

WHAT IS A MERCHANT'S LIABILITY FOR CHARGEBACKS?

By Paul A. Rianda, Esq.

I get many calls from merchants and sales agents seeking advice about the extent to which merchants are liable for chargebacks. Most tell me a story about how the merchant was charged a significant chargeback, how the merchant did nothing wrong and therefore should not be subject to paying for the chargeback. As will be explained below, merchants are ultimately financially responsible for most chargebacks, even if the merchant has done nothing to cause the chargeback in the first place.

What is a Chargeback?

A typical chargeback situation involves a cardholder that has made a purchase from a merchant who then contacts the company that issued the card to the cardholder, tells the card issuer that the purchase was not authorized and requests that the transaction be charged back to the merchant. This scenario occurs when a customer either does not get the product or service bargained for or the product or service is not provided at all. One example of such a situation is the airlines that recently went out of business. All the people who paid for their tickets by credit card were able to call up their card issuers and requests a chargeback because they were not able to take the flight they paid for. Most merchants think that this is the only type of chargeback they can be held liable for but that is not the case. If the transaction is charged back for any reason, including fraud, the merchant has to pay for the chargeback.

Chargeback Examples:

Chargebacks can take many forms, one example of which that has recently increased is the so-called "friendly" chargeback. These tough economic times have led many cardholders to request chargebacks, even when they have actually received the product that was ordered. For instance, someone who purchased a new flat screen T.V. via the internet for home delivery might after a couple of months lose his or her job and as a result call the cardholder's issuing bank and say he or she never got the T.V. To free up additional room on their credit card to pay for essentials, the purchaser could call up the issuing bank to request a chargeback on that purchase even though the T.V. was sitting in the purchaser's living room.

The purchaser is hoping that the company that sold the T.V. will somehow not get the chargeback notice, will not contest the chargeback or that the merchant will not comply with the rules governing how chargebacks must be contested. There are very strict time frames that are imposed on a merchant to contest a chargeback. If the merchant does not reply in the required time period, the chargeback cannot be contested and the merchant has to pay the chargeback regardless of whether a merchant has proof-positive that the T.V. in question was delivered. So, consumers have every incentive to make a "friendly" chargeback, as the customer has the potential for a financial windfall and very little risk, since in a lot of cases, card issuers are not aggressive in pursuing their customers for fraud.

There are other instances that I have seen involving merchants that were duped into accepting fraudulent credit cards. For instance, a merchant could get a seemingly legitimate order online to purchase a product. The purchaser pays through a secure payment gateway and the merchant sees that the card has been accepted by the system and the transaction is authorized. The product is shipped and the merchant is happy to have made another sale. But, even if the transaction was authorized at the time of sale that is no guarantee that the card in question was valid.

I have had merchants contact me in situations as described above, where they got a valid authorization at the time of sale and shipped the product, but the transaction has been charged back at a later date. The reason that was provided for the chargeback was that the card in question was fraudulent, even though it was processed by the system. Merchants always ask me the same question, “how was I to know the card was fraudulent, especially when the credit card system accepted it?” The answer is, it does not matter the reason, the merchant is liable. In my experience, that is the concept that many merchants do not understand. The merchant is in fact, the guarantor that the transaction is valid, and if **for any reason** the transaction is not valid, the merchant is liable assuming there is no valid defense, such as in a “friendly” chargeback situation. I must again emphasize that there is no requirement of fault on the part of the merchant.

In preparing to write this article, I reviewed some representative merchant agreements. For the most part, the agreements list a number of reasons why a chargeback occurs that could lead to the merchant having to pay the chargeback. However, there is generally one last catch-all provision that states the merchant would be liable for any chargeback in “any other situation in which a Transaction has been charged back to us in accordance with the chargeback rules established by the Card Association.” So as you can see, there is no requirement that the merchant be in the wrong. The fact is that if there is a chargeback the merchant is liable unless it has some defense to the particular situation that falls within the association rules and is able to prove the rules allow the chargeback to be reversed.

Ramifications:

The largest ramification to the merchant is usually the financial impact of the chargeback itself, but it does not end there. The standard procedure is that the merchant’s card processor takes the chargeback out of the merchant’s bank account without any notice or warning. If the merchant has plenty of money in its bank account that is fine, but I have seen instances where a small merchant had a significant chargeback that in effect cleared-out the merchant’s bank account. This led to a situation where all the merchant's outstanding checks to its vendors and customer bounced, resulting in the imposition of hundreds of dollars in fees from its bank. Or, often when there is a significant chargeback, there are insufficient funds in the bank account resulting in a rejection of the attempt by the card processor to collect the chargeback.

If the chargeback is rejected from the merchant bank account, there are a number of different paths that the resolution of this issue can take: The merchant can when notified elect to pay the chargeback in an alternate manner. However, this does not solve the problem that the merchant has in fact breached its agreement with the processor by having insufficient funds in its bank account to allow the card processor to collect the chargeback from the merchant’s bank account. Often this leads to the

merchant being placed on the terminated merchant file (“TMF”) list, which is essentially a list that keeps the merchant from getting credit card processing services in the future.

But what if the merchant simply can’t pay the chargeback? Again, this results in the merchant being placed on the TMF list, which will often put the merchant out of business because it cannot get by without accepting credit cards. The merchant and the owners also often end up getting sued and having a judgment outstanding against them. Where there is a substantial unpaid chargeback, the result to the merchant can be disastrous. .

The reason the merchant is sued is because if the merchant does not pay the chargeback, risk moves up the line. The chargeback becomes the responsibility of the next person up the chain that has agreed to take the risk for chargeback losses. This usually is a large ISO, not a feet on the street sales person, that has agreed to be liable for chargebacks. If there is no ISO in the picture, it could even be the merchant’s sponsoring bank that has to pay the chargeback. In any event, the customer that made the purchase is protected by this system, while the merchant bears a huge amount of risk for chargebacks.

So, the lesson is, that accepting credit cards is not without risk to a merchant. The merchant, even if it does nothing wrong and obtains authorization for the transaction, still can be held liable for a chargeback months later. Merchants should keep this in mind and to the extent possible, ensure that they do everything they can to try and minimize their potential liability for chargebacks.

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