LEGAL REGULATION OF CONSUMER CREDIT

by Stanley Morganstern, B.S., J.D.

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This is the seventieth number in a series of LEGAL ALMANACS which bring you the law on various subjects in nontechnical language. These books do not take the place of your attorney's advice, but they can introduce you to your legal rights and responsibilities.

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INTRODUCTION

Credit, in its various forms, has become the mainstay of our economy. Very few persons can afford to make purchases of any substantial nature without the aid of time payments or other types of credit extension. For those persons who can adequately handle credit problems by budgeting payments against earnings, the easy availability of credit has been a blessing. For those persons who find that each month presents a panic situation as to how to meet those credit payments, the record-breaking pace at which credit has been extended has caused untolled anguish.

Time Magazine, January, 1971, uniquely characterized the payment policies of the average credit buyer as a "hat trick." That is, the debtor tosses all his bills into a hat and at the end of each month, pulls out a random few for payment. The remaining bills are left to the next month with the thought that somehow they will be paid.

The inability of the credit buyer to perform his monthly obligations has resulted in a substantial increase in the number of personal bankruptcies, trusteeships, and other insolvency proceedings. Collection agencies have been reporting a record volume of business, but unfortunately, no proportionate increase in actual collections. Likewise, credit card firms have found that their ability to collect outstanding accounts has declined significantly.

These problems are not, however, totally of the credit buyers' own making. Credit card distributors have, with no degree of selectiveness, flooded the consumer market with tickets to financial disaster. Now, in the face of rising account delinquencies, credit extenders have begun to screen credit applications more closely in an effort to cut down their losses.

The credit problem is not limited to the small credit purchaser. Businesses, large and small, have for years experienced a growing accounts receivable position not only from ultimate consumers but from other businesses. It has become customary, if not acceptable, to work with someone else's money. Each company tries to delay making payments for services and merchandise as long as possible so as to maximize its cash position and to avoid the necessity of having to pay interest on borrowed funds. This now entrenched business practice can be called "involuntary financing." Many a small business which relied upon a quick turnover of inventory suddenly found that the inventory was, in fact, turning over quickly, but that it was turning into accounts receivable rather than cash. Result: end of business.

To combat this situation, many companies are now charging interest on all payments which are not made in quick fashion. Without the added incentive for businesses to pay their suppliers on time, "involuntary financing" would continue to a point of no return.

State and Federal legislators have recognized the tremendous problems which have developed as a result of the wide use of credit both on the consumer level and among businesses. There is currently Federal legislation, the Consumer Credit Code, and many individual state statutes which have been enacted to protect the consumer in his credit purchases and in the borrowing of money. These statutes are designed to make the debtor aware of the costs of credit before he obligates himself. The acts also protect the debtor from abusive collection tactics. Garnishments are severely regulated as is the use and distribution of credit reports.

These acts are mainly disclosure types of legislation in that they require the potential creditor to inform the potential debtor of all the cost elements of any transaction. The Consumer Credit Protection Act has been characterized as the most controversial and far-reaching consumer credit law enacted in many years. Its stated purpose is:

> . . . to assure that every customer who has need for credit is given meaningful information with respect to the cost of that credit which in most cases, must be expressed in the dollar amount of finance charges, and as annual percentage rate computed on the unpaid balance of the amount financed. Other relevant credit information must also be disclosed so that the customer may readily compare the various credit terms available to him from

different sources and avoid the uniformed use of credit. 15 U.S.C.A. 1601.

Whether or not the Consumer Credit Protection Act, commonly referred to as Truth-in-Lending, will accomplish its stated purpose is open to debate. Surely reputable creditors will comply, if for no other reason than the possibility of incurring civil and criminal penalties. On the other hand, consumers must be made aware of the bare essentials of the law before it can have significant meaning to them.

Recently, this writer empaneled a jury in a case involving the Truth-in-Lending law. Only one of the fifteen prospective jurors had heard of the law and even he knew nothing of its provisions. Obviously, then, those persons would not know if the creditors they deal with were complying with the Act, and it is a safe assumption that the majority of consumers are no more informed.

The Uniform Commercial Credit Code is proposed state legislation, and in most respects, is substantially similar to the Consumer Credit Protection Act. It has been adopted in whole or in part in Colorado, Idaho, Indiana, Oklahoma, Utah, and Wyoming.

Traditionally, individual states have had small loan acts and statutes regulating the rate of interest that can be charged to individuals. These will be examined in terms of their purpose and general provisions.

It is the intent and purpose of this Almanac to examine the new as well as the traditional legislation as it pertains to our credit-minded economy.

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Chapter I

CREDIT AND CONTRACTS

Identifying Credit Transactions

There are numerous types of credit transactions. Consumer credit may be divided into open end (open charge credit) and installment credit. These classifications can apply to either goods or services. There is, of course, cash credit where the debtor obtains funds upon his secured or unsecured promise to repay. This type of transaction may require a single repayment or may afford the borrower installment repayments.

Business or commercial credit usually takes the form of long-term or short-term borrowing. There may only be considerations of interest rates or there may be the very complicated consideration of state and Federal securities laws, as would be the case in the issuance of bonds and debentures. While this Almanac is concerned primarily with the regulation of private or consumer credit, there will be mention and explanation of the differences in regulation of the two basic types of credit transactions.

An open end account is one where the consumer is allowed to make any number of purchases provided the total dollar volume of his purchases does not exceed the limits established by the creditor. There is usually no written contract in this type of arrangement, and is epitomized by the normal charge account situation.

A fast growing type of credit plan is the revolving account. This arrangement falls somewhere between a true installment transaction and the open end account described above. Typically, this type of credit involves no security as is usually the case in an installment purchase where the seller retains an interest in the goods sold. A revolving account usually gives the buyer a specified line of credit. He receives a bill each month which reflects the total amount of his purchases; but unlike the open end account, the purchaser need not pay his total monthly bill, as installments are extended to him at a predetermined interest rate. There is no finance charge if the total bill is paid during the first billing period. This plan, then, gives the purchaser the option of having his account treated as either open end or an installment account without the necessity of giving security.

Installment buying is the typical credit transaction used when the item purchased is a durable good. Appliances, automobiles and large household items are traditionally bought on installment plans. Under the present state of the Federal law, finance charges and the like must be disclosed to the purchaser before the transaction is consummated. Likewise, there is considerable legislation which governs how the creditor must take and record his security interest in the goods sold. The chattel mortgage or a security agreement are the prime documents used in this type of transaction. The debtor gives a security interest in the goods he buys to either the original seller or the financial institution which extends the credit for the purchase.

The goods sold in this type of transaction can be described as those which can be repossessed. A seller would like to know that if the debtor defaults on his payments, he can reclaim the goods and resell them to mitigate his loss. There are strict statutory requirements which the creditor must follow before he will be allowed to proceed against a debtor for any deficiency which might exist after repossession and resale of the goods. These requirements will be fully discussed in another chapter but basically pertain to the giving of notice to the debtor.

Once a credit transaction can be categorized, it is then important to understand the very basic legal rights and obligations each of the parties acquires by reason of the transaction.

Contracts Establish Legal Relationships

The debtor-creditor relationship, of course, arises out of the legal relation known as contract. Even the simplest consumer transaction of necessity involves a contractual relation.

The restatement of contracts defines a contract as "a promise or set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty."

Contracts can be express or implied, but we are only concerned here with those contracts which are made expressly between the parties who eventually become debtor and creditor. Each party to the contract must have legal capacity to enter into the contract. The parties must not be infants or under some judicial determination of incompetency.

There must, of course, be consideration for the promises made or the goods or services exchanged. The exchange of promises may be sufficient to satisfy that element of a valid contract; but in the debtor-creditor relationship which we are here considering, the loan of money, or the performance of services, or the delivery of goods represents the consideration for a promise to pay.

Each valid contract begins with an offer and an acceptance of that offer. Once that has been accomplished, the parties may reduce their understanding to a written agreement, or the contract may remain an oral one. In the type of relationship which we are most concerned with here, the contract is usually written. In addition to the agreement, there normally are other documents executed as part of the transaction.

If the transaction involves the giving of security of some type, either real or personal property, the debtor will be required to sign a mortgage, security agreement, financing statement, or other instrument to satisfy the various state statutes so as to give the creditor a binding interest in the property secured.

Without examining the elements of a valid contract extensively and all the problems that can arise in the construction and interpretation of contracts, it is sufficient at this point to be aware that the debtor-creditor relationship begins with a contract and that the rights and obligations of the parties are, in the first instance, governed by the terms of the contract.

The Uniform Commercial Code, in some instances, varies the traditional contract law. For instance, under common law, an offer made for a stated time could be withdrawn at any time. Under the Uniform Commercial Code, an offer made by a merchant to be held open up to three months is not revocable. Traditionally, an acceptance of an offer had to be unconditional, but under the Uniform Commercial Code there are instances where the acceptance can be effective even though requiring assent by the offeror to additional terms or conditions.

A contract must be definite and agreed to in all its terms and conditions by each party to the contract. There are cases under the Code which allow a certain degree of indefiniteness, such as output and requirement contracts. These contracts are valid and enforceable under the Code.

Consideration, as previously mentioned, must be present in every contract. Under the Code, however, there need not be consideration for an agreement modifying a sales contract.

After the covenants and conditions of the contract are considered, to determine the rights and obligations of each of the parties, attention must then be directed to the laws and judicial decisions which govern the interpretation of the contract and sets forth rights and obligations not expressly contained in the contract.

In many instances the law, state or Federal, controls the course of conduct of the parties before the contract is entered into as well as conduct after there has been a breach of the contract by one of the parties. The Consumer Credit Protection Act, for example, controls the activities of potential creditors before the transaction is consummated, while the Uniform Commercial Code may control the formalities of the transaction as well as the rights of both the debtor and creditor after there has been a default of performance by either of the parties.

This Almanac will examine those statutes which control consumer credit transactions from the standpoint of formality of contract, terms of contract, enforcibility of remedies and disclosures.

Chapter II

TRUTH IN LENDING

Background

On July 1, 1969, the Consumer Credit Protection Act went into effect. This Act, designed to protect the credit buyer in all phases of his credit life, was enacted into law by the Congress of the United States.

Perhaps the best explanation of why the Act was passed and why Congress considered the legislation a must is set forth in the Act itself:

> The Congress finds that economic stabilization would be enhanced in the competition among the various financial institutions, and other firms engaged in the extension of consumer credit would be strengthened by the informed use of credit.
>
> The informed use of credit results from the awareness of the cost thereof by consumers. It is the purpose of this title to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various terms available to him and avoid the uninformed use of credit.

The Consumer Credit Protection Act includes three subchapters. The first subchapter has come to be known as truth-in-lending and primarily covers the disclosures which must be made to a customer, potential credit buyer or borrower before, or at the time credit is extended to him. The second subchapter of the Act pertains to restrictions on garnishments, and the third deals with credit reporting agencies.

General Provisions

Since the purpose of the Act is to control consumer credit, there are certain transactions involving credit which are exempt from the operation of the Act. For example, credit given or used in business, or commercial or governmental use need not follow the same procedures of disclosure that are required in consumer transactions. Likewise, security and commodity transactions are exempt. An extension of credit in the amount of more than $25,000, except as to real estate transactions, is exempt from the disclosure provisions of the Act as are transactions under public utilities tariffs filed with the state and Federal power commissions. These actions which are regulated by the states are exempt.

Basically, the Act extends its coverage to all persons who in the course of their business regularly extend or arrange for consumer credit. Consequently, a casual extension of credit would not be subject to the provisions of the Act. The act does, however, cover those persons who offer to extend or arrange for the extension of consumer credit. Therefore, a real estate broker who does not in his business extend credit but regularly offers to arrange for the extension of credit with a local financial institution would be subject to the pain and penalties of the Act if proper disclosures were not made.

Since coverage under the Consumer Credit Protection Act does not extend to the casual or infrequent extension or arrangement of credit, the small businessman who occasionally extends credit to his customers may not be subject to the Federal legislation. On the other hand, if the small businessman normally extends credit as a part of his business, he will be bound by the provisions of the Act. As a general rule, banks, savings and loan associations, credit card issuers, auto dealers, credit unions, consumer finance companies, craftsmen and the like, are covered within the scope of the Act.

Installment payments made to a person in the position of a bailor are not within the scope of the Act. Likewise, lease arrangements are not covered so long as the arrangement is not merely a disguised sale. If the lessee is to pay an amount over the term of the lease which substantially approximates the value of the property leased, and the lessee is eventually to become the owner of the property, there is a good chance that the transaction will be treated as a sale and be subject to the disclosure provisions of the Act.

While it might appear that securities transactions involving margin buying where interest is charged should be covered by the Act, the Securities Exchange Commission has exclusive control of these transactions. Thus the Consumer Credit Protection Act would not apply. The same is true of any other area of transactions governed by other Federal legislation.

The Federal Reserve Board, which provides the rules and regulations for application of the Act, may exempt individual states from coverage under the Act if those States have enacted legislation substantially similar to the Federal law. Those statutes may be more restrictive but may not be less restrictive than the Federal Act. Inconsistent state laws which require fewer disclosures different in form, substance, terminology or time of delivery will not be effective as against the Federal Act. But the Federal Act does not nullify state laws to the extent those laws do not clash with the Federal Act.

An important aspect of the Act is that it in no way affects the validity of any transaction. With the exception of the recission provisions of the Act, a consumer cannot expect to be relieved of his obligations under a contract merely because the creditor failed to comply with some provision of the Consumer Credit Protection Act. Nothing in the Act, including the civil and criminal penalties provided therein, affect the substantive aspects of the sale or loan.

The Federal Reserve Board is basically charged with prescribing regulations necessary to carry out the purposes of the disclosure subchapter of the Act. The first of these regulations is known as Regulation Z, by which name the Act is often called. Other provisions of the Act may involve enforcement by such diverse agencies as the Civil Aeronautics Board, Federal Trade Commission, Federal Housing Administration, Veterans Administration, Department of Housing and the Secretary of Labor.

Definitions

Definitions are important in understanding the provisions of this Act as is true in all statutory enactments. "Consumer credit" is that credit offered or extended to a natural person upon which a finance charge may be imposed. Again this is limited to a personal family or consumer type transaction as opposed to a business or agricultural purpose.

There may be certain situations in which a finance charge or interest is not incurred, but the transaction may still fall within the scope of the Consumer Protection Act. If the repayment of the loan or credit requires more than four installments, the transaction is covered by the Act no matter that no interest or other charges for credit are made.

"Credit" as defined by the Act, is that right granted by a creditor to a debtor to defer payment of a debt or to incur a debt and defer its payment.

A "creditor" is a person or organization who regularly extends credit or arranges for the extension of credit for which payment of a finance charge is required. Someone arranges for the extension of credit when he provides or offers to provide the consumer with credit to be extended by someone other than himself. This is especially true when the person arranging the credit is to receive some kind of compensation or fee. It is not necessary that there be such a monetary arrangement if the person making the arrangement for credit has knowledge of the credit terms and, in fact, participates in the preparation of the necessary documents, or contracts to consummate the transaction.

Perhaps the most important definitions contained in the Act for disclosure purposes are "amount financed," "annual percentage rate," and the "finance charge."

The "amount financed" means that amount of credit which the consumer will actually have. The "finance charge" includes interest, points, carrying charges, loan fees, finders fees, investigation of credit report fees, charges for insurance written in connection with the credit transaction and any other change including the cost paid by the consumer to the creditor for discounting of the paper.

Items such as filing fees, license fees, and taxes required to be paid by law are excluded from the finance charge even though they were paid over a deferred period of time.

Insurance premiums may also be excluded from the finance charge if the insurance is a substitute for a security interest, rather than the type of insurance normally written in connection