

# **LIABILITY FOR CHARGEBACKS**

By Paul A. Rianda, Esq.

Whether you are a member bank, ISO, or “feet on the street” salesperson, who bears the liability for any chargebacks is often one of the most important issues you must determine in a contract. In this article, I will discuss, in general terms, what is a chargeback, who is liable for a chargeback, and important contractual issues regarding chargebacks.

## **What is a Chargeback?**

In most ISO contracts, a chargeback is defined as a transaction that has been returned to a merchant by an issuing bank in accordance with the VISA, MasterCard or other rules. In laymen’s terms, what this means is that a consumer contacts the credit card company that issued his or her credit card to dispute a transaction on the credit card bill. The consumer makes a request through the issuing bank to charge the transaction back to the merchant that sold him or her the goods or services. The credit card issuing bank issues the chargeback that results in the funds for the disputed transaction being taken out of the merchant’s bank account if such funds are available. Issues occur when the merchant has insufficient funds to pay for its chargebacks.

## **Who is liable for a Chargeback?**

Assuming that each party in the chain has accepted liability for chargebacks, the potential for chargeback liability begins with the merchant that initiated the transaction. If a chargeback occurs, then the merchant is the first entity that is liable to pay the chargeback. If the merchant is unable to pay the chargeback, then often times the “feet on the street” sales person is the next person potentially liable for the chargeback and/or an ISO. If neither the sales agent nor ISO is available to make good on the chargeback, the liability for the chargeback continues up the chain to the member bank that sponsored the ISO. Theoretically, if the member bank were insolvent, the chain of liability would continue up to the credit card association, but this rarely occurs.

## **Contractual Issues:**

One of the key terms to negotiate in any contract between an ISO and a sales agent is who will be liable for chargebacks. Many credit card processors advertise that they have programs where the sales agent is not liable for any chargebacks. However, there are often exceptions to these “no liability” deals that do allow the credit card processors to chargeback transactions to the sales agent.

If a sales agent does not want to take any risk for chargebacks, the agent should ensure that its contracts with the credit card processor clearly sets forth that it is “no risk” deal. Generally, there should be a provision in the agreement that states that the sales agent is not responsible for **any** chargeback risk. At a minimum, I usually recommend a clause in the contract that states the “Agent shall have no liability for losses, chargebacks, uncollected fees, expenses or any other items relating to the Merchants.” If the contract is silent on the subject, the sales agent could be subject to liability for chargebacks. In addition, it should be clearly set forth in the agreement that as to any indemnity provision, there is no duty for the sales agent to indemnify the credit card processor for any risk of

chargebacks. The important thing is to make sure that, viewing the contract as a whole, there are no hidden provisions that could serve to subject the sales agent to liability.

### **Chargebacks and Profit Splits:**

In addition, the issue of chargebacks often determines the percentage of profits that will be paid to the sales agent. As should be expected, the greater risk the sales agent is willing to take in the form of chargebacks, the greater amount of income the agent can expect from the residual stream available from the merchants. Therefore, agents need to balance their tolerance for risk with their desire to make the maximum amount possible from every merchant.

As a general rule, sales agents should not agree to take chargeback risk unless their residual stream rises to the level where they can afford some risk of chargeback loss. Individual merchants can often times incur tens of thousands of dollars in losses in a fairly short time period, potentially wiping out a sales agent's residual for a long time. The safer way to go with smaller residual streams is to not assume any risk of liability for chargebacks.

As a sales agent grows and prospers, the agent needs to analyze whether or not it would be advantageous to assume some chargeback risk. If the agent is willing to do so, the agreement should clearly set forth the percentage split of the chargebacks that will be chargeable against the residual stream. Also, it is good practice for the sales agent to limit its chargeback exposure to the residual stream that the agent is due under the agreement. This serves to protect the sales agent from having exposure for chargebacks greater than the residual stream, if indeed a catastrophic merchant loss occurs.

Lastly, is the issue of the collection of any chargebacks from the merchant. If a merchant incurs a large loss, the parties to the contract should have a pre-existing agreement as to how they will split the proceeds from any successful collection efforts.

All parties to the transaction need to make sure that they understand the potential risk for chargebacks and the ramifications if any chargebacks occur.

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