THE LAW AND LEGISLATION OF CREDIT CARDS:
Use and Misuse

by Irving J. Sloan

Legal Almanac Series No. 70

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General Editor

1987
Oceana Publications, Inc.
London • Rome • New York

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.

Library of Congress Catalog Card Number: 86-063542
ISBN: 0-379-11158-6

Manufactured in the United States of America

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INTRODUCTION

"All of a sudden, the credit card was like an Aladdin's lamp and you didn't even have to rub it." These words, expressing something more akin to pride than to remorse, were offered by a nineteen-year-old boy in explanation of a one month trip back and forth across the country. During his escapade, the boy purchased nearly ten thousand dollars' worth of goods and services by the simple expedient of making frequent and extravagant use of his credit card. The omnipotent credit card was used to obtain rental cars, airline tickets, luxurious hotel suites, food and drink, clothing, a mink coat for a newly-acquired girl friend, and a dog for himself. This brief case history reported in the press recently bears out the fact that credit cards can be used to buy almost any conceivable item or service. It also indicates that credit cards are subject to serious abuse and that the potential liabilities of the credit card issuer, credit card holder, and honoring merchant are not hypothetical or trivial, but very real and very substantial.

Clearly one of the most important commercial developments since the Second World War is the emergence of the credit card as a substitute for cash. While it appears that losses due to improper or fraudulent use of credit cards is negligible compared to the overall volume of use, there have been some startling examples of individuals who have stolen thousands of dollars through fraudulent use of credit cards, and losses have increased as a result of the inability of users to meet their financial obligations. As the reader will see from a review of the Appendix A in this volume, the general criminal statutes of the various states relating to larceny and forgery seem to cover most of the more flagrant misuses of credit cards. In addition, again as seen in the statutes reproduced in Appendix A, many states have enacted statutes imposing criminal penalties for specified improper uses. Increasingly, a large number of states have enacted special legislation dealing with the use and misuse of credit cards. This legislation, as the reader will note in our Appendix A, comes under titles such as "Credit Card Fraud Act" (Arizona), "Credit Card Crimes" (Connecticut), "Illegal Use of Financial Transaction Cards" (Georgia), "Credit Card Number Protection Act" (Maryland), and "Financial Transaction Card Crime Act" (North Carolina).

History of the Credit Card

Since the beginning of history man has been involved with trade and commerce. As this area has expanded and become more important, different mediums of exchange have been developed. Barter gave way to the advance of money, and money in turn has faced the advance of checks. Now both are feeling the advance of credit cards. In this age of rapid technological advances it is only natural that man should seek out a new, more efficient system of carrying on trade and commerce. This system seems to be the credit card.

Again, credit cards are not new. They, or some equivalent, have existed since the early part of this century. Some time before 1920 some large department stores began to issue "credit coins." These coins were a small piece of metal which displayed the name of the merchant and a series of numbers identifying the customer's account. These coins were issued to good customers and allowed them to purchase merchandise on credit in the store. About the same time, oil companies began to issue charge plates (usually made of metal) to their customers for the purchase of gasoline, oil, etc. at the companies' service stations. All of this development notwithstanding, the yield was relatively insignificant until 1950.

In 1950, the Diners' Club, Inc. introduced the first independent credit card plan. This plan involved an agreement between the club and its members and between the club and the merchants. The members agreed to pay the club to obtain a card and then agreed to pay each monthly billing as it came in. The merchant agreed to honor the card and then forward his credit vouchers to Diners' Club for payment once a month. The members thereby were able to get service from many types of establishments by carrying only one card and were able to pay for it at the end of the month. The merchant, on the other hand, was relieved of having to have his own plan and was also likely to increase the volume of his business since card holding members would find it more convenient to deal with him than with a merchant who wouldn't honor his card. The success of the Diners' Club plan was such that the American Express Company entered the field in 1958, while Hilton Credit Corporation initiated the "Carte Blanche" plan the following year.

In 1951, the First National Bank of Long Island became the first bank to offer its customers a credit card plan. This area was not very important, however, until the late 1950s when the Bank of America and the Chase Manhattan Bank issued their cards. In 1966, the Midwest Bank Card System was started.

With the advent of the bank credit card the range of goods and services available on credit became staggering. They range from the normal expenditures of food and clothing, shelter, entertainment and travel.

By at least the beginnings of the 1970s the personal (as well as the corporate) credit card had become a fixture in the nation's economy. Today more than 60 million credit card accounts exist in the United States, and seven out of ten households possess at least one credit card. By 1986 outstanding balances on credit card accounts total more than $80 billion.

The law and legislation relating to credit cards is essentially in an embryonic condition. However, statutory treatment codifying the law related to credit cards has increased in recent years. This development will, hopefully, avoid the problem of forcing the credit card into an existing legal mold in which it does not quite fit. The statutory treatment offers the advantages of removing much of the uncertainty which has greatly characterized the "law" of credit cards until very recently. The statutes serve as guidelines both for commercial practices and court decisions. Because the statutes play such a crucial role in this field, our appendixes are fairly comprehensive in the inclusion of both state and federal statutes.

In short, what we have here is an evolving commercial system, the cashless society not so much of the future but already in our present.

Chapter 1

THE MECHANICS AND ECONOMIC CHARACTERISTICS OF CREDIT CARD PLANS

Mechanics

Credit card plans involve one card issuer and many merchants and card holders. Because the form contracts used are drafted by the issuer and because only one merchant and one card holder are involved in a particular credit card transaction, it is appropriate to consider the plans as three-party arrangements, referring to all merchants as "the merchant" and to all card holders as "the card holder." The issuer is the moving force of the plan, and the success of its endeavor is dependent upon the solicitation of both merchants and retail buyers.

The issuer distributes credit cards upon application. In the early years of the credit card movement card issuers mailed unsolicited credit cards to individuals whose names had been taken from mass-mailing lists. Large quantities of these credit cards were stolen in the postal system and from recipients' mailboxes without the knowledge of the individual to whom the unsolicited card had been sent. In 1970, Congress curbed such practices by amending the Truth in Lending Act to provide for regulation of the credit card industry. An absolute ban on the unsolicited distribution of credit cards presently exists in the law.

The credit card holder is entitled to purchase goods and services at any retail outlet which has become a merchant member of the plan. For this privilege, the card holder is to pay the issuer for "all credit extended on the basis of this card" or for "all purchases made with the card" until the issuer receives written notice of the loss or theft of the card.

At the end of each billing period, the issuer consolidates all of the purchases made by the card holder from merchant members during the period and sends him one all-inclusive statement. Under the consumer plans, upon receipt of each monthly statement the holder has the option of paying the face amount of the bill within a specified period, usually twenty-five to thirty days from the date the statement is mailed, or of paying according to a deferred payment schedule. On the other hand, credit cards held by business people as distinguished from retail purchasers of consumer goods, usually have no such option, nor do they pay a service charge. The sole cost imposed upon such credit card holders is the annual fee. Upon receipt of their statement, they are expected promptly to pay their bill in full.

If the consumer credit card holder selects the deferred payment plan, he must pay a certain percentage of the total bill within twenty-five to thirty days, depending upon the particular plan. The remainder is paid in monthly installments and is subject to a service charge which is essentially interest which is computed each month at a specified percentage of the previous month's balance less all appropriate credits.

At the time of the customer's application for a credit card, he is given a maximum amount of credit. At any given time the credit available to him is dependent upon the amount owing to the issuer. This is known as a "revolving credit" feature.

The rights and duties of the merchant member of the plan are contained in a form contract drafted by the issuer. He is obligated to "assign" or "endorse" to the issuer all "sales drafts," "charge slips," or "accounts," which represent sales made to card holders (see Chapter 3 for the legal implications of this). With certain exceptions, the issuer's "purchase" of sales drafts or accounts is "without recourse' to the merchant in the event of nonpayment by card holders.

These exceptions are defined in some of the form contracts in vague and uncertain terms for the issuer's own protection. But generally it can be said that the issuer will have recourse to the merchant (meaning the issuer can hold the merchant liable for a card holder's non-payment) when the face of the card indicates that it has expired; when the card is on the current void list sent by the issuer to the merchant; when the sales slip is illegible or not signed by the person who made the purchase; when there is non-delivery of merchandise; when there is a breach of warranty or fraudulent acts on the part of the merchant; or when the merchant, without prior clearance from the issuer, allows the card holder to make a purchase in excess of the single-purchase limit established by the issuer. In other words, in those situations where the conduct of the merchant is responsible for improper validation of the purchase, the issuer may hold the merchant liable.

In addition to assuming the credit risk (apart from the above litany of exceptions), the issuer handles the billing procedures, makes all collections from card holders, and investigates the credit rating of card applicants. The issuer's compensation for these services is obtained by discounting the sales drafts assigned to it by the merchant at a rate established by the contract.

What has thus far been described is the *three-party* credit card which has become pretty much the prevailing credit card transaction. But the original *two-party* credit card arrangement remains popular and its operation should at least be briefly described here.

In the *two-party* credit card transaction—exemplified by the department store credit card or plate—the customer agrees to pay for his credit purchase in one lump sum at the next regular billing date, or he may place his charges on a revolving line of credit basis. There may be a combination of these payment plans. These credit cards are then used by the customer in making purchases at the store of the issuer and the store's salesperson may be required to ascertain if the purchase is within the limit of credit set by the store for this particular customer. While this was once carried out by telephone today the system is computerized and a computer next to every cash register conveys the information within seconds.

A newer development in the use of credit cards has been to obtain cash or a line of credit. Most banks have issued credit cards which enable the holder to secure an installment loan from the bank, to cash bank checks (which resemble a hybrid of postal money order and a cashier's check) and to overdraw his checking account and cover it by a loan.

Economic Characteristics

Gasoline Company Credit Cards

Gasoline credit cards are "two-party," arrangements—credit cards that are issued by a merchant or vendor for customers to use in making credit purchases primarily or exclusively at the retail outlets of the issuing company. Most gasoline company credit card programs provide credit for a one-month billing period with no provision for extending repayment over a longer period. Some gasoline companies offer optional extended periods to pay for purchases of more expensive items such as tires, batteries, or repairs.

As a result of the short repayment period, the gross expense to the gasoline companies of financing these receivables is lower, relative to the dollar volume of credit billings, than for credit card programs that offer extended repayment terms. However, an offsetting factor is the relatively low amount of finance charge revenue generated by this type of credit card plan. Moreover, the rather low average amount of credit purchases at gasoline stations implies that costs of processing credit card transactions tend to be fairly high per dollar credit of sales.

Since publication of this volume, Congress has passed legislation which requires gasoline stations to offer consumers a choice between purchasing their products and services either at a discount if they pay cash or with a credit card. This requirement removes the burden of both higher prices and service charges for credit card holders.

Bank Credit Cards

By contrast, bank credit cards are, again, "third party" arrangements in which the company that provides the financial service has no affiliation with the buyer or seller of the goods and services purchased with the credit card. Bank credit cards offer highly flexible credit terms. Customers who can qualify for a fairly large credit limit-those who have a good credit history and adequate income can incur relatively large indebtedness on such an account. Also, by choosing to pay less than the entire balance, account holders can stretch out repayments over an extended period of time. Bank credit cards can therefore be used to satisfy fairly large needs for immediate credit, and, if desired, to scale repayments to available income. Furthermore, bank credit cards are widely accepted for purchases of a large variety of goods and services, and can also be used to obtain cash at many financial institutions, as indicated earlier.

The gross financing cost incurred by a typical bank credit card issuer per dollar of credit billings likely exceeds that of most gasoline credit card programs, since a lower proportion of bank credit card customers usually pay the entire balance when billed. Processing costs are lower relative to the volume of bank credit card billings because of the larger average dollar amount of bank credit transactions.

Although the term "bank" credit card is commonly used, it obscures the growing diversity of institutions and organizations offering such services. "Bank" cards now are issued by finance companies (through commercial banks that may be subsidiaries), savings and loan associations, and credit unions. Some nonfinancial organizations such as the American Automobile Association (AAA) have made arrangements with commercial banks to issue bank credit cards to members in the name of the organization.

To offset the cost pressures, many banks have adopted periodic fees in an effort to boost their revenues and to reprice credit card services on a basis better suited to an environment in which customer deposit rates are unrestricted. Some banks have pursued means of boosting revenues other than through imposing periodic fees, such as charging for each transaction billed to a credit card account and assessing penalties for late payments, for replacement of lost cards, or for balances that exceed credit limits.

A variant of the bank credit card offered by many institutions is the so-called "gold card" or the "premium card." This specialized type of "premium" bank credit card combines the features of the regular bank credit card with a larger credit line and a package of additional services that may include accident insurance, lost credit card service, hotel and car rental discounts, and free travelers checks. Fees charged cardholders for gold card services usually are greater than the range of fees on regular bank credit card accounts, but ordinarily are less than the fees charged for general purposes (travel and entertainment) cards.

One-half of all families in the United States now hold one or more bank credit cards, up from nearly two-fifths in 1977. The proportion of families holding a bank credit card has expanded continually, as has the percentage of families that use bank credit cards, which rose from one-fifth in 1971 to somewhat more than one-half in 1982.

General Purpose Credit Cards

These credit cards are also frequently referred to as travel and entertainment cards." Major issuers of such cards include American Express, Carte Blanche, and Diner's Club.

Also frequently referred to as "travel and entertainment cards," this type of third-party credit card is oriented toward more affluent customers able to pay a larger annual membership fee for access to premium credit card services. Since higher income requirements must be met to qualify for general purpose credit cards, an element of prestige may be attached to carrying such cards as well as some presumption that cardholder credit worthiness is less subject to question than with other credit cards. Therefore, these programs appeal to customers who travel and/or entertain frequently, for whom an easily accepted credit card with a relatively high credit limit can be especially convenient.

A variety of ancillary services is typically offered as part of a general purpose credit card package. Travel accident insurance, discounts on travelers checks, on hotel accommodations, and on car rental, and access to check cashing or cash advances from company or affiliated offices or from card-activated cash dispensers are examples of these additional services.

In addition to membership fees, card issuers also derive revenues from merchant discount charges paid by retailers. Another important feature of general purpose credit cards is the requirement that balances be repaid within 30 days after billing. Thus, although the average balance for such accounts may be large, credit remains outstanding for only a relatively short period of time, so that gross financing costs incurred by the card issuers are kept fairly low in relation to the volume of billings.

General purpose credit cards are held by almost 15 percent of families, up from only eight percent in 1977. The percentage of families using general purpose credit cards has almost doubled since 1977.

Retail Store Credit Cards

Two-party credit cards issued by retail stores are the most widely held and used type of credit card. Over three-fifths of families in the United States held some kind of retail store credit card in late 1982. One can readily assume that this figure has since increased by the year of copyright of this volume. Holding and use of retail store cards have continued to expand in recent years, even though retail credit cards have long been available and despite increasing competition from third-party credit cards, some of which are now accepted by many leading department stores and specialty shops.

Retail store cards typically offer lower credit limits and have less demanding credit qualification requirements in comparison with third-party credit cards. Of course, use of retail credit cards is limited to the variety of merchandise carried by the issuing merchant. Retail revolving credit plans usually provide customers the option of repaying over an extended period of time. Typically, three-fifths of retail credit card customers usually pay the entire balance billed to their accounts, about the same proportion of nonrevolvers as is found with bank credit cards. (see Appendix D.)

Other Credit Cards

The remaining category of credit cards used by consumers is highly specialized and appears to be growing slowly. Such credit cards mainly are issued by some airlines and car-rental firms.

The larger car-rental firms offer credit card accounts that have no annual fees and require full payment by the end of each billing period. Some companies provide credit card accounts only for businesses. A number of major airlines provide credit card plans that are available to individuals, permit extended payments, and have no periodic fees. In addition, many carriers accept Universal Air Travel Plan credit cards, although this account is mainly available for business travel and requires full payment during each billing period.