creditor will find itself in violation of the Proposed Rule if it refuses to include the Notice whenever a dealer refers an applicant to the creditor for a loan. This is because, as Mr. Stansberry will indicate, the definition of purchase money loan is so vague as to render the Proposed Rule incomprehensible and difficult to follow. Because creditors would open themselves to suits for criminal or civil libel or slander whenever they advised an applicant of a dealer's history of poor service to consumers, *lenders* cannot reasonably be expected to give advice to loan applicants and are therefore unable to change the practices of the marketplace. Notwithstanding this inability to advise applicants, creditors will find themselves subject to claims of disgruntled borrowers because the Notice must be included on the loan documents. The only other rational choice for creditors is to get out of consumer lending.

I see the Proposed Rule as unfair to creditors and in need of substantial clarification. There is no creditor recourse to sellers in a *referral loan*, as this transaction is defined in the Proposed Rule, and while creditors possess the financial means to sue for losses the consumer may have suffered as a result of seller misconduct, creditors are not the proper parties to bring suit. This is because the loan and the sale are *separate* transactions. Courts would invariably hold that, without the existence of some contract or other business relationship between the creditor and the seller, the creditor is without standing to sue the dealer in order to vindicate a purchaser's rights.

Let us now look for a moment at the Commission's contention that "seller misconduct" will be translated by the creditor into "a more accurate price for consumer goods." Without the existence of the proposed rules we already work closely with our lenders on customer satisfaction. It's good business for both of us. Unfortunately, we are finding a small but growing incidence of "professional consumers" who use the rules and regulations already in effect, the age of consumerism, and the cost of suit as a way to avoid legitimate obligations and get more than they were entitled to. To protect its valid dealer relationships there will be occasions where the creditor's costs will not be passed back to the seller but will be absorbed by the creditor.

What are the ramifications of this eventuality? The Commission says that there may be a "slight reduction in efficiency" with respect to "consumer misconduct" costs. I respectfully suggest that the price that 99% of honest, straightforward consumers may pay is higher costs of credit, reduced terms or even credit unavailability. As we absorb more costs which cut our profit margins we must reduce risk by raising credit standards. Should we tell those consumers we turn away that the denial was as the result of a slight reduction in efficiency.

If policing the marketplace is the aim of the Proposed Rule and the Seller Rule, which is indicated in the Statement of Basis and Purpose, then the Commission is abdicating its trade regulating function in credit transactions by making sellers and creditors market policemen, and is taking no action to protect cash customers who are just as subject to merchant misconduct. To the extent that credit customers are given additional rights not accorded cash customers the Rules discriminate unfairly against cash customers and have the effect of discouraging thrift.

ALTERNATIVE METHODS

Because I firmly believe that promulgation of the Seller Rule and the Proposed Rule may cause more harm to consumers than benefit, but that action should be taken to rid the marketplace of improper practices by sellers, I would suggest the following courses of action as viable alternatives to accomplish the Commission's aims, which would not penalize those creditors who deal with reputable merchants, would not unduly affect the marketplace, and yet would tend to rid the marketplace of those sellers and creditors who engage in improper practices.

(1) Promulgate a trade regulation rule making it an unlawful or deceptive act or practice for a seller to take a negotiable instrument or to include in any installment sales contract waiver provisions in connection with the sale of consumer goods or services, and not requiring sellers or creditors to include a Notice such as is contained in the Proposed Rule.

(2) Prohibit practices such as "dragging the body" or the like, by sellers in order to avoid the above rule and impose liability against creditors only in those situations where the creditor knows, or should have known, that the seller engages in improper practices.

(3) Permit a creditor, by an affirmative regulation, to advise prospective loan applicants of the bona fides of any dealer from whom the loan applicant intends to purchase consumer goods or services, in whole or in part, with the proceeds of the loan. Require such advice when the creditor is aware, or should have been aware, of three (four? five?) instances of seller misconduct within a preceding one (or two, three) year period.

CONCLUSIONS

For all of the above reasons, I ask the Commission to review both the Seller Rule and the Proposed Rule in order to reassess the benefits to some consumers against the costs of all consumers must bear. Being a consumer finance officer, I know that creditors will have to take steps to minimize the risks of loss inherent in consumer paper which contain the prescribed Notice. While these steps may mean some belt tightening and restructuring of our present practices, we will not go out of the consumer finance business just because of the Proposed Rule.

To the extent that the Rule places seller misconduct costs on creditors, whether fairly or unfairly, such costs must be made up in some way in order for us to maintain profitability. A creditor engaged solely in the consumer finance business would have no alternative but to raise rates (if the creditor was not already charging the maximum rates permitted by law) or reduce the risks of consumer claims by (i) cutting out marginal or unknown dealers from those persons from whom the creditor will purchase installment sales contracts, and (ii) raising credit standards. But, as discussed above, no action can be readily taken by creditors to protect a loan portfolio when dealers refer applicants for purchase money loans. Banks and other creditors which engage in lending activities in addition to consumer finance will, from time to time, look at the profitability of consumer finance paper and, in addition to taking steps to minimize risks of lower profits, may allocate their resources out of consumer finance.

Because I have no way of foreseeing the future I cannot predict what actions creditors will taken when confronted with a bad loss problem in any given period. Suffice it to say that if the Proposed Rule causes creditors to leave the consumer credit market or to reallocate resources to commercial borrowers which resource should have been earmarked for consumers, the Proposed Rule cannot be changed in time to reverse a process which will be highly detrimental to consumers seeking credit. And because of the vast amount of laws, rules and regulations which govern consumer credit today, and the enormous liability exposure for even the most technical violations, it is unlikely that many potential creditors will be found waiting to fill the void.

Thank you for this opportunity to express my views. I will be happy to answer any questions you may have.

Very truly yours,

LESLIE R. BUTLER,
Senior Vice President.

STATEMENT OF PAUL L. STANSBURY, PRESIDENT, THE CONSUMER BANKERS ASSOCIATION

Gentlemen: I am Paul L. Stansbury, Senior Vice President and Manager of the Consumer Lending Division of The Valley National Bank of Arizona in Phoenix, Arizona, and President of The Consumer Bankers Association. Accompanying me today are Mr. Leslie R. Butler, Senior Vice President of First Pennsylvania Bank, Mr. Drew V. Tidwell, Legislative Representative of The Consumer Bankers Association and Mr. Michael S. Milroy, a lawyer with Rawlins, Ellis, Burrus & Kiewit of Phoenix and counsel to The Valley National Bank of Arizona. We appreciate this opportunity to present our thoughts on this subject.

In presenting my statement today, I wish to first address the various definitions found in Section 433.1 of the Federal Trade Commission Trade Regulation Rule relating to Preservation of Consumers' Claims and Defenses. In reviewing these definitions, and attempting to speculate upon the scope of the application of this Rule by reviewing the definitions, we hope to demonstrate our point that we quarrel not so much with the general reason or need for the Proposed Trade Regulation Rule as we do with the scope and applicability of that proposed Rule.

To be more specific, and in dealing with the first important definition of Section 433.1, we would point out that the "consumer" which is here sought to be protected is one who acquires "goods or services" for personal, family or household use. The phrase "goods or services" can encompass literally every purchase which could be made by a consumer, including construction or purchase of a home, a swimming pool, or a permanent addition to that consumer's residence. The Real Estate Settlement Procedures Act should give sufficient and desired protection to home buyers which would justify excluding from the operation of this Regulation purchase money loans or financed sales relating to the acquisition of a consumer's principal place of residence. Likewise, it would seem that home improvement projects and property modernization undertakings should be excluded from the operation of this Regulation (or otherwise appropriately limited) by some definitional change which would, for example, restrict the phrase "goods and services" to personal property transactions covering items of personal property which are or are to be affixed to real property and exclude from that definition the total mass of general construction materials which would necessarily be accumulated to complete a construction project. The personal property items traditionally thought of as "goods or services," such as dishwashers, carpeting, alarm systems, aluminum siding, and similar items (and installation services) would continue to be subject to this Regulation so as to regulate home repairs and home improvement-type additions of a minor nature while exempting from coverage the purchase of dwelling and the major construction and improvement projects relating to dwellings, which generally are covered by contractor's bonds, building inspection codes, contractor's licensing provisions and other consumer protection devices.

One can readily imagine the long-range impact of a seemingly appropriate consumer protectionist device which reaches out to cover the participation of a creditor, and especially a banking institution, in the financing of a consumer purchase money loan for the acquisition of a personal residence. Such a mortgage loan would be written for a period of from twenty to thirty years and might be generated for the purpose of sale ultimately to a governmental agency or to a mortgage banker or other lending institution. To deny those ultimate holders the existing protections of a holder-in-due-course would almost certainly destroy the salability of that mortgage loan; further, if you care not to consider the salability of that mortgage loan, consider then the reasonable value which could be assigned to that mortgage loan for asset evaluation or collateral security evaluation purposes. The uncertainty of the possibility to interposed consumer defenses—especially over the long period of that mortgage loan—could very conceivably have a striking and long-range impact upon the money management and money brokering techniques which have been devised and perfected over the years by political subdivisions as well as the business and finance sectors of the economy. Although we will intentionally refrain from making any statements that we cannot support by statistics or affirmations by appropriate entities, we do not feel that the foregoing statement is intemperate or irresponsible.

The home improvement loan presents a more difficult question. These loans are generally written for a term ranging from 5 to 15 years. For example, in the construction of a permanent addition to a consumer's personal residence, as in the construction of a swimming pool or similar improvement, which should be considered to be a major undertaking, there seems to be a logical distinction between expected abuses of consumer rights in that area when compared with the expected abuses of consumer rights in sales and installation of carpeting, alarm systems, aluminium siding, texture coatings and sealings, and roofing materials. Because of the amounts generally involved in major home improvement projects and the necessary term of amortization of such a loan, the Commission's Regulation would be tantamount to making the creditor acquiring a consumer credit contract for such an improvement an absolute insurer of the advisability, fitness and quality of the construction project, as well as the workmanship and the materials incorporated therein. A lending institution would probably look away from undertaking such a long term responsibility, especially a responsibility of such magnitude. Whether lenders would decline to make this type of credit except in isolated situations involving highly reputable contractors of unquestioned financial strength can only be a matter of speculation; however, that speculation would have to include the thought that the Regulation would necessarily force lending institutions to favor the financially strong, long-established companies over small, new contractors and that further leads one to speculate on the monopolistic overtones that accompany that kind of discussion or speculation.

Turning to the definition of "creditor" under Section 433.1, we find what appears to be an exclusion from the operative definition of any credit card issuer which is becoming a creditor by a specific credit card transaction, with the apparent benefit that the prescribed notice would then not be necessary and waivers of defenses would continue to be available within the permissible and practical limitations of the Fair Credit Billing Act. The phrase "credit card issuer" is a defined phrase under Section 433.1; however, we do not find a definition of the phrase "credit card" and we do not find any point of reference from which we might obtain a definition of that phrase. We recommend that the proviso relating to a credit card issuer be set aside by stating it as a separate sentence under the definition of "creditor." We strongly recommend that the phrase be given further specific meaning by including in Section 433.1 a specific definition of "credit card" to add clarity to the entire concept that this type of consumer credit purchase money loan is exempt from this Regulation. To obtain further uniformity, it is suggested that the definition of "credit card" found in Truth-in-Lending Regulation Z, Section 226.2(r), or a substantially similar definition be adopted by the Commission so that the phrase "credit card" would mean "any card, plate, coupon book, or other single credit device existing for the purpose of being used from time to time upon presentation to obtain money, property, labor or services on credit." The phrase "credit" as found in the previous definition might also be adopted from Regulation Z, Section 226.2(q), to generally cover "the right granted by a creditor to a consumer to defer payment of debt, incur debt and defer its payment, or purchase property or services and defer payment therefor."

As the Commission pointed out in its Statement of Basis and Purpose, credit card issuers can and do undertake to intervene in consumer disputes with sellers and consumer injury from reliance on the standard form of waiver of defenses in credit card contracts is infrequent; consequently, there is no reason to believe that the Fair Credit Billing Act will not afford adequate protection to consumers at the present time. We fully agree with the Commission's conclusion on this point but seek to go one step further in supporting the adoption of a rule containing language which will not separate a buyer's defenses from his obligations to pay under any holder-in-due-course or defense waiver theory and, at the same time, will not place undue strictures on issuers of credit cards, check guarantee cards, debit cards and other cards which are now and will soon be upon the scene as additional tools of access to consumer funds and to consumer credit programs.

There are additional problems with this concept and those problems are sufficiently complicated to indicate that the proposed solution of adding two small definitional phrases is probably too simplistic in its approach. For example, a true "credit card," such as Master Charge, BankAmericard or American Express, would seem clearly to fall within the exclusion under the phrase "creditor." Granting that as a fact, we get into variations on that theme which would seem to require, at the very least, that the phrase "credit card" be defined to clearly include access to a credit program by an instrumentality other than the traditional "plastic."

For example, there are many banking institutions across the country that use a check-line item which can be written in favor of a merchant, whether or not that merchant is participating in the credit card program by prior agreement, in payment of purchase of consumer goods or services from that merchant and that check is debited not to the consumer's general demand deposit account, but to his credit card account as a cash advance or loan. Similarly, a credit card arrangement with a consumer can be such that there is a "loan checking" or "credit reserve" feature appended to the consumer's regular checking account so that any check written by the consumer which would normally overdraw that demand deposit account will not operate to create an overdraft but will trigger a "loan" from the credit card account, as a cash advance, which will be automatically disbursed to the consumer's demand deposit account to avoid the occurrence of the overdraft. The loan made under the credit card account is payable on a deferred basis according to the terms of that particular credit card plan and is another instance where the "credit card" is not the traditional "plastic" but is some other instrumentality. Added to that fact is the additional fact that credit card accounts can, in many instances, be accessed by appropriate telephonic or mail requests, both of which do not involve presentation of a "plastic" or any other device evidencing the existence of a credit card account.

Aside from the definitional complications involved in these concepts and variations on these concepts, the ultimate point to be made is that these programs can and should be logically excluded from the operation of the Regulation for the reason that they are adequately covered by the Fair Credit Billing Act, which the Commission has recognized as affording adequate protection to consumers at this time. Going one step further, and at the same time moving to the definition of "purchase money loan" under Section 433.1, we have additional motives in urging the inclusion of a check guarantee card or similar program or device in the definition of "credit card" so that such device and program could be excluded from the operation of the proposed Regulation since, without such specific exclusion, such a program could become subject to the Regulation by virtue of the definition of "purchase money loan." Let me explain this statement.

Use by a consumer of a check guarantee card, in connection with a check drawn on that consumer's demand deposit account, could serve to overdraw that account and, if the Bank were to permit that overdraft and honor the check as an accommodation and not as a part of an overdraft banking program, and levy an overdraft or item handling charge against that transaction, it could easily be said that the Bank had made a loan or a "cash advance" which was received by the consumer in return for a finance charge under the meaning of Regulation Z. Assuming that check obtained proceeds which were applied by the consumer in whole or substantial part to a purchase of goods or services, the rest of the definition will be satisfied since the seller honoring that check guarantee card will, almost certainly, be doing so under the assurances given by the card issuing bank to that merchant by a check guarantee agreement, or a "business arrangement" previously entered into between the bank and the check-accepting merchant.

The only factor in this definition which might be susceptible to argument is whether the overdraft charge could be said to be a "finance charge" within the meaning of Regulation Z and, it is submitted, *that* uncertainty need not be imposed upon lenders when a much more certain and equitable solution to that potential problem can be obtained through an appropriate definitional change. While on this rather narrow point, let me point out further that the phrase "cash advance" included within the definition of "purchase money loan" should be clarified to indicate the cash advance in question is actually the advance of cash as the proceeds of a consumer credit contract, and are not the consumer's funds which are being disbursed or released to him or on his behalf pursuant to his order in the form of his personal check drawn upon his demand deposit account where that check might, as pointed out previously, become an overdraft and bear an overdraft charge which might be (or be alleged to be) a finance charge so that such transaction technically became a "purchase money loan"— which appears to be contrary to the primary intent of the Regulation.

There is a much more fundamental problem in the definition of "purchase money loan." We have great difficulty accepting the lack of distinction in the Regulation between dealer tie-in loans (whether through a three-party dealer paper transaction or by a direct loan transaction) and a legitimate, genuinely two-party traditional direct loan transaction, all or a part of which loan proceeds might be used to purchase consumer goods.

Where the consumer has selected the seller and the creditor or lender involved has not actively participated in that particular extension of credit or in any way encouraged that sale transaction between the seller and the consumer, a genuine and traditional two-party direct loan transaction between the consumer-purchaser and the lender or creditor should not destroy or dilute legitimate holder -in-due-course protections and we submit there is much or as little logic in continuing unimpaired those holder-in-due-course protections in a legitimate direct loan as there is in making a lender or creditor under a "purchase money loan" an insurer of the seller's performance and representations under that sale transaction, as the Regulation would do.

Technically, this should be true even though that creditor may have a recourse agreement or other dealer arrangement with that particular seller as to general dealer paper transactions—although the logic of the distinction between which transactions with that particular dealer should have holder-in-due-course protections and which should not admittedly pales under the light of reason. However, I should be quick to point out this light of reason is powered by the concept of lender or creditor *control* over that seller and we must not forget it is the ultimate goal of the Commission to make certan that sellers are wholly responsive to legitimate consumer complaints and the sellers, and not the lenders or creditors, are the ones who should ultimately respond to and adjust any legitimate consumer complaints.

With that thought in mind, let's first deal with the concept of involving a lender or creditor in a regulated "purchase money loan" simply because funds are provided to a consumer which are used to purchase goods or services from a seller who "refers" a consumer to the lender or creditor. The concept of referral is inappropriate in that it provides no predictability for a lender or creditor. Even more importantly, it provides no ability of the lender or creditor to control its own destiny within the framework of the Regulation since activities wholly outside the knowledge or control of the lender or creditor can be used to place that lender or creditor in a position which he might choose not to occupy insofar as that particular seller might be concerned. A seller could make referrals in favor of a particular lender or creditor under circumstances where that lender or creditor did not encourage those referrals in any way or even know of those referrals. Yet that sole factor could, by a development of facts *subsequent* to a transaction complained of, result in an enforcement entity decreeing that such lender or creditor had, in fact, been a participant under the definition of "purchase money loan" to such an extent that it was covered by the Regulation. A lender or creditor has then only the alternative of including in every one of its loan documents the required notice, in which case it waives holder-in-due-course protections to which it might be fully entitled and might not choose to abandon, or it refrains from including the prescribed notice, in which case it could find that, by an after-the-fact development of circumstances, it should indeed have included that notice in its loan documentation and is, therefore, guilty of a deceptive trade practice. Both of these alternatives are wholly unacceptable and alternatives which are imposed upon a lender in a grossly inappropriate and unfair manner.

Because the concept of referrals is basically illogical and unmanageable from an enforcement standpoint, we very strongly recommend that the concept be discarded and suggest that such could be done without doing violence to the protections of consumers legitimately sought to be secured. It becomes an even more obvious anomaly when it is understood that the other set of actions of a creditor or lender interfaced with a seller are *fully defined* under subsections (f) and (g) of Section 433.1. Consequently, a lender or creditor is fully able to know what will be deemed to be a "contract" with a seller or a "business arrangement" with a seller; however, the most uncontrollable act which serves ultimately to prejudice a creditor or lender is not in any way defined or explained or characterized so that a creditor or seller might predict what level of action or inaction might operate to ultimately force the conclusion that a lender or creditor was subject, as to that transaction and future transactions (and, maybe, as to past transactions) to the force and requirements of the Regulation.

A premise of the Commission contained in your Statement of Basis and Purpose is to permit full defenses to consumer obligations when that obligation arose out of credit being arranged or secured in connection with a *continuing relationship* between a seller and a creditor. The touchstone of this whole concept is, it seems, a creditor's or lender's ability to CONTROL a seller and "cut him off" if not satisfied with his honesty and responsiveness to legitimate consumer complaints.

Clearly, a lender or creditor should have the privilege of consenting to become an insurer of a particular seller's performance under a consumer credit contract and that consent would normally be based upon the evaluation of a particular seller in light of a creditor's or lender's ability to *control* that seller by the terms of a recourse agreement or other dealer agreement, or at least upon the basis of an ongoing financial arrangement, by which the lender of creditor could force or attempt to force that seller to be responsive to legitimate consumer complaints and make appropriate adjustments.

Obviously, if a lender or creditor is made the insurer of a seller over whom that lender or creditor has no control and was made an insurer simply because of a "referral" (which could deny the lender or creditor his right to consent to become such party's insurer), the basic thrust of the Commission's Regulation has been misdirected since there may exist no manner in which the lender or creditor can force that seller's responsiveness; rather, through no conscious choice by the lender or the creditor, or by a Regulation which serves to deprive that lender or creditor of a conscious choice, that lender or creditor becomes assigned the rule of an insurer of a seller with which that lender or creditor might, on an informed and voluntary basis, choose not to do business.

An additional practical problem is the Regulation does not require connection of a creditor or lender to a specific sale transaction, which as where the lender or creditor has taken a security interest in the goods sold or the proceeds of the loan are made payable directly to a seller or the seller is receiving a commission or has assisted in preparing the loan documents or formulating the loan concept and loan transaction.

It seems fair to say that, under the Regulation, a creditor or lender would have to know what would be done with the proceeds of the loan and, if the use were to pay for all or a substantial part of the purchase price of consumer goods or services, from whom such goods or services had been or would be purchased. The "Statement of Purpose" which would have to be obtained by each creditor or lender proceeding in a prudent fashion would then force that lender or creditor to make what might prove to be an unwelcome invasion of an individual consumer's privacy with regard to the use of loans which, on their face, would invite no such inquiry—such as in those instances where a loan might be unsecured or might be secured by assets other than the items being purchased by the proceeds of the proposed loan. The only other alternative is to include the prescribed notice in every debt instrument used or received by a lender or a creditor, which necessarily forces that lender or creditor to abandon certain holder-in-due-coruse protections under circumstances where that lender or creditor might otherwise choose not to do so and might otherwise not be required to do so, just to make certain that the infection of unknown "referrals" had not built up to a level where all loan transactions with a particular seller would be subject to compliance with the Regulation.

The Commission must recognize that there are instances where there is no affiliation with the seller, no common control or business arrangement and no contract, even though the seller may have "referred" that consumer to a lender or creditor by an unencouraged suggestion and not because of any tie-in. An isolated referral, without more, gives a lender or creditor no reason to check the credentials of that seller—especially in states where lenders or creditors have numerous branch offices and all consumer credit contracts generated by that seller would not come to the attention of any one office—and the lender or creditor certainly would have no "control" over that seller under those circumstances. Following this line of reasoning, it seems fair to classify "purchase money loans" as:

(*a*) "indirect-dealer paper"
(*b*) "direct-vendor-related"
(*c*) "direct-non-venor-related."

Most creditors or lenders should have no conceptual or control problems with the indirect loan or "dealer paper" function. Using "control" as the key point once again, it would seem fair to surmise creditors or lenders would have no insurmountable control problems or conceptual problems with the second category, the "vendor-related direct loan" function, *if* that creditor or lender is dealing with affiliation by common control, contract or business arrangement. Here, we are suggesting elimination of the principle of "refers" and change in the definition of "business arrangement" to generally mean any understanding, procedure, course of dealing, or arrangement between a lender or creditor and a seller by which the seller acts to arrange for the extension of credit (within the meaning of the Truth-in-Lending Act and Regulation Z).

The thrust of this concept would then mean all sellers with which a lender or dealer had a written dealer agreement, or a course of prior dealing, or contract, or arrangement whereby the seller received a fee or commission or some other type of compensation (other than the sale price of the goods or services sold) for generating that credit, or prepared loan papers for the lender or creditor or otherwise assisted in getting the loan "booked" for the creditor or lender would be deemed to be controllable by that creditor and subject to the full force of the Regulation.

The third category, that involving a "non-vendor related direct loan," perhaps, in practical occurrence, does exist and should be dealt with as a separate part of the Commission's deliberations. If a particular seller is not tied to a creditor or a lender by a course of dealing (which certainly is a more tangible and predictable concept than "referral"), or dealer agreement, or contract, or by an "arrangement" (as one might define that term) and if that seller is not an arranger of the credit but simply receives the purchase price—without more—there can be no principle that would be sufficiently important to compel overriding holder-in-due-course and defense waiver theories to impose unpredictability and expense upon a lender or creditor—especially with Magnuson-Moss Warranty protections available. Repurchase agreements and "dealer reserves" and "cost of credit" and "availability of credit" arguments are fine points for philosophical discourse, but are not practical answers to the problem at hand.

As an ultimate practical matter, a lender's or creditor's experience with a particular dealer over the history of that relationship will govern and that is the point the Commission has recognized—but only in passing. We should all take care that the basic question, which is how we can make sellers responsive to legitimate consumer complaints so *all* persons perform as agreed, must not be lost in the course of these discussions. As a part of that thought process, we must also avoid lengthy dissertations on who can best bear the cost of *non-performance*, which becomes a matter of concern only when you have abandoned the main point and purpose of this Regulation and indulged in the expedient of assigning burdens upon presumed ineffectiveness of the Regulation in causing the seller to perform as agreed. Again, the touchstone is "control" and if the creditor or lender cannot control a seller as *a practical matter* and cannot be fairly charged with any responsibility for a seller's misadventures (as in a *genuine* "non-vendor related" direct loan), upon what authority and logic is the lender or creditor to be made to bear the burden of a bad bargain not his making simply because he has more money than the consumer and is therefore preemptorily assigned by the Commission the role of the one best able to stand the loss?

As we mentioned, we would suggest amending the definition of "business arrangement" slightly to make it clear that there was included within that phrase the concept of an "arrangement for the extension of credit," as that term is defined in Truth-in-Lending Regulation Z. Even with that change, however, there is still the residual difficulty presented by the retention of the concept of "referral" as it might relate to a non-vendor related direct loan. On the other hand, and again using the concept of lender or creditor "control" over the original seller, any consumer credit contract sold by a particular seller to a lender or creditor would generally be conveyed and transferred by the execution of a seller's assignment and warranty. Under those circumstances, the language of the seller's assignment and warranty would generally have at least minimal protections that would be analogous to a dealer agreement or repurchase agreement so that there would be at least some degree of direct and contractual control that could be

exerted or exertable by the lender or creditor upon the originating seller. In this case there is at least knowledge of the seller whose performance may be insured, just as there would be if the lender or creditor seeks to take a security interest in the consumer goods being obtained with the purchase money loan. Under these two examples and without evidence of any affiliation between the creditor or lender and seller by common control, other contract or business arrangement, that lender or creditor could very well and fairly then be argued to be connected in some way to that seller by a "business arrangement." This would leave the pure and genuine non-vendor related direct loan outside the scope of the Regulation (assuming the concept of referral is eliminated) except in those loans where the lender or creditor obtains or seeks to obtain a security interest in the goods or services acquired with the purchase money loan proceeds.

It also appears that *any* single act of making a "business arrangement" would *forever* cause that lender to be an insurer of, and responsible for, the performance of the originating seller since there is apparently no manner in which a lender or creditor could subsequently terminate any "business arrangement" with such a seller. If that is actually the case, and it appears not unreasonable to assume that this is precisely the manner in which this Regulation must be interpreted, the only alternative that a creditor or lender would have would be to initiate the procedure of a purpose statement from every consumer seeking a direct loan to determine the proposed seller, and the reason for the purchase, and then pass judgment not only on the consumer's ability to service that credit as presented, but upon the desirability of the seller and the lender or creditor's desire to do business with that particular *originating* seller. To take this to its logical extension, you would then place a lender or creditor in the position of approving a proposed consumer credit but denying the extension of that credit because the seller was not acceptable to the lender or creditor. Obviously, this type of judgment decision is going to be viewed in some circles as discrimination and, in light of the generally acknowledged aversion to being called a "discriminator" and in light of the principles of the Equal Credit Opportunity Act, which are now sought to be expanded even further, such discrimination is going to have to be based upon full and logical justification. Under the circumstances, it appears the Commission's Regulation—at least in the practical effect of its operation—actually requires that kind of discrimination as against certain sellers and this purpose of the Regulation should be forthrightly acknowledged.

We now turn from discussion of definitions to the fact the Commission has expressed some concern over the "boiler-plate" nature of certain consumer credit contracts as constituting contracts of adhesion. These adhesion contracts are impugned by the same Commission Statement that imposes almost absolute responsibility upon a lender or creditor to "control" sellers or bear the cost of any loss arising out of the failure to control those sellers. We must assume it is the Commission's actual intent *in making* these statements to criticize "contracts of adhesion" only in those instances where such contracts permit sellers to foreclose consumer equities in credit sale transactions while at the same time serving to cut off consumer defenses against third party financers.

As the Commission has stated, consumers are not in a position to police the market, exert leverage over sellers, or vindicate their legal rights in cases of clear abuse. For a lender or creditor to effectively and correctly control and police loan terms and disclosures—as they must under Truth-in-Lending Act, Equal Credit Opportunity Act, and other regulations, those lenders and creditors must be at liberty to prescribe use of certain recognizable phrases, and contractual and disclosure formats. With the boiler-plate notices of the Magnuson-Moss Warranty Act and this Regulation, among others, the onerous "adhesions" should be eliminated or neutralized so that only state law provisions and Uniform Commercial Code and other boiler-plate items not yet revised or deemed unenforceable, unconscionable or unconstitutional remain.

To label consumer credit contracts as "contracts of adhesion," offered to a consumer on a take it or leave it basis, intimates that the creditor or lender engages in some predatory practice in order to squeeze every right from the consumer and compound seller abuses found to exist in the marketplace. This is specious. Consumer credit contracts are offered to consumers on a take it or leave it basis in this age because to do otherwise would be expensive, imprudent and risky. As the Commission can certainly appreciate, the proliferation of laws, rules, disclosures and regulations in the consumer credit area that require modification and specific phrases to be included in consumer credit contracts makes it even more critical that a lender or creditor use credit contract forms that are reviewed, approved and inflexibly prescribed as the debt and disclosure instrument which will be used and accepted by that particular creditor or lender in conducting its business. To this end, this Regulation will have the effect of re-enforcing the necessity for creditors and lenders and sellers to use boiler-type and inviolate form contracts in consumer transactions.

Our final point of discussion relates to the prescribed Notice of Section 433.2 of the Regulation. We would very strongly characterize that notice as containing a completely onerous and inappropriate provision relating to "claims and defenses." The Commission has gone far beyond merely limiting the effectiveness of a waiver of defense provision in a consumer credit contract or limiting the creation of a holder-in-due-course of a consumer obligation to prevent the seller from separating a consumer's duty to pay from the seller's duty to perform. The claims and defenses assertable must be related and limited to personal property warranty breaches and appropriate rescission and restitution rights arising out of a particular consumer credit contract covering the defective item in question; all residual claims must be specifically denied and clearly excluded from the language of the Notice. For example, it cannot be the Commission's intent to decree, by this Notice and its forced inclusion within certain consumer credit contracts, that a lender or creditor is to be considered liable for punitive damages for a seller's fraudulent misrepresentation not participated in by the lender or creditor, or for damages for bodily injury or wrongful death resulting from the purchase or ownership of consumer goods which might coincidentally have been financed by that creditor or lender. It surely cannot be the suggestion of the Commission that the phrase "claims and defenses" covers every possible and conceivable aspect of a consumer's purchase, use, ownership, control, custody or possession of consumer goods or services.

It seems apparent in reading the Commission's Statement of Basis and Purpose (middle column, page 53524 of Federal Register, Vol. 40, No. 223, November 18, 1975) that the preservation of claims and defenses was meant to secure for a consumer only the performance from a seller that was initially bargained. In speaking of the Regulation, the Commission stated that "from the consumer's standpont, this means that a consumer can (1) defend a creditor's suit for payment of an obligation by raising a valid claim against the seller as a set-off, and (2) maintain an affirmative action against a creditor who has received payments for a return of moneys paid on account. The latter alternative will be available only where a seller's breach is so substantial that a court is persuaded that rescission and restitution are justified." If this statement by the Commission is actually the foundation of the language and intent of the Notice, then it is suggested the Notice should be specifically modified and the history of the Regulation specifically footnoted to the extent necessary to make certain that all who might deal with this question are adequately apprised of the nature and scope of the responsibility and liability sought to be imposed upon a seller and the transferee of the seller's position in any consumer credit contract. If, on the other hand, it is the Commission's intention to strike down privity of contract concepts, negligence and contributory negligence concepts, and other very complex bodily injury and wrongful death principles that have been developed over decades of agonizing court battles, then the Commission must clearly so state in certain and specific terms so each seller and each lender and each creditor can evaluate and accept its desired level of risk and responsibility and formulate its business plans and intended warranty coverages and disclaimers.

While on this point, we would simply note that it seems completely reasonable to suggest that a clear and concise statement by the Commission of the fact that "all claims and defenses" means precisely that without any limitations whatsoever will have a considerable impact upon the cost and availability of credit and will have far-reaching impacts not only upon those sellers whose business ethics and honesty might be questioned, but also upon those sellers and manufacturers who are unquestionable financially and morally responsible but who deal in or manufacture consumer goods or services which are inherently thought generally to be of a high risk or high injury possibility level.

Certain other points should be raised in connection with the prescribed Notice. For example, we would suggest that it must be specifically stated by the Commission, for reasons similar to those stated above, whether the dollar limitation apparently stated is applicable to the particular consumer credit contract covering the defective item, or to any contract entered into with the seller

in question. In that regard, although it seems somewhat clear that the limitation is related to that particular consumer credit contract, the final word "hereunder" in that notice might probably be deleted and the following words added, "to the holder of this consumer credit contract."

We would also suggest that, since the limitation on recoverable amounts appears to be actually designed to permit rescission and restitution, this fact be more explicitly stated so all will know the scope of their responsibilities and can measure their participation in consumer credit contracts.

In connection with the point made concerning "all claims and defenses," we would assert there is no solace or comfort in the limitation on recovery without a specific limitation on type and extent of claims assertable. We would further submit that a consumer can assert his *claims* on whatever basis the *law* now permits, and that it is totally outside the scope of a project to prohibit the separation of a buyer's duty to pay from the seller's reciprocal duty to perform as promised to insert an encouragement to assert *claims* and an apparent Commission-decreed "right" to assert *claims* in a situation designed to preserve a consumer's remedies in the nature of withholding payment as a "defense" to nonadjustment of legitimate consumer complaints. In that connection, a proposed revision of the prescribed notice is suggested:

"Any holder of this consumer credit contract is subject to all rescission and restitution rights, and all defenses, which the debtor could assert against the seller from which the subject goods or services were obtained pursuant hereto or with the proceeds hereof. Recovery hereunder by the debtor shall be limited to amounts paid by the debtor to the holder of his consumer credit contract."

In passing, it should be noted that, because of the modification of this proposed notice, specific treatment of any funds paid by a debtor as a "down-payment" on a particular consumer credit contract would have to be prescribed by the Commission as being included or excluded from the definition of "amounts paid under the consumer credit contract." While that point is not completely clear under the Commission's proposed notice, we would assume that the general tenor of this proposed Regulation is such that rescission and restitution would completely restore a consumer to his original position and that, therefore, the amount in question would necessarily have to include every penny paid by the debtor as a part of that consumer credit transaction, regardless of label, and we would suggest that this interpretation be specifically included somewhere within the Regulation—if that be the intent of the Commission—so consumers would have less difficulty in enforcing their rights under a consumer credit contract containing an appropriate notice and so sellers, lenders and creditors would be more fully apprised of their duty and responsibility under the Regulation.

Finally, we would like to comment briefly on the fact that the Regulation places no reasonable time limitation upon the rights of a consumer to assert his defenses against the seller and/or the lender or creditor and seek rescission and restitution. We are aware the Commission considered suggestions of some which would require the consumer to notify the creditor or lender of any defenses within a specified period and that such an affirmative responsibility upon the consumer was rejected by the Commission. While we do not advocate a "complaint period" approach, we do very strenuously suggest that a lender or a creditor must not remain exposed to the threat of defenses, rescission and restitution for the entire term of the amortization program on a particular consumer credit contract, or for some indeterminate time extending past the satisfaction date or originally scheduled satisfaction date of that consumer credit contract. There appears now to be no time limitation whatsoever and it would seem fair to put some limitation upon the time within which a consumer could assert defenses and restitution or rescission claims and it would further seem fair to limit that time period to a specified term. We would suggest that, especially in view of the disclosure provisions of the Magnuson-Moss Warranty Act, which the Commission has statutory authority to oversee and regulate, a creditor or lender could be subjected to defenses and claims of rescission and restitution only during the period of full or limited warranty coverage offered by the seller, but in no event longer than three years.

This term would generally be related to the "average installment credit" term that would be used in consumer credit contracts and would allow lenders and creditors to avoid the obvious agony of assigning a defense period coexistent with the particular term of a contract, regardless of the nature of the consumer credit contract, in those instances where home improvement loans and purchase money mortgage loans constitute the consumer credit contract in question—unless the suggestions made previously about exemption of this particular type of credit would be received and acted upon favorably by the Commission. We offer this as a reasonable alternative to the "complaint period" approach and submit that it would not be unreasonable to provide in the prescribed Notice that the debtor can raise such defenses and rescission and restitution claims against the holder during the warranty period which covers the consumer goods or services, or during a period dating three years from the date of the consumer credit contract, whichever is less.

In conclusion, and at the risk of being accused of making the expected self-serving statement, let me assure the Commission that the Consumer Bankers Association does not condone unethical practices of either sellers or lenders who purchase consumer credit contracts, and members (who conduct their business in the various states) have been operating under varying forms of limited holder-in-due-course and waiver of defense theories for some time now, which they generally have expanded to the projected benefit of all concerned to assure themselves that they get involved in the fewest possible number of consumer-seller-lender disputes. Our comments are not meant to be argumentative; rather, we submit these thoughts in hope of obtaining these consumer protections without causing expensive and massive revisions of loan making and "policing" procedures. There is no reason to believe these goals are *not* compatible and our Association will cooperate with the Commission in all ways necessary to accomplish this.

THE CONSUMER BANKERS ASSOCIATION,
May 25, 1976.

CHRISTOPHER W. KELLER,
Presiding Officer, Bureau of Consumer Protection, Federal Trade Commission, Washington, D.C.

DEAR MR. KELLER: During the appearance of The Consumer Bankers Association before your panel which was holding hearings on the Commission's proposed amendment to 16 CFR 433.2, you and members of the staff requested that this Association furnish additional material on various issues raised in our testimony.

WARRANTY CLAIMS

On April 8, 1976, representatives of The Consumer Bankers Association argued before the Commission that the Commission did not have the authority to impose warranty liability on lenders pursuant to Section 110(f) of the Magnuson-Moss Warranty Act (the "Act"). As the Commission is aware, Section 110(f) provides that any rights arising under the Act may be enforced only against the person making the written warranty and no other person. Without going into the question as to whether or not the buyer of consumer goods from a seller who assigns an instalment sales contract to a creditor could raise warranty claims against the creditor, it is clear that in many jurisdictions today the buyer could not raise warranty claims against a lender who made a loan to the borrower to enable the borrower to purchase the goods for cash.

Furthermore, even though there are 11 states (plus the District of Columbia) which impose varying degrees of liability exposure upon lenders who participate in or are directly involved with the underlying sales transaction, to the extent that the Preservation Rule (the "Rule") would extend warranty liability to lenders in those 12 jurisdictions who would not otherwise be subject to liability under state law, we are of the opinion that the Commission is exceeding its authority under the Act. That is, as no existing state rule imposes liability on lenders for a buyer's claims or defenses, including warranty claims, on a mere referral of the buyer to a creditor, the Rule will create a new Federal cause of action.

Another question raised by the Commission in connection with warranty liability was whether a buyer could seek to impose warranty claims after the expiration of the period stated in the warranty. Sections 104(a)(2) and 108(b) of the Act deal with limitations on the duration of implied warranties and impose minimum standards to which warrantors must comply. In connection with full warranties, Section 104(a)(2) provides that a warrantor may not impose any limitation on the duration of any implied warranty. For limited warranties, Section 108(b) provides that a limitation on the duration of implied warranties is permitted, unless it is found to be unconscionable, unclear or not prominently displaced on the face of the warranty. Such implied warranty would

apply against the person making the written warranty and, in accordance with the Rule, against the creditor who purchases the instalment sales contract or who makes a "referred loan." See the Commission's Rules, Regulations, Statements and Interpretations under the Act contained in 40 Federal Register No. 251 of December 31, 1975, at page 60168, and especially the discussion of limitation on implied warranties beginning at page 60176.

For the reason that it would be extremely difficult to treat in the required Notice those instances where warranty liability under the Rule may lawfully be imposed against a creditor from those instances where it would not, we suggest that the Notice contained in the Creditor Rule be amended to provide that it does not cover claims arising from written warranties. Furthermore, as a matter of common sense, we believe that buyers of goods and services who obtain written warranties would seek to obtain satisfaction from those persons who make written warranties and would not consider it fair or equitable to impose warranty liability against a creditor who is not involved in the underlying sale.

CALIFORNIA UNRUH ACT AND HOME MORTGAGES

The Presiding Officer presented a direct question to the Association regarding the application of the California Unruh Act to mortgage lending for residential real estate, the contention of the Presiding Officer being that since Holder-in-Due-Course with regard to mortgage lending had been abolished in California consequently there had not been any adverse effect on the negotiability of California originated mortgages in the secondary mortgage market.

The Unruh Act, as originally passed, was not clear as to whether it would apply to home mortgages. The general assumption was that the Act would not apply since it was supposed to apply only to "goods and services" except for automobiles. The Attorney General in California ruled that a first deed of trust on property was under the retail instalment sale law if the purchase price is paid to a contractor in instalments over a period of years and a service charge is added to the contract price in arriving at the face amount of the note which is secured by the deed of trust [Opinion of California Attorney General (Dec. 2, 1962) No. 62-168]. In 1968 the California Court of Appeals and the Supreme Court of California upheld this Opinion and held that a contract for the construction of a residence by a contractor on land owned by plaintiffs constituted a retail instalment sale subject to the requirements of the Unruh Act, *Morgan v. Reason Corp.*, [69 A.C. Cal. 919, 73 Cal. Rept. 398 (1968)].

The California Assembly quickly reacted to this decision by exempting realty transactions from coverage under the Unruh Act. Specifically, section 1801.4 California Civil Code was amended to exclude residential, commercial or industrial loans from coverage. The legislature in its report on this measure specifically stated that the case of *Morgan v. Reasor Corp.* was being overruled. One of the primary reasons for the California Assembly's action was the problem that would arise in the secondary market for first mortgages. Many financial institutions in California found that if mortgages were subject to the Unruh Act, their negotiability would be impaired. [Note: Laws 1969, A.B. No. 2101, Approved July 18, 1969, effective November 10, 1969].

INTERLOCKING LOANS

The Presiding Officer questioned the statement our Association had listed regarding loan statutes of various states. Listed below are the states and appropriate sections from the states' code:

Arizona—Sec. 44-145 Ariz. Res. Stat.
Connecticut—Laws of 1972, P.A. No. 937.
District of Columbia—Sec. 28-3809.
Iowa—U.C.C.C. 3-405.
Kansas—U.C.C.C. 16A-3-405.
Maine—Sec. 3.404 Maine Consumer Credit Code.
Maryland—Sec. 12-309 Commercial Law Article.
Massachusetts—Chapter 255, Sec. 12F, General Laws of Mass.
New York—Sec. 253, General Business Law, Ch. 20, Art. 15.
South Carolina—Sec. B. 410, S.C. Consumer Protection Code.
West Virginia—Sec. 46 A-2-103, W. Va. Consumer Credit and Protection Act.
Wisconsin—Sec. 422, 408, Wisc. Consumer Act.

We would strongly recommend that the Commission review these statutes when considering the proposed amendment.

TORT CLAIMS

An issue which developed during the hearing on the proposed amendment related to the inclusion of tort claims, as well as the length of time a creditor would be liable for such claims.

As the Commission is aware, the Congress in the Fair Credit Billing Act (P.L. 93–495) in Section 170(a) specifically excluded credit card issuers from tort claim liability. In light of the fact that the authority of the Commission (if it has such authority) rest upon an Act of Congress, we believe that the Commission should take notice that when the Congress decided upon an issue similar to that which is before the Commission, it excluded tort claims. Therefore, we suggest that the Commission follow the stated Congressional policy of excluding tort claims.

During the course of the hearing, the Commission staff and several consumer witnesses who were invited by the staff stated that it was a question of state law as to whether "claims and defenses" included tort claims. The leading authority in this area, Professor William L. Prosser, has stated, "The rule that has finally emerged is that the seller is liable for negligence in the manufacture or sale of any product which may reasonably be expected to be capable of inflicting substantial harm if it is defective." (Prosser, Law of Torts, Sec. 96, Chap. 17, 4th Ed.). Also, the Commission should be referred to the following cases:

Pitts v. *Basile*, 1965, 55 Ill. App. 2d 37, 204 N.E. 2d 43, reversed on other grounds 1966, 35 Ill. 2d 49, 219 N.E. 2d 472 (child's dart);

Sheward v. *Virtue*, 1942, 20 Cal. 2d 410, 126 P. 2d 345 (chair);

Smith v. *S. S. Kresge Co.*, 8 Cir. 1935, 79 F. 2d 361 (hair combs);

Carter v. *Yardley & Co.*, 1946, 319 Mass. 92, 64 N.E. 2d 693 (perfume);

Simmons Co. v. *Hardin*, 1947, 75 Ga. App. 420, 43 S.E. 2d 553 (soft bed).

Since the rule is firmly established that the seller is liable for negligence, this rule has been extended to strict liability in tort and was recognized by the American Law Institute in its drafting group of the Second Restatement of Torts. Without running afoul of the statutory limitations on warranty, it drafted the following Restatement:

Special Liability of Seller of Products for Physical Harm to User or Consumer.

(1) One who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property, if

(*a*) the seller is engaged in the business of selling such a product, and

(*b*) it is expected to and does reach the user or consumer without substantial change in the condition in which it is sold.

(2) The rule stated in Subsection (1) applies although

(*a*) the seller has exercised all possible care in the preparation and sale of his product, and

(*b*) the user or consumer has not bought the product from or entered into any contractual relation with the seller. (Restatement, Tort 2d Sec. 402A)

Since all these liabilities fall upon "sellers" the bank could be subject to the same liability under the Rule. Reference was made by the staff to statutes of limitations of various states as to providing some degree of protection. However, little comfort is afforded to the lender in this area. In the recent case of *Victorson* v. *Bock Laundry Machine Co.*, 373 N.Y.S. 2d (1975), the Court of Appeals of New York ruled that the period of limitation with respect to strict product liability claims by remote users for injuries arising out of defective products begins to run at time of injury. Furthermore, the Supreme Court of South Carolina in *Mickle* v. *Blackmon*, 252 S.C. 202, 166 S.E. 2d 173 (1969), held that even though a vehicle was over twenty years old, the subsequent purchaser had a cause of action in strict liability in tort.

For these reasons the Congress properly has decided to exclude tort liability. We believe that the Commission should follow this lead since there is no logical reason to place lenders in the same position as sellers with regard to this sort of claim. Frankly, the contention is too tenuous to logically support the imposition of liability for product liability.

On the practical side of the question the only possible way for a lender to protect himself would be to pass on the quality of all products. This is not possible and certainly not the business of banking. To require the bank to tell the consumer which products it will finance is beyond our general duty to determine creditworthiness and properly secure a loan.

PRIVACY

In line with the concept above, we believe that the consumer's right to financial privacy is being unnecessarily invaded.

It is sad that in 1976, a bicentennial year celebrating freedom for Americans, a federal agency should choose to impose a concept mandating a "Big Brother" role for the private sector. Surely, it would bring wry smiles from Orwell and Huxley.

If a customer seeks a personal loan and is creditworthy, why should a financial institution require that he disclose what type of product and the dealer from whom he is purchasing? To comply with the FTC proposed amendment and to protect the financial institution, this information will have to be obtained. As bankers, we believe that if the customer has demonstrated the financial ability to repay the loan no further information should be elicited. The same situation would exist if the loan were secured by savings accounts, securities, or real property. We do not argue that many times a banker has a need to know in order to secure a loan. However, when there is no need to know and the loan would have been made without such a disclosure, why should the bank compile this information on the private affairs of the consumer?

While the courts have not extended the right of privacy beyond a very narrow scope, the Congress in the Privacy Act of 1974 (P.L. 93–579) recognized that there was a need to protect individual privacy from unwarranted invasion by the government. Furthermore, this legislation established the Privacy Protection Study Commission which has held hearings on the financial recordkeeping practices of banks. Specifically, the Commission was concerned with the necessity of having to regulate the activities of financial institutions "to prevent the records of financial institutions from being used to intrude upon an individual's personal privacy."

The Commission went on to state: "Americans have long believed that the details of their personal finances are nobody's business but their own and that the information they disclose to depository and lending institutions will not travel much further. Today, however, there is a growing feeling that this belief may no longer be valid. Because it is difficult today to avoid taking adavntage of the services that depository and lending institutions offer, and because of the arrival of electronic funds transfer technology, serious questions are being raised about the adequacy of existing legal protections for the records that financial institutions maintain on their individual customers."

For these reasons we believe that the Commission should carefully consider the impact this regulation might have on individual privacy.

TRADE LIBEL

During the Commission Hearings two torts, Injurious Falsehood and Interference with Contractual Relations, were alluded to. We believe that the Commission should carefully review the impact the proposed rule would have on these areas of tort liability since, in many instances, lenders will be forced to deny credit because they do not want to warrant the performance of a particular dealer or product.

Under the provisions of Regulation B of the Federal Reserve Board (12 CFR 202), the creditor must provide all applicants with a "Statement of Reasons for Denial." [12 CFR 202.5(m)] Furthermore, the recently enacted Equal Credit Opportunity Act Amendments of 1976 (P.L. 94–239) provide in section 701(d)(2) and (3) that a creditor must provide in writing the "specific" reasons why credit was denied. Undoubtedly, one of the reasons for denial might be that the creditor does not approve of the seller's products or his workmanship. It can easily be seen that various causes of action under these two types of tort could occur.

Basically, the tort of injurious falsehood would occur when it is shown that the aspersion reflects upon the quality of what the merchant has to sell, or the character of his business as such. As usual, that proof of damages must be proven is essential. However, if the bank refuses to extend credit to a consumer to purchase goods, damages are easily shown. The requirement that the publication has induced third parties not to deal with him is also easily proven. As with all types of slander or libel actions, malice must be proven. However, many courts have presumed malice from the mere fact of publication, while other courts have found malice when there was no more than intent to publish with lack of privilege. [Prosser, The Law of Torts, Chap. 25, Sec. 128, 4th Ed. (1972)].

To give the creditor the needed "privilege" the Commission should amend its rule to state that it would be proper for creditors to deny credit for the reasons outlined above. On the practical side of this issue is the problem that the bank will have to compile financial reports on all merchants with whom it has an "affiliation." Also, it will have to publish a list of merchants to whom it will not extend credit to consumers to buy these products or services. If the FTC is going to impose this burden with its potential liability then some form of "privilege" must be given.

The bank could also be liable for the tort of Interference with Contract since by refusing to extend credit to a borrower who is going to purchase goods from a business that has an "affiliation" with the bank, it would be a third party interfering with economic relations between two groups. While the requirement of malice is again present, courts have tended to weigh economic factors in reaching a decision in this area.

In the typical small merchant versus bank situation the weighing of factors would easily work against the bank. Many actions have been allowed under this doctrine where the defendant's actions merely prevented the performance of a contract, or made performance more difficult and onerous. Clearly, when a bank refuses to loan funds to a customer because it does not want him to use the funds to execute a contract with a particular dealer, this shows intent to interfere with contract. Again, we urge the Commission to state in its regulation that banks are privileged in this and have a legitimate purpose to engage in the type of conduct.

VAGUENESS

One of the primary reasons Congress has delegated authority to agencies to write regulations is that it would defer to the expertise in various agencies to draft explicit and technical regulations. The main purpose of regulation writing should be to make implementation of the law clear and understandable. Unfortunately, a reasonable and prudent man, reviewing the present rule or proposed rule, could easily be in doubt as to whether a transaction falls under the ambit of this regulation. Many bankers and their attorneys are completely confused as to when the required "Notice" should be inserted in contracts where the proceeds possibly could be used in a purchase money situation.

The terms used to define "business arrangement" are exceedingly vague. What is meant by "course of dealing," "understanding," "procedure," "formal or informal," etc. Easily, it can be said that reasonable men can differ. The same criticism would fall on the definition of "referral."

The general rule in this area of vagueness was stated in *Ellis* v. *United States*, 206 U.S. 246, 257, as follows: "If a man intentionally adopts certain conduct in certain circumstances known to him, and that conduct is forbidden by the law under those circumstances, he intentionally breaks the law in the only sense in which the law ever considers intent."

Under that test a businesman or bank violates the rule and commits a federal offense for which he can be fined $10,000 if he does an act which some court later holds as violating the rule. He has violated the rule though his motive was pure and not intentional.

The Void-for-Vagueness Doctrine has usually been applied in the area of criminal law and restrictions on First Amendment rights. However, the Commission can impose substantial penalties upon sellers for non-compliance and if the proposed rule is implemented, the financial institutions could be liable for substantial penalty. Therefore, we urge the Commission to carefully review this area and se if the present or proposed rule meets the standard set by the U.S. Supreme Court.

The court has found serious due process problems when a statute fails to give adequate guidance to those who would be law-abiding. *Musser* v. *Utah*, 333 U.S. 95 (1948). A common rule is that men of common intelligence should not be required to guess at the meaning of an enactment. The vagueness may come from uncertainty in regard to the persons within the scope of the Act or with regard to the applicable test to determine if an action violates the Act. *Winters* v. *New York*, 333 U.S. 507 (1948). Recently the court addressed the problem of vagueness and stated: "The root of vagueness doctrine is a rough idea of fairness. It is not a prinicple designed to convert into a constitutional dilemma the practical difficulties in drawing criminal statutes both general enough to take into account a variety of human conduct and sufficiently specific to provide fair warning that certain kinds of conduct are prohibited." *Colten* v. *Kentucky*, 407 U.S. 104, 110 (1972).

In a case that is still considered good law, the court held that a statute was void because it was "so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application." *Connally* v. *General Construction Co.*, 269 U.S. 385 (1926).

Also, the court has set some basic values that must be assessed in considering vagueness: "It is a basic principle of due process that an enactment is void for vagueness if its prohibitions are not clearly defined. Vague laws offend several important values. First, because we assume that man is free to steer between lawful and unlawful conduct, we insist that laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly. Vague laws may trap the innocent by not providing fair warning. Second, if arbitrary and discriminatory enforcement is to be prevented, laws must provide explicit standards for those who apply them. A vague law impermisisbly delegates basic policy matters to policemen, judges, and juries for resolution on an *ad hoc* and subjective basis, with the attendant dangers of arbitrary and discriminatory application." *Grayned* v. *Rockford*, 408 U.S. 104, 92 S.Ct. 2294, 33 L.Ed.2d 222 (1972).

We firmly believe that neither the present nor proposed rule meets the test laid down by the court and we would urge the Commission to clarify the rule. In this Association's testimony we pointed out how this could be accomplished and the Federal Reserve Board, in its memorandum to the Commission, outlined many areas of confusion. Therefore, we strongly urge the Commission to redraft the definition of Purchase Money Loan, Contract and Business Arrangement.

We are aware of the argument that the FTC staff has published guidelines to clarify the rule. However, the banking community has had experience with such Opinion Letters and we have found courts many times reject them and impose liability on the creditor. *Ives* v. *W. T. Grant Company*, 522 F.2d 749 (1975). Furthermore, in a recently decided case in the Northern District of Georgia, *Willis* v. *Town Finance*, the court stated that opinion letters issued by the Fed staff were undeserving of great difference by the court. For these reasons the staff guidelines issued by the Commission's staff cannot safely be relied upon.

Secondly, even if there is an interpretation issued by the Commission which would be considered "official," its validity could be challenged. The case of *Hatten* v. *Board of Governors*, D.C. Comm. Civ. No. N76–14 (Jan. 7, 1976), held that interpretations must follow the rules of the Administrative Procedures Act. Therefore, it can only be assumed that the interpretations of the Commission, if they are to be considered official, must follow the Magnuson-Moss Act requirements.

For these reasons this association urges the Commission to be as clear and explicit as possible when issuing the revised rule.

CONCLUSION

In this Association's previous presentations to the Commission we affirmed our support of the objective which the Commission is seeking to obtain. However, we still believe that the present rule has only tended to cause confusion in the consumer credit market. We feel strongly that much of this confusion could be eliminated if the Commission would refine the proposed rule so that it follows the policies which have been set forth by the Congress and the various States who have enacted statutes modifying Holder-in-Due-Course.

Secondly, the Commission should give serious consideration to the effect this rule could have on the National economy. We feel that it is highly irresponsible for the Commission and its staff to lightly pass over the fact that consumer credit might drop ten percent because of the present rule or the proposed rule. Vol. IV. The National Commission on Consumer Finance—Technique Studies, Greer, Douglas F. and Nagata, Ernest A, *An Economic Analysis of the Other Consumer Goods Credit Market*, p. 313 (1972).

The Commission recognized and dismissed this fact in its *Statement of Basis and Purpose*. However, we believe that the Commission should clearly state in the promulgation of the ceditor rule that, as a matter of National policy, it endorses and approves of the drop in credit available. Furthermore, the Commission should clearly state that it recognizes that this action might affect the economic recovery and have an effect on employment. If there is a ten percent drop in credit, it is obvious that those at the lower end of the economic ladder will be affected.

Also, it should be pointed out that those whom the FTC desires to protect will probably be the ones denied credit. The FTC should face these facts and state if this result is acceptable to it.

As always, this Association and its staff stand ready to meet and confer with the Commission and its staff in order to make the rule more workable and to mitigate its adverse effects.

Sincerely yours,

DREW V. TIDWELL,
Legislative Representative.

SECTION 433.1 DEFINITIONS

(*a*) "Commerce" has the same meaning as is contained in the Federal Trade Commission Act.

(*b*) "Consumer" means a natural person to whom credit of $25,000 or less is offered or to whom it will be extended for personal, family or household purposes, other than a comaker, surety or guarantor.

(*c*) "Consumer credit contract" means any document which evidences a credit sale of goods or services of $25,000 or less by a seller to a consumer.

(*d*) "Consumer credit obligation" means a consumer credit contract or the note or other form of contract document taken in a regulated purchase money loan transaction.

(*e*) "Contract" means a promise, or set of promises, for breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty, whether formal or informal, express or implied, executed or executory, or enforceable, unenforceable or voidable.

(*f*) "Credit card" means any card, plate, coupon book, or other single device existing for the purpose of being used from time to time upon presentation to obtain money, goods or services on credit.

(*g*) "Creditor" means a person who, in the ordinary course of business extends consumer credit which is payable by agreement in more than four installments, or for which a finance charge is or may be required, whether in connection with sales of goods or services or regulated purchase money loans, but does not include third party credit card issuers, whether or not the payment of a finance charge is or may be required, nor the person who honors a third party credit card, nor persons other than the seller who extends credit pursuant to open end check credit or overdraft check credit account agreements.

(*h*) "Credit sale" means any sale of goods or services with respect to which consumer credit of $25,000 or less is extended by the seller. The term includes any contract in the form of a bailment or lease if the bailee or lessee contracts to pay as compensation for use a sum substantially equivalent to or in excess of the aggregate value of the goods or services involved and it is agreed that the bailee or lessee will become, or for no other or for a nominal consideration has the option to become, the owner of the goods upon full compliance with his obligations under the contract. The term does not include credit extended in connection with any third party credit card, check, overdraft check, or other open end credit device issued by a person other than the seller.

(*i*) "Goods" means tangible personal property used primarily for personal, family, or household purposes, whether or not in existence at the time the transaction is entered into, but does not mean goods used or intended to be used for agricultural purposes.

(*j*) "Open end credit" has the same meaning as contained in the Truth in Lending Act and Regulation Z of the Board of Governors of the Federal Reserve System.

(*k*) "Regulated purchase money loan" means any loan offered by a person other than a seller, to enable a consumer to purchase goods or services with all, or substantially all, of the proceeds of such loan, which was granted to the consumer pursuant to a contract between the creditor and the seller the purpose of which is to enable the seller to arrange loan financing for the buyer from the creditor; or in which the seller is affiliated with the creditor by common control, or is related to the creditor by blood or marriage, unless the relationship is remote and not a favor in the transaction; or the seller guarantees the payment of the loan to the creditor or otherwise assumes the risk of loss by the creditor upon the loan; or the seller prepares the loan documents (other than applications for credit) which evidence the consumer's obligations to the creditor and has knowledge of the credit terms imposed by the creditor. A contract between

a creditor and a seller in connection with any regulated purchase money loan may be inferred from any conduct, agreement, procedure or course of dealing between the creditor and a seller pursuant to which the seller not only sells goods or services to a consumer, but arranges the financing thereof from that creditor. Consideration that would support a contract in connection with any regulated purchase money loan includes, without limitation, any commission, brokerage or referral fee paid by the ceditor to the seller or the seller's participation in the finance charge earned by the creditor. Regulated purchase money loans do not include any open end credit transactions in which the consumer purchases the goods by use of a third party credit card, or any check, overdraft check or other credit device issued by a person other than the seller.

(*l*) "Seller" means a person who, in the ordinary course of business, sells goods or services to consumers.

(*m*) "Services" means work, labor and other personal services for other than agricultural, commercial or business use, including services furnished in connection with the sale or repair of goods, education, physical culture, self-improvement and insurance activities.

(*n*) "Third party credit card" means any credit card issued by a person who is not, in the same credit sale transaction, also the seller of the goods or services to a consumer who uses the credit card to effectuate a purchase.

SECTION 433.2 RULE PRESERVING RIGHTS OF CONSUMERS

In connection with any credit sale or regulated purchase money loan, in or affecting commerce, it is an unfair and deceptive act or practice within the meaning of Section 5 of the Federal Trade Commission Rule for a seller:

(1) To obtain a consumer credit obligation or arrange a regulated purchase money loan evidenced by a consumer credit obligation unless the consumer credit obligation contains the following Notice in at least 10 point bold face type at or above the place where the consumer ordinarily places his or her signature:

NOTICE—THIS CONSUMER CREDIT OBLIGATION IS NON-NEGOTIABLE

Any holder of this consumer credit obligation takes it subject to all claims (other than tort claims) and defenses which the buyer could assert against the seller of the goods or services obtained pursuant to or with the proceeds of this obligation. The buyer may withhold payment from the holder up to the amount of credit outstanding with respect to the goods or services which gave rise to the claim or defense up to 3 years from the date of the sale, if the buyer has first made a good faith attempt to obtain satisfactory resolution of the claim or defense relating to the goods or services from the seller.

(2) To obtain a negotiable instrument (other than a check taken in conditional payment or downpayment) in connection with or embodies in any consumer credit contract.

(3) To include any provision in a consumer credit contract wherein the buyer agrees to waive any claims and defenses against any holder of the consumer credit contract that may be brought against the seller.

Mr. MURPHY. Thank you, Mr. Tobey. Mr. Tidwell.

Mr. TIDWELL. I don't have a statement, Mr. Chairman.

Mr. MURPHY. Mr. Tobey, how many banks stopped discounting installment contracts on appliances and home improvement loans?

Mr. TOBEY. Mr. Tidwell can give you, I think, more detailed information on that, sir, than I can.

Mr. TIDWELL. Our association, Mr. Chairman, has decided not to do a survey at the present time on this matter. We wrote to all our members asking them to write back and give the general trend in the area. Certain banks, a number of them large east coast banks informed me that they were discontinuing their appliance dealers because of the possible claims that could be brought there. We feel that it's rather early at this time to do any detailed analysis since we think it might be 6 to 9 months before the full effects of the rule was felt one way or the other.

Mr. MURPHY. Mr. McCollister.

Mr. McCOLLISTER. Mr. Tobey, on the last page of your statement you discuss several areas in which the Congress has acted to regulate consumer contracts terms. Is it your position that the rule should have been a matter for congressional action rather than administrative fiat.

Mr. TOBEY. Mr. McCollister, yes, I do.

Mr. McCOLLISTER. What do you feel would be the economic impact of this rule as far as your ability to purchase installment sales contracts from dealers?

Mr. TOBEY. We have amended our position with dealers. We operate in what we refer to as without recourse market in Detroit and up until this time we've bought contracts from dealers with only a few warranties, as to the validity of the contract, the enforceability because of age requirements, et cetera. We have asked dealers and have insisted that dealers who will continue to sell paper to us have signed an indemnity agreement that indemnifies us against loss because of a valid or legally valid or legally enforceable claim or defense that has been dictated by court action.

Now this has allowed us, with some apprehension, I might add, to continue buying third party paper from dealers. We obviously are going to be faced with a substantial increase in cost because the legal actions involved up to and including the unenforceable claims and defenses which we feel will result from this rule are our expense and are not passable along to the dealer.

Mr. McCOLLISTER. Can you identify the additional administrative costs or the additional risks in terms of an interest percentage added to what would otherwise be the normal interest rate prevailing?

Mr. TOBEY. It's almost an impossibility, sir, for the simple reason that we do business in a rather wide area and where we would often use house counsel in attempting to resolve the difficulties, we may find it expedient and necessary to hire local counsel which becomes an expense in addition to that which we already incurred.

Mr. McCOLLISTER. Are there States where you're already lending at the maximum rate where it would be impossible to raise the rate to cover the increase in costs?

Mr. TOBEY. We have what we consider and I'm sure every bank in every State feels the same, but at least in our case we feel that our rates are inadequate. We are lending at the maximum rate. Any expense that we incur will, of course, be a reduction in the bottom line and cannot be passed along to the consumer. Consequently we have taken action to reduce the buy ability, if you will, of a certain percentage of our paper. This was not done with any specific aims in mind but we feel, and again it's too early to tell, that many of the claims and defenses that will subseqeuntly prove to be invalid will be raised by the lowest strata of credit customers and as a consequence, as a way of reducing our expenses and potential loss, we are reducing our ability to buy the borderline paper. We are going to move toward a tighter screen on the selection of credit.

Mr. McCOLLISTER. The premise on which I think the FTC operates is that that borderline paper is most often a dishonest or fraudulent dealer and my position has been that it is very often a new guy getting started, the new entrants to the business under which they now must operate with considerably greater difficulty. Do you have any comment on that?

Mr. TOBEY. My reference to the restriction of credit was to the retail buyer, not to the dealer.

Mr. McCOLLISTER. I see.

Mr. TOBEY. I estimate that we will be extending credit to about 10 percent fewer people, retail buyers, than we have previously been able to do because of the additional cost, the additional expense and the potential risk that this will present to us.

Mr. McCOLLISTER. Because those are direct loans?

Mr. TOBEY. No; these are dealer loans. But if they are productive of a great number of claims and defenses that may prove invalid, the expense that I incur in handling that situation is just as great as if the claim were as eloquent and this is the expense that we are not in a position to either absorb or pass along and consequently we must improve the quality of our portfolio by so doing.

Mr. McCOLLISTER. Of course, I was ignoring that aspect of it and thinking about the impact it had on the marginal dealer but you have to increase the quality of your portfolio.

Mr. TOBEY. The marginal dealer, there's no room for him in the marketplace because even if he signs my indemnity agreement he must be around when I need him and if he's gone, then the agreement has little value.

Mr. McCOLLISTER. Do you have any experience as to the effects on consumer credit, the abolishment of the holder in due course has had in other States?

Mr. TOBEY. Well, in our State, in the State of Michigan, we effectively eliminated the holder in due course doctrine on everything but automobile financing something over 2 years ago. In other words, a very, in our opinion, important difference in the language involved, the State law that enabled this change stated that defenses could be raised by the consumer because of the failure of the product to perform or the goods to perform or service to perform. This implied that if we as a financial institution attempted legally to force payment, then this would be a viable means of the consumer to bring pressure to the situation and thereby get justice. This rule also encompasses claims which, in our way of interpretation, indicate independent action that can be brought against us because of some other action of the dealer or the seller. There was some comment earlier about how long does this risk exist. In our opinion, we have taken a slightly different approach to this. We are being forced or will be, to include in our contracts a paragraph that says, without question, that we are subject to any claim or defense that can be raised by the purchaser against the seller. Now, there are no time limits on this, nor is there any distinction as to what kind of claims or defenses we might encounter. These could be tort claims or warranty, failure of the warranty claims to perform, implied warranties as well as stated warranties. There is a broad spectrum of risk as we see it and, of course, the thing that makes it so hard for us to understand is that our responsibility and liability does extend obviously to funds which we have never received, which includes the downpayment which the customer has paid to the dealer, which include any types of fees that are involved in the transaction and in some cases may increase our exposure by thousands of dollars. It is not uncommon with an expensive automobile to have a $4,000 or $5,000 downpayment and this again becomes a part of our liability.

Mr. McCollister. How would good accounting practice require you to identify that potential liability or how do you create a reserve?

Mr. Tobey. Well, we do establish reserves for losses and thankfully our reserves in the past have been adequate to meet the losses encountered.

Mr. McCollister. Isn't this the bottom line really?

Mr. Tobey. Yes, it is. It may prove to be the bottom line as to whether our operations are profitable or not depending upon the results.

Mr. McCollister. One final question, do you know of any other rule pending before the Federal Trade Commission, that independent regulatory agency, that would have an adverse effect upon the consumer credit?

Mr. Tobey. Well, I'm sure you and all the other members of the committee recognize there are 12 additional items under consideration, 2 of which tend to boggle my mind. In the event of the retaking of collateral, we should immediately apply against the balance due the fair retail market value. I suggest that it is impossible for us to determine, first, what is the fair retail market value and, secondly, in 35 years of disposing of repossessions, I have yet to realize the fair retail market value from any one of them. So this I really would find hard to understand.

Second, some prohibition against the collection of legal fees in the event that we must of necessity take legal action to recover our investment. I don't recall the exact details but if the interest rates exceed a given figure, then no legal fees can be recovered. I think this takes a lot of soul searching and a very hard look to make certain that from the standpoint of the creditors and not—we have a saying in our part of the country, "Ain't it awful." You know we can sit around the hot stove in the middle of the winter and worry about all the things that could happen to us and thank the Lord, most of them do not, but if a few of them do, and really in all seriousness, I think it's possible that we can fiddle with an extremely important instrument in terms of the American economy, which is the extension of credit, particularly at the consumer level. And I'm not saying we shouldn't be subject to regulation and legislation but I firmly believe that any such practice and regulation and legislation should be carefully thought out and searched in depth and with every possible piece of information added to the weight of evidence before rules such as this are promulgated.

Eventually some day—it is not beyond the realm of possibility, that the availability of credit for consumers could be severely restricted.

Mr. McCollister. We have a statement in the record, I put it in the record last Thursday, the Wharton School estimated that this would have an adverse impact on our gross national product of about $2 billion. The FTC and others suggested that the Wharton study really wasn't very authoritative. I didn't know at the time and it would have been the trump card to play then and so knowing it now, I'll play it now, that the director of that study was Jimmy Carter's chief economic adviser, Mr. Larry Klein, and, of course, that ought to satisfy everybody.

Mr. Murphy. We're going to have to suspend. We're going to have to stand in recess for a few minutes. A new chairman will be in. Mr. McCollister and I have to take up a bill with the Rules Committee, so we'll be in recess until Mr. Brodhead returns.

[Brief recess.]

Mr. Brodhead [presiding]. We'll come to order. The Chair recognizes counsel, Mrs. Foldes for questions.

Mrs. Foldes. You indicated in your written statement that if a lender who is—well, let me see—I guess I had better go back to what you said orally versus what was in your written statement, in order to clairfy a couple of points. Your oral and written statements were a little bit different.

Mr. Tobey. I think I added a phrase and I know the section you're refering to, "and purchased retail paper."

Mrs. Foldes. That's right. You recognize that more bank financing of dealer inventory would not be sufficient to constitute a referral?

Mr. Tobey. Yes; because of the enforcement policy.

Mrs. Foldes. The taking of paper is the key factor.

Mr. Tobey. That was clarified by the enforcement policy. We are aware of that.

Mrs. Foldes. Where a bank has difficulty obtaining tort insurance you said there were certain aspects that were difficult to cover. For what things do you find coverage difficult to obtain?

Mr. Tobey. If I understand your comment properly, I think it has reference to the statement that is included in our contract is quite broad and states that we are, in effect, subject to any claims or defenses which the seller could raise against—which the buyer could raise against the seller. My point there is that there was some previous conversation relative to the limitation on what possible claims could exist and my counsel is of the opinion that there is no such limitation, that this is a wide open area which is simlar to the comments that were made by the prevous witnesses.

Mrs. Foldes. Are you talking about limitation on time?

Mr. Tobey. Both. Limitation on time and limitation on type. This covers warranties as well as implied warranties. There is a strong possibility and a lot of attorneys across the country that I've been in touch with feel that tort claims can also be included in just about anything in the order of claims that could be raised. That essentially is what it says. It's quite clear and distinct in the limitations that exist.

Mrs. Foldes. There are time limitations in State laws on warranty claims and warranty claims.

Mr. Tobey. You could be right, but I'm not so sure. I'm not in a position——

Mr. Tidwell. With regard to tort claims, there are several decisions that have recently come down from the Court of Appeals in New York which have held that as far as tort claims are concerned the statute of limitation time does not begin to run until after the injury has occurred. So as long as the claim or the contract is still valid, you would be subject to that or the lender would be subject to that claim.

Mr. Tobey. Let me get back to a point under the warranty claim. It's pretty common now for automobiles to have a 12-month or 12,000-mile warranty but there have been numerous cases recently where extensive rust damage on vehicles 2 to 3 years old have been the subject of a lot of controversy. In fact, some of the manufacturers, I believe, have, without public statement to the effect, have corrected these deficiencies after 2 or 3 years. So I'm not so sure that the stated warranty period of 12 months is truly a binding warranty period. It would really be up to a judge. Here is the customer with his automobile and it's badly rusted, and if you will pardon the vulgarity, the air showing through on the trunk, for example, and I've seen a few like that and he says he still owes 2 years' payments on the car. Forty-eight month financing is now a common place happening and in certain parts of the country and you're fortunate you don't live in one, with the rust piled akle deep on the streets, it does not take long for these automobiles to start to come apart and I don't care whether it's a Ford or a Cadillac or anything else.

Mr. Brodhead. It's the foreign types especially that are bad, isn't it?

Mr. Tobey. Oh; yes, definitely.

They're all subject to the same thing, unless they're made of fiberglass, I'm sorry to say.

Mrs. Foldes. Have these kinds of things been raised in law suits or have they been——

Mr. Tobey. It's really too early to tell. Again we're back to ain't it awful and what could possibly happen to us. We're not really looking for things to come out of the woodwork, but by the same token, when you invest literally millions of dollars in financing of this type, then it behooves us to atempt to measure the potential problems that we could encounter.

Mrs. Foldes. Let me ask you one other question relating back to inventory financing. As I understand the example you gave, it would be possible, in the case in which you, the banks, had an affiliation with a dealer/seller, for a consumer to come to you for a loan, then go back to the seller, and for the seller in that situation to have to include in the notice where neither one of you knew it was required?

Mr. Tobey. That's true.

Mrs. Foldes. It's my impression the enforcement policy statement states that if the seller has no reason to inquire where the funds came from, where there's nothing which should tip him off, then he has no duty to inquire or to include the notice.

Mr. Tobey. Yes, I would agree with you on that. I take exception, however, and during the interval while we were waiting for the meeting to start again, I had a brief discussion with the FTC representatives over here. My point is more pertinent to this situation. Let's say I do business with a dealer as obviously I do and that we are, over the course of years, buying retail paper, three-party paper from him. By the very nature of the business he controls only a small percentage of the time sales that arise from the sale of automobiles, perhaps 30 percent, and there is another 20 percent that actually pay cash, take it out of savings accounts and pay for the automobile and there is this

great unwashed 50 percent that nobody controls. They control themselves. Now, many of those will do business with my bank, or our bank, and consider themselves to be customers, not of Art Moran or of any other dealer, but of our bank and they wander of their own free will and accord into one of our branches and sit down with the branch manager and this may be the fifth car we've financed with them, and arranges the financing of that automobile.

Now, the way the FTC rule is written, that set of circumstances, the fact that I do business with a given dealer requires that we put the language in that contract or requires today that the dealer insist that we put the language in the contract.

Mrs. Foldes. But only if he knows that money comes from your bank.

Mr. Tobey. Well, our normal practice is that we'll make a check jointly payable to the customer and the dealer or ask the dealer to make certain that our lien is on the title which is in our State held by the customer to protect our position against the borrower.

I understand what you're saying and I think I understand the reason behind that position but the truth of the matter is that where you have the circumstances as I've outlined, then there is nothing unfair or deceptive in the practice and I really question why it is necessary for the bank at that point with that dealer or that customer, what the bank should be required to take on that additional responsibility.

Mrs. Foldes. So your reaction is to the concept of two-party paper being covered by the rule?

Mr. Tobey. That's right. Now, if the dealer had arranged for the customer to come down to the bank to borrow the money and the customer had obviously no arrangement with the bank as to previous financing or other dealings with the bank, then that should be covered. This is really three-party paper with only two names appearing on it. But where it is the customer's insistence or he instigates the entire transaction, I find it hard to understand why that type of a transaction needs to be covered.

Mrs. Foldes. Just a couple more questions.

Did you say that your major decrease in lending is to lower income customers in the sense that they are the ones dealing——

Mr. Tobey. Not necesarily lower income but poorer credit risks. There is a certain number of people that we do busines with and have in the past that are chronic collection problems. For some strange reason they don't like to pay on time and we have always had this problem and we probably always will. Not everybody pays on time. Probably 10 percent of anyone's portfolio that will produce 90 percent of the expense incurred in collections and a large percentage of the loss in repossessions that a bank is going to have.

Mrs. Foldes. Do most of those customers fail to pay on time because of income problems?

Mr. Tobey. Could be or impulse buying or overloading or over obligation.

Mrs. Foldes. I guess my point is this—two of them. One is that you state that in Michigan the "holder" doctrine has been repealed insofar as it restricts a consumer's right to raise defenses in a collection proceeding.

Mr. TOBEY. That's on everything but automobiles. The legislature is very confused. At the same time this rule was promulgated, they were in the process of attempting to arrive at acceptable legislation governing the elimination of some form of the holder in due course on automobile. And, of course, there may be as many as 45 States today that have previously enacted such legislation and there is a great deal of confusion as to which one prevails, whether it's the FTC rule or whether it's the State law.

Mrs. FOLDES. Well, have you had any problems with the increased number of deadbeats who won't pay under the Michigan law?

Mr. TOBEY. As it pertains to the other type of financing that we do which covered home improvement and mobile homes?

Mrs. FOLDES. Yes.

Mr. TOBEY. Not as much as we frankly had initially anticipated, although there has been a substantial increase, particularly with one organization because of the publicity that arose from their financing of the home improvement dealer that proved not to be crooked but more inept than he should have been in the completion of the work. They had problems and it became quite widely publicized and as a result, their experience in terms of complaints and defenses raised, grew appreciably.

Mrs. FOLDES. Sounds like once they know their rights, they exert them?

Mr. TOBEY. Or once they know they have another means of deferring payment. Not all of these claims are valid ones. Most people won't admit that the reason they don't pay is because they don't have the money. They would like to have a little something else that is more acceptable from their point of view so they tend to delude themselves into saying it doesn't work or it didn't fit or whatever the case might be. That happens.

Mrs. FOLDES. I'm sure it happens. I wonder, though, if that doesn't also happen in the situation where you have not abolished the holder in due course law. Don't people who have complaints about products stop paying now?

Mr. TOBEY. For years customers have had problems with automobiles, particularly our fine American cars because we have so many power systems and some of these tend to cause a problem once in awhile, but the dealers for years have been taking care of the bulk of these complaints. Many times the customers have contacted the financial institutions and asked us for help, would we intercede in their behalf and we've been very happy to do so. Your point is well taken. It's just that maybe the situation had been fairly well contained among reputable businessmen without the necessity for further legislation.

Mrs. FOLDES. I have no further questions.

Mr. BRODHEAD. The Chair recognizes counsel for questions.

Ms. NORD. I think I'll pass.

Mr. BRODHEAD. Is there anything else that you want to add?

Mr. TOBEY. No.

Mr. BRODHEAD. You, sir?

Mr. TIDWELL. No, thank you.

Mr. BRODHEAD. Thanks very much for being with us. We appreciate it.

We have also waiting to testify today, in addition to Mr. Vaughan, Mr. Charles Maddox. Are you here, sir? All right, and Mr. James Goldberg and Mr. John Pohanka. We have four people here. I'm not sure how long we're prepared to stay, but unless we shorten the presentations, I'm afraid someone is going to be left out. Mr. Vaughan, proceed, please.

STATEMENT OF WALTER W. VAUGHAN, VICE CHAIRMAN, INSTALLMENT LENDING DIVISION, AMERICAN BANKERS ASSOCIATION, ACCOMPANIED BY RON R. TULLIS, ASSISTANT LEGISLATIVE COUNSEL

Mr. VAUGHAN. I am Walter Vaughan, vice president of the Lincoln First Bank in Rochester, N.Y., and manager of consumer loan services for that bank. I also serve as vice chairman of the installment lending division of the American Bankers Association. I am accompanied today by assistant legislative counsel of the ABA, Ron Tullos. It is my understanding that our prepared statement will be entered into the official record in its entirety and I will take the time allocated to me to share with you some of the concerns that we as consumer lenders share either as a group or as individual members of that group.

Our association was particularly appreciative of the concern exhibited by members of this subcommittee for the serious problems created by the FTC seller rule and the proposed creditor rule. The effects of the FTC trade regulation rule in question are of paramount concern to our industry as this rule and its proposed amendments affects millions of consumer credit financial relationships and agreements.

Commercial banks have total consumer loans in excess of $80 billion or nearly 50 percent of the total market and it is obviously our desire to maintain this share of the market. But we also feel a very strong commitment to provide a reliable input into this issue with our assessment of the potential impact of this rule.

Obviously there is a significant and real economic concern as we did not develop our penetration into the consumer marketplace overnight, but hopefully as a result of a sustained effort to effectively enter into a competitive market, properly evaluate the needs of the consumer and develop and price a product that would satisfy those needs in both an equitable and profitable way after properly evaluating the elements of risk and potential income.

Increased risks combined with fixed interest ceilings narrow any margin of profitability and cause a continued review by asset and liability management of our banks as to whether the investment of bank funds and consumer loans represents the most effective use of available money. This situation receives increased emphasis when we are involved in a loan restraint period. Obviously intelligent senior management is aware that our business from a profit viewpoint has to be evaluated cyclically but the margin based on cost of doing business is becoming very slim even under optimum money cost conditions.

I have no intention of trying to convince you that the needs of the consumer will not be served as I am very convinced that they will, if not by our industry, then by the lending industry as a whole. I do feel strongly, however that any significant withdrawals by the banks will result in an increased cost to the consumer.

The FTC has said that the banks are not assuming any real risk by the enactment of this rule as they can properly protect their position either through the use of recourse or heavy reserve requirements of through insurance helped to underwrite this risk.

Let me treat the insurance situation first and briefly by asking who is going to pay for this protection, the bank who is already concerned with its profit margin or the dealer who will provide this insurance as a consideration to the bank for doing business with it. No, I don't believe that either one of them are going to ultimately pay for this insurance. I feel that the only one that can bear the cost in one form or another is the consuming public.

Let me talk again generally about the concept of the repurchase agreements that have been spoken of so often by the Federal Trade Commission. I think it exemplifies a lack of reality with what, in fact, goes on in the marketplace. The banks attempting to afford themselves protection in several areas inclusive of New York State did, in fact, prepare an indemnification agreement for the dealers which basically said that in the event a claim by a customer was not resolved by the dealer within a specific period of time, 60 or 90 days, then the bank would ask the dealer to assume responsibility for the contract. Ford Motor Credit, General Motors Acceptance, and Chrysler took the position similar to ours with the one addition, that they would litigate any claims to the point where they were determined valid by the court. Obviously a dealer would much prefer to sign with a captive sales finance company under the condition that the litigation expense would be borne by the captive sales finance company rather than sign that agreement with the bank, and here within the District of Columbia one of the primary lenders who had 22 dealers did, in fact, attempt to enforce this type of indemnification situation. Several of the dealers signed but two of the principal dealers of that bank were lost to that bank.

I am aware of a situation in Kentucky where the bank did attempt again to adopt this same type of indemnification and ran headlong into Ford Motor Credit and General Motors Acceptance, the captive sales finance company approach and either stepped back from their position or took no position whatsoever as it related to that indemnification agreement.

Another thing that came up in the reality of the marketplace is that as long as the seller was not aware of the relationship between the creditor and the customer then there was no obligation on the part of the seller to make sure that the official statement was included in the papers. It is obvious common practice within our industry on direct loan transactions to make checks payable to both the seller and to the customer for the purpose of establishing a purchase money obligation as it relates to the lien recordation. We want to indicate to the dealer that, in fact, the proceeds did come from us and I think that it is a prudent practice and I think it may be a practice that helped keep down the cost of credit, but I in turn, feel that that practice if followed through would be evidence of a dealer, or could be construed as evidence itself of a dealer relationship.

We also find in the FTC's new regulations or their new statement that they speak to the fact that inventory financing of itself does not bring the conditions into play. But I really wonder why a lender would engage in inventory financing if they weren't trying to attract the retail product and I'm really confused by why they made inventory financing an exception, why they were specific to exclude that. I would have to say based on 20 years of experience that there are few, if any, banks that enter into inventory financing arrangements without expecting the retail sales contract as a collateral benefit of that relationship.

I guess I'm trying to illustrate that I don't feel the Federal Trade Commission has been sensitive enough to the real world of the marketplace and, frankly, I came before this committee in 1971, I believe, representing Consumers Bankers Association and American Bankers Association, exhibiting a great deal of concern about the FTC's involvement in the economic affairs as it related to banking. Right then the most critical issue was affecting the negotiability of checks but we did indicate that perhaps they were going into uncharted waters that could prove very dangerous and that could have a significant economic impact. I've carried that opinion all the way through and I still feel that the Federal Trade Commission, whether by intent or not by intent, is going to have a measurable economic impact as it relates to banks and consumer credit.

Again, in the interest of time, I would like to go over the role of the small business in this whole scenario. I couldn't agree more with Mr. McCollister that this is going to have a serious impact on the small business person, particularly that small business person that is attempting to enter into the marketplace. We're all well aware that the survival rate, at best, of small businesses isn't quite that good. So when we talk about the fiscal responsibilities and the financial statements of these small businesses run by honest people attempting to enter into the marketplace, taking the risks of that entry, when we start talking about dealing only with those people that are truly financially responsible, then I don't think they meet those criteria. When we start talking about the home improvement contractor—my associate from the Savings and Loan League spoke of the home improvement contractor with the pickup truck. He may take $12,000 or $15,000 out of his business but he may be one of the few true craftsmen left and certainly he will not meet any of the financial responsibility criteria that could be imposed if you were looking to analysis of financial statements.

I'm also concerned with the mobile home area and I would like to, not talk against what appeared to be a persuasive argument, but the banks did, in fact, go out of the mobile home business for the most part 4 to 6 months ago and some as many as 2 years ago. One of the primary reasons is they had chosen, in many cases, to underwrite their risks through service companies, service companies that were backed up with insurance bonds, all risk type of bonds. These insurance companies came on hard times, their requirements became more stringent as to the payment of the claim, the effect on yields by pro rata payoffs instead of an accrual method of rebate had much more significant impact on income than anyone imagined when they entered into them.

So I really think when we're talking about a decrease now in sales that goes back 20 months, it's not because of the preservation of claims and defenses rule. But I notice now that banks are now looking into the mobile home business much more aggressively and I feel this is a definite stumbling block to their reentry into the mobile home business, a definite stumbling block. I think we have even seen the curtailment of some terms by lenders that are in the mobile home business.

I'm also concerned that 45 of our States have acknowledged to participate in coordinated efforts based on industry, financial community, and legislative efforts within their States. They have recognized that there were injustices that were created by a broad application of the holder in due course rule. But I think they treated them adequately for the needs of their States, or at least I have to feel that they did not treat them with an understanding that their treatment would be unsatisfactory or that their treatment would be contrary to the interest of the people within the States.

I am deeply concerned by the confusion that exists. We have within our bank and within the previous bank that I was with, we have bankers that do not understand the implication of the regulation and the rule. We have lenders who try to comply with it but really don't understand what they're doing. We have the public that becomes involved in it and they are rather confused. I'll illustrate it by an example. A very reputable dealer within the Washington trade area trying to completely comply with this regulation sent a statement, a letter and a copy of the security agreement on every customer that bought a car that was financed through the bank, to the bank that financed it and asked that notice be placed on the direct credit instrument. Our bank at that time, and I was with American Security, called this dealer and told the dealer that we had no working relationship, we had no inventory, we had no dealer agreement, and although he was a foreign dealer we had not enjoyed that type of relationship and, frankly, we weren't going to do it, and other banks did the same thing. It produced utter confusion on the part of the consumer because here the consumer had been commissioned to come in and get this done and the bank said no, and the consumer is saying you have an obligation to do it, and we can't get lending officers and platform officers to explain properly where that obligation does or does not exist. That's just a specific example of the confusion that can be created by well-intentioned, well-meaning people.

I don't think that Congress, in fact, understands the regulation or the rule. I really don't. I think perhaps this oversight committee evidences the deep concern that is felt. I think it is shared. I can recall being at a reception and having a Congressman come in to me and say, "Hey, I just heard on the news that something has happened that is going to create all sorts of conflict in the consumer credit industry. Help me out, what is this that's going to happen." I said, "What is going to happen, happened today. You, a Congressman who I think is pretty alert to what is going on, are being exposed to the preservation of claims and defenses rule on the day of enactment and it seems a shame to me that you have to talk to me about it now." I had pushed very hard in whatever associations I had had to insure some form of oversight to this type of regulation and ruling.

Again, I would like to summarize, if I may, by saying that the American Bankers Association does applaud the responsibility and the concern shown by members of this subcommittee in scheduling an oversight hearing on the effects of the FTC rule in question. We do, in fact, remain confident that after the issue has been carefully reviewed and the facts surrounding the FTC action made clear, that this subcommittee will promptly initiate corrective legislation. In fact, various bills have already been introduced which have addressed this problem.

We strongly encourage this subcommittee to recommend to Congress a permanent solution to this problem such as that proposed in H.R. 14685 and Senate bill 3652 where the authority to determine what claims and defenses will be available to a consumer is properly vested in State law. However, because of the widespread unfamiliarity with the intricacies of this issue, we realize that House bill 15082 which would suspend the rule until it could be further studied may be more intriguing to many Members of Congress. Therefore, we would welcome the relief which this measure would grant or any other responsible proposal which addresses this vitally important issue.

Thank you.

[Testimony resumes on p. 142.]

[Mr. Vaughan's prepared statement follows:]

STATEMENT OF WALTER W. VAUGHN, VICE CHAIRMAN, INSTALLMENT LENDING DIVISION, AMERICAN BANKERS ASSOCIATION

Mr. Chairman and distinguished members of the Subcommittee, I am Walter W. Vaughan, Vice President of the Lincoln First Bank in Rochester, New York and Vice Chairman of the Installment Lending Division of the American Bankers Association on whose behalf I am appearing today. Accompanying me is Mr. Ronald R. Tullos, Assistant Legislative Counsel of the American Bankers Association. Membership in our Association consists of approximately 96% of the nation's 14,000 commercial banks.

The American Bankers Association welcomes this opportunity to provide assistance in identifying and describing the unfortunate results of a recent FTC Trade Regulation Rule concerning Preservation of Consumer Claims and Defenses.

The Trade Regulation Rule (TRR) in question (16 CFR 433), which became effective May 14, 1976, is a classic example of a regulatory agency attempting to carry out its perceived responsibility and drifting dramatically astray in the process.

Background information

The May 14 rule to which we refer is designed to prevent an allegedly "Unfair or Deceptive Act or Practice" created by transactions where an unscrupulous seller of goods or services, trying to avoid responsibiilty for a defective product, leaves the unsatisfied consumer in the unfortunate position of having a legal obligation to continue payments to a third party who has purchased the contract evidencing the debt. This situation, which initially seems inequitable, is an unfortunate ramification of a major legal doctrine known as "Holder-In-Due-Course." The concept of holder-in-due-course is a reflection of more than two hundred years of case law in the area of negotiable instruments. Briefly stated, the doctrine declares that a third party who takes a negotiable instrument for value, in good faith without notice of any claim or defense against the seller, is not subject to the later claims and defenses of the buyer against the seller.

This doctrine of commercial law was developed in response to an economic need for merchants wishing to engage in volume sales. Sellers would sell debt instruments to lenders, usually at a discount, and hereby circumvent the liquidity problem normally created by waiting for each credit purchaser to fully perform on the sales contract. This practice contributed dramatically to the growth of our economy by allowing each party to do what they did best—sellers selling and lenders lending. What made this concept work, however, was the critical provision which protected the third party buying the contract from any subsequent disputes between the buyer and the seller. This protection was deemed necessary because the third party never inspected the product being sold or involved themselves in any manner in the sales transaction.

However, in recent years as consumer protection has become increasingly important, most states (45) have chosen to partially restrict the protections of a holder-in-due-course of a consumer sales contract. These decisions were made largely in direct response to the situation mentioned earlier where a buyer had to continue installment payments to a third party even though product satisfaction could be obtained from the seller. Without discussing (at this point) the various approaches taken by the respective states, or reasoning therefore, it will suffice to say that each state legislature addressed the problem and resolved it in the manner determined to be appropriate for the unique needs of the consumers in each state.

Role of FTC re: Abrogation of doctrine of holder-in-due-course

The Federal Trade Commission, acting under its authority and directive to prevent "Unfair or Deceptive Acts or Practices" focused on the above-mentioned side effect of the holder-in-due-course doctrine during the approximate time period the respective states were considering the same problem. Subsequently, the Commission, after apparently concluding that state law was not enough, acted under authority granted by Section Five (5) of the FTC Act and promulgated a proposed "Seller Rule." That rule requires that sellers of goods and services insert in all sales contracts a prescribed notice stating that any subsequent purchaser of such contract was subject to all claims and defenses which could be asserted against the seller. However, the FTC chose to take two additional steps which took the regulation well beyond the scope of a "seller rule." Those steps were the inclusion of the "purchase money loan" and the simultaneous proposal of applicability to all "direct loans."

The FTC, in including the "purchase money loan" under the scope of its May 14 Trade Regulation Rule, rationalized that such a step was necessary to prevent circumvention of its stated seller rule. The reasoning was as follows: that a seller wishing to continue business as usual with the parties to whom he regularly sold installment sales contracts, would simply advise a prospective buyer to obtain the financing direct from certain lenders and thereby preclude any lender responsibility to warrant the merchandise in question.

The second step was to propose for comment a regulation which would subject direct loan contracts to the same requirement as sales contracts. This proposed regulation was released at exactly the same time as the above-described "seller rule" which included the coverage of "purchase money loans." However, the proposed regulation, issued simultaneously with the final regulation, was promulgated under a different grant of authority, [the FTC Improvement Act], which requires the Federal Reserve Board to promulgate a similar proposed regulation to be applicable to banks.

To aid sellers and lenders in compliance with this sweeping regulation, the FTC offered only vague and ambiguous unofficial staff guidelines. After extensive agitation by those seeking to gain compliance, the FTC, acting on August 16, four months later, published a Statement of Enforcement Policy which fell discouragingly short of the expectations of the affected parties.

The FTC premised its decision to go forward with the rule in question on the conclusion that lenders are best positioned to "police the market" and that such a procedure is socially desirable. The FTC has tenaciously held fast to this premise through a series of appeals for reconsideration and delay, including that of Federal Reserve Board Chairman Arthur Burns. The Commission further attempts to explain the social policy issue by arguing that the thrust of the rule is a reallocation of the costs of "seller misconduct" away from the "innocent consumer" on to the lender who is better able to bear the burden.

Practical effects of FTC rule

The Commission by administrative fiat has succeeded in confusing lawyers, lenders, businessmen, and consumers by promulgating a rule fraught with uncertainty both as to its validity and intended effect. The rule restructures millions of financial relationships in a novel attempt to force the nation's consumer credit mechanism to eliminate a comparatively small number of seller abuses which the FTC has otherwise been unable to correct.

Any serious consideration of this FTC regulation must focus on the effect as perceived by lenders in comparison to the technical steps actually taken by the FTC. When the FTC promulgated in final form the "seller rule" (complete with purchase money loan coverage), it simultaneously proposed for comment its "creditor rule" applicable to all direct loans. Although the technical result on May 14 was only the partial abrogation of the holder-in-due-course doctrine,

lenders in the marketplace were largely unable to make that narrow distinction. The result has been that many lenders are treating the May 14 FTC rule as totally abolishing all protections afforded under the holder-in-due course doctrine. Of course, it remains open to question whether the FTC foresaw the consequence of this procedure which accomplished an objective otherwise unreachable at that time.

As to the overwhelming uncertainty surrounding the regulation and accompanying staff guidelines, we would spare the Committee the recitation of the voluminous material submitted by numerous associations and individual institutions both to the Federal Reserve Board and the FTC. Such information is readily available to the Committee should it be needed. However, the problem being described can only be properly dealt with in the larger sense of whether the FTC had the legal authority to issue the rule in question, and, if so, was the decision based on the proper social policies and procedural grounds.

FTC authority to issue rule

Serious questions still exist as to whether the FTC reasoned correctly on the social policy issue inherent to this rule or whether the protections afforded by the rule are needed in view of the advent of state law in almost all jurisdictions dealing with preservation of consumer claims and defenses. However, a more basic question must be answered and that is did the FTC have the legal authority to promulgate its "Seller Rule" on May 14 and does it have the legal authority to make final the proposed companion "Creditor Rule"?

It appears the FTC is relying on the exception clause of Sec. 202(c) of the FTC Improvement Act as its authority to finalize the "Seller Rule." Sec. 202(c) essentially states that any rule being promulgated under the FTC Act which was "substantially complete" at time of enactment of the "Improvement Act" shall not be subject to the much stricter administrative requirements of the new act. The FTC, realizing that the opposition to their proposal to partially abrogate the concept of holder-in-due-course would be dramatically increased if they observed the more equitable procedures required by the new Act, chose to argue that the proposed "seller rule" was "substantially complete" when the Improvement Act was passed. Realizing the difficulty of resolving this subjective argument, we raise a more conclusive related issue—the legislative intent of the Congress when the FTC Improvement Act was passed.

Analysis of the legislative history of the Magnuson-Moss/FTC Improvement Act, where Congress addressed itself directly to the question of unfair credit practices, reveals that the legislators did not intend to grant the Commission the power here asserted to abolish in a single broad stroke the considered distinctions and limitations reflected in a long series of state consumer credit statutes dealing with this subject.

The Committee Report accompanying the FTC Improvement Act filed by the House Interstate and Foreign Commerce Committee to which some members of this Subcommittee attached their signatures, specifically states;

> The expansion of the FTC's jurisdiction is not intended to occupy the field or in any way to pre-empt State or local agencies from carrying out consumer protection or other activities within their jurisdiction which are also within the expanded jurisdiction of the Commission. House Report No. 93-1107, 93d Cong., 2d Sess. June 13, 1974.

The earlier report of the Senate Commerce Committee explicitly reflects the same legislative intent by stating:

> In considering certain arguments against expansion of the Commission's jurisdiction, the Co[illegible]tee was mindful of the danger of making the Commission alone respo[illegible]e for eradicating fraud and deceit in every corner of the marketplace. This is not the Committee's intent in expanding the jurisdiction of the Commission. State and local consumer protection efforts are not to be supplanted by this expansion of jurisdiction. In many situations the Commission, through its Consumer Advisory Boards and expanded field office operations, would work concurrently with State and local governments to attack in their incipiency flagrant consumer abuses. However, this expansion of jurisdiction, in conjunction with the authority to seek injunctive relief, will enable the Commission to move against local consumer abuses where existent or where fly-by-night operators hit one local area and then quickly move on to another area before local officials can take action. S. Rep. No. 93-151, 93d Cong., 1st Sess. May 14, 1973.

This review of this legislative history therefore leads us to the conclusion that the FTC utilized a loophole in the FTC Improvement Act [Sec. 202(C)] in order to promulgate a regulation which squarely contradicts the stated legislative intent of that same act. Approval of the FTC action would be to sanction a classic disregard for Congressional intent.

A Trade Regulaion Rule is proper only if the FTC has the power under its enabling statute to adopt such a rule and if it follows the requisite administrative procedures. It would appear that the Commission lacks such power and has, in any event, failed to proceed properly so as to provide due opportunity for affected parties to participate. More specifically it is not clear that the FTC has the authority to promulgate a general rule to define as "unfair" a broad sweep of acts and practices, many of which are specifically sanctioned by state statutes.

While the term "unfair acts or practices" is undefined by the Act, it is clear that:

> The Commision is hardly free to write its own law of consumer protection and antitrust, since the statutory standard which the rules may define with greater particularity is a legal standard. . . . [and] the standard must get [its] final meaning from judicial construction. *National Petroleum Refiners Association v. FTC.* 482 F.2d 672, 693 (D.C. Cir. 1973) *cert. denied,* 415 U.S. 951 (1974).

Therefore, the FTC should legally justify its implied declaration that all of the acts and practices covered by the rule are "unfair" in all of the circumstances covered. We understand an earlier FTC analysis revealed that most state legislatures feel an across-the-board prohibition (such as contained in the proposed rule) is neither desirable nor necessary to prevent substantial injury to consumers.

The effect of the FTC's action as interpreted from the lenders point of view is that the Commission has determined "to occupy the field" and "to write its own law of consumer protection" on the subject of consumer claims and defenses on the broadest possible basis, ignoring in the process long-standing state legislation and differences in local and regional practices as well as necessary distinctions based upon the nature of the credit extended and the parties involved.

This cavalier treatment of both state law and Congressional intent causes great concern for lenders, and we anticipate that it will be of equal concern to this Committee in its FTC oversight capacity. An offensive precedent will be established if a regulatory agency is allowed to manipulate and stretch its authority by the regulatory preemption of state laws, particularly in view if explicit legislative intent to the contrary which directs the FTC to not preempt state law in the areas of consumer protection.

Anti-trust questions prompted by rule

The FTC decision that it is a desirable social policy for lenders to serve as policemen for their borrowers will often result in borrofers being told where they should or should not make purchases. Forcing lending institutions to favor one seller over another, because one is financially strong with a history of good borrowing practices as compared to a new seller attempting to establish a business reputation, appears to create strong anti-trust implications.

How shall the lender deal with a new entrant into a particular business, an entrant who, by definition, does not have a reputation—one way or the other—for fair dealing with buyers? How shall the lender deal with a heretofore reputable firm which is suddenly the subject of a series of complaints, justified or not? How shall the lender deal with a heretofore disreputable firm which now represents that it has conformed its practices and policies to more acceptable standards?

It would appear that there are but two alternatives. The lender may deal with these merchants, taking the risk that they will deal fairly with consumers. Or, the lender may refuse to deal with these merchants. To adopt this course, however, could result in the erection of a major barrier to full and fair competition in the market area in question. How can the prospective new entrant into a business begin to establish a reputation for fair dealing when he is denied needed financing at the outset—financing which he could have acquired if the lender's risk had not been increased? How can the reputable dealer resolve temporary problems and reestablish his reputation when the lenders cut him off at the first sign of trouble?

Obstacles to free competition are to be avoided, purely as a matter of public policy. But, of course, when obstacles exist, they will be challenged under the anti-trust laws. This possibility is perceived as a very real danger by lenders. Group boycotts or concerted refusals to deal are violations of the anti-trust laws

unless such refusals are "reasonable." The interpretation of this word has been the subject of considerable litigation, and it may fairly be said that each case is decided upon its own facts. In fact, research on this question reveals that courts have held both ways. Some courts have held that it was reasonable for the various defendants to refuse to deal with the various plaintiffs when there was a demonstrable probability of economic harm to the defendants if they had chosen to deal. Other courts have reasoned exactly opposite.

In the the future, when a lender refuses to deal with new or marginal merchants, the lender would have his own economic interest at heart in making this decision. But is this a sound and reasonable business decision when the actual extent of risk is not and cannot be determined? Or, perhaps more importantly, what is a court going to say the correct decision should have been, two years after the fact? So, it would appear that lenders are placed in the position of potentially risking a loss or an anti-trust suit as yet another ramification of the ill-conceived FTC rule.

Question of lenders tort liability

The required wording of the *Notice* which must be included on sales contracts is such that the third party holder is subject to "all claims and defenses which the debtor could assert against the seller." A most distressing effect of this language if the rule itself is determined to have been validly promulgated, is that lenders will also be subject to tort liability (including personal injury and property damage claims) caused by defective merchandise.

Many lenders thoroughly frustrated with the FTC Rule have yet to learn of the magnitude of their liability under tort law. Only when personal injury suits and other similar legal actions, where recoveries are often enormous, are filed, will lenders react to the fullest degree.

We are unaware of any reasonable explanation on behalf of the FTC for what will be an almost unprecedented innovation of law. Further, no reasoning has been set forth to explain why the FTC did not follow the precedent established by Congress in Section 170 of the Truth-in-Lending Act where credit card issuers were specifically exempted from tort claims resulting from defective merchandise purchased with a credit card.

In fact, the Federal Reserve Board advised the FTC that "claims of this type has no relation to the type of unfair practices which the Holder Rule addresses, nor does there appear to be any valid reason for holding the creditor liable for problems which are traceable to the manufacturer of a product."

Of particular disappointment was the fact that the recent FTC Statement of Enforcement Policy in no way addressed this vital issue. This issue must be resolved promptly, otherwise, the reaction from the marketplace will be unacceptable to all parties involved.

Economic impact of elimination of holder-in-due-course

Another facet to the FTC rule will be a significant adverse economic effect on consumer credit markets. Under this rule, lenders will be liable for any defaults on explicit or implied product or service warranties up to the entire amount of the loan, including finance charges. The FTC has promulgated this rule on the theory that it is relatively cheap for lenders to assess the probability of a dealer defaulting on such a warranty, and that lenders have enough financial leverage to correct dealer abuses when they occur. Such sweeping assumptions reflect little knowledge of the real world of business arrangements. Although these theories will apply in certain instances, they are generally incorrect.

Many lenders deal with a large number of retailers, making it very difficult for them to assess the reliability and fairness of each dealer's consumer policies. While a lender may be familiar with a dealer's financial affairs—a bank balance is insufficient criteria by which to measure willingness or ability to fulfill a consumer contract. In fact, only a few of the instances of dealer abuse documented by the FTC involved bankruptcy. It is an unfortunate fact that some dealers with adequate financial resources consistently fail to fulfill their obligations to buyers. However, banks are not in a position to acquire information about such poor service in the normal course of business. This simple fact has been ignored by FTC, although in its comments on the FTC rule, the Small Business Administration clearly noted that banks ". . . have neither the facilities nor the inclination to become involved in consumer complaints to investigate the business practices of the concerns with which they deal, except as these may affect their credit standing. . . ."

Even when a lender has a substantial business relationship with a retailer, he may not have market power necessary to exert any leverage. Most retailers have several alternative sources of consumer credit. If one lender tries to exert too much pressure over a dealer, the dealer will simply find another source. This has already resulted in significant shifts from bank borrowing to captive finance companies such as GMAC.

Lenders will respond to the FTC rule in one or more of several ways: (1) by reducing the volume of consumer credit subject to the new rule; (2) raising interest rates; or, (3) by requiring more stringent recourse agreements and increased reserves to protect themselves against increased risk of losses. The initial experience under the FTC rule and in those states which have eliminated holder-in-due-course indicates that the most widespread response is a reduction in consumer credit. Nevertheless, all of these responses occur and we think it important to spell out their consequences.

To do so, it is helpful to examine the experience of those states which have previously eliminated holder-in-due-course and waiver-of-defense clauses. Professor David Greer addressed this issue in a 1973 study for the National Commission on Consumer Finance. Although Greer generally supported elimination of holder-in-due-course, he estimated that the volume of retailer-originated instalment credit decreased by five-to-ten percent in those states which had partially eliminated holder-in-due-course. Thus, it seems fair to conclude that the much publicized FTC rule will likely result in even more than a five-to-ten percent reduction nationwide in retailer-originated credit. The significance of this amount is illustrated by the less than 4 percent decrease in retailer-originated credit during the recent recession—the only significant decline in consumer credit since 1952.

It is, of course, too early to accurately forecast the impact of a reduction in consumer credit on the total economy. Nevertheless, work done by the Wharton Econometric Forecasting Associates indicates that it may be substantial. On the basis of a survey of the consumer credit and retail sales industries, the Wharton group estimated that consumer credit would be reduced by $2.2 billion in 1976. This would be nearly 5 percent of retailer-originated consumer instalment credit and the Wharton model predicts it would lead to a $1 to $2 billion fall in GNP.

We have long contended that the FTC rule will have far wider impact than the current state laws which partially eliminated holder-in-due-course, and we find the results of a recent ABA survey reinforce our concern.

The surevy, although comparatively small, represents a fair cross-section of banks both in terms of size and geographic distribution. Survey results indicate that a significant number of lenders have begun to cut back on several types of indirect loans as a result of the FTC rule. For example, the percentage of banks cutting back on indirect home improvement loans increased from 13 percent in April 1976 to 24 percent in July. The percentage of banks cutting back on indirect auto loans increased from 7 percent to 13 percent during the same period. The cut-back in direct loans was not discernible, presumably because many banks have been advised by counsel that direct loans are not yet subject to the FTC rule.

The FTC rule will have a negative effect on competition. To understand why it is helpful to examine the reasons for the decline in the amount of consumer credit. In order to limit the additional risk exposure on loans subject to the FTC rule, lenders will need information about both the financial condition and past performance of retailers. The acquisition of this information is essentially a fixed cost—whether the data is on a small retailer or on a large one. But retailers below a certain size will not generate enough loans for the lender to recover these costs, and he may well refuse to make loans for goods purchased from such dealers. Without access to credit, many small retailers will be driven out of the market, resulting in a reduction in retail competition.

The FTC rule also will reduce competition in consumer credit markets. If lenders minimize the cost of obtaining necessary information by doing business with only a small number of dealers, it follows that each retailer will have access only to a small number of lenders. Thus, consumer borrowing choices will be limited and competition among lenders reduced.

The ABA survey clearly illustrates the potential risks here. A number of banks reported significant reductions in the number of dealers from which they pur-

chase indirect consumer loans. For example, 31 percent of the respondents indicated that they reduced the number of dealers from whom they purchase consumer loans by an average of 6.6 dealers. Only 14 percent of the respondents increased the number of dealers from whom they purchased consumer loans, by an average of only 6.2 dealers. Six weeks after the FTC rule went into effect, survey respondents had reduced the number of auto dealers from whom they purchased consumer loans by an average 3.5 percent. Although the full impact of the FTC rule will not be felt for at least several months the ABA survey is the only information about this aspect of the FTC rule currently available. Thus, we consider this six-week 3.5 percent decline in dealer-lender relationships quite significant.

A SBA study of the impact of this rule was requested by a member of Congress to determine the impact on small business. The Small Business Administration study found that small business concerns and their high-risk customers were most significantly affected by the reduction in consumer credit resulting from the elimination of holder-in-due-course in several states. Professor Greer also indicated, in testimony before the FTC, that low income, high credit risk consumers were most strongly affected by the elimination of holder-in-due-course. The effect is likely to be either higher interest rates or less available credit or both. The Greer study, for example, indicated that, on the average, interest rates had fallen somewhat in those states which eliminated holder-in-due-course. He made it clear, however, that this does not mean that those people who still get credit receive it at a lower rate. According to Greer, the average rate fell because some high interest rate (i.e., high risk) borrowers were cut out of the market, which in turn lowered the average interest rate.

The third option is for lenders to require dealer repurchase agreements and reserves. This passes the costs imposed by the FTC rule back to the dealer, who will, in turn, pass these costs on to the consumer. However, some less competitive smaller dealers may be forced out of business by the additional costs. In addition, imposition of reserve and recourse agreements will act as financial barriers to entry in the retail sector. Yet, strong competition within the retail sector is the best mechanism to eliminate the abuses to which the FTC rule is addressed.

Also, whether or not repurchase agreements can be imposed on dealers depends on the financial institution's market power vis-a-vis the dealer. In many situations, lenders simply do not have the leverage to impose such requirements.

However, a lack of repurchase and reserve agreements may lead to even more serious problems. The bankruptcy of a retailer with whom a bank is heavily involved could impose large warranty responsibilities and loan losses on the bank. A retail bank with a heavy concentration of consumer credit would be dramatically affected by such a situation.

The FTC rule also changes the incentives for borrowers who may be able to use the rule to gain additional service or reduce debt, even when the dealer has performed satisfactorily. The FTC rule will also provide a readily available remedy for borrowers in cases where dealer abuse is less than clear-cut or even imagined. Thus, lenders may find themselves deluged with claims, only a portion of which represent genuine dealer abuses. Handling such claims will significantly increase the cost of making consumer loans.

The Rule also increases the lender's debt recovery cost. The lender may have to show that the seller performed satisfactorily in order to recover a contested debt. This will increase his investigative and legal expenses. For small loans, these expenses could well exceed the amount to be recovered, leading the lender to write-off the uncollected amount. This in turn may lead to a large number of nuisance claims—baseless claims which the borrower feels the lender will find too small to contest.

The vagueness of the FTC rule increases the probability of a large number of unfounded or shady claims. The expansion of claims generated by the Truth-In-Lending regulations illustrates the volume of litigation that results from vague regulations. And the costs of litigation are either passed on to the consumer or avoided through reduction of volume consumer credit.

Another example of costs related to this rule is found also in the ABA survey. The data gathered reflected that the initial cost of compliance with the rule averaged approximately $7,500 per bank. If this figure remains an accurate indication of average compliance costs (forms, attorneys' fees, etc.) the total compliance cost for all banks would exceed $105 million dollars.

In view of the foregoing information, careful examination must be given to the FTC argument that the benefits of its rule outweigh the associated costs. Should the economy be forced to bear a five-to-ten percent reduction in retailer-originated consumer installment credit, higher interest rates, and a reduction in competition as the cost for trying to eliminate a comparatively small number of unscrupulous sellers of goods and services?

We think not.

Shifts in the consumer credit market

Results of a recent ABA survey attempting to measure the effects of the FTC rule were identified in the earlier economic impact section. The questionnaire, however, contains one question which asked for a general response on the effect of the rule in that respective market.

The following quotes are taken directly from the completed questionnaires and prove quite valuable in identifying the subtleshifts occurring in the marketplace—shifts which are still most difficult to identify in a quantitative sense:

1. Kansas: "We have found the independent used car dealer has been seriously hurt by this rule—some have suffered a 50 percent decline in business as a result. If the aim of the government is to concentrate the entire business in the nation into the hands of a few very large companies such as Sears and General Motors, these types of rules are the quickest and most effective way to do it."

2. Mississippi: "Used car dealers are closing due to inability to obtain financing. Banks here have 'tightened' credit policies on small ticket items such as sewing machines, appliances, etc. We only buy auto (direct or indirect) paper from franchised dealers with service departments."

3. Michigan: "It is our opinion that it is too early to know what effect the Federal Trade Commission's ruling will have on the consumer credit field. Up to this time, the regulation has had the effect of curtailing new entries in the consumer field. We mean by this that new dealers wishing to enter the field of installment credit by discounting their contracts are being discouraged until the banks know their true liability, which will be sometime in the future."

"We have been holding steady and in some areas, cutting back on long term contracts, which has been depressant on the mobile home and the home improvement field because of the Federal Trade Commission's ruling."

4. Alabama: "As a result of the FTC Regulation, we feel it necessary to screen the dealers from whom we purchase paper from much more closely. We also take a closer look at the collateral we finance and we feel it necessary to now screen out all the borderline credits."

5. Illinois: "As the consequences of this regulation become known to lenders, the costs of loans will be increased and passed on to the consumer. This regulation will be extremely costly to the consumer affording him little or no additional protection he does not now have from legitimate sales outlets."

6. Arkansas: "We have rejected new applications from home improvement and mobile home dealers to buy their paper due to the additional burdens imposed on the lender with the abolishment of the Holder in Due Course Doctrine."

7. Kansas: "As a result of this amendment, we lost 6 auto dealers, 1 RV dealer and 1 TV dealer. These dealers chose not to sign the amendment. Therefore, we no longer buy RIT paper from them. In addition, we do not feel that we can take on any used car dealers because of the liability involved. This would also apply to small consumer goods dealers and any type of dealer who does not reflect a very strong financial statement."

8. Wisconsin: "We raised rates ½ of 1 percent. The price on consumer goods are up especially new and used cars—local dealers have put an additional "pack" on each sale to cover the possible cost of litigation."

9. Virginia: "We have increased our credit standards."

10. Rhode Island: "The management of this bank has decided to increase the amount of reserve being held for each dealer which will have some negative effect on the dealer's cash flow."

11. Texas: "We have discontinued solicitations of small dealers, especially in the home improvement area, because of inability to predict ability of dealer to perform throughout life of contract—the FTC ruling has had the effect of generally hampering the ability of the small businessman to sell paper. As you can see, we drastically reduced our dealer list; not because these were not good businessmen, giving good service to their customers, but because they were not financially strong enough to indemnify their total portfolio of future business."

12. Iowa: "Marginal borrowers are now being forced to pay finance company rates as a result of FTC regulation."

13. Wyoming: "We find that our dealers feel that asking customers where he or she is getting the money for the down payments or the total purchase price is an invasion of the customer's privacy and are not asking them these pertinent questions."

14. Idaho & Utah: "There have been numerous companies approach the dealer organization with a Warranty Repair Insurance Policy costing on automobiles from $15.00 to $65.00 per contract, and on mobile homes up to $365.00. We have been unable at this point to find out how substantial these companies are who are offering these warranties, and as of this date, we are not financing the cost of these warranty policies. However, it is an additional cost which will have to be passed on to the consumer because of the Holder in Due Course Doctrine."

15. Texas: "We have found that a number of smaller dealers, to avoid any complications, are referring their customers to a direct basis rather than handling a retail instalment contract."

16. Utah: "Due to the FTC Ruling, customers are being sold warranty programs by insurance companies which cost $15.00 to $65.00. This is an added expense to the consumer."

17. Arizona: "Smaller banks reducing their emphasis on indirect paper, leaving the larger banks with specialized dealer offices to compete for the profitable indirect paper."

18. California: "Our philosophy has been, and will continue to be, to solicit good dealer business. Send out another questionnaire in 6 months—have not had time to see how the new rules will effect us except very expensive to change forms."

19. Pennsylvania: "As a result of this regulation, it is most important that the bank deals only with well-established dealers who have excellent reputations in the community. As the First National Bank is now liable for the quality and condition of the goods or services (if the seller does not perform on problems), we want only to do business with dealers who will stand behind the products they sell. Consequently, we are not actively soliciting business from new dealers or from dealers whose reputation is not of the highest quality. We also feel our bank will be very cautious about taking on a new dealer or new business. It will be a barrier for entry for someone trying to start a business that required discounting instalment sales contracts."

Additionally, we are receiving at the ABA, as no doubt your respective offices are, advisory letters as to the adverse impact and effect this rule has created.

A Virginia banker writes: "The Federal Trade Commission regulation concerning 'holder-in-due-course' has created minor problems for us to date only because we have not felt the full force of the regulation. As of April 1, 1976, we had financing agreements with 250 dealers in Virginia and we have canceled agreements with 25 dealers since that date because we felt they were too small or weak to protect us from the additional risk imposed by the 'holder-in-due-course' regulation."

This particular letter goes on to point out even more dire consequences if the proposed "creditor rule" goes into effect.

A banker in New Mexico states: ". . . In view of this fact [FTC Rule] and because the bank as a lender of money is in no position to be a warrantor of products or a party which should sustain loss because of product deficiencies or alleged liability arising therefrom, this bank, which is one of the principal consumer lenders in [the] County, has elected to *discontinue completely the purchase of any retail paper* from any dealer whatsoever. This can only serve to eventually harm the consumer because it is limiting the source of funds which can be used for consumer financing. We regret this action is necessary, but quite frankly, it is the only sensible course of action we can take at this time. Other bankers with whom I am acquainted are also considering similar policy changes."

A disturbing conclusion to be drawn from these comments is that if very many lenders react in this manner, the nation's consumer credit mechanism could be placed in an intolerable position.

Summary

The American Bankers Association applauds the responsibility and concern shown by members of this Subcommittee in scheduling an oversight hearing on the effects of the FTC rule in question.

We remain confident that after the issue has been carefully reviewed and the facts surrounding the FTC action made clear, that this Subcommittee will promptly initiate corrective legislation. In fact, various bills have already been introduced which address this problem, such as H.R. 15082, H.R. 14685 and S. 3652.

We strongly encourage the Subcommittee to recommend to Congress a permanent solution to this problem such as proposed in H.R. 14685 and S. 3652 where the authority to determine what claims and defenses will be available to a consumer is properly vested in state law. However, because of the widespread unfamiliarity with the intricacies of this issue, we realize that H.R. 15082, which would suspend the rule until it could be further studied, may be more intriguing to many members of Congress. Therefore, we would welcome the relief which this measure would grant, or any other responsible proposal which addresses this vitally important issue.

Our Association feels that an equitable case for legislative relief has been made in view of the many serious questions which have been raised. A partial summary of those questions are:

1. Whether the FTC acted under proper legal authority?
2. Whether the FTC disregarded Congressional intent?
3. Whether regulatory preemption of state law will be sanctioned?
4. Whether the FTC conclusively proved the need for this rule?
5. Whether the social policy decision is correct in view of the potentially dramatic economic impact and anti-competitive effects?

And, finally, we must raise an issue which is of paramount concern to every bank in this country. Is the Congress reversing its clearly stated position—that the FTC is *not* a regulator of the banking industry?

> Under the Federal Trade Commission Act, the Commission does not have authority to regulate banks. This legislation does nothing to change this situation. House Report No. 93-1107, 93d Con. 2d Sess., June 13, 1974.

Even though the principal issue before this Committee is the FTC rule on Preservation of Consumer Claims and Defenses, to allow the FTC to regulate banking by allegedly "indirect" means such as the "Seller Rule" sets forth a precedent directly contrary to the intent of Congress in enacting the FTC Improvements Act. A review of the facts makes it clear that the FTC has succeeded quite handily in construing their authority (on this issue) in a manner which is affecting the entire banking industry. The question then becomes—what other areas will be subject to the FTC's reach as defined by their own interpretation of authority. We respectfully ask that this Subcommittee, and, ultimately, the entire Congress, rectify the circumstances created by the FTC's May 14 "Seller Rule" and proposed companion "Creditor Rule"; and by the manner this is accomplished, make the record explicitly clear regarding FTC jurisdiction.

Thank you very much for your serious consideration of these views.

Mr. BRODHEAD. Thank you, Mr. McCollister.

Mr. McCOLLISTER. Mr. Vaughan, last week Congressman Annunzio pointed to a recent ABA advertisement as evidence of the rule having no effect. Are you familiar with the reference?

Mr. VAUGHAN. I'm familiar with the testimony, yes.

Mr. McCOLLISTER. How do you respond to Mr. Annunzio's statement.

Mr. VAUGHAN. My first response to that is to indicate the time frame that was referenced to in that release. That survey was completed through the end of March. It was tabulated and released to the press in May. When related to this it seems to be very unfortunate timing but, in fact, it did relate to a period of time prior to May 14.

Mr. McCOLLISTER. The FTC stated in their testimony last Thursday that no effort was made to clarify the effect of the rule or except shortly before it went into effect because they didn't know that anybody had any questions about it. Did representatives of the banking community make any effort to get clarification at any point before the rule was to become effective?

Mr. VAUGHAN. We spent considerable time and we did from the ABA's standpoint and I know from the CBA's standpoint to engage in some formal dialog or informal dialog with the Federal Trade Commission. Some of the personal experiences that I have had would indicate to me that there was truly a lack of definition even within the staff itself as to certain parts of it. Maybe they feel, maybe it was felt, that definition will come about as we move forward into enforcement or the period of time under which this rule would be in effect but we did, in fact, at the Installment Lending Conference ask that a representative come to the installment lending conference and speak on the issues and obivously that would indicate an interest and some dialog prior to that date.

Mr. McCOLLISTER. As you know, under the Magnuson-Moss Act, the rulemaking procedure is changed insofar as the element of cross-examination is concerned. Do you believe that some of the unexpected effects, at least as far as you're concerned, might have been avoided if there had been cross-examination during the period of rulemaking?

Mr. VAUGHAN. I would prefer to refer that to Mr. Tullos if I may.

Mr. TULLOS. Yes, Mr. McCollister, definitely. That is the intention that I think you and other members of the committee had in passing on legislation like the Magnuson-Moss Act, was to allow this cross-examination and full development of the record.

Mr. McCOLLISTER. The FTC said there was an opportunity for cross-examination.

Mr. TULLOS. Well, you must understand that there is a basic premise here that I don't think everyone understands. The FTC in going forward with the rule referred to it as a seller rule. There has been some reference, as you're referring to, that the FTC might not have been hearing from the credit community. I think most members of the credit community will be of the opinion that they were not to be affected, that it was, in fact, a seller rule. No one until near the very final day of May 14 realized that the purchase money loan was to be included and certainly there was no anticipation of a proposed amendment to include the creditor rule to include all direct loans.

So I think some members of the credit community simply were not anticipating the scope of the final FTC rule and its proposed amendments.

Mr. McCOLLISTER. The Magnuson-Moss Act provides that the new rulemaking would not apply to proceedings that have been substantially completed, I think is the language. Is it the opinion of the ABA that this rulemaking procedure was substantially completed and therefore, was not subject to the provisions of the new procedure developed in the Magnuson-Moss Act?

Mr. TULLOS. Well, I think it's very difficult to satisfy the argument as to whether or not the rule was substantially completed. There was obviously a pretty good period of time between the conclusion of the hearings on the rule and the promulgation on May 14. However, I don't think we can accurately ascertain if the rule was substantially completed, but I do think we can point you to an interesting device that was used. They used a particular section of the Magnuson-Moss Act to say that they could go forward with the rule but at the same time they did not heed the legislative intent of that same act saying that Congress specifically intended that State laws not be preempted. We have difficulty understanding how you can proceed on one clause under the law while disregarding the legislative intent of that law.

Mr. McCOLLISTER. Well, do I not infer from what you said a moment ago that the whole impact of the rule was changed when the purchase money loan proposition became a part of it which might suggest that the rule was not substantially completed prior to the effective date of passage?

Mr. TULLOS. I would agree with you on that conclusion. I realize the difficulty in solving that argument, however. I think there are two basic questions that this committee and ultimately the entire Congress must look at, and that is whether or not the FTC is disregarding congressional intent in going forward with this rule and whether or not Congress is going to sanction the preemption of State laws in the consumer protection area, as well as the basic question of whether the FTC was acting correctly on social policy. I'm speaking now of shifting the burden to the lender rather than using other procedures available to the FTC such as cease and desist proceedings, small claims courts, and other devices rather than the lender becoming the policeman.

Mr. MCCOLLISTER. Well, for those two reasons, the preemption of State law and the contention that the rulemaking procedure had not been substantially completed, Mr. Broyhill and I have introduced a bill which addresses itself more to the procedural aspects of the rule than of the more basic question perhaps. There is a bill pending before the full committee on another FTC subject to which I think our bill might be germane if offered as an amendment.

If we were able, either in the committee or on the floor, to amend the other bill to cause the FTC to go through the proper prescribed procedural requirements, do you think that many of these difficulties now prevalent might be resolved by such a new hearing procedure?

Mr. TULLOS. Yes, sir; I do. I think as the representative from the FTC testified last Thursday, the goal of the FTC in promulgating their rule was one of simplicity and ease of compliance. I think the confusion that has surrounded what has happened shows that they missed that goal. I think to go forward under the provisions of Magnuson-Moss would allow the FTC to do what they originally had intended to do much more effectively, if that is their utlimate goal and we certainly would encourage such a legislative move as I think all responsible industry parties would join us in doing.

Mr. MCCOLLISTER. One last question. Do you have an opinion about whether it's a basis of judicial review on the rule that is now in effect? Is it the arbitrary and capricious standard or is it the substantial evidence standard of the record taken as a whole that the Magnuson-Moss Act requires?

Mr. TULLOS. I heard you raise the same question on Thursday and I think it's an excellent question. It's kind of a 50 percent chance of being correct.

Mr. MCCOLLISTER. Those are better odds than I get normally.

Mr. TULLOS. I would prefer to research that very carefully and provide a statement to the committee that gives a full statement of our opinion on judicial review. I personally have a little difficulty with what the correct standard should be in this case.

Mr. MCCOLLISTER. And very finally——

You make a comment about the Wharton study in your written statement. If you were at the hearing last week, you may have heard the FTC discredit that study. Is there anything that either of you can say in its defense?

Mr. VAUGHAN. I would prefer, if I may, to speak to the whole subject of surveys and studies. I think right now it is pretty early in the game to make any true determination. The American Bankers Association in its efforts to measure what we felt may be the impact of this, have tried to track this. We have made a comparison study based on two given dates by surveying 150 banks, over 80 of which responded. We would be happy to make that survey available. But even that isn't positive evidence that this rule has measurable evidence as to the economic impact this rule may have on banks.

Mr. MCCOLLISTER. Mr. Chairman, I yield back the remainder of my time.

Mr. BRODHEAD. Thank you for your generosity.

Mr. MCCOLLISTER. We had the FTC going for 1 hour and 20 minutes the other day.

Mr. KINZLER. Mr. Tullos, if I understand your testimony correctly, you state that the whole rule became a significantly different question at the point at which vendor related loans were covered; is that correct?

Mr. TULLOS. Yes, sir.

Mr. KINZLER. At a point at which, obviously, the American Bankers Association would have been involved and active in terms of discussing the rule; is that correct?

Mr. TULLOS. That's correct.

Mr. KINZLER. Do you know at what point in time the FTC proposed such a change?

Mr. TULLOS. The specific time I do not.

Mr. KINZLER. Well, let me suggest to you that the specific time was after the first set of hearings and before the second set of hearings in 1973. Thereafter, they held hearings in two or three cities and I would cetrainly think you would have had input at that time, would you not?

Mr. TULLOS. Well, sir, you're referring to something specific that I do not have, but I'm also basing that conclusion on the—you see, we're the conduit for lenders who are members of our association and although there can be a staff transition where you do not necessarily know what went on before you, technically you do realize—how the FTC rule is registering in the marketplace. Now, if there was some failure in staff transition to make this known to the lenders, that's a staff problem. The lenders in the marketplace did not understand this rule was going to apply to them and that is a fact. We are getting at the time period which I have conveyed to the committee.

Mr. VAUGHAN. I think we do have a record going back to 1971 where we evidenced some very serious reservations as to the intrusion of the Federal Trade Commission into banking affairs and I think we also spoke at one of these meetings. We frankly don't feel and I can't feel that we've been listened to.

Mr. KINZLER. That's a separate question from the matter of what kind of rulemaking procedure was followed, isn't it? That's a question of whether they listen to you or not and that we can't mandate them to do.

Mr. VAUGHAN. Right.

Mr. KINZLER. We're not going to write a provision that says the American Bar Association's comments must be accepted by the Federal Trade Commission. The question here is, has the Magnuson-Moss Act been followed in spirit and letter and you're suggesting, I think quite correctly, that banks did, indeed, participate in this matter before the Commission because they were aware of it. To the extent they participated, they were afforded the same rights of cross-examination, the Federal Trade Commission tells us, as would be afforded under the Magnuson-Moss Act. What purpose would possibly be served by going back through the Magnuson-Moss Act again?

Mr. TULLOS. I certainly don't think that the FTC could possibly have anticipated the confusion and concern that the marketplace is reflecting. We should go back and go through the procedures of the Magnuson-Moss Act. The business community to which I refer and the concerns to which this entire group of people testifying today have pointed out will be brought to bear if they go through all the procedures of the Magnuson-Moss Act even though those procedures——

Mr. KINZLER. So, you want at least two bites at the apple and maybe three and maybe four——

Mr. MCCOLLISTER. A different apple.

Mr. TULLOS. I think considering the magnitude of what we're dealing with, if it takes two bites of the apple, it deserves it.

Mr. BRODHEAD. The gentleman from Nebraska and I have to go to the floor, and I believe, counsel has some more questions. Ms. Nord, do you have some questions?

Ms. NORD. I will be quite happy to submit them in writing in view of the time.

Mr. BRODHEAD. Why don't you discuss them informally while we're voting. We'll be back within 10 minutes, but please go ahead and discuss them.

[Brief recess.]

Mr. BRODHEAD [presiding]. The hearing will come to order. The Chair recognizes counsel, Mrs. Foldes, for some questions——

Mrs. FOLDES. I have a couple of questions relating to the series of studies which you cite in your statement. As I understand from what you said earlier, you're not sure, first of all, that any studies accurately reflect what has happened or what will happen under this rule. Is that approximately——

Mr. TULLOS. Yes. I would restate that for the record. I think the very studies that have been referred to, a Member of Congress on Thursday referred to a study that he did and Mr. McCollister referred to his own study. The FTC has referred to a study and then we do in our statement and the Independent Bankers as well. I think our initial position, as that of the Federal Reserve Board, is that it is entirely too early to get an accurate register as to the economic impact but that is not to say that we think we should wait until that is done. I think the initial signals that we're receiving, as we read them and as the economists advising us read them, is that the economic impact is starting to be and will be quite significant and, therefore, we need relief.

Mrs. FOLDES. How would you compare the Commission-contracted Yankelovich study, which indicates that the rule appears to be having little or no effect in the marketplace in terms of credit dislocation, to the Wharton study?

Mr. TULLOS. Well, speaking first to the study released by the FTC, I think they indicated that only 38 commercial banks were involved in only 4 States.

Mrs. FOLDES. 127, I think it was.

Mr. TULLOS. Institutions, but commercial banks from the perspective of which we're speaking. So we're speaking of a very limited number of commercial banks in a very limited geographical area. I think that possibly as I am suggesting, that that is not a fair cross section from which to measure. I would suggest that probably the same thing will ultimately be proven true from what I have learned during the course of this hearing about the Wharton study. I would say in our own study which does register a cut back in lending and decrease in the number of dealers with which we're doing business represents some 100 banks from all 50 States both in a geographic location and size distribution. So even though I would not refer that to you as a benchmark for consideration, I would say that that study might be more representative of the marketplace than either of the two you've asked about.

Mrs. FOLDES. I'll have some specific questions about that study, but are you aware of the Wharton forecasting statement on the holder in due course rule contained in it's forecast review of August 11?

Mr. TULLOS. No; I'm not.

Mrs. FOLDES. Well, that stated and I quote from two places in it:

> We continue to foresee only minimal and temporary reduction in expenditures accounted for by the holder in due course rule.

Then came a second statement:

> We assume that the effect of the FTC ruling will be to temporarily depress purchases in certain durables categories while dealers in retail and financial markets adjust to the new regulations.

The forecast estimated at least a coming back to zero, if not a positive forecast, by the second quarter of 1977 in terms of economic dislocations.

Mr. TULLOS. The difficulty in a study trying to measure this is that you are measuring a unique market. The consumer credit market, and Mr. Vaughan can speak to this much better than I, has been depressed and we are trying to measure the market while it is on an up-turn and I think that is going to be particularly difficult in using any econometric model o rany basic survey, to get an accurate reading. In other words, we're trying to measure a decline as we relate it to the FTC holder in due course rule but we're trying to measure it in an up-swing consumer market. Mr. Vaughan alluded to that in his statement in saying that let's measure this in a time of loan constraint rather than a time of open solicitation of lending and see what the effect of it is and we think there is considerable credence to that point of view.

As I say, I hope the committee in making its decision looks at some of the more basic questions regarding FTC authority and legislative intent than to try to take an individual economic survey now and say based on what this survey said, we're going to make our final decision. I think commonsense conclusions based on the remarks expert financial witnesses are giving, are the best measurement—that's why these people are here. They wouldn't say these things if they didn't believe them. They're putting their own personal reputations on the line. Commonsense leads you to believe what they're saying is that there is going to be a down-turn in credit in the marketplace. I think that is a more accurate register than any econometric study that you're going to look at.

Mr. VAUGHAN. I think there are two issues there. I don't know of any bank that wasn't in a loan restraint environment up until 8 or 9 months ago and that loan restraint environment may have existed for a period of 2 or 3 years in some form or another. Banks are beset by problems. Personal bankruptcy reached an all time high, business failures were predominant and banks were dedicating their efforts toward liquidation of assets, trying to establish new payment bases, and trying to survive that economic crisis. Obviously the time has now turned towards the continuation of earning assets because the well is getting dry and I think that is what you are seeing right now.

Mr. BRODHEAD. The Chair observes the time of counsel has expired. Thank you very much for being with us.

Mr. VAUGHAN. Thank you.

Mr. BRODHEAD. Mr. Charles O. Maddox. Thank you for being with us today. We're sorry to keep you waiting so long.

STATEMENT OF CHARLES O. MADDOX, JR., PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA, ACCOMPANIED BY RICHARD W. PETERSON, LEGISLATIVE COUNSEL

Mr. MADDOX. I am Charles O. Maddox, president of the Peoples Bank, Winder, Ga., and president of the Independent Bankers Association of America. I have with me Mr. Peterson, our legislative counsel. IBAA greatly appreciates this opportunity to appear, realizing that the hour is late for this Congress and that this subcommittee has many irons in the fire.

We are an organization of about 7,300 commercial banks, better than 50 percent of the country's total, which are mostly rural and suburban, locally controlled, and less than $25 million in size. IBAA has a total staff of 19 and only 1, inhouse attorney, Mr. Peterson.

As an organization of small businessmen, we feel this body should be commended for paying attention to a subject which is causing great, perhaps insurmountable, problems for small enterprises such as ours.

In the last 4 to 5 years there has been a very noticeable increase in legislative and regulatory activity that is making our affiliates, which are usually run by a very few officers, cope with rafts of elaborate material that really can only be understood by a limited number of super-specialist lawyers and often even not by them. Because of this trend, great frustration is now strongly evident among our members who worry constantly over whether they are behaving legally, especially since their liabilities for mistakes can run from stockholder derivative suits to criminal penalties. This attitude is made stronger by their common belief that the economic and social analyses which are used to justify or excuse the spread of Federal legalistic minutiae are unsound and because they do not believe that gigantic Government demonstrates much real concern with their educational needs.

The FTC regulation under discussion today is a prime example of what is causing serious alienation among small businessmen.

Our concern arises not only because our studies of the FTC's action show serious economic difficulties are resulting but also because we are deeply distressed over the rule as a symptom of how the Commission intends to handle its powers in the future. This first major FTC venture into the core of general business practices has been marked by great consternation in the commercial community. A host of issues have arisen that range from the FTC's implications that it can, under the Moss-Magnuson Act, supersede or substantially modify acts of Congress to the confusing process under which the action has been conducted.

If the formulation and implementation of the rule shows what can be expected down the road, then IBAA believes that Congress must immediately begin to consider steps to insure that does not happen again.

Our written statement has detailed quite a few of the problems which have made this an almost nonsensical situation. I would like to touch on three major ones this afternoon.

First, nearly ever State has a law modifying the holder in due course doctrine to one extent or another for consumer credit and these statutes vary greatly from one jurisdiction to another. They have been crafted by elected legislators to fit into a State's overall scheme for regulating consumer credit. However, only New Hampshire and New Jersey come even close to what the FTC has done.

In the main, these many laws have been structured to prevent consumers from having to pay for products which have gone bad. On the other hand, the FTC's regulation, in effect, is saying to a lender: "If you want to finance consumers by purchasing their debts from sellers of goods and services, you must also agree to insure those goods and services to a considerable degree."

This is so because the "notice" which the lender must accept certainly seems to provide, one, that the creditor can be sued for an affirmative, monetary recovery and cancellation of the debt; and, two, the ceiling of monetary recovery, which could be based on any claim the buyer could assert against the seller, including torts, will be everything up to full purchase price of the good or service.

For one likely example, let us suppose a buyer comes to a mobile home dealer. He has a trailer for trade-in which is worth $3,000. The seller wants another $1,500 in down payment. The home to be purchased costs $20,000. This leaves a balance to be financed of $15,500 by a bank. Not only is the financing bank liable, given the FTC's wording, for the cancellation of the debt, but, immediately becomes liable for the $4,500 value which it did not even finance.

The Commission has put great reliance on recourse agreements as a mechanism to alleviate this burden on the financial system. In our written statement, we have explained that there are many reasons why this is unfounded and, should there be questions on this subject, we will be glad to respond. However, I would like to mention one of the most obvious. Recourse only works as a buffer if the seller is still around. Thousands of merchants go bankrupt, into insolvency, or liquidation every year. Many more thousands are always on the verge of such serious trouble that recourse on them is not dependable. In the great majority of cases, I would estimate, this has absolutely nothing to do with shoddy merchandise. Merchants who sell quality, but not infallible, goods and services go out of business, too.

I emphasized the word "seems" several paragraphs back when describing what the FTC notice provides. I did so because it is still quite unclear whether the explanatory material the Commission provided in its Statement of Enforcement Policy of August 13, 1976, means that State law can modify what the Commission has done. They said there, and it stands as the extant official position of the FTC: "The manner and procedure by which a buyer may assert claims and defenses is governed by the terms of any contractual obligation and by applicable State law."

One is, therefore, caught in the "Catch 22" situation of not being able to determine whether the Commission has or has not preempted State law and, if it has, to what extent. Since the rule can legitimately be interpreted as forcing creditors who buy paper into the insuring of goods and services business, it seems inexcusable to us that the degree of risk cannot be determined from the rule and that consequently the creditor cannot determine what premium he needs to charge or whether he wants to write the policy at all.

Incidentally, if you think our comparisons to insurance are faulty, it is interesting that insurance companies are trying to figure out how to write policies to cover liabilities arising from the FTC rule.

Our second major objection is the process by which this rule has been implemented and its implications for how the Commission intends to handle its powers in the future.

The Commission used its pre-Moss-Magnuson powers on the grounds that act had not compelled it to follow that statute's procedural guidelines and was specially exempted since proceedings on the rule were substantially completed prior to passage of Moss-Magnuson. In our opinion, the Commission itself admitted it had not really completed its compilation of data when, on the same day it promulgated the regulation which is now in effect, it proposed a superseding rule on the grounds that it had reason to believe the regulation now in effect was inadequate since it did not directly include creditors.

Be all that as it may, the more important point is that if the Commission had followed the routines laid down by Moss-Magnuson, it is more probable that what ensued after November 14, 1975, would not have occurred.

To begin with it was obvious that no one could understand the rule because, among other things, of its treatment of affiliates and referrals. Ten days before the effective date, the staff of the Commission issued guidelines. These however, contained a disclaimer of authoritativeness which made them of little value. On May 5, Chairman Arthur Burns of the Federal Reserve formally requested a delay because of the confusion. It was not granted. Finally, on August 13, 1976, the Commission itself issued the enforcement statement which addressed some of the major confusions but left other untouched. Part of the enforcement policy, it should be noted, is going to have the practical impact of making the seller ask a buyer who already has the money to make a purchase, "Where did you get this money?" a question which, I suspect, many consumers will resent.

Is this any way to regulate a $150 billion credit market which is dependent on people knowing their rights and obligations.

Two additional points should be made on revelations which occurred during the implementation as far as the Commission's notions about future use of its powers.

First, the Commission tacitly claimed it could alter the United States Code should it find that the code was permitting unfair or deceptive acts or practices. Moreover, it evidenced no problems with varying from established trends of congressional policy. For instance, the Fair Credit Credit Billing Act, which contains a holder rule for credit cards which the Commission elected to exclude from the regulation prevents tort liability and sets creditor exposure for flawed goods and services at outstanding balances which are owed at the time the borrower notifies that bank which issued the card of claims and defenses. The FTC rule is contrary to these approaches to lender accountability.

Second, it is apparent from the congressional committee reports at the time Moss-Magnuson passed that it was not intended as a grant to the FTC to federalize large areas of law customarily left to the States. On the other hand, it is obvious now, when this rule and other announcements of the agency that it is thinking about codifying case law principles, that such federalization is their goal.

I would like to turn to IBAA's study of the economic impacts of the rule. We realize it has its imperfections but we do call attention to the fact it is, to our knowledge, the broadest sample yet taken. It echoes the Yankelovich study, done for the FTC, as far as the degree of creditor dissatisfaction with the rule, but differs from it in that it shows significant creditor action. We would be glad to work out with the subcommittee staff methods of providing the raw data, absent the names of respondents who were told their anonymity would be respected.

The survey was conducted of our 7,300 member banks on August 7, 1976 to determine the impact of the FTC's holder in due course regulations. It produced 1,784 responses. The survey sought to determine the impact of the HDC regulations on new and used automobile loans, mobile home loans, small business loans as well as the anticipated future effect of the regulations on these loans and on the cost of these loans to consumers for our members. It is to be emphasized, the study was not contrived to gage influences on the gross national product or other indexes of national economic trends.

With respect to loans on automobiles, the survey revealed that between May 14, 1976 when the HDC regulations became effective and early August, 1,097 banks, or 61 percent of the banks responding, had curtailed lending due to these regulations. With respect to loans on new automobiles, 76 percent of the banks reported loan curtailment of up to 30 percent. The curtailment of lending on used cars as a consequence of the HDC regulations was more severe. This is revealed by the fact that 85 percent of the banks reporting had curtailed these loans by as much as 50 percent. While 51 percent of the banks reported curtailment of mobile home loans up to 50 percent, almost 40 percent of these banks either stopped making these loans or reduced them by 90 percent or more.

As to those banks which did not report a curtailment of their lending since the issuance of the HDC regulations, most of them took steps to reduce their liability by the use of recourse agreements, this covered

588 banks, and/or by tightening their lending policies, 758 banks. Furthermore, most of these banks, 692, anticipated that the HDC regulations would force them to curtail their lending in the future and that as a consequence, new small businesses and purchasers of used automobiles and mobile homes would be most severely affected.

In response to the question, has the increased liability you are exposed to as a result of the HDC regulation forced you to increase your lending rates, only 326 of the 1,501 banks which answered that inquiry replied affirmatively. However, the survey indicates that at least 500 of these did not engage in buying or selling consumer paper and, thus, would not have felt the full impact of the rule.

It is IBAA's conclusion that Congress should, with respect to the Commission in general, begin to provide it with more explicit and restrictive guidelines on its powers. With regard to the rule itself, we believe that, at a minimum, it should be suspended until the Commission has reviewed it under the procedural safeguards of the Moss-Magnuson act and with due consideration for the position of the States in the consumer credit arena.

[Testimony resumes on p. 163.]

[Mr. Maddox's prepared statement with appendix A follows:]

STATEMENT OF CHARLES O. MADDOX, JR., PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA

My name is Charles O. Maddox. I am president of the Peoples Bank, Winder, Georgia and of the Independent Bankers Association of America (IBAA). Richard W. Peterson, Legislative Counsel of the Association, accompanies me. IBBA greatly appreciates this opportunity to appear with respect to the Federal Trade Commission's Trade Regulation Rule, Preservation of Consumers' Claims and Defenses, 16 C.F.R. 433, promulgated on November 14, 1976.

The IBAA is a national trade organization of approximately 7,300 state and national commercial banks, better than 50% of the Country's total. The vast majority of members are in rural and suburban communities; locally controlled; and less than $25 million in deposit size. Put otherwise, the Association, in main, represents a group of small businessmen in non-urban settings. Our staff consists of ten persons with executive responsibilities and approximately nine support and clerical assistants. We have only one, in-house, attorney, Mr. Peterson.

For many years, IBAA has devoted most of its efforts to preventing inordinate deposit concentrations in fewer and fewer banks and to ameliorating consequences of certain advantages that savings and loan associations, mutual savings banks, and credit unions have over our equity based constituency. Experience in these areas, despite serious problems, has long accustomed the Association and its members to having governmental authorities regiment many basic financial practices such as interest rates on loans and savings, capital adequacy, and fundamental industry soundness. While we might not have agreed with a given policy, we could understand, even as small businessmen, how to implement it, and we did not normally need a platoon of attorneys to advise us on what was or was not the "straight and narrow."

However, in the last four to five years, Federal legislation and its regulatory progeny have been evermore rigged to dictating where it is permissible to cross the "i's" and dot the "t's". This has begun to force our affiliates, which are usually run by a very few officers, to conform with rafts of elaborate material that really can only be seamed together by lawyers who are, in fact, specialists on a given subject. Mr. Peterson, who has closely monitored these innovations, tells me that he doubts if there are more than four hundred lawyers in the Nation who are really able when it comes to, say, the Consumer Credit Protection Act, a major dynamo for fabricating rococo regulations, and that most of these work for the Federal government or large businesses. They certainly are not accessible to firms like ours, dependent for advice on local, general practitioners who cannot normally even be banking specialists, much less consumer finance experts. Yet, even more difficult than the intensification of administrative activity itself have been the facts that: it is frought with so many

ambiguities; demands so much second guessing; and is foisted on the small businessman with a minimum of educational effort by the Federal bureaucracy. (See statement of Jonathan M. Landers, Professor of Law, University of Illinois and Visiting Scholar, American Bar Foundation on the Consumer Credit Protection Act, before the Senate Committee on Banking, Housing and Urban Affairs, July 28, 1976.) As we will discuss shortly, the subject of these hearings is a prime example of these failings.

Because of this trend, frustration is now strongly evident among small, community bankers who worry constantly over whether they are behaving licitly, especially since their liabilities—based directly or indirectly on these burgeoning cannons—can run from stockholder derivative suits to criminal penalties. These sentiments are compounded by the fact that, like many small entrepreneurs, they sense the economic analyses which are deployed to justify or excuse the spread of legalistic minutiae are unsound. Further, they are discouraged because they feel that leviathan government demonstrates very little genuine concern with their attitudes and needs and because they do not believe current talk in political circles about reining in the bureaucracy's excesses is much more than rhetorical flourish.

For these reasons, IBAA was pleased that these hearings on the FTC's rule were announced. This was so not merely because our studies betoken significant economic difficulties, a matter taken up near the end of this statement. Rather, we are also deeply concerned over the consternation it has produced on a host of issues that range from the Commission's implications, at the time of promulgation, that it can, under the Moss-Magnuson Act, supersede or substantially modify Acts of Congress to the confusing process under which 16 C.F.R. 433 has been placed into effect.

As you are probably aware, the FTC is already engaged in extensive projects to write legislative rules, in effect Federal statutes, on a great many subjects. For one instance, on January 22, 1976, it placed notice in the Federal Register that it was going to undertake codification of case law principles on many topics, such as price advertising, employment opportunity advertising, debt collection practices, referral sales, and credit balances. In short, it would take judicial decisions, presumably both state and federal, and reorganize them into codes. Senator Lawton Chiles even held hearings in December 1975 on the Commission's investigations to "protect people from petunias." (See Statement of Senator Lawton Chiles, Chairman, Subcommittee on Fedeal Spending Practices, Efficiency and Open Government, Senate Committee on Government Operations, on FTC Investigation of the Plant Industry, December 4, 1975.) Justinianus ex machina. If the formulation and promulgation of the rule on Preservation of Consumer's Claims and Defenses is symtomatic of what can be expected from the FTC in the future, then we believe this subcommittee must immediately begin to consider remedial steps to insure that this does not occur again.

I. BACKGROUND OF THE REGULATION, PRESERVATION OF CONSUMERS' CLAIMS AND DEFENSES

The doctrine of holder in due course (HIDC), which the agency's action abrogates with respect to consumer credit on a sweeping basis, has grown out of one of the classic cases of English law, *Miller v. Race*, 97 Eng. Rep. 396 (K.B. 1758). It reached its most complete domestic statement in our time in the Uniform Commercial Code (UCC) a product of the Commissioners on Uniform State Laws which has been adopted, in large measure, in all jurisdictions save Louisiana. Briefly, a holder in due course is one who takes a negotiable instrument for value, in good faith, and without notice of any defense or claim against it. (See UCC 3-302.) Under UCC 3-305, such a holder takes an instrument free from all claims by any person and free from all defenses of parties to the instrument with whom the holder has not dealt, except "real" defenses such as infancy, incapacity, and discharges in insolvency. While, at first blush, this might sound like so much legal mumbo jumbo, it is the fundament of our financial system since it is the keystone of negotiability which underlies everything from the workability of the check system to bearer bonds. In short, it is the basis for defining the rights and duties of parties who are involved in most transfers of value, except those entailing such items as certain instruments of the Federal government, like Federal Reserve notes, some forms of equities, and bank credit cards.

Since the UCC is designed to handle many kinds of exchanges, it is quite lengthy and rather than spend time on its intricacies, it seems best to proceed directly to the problems which have arisen with respect to its use in the context of consumer credit transactions, only one of the numerous varieties of undertakings it covers.

Under "classical" UCC provisions, a seller of consumer goods may act as the original extender of credit to the buyer of consumer goods. The seller executes a retail installment sales agreement with his buyer, together with a promissory note in negotiable form. He then sells the contract and/or note to, say, a finance company or bank. Assuming the sale finance company or bank takes the instrument in good faith, pays value for it, and has no notice of defenses or infirmities arising from the transaction between the obligee (the buyer) and original obligor (the seller) the finance company or the bank is a holder in due course. In this situation, if the goods or services turn sour, the buyer might have a cause of action against the seller because of the non-delivery or faulty character of what was sold. He would still have to pay the finance company or the bank since they would have become holders in due course. The buyer could defeat the HIDC only on grounds of the aforementioned "real" defenses which are unusual and of limited applicability. (There is a variant on this theme involving "waivers of defense" which is also sanctioned by "classical" UCC law, but the differences are mostly technical in nature. See UCC 9-206)

The rationale for this "classical" approach is that if a person had gone directly to a lender and simply asked for a loan, received the funds, and spent them as he chose, then there was nothing for which the lender had responsibility, and he still should be repaid. Likewise, if a person went to a seller, made a decision to buy x or y and signed a promissory note, which was eventually negotiated to a finance company or bank, these ultimate lenders should have no more responsibility for the quality of the wares and services, selected at the buyers discretion in the marketplace, than if the person had simply borrowed funds from the finance company or bank directly and employed them to purchase defective products.

Yet, even as the UCC proceeded through state legislatures, several decades past, use of the doctrine for consumer credit beg[illegible]n to come under heavy criticism. The grounds were, generally, some creditors [illegible]o received the promissory notes from sellers and who were protected by the doctrine from assuming accountability for the goods and services were reaping benefits from their intercourse with merchants who were peddling shoddy material to the lower middle class and the poor. Moreover, opponents of the doctrine claimed that even where there was no actual transfer of a note from a seller to a HIDC that abuses arose where the vendor was "related" to the financer. By this term it was meant that the vendor was affiliated by some sort of common control with the lender or that he referred the buyer to the lender in such a manner that the buyer almost had to obtain the financing from the referrent. The lender in these circumstances did not need the HIDC status since he could claim that the formalities of the borrowing were those of a direct loan and whether the goods and services were defective was not his responsibility.

On the other hand, proponents of the UCC asserted that abolition would result in increased costs and lower availability of consumer credit for the public at large, because the lender would, in effect, have to guarantee vendor performance if the insulation of the doctrine were absent. Put otherwise, credit would contract and/or become more expensive since a "premium" would have to be charged by a pass through to the buyer for the lender's guarantee. These advocates also noted that buyer loan rates and charges were controlled by State usury laws and that, during periods of high interest rates, these ceilings would add considerable strain to the granting of credit that did not carry the HIDC shelter. They further maintained that new, small businesses could not finance their sales of merchandise and services to consumers if they could not negotiate promissory notes given them in exchange for products to holders in due course.

All these questions, plus many more affecting consumer credit, were covered in the report of the National Commission on Consumer Finance (NCCF), "Consumer Credit in the United States" which was made public in January, 1973. Among the recommendations are proposals to abolish the holder in due course doctrine and to restrict vendor-related loans. However, the NCCF also urged on p. 167 of the report that at least four years elapse before Congress begin to act and then only if the States had not moved on the study groups' conclusions. (The Commission acted on HIDC a full year prior to that date.) Moreover, the NCCF also declared on p. 24 that diminution of lenders' recovery remedies should not be attempted piecemeal but should be coupled with States allowing creditors to charge higher rates.

"* * * Under existing rate structures and legal restraints on new entry into certain consumer credit markets (Chapters 6 and 7) any abolition or restriction of creditors remedies or collection practices may result in reduced credit availability or high rates or both, to segments of the consuming public. Thorough analysis of Commission Survey findings support this hypothesis * * *

Recommendations regarding remedies are inextricably interwoven with Commission recommendations on rates and availability (Chapters 6 and 7). It is imperative that the relationship be realistically assessed—the higher the rate the fewer remedies needed and vice versa. States may decide to narrow or broaden Commission recommendations on remedies and contract provisions. But they should recognize that modifications are likely to affect the cost/availability of consumer credit."

Prior to and after the NCCF's report, State legislatures showed considerable interest in modifications of the doctrine. Indeed, while the rate restructuring that the Finance Commission proposed has not occurred—sometimes due to State constitutional requirements, as in Tennessee which has just called a constitutional convention to consider specifically raising usury ceilings—or was not needed in some jurisdictions, the overall status of the holder in due course doctrine at the State level no longer suggests that Federal intervention is warranted. By our count, there are only five jurisdictions which have not legislatively modified the doctrine. The others have tailored their alterations to the "classical" approach in myriad manners to meet their needs.

II. EFFECTS OF THE RULE ON STATE LAW

Against this general background, the Commission moved on November 14, 1975 to impose its own standards on the balances between buyer, seller, and creditor suggested by the National Commission on Consumer Finance and those struck by the forty-five jurisdictions.

The methodology was to determine that it was an unfair or deceptive trade practice not to include a notice in an instrument of consumer debt that read in at least 8 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.

The same notice was required in instances where the creditor and the seller were "affiliated" or where the seller "referred" the buyer to the "creditor" even though the creditor was "nominally" making a direct loan to the buyer, taking the wares to be purchased as collateral. With the insertion of the notice, creditors would be precluded from becoming HIDCs or, for that matter, direct lenders since they could not meet the criteria of the UCC that a holder had to take without notice. Moreover, the terms of the FTC's stipulations were to be integrated in the contract that set the levels of potential liability.

The effects of the rule on the structures of State law were devastating on a number of scores and, despite certain subsequent efforts by the Commission to straighten out the ambiguities created, it remains so today. We would like to enumerate a few of these problems.

The first source of confusion was the FTC's mandating through the f[illegible] terms of the contract, of the consumer's right not only to defend against effor[illegible] at collection by claiming a faulty product but to assert agains the creditor, including one who was not even trying to collect on the note. In other words, the "guarantee" imposed on the holder means he can be sued affirmatively because of the shoddy products of the seller. In the majority of jurisdictions, this materially expands the liabilities contemplated by State legislatures.

The second was the fact that the Commission's notice does not contain any formula to determine when a creditor's liability might cease. Thus, in the case of a mobile home purchase on, say, a seven year financing arrangement, the creditor's liability continues throughout the life of the loan. By our count about 18 states have provisions limiting the life of creditor liability directly in terms of time. Others have other kinds of restraints which indirectly arrest liability.

The third is that the FTC's terms of contract set a high potential limit of affirmative recovery. In other words, not only can the obligee defend against further payments, he may also sue to recover under the following formula: "Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder." In all but two states, New Hampshire and New Jersey, the potential judgment excludes the possibility of the creditor being penalized in tort for personal damages caused by faulty products. Under the Commission's rule, since the seller could be liable for such injuries, the creditor shares, to a degree, in that potential exposure. Moreover the financier also becomes liable for the amount of any down-payment or interest paid to the seller by the buyer. This seems to include the value of trade-ins. Again, only New Hampshire and New Jersey have clearly subjected the third party lender to such a broad range of factors that he must calculate into his "premium" or into whether he wants to write the "insurance" policy at all.

A fourth consideration is that the Commission has maintained that the claims and defenses which will arise under the terms of the contract are to be settled under State procedural and evidentiary laws and that it is not its intention to modify these. In many jurisdictions, however, this would render the whole regulation a nullity if the creditor were cautious and did not, himself. sign the instrument, as he need not. This is so because under the Statute of Frauds, a general evidentiary provision in effect in most States, no liability is enforceable against a third party (the financier) in the absence of a writing signed by the creditor who in such case can assert that the liability is barred by the Statute of Frauds requiring promises to answer for the default of another to be in writing and signed by the party to be charged. (See, for example, Code of Virginia, § 11–2.)

A fifth problem relates to the Commission's understanding of recourse agreements. These are, generally speaking, arrangements between sellers and creditors to the effect that if a buyer refuses to pay the creditor, the seller must reassume or repurchase the obligation from the creditor. This immediately poses problems for small lenders. It is perhaps best explained on page 17 of the Federal Reserve Board's Staff's comments on the rule which is attached under a cover letter from Board Chairman Arthur Burns as Appendix A of this testimony.

"Additionally, the Commission rule will have to fit into the broad framework of each State's laws, and such interplay may pose many potential problems. An example of such State law difficulties concerns the problem of recourse arrangements of creditors with small lenders. The rationale behind the Holder Rule assumes that creditors and sellers will enter into some type of recourse arrangement so that creditors will not be required ultimately to bear the cost of seller misconduct. However, many States have "small loan" laws which prohibit any person from owing or potentially owing more than a statutory amount (the small loan limit) to a small lender. If a mall lender enters into several purchase money loans for consumers' purchases from a specific seller and also has a recourse arrangement with that seller, the seller will also potentially be liable to the small lender for an aggregate amount in excess of the small loan limit. These laws may prevent small lenders in some States from protecting themselves through recourse agreements with sellers as envisioned by the rule and the rule does not provide any other means for creditors to protect themselves."

The original, unclarified 16 C.F.R. 433 did not speak very much on its interplay with State law. The FTC's staff guidelines, which became available on May 4, 1976, ten days before the effective date, were issued under a disclaimer as to their authoritativeness and consequently of very little use. Finally, on August 3, 1976, the Commission itself published a "Statement of Enforcement Policy" which apparently went into immediate effect but which was tagged with a comment period until October 15, 1976. Presumably, it has some sort of binding stature. Most of the August 3 pronouncement is devoted to disentangling the question of when a seller must put the notice in the obligation if it is a situation in which he refers buyers to creditors or if he has reason to believe the buyer might have come to him, the seller, already in funds from a creditor with whom, he, the seller, has a business relationship.

However, the difficulties surrounding the State law problem were substantially aggravated by the FTC's holding that:

> The manner and procedure by which a buyer may assert claims and defenses is governed by the terms of any contractual obligation and by applicable state law. Federal Register, Vol. 41, No. 159, Monday, August 16, 1976, 34595.

One is therefore caught in the conundrum of not being able to determine whether the Commission has or has not pre-empted state law and, if it has, to what extent. Since the rule places parties that finance consumer paper in the

insuring of goods and services business, all the way from automobiles to, say, orthodontal work, it seems requisite that the degree of risk which the rule imposes should be clear, and it is not.

III. THE MANNER AND LEGALITY OF RULE IMPLEMENTATION

It is quite obvious that with the passage of Title II of the Moss-Magnuson Act, 15 U.S.C. 57a, the Congress delegated a massive legislative power to the FTC while at the same time cutting back on claims to even more dominion which the Commission had made good in the Federal courts. Therefore, we believe it's extremely important for this subcommittee, with its responsibility for reviewing the Commission's activities, fully to be aware of how the deputization is being handled by the FTC which, it is no secret, would have preferred to retain its wider license. A review of 16 C.F.R. 433's adoption, therefore, seems in order.

The Commission promulgated pursuant to Section 6(g) of the FTC Act (15 U.S.C. 46(g) (Supp. 1976)). However, this was after the Congress had enacted Moss-Magnuson. That Act created a new section 18 of the FTC Act, 15 U.S.C. 57a, which specifically granted to the Commission the power to make substantive trade regulation rules to protect consumers against unfair or deceptive trade practices in or affecting commerce, subject to procedural constraints. In doing so, the Congress revoked the Commission's power to enact such rules pursuant to Section 6(g) which had previously been recognized. See *National Petroleum Refiners Ass'n* v. *FTC*, 482, F. 2d 672 (D.C. Cir., 1973), cert. denied 415 U.S. 951 (1974). It did so in Section 18(a)(2) (codified as 15 U.S.C.A. 57a(a)(2) (Supp. 1976)):

> (2) The Commission shall have no authority under this Act, other than its authority under this section, to prescribe any rule with respect to unfair or deceptive acts or practices in or affecting commerce . . .

However, Congress made an exception to this withdrawal where the proceedings under a proposed 6(g) rule were substantially completed at the time of enactment:

> . . . Any proposed rule under section 6(g) of such Act with respect to such presentation of data, views and arguments was substantially completed before such date may be promulgated in the same manner and with the same validity as such rule could have been promulgated had this section not been enacted. (15 U.S.C.A. 57a, note)

Consequently, the agency had the ability to act under the wider, pre-Moss-Magnuson law only if a substantial presentation of data, views, and arguments had been made with respect to that rule.

It is our contention that the presentation of data, views, and arguments on 16 C.F.R. 433 had not been substantially completed at the time of the passage of the Moss-Magnuson Act because the Commission, by its own admission eleven months later, had not fully explored (1) whether creditors engage in the acts or practices which the holder rule is designed to alleviate, (2) whether inclusion of creditors in the rule was necessary for proper enforcement, and (3) the effect of the inclusion of creditors. Presently the rule only works directly on sellers although it obviously has a very heavy indirect effect on creditors who buy consumer paper. See 40 Fed. Reg. 53,530. In short, by the Commission's own admission it had not considered, prior to adoption of Moss-Magnuson, rudimentary ramifications of issuing a rule to "preserve buyers' claims and defenses."

Be all that as it may, the more important point is that though the Commission had, indeed, held some hearings and received comments on the general subject of holder in due course, it did not observe the spirit of the Congressional signal in the Moss-Magnuson Act that the Commission should not function on a carte blanche basis. Rather, it should operate under a number of procedural protections aimed at assuring that the evidentiary and legal elements upon which it bases substantive statutes are of high quality and not a set of unverified and uninvestigated "horror stories" nor wanting in jurisprudential considerations. Perhaps, most important among these is the right of cross-examination. In any case, if the Commission had followed Moss-Magnuson procedures, it is more probable that what ensued after November 14, 1975, would not have occurred since these safeguards, one has been led to hope, will compel the Commission to be thoughtful and thorough when legislating.

It was immediately clear the rule was so ambiguous it would be unworkable. However, not until May 4, 1976, ten days prior to the deadline for a regimen that would have great impact on an installment market of better than $150 billion, were there significant steps for clarification in the form of staff guidelines. However, they contained a disclaimer which neutralized their utility:

> 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.

On May 5, 1976, Arthur Burns, Chairman of the Federal Reserve Board, submitted a formal request to the FTC to delay implementation until the numerous confusions which his staff saw could be ironed out. Some we have touched on. As to others, we have the Chairman's letter and the Board's staff memorandum, attached as Appendix A, to speak for themselves. Not until August 13, 1976, nine months after promulgation of 16 C.F.R. Part 43, did the FTC itself speak in a manner that could be considered authoritative via the aforementioned Statement of Enforcement Policy.

This latter document, as already explained was primarily addressed to trying to explain when a seller had to include the notice if he was affiliated with a creditor or referred buyers to a lender, the provisos which Chairman Burns had found among the most nebulous. We have already covered the fact that it did not alleviate the many problems surrounding interface of 16 C.F.R. 433 with state frameworks. One might also add that it failed to uncloud a number of other problems, such as whether agricultural credit was in the ambit of the rule—a difficulty which is mentioned on page 14 of the Board's staff memo.

However, perhaps the greatest predicament which began to surface with the August 13 interpretation arises from its explanation of when the Commission's words of guarantee are essential in a certain referral or affiliation situation, i.e., the one where the vendor and creditor are connected; the buyer goes to the creditor on his own, without having any reliance on the vendor-creditor relationship; and, quite conceivably before even going to the vendor, obtains a loan which he then uses to make purchases from the seller. The Statement of Enforcement Policy addresses these circumstances as follows:

> 7. A seller has a referral or affiliation relationship with a creditor. A buyer, on his own, goes to the creditor to obtain a loan to purchase an item from seller. The Notice must be in.
>
> Comment—If a Seller has an arrangement whereby he refers his customers to a creditor, all loan contracts between that creditor and a borrower who uses the proceeds to purchase goods from that seller must contain the Notice. The Notice must be in whether the particular loan contract was the product of a referral or not.

Already, sellers, in order to protect themselves from liability, including FTC civil fines, have begun to ask customers about the sources of monies even when the customer is in funds at the time of purchase. They are doing this because if it should occur, quite extraneously, that unbeknownst to the buyer, vendor, and lender, there is a vendor-lender relationship, the vendor is still subordinate to 16 C.F.R. 433. The Commission attempted to modify this result in the Enforcement Policy by describing an abstruse set of "objective conditions" under which the merchant would not have to make such inquiries. However, rather than meet this scenario, it is going to be much easier and, indeed to protect against violation, necessary for the dealer to ask the consumer: "Where did you get this money?" We understand letters have begun to appear in the off es of some Senators from buyers who are upset over having to disclose this information on the grounds of privacy invasion.

While these dilemmas prove troublesome enough, IBAA is particularly worried about how they will be treated in the FTC's education effort. On p. 52526 of the November 14, 1976, Federal Register, the agency declared:

> The Commission also anticipates a substantial consumer education effort on the part of its staff after enactmen of this rule. We will direct our staff to take reasonable action via the media to publicize the existence of the rule and what it means to consumer buyers. Announcements directed at the Spanish community will appear in the Spanish language. As legal services offices, consumer groups, and individual consumers test the rule by periodic lawsuits against creditors and sellers, and as the courts thus become more receptive and accustomed to considering competing equities in consumer sale transactions, the rule will enjoy increasing knowledge and use on the part of all consumers.

This Association feels very strongly that before the Commission begins to stir up litigation through the media, that sellers and creditors have a right to some education as well. So far, we are just beginning to get, at least in official Commission statements, the full import the regulations for actual daily commercial operations. Distributing this information in comprehensible form to the Nation's business community is another matter and, considering the size of the task, the surface has not even been scratched. IBAA hopes that this subcommittee, at a minimum, will take appropriate action to compel the agency to assist the small businessman in understanding the decree.

Two additional points relating to legality and implementation in the context of the Commission paying heed to the tenor of the grants of power in Moss-Magnuson are worthy of mention.

First, the Commission excluded bank cards from 16 C.F.R. 433. However, in doing so, it was quite obvious that the agency considered it within its jurisdiction to include them if it so chose. For instance, on page 53517 of the Federal Register on the date of promulgation, it said:

> The recently enacted Fair Credit Billing Act invalidates waivers of defenses in credit card contracts where a card is used to make a purchase of more than 50 dollars within the state where the user resides or within 100 miles of the place where the card is issued. The Commission has no reason to believe that this legislation *will not afford adequate protection to consumers at the present time.* (*Emphasis added.*)

This comment, when coupled with explanatory material immediately preceding it, is a tacit claim that the Commission can interpret Title II of Moss-Magnuson so as to allow it to overrule Congress on subjects about which the National assembly has spoken in quite specific terms. Moreover, the Commission seems to have no problems with variances from established trends of Congressional policy. For instance, the Fair Credit Billing Act, at 15 U.S.C. 1661i, specifically excludes the tort claims of a credit card holder (a buyer) against a credit card issuer (a bank) which was used to acquire goods or services from a merchant. Moreover, that statute specifically adopts the stance that creditor exposure for flawed goods and services is restricted to outstanding balances which are owed at the time the borrower notified the bank of claims or defenses. In other words, the bank is not responsible with regard to money already paid on account. 16 C.F.R. 433 is contrary to these approaches to lender accountability.

Second, and to return to the imbroglio concerning State law—through in the context of Congressional intent as to its place under the Moss-Magnuson Act—it seems patently true that both chambers did not want the Commission to move without giving, at least, heavy consideration to the consumer protection policies and legal structures of the States. H. Report 93–1107 is illustrative of this purpose:

> The amendments made by section 201 will permit more effective regulation of the marketplace by the FTC by placing within its reach unfair or deceptive acts of practices which, although local in character, affect interstate commerce. The expansion of the FTC's jurisdiction made by this section 201 is not intended to occupy the field or in any way preempt State or local agencies from carrying out consumer protection or other activities within their jurisdiction which are also within the expanded jurisdiction of the Commission.

Manifestos such as this make it plain that Congress was, at a minimum, telling the agency to treat states' rights with great deference when using the mandate of the Act. They lucidly demonstrate that no authority was granted to the FTC to federalize large areas of law customarily left to the states, something which is not quite apparent they plan to do, given such indications as this rule and the codification project mentioned on page 4 of this testimony.

In summary, the FTC's first truly major venture in imposing its standards on core commercial practices through legislative rulemaking has been a "poor show" insofar as demonstrating a willingness to hew to the U.S. Code and Congressional purpose and an ability to communicate Commission actions coherently into the corpus of the law. Perhaps more alarming, however, are the conspicuous, though indirect, claims to as much dominion over commerce as is technically feasible under Moss-Magnuson and a decided effort, to return as far as possible, to the broader plains of power that existed prior to that Act. If this is what Congress is going to have to contend with in the future, the IBAA suggests the FTC Act might have to be further modified to keep the Commission in line with Congressional will.

IV. RECOURSE FINANCING

To repeat a previously mentioned quote of the Federal Reserve's staff memorandum:

> The rationale behind the Holder Rule assumes that creditors and sellers will enter into some type of recourse arrangement so that creditors will not be required ultimately to bear the cost of seller misconduct.

We will not here enter into a detailed discussion of the complicated field of recourse financing. However, a few observations are in order since the Commission has placed so much reliance on it as a mechanism with which to cushion lender reaction.

First, it must be realized that, heretofore, there has been a great deal of diversity in recourse arrangements. Some of them are conducted under a blanket agreement between a dealer and a lender. Others are organized on a per loan basis. In some cases, they are combined with actual reserves of the dealer held by the lender. In other words, he assents to keeping a deposit of a given size with the lender to cover losses on paper the lender holds which goes sour. In other cases, there is no dealer reserve.

Second, this diversity is due to a combination of factors resting on state or federal law, the cash needs of the dealer, the overall financial stability of the dealer—quite outside of the quality of the goods he sells—and the general economic condition of a community.

Third, we doubt that the Commission devoted much time to surveying how these arrangements work in small lending institutions. In larger firms, they tend to have uniform characteristics, but this is not the case with smaller institutions that try to match their services to the diverse needs of smaller businesses.

Fourth, since the rule envisions heavy reliance on recoursability which, in turn, is dependent upon actual flows of notes and contracts between merchants and lenders, it is very discriminatory against the referral method of doing business. In other words, heretofore, recourse was simply not germane to referrals since the referred loan was made directly by the lender and, consequently, recourse rarely occurred since there was no documentary nexus between vendor and creditor. Dealer reserves were equally uncalled for. However, under the Commission's scheme, such a paper flow will have to be instituted and reserves will become more commonplace. Indeed, we cannot see how typical referral arrangements will remain at all. Since referrals did not involve dealer expenses in the transaction, they were often cheap methods of financing for the consumer and should have been treated as such by the Commission.

Fifth, IBAA is concerned over the interplay of the recourse agreements contemplated by 16 C.F.R. 433 and a number of banking statutes. For instance, 12 U.S.C. states:

> No national banking association shall at any time be indebted, or in any way liable, to an amount exceeding the amount of its capital stock at such time actually paid in and remaining undiminished by losses or otherwise plus 50% of the unimpaired surplus fund, except on account of demands of the following nature: (Emphasis added.)

The subsequent list does not incorporate the type of guarantees contemplated by the FTC. Consequently, if the Commission's holding is overlaid on this clause, it would mean a bank's consumer lending portfolio partakes, to an indeterminant degree, of a potentially forbidden concentration of liability. At some point, then, a national bank would have to curtail granting consumer loans because they would exceed the restrictions of 12 U.S.C. 82.

While it is true that banks in many states are subject to circumscribed exposure for product failure by their current HDC law, as covered above, that burden is very rarely fashioned as an explicit creditor warranty. Rather, it is merely a provision of State law that yields a potential defense or cause of action. Another national bank statute which could cause "technical" violations of the law and which is frequently paralleled in State structures governing State banks, is 12 U.S.C. A 24 (see notes 200 and 201) which forbids a national bank to guarantee the performance of contracts of another party. Again, though national and State banks are vulnerable under certain presentments at State law, it is an unexplored question when the contract itself includes words of surety by the bank for both the claims and defenses of the buyer, including responsibility for trade-in and downpayment value and torts.

IBAA is, for these reasons, very dubious over whether recourse arrangements can be worked out with the ease and economies that the Commission predicts

are possible, and, in any case, they are really only feasible with dealers who are in all round strong positions. In other words, the small, legitimate businessman will find increasing difficulty in acquiring financing for his sales.

V. ECONOMIC IMPACTS—IBAA HDC SURVEY

A survey of IBAA's 7,300 member banks conducted August 7, 1976 to determine the impact of the FTC's holder in due course regulations produced 1,784 responses. The survey sought to determine the impact of the HDC regulations on new and used automobile loans, mobile home loans, small business loans as well as the anticipated future effect of the regulations on these loans and on the cost of these loans to consumers for our members. It is to be emphasized, the study was *not* contrived to gauge influences on GNP or other indices of national economic trends.

With respect to loans on automobiles, the survey revealed that between May 14, 1976 when the HDC regulations became effective and early August, 1,097 banks, or 61 percent of the banks responding, had curtailed lending due to these regulations. With respect to loans on new automobiles 76 percent of the banks reported loan curtailment up to 30 percent. The curtailment of lending on used cars as a consequence of the HDC regulations was more severe. This is revealed by the fact that 85 percent of the reporting banks had curtailed these loans by as much as 50 percent. While 51 percent of the banks reported curtailment of mobile home loans up to 50 percent, almost 40 percent of these banks either stopped making these loans or reduced them by 90 percent or more.

As to those banks which did not report a curtailment of their lending since the issuance of the HDC regulations, most of them took steps to reduce their liability by the use of recourse agreements (588 banks) and/or by tightening their lending policies (758 banks). Furthermore, most of these banks (692) anticipated that the HDC regulations would force them to curtail their lending in the future and that as a consequence, new small businesses and purchasers of used automobile and mobile homes would be most severely affected.

In response to the question: "Has the increased liability you are exposed to as a result of the HDC regulation forced you to increase your lending rates," only 326 of the 1,501 banks which answered that inquiry replied affirmatively. However, the survey indicates that at least 600 of these did not engage in buying or selling consumer paper and, thus, would not have felt the full impacts of the rule.

In response to the question: "If you have not curtailed your lending at present as a result of the HDC ruling, do you anticipate having to do so in the future,?" 692 of the 1,005 banks which answered that question responded affirmatively.

VI. SUMMARY

In this testimony, IBAA has attempted to make four major points.

First, small businessmen, such as those in our Association, are being forced into a completely untenable position by the proliferation of federal regulatory demands that are incomprehensible; in excessive flux; often subject to criminal indictment and many varieties of civil penalization; and frequently founded on very questionable economic appraisals excusing their adverse effects on the public at large. The FTC's rule, Preservation of Buyers' Claims and Defenses is an outstanding example of this arbitrary and irrational approach to governing and flies in the face of the basic maxim of American jurisprudence that the law should be fundamentally intelligible and predictable.

Second, with respect to the FTC specifically, we have pointed out that one of the most important features of the rule is that the Commission is using it as the foundation for the pyramiding of power to the extent it will be able to federalize, by its administrative decrees, large areas of law hitherto left to the decisions of local authorities and, indeed, is capable of overruling Congress on issues to which the National assembly has spoken very specifically. We have used its attitudes toward the Federal Fair Credit Reporting Act as witness of this conclusion.

Third, and in support of the above two points, the testimony has recounted the devastating effects of the regulation on State laws and the confusing manner in which it has been implemented. In this respect, we have been particularly critical of the fact that the rule imposes a duty on lenders who engage in indirect lending to write a form of insurance on an extremely wide variety of consumer goods and services and that, to date, the FTC has not described the coverage of such a policy.

Fourth, we have summarized a survey of our 7,300 member which produced 1,784 replies. In our opinion, they indicate lender reaction which impeaches the rule on the grounds that its utility cannot be justified given the disruptions it is causing for consumers and small businessmen obtaining financing.

It is IBAA's conclusion that Congress should, with respect to the Commission in general, begin to provide it with more explicit and restrictive guidelines on its powers. With regard to the rule itself, we believe that, at a minimum, it should be suspended until the Commission has reviewed it under the procedural safeguards of the Moss-Magnuson Act and with due consideration for the position of the states in the consumer credit arena.

APPENDIX "A"

CHAIRMAN OF THE BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., May 5, 1976.

Hon. CALVIN J. COLLIER,
Chairman, Federal Trade Commission,
Washington, D.C.

DEAR CHAIRMAN COLLIER: I am writing to convey the Board's urgent concerns regarding the likely impact of the Commission's Trade Regulation Rule entitled "Preservation of Consumers' Claims and Defenses." Based upon numerous comments received from lenders and our staff analysis of this rule, we believe that the consumer credit business may be seriously disrupted if the rule goes into effect on May 14, 1976, as scheduled. Such disruption, if it occurs, could have harmful consequences for the economy.

The Board did not investigate the issue in detail or comment when the Commission initially proposed the rule because only sellers appeared to be affected and no regulatory action by the Board was required. When the Commission adopted the rule and also proposed an amendment to cover creditors, it triggered the Board's responsibilities under the Federal Trade Commission Improvement Act. Therefore, the Board on February 3 published for comment a substantially similar version of the Commission's proposed amendment relating to banks.

The Board received 1,080 letters of comment on this proposal, of which only 8 favored it. The adverse comments, many of which were quite specific in character, brought to the Board's attention the adverse ramifications of implementing the rule as written at present.

The most serious problems concern the definition of a "purchase money loan." The Board believes that the definition is overly broad and will create uncertainty about the applicability of the rule to several important categories of consumer credit. The rule as drafted will greatly complicate the signature loans that banks and other financial institutions commonly make to their most credit-worthy applicants. The rule could also unduly complicate overdraft checking account systems, which millions of consumers are using today.

The Board is concerned also about the absence of any time limit on the duration of the creditor's liability. This may make creditors hesitate to offer long-term loans to finance home improvement projects or mobile home purchases. In addition, a creditor's liability for claims for personal injury and property damage arising from the goods or services purchased should be eliminated, as it is in credit card purchases under the Truth in Lending regulations.

I am enclosing a commentary by the Board's staff elaborating on these and other issues raised by the rule.[1] The comments propose remedies to resolve many of the problems related to these issues, which we believe merit your serious consideration.

The Board is sympathetic to efforts to promote consumer credit terms that are fair to both borrowers and creditors. It appears to us that this goal would be served more effectively by issuing simultaneously the rule applying to sellers and the rule applying to creditors. Accordingly, the Board strongly urges that the Commission defer the May 14 effective date of the rule adopted for sellers so that the necessary clarifications and technical refinements can be considered for both rules.

Governors Jackson and Partee, on behalf of the Board, will be pleased to meet with you and other members of the Commission if further discussion of this important matter is desired. Of course, our staff will be glad to work actively with the Commission's staff in examining further our concerns regarding the Commission's rule.

Sincerely yours,

ARTHUR F. BURNS,
Chairman.

[1] See p. 182 for text of enclosure.

Mr. BRODHEAD. Thank you. Under the rules of the committee the gentleman from Nebraska is entitled to be recognized for 5 minutes.

Mr. MCCOLLISTER. Does the Chair have a stopwatch?

Mr. BRODHEAD. The Chair is looking at the clock.

Mr. MCCOLLISTER. I can do it very readily in 5 minutes, I think, Mr. Maddox, and I would take the first part of that 5 minutes to compliment you and your association for some excellent testimony. I refer in particular to two parts of it that seemed to me to stand out. The survey that the independent bankers have taken match almost the survey I took of Nebraska bankers, many of whom I suppose are affiliated with your association since we're basically a small-bank State. I think the results of that survey would indicate the impact is going to be something that we're going to have to contend with.

Secondly, I want to go to what I think is the most interesting part of your testimony and that is the comment you made that the FTC did not follow the Moss-Magnuson Act procedures which you believed they were required to do. The FTC last week testified that they followed, if not the letter, certainly the spirit of the act in that all interested parties were given the opportunity to both fully testify and cross-examine witnesses during the various sets of hearings that the FTC held. How do you respond to that?

Mr. MADDOX. If I may, I'd like to refer this to my associate, Mr. Peterson. He's very well acquainted with the whole procedure back to 1971 when it was initiated.

Mr. PETERSON. Well, I think one has to return to the history of this regulation, back to 1971, when the rule was first proposed and the banking community began to address the issue. Given analysis in 1971—and at that time I was the assistant counsel of the American Bankers Association and did considerable work in this field—the rule would have had some much more patently absurd results, than the present one. For example, the check clearing system would have been impaired since the legal structure that underpins it would have collapsed. The rule even went so far as to say that whenever you had a credit card transaction—you know those little receipts that you get—every one of those for every purchase—we even read it so that it applied to food in restaurants—you would have to have appended to it a rather large statement: "Do not pay this bill if you were dissatisfied. There was even a good deal of discussion of making it in the language of the purchaser. One might allow how that might be done in Spanish, but in San Francisco we found some trouble with Chinese. Quite literally that was the situation.

Most of the comments at that time when dealing with the specifics of the rule dwelt on just analyzing the legal consequences. The statements were also made in the conext of litigation that was then in process, the National Petroleum Refiners' suit, and the fact that early renditions of the Moss-Magnuson Act were moving through this subcommittee and over on the Senate side. The context was completely different in 1971–73. At the same time, yes, there were hearings and many members of the financial community did appear and comment. I think, however, that the belief was after the passage of Moss-Magnuson, that any promulgation of a rule of this nature would be precluded by Moss-Magnuson and that they would redo the rule after a reading of the established record and after what would be legitimate cross-examination.

I well recall the cross-examination procedures that were in effect in those hearings and were drawn out of allowances that were in the Administrative Procedures Act at that time. Those cross-examination procedures were not what I would call discoursive cross-examination in which you could directly cross-examine. What it amounted to was you could submit questions to the hearing examiner which he might or might not place. As far as any direct followup to the cross, to figure out whether you were dealing with a horror story, to follow through to the conclusion of the case that was being presented, the factual situation, no, that was not there.

So I think the issues as far as the procedures under Moss-Magnuson, we thought we were going to have a crossed record before promulgation of the rule and that the Commission would not issue this kind of a regulation without going through Moss-Magnuson.

Mr. BRODHEAD. The Chair observes the time of the gentleman has expired. Thank you for being with us, Mr. Maddox.

Mr. MADDOX. Thank you very much.

Mr. BRODHEAD. Mr. James M. Goldberg.

STATEMENT OF JAMES M. GOLDBERG, COUNSEL, ON BEHALF OF THE NATIONAL RETAIL HARDWARE ASSOCIATION, PHOTO MARKETING ASSOCIATION, RETAIL JEWELERS OF AMERICA, AND WESTERN HOME FURNISHINGS ASSOCIATION

Mr. GOLDBERG. Mr. Chairman, my name is James M. Goldberg. I am a partner in the Washington law firm of London & Goldberg, and I am appearing here today on behalf of four trade associations whose members have a great interest in the Federal Trade Commission action with respect to its trade regulation rule regarding the preservation of consumer claims and defenses.

These associations, the National Retail Hardware Association, Photo Marketing Association, Retail Jewelers of America, and Western Home Furnishings Association, have a combined membership of more than 30,000 companies. Most are small, with annual sales volume well below $1 million.

The previous witnesses who have testified here today have all been from the lending community and we appreciate the opportunity to express the views of retail sellers who are subject to this holder in due course rule.

Our concerns with the so-called holder in due course rule stem not so much from its contents, but the imprecise manner in which it was written, the misleading publicity concerning its applicability, and the timing of its implementation.

Let me explain.

IMPRECISE DRAFTING OF THE RULE

The rule as promulgated makes it an unfair or deceptive act or practice to take or receive a consumer credit contract which fails to contain the specified notice in at least 10 point bold face type. The term, "consumer credit contract" is defined in section 433.1(i) to mean "any instrument which evidences or embodies a debt."

This definition is most confusing because the typical retailer operating an open-end credit plan, a term I will define later in this statement, uses a lot of instruments to evidence a debt but he may not use a contract in the context which you and I think about a contract; that is, a written document, a document signed by both parties.

For example, when you go into a retail store, be it a hardware store, a photo supply store, a jewelry store, or a home furnishings store, you open a credit account usually by filling out a credit application, and in many cases you sign nothing. Later, as required under the Federal Truth-in-Lending Act, you receive a disclosure statement detailing the terms and conditions of the retailer's credit plan. Question, is this disclosure statement an instrument evidencing a debt?

When you make a purchase, you typically sign a sales slip. Now I don't know how many of you have read these sales slips recently but very commonly over the line where the X is for your signature there will be some language which says, "I hereby agree to pay for this purchase under the terms and conditions of the—name of the store—credit plan." Question, is that an instrument evidencing a debt?

At the end of the month, you receive a statement from the retailer detailing your purchases, and totaling the amount owing. This is the monthly statement that we're all familiar with. Question, is this an instrument evidencing a debt?

We submit that the Truth-in-Lending disclosure statement, the sales slip and the monthly statement all constitute instruments evidencing a debt and, under the terms of the rule, the 10 point bold face disclosure would have to appear on all of these documents.

Such a requirement is, in our view, a clear example of regulatory overkill. The Federal Trade Commission apparently thinks so, too, because when it issued staff guidelines on the rule it indicated that the notice only had to appear on one document and not on each and every one and this, in our view, clearly contravenes the express language of the rule.

Incidentially, it should be noted that these staff guidelines were issued on the very day the rule was scheduled to take effect. Mr. McCollister, I think, pointed out last week at the hearings that the guidelines had a May 4 date on them and, in fact, they did have a May 4 date but it wasn't until May 14, which is the day the rule took effect, that they appeared in the Federal Register and therefore, became an official document for whatever status they had. The timing obviously couldn't have been worse if the FTC was really trying to help facilitate compliance.

MISLEADING PUBLICITY

The second problem faced by retailers in connection with this rule is the misleading FTC publicity surrounding its promulgation.

Let me begin by explaining that retailers generally offer two types of credit. So-called open-end credit which I referred to earlier is the type with which most of us are familiar. It's often called revolving credit, option credit, or department store credit. It's the type of credit typified by the charge plates you and I carry in our wallets, where we have a continuing account with a retail store and we can make purchases from month-to-month.

The other type of credit is closed end or installment credit. This is term of art which identifies the kind of credit extended for a home purchase, an automobile purchase, or some types of furniture purchases. A fixed amount is borrowed or owed and a repayment schedule is worked out; 36 month financing on an automobile or 10 year financing on a home improvement situation or 20 year financing on a home mortgage; fixed monthly payments, fixed amount borrowed.

When the FTC promulgated the holder in due course rule in November 1975, it led most everyone to believe that the rule was only applicable to the latter type of credit; that is, installment credit, notwithstanding the fact that the rule itself, as I have explained earlier, applied to any instrument evidencing a debt.

To illustrate, let me quote from the first paragraph of the FTC news summary No. 48–1975, dated November 21, 1975. This is the agency's weekly compilation of announcements and press releases made during the previous 7 days. The news summary says in part:

> The FTC has adopted a trade regulation rule designed to protect consumers' rights against sellers when consumers purchase on credit and become obligated to make payments to a financial institution.

The agency compounded the error in the 10th paragraph and here it gets worse:

> The Commission's rule will require sellers to insert a specific notice in any installment sales contract used to finance retail purchases.

Since most retailers with open end credit plans don't sell or assign their accounts to third parties, as is more often done with installment credit contracts, is it really any wonder that most retailers read this and concluded that the rule is inapplicable to them? In addition, no less an authority than Consumers Report in May of 1976 carried a one page story captioned, "New Rights When You Buy on Time" and in this story what Consumers Report said in part was:

> An FTC rule that goes into effect on May 14th requires merchants to include this notice in all installment sales contracts they write for customers.

Elsewhere in this story there is a discussion of the holder in due course doctrine, all couched in the context of installment sales contracts and for retailers that means the type of closed end contracts that I talked about before.

Now, with respect to this confusion, an FTC staff letter was written in mid-December, indicating that the rule was, indeed, applicable to open-end credit situations, but the author of the letter was an agency attorney with little authority to make such determinations and it simply constituted a staff letter which was not even couched with the usual FTC disclaimer about the letter representing the best view of the staff and is not an expression of agency opinion. It was not until the staff guidelines were published on the day the rule was to take effect that the applicability to open-end credit was formally and officially announced.

Now, to be fair to the FTC, let me say there have been meetings held with officials of the Bureau of Compliance to discuss this problem, and the problem with making the rule applicable to consumer credit contracts which are not intended to be assigned to third parties.

Out of these meetings, it is our understanding that some retail organizations have filed a formal petition for exemption with the FTC asking that the applicability of the rule be suspended in the case of retail credit transactions meeting certain criteria. That petition has not yet been published for comment in the Federal Register.

In the meantime, the rule has been in effect for more than 5 months, and retailers are still as confused today about its scope and applicability as they were last November. The FTC has made little effort, save for a mid-May letter to many trade associations containing the text of the rule itself, to explain some of its intricate details. This letter was written on May 13th, the day before the rule was to take effect.

Mr. Brodhead. Mr. Goldberg, I'm afraid at this point that we're out of time and I'll have to ask that the balance of your statement be entered into the record.

Mr. Goldberg. That's fine. Thank you very much, Mr. Brodhead.

[Mr. Goldberg's prepared statement follows:]

STATEMENT OF JAMES M. GOLDBERG, ON BEHALF OF THE NATIONAL RETAIL HARDWARE ASSOCIATION, PHOTO MARKETING ASSOCIATION, RETAIL JEWELERS OF AMERICA, WESTERN HOME FURNISHINGS ASSOCIATION

My name is James M. Goldberg, and I am appearing here today on behalf of four trade associations whose members have a great interest in the Federal Trade Commission's action with respect to its Trade Regulation Rule regarding the Preservation of Consumer Claims and Defenses.

These associations—the National Retail Hardware Association, Photo Marketing Association, Retail Jewelers of America, and Western Home Furnishings Association—have a combined membership of more than 30,000 companies. Most are small, with annual sales volume well below $1 million.

Our concerns with the so-called Holder in Due Course Rule stem not from its contents, but the imprecise manner in which it was written, the misleading publicity concerning its applicability, and the timing of its implementation.

Let me explain.

IMPRECISE DRAFTING OF THE RULE

The rule as promulgated makes it an unfair or deceptive act or practice to take or receive a "consumer credit contract" which fails to contain the specified notice in at least 10-point bold face type. The term "consumer credit contract" is defined, in Section 433.1(i), to mean: "*Any instrument which evidences or embodies a debt* . . . (emphasis added)."

This definition is most confusing because the typical retailer operating an open-end credit plan—a term I will define later in this statement—uses a lot of instruments to "evidence a debt", but he may not use a "contract", in the context which you and I think of a contract (that is, as a written document).

When you go into a retail store, be it a hardware store, a photo supply store, a jewelry store, or a home furnishings store, you open a credit account usually by filling out a credit application. In many cases, you sign nothing.

Later, as required under the federal Truth-in-Lending Act, you receive a disclosure statement detailing the terms and conditions of the retailer's credit plan. Is this disclosure statement an "instrument evidencing a debt"

When you make a purchase, you typically sign a sales slip. Is this an "instrument evidencing a debt"?

At the end of the month, you receive a statement from the retailer detailing your purchases, and totaling the amount owing. Is this an "instrument evidencing a debt"?

We submit that the Truth-in-Lending disclosure statement, the sales slip, and the monthly statement all constitute "instruments evidencing a debt" and, under the terms of the Rule, the 10-point bold face disclosure would have to appear on all of these documents.

Such a requirement is, in our view, a clear example of regulatory overkill. The Federal Trade Commission apparently thinks so, too, because when it issued Staff Guidelines on the rule it indicated that the notice only had to appear on one document, and not each and every one. This clearly contravenes the express language of the rule.

Incidentally, it should be noted that these Staff Guidelines were issued on the very day the rule was scheduled to take effect, (41 Federal Register 20022 et. seq., May 14, 1976) six months after it was originally promulgated. The timing couldn't have been worse, if the FTC was really trying to help facilitate compliance.

MISLEADING PUBLICITY

The second problem faced by retailers in connection with this rule is the misleading FTC publicity surrounding its promulgation.

Let me begin by explaining that retailers generally offer two types of credit. So-called "open-end" credit is the type with which most of us are familiar. It's often called revolving credit, option credit, or department store credit. It's the type of credit typified by the charge plates which you and I carry in our wallets, where we have a continuing account with a retail store, and can make purchases from month-to-month.

The other type of credit is "closed-end" or installment credit. This is a term of art, which identifies the kind of credit extended for a home purchase, an automobile purchase, or some types of furniture purchases. A fixed amount is "borrowed" or owed, and a repayment schedule is worked out.

When the FTC promulgated the Holder in Due Course rule in November, 1975, it led most everyone to believe that the rule was only applicable to the latter type of credit, that is, installment credit, notwithstanding the fact that the rule itself, as I have explained earlier, applied to "any instrument evidencing a debt."

To illustrate, let me quote from the first paragraph of FTC News Summary No. 48–1975, dated November 21, 1975. This is the agency's weekly compilation of announcements made during the previous seven days. It says:

"The FTC has adopted a trade regulation rule designed to protect consumers' rights against sellers when consumers purchase on credit and *become obligated to make payments to a financial institution.*" (emphasis added).

The agency compounded the error in the 10th paragraph:

"The Commission's rule will require sellers to insert a specific notice in *any installment sales contract* used to finance retail purchases." (emphasis added).

Since most retailers with open-end credit plans don't sell or assign their accounts to third parties, as is more often done with installment credit contracts, is it any wonder that most retailers read this and concluded that the rule is inapplicable to them?

An FTC staff letter was written in mid-December, indicating that the rule was, indeed, applicable to open-end credit situations, but the author of the letter was an agency attorney with little authority to make such determinations. It was not until the Staff Guidelines, discussed earlier, were published on the day the rule was to take effect that the applicability to open-end credit was formally announced.

To be fair to the FTC, there have been meetings held with officials of the Bureau of Compliance to discuss this problem, and the problem with making the rule applicable to consumer credit contracts which are not intended to be assigned to third parties.

Out of these meetings, it is our understanding that some retail organizations have filed a formal Petition for Exemption with the FTC, asking that the applicability of the rule be suspended in the case of retail credit transactions meeting certain criteria. That petition has not yet been published for comment in the Federal Register.

In the meantime, the rule has been in effect for more than five months, and retailers are still as confused today about its scope and applicability as they were last November. The FTC has made little effort, save for a mid-May letter to many trade associations containing the text of the rule itself, to explain some of its intricate details.

EFFECTIVE DATE WAS POOR TIMING

Finally, a word about timing. While we are appreciative of the six-month lead time provided between issuance of the final rule and its effective date, we are less than pleased with the final timing of the rule.

Retailers have had to make numerous changes in their forms over the past several months, changes necessitated by Congressional action in passing the Fair Credit Billing Act, and the Equal Credit Opportunity Act, and changes mandated by the Federal Reserve Board in issuing regulations to implement these provisions and others contained in the Truth-in-Lending Act.

Frankly, Mr. Chairman, retailers are "snowed under" with these forms changes. We need some relief. We have suggested, for example, that forms changes dictated by these laws be made only once a year on pre-established dates, so the cost of constantly changing forms can be reduced, and paperwork sharply curtailed. Is it too much to ask that the Federal Trade Commission check with the Federal Reserve Board, which is responsible for most of the federal credit regulations affecting retailers, and establish some coordinated procedure for announcing new requirements and putting them into effect?

In conclusion, many small retailers feel that the Federal Trade Commission has mishandled this rule from the very beginning. Retailers are anxious to comply with any federal requirement, but we need specificity, simplicity, explanation, and some kind of coordination between federal agencies, in order to make these rules work. Without all these things, there will be widespread non-compliance and the consumer will be the loser.

Mr. BRODHEAD. Mr. Pohanka, we're going to have to have your statement entered into the record. We're out of time and we're unable to schedule this at another time. We will enter your statement into the record and circulate it to the other members of the committee.

Without objection, so ordered.

[Mr. Pohanka's prepared statement and attachments follow:]

STATEMENT OF JOHN J. POHANKA, PRESIDENT, NATIONAL AUTOMOBILE DEALERS ASSOCIATION

Mr. Chairman, I would like to thank the Subcommittee for this opportunity to present the views of the National Automobile Dealers Association on the Federal Trade Commission's Rule concerning Preservation of Consumers Claims and Defenses which went into effect this past May 14, 1976.

For the record, Mr. Chairman, my name is John J. Pohanka, and I am an Oldsmobile and Fiat dealer in Marlow Heights, Maryland. I am currently the President of the National Automobile Dealers Association. Accompanying me today are Messrs. Frank E. McCarthy, NADA Executive Vice President, and Kevin P. Tighe, NADA Legislative Counsel. The National Automobile Dealers Association (NADA) is a nation-wide trade association representing over 20,000 franchised new car and truck dealers in all fifty states and the District of Columbia.

This past May 14th the Federal Trade Commission's Trade Regulation Rule concerning Preservation of Consumers Claims and Defense (or Holder in Due Course Rule, as it is more commonly referred to) went into effect. I would like to note for the record that NADA had formally petitioned the FTC to delay the effective date of its rule at least until such time as the issue of whether the rule would also apply to the various creditors involved in financing consumer purchases of goods subject to the rule was decided. This petition for a delay was denied by the FTC, and the rule is now in effect.

NADA would first like to summarize its major concerns with the rule as follows:

(1) The rule has resulted in a reduction in the availability of consumer credit with respect to consumer financing of automobile purchases.

(2) The Federal Trade Commission, by administrative rulemaking, has overridden the duly considered laws of the several states with respect to the holder in due course doctrine and waiver of defense clauses, despite the fact that a majority of the states have already acted on their own to modify the previous

commercial law concerning holder in due course and waiver of defense clauses in consumer finance transactions.

(3) Only sellers are presently subject to violating the rule. There is presently no legal requirement on creditors to insert the necessary notice even in those cases where the rule clearly applies.

I. INTRODUCTION

The Holder in Due Course Doctrine has its roots in English Commercial Law of the 18th Century. The Doctrine developed to insure credit availability and protect innocent assignees of negotiable instruments taking without notice of claims and defenses of the debtor against the seller/assignor.

This doctrine, along with waiver of defense clause, became an integral part of American commercial law and is recognized in the Uniform Commercial Code which has been adopted by 49 of the 50 states (Louisiana being the sole exception). A number of states in recent years have substantially modified the U.C.C. law pertaining to waive of defense clauses and the Holder in Due Course Doctrine with respect to consumer finance transactions. This action by a majority of the states was taken in light of the modern American consumer credit economy and the need to protect consumers from unscrupulous 'fly-by-night' sellers who utilized both the HIDC and waiver of defense clauses to separate their duty to perform under the sales contract from the consumer's duty to pay for the consumer product.

Despite the steps taken by the individual states to modify the commercial law in this area to adequately protect consumers from this type of abuse while insuring a continuing steady flow of adequate credit to consumers, the Federal Trade Commission commenced a rulemaking proceeding in 1971 to abolish, by administrative fiat, the Holder in Due Course Doctrine and waiver of defense clauses in consumer finance transactions. NADA testified in both 1971 and 1973 before the Commission in opposition to its proposed rule. Our objections were twofold We felt strongly that this area of the law should remain within the jurisdiction of the individual states, particularly since a number of states had already taken action, or were about to take action, to cure the problems with which the FTC was concerned. Thus there was no need for the FTC to act at all in this area. NADA also stressed that the abolition of the HIDC doctrine and waiver of defense clauses in consumer credit transactions, particularly if no time limitation was included, would have an adverse impact on the availability of credit to consumers and would significantly add to the cost of credit, particularly for marginal credit risks.

During the period of time between promulgation of the rule (11/14/75) and its effective date (5/14/76), NADA continued to advise the FTC of its serious reservations with the rule, particularly since the rule as promulgated would apply only to sellers, not to creditors. NADA petitioned the Commission to delay the rule's effective date until the issue of whether creditors should also be included within the scope of the rule was resolved. I would note that NADA was not alone in strongly urging the Commission to delay the effective date of the rule. Chairman Burns of the Federal Reserve Board in a letter to Chairman Collier of the FTC dated May 5, 1976, also urged that the rule's effective date be postponed. Chairman Burns specifically states in his letter that:

"The Board is sympathetic to efforts to promote consumer credit terms that are fair to both borrowers and creditors. It appears to us that this goal would be served more effectively by issuing simultaneously the rule applying to sellers and the rule applying to creditors."

Chairman Burns and NADA also indicated to the FTC problems concerning the definition of a "purchase money loan" for purposes of the rule. Under the rule as promulgated, it was certainly unclear to NADA and others as to what specific activities between a seller and creditor would come within the parameters of the rule's purchase money loan situation.

Despite these problems, the FTC went forward with its rule as promulgated on November 14, 1975. As of May 14, 1976, NADA and its members have attempted, as best we can, to comply with the new FTC requirements. The following is a detailed discussion of what has occurred in the "marketplace" as a result of the new FTC rule and what steps NADA would urge the Congress to take to rectify the present disruption in the consumer credit field which has resulted from the FTC's Trade Regulation Rule abolishing the Holder in Due Course Doctrine and waiver of defense clauses in consumer credit contracts.

II. REDUCTION IN AVAILABILITY OF CONSUMER CREDIT

Immediately following the effective date of the rule NADA received a flood of telephone calls from its members making inquiries as to their proper compliance with the rule. One state in particular, Texas, had a pressing problem as to whether the ongoing procedure between a seller and lender in order to perfect a lien constitutes a business arrangement for purposes of the rule. The Commission issued an immediate advisory opinion on this issue clarifying the fact that this situation does not constitute a business arrangement for purposes of the rule. While the Commission's action with this particular problem proved most helpful to a limited segment of the NADA membership, calls continued to pour in regarding the applicability of the rule to other situations.

Letters followed phone calls. Over 1,500 dealers wrote NADA advising that their creditors were in some way modifying the terms of their traditional credit financing arrangements. These modifications ranged over a broad spectrum, including, but not limited to requiring dealers to sign strongly worded indemnification agreements. These indemnification agreements even went so far as to require dealers to indemnify creditors if there were merely consumer complaints about a car that went unresolved within a short period of time. In addition, NADA received over 150 letters from its membership indicating that their creditors were ceasing to do business with the dealership as a result of the rule. I have several of these letters which will be submitted with my statement, one of which I will read for the Subcommittee's information at this time.

NADA believes that this information which it has received from its membership is indicative of a very serious trend in the consumer credit market. With creditors dropping out of the dealer paper market the obvious result will be a restriction in the availability of consumer credit. In addition, there will be less competition within the creditor market which will also result in a lessening of credit availability to consumers. NADA believes the Subcommittee should also be concerned with a reduction in credit availability to certain classes of marginal risk consumers. It is reasonable to assume that various lending institutions, because of their increased potential liability, will scrutinize loan applications, particularly from the marginal credit risk, much more closely. If lending institutions are refusing to accept dealer paper at all, as noted above, it seems obvious a much higher percentage of these institutions will be refusing loan applications in the case of marginal credit risks. The overall effect of these factors in the consumer credit market will be a rise in the rates in the long term for this type of financing.

It should be pointed out that prior to the promulgation of this rule, many major credit institutions have gotten out of consumer credit financing due to the risks involved. It is reasonable to assume that more federal regulation on these credit institutions will simply give them further reason to get out of the consumer credit market. In light of the fact that approximately 75% of new cars are financed by consumer financing, it is critical to the automobile industry that the availability of consumer credit not be restricted.

In summary, NADA feels strongly that the first three months actual experience under the rule has borne out what NADA strongly argued in its testimony before the Commission in 1971 and 1973—that is, adoption of this rule would result in a decrease in the availability of consumer credit and a consequent increase in the cost of consumer credit, particularly with respect to marginal credit risks. NADA also believes that this unfortunate trend will continue and have serious impact on new car sales in the future.

III. EFFECT ON STATE LAW

NADA and its members are particularly concerned with the action of the FTC in overriding the various state laws in this area. This ability of a Federal administrative agency in particular to overturn the duly considered state law in this or any other area is viewed by NADA with great alarm and serious concern for the future of this country. It is one thing for the duly elected Federal officials of Congress and the President to decide that state law should be changed. It is quite another thing, in NADA's view, for unelected Federal bureaucrats to decide that "they know better" than the elected representatives of the state.

While the rights and remedies which a consumer can now exercise against both the seller and lender remain a matter of state law, the FTC rule does change the substantive law of the various states with respect to when a seller can include a waiver of defense clause in an installment sales contract subsequently assigned to a lender, and whether a lender can claim holder in due course status with respect to a negotiable instrument. Let there be no uncertainty on this point—this rule promulgated by the FTC overturns the law of the states and the District of Columbia.

The action of the FTC is particularly disturbing when one examines the recent changes which a number of states have already adopted in this area. A majority of states have now abolished or modified the holder in due course doctrine to provide consumer purchasers additional protection in the case of sheddy goods or the so-called 'lemon' situation. A number of states have also, either legislatively or by judicial decision, limited the validity of waiver of defense clauses in the case of consumer sales. These actions by the states generally are reasonable attempts to cure the 'fly-by-night' disreputable seller problem while minimizing the adverse impact on the vast majority of consumer finance transactions where neither the HIDC or waiver of defense clauses ever becomes an issued. In short, many states have molded a limited and specific cure for a limited and specific problem.

It is very unfortunate, in NADA's view, that the FTC chose not to let the individual states continue to formulate appropriate solutions in their own jurisdictions to these problems.

IV. APPLICATION OF THE RULE TO SELLERS ALONE

The same day that the Federal Trade Commission promulgated its rule with respect to sellers, it proposed extending coverage of the rule to creditors. Since May 14, 1976 when the rule went into effect with respect to sellers, the FTC has in a sense required sellers to be their 'policemen' with respect to direct loans subject to the 'referral' or 'business arrangement' purchase money loan situation. That is, in the situation where a consumer obtains a direct loan from a lending institution and uses the proceeds from the loan to purchase a car or other consumer goods, and the dealer or other seller has 'referred' customers in the past to the lender or has a 'business arrangement' with the lender, then the seller must insure that the lender inserts the appropriate notice in the lender's credit instrument. If the lender doesn't put the notice in, the result is that the dealer cannot sell the car, otherwise he will be in violation of the rule.

If the direct loan is subject to the FTC's rule and the notice is not placed in the credit instrument, then the seller—and only the seller—is subject to a severe fine (up to $10,000) for violating the rule.

It seems a matter of fundamental fairness that both the seller and the creditor should be equally subject to violation of this rule. As noted before, both NADA and Dr. Burns of the Federal Reserve Board strongly urged the Commission to delay the effective date of the rule with respect to sellers until an appropriate decision was made (by the FTC and the FRB) as to whether the rule should also apply to creditors. Unfortunately, the FTC did not agree and permitted the rule to go into effect on May 14, 1976, with respect to sellers.

NADA continues to feel that this piecemeal approach to implementation of the rule has been, and continues to be, highly unfair and discriminatory towards sellers.

V. THE "PURCHASE MONEY LOAN" PROBLEM

The FTC rule effects two types of credit transactions. The first type involves a finance agreement between the consumer buyer and the seller. The evidence of indebtedness could be in the form of either a negotiable instrument such as a promissory note or a non-negotiable instrument such as an installment sales contract. These instruments are normally assigned by a seller to a lender/creditor. The seller receives his proceeds from the lender/creditor assignee, and the consumer purchaser then pays back the lender/creditor. In this type of transaction, the seller must insert the appropriate notice in the evidence of the indebtedness if the purchaser is a consumer. This type of finance transaction has not presented a problem for dealers at least to the extent of knowing whether the notice must be inserted in the finance instrument, however as noted above, it has presented a problem because banks are getting out of the dealer paper business.

The second type of transaction subject to the rule—the purchase money loan situation—has presented serious problems for dealers. This type of transaction involves a direct loan from a lender to the consumer purchaser.

The consumer purchaser then pays the seller with the proceeds of the loan and pays back the lender according to the terms of their finance agreement. In short, the loan instrument is between the lender and the consumer purchaser; the dealer or other seller is not a party to this contract.

The FTC in its rule, however, requires that a specific notice be placed in this instrument if there is a 'business arrangement' between the seller and lender, or if the seller as a continuing practice 'refers' his customers to that lender.

A tremendous problem facing sellers such as dealers when the rule went into effect on May 14, 1976, was simply trying to determine which direct loan transactions from which lenders came within the scope of these definitions of 'business arrangement' or 'referrals.' A second serious problem arose when the dealer determined in good faith that a transaction involved a lender to whom the dealer had referred customers or had established a business arrangement for purposes of the rule. The dealer then had to try and ascertain whether the lender had inserted the correct notice in the lenders finance agreement with the consumer purchaser, and if not, then the dealer had to attempt to persuade the lender to insert the necessary notice.

I would again emphasize that under the present rule it is the seller (even in the direct loan situation) who is liable if the notice is not included in the loan contract. With the ambiguities and vagueness of the definitions in the rule of what constituted a 'business arrangement' or a 'referral' relationship, disagreements naturally arose between various sellers and creditors as to whether the direct loan transaction was subject to the rule and the necessary notice should be included in the loan instrument between the lender and the consumer purchaser. In unclear situations (and there were many), dealers and other sellers would argue that the notice should be included in order to insure that the dealer or other seller was not in violation of the rule. Lender/creditors, on the other hand, would argue that the transaction was not subject to the rule and the notice did not need to be placed in the loan instrument. Lender/creditors had a stake in not placing the necessary notice in the instrument since including the notice would expose them to liability for any claims and defenses which the buyer might have against the seller. Additionally, lender/creditors are not presently subject to the rule's requirements and face no liability for violating the rule's requirements. It is important not to forget that sellers also have a stake—they are subject to a $10,000 fine for violations of the rule.

The Statement of Enforcement Policy, Federal Register, August 16, 1976, which the Commission has now adopted has assisted sellers and lender/creditors in determining when the rule applies to a direct loan situation. NADA believes this is a very positive and helpful step on the part of the Commission to assist sellers and lenders in the consumer credit market in understanding the scope and application of the 'purchase money loan' requirements of its rule.

VI. NADA RECOMMENDATIONS

NADA supports H.R. 15082 which has been introduced by Congressmen McCollister, Broyhill and Johnson. This legislation suspends the effect of the Commission rule until the General Accounting Office has had an opportunity to report to Congress as to the effect of the rule on consumer credit markets and present avenues of consumer redress for grievances arising from consumer sales. The FTC would then have an opportunity to review the report of the GAO and conduct a new rule making procedure to repeal the present rule, give it effect in its present form, or give it effect in an amended form.

In light of the present problems with the rule and the strong possibility that it may, indeed, have a long range adverse impact on the availability and cost of consumer credit, NADA would urge the Congress to speedily enact H.R. 15082.

This concludes my prepared remarks. I would be very happy to answer any questions which the members of the Subcommittee may have.

Thank you.

PAN AMERICAN BANK OF ORMOND BEACH,
Ormond Beach, Fla., October 31, 1975.

Re Dealer contracts.

Mr. LEE SPENCE, *President,*
Spence Chevrolet Co., Inc.,
Daytona Beach, Fla.

DEAR MR. SPENCE: Now that the Federal Government has thoroughly fouled up the automobile industry, they have turned their attention to the financial industry. In the same manner that their vain efforts to legislate clean air has actually created side effects that are intolerable, their attempts to 'protect' the consumer are now creating side affects that will eliminate many of the consumers from the financial market.

With the advent of these new consumer laws, several that are about to be enacted and recent court decisions, we find it necessary to take defensive action that will act to the consumer's detriment, your detriment and our detriment.

Our dealer financing arrangement with you has been working well, and we certainly appreciate the fine co-operation that you and your staff have shown. Unfortunately, we must discontinue purchasing paper written outside our office. We know that this will work a hardship on your sales staff because, to close a deal, it should be handled in your office as quickly as possible. To send them out of your office, potentially decreases your chances of making a sale. To help offset this potential loss of sales, we offer the following procedure to follow for our customers who have borrowed from us before:

(1) When your salesman has made his deal, he should call us immediately, while the customer is there, if we are open. He will then give us the terms of the sale, trade-in, description of the new vehicle, amount to finance, etc. He then will put the customer on the phone so that we can get personal information updated for our records. We will then process the application and get an answer back to you within 30 minutes, while the customer waits. The customer can then come directly to the bank to sign the papers.

(2) If we are closed, the salesman should call us immediately on our next business day giving us details as set forth in step one, except personal information. He will give us a phone number where the customer can be reached and we will take it from there. We will notify you when the deal is approved and again when it is closed.

OAK PARK TRUST & SAVINGS BANK,
Oak Park, Ill., May 13, 1976.

Re FTC regulation holder in due course.

MACLONEY CADILLAC,
Elmhurst, Ill.

DEAR SIRS: As an active participant in Retail Installment Financing, Oak Park Trust & Savings Bank is under the Jurisdiction of the Federal Trade Commission's New Regulation, "Holder In Due Course", which becomes effective May 14, 1976. The Ramifications of this New Regulation has made it necessary for us to reappraise our relationship with our Dealers and our position in the Retail Finance Market.

It is our understanding that this New Regulation calls for some modifications in our contracts, both in type of print and content of language. Also, it is our understanding that if a Buyer asserts a valid claim against the Seller, it becomes a valid defense against the Holder, i.e. Oak Park Trust & Savings Bank, for Non-Payment of his Loan. This New Regulation will constitute some change in our business relationship. To what extent, has not yet been determined.

As other Financial Institutions are making their decisions, we also are formulating our decision. Some Banks are asking for Full Recourse, some Repurchase, some are going to buy Prime Paper only, and others are pulling out of the market altogether. At the present time, until we can firm up a New Policy for Oak Park Trust & Saving Bank, we are asking for your cooperation on a temporary suspension in business commensurable on May 14, 1976. Our experience in this market has been good, and we expect to resolve this matter with a limited delay in business. We are seeking to make the right decision, one that will benefit all concerned. As soon as our New Policy has been established, we will contact you with reference to any changes in procedure or liability.

Very Truly Yours,

GERALD R. MARSHALL,
Vice President.

HEIGHTS STATE BANK,
Houston, Tex., May 20, 1976.

FRONTIER FORD SALES, INC.,
Humble, Tex.

GENTLEMEN: Due to the new Federal Trade Commission ruling involving consumer credit contracts, you are hereby notified that our agreement with your dealership to purchase retail automobile contracts is terminated.

We regret having to take this step, but we feel that at this time we have no other choice.

We appreciate the business that you have sent our way in the past.

Yours very truly,

HARLEY L. BONDS,
Vice President.

CIRCLE BOULEVARD BRANCH,
CITIZENS BANK OF CORVALLIS,
Corvallis, Oreg., May 14, 1976.

JOHN & PHIL'S TOYOTA, INC.,
Corvallis, Oreg.
(Attention: John L. Nussbaumer and Philip K. Doud).

DEAR JOHN AND PHIL: Recently the Federal Trade Commission has passed rules and regulations which removed lender's protection as a holder in due course of consumer retail installment notes and contracts. This along with other legislation pertaining to consumer financing has forced our bank to re-evaluate our policy as it pertains to dealer-generated transactions. Consequently, effective immediately, Citizens Bank of Corvallis is advising dealers from whom it has purchased consumer contracts that it will no longer directly or indirectly purchase consumer retail installment contracts nor enter into any transaction that could be interpreted as a relationship by which consumers are refered to the Bank.

This action does not change our bank's present policy of assisting deserving applicants to finance consumer goods on a direct basis.

Should there be any questions pertaining to this, please contact the undersigned.

Very truly yours,

WM. J. COSTE, *Assistant Manager.*

BURLINGTON BANK AND TRUST CO.,
Burlington, Iowa, May 20, 1976.

IMPORT MOTORS,
Burlington, Iowa.

GENTLEMEN: As you will recall, we sent you a letter on April 23, 1976 regarding the Holder In Due Course Doctrine, which went into effect May 14, 1976. Our Legal Department has reviewed this doctrine and as much as we hate to be forced to change our policy on purchasing contracts, we have no alternative.

We have been instructed to discontinue any existing dealer agreements and therefore, will be unable to purchase contracts from you until further notice. We sincerely appreciate any customers you have referred to us in the past. I am sure you can appreciate the extremely difficult decision this had to be for our people. We realize that this may cause you some inconvenience, as it has for us, and we are sorry for any inconvenience caused.

Hopefully our legislators will be convinced someday of the serious ramifications caused by this regulation, and will consider some amendments. Perhaps a letter to your representative would encourage such an amendment. Please feel free to call if you have any questions.

Sincerely,

ROBERT J. ALBERTS,
Vice President.

FIRST NATIONAL BANK,
Houma, La., May 13, 1976.

DICK BARKER, INC.
Houma, La.

GENTLEMEN: The Federal Trade Commission has issued a regulation which becomes effective May 14, 1976. Under this regulation the bank would lose its defenses as a holder in due course in connection with the paper received from you under our present arrangement. Your customer could sue us in the event there was a defect or alleged defect in the product purchased from you, and we could conceivably be liable for the amount of the loan and would also incur legal expenses.

We have vigorously opposed and protested this regulation; however, it has become effective. We have, therefore, decided to limit our consumer loans to those which are direct in nature and we are notifying you of this action by this communication. We regret that we must terminate our previous arrangement with you, wherein we have been taking paper evidencing indirect loans made by your customers.

We have had an excellent relationship with your firm in the past, and we greatly appreciate all of the courtesies which you have extended us. We are, of course, interested in making direct loans to your customers, as a direct loan would not be subject to the regulation.

Sincerely yours,

WARREN H. BOURGEOIS,
Executive Vice President.

ECTOR COUNTY SCHOOL EMPLOYEES CREDIT UNION,
Odessa, Tex., May 21, 1976.

Mr. TOMMY THOMPSON,
Sales Manager, Sewell Ford Inc., Odessa, Tex.

DEAR MR. THOMPSON: We regret to inform you that due to the new "holder-in-due course" regulation adopted by the Federal Trade Commission the Ector County School Employees Credit Union can not continue to participate in your discount program offered to the members of our credit union thru Mr. Wayland Pope.

The reason for not participating being that although there is no contract between the credit union and your dealership, this program could be construed as a business arrangement between a seller and a financing institution.

Although, we do not wish to participate in the Discount Program, we certainly intend to continue to finance cars for our members when they make a purchase from your dealership.

Thank you for your service.

Sincerely,

EUGENE KINSER, *President.*

THE PLAINS NATIONAL BANK,
Lubbock, Tex., April 21, 1976.

ALDERSON CADILLAC, INC.,
Lubbock, Tex.

DEAR SIRS: With regret we have decided to cancel our retail contract purchase agreement with Alderson Cadillac, Inc., effective May 13, 1976.

We were forced to this decision because of the possible effect that the "Holder in Due Course" regulation could have on contracts purchased as of May 14, 1976. This new regulation governing consumer credit purchases in effect puts the lender in the same position as the seller and becomes liable to the extent of the amount of the contract for any claims or defenses which the debtor could assert against the seller.

With this increased exposure we do not feel obliged to continue buying retail contracts under our present non-recourse agreement. We shall continue to make direct loans for automobile purchases and hope that we can be of service to you in this respect.

If you have any further discussion or have any questions regarding this letter, or any other problems with which we may help you, please contact me.

Sincerely yours,

HARLAN LAMBERT,
Vice President.

SKOKIE TRUST & SAVINGS BANK,
Skokie, Ill., April 30, 1976.

WALTON ON DEMPSTER, INC.,
Skokie, Ill.

GENTLEMEN: This letter is to advise you that as of May 14, 1976 the Skokie Trust and Savings Bank will not be purchasing Retail-Installment-Contracts due to the new law going into effect.

These instructions are from our Board of Directors.

Very truly yours,

VIOLET WESTERLAND,
Assistant Vice President.

DEL RIO BANK & TRUST CO.,
Del Rio, Tex., May 20, 1976.

TOWN & COUNTRY FORD,
Del Rio, Tex.

GENTLEMEN: The Federal Trade Commission has issued a Trade Regulation Rule concerning the Preservation of Consumer's Claims and Defenses which, in effect, does away with the Holder in Due Course Doctrine which has permitted this bank to purchase Retail Installment Contracts from you in the past. Under the provisions of this F.T.C. Rule, certain Retail Installment Contracts may no longer be prudent bank investments. Since our first priority must be to safeguard our depositors funds, we have no alternative but to terminate our "Dealer Agreement" with you, and cease purchasing Retail Installment Contracts from you as of this date.

Yours truly,

JOHN P. SAPP,
Senior Vice President.

DOUGLAS NATIONAL BANK,
Roseburg, Oreg., May 19, 1976.

NAPIER TOYOTA,
Roseburg, Oreg.
(Attention of John Napier).

DEAR MR. NAPIER: Due to the recent ruling made by the Federal Trade Commission, concerning the Holder in Due Course, Douglas National Bank will no longer be buying any dealer contracts.

We are very sorry that this has been brought about; however, we do hope that we can continue to be of service to you. We have very much appreciated your business in the past, and sincerely hope that we can continue a business relationship with you.

Sincerely,

LESTER OCUMPAUGH,
Assistant Cashier.

BURLINGTON BANK AND TRUST CO.,
Burlington, Iowa, May 20, 1976.

DELZELL MOTOR,
Burlington, Iowa.

GENTLEMEN: As you will recall, we sent you a letter on April 23, 1976 regarding the Holder In Due Course Doctrine, which went into effect May 14, 1976. Our Legal Department has reviewed this doctrine and as much as we hate to be forced to change our policy on purchasing contracts, we have no alternative.

We have been instructed to discontinue any existing dealer agreements and therefore, will be unable to purchase contracts from you until further notice. We sincerely appreciate any customers you have referred to us in the past. I am sure you can appreciate the extremely difficult decision this had to be for our people. We realize that this may cause you some inconvenience, as it has for us, and we are sorry for any inconvenience caused.

Hopefully our legislators will be convinced someday of the serious ramifications caused by this regulation, and will consider some amendments. Perhaps a letter to your representative would encourage such an amendment. Please feel free to call if you have any questions.

Sincerely,

ROBERT J. ALBERTS,
Vice President.

LANDMARK BANK OF ORLANDO,
Orlando, Fla., May 14, 1976.

Mr. J. JONES,
McNamara Financial Services, Inc.,
Orlando, Fla.

DEAR MR. JONES: Please be advised that effective until further notice Landmark Bank of Orlando is cancelling all dealer contracts covering retail installment papers. The reason for this cancellation is the recent Federal Trade Commission Holder-in-Due-Course Ruling.

This bank will be happy to assist you in anyway with your financing needs; however. until the ruling is clarified we regret that it will have to be on a direct basis.

Thank you very much; and we will contact you in the very near future.

Very truly yours,

W. A. Barwick, Jr.,
Executive Vice President.

Oak Park Trust & Savings Bank,
Oak Park Ill., May 13, 1976.

Re FTC regulation holder in due course.

Czarnowski Lincoln Mercury,
Chicago, Ill.

Dear Sirs: As an active participant in Retail Installment Financing, Oak Park Trust & Savings Bank is under the Jurisdiction of the Federal Trade Commission's New Regulation, "Holder In Due Course," which becomes effective May 14, 1976. The Ramifications of this New Regulation has made it necessary for us to reappraise our relationship with our Dealers and our position in the Retail Finance Market.

It is our understanding that this New Regulation calls for some modifications in our contracts, both in type of print and content of language. Also, it is our understanding that if a Buyer asserts a valid claim against the Seller, it becomes a valid defense against the Holder, i.e. Oak Park Trust & Savings Bank, for Non-Payment of his Loan. This New Regulation will constitute some change in our business relationship. To what extent, has not yet been determined.

As other Financial Institutions are making their decisions, we also are formulating our decision. Some Banks are asking for Full Recourse, some Repurchase, some are going to buy Prime Paper only, and others are pulling out of the market altogether. At the present time, until we can firm up a New Policy for Oak Park Trust & Savings Bank, we are asking for your cooperation on a temporary suspension in business commensurable on May 14, 1976. Our experience in this market has been good, and we expect to resolve this matter with a limited delay in business. We are seeking to make the right decision, one that will benefit all concerned. As soon as our New Policy has been established, we will contact you with reference to any changes in procedure or liability.

Very Truly Yours,

Gerald R. Marshall,
Vice President.

First National Bank of Daly City,
Daly City, Calif., May [illegible], 1976.

Re "Holder in due course comment" (The Preservation of consumers' claims and defenses . . .).

Massagli Motors, Inc.,
Daly City, Calif.

Gentlemen: Under the above mentioned act, which is effective May 14, 1976, it is unfortunately necessary for our bank to suspend all dealer contract business as of the above date.

The Federal Trade Commission is presumably attempting to put lenders in a position to be regulators and to use financial leverage over sellers to guarantee goods and services.

This rule pertains not only to contracts, but also to consumers referred by sellers, which in and of itself will be impossible to police.

We regret this decision and hope it to be only temporary pending further scrutiny by both the Federal Trade Commission and the Federal Reserve Bank.

We will keep you informed of any policy change applicable to First National Bank of Daly City.

Very Truly Yours,

Michael R. Wyman,
Executive Vice President.

Valley Bank,
Kewaskum, Wis., May 6, 1976.

Stocker Ford,
West Bend, Wis.

Dear Tony: Until we receive further clarification on the new Federal Trade Commission ruling on preservation of consumers' defense, we regret that we will be unable to accept any contracts or referrals for any loans from your dealership. As you will realize after reading the enclosed letter, from Foley and Lardner, to the Board of Governors of the Federal Reserve System, we cannot risk the capital of our bank on indirect sales contracts.

We hope that a new ruling will be amended shortly so that we can once again finance contracts with you.

The last day on which we will buy contracts is May 13, 1976. As of May 14, 1976 we will no longer accept any contract. If you have any further questions, please feel free to contact me.

Sincerely,

Robert A. Danielsen,
Loan Officer.

[The following letter was subsequently received for the record:]

National Automobile Dealers Association,
McLean, Va., September 3, 1976.

Hon. John M. Murphy,
Chairman, Subcommittee on Consumer Protection and Finance, House Interstate and Foreign Commerce Committee, Washington, D.C.

Dear Mr. Murphy: On Tuesday, August 31, I was scheduled to testify before your Subcommittee on behalf of the National Automobile Dealers Association regarding the impact of the Federal Trade Commission's new regulation eliminating the Holder in Due Course doctrine and waiver of defenses. Unfortunately, the hearing was adjourned just prior to our appearasce. While waiting to appear, I did have the opportunity to hear all of the witnesses. The witnesses who were permitted to testify, incidentally, all represented creditors and not sellers (who are the only ones covered by the rule at the present time). It was interesting to note, however, that the creditors' assessment of the impact of the rule on credit availability and cost was the same as our ows. With regard to the sale of automobiles, our assessment is that the FTC regulation has restricted the availability of retail credit and will certainly add to the cost of retail credit in the very near future.

Enclosed in our prepared statement that we would like included in the record. We have attached to our statement sixteen (16) sample letters sent to dealers from credit institutions announcing the cancellation of dealer contracts covering retail installment paper.

While waiting to testify before your Subcommittee, I had the opportunity to hear not only the prepared statements of the various witnesses, but I also noted the questions raised by the Subcommittee members and staff. I would like to take this opportunity to respond to these questions in writing, since I did not have the apportunity to do so orally. I think it is particularly important that NADA's answers to these questions be inserted into the record since they represent the views of sellers and problems related thereto under the new regulation.

Questions of Witnesses by Subcommittee Members and Staff

Question 1. Has the new FTC regulation altered in any way traditional financing relationships between sellers and lenders?

NADA response. Yes. NADA in a survey it conducted of its members found that many banks as a direct result of the rule have demanded that the dealer (seller) sign an indemnification agreement with the financial institution similar to the one I personally received from the National Savings and Trust Company (copy attached). This and many other similar indemnification agreements imposed by creditors on dealers require that, ". . . In the event that the buyer asserts a claim alleging a breach of any warranty by the dealer or the manufacturer and the buyer's complaint is not satisfied within ninety days, the dealer must repurchase the contract for the balance outstanding."

Prior to this regulation, 80% of my retail financing was with the National Savings and Trust Company, since I found them to be more competitive than GMAC which is the financing subsidiary of my own manufacturer. For obvious reasons, since the enactment of this regulation I have found it necessary to discontinue this relationship because of what I consider to be an oppressive indeminification agreement. This type of indeminification agreement could result in any dealer, including myself, being subject to repurchase of portions of his retail consumer credit contracts based on allegations raised by a customer, the validity of which have not been determined at that point in time. NADA questions whether it is the intent of Congress to allow, through the implementation of this regulation, the placement of a seller in the position of not only being a retailer of his products but now a financier of his own credit sales as well.

Question 2. Has there been any adverse impact on the availability of consumer credit to date?

NADA response: With respect to new car financing, dealers are experiencing a reduction in the number of credit sources available for such financing. The more creditors available to dealers for financing the better the chance that a new car purchaser, particularly one that is a marginal credit risk, will be able to obtain financing. This means that in some instances people will be denied the opportunity to buy a new car because of the implementation of this rule.

Another very important consideration is that because of the reduction in the number of creditors offering financing on new cars due to this rule, there is less competition and financing rates will go up. This will add to the cost of those purchasers who do obtain financing.

Question 3. What impact has the rule had in the direct loan situation wherein the bank customer purchases a new car from a dealer who has an existing business relationship with that bank?

NADA response: This situation presents the most rediculous result under the rule. In such cases, the dealer must request that the bank insert the notice required by the rule in the instruments accompanying the loan to the bank's customer. In most cases, the bank refuses to insert such a notice, because they are not covered by the rule, and not subject to any penalty. In such cases, the dealer is left with two completely unacceptable choices:

(1) to refuse to sell the car to the customer, or

(2) to sell the car and run the risk of a $10,000 fine because a notice was not placed by the bank in making a loan.

I have highlighted in this letter some of the problems dealers are experiencing from the implementation of the FTC rule. We strongly urge the Subcommittee to take prompt and effective action as recommended on Page 13 of our prepared statement by supporting the passage of H.R. 15082. Relief must be provided in the very near future unless the Congress and the FTC is willing to run the risk of a substantial decrease in new car sales with the resultant adverse impact on the nation's economy.

Sincerely,

JOHN J. POHANKA, *President.*

Mr. BRODHEAD. This hearing is adjourned.

[The following letters and statements were received for the record:]

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., August 26, 1976.

Hon. JOHN M. MURPHY,
Chairman, Subcommittee on Consumer Protection and Finance, Committee on Interstate and Foreign Commerce, U.S. House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: I am pleased to respond to your request for the views of the Board of Governors regarding the Federal Trade Commission's Trade Regulation Rule on Preservation of Consumers' Claims and Defenses (the Holder or Seller rule). The Rule, which went into effect on May 14, 1976, provides that it is an unfair practice for a seller to take or receive a consumer credit contract or the proceeds of certain consumer loans unless the contract evidencing the indebtedness includes a provision preserving the consumer's

right to assert any claims and defenses the consumer may have against the seller against any holder of the contract. The Commission has proposed to amend this Rule so as to include creditors. Should it do so, the Board would be required by the Federal Trade Commission Improvement Act to consider adoption of a similar rule for commercial banks. The Board is concerned that the competitive balance between financial institutions not be disturbed by the adoption of rules in this area.

The Board's interest in the Holder Rule, however, goes beyond this specific regulatory responsibility. The Board must be attentive to any development that may have a significant impact on the performance of financial markets or the general economy. In the context of this broad concern, Chairman Burns wrote to Chairman Collier of the Federal Trade Commission prior to May 14 in order to convey the Board's view that, without certain interpretive clarifications and technical refinements, the Rule might prompt a disruption of the consumer credit market and thereby adversely affect the course of the economic expansion. Chairman Burns transmitted with his letter a document prepared by the Board's staff that included specific recommendations aimed at improving the Rule and clarifying its intended scope. A copy of that document is enclosed.

During subsequent weeks the Commission issued several official and unofficial statements that provided answers to many of the questions raised in Chairman Burns' letter. Most recently the Commission has adopted and published for comment a Statement of Enforcement Policy. This document focuses particularly on the definition of "purchase money loan," a facet of the Rule that was of major concern to the Board. The statement substantially alleviates that concern by defining the term to include only those loan transactions that involve sellers and creditors related on a continuing basis through affiliation or referral activity.

There nevertheless remain several other significant aspects of the Rule that the Board feels warrant further clarification by the Commission. A staff document summarizing the status of the public positions taken by the Commission or its staff regarding the Board's concerns is also enclosed. The Board would be glad to furnish additional information to the Committee for the record in further explanation of any points in this document.

The Seller Rule has been in effect for approximately three months. Any specific conclusion based on information accumulated by the Board thus far on the impact of the Rule must be considered tentative. In general, however, developments to date reflect the process of adjustment by financial institutions to the increased costs and potential risks imposed by the loss of the holder in due course doctrine. Extending the rule to cover creditors as well can be expected to intensify that effect, as more institutions become fully aware of its applicability to their operations.

As a result of the Seller Rule, many financial institutions have begun to take a closer look at their relationships with sellers. Creditors reportedly are attaching greater significance to the financial standing and customer service records of sellers in determining their willingness to continue to finance associated consumer purchases. As a further step, creditors are strengthening a variety of recourse devices designed to apportion any risk of loss between sellers and themselves. Thus creditors appear to be policing vendor performance to a greater extent, as was contemplated by the Commission.

The adjustments being made by lenders to limit their increased costs and risks under the Rule seem likely to carry with them certain adverse economic effects, however. The more stringent standards being applied by lenders apparently have led them to end business or referral relationships with some sellers; the affected firms consequently have had to turn to less preferred sources of finance, presumably at higher cost. It seems likely that, over time, some marginal firms will be forced out of business. Moreover, entrepreneurs attempting to establish new retail firms without proven financial and service records are likely to encounter greater barriers to market entry.

Creditors appear also to be attempting to decrease the duration of their exposure to possible consumer claims. It is reported that some lenders either have cut their loan maturities or have put pressure on retailers to shorten product or service warranty periods. A widespread reduction in loan maturities could have a significant impact on the availability of credit for certain types of transactions often associated with long-term obligations, such as mobile home purchases or major home improvements. To offset added costs, some financial institutions reportedly have also reduced the compensation paid to sellers for originating instalment loan contracts that are purchased by the institutions.

This development may prompt sellers to increase prices in an attempt to recoup the loss of revenues.

In summary, the evidence now available indicates that the Seller Rule is having its intended effect of encouraging financial institutions to police vendor behavior. This result, however, may carry with it certain undesirable effects, including a reduced degree of competition in product and credit markets and an increased average cost or lessened availability of credit for the financing of consumer expenditures. The full economic impact of the Rule will be felt only with the passage of a considerable period of time. Continued monitoring of developments in consumer loan markets will therefore be needed in order to gauge the over-all consequences of the Rule. Recent actions by the Federal Trade Commission have alleviated some of our concerns, but the Board feels that the Holder Rule still has deficiencies which the Commission should resolve promptly.

Sincerely,

STEPHEN S. GARDNER,
Vice Chairman.

Enclosure.

COMMENTS OF THE STAFF OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM ON THE FEDERAL TRADE COMMISSION RULE ENTITLED "PRESERVATION OF CONSUMERS' CLAIMS AND DEFENSES" (16 CFR 433)

This memorandum comments on a proposal of the Federal Trade Commission to amend the rule it has adopted effective May 14, 1976. The adopted rule specifies, among other things, that it shall be an unfair or deceptive act or practice for a seller to accept the proceeds of any "purchase money loan" unless the consumer credit contract made in connection with the loan contains a prescribed notice that the holder of the contract is subject to all claims and defenses which the debtor could assert against the seller. The proposed amendment is an almost identical rule applying to extensions of credit by creditors. The Rule, as adopted, is sometimes referred to herein as the "Seller Rule," the amendment as the "Creditor Rule," and both together as the "Holder Rule." [1]

Staff believes that the Seller Rule may have a serious impact on many bank extensions of consumer credit. This follows from the rule's definition of the term "purchase money loan" to include loans where the proceeds are used by the customer to purchase goods or services from a seller who either refers customers to the creditor or is "affiliated with the creditor by common control, contract, or business arrangement." The possible scope of the term "business arrangement" and the provisions regarding "referrals" are such that banks do not know which loan contracts will have to include the notice to avoid placing a seller who accepts proceeds of the loan in possible violation. Banks are also unsure of their possible liabilities, should they decide to make such consumer loans under contracts containing the notice.

Under § 18(f) of the Federal Trade Commission Act as amended, the Board of Governors of the Federal Reserve System is required, with specified exceptions not discussed herein, to respond to the Commission's adoption of trade regulation rules by promulgating within 60 days after the effective date of such rules, substantially similar regulations applicable to banks. The Seller Rule was adopted pursuant to administrative proceedings begun prior to enactment of that Act and was not covered by this requirement. On November 18, 1975, in conjunction with the final adoption of the Seller Rule, the Commission issued the Creditor Rule for comment as a proposed amendment to the Seller Rule (40 Fed. Reg. 53530 (1975)). Under § 18(f) of the Federal Trade Commission Act, the Board may be required to adopt a rule similar to this amendment and applicable to banks.

The Holder Rule was published as the result of a Commission inquiry into certain abuses in the consumer credit field where consumers who had been sold defective goods and services found that their "duty to pay" had been separated from the "seller's duty to perform" by the utilization of certain abusive credit practices (Statement of Basis and Purpose, "Preservation of Consumers' Claims and Defenses," p. 13).

The Seller Rule as adopted and the Creditor Rule as proposed, however, will cover a much broader spectrum of consumer credit transactions than is necessary to prevent the abuses to which the rules are apparently directed. These include transactions (1) where there is no arrangement between creditor and seller relating to the credit extended and (2) where the creditor has no way of knowing—and the consumer may not even yet have decided—whether the proceeds of a loan will be used to purchase goods or services, and if so, from what seller. There will certainly be many transactions in which neither creditor nor seller will be able to determine whether the rule applies (or if it applies, whether the required notice has been used).

The remainder of the comments will be addressed to the proposed "creditor amendment" to the Commission's rule entitled "Preservation of Consumers' Claims and Defenses" (hereinafter referred to as the "Holder Rule").

[1] Copies of the Seller Rule and proposed Creditor Rule are attached.

I. THE DEFINITION OF "PURCHASE MONEY LOAN"

The Holder Rule addresses seller-originated credit (credit sales) and nonseller-originated credit (direct loans). The rule is clear in its requirement that all consumer credit contracts taken by sellers must contain the "notice" preserving claims and defenses. Thus, any purchasers of such contracts will take them with full knowledge that they stand liable for the named seller's misconduct.

Similar certainty regarding which contracts must contain the "notice" and which sellers' conduct a creditor must stand liable for is not present in the portion of the rule which applies to non-seller-originated credit. Also, that portion of the rule appears to go much further than is necessary to eliminate the practices which were found to be unfair as outlined in the Commission's Statement of Basis and Purpose accompanying the rule. There is concern that the rule, as drafted, will impose substantial unfair hardships on banks and other direct lenders. A discussion follows of some of the problems which are likely to arise from the present definition of "purchase money loan."

Referrals

The Holder Rule defines "purchase money loan" as a consumer loan made to purchase goods or services from a seller who "refers consumers to the creditor." Permitting the simple fact of a seller referral to trigger the disclosures required by the rule is unwise. Generally, creditors have limited control over which sellers make referrals to them. As a result, the creditors may not know which sellers the rule requires them to police. Under the present rule, a transaction will require inclusion of the "notice" even when it involves a seller who makes as few as two referrals to the creditor, with or without the creditor's knowledge or permission.

Since seller referrals, with nothing more, can determine whether a loan is a "purchase money loan," in many situations the creditor's only way of determining whether a specific transaction must include the "notice" is to ask whether the customer was referred by the seller from whom he or she intends to buy. An affirmative answer requires the creditor either to include the "notice" in the contract or to decline to make the loan.

In many cases, a customer, assuming that the application is only for a personal loan, may not wish to state the purpose of the loan or where it will be spent. While it may not be true of other creditors, banks commonly make signature loans on the basis of a good credit rating. Many consumers will consider an inquiry as to how or where proceeds of a bank loan will be spent an invasion of privacy. Many banks have expressed concern that the rule as drafted will disrupt relations with preferred customers because it requires prying into customers' private affairs.

A similar problem arises where a consumer wants a direct loan in order to shop around before deciding where to make a purchase. The consumer may be perfectly willing to divulge the intended use of the loan, but the rule effectively requires that the consumer also know where the loan proceeds will be spent when the credit contract is entered into. This is an inconvenience, and the delay involved may prevent the consumer from getting the best buy.

The rule as drafted presents more profound problems in cases in which it is impossible for the creditor to determine whether the seller is a "referring seller." In many situations, asking the consumer if there has been a referral from a seller will not be sufficient to protect the creditor from inadvertent violations of the rule. The rule applies whenever a seller generally refers consumers to a creditor; there is no requirement that a specific customer have been referred, or that the referral be pursuant to some course of conduct or agreement between creditor and seller.

The referral aspect of the rule creates problems even when the customer knows the seller's identity and the creditor knows that the seller makes referrals. Assume, for example, that the customer decides to make the purchase from a seller other than the referring seller after the "notice" has been included in the contract. The creditor will be liable for the conduct of *any* other seller who receives the proceeds because the "notice" is effective regardless of who the seller is. Likewise, if the customer informs the bank that the purchase will not be made from a referring seller and no "notice" is included, a subsequent decision to purchase from a referring seller will place the unwitting creditor in violation of the rule. Therefore, creditors may have to require their debtors to sign a statement indicating where they will use the proceeds or convert all their loan proceeds checks into payee-designated checks in order to insure against inadvertent violations.

From the foregoing, it would appear that one of the results of the Holder Rule may be to constrict the market for personal signature loans since creditors may not be willing to take the chance that loan proceeds will not be received by a referring seller. The other alternative available to the creditor would be to include the "notice" in all consumer credit contracts, thereby waiving holder in due course status and subjecting the creditor to all claims and defenses no matter who the seller turns out to be. This is an unreasonable burden to impose on creditors.

The broad scope of the referral aspect of the present Holder Rule may subject creditors to liability for the misconduct of sellers over whom creditors have no control. Control over sellers appears to be one of the rule's underlying assumptions since creditors must have some means of assuring that sellers respond to consumer problems. Under the rule as presently drafted, creditors will stand liable for misconduct of sellers over whom they have no control in cases where unsolicited referrals are made or where there is no arrangement between the seller and the creditor. The Commission's goal of eliminating seller misconduct from the market will not be achieved in such situations because sellers will have no incentive to respond to consumers' problems unless they depend to some degree on the creditors' financing. Thus the rule could result in creditor forfeitures (which merely shift the costs of seller misconduct from consumers onto the credit industry) or a substantial decrease in direct loan financing of sales.

It is recommended that the more difficult problems with the referral aspect of the rule be eliminated by providing that only those loans resulting from referrals made pursuant to some specific business arrangement or course of dealing between the creditor and the seller be considered "purchase money loans." Under such a revised rule, creditors could be certain of which sellers' conduct they were guaranteeing and could also be assured that a loan made to a consumer who was not referred to the creditors by a referring seller would not become a "purchase money loan" by virtue of subsequent action by the consumer. Also, since the business arrangement would be advantageous to the seller, the seller would have an incentive to respond to the creditor's requests that consumer problems be resolved.

The Commission's Statement of Basis and Purpose states that the referral aspect of the rule was intended to prevent the collusive use of vendor-related loans to avoid putting the "notice" in credit sale contracts (pp. 58–67). This goal would be accomplished by requiring that any loan made pursuant to a business arrangement between a seller and a creditor should include the "notice" because any collusive referral arrangement would constitute a sufficient business arrangement to bring the rule into operation.

In view of the fact that the Holder Rule preempts State laws and is likely to have a very widespread impact, care should be exercised to assure that the rule is no broader than is necessary to eliminate the practices which were found to be unfair. The limitation on the scope of the rule suggested above would not limit the effectiveness of the rule in preventing the practices which were found to be unfair and, at the same time, would eliminate most major problems raised by the referral aspect of the rule in its present form.

Affiliation by Common Control, Contract, or Business Arrangement

The second aspect of the definition of "purchase money loan" requires inclusion of the "notice" preserving claims and defenses when a consumer loan is made to purchase goods or services from a seller who "is affiliated with the creditor by common control, contract, or business arrangement." "Contract" and "business

arrangement" are defined, in general, as any arrangement or course of dealing "in connection with the sale of goods or services to consumers or the financing thereof."

Just as the referral aspect of the rule may be read as not requiring that a specific loan actually be made pursuant to a referral in order to be covered, the contract-business arrangement aspect of the rule may be read as not requiring that a specific loan actually be made pursuant to the contract or business arrangement between the seller and the creditor in order to require inclusions of the "notice." The only requisite is that a contract or business arrangement must exist between a seller and a creditor; where this is present, any loan made by the creditor, which is used to purchase goods or services from that seller, will be covered by the rule. Many of the same problems which were raised under the discussion of the referral aspect of the rule are also present in the contract-business arrangement aspect of the rule. For example, if a borrower, without being referred, applies to a bank for a direct personal loan with the intent to buy a refrigerator from a seller who has a business arrangement with the bank, the credit contract must contain the "notice."

The rule also would provide that the loan would come within the scope of the rule if the consumer, at the point of application, had not decided where to purchase the refrigerator and later purchased from a "related" seller, or if the consumer, after indicating an unrelated seller, purchased from a related one. If the "notice" had not been included in the contract, a subsequent decision to purchase from a seller who was related would place the creditor inadvertently in violation of the rule. Conversely, if the "notice" was included, the creditor would stand liable for the misconduct of any seller chosen by the consumer, whether or not a business arrangement existed.

All creditors who make personal loans face these problems because, without adopting payee-designated checks, they have no control over the loan proceeds once the loan is made. As previously discussed, the effect of the rule could very well be to eliminate the traditional direct personal bank loan from the market. The rule would in effect require creditors to inquire into the "what for" and "where" of each loan and would necessitate the development of means of assuring that loan proceeds be spent only at the disclosed seller's establishment. The other creditor alternative would be to include the "notice" in all loan contracts and hope that the seller eventually chosen is reputable. Neither of these alternatives is desirable to creditors.

It is recommended that the problems indicated above be eliminated by drafting the rule so as to provide that each loan must be made pursuant to a contract or business arrangement concerning consumer financing between the seller and the creditor in order for it to come within the definition of a "purchase money loan." If the consumer indicated that a related seller had recommended the creditor, the "notice" would have to be included in the contract. The "notice" would not have to be included if the creditor was unable to determine the identity of the seller after a good faith effort to do so. As the Commission stated in its Statement of Basis and Purpose (p. 129), the rule is intended to prevent "concerted or cooperative conduct between sellers and creditors" directed at separating the seller's duty to perform from the buyer's duty to pay. This solution goes as far as is needed to eliminate the practices found by the Commission to be unfair.

The second major problem involving the contract-business arrangement aspect of the definition of "purchase money loan" concerns the type of contract or business arrangement that was intended to bring the rule into operation. The definitions provide that only those contracts and business arrangements which are "in connection with the sale of goods or services or the financing thereof" would bring a transaction within the scope of the rule. No further guidance is provided as to what type of contract or arrangement is contemplated. The types of abuses discussed in the Statement of Basis and Purpose, together with the definition, would lead one to the conclusion that "contract" and "business arrangement" refer to some agreement, understanding, or course of dealing pursuant to which the creditor supplies financing for consumer purchases from the seller. Informal discussions between the staffs of the Board and the Commission have indicated, however, that the Commission staff's interpretation of the rule is that any contract or business arrangement which "touches" the goods or services is sufficient to bring a loan made to purchase those goods or services within the definition of a "purchase money loan." Thus, the following types of arrangements, understandings, and procedures may qualify as "business arrangements": (1) checking account, (2) floor planning, (3) unrelated loan to the seller, and, (4) unrelated loan to the seller where inventory of seller secures the loan.

This interpretation seems to expand the rule's scope beyond the type of transactions which the Commission found to be unfair. It is recommended that the types of contracts or business arrangements which will bring the rule into operation be clarified.

II. CHECK CREDIT

"Check credit" refers to credit extended pursuant to check overdraft plans. Informal discussions with Commission staff have indicated that the Commission had not intended the rule to reach check credit. Nonetheless, the definition of "purchase money loan" would encompass check credit when the proceeds of a check credit transaction are used to make a purchase from a referring seller or from a seller with whom the bank has the requisite contract or business arrangement.

Check credit transactions would apear to have no relation to any of the unfair practices which the rule was intended to address. No collusion can exist between the seller and the creditor in such transactions since neither the seller nor the creditor is aware thaat a credit transaction has occurred when a check which will overdraw the consumer's account is written. Even the consumer may not be aware that a credit transaction is taking place. Furthermore, because of delays inherent in the check clearing process, checks which were not expected to overdraw may do so and checks which the consumer thought would overdraw may not do so.

The Holder Rule as it relates to check credit would be unfair to banks which account for nearly all demand deposit accounts nationally. Banks have no control over where the proceeds of an overdraft check will be spent. Nevertheless, under the proposed rule factors totally beyond a bank's control will effectively compel the bank to accept liability for the misconduct of a seller who accepts a check or its proceeds.

Another operational problem arises in the case of check credit. Arguably, the consumer credit contract in cases of check credit is the check itself. If so, the "notice" would have to be printed on all checks used in overdraft accounts since the bank would have no way of knowing in advance whether any particular check would overdraw and whether the check or its proceeds would be used for a purchase from a seller who made referrals or had the requisite relationship with the bank.

It is recommended that the Holder Rule's definition section be amended to specifically exclude check credit from the scope of the rule.

III. AGRICULTURAL CREDIT

The Holder Rule reportedly was not intended to extend to agricultural credit, but this type of credit is specifically brought within its scope by defining "financing a sale" as: "Extending credit to a consumer in connection with a 'credit sale' within the meaning of the Truth in Lending Act and Regulation Z."

Credit sales under Truth in Lending include those for agricultural purposes. The definition appears to be an affirmative expression of intent to include agricultural credit sales within the rule's scope. The rule contains no similar affirmative indication that *loans* (as opposed to credit sales) for agricultural purposes come within its scope, but neither is there any indication suggesting the contrary interpretation.

It is questioned whether there is a reed for the inclusion of agricultural credit under the Holder Rule. There has been no indication that agricultural transactions have been subject to any of the practices found to be unfair by the Commission.

It is recommended that agricultural credit be exempted from the rule's coverage until it has been demonstrated that agricultural transactions do involve abusive practices similar to those addressed by the Holder Rule.

IV. GOOD FAITH ATTEMPT TO RESOLVE THE PROBLEM WITH THE SELLER

It is recommended that a provision be included in the Holder Rule which would require that a consumer who has encountered problems with—a seller's needs or services make a good faith attempt to resolve the problem with the seller prior to taking action against the creditor. A good faith effort at such a resolution would not impose an unreasonable burden on the consumer and would seem to encourage the most expeditious resolution of consumer problems. Normally, it is only after the consumer is unable to get any satisfaction from the seller

that the creditor should be brought into the negotiations. In many situations a consumer will attempt to resolve the problem with the seller first, but this may not always be the case. It should be noted that the holder in due course provision in the Fair Credit Billing Act preserving consumers' claims and defenses does contain a provision requiring a good faith effort by the consumer to resolve the problem with the seller.

V. TORT CLAIMS

The Holder Rule subjects holders of consumer credit contracts to all claims and defenses that the debtor could assert against the seller of the goods or services that were the subject of the contract. This includes any tort claim that the debtor may have. Congress, in § 170 of the Fair Credit Billing Act, specifically excluded tort claims from the types of preserved claims. Claims of this type have no relation to the type of unfair practices which the Holder Rule addresses, nor does there appear to be any valid reason for holding the creditor liable for problems which are traceable to the manufacturer of a product.

It is recommended that, in light of a specifically expressed contrary Congressional view regarding precisely the same issue, the Commission give consideration to excluding tort claims (or at least personal injury and property damage claims) from the type of claims that may be asserted by a consumer under the rule.

VI. LEASING

The Holder Rule is unclear as to its intended coverage of leases. Section 433.2 declares that any consumer credit contract in connection with a lease of goods or services must contain the notice. Yet the rule's definitions contain an indirect reference to leases based on the definition of "credit sale" under the Truth in Lending Act. This definition of "credit sale" applies only to those leases which are the functional equivalent of a "credit sale" because the "lessee will become, or for no other or for a nominal consideration has the option to become, the owner of the property" which is the subject of the lease (15 U.S.C. § 1602(g)). It is recommended that the rule be clarified to indicate that only leases which are the functional equivalent of an extension of credit are covered.

VII. AVAILABILITY OF RECOURSE ARRANGEMENTS

Under the Holder Rule as currently drafted, a creditor who makes a purchase money loan is subject to any claims or defenses that may be asserted against the seller. As previously discussed, the mere fact that a seller refers consumers to a creditor will bring any loan made by that creditor to finance a purchase from that seller within the scope of the rule. It is not necessary that such referrals may not occur pursuant to any business arrangement or understanding; they may occur totally on the initiative of the seller. If the consumer subsequently asserts a legitimate claim or defense against the creditor, the creditor will have no recourse against the seller to recover the loss. The creditor will not be able to exert any pressure on the seller to obtain reimbursement. Nor in this instance is it possible for the creditor to require a recourse agreement as a condition of an assignment of a consumer credit contract. Losses owing to seller misconduct would have to be absorbed by the creditor in this situation. As previously recommended, this problem should be remedied simply by requiring referrals to be pursuant to a business arrangement or understanding in order for a loan made pursuant to such referrals to qualify as a purchase money loan.

VIII. THE HOLDER RULE AND STATE LAW

Many States currently have laws in effect which limit the use of holder in due course status, although none appear to be as comprehensive as the Commission's proposal. It apparently is the Commission's intent that all these State laws be preempted by the rule. It is recommended that the Commission's intent with regard to preemption of State law by the Holder Rule be clarified.

Additionally, the Commission rule will have to fit into the broad framework of each State's laws, and such interplay may pose many potential problems. An example of such State law difficulties concerns the problem of recourse arrangements of creditors with small lenders. The rationale behind the Holder Rule assumes that creditors and sellers will enter into some type of recourse arrangement so that creditors will not be required ultimately to bear the cost of seller misconduct. However, many States have "small loan" laws which prohibit any

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person from owing or potentially owing more than a statutory amount (the "small loan" limit) to a small lender. If a small lender enters into several purchase money loans for consumers' purchases from a specific seller and also has a recourse arrangement with that seller, the seller will potentially be liable to the small lender for an aggregate amount in excess of the small loan limit. These laws may prevent small lenders in some States from protecting themselves through recourse agreements with sellers as envisioned by the rule and the rule does not provide any other means for creditors to protect themselves.

It is recommended that attention be given to conflicts between the Holder Rule and State laws which, although not preempted, may affect the assimilation of the Holder Rule into State statutory frameworks.

IX. ECONOMIC IMPACT

The Holder Rule's Statement of Basis and Purpose indicates that the Commission has given consideration to the reduction in the availability of credit and the increase in the cost of credit which are likely to result from the adoption of the Holder Rule. The Statement of Basis and Purpose suggests that a balancing test has been applied and that the Commission has determined that the benefits to accrue from the adoption of this rule outweigh the costs (p. 116). The rule's impact in the following areas may warrant further attention to determine whether the rule's adverse impact can be minimized without doing damage to the rule's effectiveness.

Large Ticket Items Involving Long-Term Loans

The application of the Holder Rule to the sale of large ticket items such as mobile homes and boats which are generally financed over a long period of time may cause a restriction in the availability of credit for such purchases. A creditor faced with the prospect of continuing exposure to liability over several years for claims and defenses assertible against the seller is likely to be hesitant about making such loans. The seller may go out of business during the term of the loan leaving the holder of the contract as the sole guarantor of the goods. Also, over the life of the loan contract there are apt to be problems arising with the goods which are caused by the passage of time rather than by any seller misconduct or product defect. While the rule does not subject the creditor to liability for such problems, the fact remains that the consumer may feel that the seller or the creditor should be liable and stop payment on the obligation. In that situation, the only way the creditor can force the consumer to resume payment involves the expense of taking the consumer to court. Toward the end of a long-term obligation, the amount remaining to be paid will probably be small and it may cost the creditor more to go to court than to write off the remainder of the obligation. The creditor on a long-term obligation must face this possibility as long as any money is owed on the obligation.

It is recommended that this problem be given further careful consideration before it is dismissed. One possible solution would be to limit the time during which a creditor would be subject to claims and defenses to a reasonable number of years.

Barriers to Entry

The adoption of the Holder Rule is likely to make it more difficult for new businesses to enter the market. Creditors may well be hesitant about buying consumer paper from a new business and may not enter business arrangements with a new enterprise because of uncertainty about that company's business practices. The very real possibility that the business may fail leaving the creditor as the only guarantor of any goods sold may also make creditors reluctant to finance credit sales by new businesses or take assignments of their consumer paper.

X. TECHNICAL AND OPERATIONAL QUESTIONS

Comments and telephone communications with affected creditors have raised numerous questions on the operation of and compliance with the rule. It is recommended that the Commission attempt to answer as many of these questions as possible in order to facilitate compliance. It is suggested that this be done either by making clarifying modifications in the rule or by disseminating explanatory material on the rule.

Among the questions raised are the following:

1. Concerning the "notice":
   (*a*) May the notice be on the back of the contract?
   (*b*) May the notice be stamped on the contract?
   (*c*) Must the notice be above the consumer's signature?
   (*d*) May the notice go on a separate page and be incorporated by reference?

One particularly troublesome question has arisen from creditors' uncertainty at the time of entering into a transaction as to whether the rule applies to that transaction. Creditors have asked whether they can include the "notice" in all consumer credit contracts and precede it with a provision such as the following:

"If this loan is a purchase money loan as defined in the rule, the following provision applies:"

The rule does not specifically prohibit this type of provision, but the result of its use will be to severely limit the rule's effectiveness. A consumer will not be able to respond to a creditor's suit for payment simply by raising a valid defense which the consumer has against the seller. Instead, the consumer will first have the burden of proving that the loan was a purchase money loan which will, in all probability, involve hiring an attorney. As a result, the expense of asserting a defense is likely to be more than the amount involved; consumers will not rely on the rule and it will be reduced to a nullity.

The use of such a clause is merely a response to the uncertainty in the rule regarding which transactions are covered by the rule. It is hoped that the Commission will revise the rule to add the necessary certainty. In any event, the use of a clause similar to the above-discussed should be prohibited and such prohibition made clear.

2. Regarding seller-originated paper, does the value of a trade-in constitute an amount paid by the debtor under the contract so as to be recoverable?

3. The definition of "purchase money loan" covers loans which are "applied in whole or substantial part, to a purchase of goods or services" from certain sellers. What constitutes a "substantial part" of a loan?

4. It is assumed that the Commission, by its use of the term "goods and services," intended to eliminate real property transactions from the scope of the rule. Is the rule intended to reach certain borderline property transactions such as:
   (*a*) Home improvement loans where the improvement will become real property but the loan proceeds are used to pay for materials and the builder's services?
   (*b*) Mobile home sales which are considered real property transactions in some States and personalty transactions in others?

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SELLER RULE

"PRESERVATION OF CONSUMERS' CLAIMS AND DEFENSES"

Sec.
433.1 Definitions.
433.2 Preservation of consumers' claims and defenses, unfair or deceptive acts or practices.

AUTHORITY: The provisions of this Part 433 issued under 38 Stat. 717, as amended; 15 U.S.C. 41, et seq.

§ 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.

(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 least 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 for 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.

Creditor Rule

"PRESERVATION ON CONSUMERS' CLAIMS AND DEFENSES"

Sec.
433.1 Definitions.
433.2 Preservation of Consumers' Claims and Defenses, Unfair or Deceptive Acts or Practices.

AUTHORITY: The provisions of this Part 433 issued under 38 Stat. 717, as amended, 15 U.S.C. Section 41, et seq.

§ 433.1 Definitions[1]

(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

[1] The amendment makes no changes in this section.

or (2) is affiliated with the creditor by common control, contract, or business arrangement.

(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 Purchase Money Loan (as that term is defined in § 433.1) or[2] any sale or lease of goods or services in or affecting commerce as "commerce" is defined in the Federal Trade Commission Act, it constitutes an unfair or deceptive act or practice within the meaning of Section 5 of that Act for a seller or a creditor, directly or indirectly, to take or receive a consumer credit contract which fails to contain the following provision in at least ten point, boldface 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.

Staff Memorandum Summarizing the Federal Trade Commission's Clarifying Actions on its Holder in Due Course Rule

On May 5, 1976, the Board of Governors of the Federal Reserve System submitted to the Federal Trade Commission the comments of the Board staff on the Commission's rule entitled "Preservation of Consumers' Claims and Defenses" which was scheduled to go into effect on May 14. The comments raised a number of questions and problems regarding the scope, operation, and impact of the rule and made suggestions for clarifying and improving it.

The rule went into effect on May 14 as scheduled. Since that time, the Commission and its staff have issued a number of documents which respond to the problems raised by the Board staff and which clarify the intended scope and operation of the rule. These documents include the Statement of Enforcement Policy in Re Trade Regulation Rule on Preservation of Consumers' Claims and Defenses (SEP; adopted August 3, 1976), Guidelines on Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses (Staff Guidelines), and Commission advisory opinions issued in response to specific questions.

Staff considers the SEP to be the most significant of these documents because it is an official Commission response to the Board's most urgent concern, the scope of the definition of "purchase money loan." With a few exceptions, the SEP adequately answers most of the questions that have been raised by staff regarding this troublesome definition. However, this document does not attempt to respond to other questions raised by the Board such as the applicability of the rule to agricultural credit, leases, and check credit and the interplay of the rule with State law. Presumably, the Commission felt that these questions and the others raised in the Board staff's comments to the Commission were answered in the FTC Staff Guidelines document. While this is true with regard to many of the issues, staff would prefer that these questions be answered in a document formally adopted by the Commission.

[2] The proposed amendment adds the underscored words and deletes § 433.2(b).

1. *Definition of "Purchase Money Loan."*—The purpose of the SEP is confined to clarifying the scope of the definition of "purchase money loan." The SEP makes the following three basic clarifications:

(1) A business arrangement must be ongoing and clearly related to sales or sales financing. The statement made in the Staff Guidelines document that a floor planning arrangement qualifies as a business arrangement has been retracted; according to the SEP, floor planning is a business relationship unrelated to the financing of consumer sales.

(2) Unilateral referrals by a seller with no knowledge and permission of the creditor are not sufficient to bring the rule into play. In order for the rule to apply, the seller and the creditor must be engaged on a continuing basis in cooperative or concerted conduct to channel a consumer to a particular lender. Occasional isolated referrals where there is no pattern of cooperative activity do not bring the rule into play.

(3) The rule is not intended to subject a seller to liability for accepting the proceeds of a "purchase money loan" when the seller had no reason to believe that he was receiving proceeds of such a loan. When the objective circumstances do not indicate the source of the proceeds or do not provide reason to believe that the proceeds may be from a "purchase money loan," there is no obligation to further investigate the source of the proceeds.

Examples illustrating each of these points have been provided in the SEP with clarifying comments where necessary. Staff believes that the clarification of what is meant by a "business arrangement" and the statement specifying the extent of the seller's duty to determine the source of proceeds eliminate the problems connected with these issues. However, two issues remain:

(*a*) What is the applicability of the rule when the creditor makes a signature loan to a customer who either will not disclose where he intends to use the proceeds or has not decided where he will spend the proceeds?

(*b*) How does the rule operate when the borrower, after informing the creditor where he intends to spend the proceeds and having the contract made out accordingly, changes his mind and spends the proceeds somewhere else?

2. *Coverage of Check Credit.*—The Board staff comments urged the Commission to specifically exclude check credit from the Holder Rule's coverage. Commission staff has indicated that the rule was not intended to cover check credit, but as yet no formal confirmation has been issued by the Commission.

3. *Coverage of Agricultural Credit.*—The Board staff comments, citing ambiguities in the rule's definitions, recommended that the FTC exempt agricultural credit from the rule. Commission staff has informally stated that such credit was beyond the rule's scope and has reiterated this position in a letter to Congresswoman Sullivan. However, no formal statement from the Commission has been released.

4. *Coverage of Consumer Leasing.*—The rule's definitions raise questions concerning the coverage of consumer leases. The Board staff comments recommended that such coverage be limited to those leases which are the functional equivalent of an extension of credit. The Commission has issued no formal statement on this issue.

5. *Required Good Faith Attempt by Consumers to Resolve Disputes With Sellers Before Assertion of Claims and Defenses Against Creditors.*—The Board staff comments recommended that such a requirement be added to the rule. While the SEP does not address this question, by a separate formal opinion of FTC counsel to the National Automobile Dealers Association, approval has been given to insert such a requirement in consumer credit contracts where State law requires a good faith attempt to resolve the dispute with the seller in order to assert the claim or defense.

6. *Assertion of Tort Claims by Consumers.*—The Board staff comments recommended that the FTC consider excluding personal injury and property damage claims from the rule. The Commission did not address this issue in the SEP and all indications are that the Commission and its staff believe that such claims should be assertible against the holder to the extent of the amount already paid on the obligation.

7. *Impact of State Law.*—The Board staff comments recommended that the FTC clarify its intent as to the preemption of State laws dealing with holder in due course status. The comments also recommended that close attention be given to the rule's impact on State small loan laws. To date, neither the Commission nor its staff has addressed this very complex issue, although it appears that the FTC intends to preempt all State provisions regarding the holder doctrine.

8. *Economic Impact of the Rule.*—The Board staff comments recommended that a time limit be placed on a creditor's exposure to claims and defenses in long-term contracts and warned the FTC that the rule could raise barriers to the entry of new sellers to the market. These issues have not been addressed by the Commission or its staff.

9. *Technical and Operational Problems.*—The Board staff comments raised several operational problems associated with the placement of the rule's required notice. FTC staff has addressed these issues but no formal Commission position has been taken.

TEXAS MANUFACTURED HOUSING ASSOCIATION,
Austin, Tex., August 19, 1976.

Chairman JOHN MURPHY,
Subcommittee on Consumer Protection Finance, Committee on Interstate and Foreign Commerce, Washington, D.C.

DEAR MR. CHAIRMAN: As an industry producing a form of shelter which, for thousands, is providing an affordable answer to their housing needs, we are deeply concerned about the recent FTC Holder in Due Course rule.

At Congressman Bob Eckhardt's suggestion, we are appealing to you directly for consideration in view of your scheduled hearings on the Holder in Due Course August 24 and 25.

This amendment would suspend the current FTC Holder in Due Course rule and require the Federal Trade Commission to reissue its ruling in compliance with the due process procedures of the 93rd Congress FTC Improvements Acts (Titles II of the Magnuson-Moss Warranty Act.)

The FTC rule, as it currently stands, could either force the lender to increase his interest rate to cover his liability or it could stop him from making mobile home loans where the contract has ben generated through the mobile home dealer.

This issue will severely restrict the availability of mobile home financing in Texas. And, considering the currently restrictive lending practices now in effect along the Texas coastal areas due to our windstorm insurance problem, the Holder in Due Course rule will simply compound this intolerable situation.

Your consideration of this issue will be most deeply appreciated.

LESLIE M. BEARS, *President.*

HOUSING AUTHORITY,
Decatur, Ga., September 2, 1976.

Hon. JOHN MURPHY,
Subcommittee on Consumer Protection Finance, Committee on Interstate and Foreign Commerce, Washington, D.C.

DEAR MR. CHAIRMAN: I would like to take this opportunity to set forth how this Authority and its rehabilitation program has been affected by the "Holder in Due Course Rule" promulgated by the Federal Trade Commission on May 14, 1976. Further, I request that the following be written into the Congressional Record as being submitted from an Authority that is opposed to and/or desires relief from the aforementioned Rule.

The City of Decatur, population of 22,000 people, has successfully participated in various programs through the Department of Housing and Urban Development and is currently undertaking a Community Development Program as a hold-harmless City with a funding level of $678,000.00. Of that amount, the City has seen fit to direct at least ⅓ of same toward rehabilitating properties within the Community Development Target Area.

This Authority has contracted with the City of Decatur to carry out the rehabilitation portion of the Community Development and the Urban Homesteading Program. Due to the limited funding under the Section 312 Program, this Authority sought-out and arranged for private financing through a local savings and loan association at an interest rate considerably less than the going rate for the locale. In addition, the Association has agreed to accept or deny each case on its own merit with the Authority securing any high risk loans that might be involved in the rehab or homestead area.

Briefly, the Authority's rehab staff was to contact owners within the target area, make work write-ups as needed in order to bring the properties to rehab standards, refer the owners to the savings and loan association for financing and stay with the owner until such time as a contractor had completely rehabilitated the property to the standards required. Due to the fact that Section 433.1 (d) of the May 14, 1976 Rule incorporates referrals to the creditor, the holder of that consumer credit contract is then subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained with the proceeds of the loan. In essence, the Federal Trade Commission Rule has all but killed any chances that we might have for rehabilitation of properties in the Target Area with private financing due to the risk that would be involved to the local savings and loan association.

Yes, this community is suffering and I am sure that other communities will suffer likewise unless the Federal Trade Commission amends the Rule to exempt home improvement loans or same is modified to place a time limitation as to its applicability; if not, rehabilitation loans from private sources within a Community Development Area will be non-existent and the intent of the Community Development Act destroyed by an administrative ruling from another governmental agency.

I am therefore asking that Congress act to amend the Rule to exempt home improvement loans. If, the Rule is not modified, same will eliminate participation by a vital sector of our community in a program that not only requires but dictates public and private cooperation in order to meet the objectives set forth by the 1974 Community Development and Housing Act.

For your convenience and information, I am enclosing a letter from the participating Association to the Federal Home Loan Bank Board and an opinion of counsel relative to the Rule. I would hope that this would further indicate to you the problems that we are experiencing and how this Rule has completely devastated the program that we are all so interested in pursuing.

I appreciate this opportunity to advise you of our situation and hopefully your Committee will see fit to legislate relief that will allow us to proceed with private financing of our program.

Sincerely yours,

David L. Smotherman,
Executive Director.

National Association of Federal Credit Unions,
September 2, 1976.

Re rule on the preservation of consumer's claims and defenses.

Hon. John M. Murphy,
Chairman, Subcommittee Consumer Protection and Finance, Committee on Interstate and Foreign Commerce, U.S. House of Representatives, Washington. D.C.

Dear Mr. Chairman: Few debates have generated as much heat and as little light as the current fevered argument over the Federal Trade Commission's rule on the preservation of consumer's claims and defenses, more commonly known as the "holder-in-due-course" rule.

Proponents of the rule contend that its adoption was an essential element of the government's effort to protect the consumer. Opponents believe that it does not in fact protect the consumer adequately, and may lead to actions that would adversely effect the very persons it was designed to protect.

Surely no one can argue against the laudable goal of consumer protection, and we do not propose to do so in these brief remarks. Indeed, credit unions are themselves consumer organizations. They are owned by consumers; they are operated by consumers; and if an individual credit union wanders very far from its consumer origin, it will shortly be called to task by its democratically elected consumer directors. Moreover, credit unions and their representatives—including the National Association of Federal Credit Unions—have stood in the forefront of those seeking consumer protection legislation, including such once-controversial legislation as Truth-in-Lending.

Now, however, our association has come to the point where it must ask who is being helped and who is being hurt by new "protective" rules, especially the holder-in-due-course rule. We do not propose to reiterate the arguments against this rule advanced by the spokesmen for other types of credit-granting institutions, although we believe many of these arguments have merit.

Instead, we would like to focus on this rule as it affects credit unions. What precisely are the implications of the FTC effort for credit unions?

(1) We believe, after consultation with some of our members, that the rule will increase consumer credit costs. This will affect credit union members in two ways:

(*a*) It will directly increase the cost of consumer credit to borrowers. Some proponents of the rule believe this is acceptable, since the cost will go up only marginally for all borrowers, while simultaneously reducing the burdensome costs previously suffered by some borowers. In short, they view the borrower's added cost as a sort of insurance that protects unlucky borrowers from being unable to exercise a claim when goods bought on credit prove deficient. We believe this to be nothing more than a way to shift the costs of credit from the careless to the careful buyer. It can, of course, be argued that some buyers have suffered in the past despite their carefulness; but even here, it appears to us a poor practice to apply the standards of the worst possible case to all transactions.

(*b*) In credit unions, these costs are also passed on to savers. As you know, all members of a credit union share equally in the income of the credit union. Once operating costs are met, dividends are divided among members. As the credit union as a financial institution is forced to pay higher costs, the dividends must be reduced. This can hardly be considered a consumer benefit.

(2) There is another aspect of the cost problem that has a special adverse impact on credit unios. Many credit unions, including many large and sophisticated credit unions, keep their operational costs to a minimum by relying on volunteer help. The growing burden of government imposed red tape is forcing credit unions to either reduce their services to members—hardly a consumer benefit—or spend more money on professional staffing and/or legal advice. Once again, the money to pay for these expensive commodities comes directly from the pockets of the consumers that own and operate the credit union.

(3) Related to this, of course, is the sheer ambiguity of just what the rule means. Determining whether or not the holder-in-due-course regulation applies in a given situation is obviously difficult, protestations of the rule's supporters notwithstanding. Once again, we believe that interpreting the rule could be both time-consuming and expensive, especially for smaller credit unions, and could intimidate such organizations (and their volunteer leaders) into restricting credit "to be on the safe side."

(4) There remains unresolved as well the question of long-term contingent liability that may be imposed on a creditor by this rule. The question has been raised—and not satisfactorily answered—as to the nature of a creditor's liability if a product fails to perform adequately after its manufacturer's warranty/guarantee expires. Is the creditor then liable, perhaps two or more years after a purchase, for the expenses of the defect? And to carry the point further, is the creditor in any way liable if the defect itself creates a liability, as in the case of an automobile that crashes because of a defect unrepaired by the manufacturer and/or seller? Thus the problem seems to exist that a creditor has absolutely no way of assessing potential liability and consequently no way to insure against claims on future earnings.

In addition, we believe that the rule suffers from a fundamental philosophical weakness. It appears to us that it was designed to protect victimized consumers from larcenous retailers by putting the burden of enforcement of buyers' rights on a third party for the most part incapable of enforcing them. We do not suggest that no creditor has ever been the accomplice of an unscrupulous merchant. Surely some creditor somewhere has been at least the knowing, if not the willing, participant in a sale that amounted to a defrauding of a consumer.

What we do suggest is that such creditors be punished, as would any accomplice in a criminal act. And we simultaneously suggest that the overwhelming majority of creditors who function honestly and fairly not be made to bear the burdens of those few which have functioned dishonestly.

To summarize, we believe that the holder-in-due-course rule as promulgated unfairly burdens the honest creditor; especially burdens creditors that are consumer-owned and operated; certainly burdens more consumers than it helps; and finally may be of little benefit to any consumers. We would be glad to comment further on these remarks, if you find it necessary. For now, we are satisfied in these brief comments to bring to your attention some of the weaknesses in the holder-in-due-course regulation that especially affect credit unions.

Respectfully yours,

Frank Wielga, *President.*

UNITED STATES LEAGUE OF SAVINGS ASSOCIATIONS,
Washington, D.C., September 8, 1976.

Hon. JOHN M. MURPHY,
Chairman, House Subcommittee on Consumer Protection and Finance, Washington, D.C.

DEAR CONGRESSMAN MURPHY: During your Subcommittee's oversight hearings last week on the FTC's holder in due course rule, you requested that the United States League of Savings Associations furnish additional facts and figures regarding the impact of the "Seller" rule on mobile home financing. The following is submitted in response to that request.

In the way of background, a mobile home because of its design, construction and component characteristics is not dissimilar from many other manufactured products produced for the consumer. What sets it apart is the nature of its use; its unfamiliarity to consumers, which necessitates a period for adjustment by the average buyer; and the comprehensive network of regulations which encompass ownership and which do not exist with respect to other consumer products.

A most significant problem with mobile home sales concerns the demographic base of the average purchaser. The Survey of Mobile Home Owners, by Owens Corning Fiberglass Corporation in 1975, reveals that only 20% of owners had previously owned mobile homes. The remaining 80% were totally unfamiliar with mobile home living and the various maintenance responsibilities that go with it. Obviously, this problem does not exist in single or multi-family housing areas. The Corning report also showed that more than 70% of mobile homes are located in commercial mobile home parks which indicates that the vast majority of such homes do not rest on permanent foundations, but are situated on blocking that requires occasional leveling. It should also be mentioned that single-wide mobile homes, because of their tubular construction, are most susceptible to movement from wind and other external conditions.

Experience has shown that most complaints regarding mobile homes defects are the result of frost heave or foundation settling and minor shifting due to improper anchoring and leveling. These cause sticking doors and cabinets, weakening of structural and decor trim, water leakage around windows and plumbing separation. Also, inadequate protection of exposed water and sewer lines between the mobile home and utility connections can result in frozen plumbing which in turn damages other internal components. Such problems are not attributable to the dealer, manufacturer or servicer but are caused by careless or neglect on the part of the owner.

In many cases where mobile home defects are attributable to owner mistakes, they still in many cases serve as the basis for claims against the dealer. If the purchaser is unable to recover from the dealer, he seeks restitution from the lender. However, with the FTC's new open-door policy created by the "seller" rule many purchasers will seek adjustment directly from the lender. The purchaser may even terminate his monthly loan payments to put added pressure on the lender to adjust the complaint. By the time a decision is rendered as to where the ultimate responsibility lies, the lender may be faced with a seriously delinquent account. In some cases, the delinquency may be so serious that the consumer cannot make up back payments. In other cases, a disenchanted consumer, upon discovering that the dealer or manufacturer is not responsible for his specific problem, may elect to terminate his loan payments, and seek another form of housing.

Apart from the problem of consumer claims is the comprehensive network of federal, state and local regulations pertaining to every conceivable aspect of the business. It is virtually impossible for a lender to ensure compliance with all of these regulations. A good example is zoning restrictions which may change at any time in regard to mobile homes. Another example are the various state and local regulations concerning the movement of mobile homes. There are untold numbers of such restrictions, a violation of any one of which could trigger a claim against the lender under the FTC rule. This creates an extraordinary burden and exposure to liability on the part of the lender.

Because of increased exposure to liability and the added burden of policing the practices of mobile home dealers including compliance with federal, state and local regulations, many banks and savings and loan associations have decreased or terminated their mobile home lending programs. Sales figures obtained this week from the Manufactured Housing Institute have reduced year end sales estimates from nearly 300,000 units to less than 260,000 units. In fact, the

most recent sales figures indicate an accelerating decrease in mobile home sales resulting from promulgation of the FTC's rule. A substantial recovery in mobile home sales was apparent until May of this year when the FTC's "Seller" rule became effective. Sales dropped from 24,440 units in May to 23,770 units in June. In July the decrease was even more pronounced with sales dropping another 3,000 units to 20,700.

Since mobile homes represent a substantial portion of the housing market for low income families we urge that Congress act to either suspend the FTC rule until its actual costs to consumers can be more accurately assessed or return such authority to the individual states.

Sincerely,

J. WILLIAM BRENNAN,
Assistant Washington Counsel.

STATEMENT OF THE NATIONAL SAVINGS AND LOAN LEAGUE

The National Savings and Loan League appreciates the opportunity to present our views to the Subcommittee on the Federal Trade Commission Trade Regulation Rule on Preservation of Consumers' Claims and Defenses, otherwise known as the "holder in due course" rule, which will be referred to hereinafter as the "Rule".

It is the position of the National League that (1) the Rule encompasses a much greater range of "sales of goods and services" than is necessary to accomplish the purposes of the Rule, as set out in the Statement of Basis and Purposes (40 Fed. Reg. 53524, November 18, 1975); (2) the Rule subjects savings and loan associations to potential liability which is unrelated to the problems which it is designed to solve; and (3) the Rule as applied to home improvement loans, mobile homes, and certain custom construction involves association management with the time-consuming task of determining whether or not a particular loan involves real or personal property.

Further, it is the League's view that the very complexity of the questions raised is a clear basis for proposing that if there is to be a Federal rulemaking authority at all, the Magnuson-Moss Act (P.L. 93-637) should be amended to transfer rulemaking authority relating to unfair or deceptive acts or practices pertaining to the savings and loan industry from the Federal Trade Commission to the Federal Home Loan Bank Board. In fact, the complexity of superimposing a Federal Rule in this area to transactions in which the rights of the parties thereto are otherwise determined by State law borne out by the need for the FTC to issue two sets of interpretative "Guidelines" (41 Fed. Reg. 20022, May 14, 1976; 41 Fed. Reg. 34594, August 16, 1976) to attempt to answer questions which have been raised in lawsuits, as well as in letters to the Commission and to Congress.

The first set of Guidelines referred to above states that "Sales of interests in real property are not covered by [the Rule]. . . . 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 and services, is often financed by credit secured by real property." (41 Fed Reg. at 20024). Home improvement loans, of course, also involve additions to an existing house. A structural addition to a house, for example, involving one or more new rooms, plus consumer goods such as possibly new kitchen appliances, heating or cooling equipment, or plumbing fixtures present the association with the problem of determining which of such appliances are "real property" under the law of the State, and the relationship between its liability under the Rule for those appliances deemed to be personal property and manufacturers' warranties covering them. In addition, when a borrower on a ten-year home improvement loan, for example, in the eighth or ninth year of the loan refuses to pay because of alleged defects in construction, the association management would be called upon to make a determination as to (1) whether the defect is due to normal wear and tear, or the result of abuse by the borrower, and (2) whether, in view of the comparably small balance remaining, to take legal action to enforce payment.

The same question would be presented in the case of a loan to purchase a new mobile home from a dealer. While this transaction, if consummated before the mobile home was located on a lot and connected to utilities, would undoubtedly be regarded as a sale of personal property, it is, for all practical purposes, a sale of a home. If the unit should become real property under State law once it is attached to the site, does the Rule continue to apply for the term of the loan or beyond, because of the fact that at the time of execution of the sales contract the unit was personalty under State law.

It should be noted that the extent of recovery by the debtor under the Rule is limited to amounts he has paid under the contract. This means, of course, that the closer the loan gets to maturity, the more the borrower can recover from the lender and the less incentive the lender has to incur the expense of enforcement, because of the decreasing amount of principal and interest remaining. There is, further, no provision for cutting off liability at any time.

Quite apart from the above considerations, the Rule poses certain problems with respect to the liability of savings and loan association lenders for the performance of appliances installed in home improvement loan projects, or in mobile homes.

The May 14 Guidelines state that "The Rule does apply to all claims or defenses, 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."

This apparently means, for example, that the lender is liable for damages incurred by the malfunctioning of appliances in home improvement projects or in mobile homes. We see no justification for imposition of this kind of liability on lenders.

Under this provision, the lender could have the entire loan proceeds as a result of the negligent or fraudulent conduct on the part of a third party. We do not believe that the problems addressed in the Statement of Basis and Purpose require extension of this kind of liability to lenders.

It should be noted that the interpretative guidelines issued on May 14, 1976 make it clear that the interpretations contained therein have not been adopted by the Commission and do not "alter the Rule or the official Statement of Purpose published with the Rule." It is not clear, therefore, whether or not the Rule applies to notes secured by first mortgages on real estate. Should the guidelines on this point be successfully challenged in a court test, the impact on the residential mortgage market would be catastrophic.

The problems outlined above applicable to home improvement loans and mobile homes would be even more disruptive as applicable to mortgage loans with terms of up to 30 years. In addition, the s ondary market, on which the mortgage market depends for liquidity transfer of funds to capital short areas, and for sources of funds, would also be disrupted. Mortgage yields are currently at historically high levels, yet the mortgage instrument has been steadily losing its appeal as an instrument by investors outside the savings and loan industry, particularly, life insurance companies and pension funds.

The mortgage instrument is not yet a completely marketable document as is a stock or bond, although many agencies and institutions are working to make it so. It would be both unwise public policy and an unjust shift of liability to subject mortgage lenders and their subsequent purchasers to problems which arise between a builder, or other vendor and the purchaser of a residence. It makes no sense, whatsoever, to permit an agency with little or no expertise in the mortgage market to wield this kind of power over the housing sector of the economy which is a complex and specialized one far outside the scope of the traditional consumer transaction to which the Rule is designed to apply.

If the Federal Trade Commission does not intend for the Rule to apply to residential mortgages, it should so state in an opinion and not leave this issue for the courts to decide.

As noted above, the National League believes that if there is to be a Federal rulemaking authority at all, the Magnuson-Moss Act should be amended to convey rulemaking power in this area from the Federal Trade Commission to the Federal Home Loan Bank Board.

When the Act, then S. 356, 93d Congress, went to Conference, the Senate version provided that all depository financial institutions would be regulated by the Federal Reserve Board. The rationale for this approach was outlined in the Report of the Senate Banking Committee on S. 356 (S. Report 93-280, pages 2-3) as follows:

"The primary basis for [this provision] is the need for expertise in the financial area and in the functioning of the monetary system in any agency which is authorized to place requirements upon the functioning of depository institutions. The FTC does not have the requisite expertise, and the committee therefore

transferred the situs of the rulemaking authority to the Federal Reserve Board. The Board would be expected to work closely with the other financial agencies in exercising this important consumer function, including the drafting and modification of regulations.

". . . banks and other financial institutions are already among the most regulated forms of business in the country today, and . . . an additional layer of regulation by a different agency is likely to detract from, rather than add to, the incentive of institution managers and owners to attempt innovations in operations which will benefit the consumer—such as the experiment in NOW accounts (interest-bearing demand deposits) presently taking place in certain Northeastern States. Bureaucracy breeds delay, inefficiency, and frustration for regulated business, . . ."

Mr. Charles E. Allen, then General Counsel of the Federal Home Loan Bank Board, in his letter of October 11, 1974 to Senator Frank E. Moss, Chairman, Senate Commerce Subcommittee on the Consumer, stated:

"Apparently, the reason the House bill does not exempt thrift financial institutions from FTC jurisdiction is because the FTC Act, as it was enacted in 1914, exempts "banks" from supervision by the FTC and it was felt that the amendments to be made by S. 356, which to a large extent clarify that exemption, should be limited to the original coverage of that exemption.

"The Board does not agree with this reasoning. In the first place, when the FTC Act was enacted in 1914, thrift financial institutions were not subject to Federal regulatory control and it is no doubt for this reason that thrifts were not specifically exempted. At present, Federal savings and loan associations are chartered by the Federal government much the same as national banks, and the majority of State associations are insured by the Federal Savings and Loan Insurance Corporation in a similar fashion to the FDIC's insurance of the majority of the nation's State banks.

"It is the Board's opinion that thrift institutions and banks, which are competitors, should be subject to the same regulatory standards with respect to consumer protection and that it is unfair and inefficient to provide for enforcement by the FTC on the one hand and by the bank regulatory agencies on the other. The FTC should not regulate some Federally regulated financial institutions, and not others. The Board has full, plenary power over the operations of Federal savings and loan associations and the authority to protect against and prevent unsafe and unsound practices in any financial institution insured by the Federal Savings and Loan Insurance Corporation."

We also support the approach of Senator Garn and other co-sponsors in the Senate of S. 3652, the "Consumer Loan Contracts Act of 1976", which is designed to leave the holder in due course matter to the State Legislatures. According to Senator Robert Morgan (D., N.C.) in his remarks as co-sponsor of the bill (July 1, 1976 Cong. Rec. p. S11413) there are some 39 States which have eliminated or limited the holder in due course rule, and 41 which have eliminated or modified the power of the buyer to waive his defenses. We do not believe that this record points to a lack of action or concern by State legislators. It clearly does not provide a basis for a Federal rule.

The direct application of the Rule to "creditors" was, as the Subcommittee knows, also proposed on November 18, 1975 (40 Fed. Reg. 53530). The adoption of this provision, of course, would subject lenders to civil penalties under the Federal Trade Commission Act for failure to include the required clause in a covered loan contract even though the seller's performance under the contract was satisfactory and even though no buyer complaints were made to the lender. This provision is unnecessary in our view if the Rule were clarified as to the exact type of transactions which are covered by it. We do, however, reiterate our opposition for reasons stated above to the adoption of a Federal Rule applicable to either sellers or creditors.

Statement of the Manufactured Housing Institute

Mr. Chairman and members of the Subcommittee. The mobile home industry has begun to return from the depths of a serious recession. As shown on the enclosed "Quick Facts," the 1975 mobile home production was more than sixty percent off the 1973 mobile home production. In 1976, the trend is upward in mobile home production, and the industry is concerned with the possibility that the Holder in Due Course FTC Trade Rule will seriously affect the availability of financing and hinder the industry from regaining its former prominence in producing low-cost housing.

A long term relationship has been established in mobile home financing between the bankers and the dealers. Often the financial institution providing retail financing will also be providing wholesale financing (floor planning). The Manufactured Housing Institute Finance Survey for 1975 indicated that seventy-five percent of the responding 414 financial institutions reported some type of business relationship between lenders and dealers.

One important factor relating to a strong demand for production in the mobile home industry is the availability of additional financing sources. The severe recession of the mobile home industry was primarily caused by a lack of available funds for retail financing. The industry fears a slow down in the return of financial institutions to the mobile home retail credit field, due to the fact that the FTC Rule places an uncertain responsibility on the lending institution with which it has had little experience. The mobile home industry fears that this will deter the return of many lenders to mobile home lending because the average mobile home loan runs around ten years, and the new FTC Rule would hold the lending institutions responsible for the entire period of the loan.

Some banks have experienced serious problems over existing state Holder in Due Course laws. An example of this is the State of Oregon which has had a state law imposed for some time; we find that in that state, at least three banks have greatly curtailed their mobile home lending. The U.S. National Bank of Oregon, the First National Bank of Oregon, and the First State Bank of Oregon have all curtailed their lending according to mobile home officials in that state.

The United Federal Savings and Loan and the First Alabama Bank of Dothan, Alabama, both stopped making mobile home loans effective May 15, 1976, as a result of the new rule concerning Holder in Due Course. We have been informed by various members of the industry that many financial institutions previously considering new lending or reentry into the business have recently decided not to become involved or postpone this decision until an equitable change occurs with the FTC Holder in Due Course Rule.

The other alternative that banks have to abandoning mobile home lending where concern exists over the FTC Rule is to increase the interest rate to allow the bank to set aside funds for potential problems caused by the rule or to purchase insurance to protect them against undue liability in this area. One potential problem with this method of solving their problem lies in the fact that interest rates charged on mobile home lending are often very near the ceiling of the state usury laws, and therefore, an increase of ½ to 1½ percent for this type of "insurance" would not be permissable under state usury laws.

In any case, the FTC Rule appears to have unduly burdened the buyer of mobile homes. The end result of this FTC Rule on Holder in Due Course will probably be a tightening of the credit availability for mobile home buyers. This will be a severe blow to the low-to-moderate income family whose only affordable alternative is a mobile home.

Statement of the Credit Union National Association, Inc. (CUNA)

The Credit Union National Association, Inc. (CUNA) is the organized voice of nearly 23,000 federally-chartered and state-chartered credit unions which serve over 32 million members. We offer this statement for the hearing record to express the concerns and problems of the credit union movement with the Federal Trade Commission's ruling on preservation of consumers' claims and defenses.

PRELIMINARY STATEMENT

A credit union is a member-owned, nonprofit cooperative thrift institution formed for the purpose of encouraging savings by offering a good return, using collective monies to make loans at competitively low interest rates to members, and providing other financial services. Members are united by a common bond of association and democratically operate the credit union under state or federal regulation. No creditor is more consumer-oriented than a credit union. One of the principal purposes of credit unions has always been to enable members to obtain loans at fair and reasonable rates (usually less than that of competitors).

Credit unions also strive to provide services for their members and to offer them special opportunities as consumer, e.g. when feasible, through group buying arrangements. All profits are passed back to members through dividends on shares or refunds of interest on loans. For nearly half a century, credit unions have been in the forefront of consumer advocacy. They have been and still are

advocates of legislation benefiting consumers. It is therefore with some discomfort that CUNA is compelled to criticize this FTC Rule that has been adopted as a consumer protection device.

CUNA SUPPORTS ELIMINATION OF THE HOLDER IN DUE COURSE DOCTRINE

We support the elimination of the traditional holder in due course doctrine. We believe that in those transactions where consideration passes between a seller and a lender, a buyer's claims and defenses should be preserved. We believe that the holder in due course doctrine is inappropriate where there is a true and realistic commercial or business interrelationship between a seller of goods or services and a lender which finances such purchases. We agree with the premise in the FTC's Statement of Basis and Purpose that consumer credit obligations should be subject to claims and defenses whenever credit is arranged or secured in connection with a continuing relationship between a seller and a creditor, working cooperatively to finance consumer sales.

CUNA OPPOSES THE RULE AS DRAFTED

We oppose the FTC Rule as drafted because it goes far beyond the repeal of the traditional holder in due course doctrine. Where a creditor is no more than a principal party to a loan and is not directly affiliated with the seller, we believe there is considerable unfairness if the consumer's duty to pay the creditor is not separated from the seller's duty to perform.

We do not think the Rules should apply to situations where the consumer voluntarily selects the seller and voluntarily selects the lender and no consideration passes between the seller and the lender either directly or through a parent association. We disagree, therefore, with the Commission's position that if a seller has an arrangement whereby he refers his customers to a creditor, all loan contracts between that creditor and a borrower who uses the proceeds to purchase goods from that seller must contain the Notice, whether the particular loan contract was the product of a referral or not. We believe the Rule should apply only to situations where the relationship between a seller and a lender bears directly on the consumer's selection of the parties.

RULE DISRUPTS CREDIT UNION MARKETPLACE

We believe that credit unions and credit union members have experienced an unfair and unnecessary amount of marketplace inconvenience and disruption because of the adopted rule. In particular, we have received numerous reports from all over the country that transactions for automobile purchases have not been consummated because of apparent over-compliance by automobile dealers. Consumers have been inconvenienced in at least the following ways:

Dealers have inquired about the source of money they were using to buy the car they selected.

Dealers have refused to accept checks made out jointly to the consumer and the dealer.

Dealers have refused to take steps to perfect security interests for credit unions that refuse to insert the FTC Notice in their credit contracts.

Dealers have refused to provide title to credit unions.

In some trade areas auto dealers have universally informed all creditors in their trade area that they will not accept the proceeds of consumer loans unless the underlying consumer credit contracts contain the prescribed Notice. One dealer notified its sale personnel not to release vehicles unless they obtained a copy of the credit contract. Another dealer unilaterally informed its customer that the prescribed notice was a provision of his consumer credit contract. Attached to this statement as Appendix A are copies of correspondence we have received to document these problems.

We realize that the recently adopted Statement of Enforcement Policy will alleviate certain of these problems. But the Statement cannot eliminate retroactively the specific operational problems and general apprehension experienced by credit unions during the more than three months since adoption of the rule.

FTC USED POOR PROCEDURES

We criticize the timing and procedures followed by the Commission in adopting and implementing this Rule. The Staff Guidelines dated May 14th were issued on the effective date of the Rule and were not available for general distribution until after the effective date. Indeed, the failure to issue a formal statement of

Commission guidelines prior to the effective date of the Rule resulted in more consumer inconvenience than protection.

We recognize that there is a predictable learning phase associated with any new complex ruling. However, we expect the same recognition from the rule-maker who must allow adequate time and explanatory material to facilitate implementation of a rule. We believe that a responsible exercise of rulemaking authority should not involve unnecessary inconvenience in the marketplace. We hope that this Committee in its oversight capacity will prevail upon the Commission to avoid these problems when adopting future trade regulation rules.

We also criticize the draftsmanship of this rule. We have learned that it is easy for the most well-intended lender or other industry representative to lose sight of the merits behind the intent of this rule because it is so poorly drafted that its apparently unreasonable scope overwhelms the reader.

We believe that one should be able to understand a rule by reading the rule. One should not have to read a statement of policy, a series of staff guidelines, and a statement of enforcement, as well as various advisory opinions, to learn that a rule is not as broad as it appears to be. It it became apparent that the rule was overly broad as drafted, as it should have in the course of the hearings on the proposed "lender" rule, and by the numerous problems raised by the consumer credit industry, we suggest that the Commission should get to the heart of the problem and simply revise the offending provisions.

We note that the recently published Statement of Enforcement Policy addresses several questions that have been frequently asked by lenders and sellers as to the applicability of the Rule. However, several significant questions remain unanswered. CUNA is awaiting replies to two requests submitted to the FTC for official advisory opinions on various issues of concern of credit unions.

LENDER RULE WOULD HURT CONSUMERS

We are concerned that adoption of the proposed "lender" rule will result in the further termination of consumer oriented credit union services. Indeed, because of the difficulty with understanding the scope of the adopted rule, some credit unions have discontinued group discount buying programs for their members. These plans are offered as a service to credit union members. Credit unions obtain no direct consideration for promoting the plan and, indeed, purchases under these plans rarely result in the generation of new consumer loans. The member is under no obligation to borrow from the credit union in order to take advantage of a group buying service.

We understand that there is a basic difference of opinion on the question of whether a thrid-party direct lender, such as a credit union, should bear the obligation of policing the marketplace and assuming liability for the quality of performance of goods or services obtained from sellers with loan proceeds from the credit union. We believe that in the absence of a meaningful affiliation between a seller and a financial organization, the credit grantor should not bear such obligation. Credit unions are in the business of receiving savings from their members and making consumer loans at the lowest possible rate. They are not in the busines of selling goods or services, nor do they have the expertise with which to monitor the quality of sellers of goods and services.

Moreover, aside from necessary reserves, credit unions pass profits back to the members in the form of dividends, shares or interest rebates. These returns are subject, of course, to losses that stem from bad loans, or from costs associated with operations or with offering membership services. To the extent that the FTC Rule imposes additional liabilities or risks on credit unions, these profits are subject to reduction of dividends or interest rebates to all members of the credit union. We believe this is unfair in light of the fact that the consumer who receives the purchase money loan is always free to select the merchant of his or her choice.

RULE SHOULD NOT APPLY TO GENERAL TORT LIABILITY

We are further concerned with the scope of the Rule as it applies to tort liability. We can understand the preservation of claims relating to fraud or duress in connection with the sale involved. But we see no justification for subjecting the direct lender to the inestimable risk associated with tort liability as it may manifest itself in personal injury, malpractice, wrongful death, or other actions that are totally beyond the control of the lender. We strongly object to applying this rule to non-sales related tort liability. Indeed, we object to the introduction into routine commercial law by an administrative agency rather than the legislature of such a revolutionary concept.

RULE PUTS CREDIT UNIONS AT COMPETITIVE DISADVANTAGE

Finally, we are concerned that credit unions are at a competitive disadvantage in comparison to other financial institutions. The May 14th Staff Guidelines reflect an assumption that, when the Rule applies, the lender and seller can contract for indemnification. It is true that a seller might be inclined to indemnify a financial institution with which it has a commercial relationship. But credit unions are empowered to offer consumer services only and therefore enjoy no leverage over sellers. To the best of our knowledge, credit unions have been unable to obtain meaningful indemnification agreements from sellers who demand the FTC Notice in alleged purchase money loan contracts. And the ultimate inequity results when dealers blame the failure to consummate a transaction on the credit union and advise the consumer to seek financing from a bank or finance company with whom the seller has a relationship.

CONCLUSION

We strongly urge this Subcommittee to use its oversight power and authority to monitor the rulemaking activities of the FTC. We believe that the poor draftsmanship and the insensitivity to marketplace reality reflected in this Rule reveal the problems inherent in delegating excessive and broad regulatory authority to an agency which has no expertise with regard to the entire segment of commerce being regulated.

We remind the Subcommittee that we are not anti-consumer or anti-consumer protection. But we object to irresponsible attempts at consumer regulation. And we regret being forced to criticize a rule when we agree with its basic intent, in this instance, the abrogation of the traditional holder in due course doctrine.

We wonder why the FTC did not simply adopt a substantive rule rendering ineffective and unenforceable any contractual provision that required consumers to waive claims and defenses arising from the subject of the transaction against subsequent holders of the consumer credit contract. Perhaps the FTC adopted a complex procedural, i.e. disclosure rule to implement a substantive reform, and failed to attempt to rescind the holder in due course doctrine because the type of substantive lawmaking needed to properly accomplish this goal rests more properly in the legislature. In this regard, the Commission could have and should have drawn on the experience of the various states that have enacted statutes which are workable means of weakening or eliminating the traditional "holder" doctrine.

We urge this Subcommittee to exercise some control over the implementation and enforcement of this Rule as well as future trade regulation rules that may have a broader, though again perhaps unintended impact on credit unions.

APPENDIX A

CLINTON LINCOLN-MERCURY CO., INC.,
Clinton, Iowa, May 17, 1976.

CHICAGO MILWAUKEE ST. PAUL
& PACIFIC RAILROAD CO.
CREDIT UNION,
Clinton, Iowa.

GENTLEMEN: In reference to the new Holder-In-Due-Course Law. This letter is to inform you any holder of a 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.

Yours very truly,

KENNETH HAVENS, *President.*

* * *

CONNECTICUT CREDIT UNION LEAGUE, INC.,
Wallingford, Conn., June 16, 1976.

SHARYN CAMPBELL,
Counsel, CUNA Washington Office,
Washington, D.C.

DEAR SHARYN: I note from some of the League publications that you are collecting information as to the types of problems experienced by credit unions as a result of the FTC's holder-in-due-course rule. Let me, accordingly, bring you up-to-date on what is happening in Connecticut.

In some areas of the state, business continues as usual. In other areas, notably Fairfield County, we are finding numerous examples of automobile dealers changing their customary practices. Generally speaking, these operational changes take one or more of the following forms:

1. The dealer advises the credit union that a check made out jointly in the name of the dealer and the member will no longer be accepted in the purchase of an automobile;

2. The dealer refuses to accept any check upon which there is a restrictive endorsement such as the following:

"By endorsement dealer agrees to list XYZ Credit Union as first lienholder on title. Failure to do so may result in subrogation against dealer."

3. Some dealers have indicated that they will not provide the title to the financial institution, but rather that the financial institution must obtain the title when it arrives from the buyer.

I am enclosing some samples of correspondence from car dealers requesting that credit unions include the notice in their consumer credit contracts. This is increasingly a problem. FTC, for its part, claims that the laws of the market-place will ultimately prevail. However, in some areas we have somewhat of a standoff with dealers refusing to finance cars where the notice is not included in the note and financial institutions refusing to put the note in their contracts.

Finally, I am sending to you a copy of the letter from the W. R. Austin Chevrolet Company in South Norwalk, addressed to a recent automobile buyer. The letter is self-explanatory.

At the CUIS conference recently in Washington, I advised an FTC attorney who was on the program as to the three problem areas we were experiencing in Connecticut, as outlined above. His response was that credit unions should continue doing business as usual, altering neither their forms nor their procedures.

I would appreciate hearing from you if there is any reason to change this policy. I would also be interested in your reaction to the W. R. Austin Chevrolet Company letter and would hope that you might also see fit to bring that to the attention of the FTC staff.

Many thanks for your interest.

Sincerely,

J. ARTHUR JOHNSON,
Director, Government Affairs.

* * *

W. R. AUSTIN CHEVROLET CO.,
South Norwalk, Conn., June 10, 1976.

Re #1035V6B491554, 1976 Chevrolet Chevelle.

MR. JAMES R. WELSCH,
South Norwalk, Conn.

DEAR MR. WELSCH: Thank you for buying your car from Austin Chevrolet! According to a rather complicated Federal Law which took effect on May 14th, known generally as the FTC Holder in Due Course Regulation; as the seller we are required to see to it that the following statement appears on your finance contract; subject to some rather severe penalties if we don't. Since your credit union has asked us to file their lien, the transaction is covered by the new law. Not having access to the credit union's contract, we are using this registered letter to notify you, and suggest that you keep it with your finance papers.

"Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods and services obtained with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder."

Yours truly,

ADDISON W. AUSTIN,
Vice President.

* * *

LYNCH MOTORS INC.,
Manchester, Conn., May 25, 1976.

Re FTC holder in due course regulation.

MANCHESTER TEACHERS CREDIT UNION,
Manchester, Conn.

GENTLEMEN: In accordance with above regulation adopted by the Federal Trade Commission, I request that on all Consumer credit contracts issued by your institution for the purpose of purchasing an automobile from Lynch Motors, Inc., you incorporate the following notice in 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."

Please notify your clients that we will want to inspect their consumer credit contracts to insure that the above notice is contained therein.

Thank you for your cooperation.

Very truly yours,

MICHAEL B. LYNCH, *President.*

* * *

LUBRIZOL EMPLOYEES' CREDIT UNION,
Deer aPrk, Tex., June 24, 1976.

Re FTC regulation—Preservation of consumers' claims and refenses, chapter I of 16 CFR, subchapter D, part 433.

AL JONES,
League's Director of Governmental Affairs,
Texas Credit Union League, Dallas, Tex.

DEAR SIR: In regards to the Holder-in-Due-Course Rule that went into effect May 14, 1976 and the effect it has had on our Credit Union:

We regretfully have had to discontinue affiliation with a discount buying service in order to keep us from being liable for the products.

This buying service was a great benefit to our members by enabling them to save money on major purchases. Other places of business used to offer discount rates to credit union members as well as those businesses connected with the buying service.

We feel that this was a very good and helpful service to our membership and truly regret having to discontinue helping our members find a good buy.

Credit unions are for service, and we feel that this particular service helped to keep our members from getting "ripped off" in the first place!

This law could have been written to serve its purpose without making the majority of the people and the institutions that help people pay for it.

Isn't there something that can be done about this law that will enable credit unions to serve and help our members without putting the credit unions in jeopardy?

Very truly yours,

KATHLEEN B. SMITH, *President.*

* * *

OHIO CREDIT UNION LEAGUE,
Columbus, Ohio, June 29, 1976.

MS. SHARYN CAMPBELL,
Credit Union National Association,
Washington, D.C.

SHARYN: The enclosed newsletter, published by the Credit Bureau of Cleveland, was picked up by one of our representatives in a credit union office in Cleveland and forwarded to me. This would appear to me to be another example of over-compliance of the Holder in Due Course doctrine. This is the type of information that is being disseminated to automobile dealers and everyone else, which I think is probably part of our trouble in the Northern part of our State.

Whta, if anything, can we do to counteract this type of propaganda. I would appreciate your comments.

Kindest regards,

CLIFFORD HATTEN,
Director, Public Relations.

Enclosure.

* * *

[From the Credit Newsletter, June 1976]

FTC RULE IS PART OF ANTICREDITOR TREND

At our May Credit Forum, attorney Edward Chitlik discussed the recent legal trend of resisting creditors' rights and its most recent outgrowth, the FTC Holder in Due Course Rule.

The FTC rule, which became effective May 14, 1976, was designed to let dissatisfied credit buyers shed their loan obligations. Consumers now have the right to stop payments to third-party lenders when financed goods or services fail to match retailers' claims. In essence, it kills the two-centuries-old legal concept known as "the holder in due course."

Retailers must now incorporate a 48-word legalistic notice in every consumer contract, subjecting the "holder" of the contract to "all claims and defenses" that the purchaser "could assert against the seller of the goods or services."

In answer to a question, Mr. Chitlik said a creditor cannot circumvent the FTC rule by making direct loans. The commission purposely covered creditors as well as sellers. If the creditor has any knowledge or hint as to what the loan will be used for, he will fall under the rule.

Although the rule will probably result in tighter credit as well as increased customer complaints and costly paperwork, Mr. Chitlik admitted that it will serve its consumer protection purpose by making sure creditors only finance with reputable dealers.

The FTC rule is just one more step in a legal trend which started with Supreme Court case *Sniadach* v. *Family Finance* 1969. In *Sniadach*, a case finding garnishment of wages before judgment unconstitutional, the court looked at the debtor's right to due process saying the use of money was a property right that cannot be taken from an individual without judgment.

Sniadach opened the floodgate. In a following case, *Fuentes* v. *Shevin*, the court held that, although the creditor protected his interest by making the debtor put up collateral, he cannot seize that collateral without first getting court judgment.

Before these cases, a creditor could seize his property and post bond, putting it in protective custody until judgment was rendered. Now, he must first file an action with the court and, at a subsequent date, the court will decide if repossession or whatever is necessary. If there is good faith between creditor and debtor there is no problem, but if not, the time difference could mean loss of goods for the creditor.

This gradual change in legislative and public attitude toward creditors' rights continued as interest in constitutional rights and consumer protection increased.

"When I was younger I thought God had invented the cognovit note and it would take the Lord to take it away. Now that's gone too," Mr. Chitlik said.

In some cases, the law still allows a creditor to take possession peacefully. Convincing the debtor to hand over the property or sneaking it off his premises without doing damage are two examples cited by the speaker. But he pointed out that legal attempts have been made to apply the Fourth Amendment, regarding search and seizure, to stop this self-help by creditors. He expects some court to rule this way in the future.

He also expects future challenges under the civil rights section claiming the taking of property is a deprivation of a person's civil rights.

The future? Mr. Chitlik sadly predicted the results for creditors will be that they will find themselves in court more often, that they will have to hire larger legal staffs, that the small businessman will have difficulty with added legal costs and tighter credit and that one day there will be no way for a creditor to protect his property before judgment.

* * *

McClellan Federal Credit Union,
North Highlands, Calif., June 30, 1976.

Sharyn Campbell,
Washington Counsel,
Credit Union National Association,
Washington, D.C.

Dear Ms. Campbell: Your letter dated May 18, 1976, clarifying the FTC/Trade Regulation Rule concerning Preservation of Consumers' Claims and Defenses was very enlightening. While we agree that "the rule does not apply to most credit union loans" it quite effectively removes one of the most worthwhile functions of the credit union.

Some of us still believe in the credit union motto "Not For Profit, Not For Charity, But For Service." We view as one of the most valuable services we can render the dissemination of consumer information. After many years of doing business in this community and having made thousands of automobile loans we have extremely valuable knowledge regarding the most reliable of the many dealers. Reliable in the value received in the selling price and possibly of greater value—reliable in the after-the-sale treatment of the customer. We are no longer making such referrals and because of that the member suffers from our inability to guide him. We have, of course, debated the referral of members to those dealers who have always been "good guys" in their dealings and consequently proceed with the inclusion of the required notice in the consumer credit contract. But, we are faced with the ever present possibility of personnel changes at the dealership and the fact that one may "go sour" at any time. At any rate, caution seems to be the prime directive.

We have enclosed what we consider to be a very informative and entertaining magazine published monthly at no expense to the credit union. In exchange for the paid advertising we receive a number of free pages to do with as we please. In the centerfold we have chosen to advertise a few of our loan policies. Our attorney had advised us that this information combined with the paid advertising of the automobile dealers places us directly under the FTC rule due to a "joint advertising effort".

The result of this has been to deny the magazine to our members and to decline renewal of the contract. Free enterprize—the magazine publisher—will suffer from the seemingly capricious FTC ruling.

We feel that this FTC rule is a prime example of consumer over-protection and places the "good guys" at the credit union in the untenable position of being just another money leader rather than financial counsellor where a member can get the "straight scoop". To put it another way, one of our reasons for being has been seriously jeopardized. We have neither the time nor the inclination to continually monitor the business practices of each of the merchants whom we believe to be reputable and to whom we would ordinarily not hesitate to refer a member. The FTC has in fact stated that this was not the intent of the rule. As any attorney knows "intent" has been the subject of many court cases and is probable the single most difficult charge to prove or defend.

Perhaps we Department of Defense credit unions are in a somewhat unique position in the movement. Our military membership is very transitory. They come here from literally all over the world—strangers in the community. Their needs are great—a new automobile, household appliances, furniture, etc. Why shouldn't they be able to turn to their credit union for help? Why are we now afraid to help them by referring them to sellers we consider reliable? The FTC says we need not have concern—but the fact remains that we do. Our intention, on advice of counsel is to do nothing that could be construed by the most uneducated member as being in violation of the FTC rule. Why do anything to provoke an encounter no matter how groundless?

Are we "running scared"? You bet we are and it really doesn't matter what the "intent" of the FTC is.

Sincerely,

Frank J. Begley, *Manager.*

* * *

Random Thoughts From Cliff Hatten

June 30, 1976.

To Sharyn: The automobile dealers in the Warren-Youngstown area of Ohio are forcing the credit union members to sign this form before they will deliver the car.

Then then attach it to the title when they send it to the credit union.

Cliff.

* * *

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.

Purchaser shall give notice to seller of any breach of contract or of express or implied warranty applicable to the goods within twenty (20) days of the time he discovers or should have discovered the said breach or the purchaser shall be barred from any remedy for the breach. Purchaser shall thereafter return the goods to seller, or anyone designated by seller, within twenty (20) days after the notice of breach of to allow the seller the opportunity to cure the said breach or the purchaser shall be barred from any remedy for the breach.

The Creditor acknowledges that the provisions of this notice supersede any contrary or inconsistent provision(s) in the credit contract to which this notice is attached.

Receipt of a duplicate of this notice, attached to my copy of the credit contract, is hereby acknowledged.

SAM BENNETT, *Customer.*

* * *

PENNSYLVANIA CREDIT UNION LEAGUE,
Harrisburg, Pa., July 2, 1976.

Re holder in due course.

Ms. SHARYN CAMPBELL,
Washington Counsel, Credit Union National Association, Inc.,
Washington, D.C.

DEAR SHARYN: Hope this finds you having a good day!

This is in response to your request for information concerning problems facing credit unions due to the FTC's new rule on holder in due course. I have enclosed a notice issued by an automobile dealer to his sales staff. A credit union from western Pennsylvania sent it to our office and related the following:

A credit union borrower attempted to purchase an automobile with a credit union check issued to the borrower and the dealer. An agreement appeared on the back of the check stating the endorsers agreed to place an incumbrance on the title of the automobile in favor of the credit union.

The sales person employed by the dealer required the purchaser to present proof that the "Notice" appeared on the loan contract. He also intimated it might be less of a hassel if the purchaser financed the automobile through the dealer because the "notice" appeared on their loan contracts and afforded the purchaser recourse if the automobile performed unsatisfactory.

Of course, the credit union did not have the notice incorporated in their note. They had made no referral or had any other tie with the auto dealer, other than requesting the encumbrance.

It appears the dealer and his employees are deploying the FTC's ruling to enhance their interests by creating the hassel and obstructing commerce.

Respectfully,

JACK P. BARTH,
Director of Field Services.

* * *

NOTICE

To: All sales personnel.
From: Mike Kelly.
Date: June 3, 1976.

HOLDER IN DUE COURSE REGULATION

Due to Federal Trade Commission ruling, we are responsible for making sure that contracts from any lending institutions have the following notation on the contract in 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."

Even when a customer secures his own loan through a bank, credit union or insurance company, we must have a copy of the contract with the above notation for our files. If the customer wishes to retain the contract which he brings in to us, a photo copy will be made.

We cannot, by Federal law, accept monies from lending institutions unless contracts are so noted. To do so would subject us to a $10,000 fine per each violation.

Please advise your customers in advance of coming in to pick up a unit. No one is to release a vehicle to a customer before obtaining a copy of the contract with the appropriate notation, when proceeds from a loan are being used to finance an automobile.

WHITE CHEVROLET CO.,
Zanesville, Ohio.

OHIO BELL EMPLOYEE: CREDIT UNION,
Columbus, Ohio.

Attn: Credit Manager.

GENTLEMEN: Due to several difficulties we have experienced lately in having our money held up after delivering title on direct loans and also the Holder In Due Course legislation, we are going to ask for the enclosed agreement to be filled out and signed by the lender so that we may have something in our file until such time as we deliver title and receive your check for the direct loan.

If you give the borrower a check to pay for the car at the time we make delivery this need not be used. This is only on direct loans where we make delivery of the car prior to receiving payment.

Since it does have some legal meaning I am sure you will want your attorney to check it prior to it being signed, therefore we will continue on the same basis as in the past until you have had time to accomplish this.

Without either the check or this agreement it will be necessary to delay delivery until the title has been processed and we are in possession of your check.

Item #1 can be changed to read "upon delivery of title" instead of a date if this is what your requirements may be.

If there are any questions please feel free to call me collect.

Sincerely,

WM. R. UPTON, *Manager.*

* * *

AGREEMENT

Whereas, ________________, hereinafter referred to as Lender, has approved a loan to ________________, hereinafter referred to as Purchaser, the proceeds of which loan are to be used to purchase an automobile from White Chevrolet Co., which automobile is more specifically described as follows: Year ________, make ____________, model ____________, serial number ______, and

Whereas, the amount of money due White Chevrolet Co. under said transaction is in the amount of ________________ Dollars ($), and

Whereas, Purchaser desires to take possession of said vehicle and White Chevrolet Co. is willing to deliver possessions of said vehicle to Purchaser upon the agreement of Lender to pay the above said amount which is due White Chevrolet Co.

Now, therefore, it is agreed by and between the parties as follows:

1. The undersigned Lender agrees to Pay White Chevrolet Co. the sum of ___________ Dollars ($) on or before the ______ day of ___________, 19____.

2. White Chevrolet Co. agrees to deliver possession of the above-described vehicle to the Purchaser upon receipt of the original of this agreement executed by a duly authorized officer of the Lender, and further agrees to transfer title of said vehicle to Purchaser in due course according to law.

3. The undersigned Lender warrants to White Chevrolet Co. that its loan contract between itself and the said Purchaser contains the following notice in at least ten-point bold face type, to-wit:

> 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 the amounts paid by the debtor hereunder.

In witness whereof, the parties have hereunto set their hands this ________ day of ____________, 19_______.

_______________________ Witness — _______________________ Lender

_______________________ By _______________________

____

_______________________ Witness — White Chevrolet Co. _______________________

[Whereupon, at 5:47 p.m., the hearing was adjourned.]

APPENDIX

A QUALITATIVE EVALUATION OF THE IMPACT OF THE HOLDER-IN-DUE-COURSE RULE ON LENDING INSTITUTIONS

Prepared for: The Federal Trade Commission—August, 1976,
By Yankelovich, Skelly and White, Inc.

INTRODUCTION

Background and Study Purpose

The Federal Trade Commissions's (FTC) Rule concerning Presentation of Consumer's Claims and Defenses (Holder-in-Due-Course Rule) became effective on May 14, 1976. The purpose of this Rule is to make it an unfair and deceptive practice for a seller, in the course of financing a consumer purchase of goods and services, to employ procedures which make the consumer's duty to pay independent of the seller's duty to fulfill his obligations.

The FTC desired to evaluate the effect of this Rule on consumer credit markets. The Commission proposed that this be accomplished in two phases. The first phase was to determine whether the Rule has caused major, damaging dislocations in the consumer credit market and, if so, whether these dislocations are a result of the substantive provisions of the Rule or uncertainties as to its provisions.

... This volume addresses the findings of this first phase evaluation of the HIDC Rule. It presents, therefore, preliminary insights into the impact of this Rule on 127 lending institutions in diverse sections of the country. The aim of this investigation was qualitative -- to produce preliminary findings and hypotheses - not to complete a statistical sample of all lending institutions.

The second phase of this study would be designed to generate statistically-based conclusions about the impact of the HIDC Rule both from a reliable sample of lending institutions and the other affected publics - dealers and consumers.

This document presents, then, the findings, hypotheses and implications/recommendations of the first phase of the evaluation. In light of the overall study purpose stated above, this initial phase of research was designed to address the following questions:

... Has the Rule caused lending institutions to alter their policies, concerning the purchase of credit contracts, toward certain dealers?

-- What is the magnitude of that change?

... Have dealers increased or lessened their demand for lending institutions to purchase consumer credit contracts?

... What criteria do lending institutions use in determining whether or not to purchase consumer credit contracts?

... Have lending institutions adjusted their reserves or made other arrangements with dealers as a result of the Rule?

... Have lending institutions altered their discount rates in buying contracts from dealers as a result of the Rule?

-- Are dealers being considered equally with regard to discount rates?

... Have lending institutions distinguished those dealers who refer customers and also have other financial relationships with the lending institutions?

... Have there been problems in differentiating dealers who meet the above conditions from those who do not?

... Has the Rule caused lending institutions to either terminate certain financial relationships or cease to purchase consumer credit contracts from certain dealers?

... Have lending institutions altered their policies on making direct loans to consumers as a result of the Rule?

... What criteria do lending institutions use when determining whether to cease making direct loans, sever certain financial relationships or instruct certain sellers to not refer customers?

... Have interest rates on consumer loans changed as a result of the Rule?

... Do lending institutions anticipate expanding activities in the area of purchases of consumer credit contracts from dealers or in the area of direct consumer loans, which were cancelled as a result of the Rule?

- To what degree can this be predicted to happen?

... What direct costs do lending institutions attribute specifically to the Rule?

-- To what degree does this add to the cost of loans?

... What percentage of total loans result in claims or defenses pursuant to the Rule?

... What other information concerning the effect of the Rule do lending institutions feel the FTC should know?

Study Plan

In order meet the above stated objectives, this initial phase of research has followed the study plan outlined below:

1. Administration

... Planning meeting with the FTC

... Development of field procedures and lines of inquiry

... Data collection (see below)

... Professional analysis

... Presentation of qualitative findings in a mutual discussion meeting

... Preparation of a written report, including study plan for further quantification

2. Data Collection

For this first phase of the qualitative research, data was collected principally from lending institutions. Additional data was obtained from a limited number of lending institution regulatory officials.

Personal interviews were conducted in the following specific categories:

Lending Institutions - 127 interviews

Saving and loan companies	19
Credit unions	27
Independent finance companies	29
Commercial banks	38
Savings banks	10
National finance organizations	4

Lending Institution Regulatory Officials - 3 interviews

Yankelovich, Skelly and White, Inc., collected data from the above-designated lending institutions in a large (over 1,000,000 population), a mid-size (100,000 - 250,000 population) and a small (under 75,000 population) municipality in each of four states - New York, West Virginia, Texas and California.

Approximately, three interviews from each of the five lending institution categories were conducted in each large city. Two interviews from each category were conducted in each mid-size city. One interview from each category was conducted in each small municipality.

Organization of This Report

This report is divided into four sections. In the first, we present an overview of our principal findings. The next two sections discuss separately the reported current impact of the FTC's HIDC Rule and the perceptions of/attitudes toward the Rule. The section discussing current impact provides hypotheses concerning:

... Overall impact

... Who is affected

... How they are affected

... Actions taken by those affected

The section discussing attitudes/perceptions provides hypotheses concerning:

... Perceived understanding of the Rule

... Perceived relevance of the Rule

... Perceived impact of the Rule

In the final section of this report we set forth the implications of this research and our recommendations thereto.

SUMMARY OVERVIEW

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1. Elimination of HIDC provisions appears not to be causing major dislocations in the consumer credit market.

   ... Consumer credit policies, practices, and activities at lending institutions are largely unchanged and unaffected by the Rule.

   ... The Rule appears to be consistent with a general trend toward less dealer "paper" and more direct loans.

2. The Federal Rule is, however, stimulating some reactions by lending institutions, the most common and important of which is their more rigorous screening of dealers:

   ... Commercial banks, savings and loans associations, and finance companies are asking dealers to sign idemnification/recourse agreements, are severing certain dealer arrangements altogether, and/or are asking dealers not to refer credit customers.

   ... Such actions have had these results:

   -- Severance of relationships/agreements with "shoddy" dealers

   -- Financial institutions are more careful and selective in entering into dealer arrangements

3. While the <u>actions</u> they have taken to date are limited, lending institutions are generally concerned about and critical of the elimination of HIDC provisions. Although a minority of lenders (including some of the largest and most knowledgeable) acknowledge there is a need for increased consumer protection, most lenders take issue with the need for this Federal Rule. Concerns/criticisms have several interrelated components:

   ... Existing state laws and lending institution practices are said to provide adequate consumer protection.

   ... The FTC Rule represents another example of what is called "creeping government", "overregulation", etc. By itself, this Rule is said not to be the most onerous, but as the latest in a series of consumer protection regulations; it is resulting in a significant increase in the cost of credit and this cost is being borne by consumers.

   ... The FTC Rule is broad and far-reaching, yet leaves too many issues to interpretation and speculation. It lacks the specifics necessary to evaluate, implement, or respond to it properly. Confusion exists -- and causes much concern -- in such areas as:

-- What is a "legitimate" claim/complaint?

-- What is the period of risk? For how long is the lender responsible/liable?

-- What is a "business arrangement" with a dealer?

-- How are claims/defenses to be handled?

... The Rule adversely affects the low income groups it is designed to help because:

-- It reduces the number of dealers from whom they can obtain credit and:

-- Makes more difficult the successful development of new, small dealerships (an important economic opportunity for low income groups) since they cannot easily obtain credit for their customers

REPORTED IMPACT/EFFECTS OF ELIMINATION OF HIDC PROVISIONS

Hypothesis #1

To date, elimination of HIDC provisions has had little impact on the consumer credit policies, practices, and activities of the lending institutions studied.

... Overall credit activity in the consumer sector by these lending institutions has not changed.

-- As indicated by pre- and post-Rule measurements, these institutions' consumer lending levels have not changed significantly. What change there has been appears principally to result from more aggressive marketing, general economic fluctuations, etc.

-- Though some lending institution officers believe consumer credit activity in all lending institutions has decreased as a result of the Rule, very few report actual decreases in consumer credit activity at their own institution

-- Dealer demand for consumer credit paper has reportedly not changed

... Lending institutions' general consumer credit policies and practices have not changed.

-- Few lending institutions have altered their policies on direct loans

-- None have changed their interest rates on direct loans

PERCENT OF DOMESTIC LOAN FUNDS IN CONSUMER CREDIT

	TOTAL %	SAVINGS BANK %	SAVINGS & LOAN ASSOC. %	COMMERCIAL BANK %	CREDIT UNION %	FINANCE COMPANY %
N=	123	10	19	38	27	29
Average percent of domestic loan funds in consumer credit - 1976	62.1%	30.4%	24.9%	28.1%	97.4%	96.4%
Average percent of domestic loan funds in consumer credit - 1975	61.5%	28.2%	24.3%	27.2%	97.4%	96.1%

CHANGES IN PERCENT OF DOMESTIC LOAN FUNDS IN CONSUMER CREDIT

	TOTAL #	SAVINGS BANK #	SAVINGS & LOAN ASSOC. #	COMMERCIAL BANK #	CREDIT UNION #	FINANCE COMPANY #
N=	123	10	19	38	27	29
INCREASED PERCENT OF DOMESTIC LOAN FUNDS IN CONSUMER CREDIT (1976-1975)	20	7	4	10	–	1
Percentage point increase:						
More than 10	1	–	–	1	–	–
6 - 10	3	1	–	1	–	1
1 - 5	16	6	4	8	–	–
PERCENT OF DOMESTIC LOAN FUNDS IN CONSUMER CREDIT REMAINED THE SAME (1976-1975)	97	3	15	22	27	28
DECREASED PERCENT OF DOMESTIC LOAN FUNDS IN CONSUMER CREDIT (1976-1975)	6	–	–	6	–	–
Percentage point decreases:						
1 - 5	5	–	–	5	–	–
6 - 10	1	–	–	1	–	–
More than 10	–	–	–	–	–	–

OVERALL EFFECT OF NEW HIDC RULE ON CONSUMER CREDIT ACTIVITY

	TOTAL #	SAVINGS BANK #	SAVINGS & LOAN ASSOC. #	COMMERCIAL BANK #	CREDIT UNION #	FINANCE COMPANY #
N=	123	10	19	38	27	29
IN RESPONDENT'S COMPANY/BANK:						
Activity has increased	4	–	1	1	–	2
Activity has decreased	15	1	5	4	2	3
Activity has not changed	98	7	13	31	25	22
Uncertain	6	2	–	2	–	2
IN ALL LENDING INSTITUTIONS:						
Activity has increased	6	–	–	4	1	1
Activity has decreased	33	4	5	9	7	8
Activity has not changed	64	2	12	21	12	17
Uncertain	20	4	2	4	7	3

PERCEIVED CHANGE IN DEALERS' DEMAND FOR INSTITUTIONS TO PURCHASE CONSUMER CREDIT CONTRACTS AS RESULT OF NEW HIDC RULE

	TOTAL #	SAVINGS BANK #	SAVINGS & LOAN ASSOC. #	COMMERCIAL BANK #	CREDIT UNION #	FINANCE COMPANY #
N=	123	10	19	38	27	29
DEALERS' DEMAND HAS:						
Increased	7	1	1	5	1	4
Decreased	6	–	2	2	2	–
Not changed	95	4	14	33	18	25
Uncertain	16	5	2	3	6	–

ALTERATION OF POLICIES ON DIRECT LOANS TO CONSUMERS AS RESULT OF NEW HIDC RULE

	TOTAL %	SAVINGS BANK %	SAVINGS & LOAN ASSOC. %	COMMERCIAL BANK %	CREDIT UNION %	FINANCE COMPANY %
N=	123	10	19	38	27	29
Our policies have been altered	4	–	2	–	1	2
Our policies have not been altered	94	9	17	37	26	27
Uncertain	2	1	–	1	–	–

CHANGE IN INTEREST RATES AS RESULT OF NEW HIDC RULE

	TOTAL %	SAVINGS BANKS %	SAVINGS & LOAN ASSOC. %	COMMERCIAL BANK %	CREDIT UNION %	FINANCE COMPANY %
N=	123	10	19	38	27	29
Have changed our interest rates	4	–	2	2	–	–
Have not changed our interest rates	116	9	17	34	27	29
Uncertain	3	1	–	2	–	–

Hypothesis #2

The Rule has little impact on, and causes little concern among those lending institutions which either do not buy consumer credit contracts from dealers -- i.e., credit unions and savings banks -- or among those finance organizations which buy such contracts exclusively.

... Credit unions and savings banks interviewed offer consumer credit through direct loans only. Neither of these institutions report purchasing consumer credit paper nor making direct loans to consumers for purchases from dealers with whom these institutions have other related business arrangements.

... Credit unions and savings banks, therefore, indicate they:

-- Are largely unaffected by this Rule

-- Are largely unconcerned with this Rule

-- Have changed their consumer credit policies and/or practices little, if at all, in response to this Rule

-- Expect to do little or nothing in response to this Rule

... Lending institutions which purchase consumer credit contracts <u>exclusively</u>, are largely unconcerned about and unaffected by the elimination of the HIDC provision.

-- They claim they have always been "tough" on, and in control of, their dealer relationships

-- Many have always had recourse/indemnification clauses with their dealers

-- None have taken any action in response to this Rule

Hypothesis #3

The impact of this Rule, then, applies primarily to commercial banks, savings and loan associations, and finance companies, since the regulation most directly affects purchase of consumer credit paper.

... These three lending institutions, in addition to offering direct loans to consumers, purchase consumer credit contracts from dealers:

-- Almost all commercial banks interviewed purchase consumer credit paper from dealers: nearly half say consumer credit paper accounts for 20%-60% of their entire consumer credit portfolios

-- About half of the finance companies interviewed purchase consumer credit paper from dealers: it can account for up to 40% of their consumer credit portfolios

-- About one-third of the savings and loan associations interviewed purchase consumer credit paper from dealers: it can account for up to 20% of their consumer credit portfolios

... Because they purchase consumer credit contracts from dealers, these three institutions realize that this part of their credit business is subject to the Rule and, consequently:

-- Have already taken some action in response to the Rule

-- Are concerned about the implications and potential problems that could result from the Rule

... Commercial banks, further, are most likely to make -- or, perhaps, realize that they make -- direct loans to consumers for purchases from dealers with whom they (the banks) have other business arrangements -- i.e., purchase consumer credit contracts or finance other sales:

-- One-fifth of the commercial banks interviewed say such loans account for up to 20% of their consumer credit portfolios

-- One-half say they are unsure how many of their direct loans fall into this category, but implicitly acknowledge the existence of such loans

... Because they provide direct loans of this nature, some commercial banks:

-- Have already taken action in response to the Rule

-- Are concerned about the implications and potential problems that could result from the Rule

PERCENT OF CONSUMER CREDIT ACTIVITY
PURCHASE OF CONSUMER CREDIT PAPER

	TOTAL #	SAVINGS BANK #	SAVINGS & LOAN ASSOC. #	COMMERCIAL BANK #	CREDIT UNION #	FINANCE COMPANY #
N=	123	10	19	38	27	29
0% - 9%	69	8	13	10	26	12
10% - 20%	13	-	-	6	-	7
21% - 40%	19	2	1	7	-	9
41% - 60%	8	-	1	7	-	-
61% - 80%	6	-	2	4	-	-
81% - 100%	3	-	2	1	-	-
Uncertain	5	-	-	3	1	1
Average percent	18.6%	10.0%	24.5%	30.6%	5.0%	15.5%

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PERCENT OF CONSUMER CREDIT ACTIVITY DIRECT LOANS TO CONSUMERS

	TOTAL #	SAVINGS BANK #	SAVINGS & LOAN ASSOC. #	COMMERCIAL BANK #	CREDIT UNION #	FINANCE COMPANY #
N=	123	10	19	38	27	29
0% - 9%	4	–	3	1	–	–
10% - 20%	3	–	2	1	–	–
21% - 40%	5	–	1	5	–	–
41% - 60%	11	–	1	9	–	1
61% - 80%	24	2	–	9	–	13
81% - 100%	74	8	12	13	27	14
Uncertain	3	–	–	2	–	1
Average percent	75.1%	86.0%	63.4%	63.9%	90.0%	79.3%

PERCENT OF DIRECT LOANS USED FOR PURCHASES FROM DEALERS FROM WHOM CONSUMER CREDIT PAPER IS BOUGHT/OTHER SALES ARE FINANCED

	TOTAL #	SAVINGS BANK #	SAVINGS & LOAN ASSOC. #	COMMERCIAL BANK #	CREDIT UNION #	FINANCE COMPANY #
N=	123	10	19	38	27	29
0% - 9%	79	8	13	15	25	18
10% - 20%	9	–	2	4	–	3
21% - 40%	6	1	2	2	–	1
41% - 60%	2	–	–	1	–	1
61% - 80%	1	–	–	–	–	1
81% - 100%	–	–	–	–	–	–
Uncertain	26	1	2	16	2	5
Average percent	9.07%	7.78%	9.12%	11.1%	5.0%	11.9%

Hypotheses #4

Changes in consumer credit policies and practices, then, have principally addressed lending institution/dealer arrangements and are limited to those lending institutions which utilize such arrangements. These changes have come primarily in the forms of indemnification/recourse agreements with dealers, the severing of business relationships and/or the requesting of dealers not to refer credit customers.

... The savings banks and credit unions, because they handle little, if any, dealer paper, have done little in response to the Rule. Furthermore, most are not considering any future changes in their consumer credit policies or practices. However:

-- A few credit unions assert they no longer refer members to dealers they consider "preferred" -- i.e., offer best prices, best service, etc. -- and they see this as a disadvantage for their members

... About one-third of the finance companies -- and 2/3 of those who have dealer relationships -- have taken action as a result of this Rule:

-- Severed relationships with some dealers

-- Asked dealers to sign recourse/indemnification agreements

... About half of the savings and loans associations -- nearly all of those who have dealer relationships -- have taken action as a result of the Rule.

-- Severed relationships with some -- or in some cases, all -- their dealers

-- Have asked dealers to sign recourse/indemnification agreements

... Almost 2/3 of the commercial banks -- and almost all of those who have dealer relationships -- have taken action as a result of this Rule.

-- Most have asked dealers to sign indemnification/recourse agreements

-- Many have severed relationships with some or all of their dealers

-- And, a few have asked dealers not to refer customers to their institution

... About half of the lending institutions -- and nearly all of those who have dealer relationships -- have also discussed the Rule and the handling of subsequent consumer complaints with dealers:

-- Most discussions were in anticipation by the lending institutions of consumer complaints

-- About one-fourth were in response to actual consumer complaints

CHANGE OF POLICIES CONCERNING PURCHASE OF CONSUMER CREDIT CONTRACTS AS A RESULT OF NEW HIDC RULE

	TOTAL #	SAVINGS BANK #	SAVINGS & LOANS ASSOC. #	COMMERCIAL BANK #	CREDIT UNION #	FINANCE COMPANY #
N=	123	10	19	38	27	29
Our policies have been changed	35	2	7	16	3	7
Our policies have not been changed	83	7	12	20	22	22
Uncertain	5	1	-	2	2	-

SPECIFIC ACTIONS TAKEN IN RESPONSE TO NEW HIDC RULE

	TOTAL #*	SAVINGS BANK #	SAVINGS & LOAN ASSOC. #	COMMERCIAL BANK #	CREDIT UNION #	FINANCE COMPANY #
N=	123	10	19	38	27	29
Severed business arrangements to finance sales	26	1	7	11	2	5
Set up recourse or indemnification agreements	24	1	3	18	1	1
Asked certain dealers not to refer credit customers	11	1	2	6	1	1
Limited credit contracts purchased	6	-	2	3	-	1
Adjusted reserves	5	-	1	2	-	2
Make no direct loans for purchased from certain dealers	5	-	1	3	-	1
Altered discount rates	2	-	1	1	-	-
Other	8	2	1	2	1	2
None/have taken no action	67	7	8	12	22	18
Uncertain	6	1	-	3	-	2

* Multiple responses

Hypothesis #5

The net effect of actions taken by lending institutions appears to achieve one of the Rule's principal objectives: to alter the operations of certain dealers. Those dealers adversely affected are often termed "marginal" or "shoddy" by lending institution respondents. Moreover, consumer credit activity at most of these institutions has been largely unaffected by such actions.

... There has been no impact on savings banks or credit unions. Consumer credit activity at these institutions has been unaffected.

... Commercial banks, savings and loan associations, and finance companies have severed relationships with dealers who are often termed "marginal":

-- These institutions have a history of complaints concerning dealers' service, cooperation, etc.

-- Their financial records and status are questionable or "poor"

-- There is some doubt as to their future -- i.e., whether they would be around to service customers/handle complaints

-- They would not sign indemnification/recourse agreements with their creditors

... Dealer relationships have also been severed because products/services offered by these dealers are particularly vulnerable to complaints:

-- Mobile homes

-- Used cars

-- Electrical appliances

... In most cases, lending institutions have severed only certain/selected dealer relationships: estimates run no higher than 13% of the total number of dealers dealt with by these institutions. However:

-- Two savings and loan associations have severed all of their dealer relationships

-- Two other savings and loan associations and two commercial banks say they will not enter into any more dealer relationships

... Most lending institutions are having little or no trouble getting dealers to sign indemnification/recourse agreements. Lending institutions have done this because:

-- It eliminates the lending institution's liability should a claim/defense arise

-- It, in their minds, places the responsibility for product satisfaction where it should be -- on the dealer

... Except in a few savings and loan associations, (those described above), this Rule has had little effect on the amount of consumer credit activity of lending institutions.

Lending institution officers describe the dealers who have been adversely affected in this way:

> "The Rule has eliminated the flaky, shady, and suede shoe dealers."

> "Those dealers we've stopped business with were pretty marginal. They had a number of complaints made against them."

> "This will cut off funds to the fly-by-night dealers."

> "We had had customer complaints about the dealers we severed. They had taken no remedial action before."

Hypothesis #6

The number of claims/defenses has not, as yet, increased from levels existing prior to elimination of HIDC provisions and is not expected to increase significantly.

... Over three-fourths of lending institutions interviewed report that no claims/defenses pursuant to the new rule have resulted:

-- Credit unions and savings and loan associations report the least number of claims/defenses

-- Claims/defenses have occurred in one-fourth of the commercial banks: the highest of any lending institution interviewed

... The claims/defenses which have occurred do not seem to be causing unusual problems:

-- All (but one) have been settled out of court by the dealer involved

... According to the lending institutions who have experienced claims/defenses to date, the number of claims/defenses which have resulted do not represent an increase over the number occurring before the Rule.

... Most of the lending institutions do not expect any increase in the number of loans resulting in claims/defenses because of the Rule.

... Of those anticipating increases in the number of loans resulting in claims/defenses, all say that no more than a small fraction of their loans will be affected.

DISCUSSION OF CONSUMER COMPLAINTS WITH DEALERS

	TOTAL #	SAVINGS BANK #	SAVINGS & LOAN ASSOC. #	COMMERCIAL BANK #	CREDIT UNION #	FINANCE COMPANY #
N=	123	10	19	38	27	29
HAVE DISCUSSED HANDLING OF CONSUMER COMPLAINTS WITH DEALERS	55	2	8	28	5	17
Discussions Were Motivated by:*						
Own anticipation of consumer complaints	27	2	5	10	2	8
Actual consumer complaints	15	1	2	3	2	7
Dealer's anticipation of consumer complaints	10	1	1	5	2	1
Other	6	–	–	6	–	–
Uncertain	2	–	–	1	–	1

*Multiple responses

CLAIMS/DEFENSES ALREADY RESULTED FROM NEW HIDC RULE

	TOTAL #	SAVINGS BANK #	SAVINGS & LOAN ASSOC. #	COMMERCIAL BANK #	CREDIT UNION #	FINANCE COMPANY #
N=	123	10	19	38	27	29
Some have already resulted	15	1	1	9	–	4
None have resulted	103	8	17	27	26	25
Uncertain	5	1	1	2	1	–

CLAIMS/DEFENSES ALREADY RESULTED FROM NEW HIDC RULE COMPARED TO BEFORE RULE

	TOTAL #	SAVINGS BANK #	SAVINGS & LOAN ASSOC. #	COMMERCIAL BANK #	CREDIT UNION #	FINANCE COMPANY #
N=	15	1	1	9	0	4
More than before	3	–	–	3	–	–
Less than before	–	–	–	–	–	–
Same as before	12	1	1	6	–	4

PERCENT OF TOTAL CONSUMER LOANS THOUGHT LIKELY TO RESULT IN CLAIMS PURSUANT TO NEW HIDC RULE

	TOTAL #	SAVINGS BANK #	SAVINGS & LOAN ASSOC. #	COMMERCIAL BANK #	CREDIT UNION #	FINANCE COMPANY #
N=	123	10	19	38	27	29
0%	67	4	9	16	22	16
1% - 3%	24	1	6	7	4	6
4% - 5%	4	–	1	1	–	2
6% - 10%	2	–	–	2	–	–
11% - 20%	–	–	–	–	–	–
21% or more	1	–	–	1	–	–
Uncertain	25	5	3	11	1	5
Average percent	1.1%	.4%	1.0%	1.8%	[illegible]	.9%

PERCEPTIONS OF/ATTITUDES TOWARD ELIMINATION OF HIDC PROVISIONS

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Hypothesis #7

Lending institutions studied believe the purpose of this Rule is to protect consumers from "shoddy" dealers, by permitting them to withhold payments and so, enlist the lender's aid in resolving product/service - related disputes.

... Lending institutions understand the Rule to be designed to protect consumers, primarily, from "shoddy" dealers. Some also believe the Rule was pointed at:

-- "Shoddy" merchandise in general

-- Dealer/lender arrangements where each could use HIDC provisions to their mutual advantage

... While many lending institutions perceive this Rule as giving consumers recourse against both dealer and lender (somewhat equally), most perceive it to mean the lender helps the consumer in resolving his (the consumer's) disputes with the dealer.

... Lending institutions believe consumers can withhold payments whenever they are dissatisfied with the dealer or the product and cannot obtain satisfaction from the dealer directly. Many also believe warranties must exist, and not be fulfilled, for a consumer to register a claim or defense. Other circumstances perceived to be applicable to the Rule include (in descending order of mention):

-- "Defective" merchandise

-- "Misrepresentation" of merchandise

-- "Legitimate" complaints

... Most lending institutions believe warranties have not been extended to the duration of the loan. However:

-- Many do not know whether or not warranties have been extended

-- A number do believe warranties have been extended

... It should be noted over one-fourth of the lending institutions from Texas that were interviewed believe consumers <u>cannot</u> withhold payments under any circumstances

EXTENSION OF WARRANTIES TO DURATION OF CONSUMER LOAN

	TOTAL #	SAVINGS BANK #	SAVINGS & LOAN ASSOC. #	COMMERCIAL BANK #	CREDIT UNION #	FINANCE COMPANY #
N=	123	10	19	38	27	29
Warranties have been extended	12	-	-	4	2	6
Warranties have not been extended	75	3	16	29	11	16
Uncertain	36	7	3	5	14	7

The following quotes typify opinions expressed by lending institution officials:

"If the dealer doesn't 'stand behind' his product, the holder of the paper is stuck with the liability. The purpose is to provide the consumer with maximum protection."

"To protect consumers from shoddy dealers. To give them some place else to turn if the seller doesn't satisfy them. They can withhold payments when not completely satisfied and can't get remedial action from the dealer. When the warranty agreement is broken on the product is defective."

"The consumer can withhold payments for any legitimate complaint where the dealer was not performing."

"I don't know if warranties have been extended. That could be a problem. Suppose the warranty is for one year and the dealer paper is for three. How long is the paper owner responsible?"

Hypothesis #8

Credit unions are generally positive in attitude toward the elimination of HIDC provisions. They believe there was a need for protection and perceive the Rule as providing it.

... Credit unions are particularly positive toward the Rule. They say:

-- Consumers were in need of increased protection against dealers

-- The Rule will effectively eliminate "shoddy dealers"

... Those credit unions, however, who are no longer referring members to "preferred" dealers -- i.e., fair prices, good service, etc. -- say their members are likely to pay more for merchandise and encounter problems as a result.

The following quotes typify opinions expressed by credit unions:

"This is to prevent conspiracy between dealers and lending institutions and it will do it. I think it is a good law. It prevents us and the auto dealer getting together to take advantage of the buyer. Used to be the dealer who would, after the sale, ask the consumer, 'Do you mind if we finance this through our bank?' Result would be consumer paying a higher interest rate than he would if he financed it himself through, say, a credit union."

"An example where the law would help is health clubs. Some of these sold contracts and then went out of business. The customers still had to pay for their contract."

"We used to tell our members about 'preferred' dealers. These were ones we knew had fair prices. We can't do that any longer and our members won't have that advantage."

Hypothesis #9

The elimination of HIDC provisions is deemed unnecessary by commercial banks, savings and loan associations, finance companies, and, to a lesser degree, savings banks. They say state laws and institution practices provided adequate consumer protection and more equitable means of resolving disputes.

... Although most lending institutions are uncertain about how the Rule differs from their own state laws, they believe those state laws provided adequate consumer protection:

-- Those from West Virginia recall that state's Consumer Protection Act of 1974. This is said to have provided ample consumer protection and mechanisms to eliminate "shoddy dealers." Many, in fact, instituted indemnification/recourse agreements with dealers as a result of the 1974 Act

-- Although it is asserted that regulations in the other three states were less stringent than the Federal Rule, many lending institutions believe these regulations provided adequate consumer protection

... Many of these lending institutions also maintain that their private business policies and practices provide adequate consumer protection:

-- Most claim they are very selective about dealers, do not do business with "fly-by-night" operators, etc.

-- Most feel they, privately, handle dealer problems/disputes equitably and prefer it this way

... Compared with other consumer credit regulations/legislation, elimination of HIDC provisions is perceived by lending institution officials to be largely unnecessary as regards protecting the interests of all concerned with consumer credit.

-- Truth in lending is perceived to be the most necessary of government regulations

-- Elimination of HIDC is one of several government actions perceived to be unnecessary by most of the lending institutions interviewed

EFFECT OF NEW FEDERAL RULE COMPARED TO RESPONDENTS' STATE HIDC LAW

	TOTAL	SAVINGS BANK	SAVINGS & LOAN ASSOC.	COMMERCIAL BANK	CREDIT UNION	FINANCE COMPANY
	#	#	#	#	#	#
N=	123	10	19	38	27	29
EFFECT OF NEW FEDERAL RULE HAS BEEN:						
Different from own state law	31	2	4	15	1	9
Not different from own state law	40	2	8	11	8	11
Uncertain	52	6	7	12	18	9

* * * * * *

	TOTAL	CALIFORNIA	NEW YORK	TEXAS	WEST VIRGINIA
	#	#	#	#	#
N=	123	32	32	29	30
EFFECT OF NEW FEDERAL RULE HAS BEEN:					
Different from own state law	31	1	11	13	6
Not different from own state law	30	13	3	9	15
Uncertain	52	18	18	7	9

REGULATIONS PERCEIVED TO BE "NECESSARY TO PROTECT INTERESTS OF ALL CONCERNED WITH CONSUMER CREDIT"*

	TOTAL	SAVINGS BANK	SAVINGS & LOAN ASSOC.	COMMERCIAL BANK	CREDIT UNION	FINANCE COMPANY
	#	#	#	#	#	#
N=	112	10	19	38	27	29
Truth in lending	97	9	15	32	21	20
Equal credit	51	5	4	23	6	13
Fair credit	41	4	4	15	9	9
Specific State Legislation	36	5	4	16	3	8
Elimination of HIDC provisions	32	3	6	11	[illegible]	7
None	6	–	–	2	2	2

* Multiple responses

The following quotes exemplify attitudes on the subject of the need for the Rule:

"This is another example of the Feds moving into areas they should stay out of. We already had a state law which took care of the problem. And if they saw some deficiencies in our law, they could have come in and suggested ammendments. But instead, they roll out the artillery with a whole new, sweeping regulation. That's what adds to the big bureaucracy down there in Washington - they add a new national rule which requires more people to enforce etc."

"We don't need another piece of restrictive legislation. We're a very ethical company. We have had no change in policy to deal with retailers. If a consumer comes to us with a dealer problem, we insist that the dealer correct it. We are used to delving into why the consumer is not paying and if it is a problem with the merchandise, we want it taken care of. It usually is taken care of because we have no 'alley dealers.'"

Hypothesis #10

Those lending institutions most affected by the Rule -- commercial banks, savings and loan associations, finance companies -- are very concerned about the implications and potential problems of the Rule. A variety of interpretations are said to be possible, and these lending institutions seek clarification on several points.

... Much of the concern and criticism raised by this Rule -- and, perhaps, some of the actions lending institutions have taken in response to it -- stems from its perceived "vague" nature. Many say the Rule is so unclear, they will have to wait for "test cases" or "classactions" to assess its meaning and implications.

... The following issues are said to be unclear to lending institutions and to contribute to their concern/anxiety:

-- The use in the Rule of the words "any claim or defense" has many confused and anxious about how this is or can be interpreted.

- -- Although few believe warranties have been extended to the length of the credit/payment period, many believe the Rule could be interpreted to mean the lender is liable "forever", past the payment period, or, at least, for the length of the credit agreement.
- -- There is much concern as to how actual claims or defenses are to be handled and/or what arbitration is available.
- -- There is some confusion and concern as to what constitutes a "business arrangement" with a dealer. Lending institution officers want to know if dealer savings accounts, floor plans, etc. constitute such an arrangement. They are concerned about keeping track of such arrangements, advising branch or loan managers about them, knowing which direct loans are for these dealers, etc.

The following quotes express where the Rule is perceived by lending institution officials to be vague:

"It's for 'any' faulty merchandise; real or imaginary."

"We presume it's for the warranty period only, but the way it's worded, it could be forever. We might assume that the statute of limitations applied. But, when should the period of that statute begin?"

"One of the main problems is that it doesn't say where a customer can withhold. We don't know whether we can collect from a customer short of going to court. It should have provisions like credit card regulations It doesn't spell out the effect and way to handle the notice not to pay."

"I listened to 3 attorneys from Baltimore explain the Rule. Then they had a question-and-answer period, and the attorneys could not answer one question put to them from people seeking clarification."

"There are so many interpretations that the banks are running scared. They're turning down loans until they get more information."

Hypothesis #11

Lending institutions affected by the Rule -- commercial banks, savings and loan associations, and finance companies -- believe elimination of HIDC provisions makes them liable for manufacturer and dealer shortcomings for which they cannot and should not be responsible.

... These institutions complain they are now responsible for dealer products, yet have no control over these.

... These institutions complain they are now responsible for consumer satisfaction/dissatisfaction with such merchandise. Several fear consumers will "abuse" the law, make less than "legitimate" claims/defenses, or use the Rule to avoid having merchandise repossessed, etc.

The following quotes express the attitudes of lending institution officials toward their desired responsibility limits:

"We loan money on the credit of the borrower and have no way of checking the mechanical merits of autos, TV sets, or other merchandise."

"A consumer could claim for example that it's the dealer's fault when his car needs repair as a result of his hot-rodding it. The law could be used as a disguise, as a way of getting out of a contract without being repossessed. And even if the dealer is at fault, why should we be required to be enforcers of the law. Let the FTC be the enforcer of the law and itself respond to consumer complaints against the manufacturer, not us. It's not under our control, so we shouldn't be liable for it."

"The lender should have responsibility to check out the dealer as to his honesty and capability, but should not be responsible for the refrigerator that doesn't work or swimming pool that leaks."

"It's our position that we are not in the dealer or manufacturer business. We take the credit risk and they should take the warranty risk."

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Hypothesis #12

> In response to elimination of HIDC provisions, lending institutions, as noted earlier, are taking measures which ensure that responsibility for service/merchandise rest with the dealers. Such measures, however, are perceived by some lending institutions to be harmful to new, small, or otherwise viable businesses.

... A number of commercial banks and savings and loan association say they now will not only turn down loans to "shoddy" dealers, but to dealers who would otherwise be reputable and/or good credit risks.

- Several believe only the "very best", oldest, or "most reputable" dealers will be able to stay in business

- Several say that new, small, or otherwise viable businesses will be undeservedly hurt by the Rule

The following quotes from lending institution officials refer to the Rule's potential impact on small businesses.

"This law not only flushes out the bad operators, it unfortunately makes it impossible for a new company to start up in business where credit sales are involved."

"The effect of the HIDC ruling eliminated all but the very best financial businesses. It has cut off the avenue of the small businessman to sell paper."

"The small contractor will be badly hurt."

Hypothesis #13

Some lending institutions perceive the ultimate "brunt" of the elimination of HIDC provisions will be borne by the consumer it was intended to protect.

... Several commercial banks, savings and loan associations, and finance companies believe that, in the long run, the consumer will be at a disadvantage as a result of the Rule. They reason:

-- Activity in the consumer credit sector will slow down.

-- Administrative costs will be added to interest rates, fees, etc.

-- Dealers and consumers will be forced to look elsewhere for credit/financing, and this will be at an increased rate.

The following quotes illustrate these concerns:

"When dealers are severed they can get financing elsewhere. They contract for higher rates and it winds up penalizing the consumer with those higher rates."

"Consumer will find it much more difficult to get credit and if he does get credit, it takes much longer to get approved and the consumer ends up paying more money. One consumer said, 'We are getting so much protection from the government, I don't see how we can afford it anymore.'"

"The new laws have increased the cost of making loans due to the added expenses of changing the wording on forms, having lawyers on staff, etc. The ultimate cost will be borne by the consumer."

Hypothesis #14

Many of the commercial banks, savings and loan associations, and finance companies believe the Federal Trade Commission implemented this Rule without proper consideration of those affected.

... Many of these lending institutions say the Federal Trade Commission eliminated the HIDC provisions without adequate discussion with, or consideration of, the affected parties:

-- Many complain their institution and/or industry was not fairly represented in Federal Trade Commission discussion/hearings

-- Several say the Federal Trade Commission eliminated HIDC without properly evaluating the impact this would have on all those affected: the lending institution, dealers, or consumers

-- A few say this Rule was implemented "too fast" and/or without giving ample notification

Note the following verbatims:

"It was implemented in a high-handed way. It should have been presented as legislation rather than a regulation. I question the regulatory authority of the FTC in this matter. They are in essence overriding states' rights. It represents increased intervention into private enterprises and allows states less chances of seeking their own direction. The FTC did not explore the consequences of the new Rule and did not receive enough input on this matter."

"The FTC did not get sufficient input from small financial companies like banks, savings and loans, credit unions, loan companies, etc., before implementing this Rule. It is an over-reaction by the FTC to a low percentage of complaints."

"The framers of rules like this, and especially this one, should have had a lot more firing line experience. They never consider the real impact."

IMPLICATIONS/RECOMMENDATIONS

1. The May 14, 1976 ruling which eliminated HIDC provisions requires "fine tuning" and clarification. There is widespread uncertainty as to its application and some of its provisions. Areas which requires such clarification include:

   ... The definition of "legitimate" claims

   ... The period of risk assumed by the third-party lender

   ... The method of resolving claims/defenses

   ... What constitutes a "business arrangement?

2. In order to make this clarification effective, it is necessary to:

   ... Quantify the number, type, location, etc., of lending institutions affected by the Rule, which institutions have taken subsequent action, and what those actions are.

   ... Segment these lending institutions according to their business characteristics, subsequent actions, etc.

Such quantification and segmentation will make it possible:

a) To target FTC communications efforts to assure that the Rule is better understood. The initial research work clearly indicates areas of misunderstanding and concern on the part of lending institutions. Some of these problems stem from the complexity of the subject matter; other problems stem from the general psychological climate toward increased government regulation. One of the best ways to reduce these problems is to pinpoint the level of understanding, the barriers to understanding, etc., among specific segments of the consumer credit market and then to address them.

b) To have necessary documentation of the extent to which the lending institutions were responding to the consumers' problems before the Rule was issued and the response which the Rule has brought about. It must be emphasized that the prevailing opinion of lending institutions is that the Rule was not needed. This proposed research step is necessary to measure reliably the accuracy of that claim.

3. Lending institutions are passing the responsibility/liability this Rule gives to them on to dealers. This raises issues and questions which require comprehensive study:

... Which dealers are affected? Who are they in terms of their product/service, financial status, business policies and practices, etc.?

... How are they affected? What impact do the actions taken by lending institutions have on their business, their credit activity, their service to customers, etc.?

... How do they react to actions taken by lending institutions? What changes in policy and practces are they making in response?

Only by answering these types of questions can we prove or disprove the hypothesis that small, new, developing dealers are being harmed by the Rule or that consumers are being harmed by dealer reactions to the Rule.

4. The ultimate impact and success of elimination of HIDC provisions will be determined in the consumer marketplace. Although it appears the Rule will meet one of its principal objectives -- e.g., consumer protection without causing major dislocations in the consumer credit industries/markets -- important issues and questions are yet to be addressed:

... Are consumers aware of the elimination of HIDC? What do they know or have yet to learn? Where did they learn this -- e.g., what sources of information do they use?

... What are their perceptions of and attitudes toward the Rule? What advantages/benefits do they see in it? What disadvantages do they perceive?

... What changes, if any, in their product purchase and use behavior are resulting?

... Who is most likely to be aware of the elimination of HIDC provisions? What attitudinal and behavioral segments exist in the consumer marketplace vis-a-vis the Rule?

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END