1982

1981 Annual Survey of Consumer Financial Services Law Developments

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I. ADJUSTABLE RATE CREDIT: By John L. Culhane, Jr.**

A. Introduction

In an effort to cope with the fluctuations in money market rates and with the eventual removal of rate controls on savings accounts and savings certificates, many consumer lenders are turning to variable rate loans. By varying interest rates in accordance with the movements of certain indices, these lenders hope to guarantee that the return on their assets will exceed their liabilities.¹ However, since variable rate loans are still a relatively new phenomenon, the operational and legal problems attendant on their use are still being identified and resolved.²

B. Federal Developments

At the federal level the primary focus has been on variable or adjustable rate mortgage loans. In quick succession the Office of the Comptroller of the Currency (OCC),³ the Federal Home Loan Bank Board (FHLBB),⁴ and then the National Credit Union Administration (NCUA)⁵ adopted adjustable rate mortgage loan regulations. Moreover, to give national banks, federal savings and loan associations, and federal credit unions the flexibility to develop their own programs, all three agencies purported to preempt state laws restricting

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¹ E. Pace, J. Lockart, & A. Sale, Variable Rate Consumer Lending 1 (1981).
² For a comprehensive review of these problems see Federal Home Loan Bank Board, Alternative Mortgage Instruments Research Study (1977).
the ability or right of the institutions under their control to offer adjustable rate mortgage loans.

A comparison of these regulations suggests that the adjustable rate mortgage loans made by national banks, federal savings and loan associations, and federal credit unions should have a number of elements in common. All three regulations apply only to home mortgage loans. All permit adjustments to the interest rate through changes in the payment amount and the rate of amortization (or both). All permit negative amortization. In all cases, a decrease in the index generally requires a downward adjustment of the interest rate. With some variations, prepayment penalties are essentially prohibited. In all cases it appears that the loans may contain due-on-sale clauses. Notwithstanding these similarities, a closer examination indicates that each succeeding regulation provides more flexibility than its predecessor.

The OCC regulations are clearly the most stringent. Unlike the other regulations, the OCC regulations do not permit extension of the loan term. Only three indices are permitted: (1) the monthly average contract rate charged by all lenders on mortgage loans for previously occupied homes; (2) the monthly average yield on U.S. Treasury securities adjusted to a constant maturity of three years; and (3) the monthly average yield of weekly auction rates on U.S. Treasury bills with a maturity of six months. Adjustments may only be made at regular intervals (which must be at least six months long).
and the maximum interest rate change may not exceed one percentage point for every six-month period between adjustments (moreover, in no event may a single interest rate adjustment exceed five percentage points). Negative amortization is limited to one percent of the principal outstanding at the beginning of the fixed-payment period multiplied by the number of six-month intervals within the fixed-payment period (although in no event may the amount of negative amortization exceed 10 percent of the principal outstanding at the beginning of the period). Decreases in the index that are not translated into changes in the interest rate must be carried over to the next rate change date (unless they are offset by a subsequent movement in the index). A disclosure form must be given to a prospective borrower when written information is provided concerning residential mortgage loans or when a loan application form is provided, whichever occurs first. Moreover, a notification must be given at least thirty but not more than forty-five days before any interest rate change takes effect.

By contrast, the FHLBB regulations are more flexible. The FHLBB regulations permit extension of the loan to forty years. Further, any index may be used as long as it is readily verifiable by the borrower and is beyond the control of the lender. There are no limitations on the frequency of rate changes, although as with the OCC regulations, notice of a payment adjustment must be given at least thirty but not more than forty-five days prior to the adjustment. There is no limitation on the maximum amount of any one adjustment nor are there any limitations on the amount of negative amortization. Although a disclosure is required, it only has to be given on request or at the time an application form is provided.

The NCUA regulations are essentially the same as the FHLBB regulations. The NCUA regulations permit extension of the loan to forty years. Again, any index may be used as long as it is readily verifiable by the borrower and is beyond the control of the lender. Adjustments may be made as frequently as monthly. There are no limitations on the amount of any one adjustment nor
on the amount of negative amortization. But unlike the FHLBB regulations, NCUA requires merely that disclosures be made in accordance with the Truth in Lending Act and regulation Z; it does not require that a notice be given prior to any rate adjustment.\textsuperscript{30}

As a practical matter, the differences among the three regulations may at this point be of academic interest only. The Federal Home Loan Mortgage Corporation\textsuperscript{31} and the Federal National Mortgage Association\textsuperscript{32} may have effectively minimized these differences by limiting the types of adjustable rate mortgage loans they will purchase to ten separate plans.

C. State Developments

Some states have enacted statutes to authorize the use of variable rate loans, either directly or by removing prior statutory impediments to their use.\textsuperscript{33} In other states, state banking commissioners and other officials have reportedly issued enabling regulations.\textsuperscript{34} In the absence of statutory or regulatory authorization, variable rate loans are apparently legal as long as changes in the interest rate are made in compliance with applicable provisions of state law—although it is not always possible to identify the applicable provisions of law in advance of litigation.

Perhaps because most of the cases to date have involved commercial transactions, contrary to expectations a distinction has not yet developed between internal and external indices. Although the index is not always challenged directly, internal indices such as the institution's savings account rate,\textsuperscript{35} its cost of funds,\textsuperscript{36} and its own prime rate\textsuperscript{37} have all appeared in reported

\textsuperscript{35} Vanguard Investments v. Central California Fed. Sav. Ass'n, 68 Cal. App. 3d 950, 137 Cal. Rptr. 719 (1977); Powell v. Central California Fed. Sav. & Loan Ass'n, 59 Cal. App. 3d 540, 130 Cal. Rptr. 635 (1976). In \textit{Vanguard Investments} the transaction survived a challenge that the index has been fraudulently manipulated. 68 Cal. App. 3d at 963-64, 137 Cal. Rptr. at 727. In \textit{Powell} the transaction survived a challenge that the variable interest rate provision was illusory. 59 Cal. App. 3d at 549-50, 130 Cal. Rptr. at 640-41.
\textsuperscript{37} In re Le Blanc, 622 F.2d 872 (5th Cir. 1980) (Louisiana law); Constitution Bank & Trust Co. v. Robinson, 179 Conn. 232, 425 A.2d 1268 (1979); State Nat'l Bank v. Dick, 164 Conn. 523, 325 A.2d 235 (1973); Sailboat Apartment Corp. v. Chase Manhattan Mortgage & Realty Trust, 363 So. 2d 564 (Fla. Dist. Ct. App. 1978). Although the prime rate survived direct challenges in \textit{Le Blanc}, where it was held to be sufficiently definite to meet a parol evidence statute requiring interest to be "fixed in writing," 522 F.2d at 878-79, and in \textit{Robinson}, where it was held to be sufficiently definite for contract purposes, 179 Conn. at ______, 425 A.2d at 1270-71, further
decisions. Only when the rate has been "at the lender's discretion" has the transaction been overturned because of the index.\textsuperscript{38} External indices, such as the prime rate of an institution other than the lender,\textsuperscript{39} employment,\textsuperscript{40} or residence,\textsuperscript{41} have largely gone unchallenged.

In contrast, usury-related allegations have frequently been made. One question that has been raised is whether negative amortization will run afoul of state laws prohibiting compounding.\textsuperscript{42} Another question that has been raised is whether an interest rate ceiling will have a special impact on a variable rate loan. At least the following possibilities exist: the lender may not collect any interest above the legal maximum;\textsuperscript{43} the lender may not collect any interest above the legal maximum but may provide for the recapture of uncollectible interest in the event the rate drops below the legal maximum;\textsuperscript{44} the lender may collect interest above the legal maximum so long as the parties contract in good faith and the total interest collected does not exceed the legal maximum at any particular time;\textsuperscript{45} and the lender may continue to collect interest above the legal maximum as long as there is a reduction in the final payment or a recomputation and refund of any excess interest at the time the loan is repaid.\textsuperscript{46}

Other state law problems have also been identified and addressed. Different states have come down on opposite sides of the questions of whether variable rate loans will violate provisions requiring level payments or prohibiting balloon payments\textsuperscript{47} and whether they will violate laws limiting interest rate increases on refinancing.\textsuperscript{48} Additional questions have been raised concerning challenges are likely to be made in the future. See Staff of House Comm. on Banking, Finance & Urban Affairs, 97th Cong., 1st Sess., An Analysis of Prime Rate Lending Practices at the Ten Largest United States Banks (Comm. Print 97-2).


43. See Arneill Ranch v. Petit, supra note 39.

44. See Kin-Ark Corp. v. Boyles, supra note 39. It appears from the decision that this might be acceptable under Texas law on the grounds that the recapture provision is akin to a savings clause.


continued lien priority,49 negotiability,50 and the disclosure requirements of
state laws.51

D. Conclusion

As can be seen from the federal and state developments, any lender's move
to variable rates involves complex choices. Since variable rate consumer loans
are relatively new, the legal issues that arise with their use are by no means
well settled. With so many questions unanswered, more litigation seems likely
for the future.

II. CONSUMER LEASING by John G. Cooluris*

Leasing has become a popular alternative to purchasing as a means for
consumers to obtain the possession and use of automobiles, furniture, and
other durable goods. Consumer lease transactions are not homogenous, but
rather have become highly differentiated as to product type; market place
competition continues to fuel innovation. As has been the experience with
other forms of consumer financial services, the law has not fully anticipated
the advent of consumer leasing.

This article summarizes the key federal consumer protection law develop-
ments of 1981 which primarily relate to consumer leasing. Excluded, there-
fore, is an analysis of the Economic Recovery Tax Act of 198152 and other
important federal income tax law developments affecting lessors’ ownership
tax benefits and ultimately the pricing of many types of leases. Also excluded
is a discussion of the movement in some quarters to develop a new article of

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49. Increases in the index are implemented either by adjusting the interest rate, making
additions to principal, extending the loan term, or a combination of all three. In the case of a
mortgage loan, all of these options raise questions concerning continued lien priority. Although
there have been no judicial developments to date, it seems to be generally assumed that if the
changes are mandatory, the note and mortgage accurately describe the variable rate feature, and
the proper documents are recorded, then the case law on future advances will support continued
priority. For a more detailed discussion, see P. Barnett, Alternative Mortgage Instruments: How
to Maintain Secured Lender Status, 96 Banking Law J. 6 (1979). Nonetheless, at least two states
have acted to remove any uncertainties by amending their statutes dealing with foreclosures. Act

50. There is some question whether a variable rate loan will be negotiable because of the
requirement of § 3-104(1)(b) of the Uniform Commercial Code that the instrument contain an
order to pay a "sum certain." At least one state has specifically amended its statutes to provide
that a variable rate loan will be negotiable. Act. No. 640, 1981 La. Sess. Law Serv. 1019 (West)

Guide (CCH) ¶ 97,082 (how to make disclosures on variable rate open end loans); Op. Me.
¶ 97,383 (change in terms notices not required before raising interest rates on variable rate open
end loans).


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*Member of the California bar.
the Uniform Commercial Code addressing personal property leases. Finally, the potential impact of the Federal Trade Commission's recently promulgated trade rule on used cars, which affects lease as well as purchase transactions, is not covered here. These excluded topics are nonetheless "must review" matters for practitioners, regulators, and others involved with the legal problems of consumer leasing.

A. Regulation M

When Congress enacted the Truth in Lending Simplification and Reform Act in 1980, the provisions of the Consumer Leasing Act were left largely untouched. As discussed in last year's annual survey, on the basis of its regulatory powers, the Federal Reserve Board proposed a variety of changes in the leasing provisions of regulation Z in its May 1980 and November 1980 drafts of the revised regulation Z. The May 1980 draft would have effected major changes and necessitated numerous revisions in existing disclosure forms.

In the November 1980 draft, the Board expressed the policy decision not to adopt any regulatory changes requiring lessors to alter their existing lease disclosure forms. The Board elaborated on its desire to simplify the leasing regulations but concluded that such efforts should await congressional action. Within that framework, the Board proposed a number of both technical and substantive refinements to the existing regulation, including the creation of significantly clearer rules regarding renegotiations and lease term extensions.

The Board surprised many in the consumer leasing community with its ultimate decision to remove all leasing provisions from regulation Z and to place them, without substantive change, in a new regulation M. With one minor exception, regulation M, which became effective April 1, 1981, is virtually identical to the leasing provisions contained in regulation Z that

56. Although neither disclosure simplification nor review of consumer lessees' substantive protections were undertaken, Congress did extend to leasing all or some of the new provisions applicable to other consumer credit transactions regarding model disclosure forms, the effective date of new disclosure rules, transactions involving multiple creditors or multiple consumers, and civil liability. DIDMCA §§ 605, 611, 615.
60. Id. at 80,689.
62. 12 C.F.R. § 213.4(c) provides that only one lessor need make the required disclosures. The lessors may decide among themselves which one will make the disclosures. 46 Fed. Reg. at 20,950 (1981).
expire on March 31, 1982. Compliance with regulation M therefore becomes mandatory on April 1, 1982.

B. Official Staff Commentary to Regulation M

In October 1981, the Federal Reserve Board issued for public comment a proposed official staff commentary to regulation M. The proposed commentary has been designed to incorporate the more important Board and staff interpretations on the leasing provisions of the old regulation Z and otherwise to provide general guidance on the requirements of regulation M. The nature and format of the proposed commentary mimics that of the official staff commentary to the new regulation Z.

C. Possible Amendments to the Consumer Leasing Act

In the supplementary information accompanying regulation M, the Federal Reserve Board indicated that it was recommending to Congress that it consider simplifying the Consumer Leasing Act in the near future in order to continue the process begun with the Truth in Lending Simplification and Reform Act. The Board's Division of Consumer and Community Affairs, in its memorandum dated April 1, 1981, asked the Consumer Advisory Council to consider a number of issues relative to amending the Act. The staff presented a variety of issues relating to the fundamental need for the law and the act's provisions regarding scope of coverage, transactional and advertising disclosures, substantive consumer rights, and civil penalties. The Consumer Advisory Council did not formulate a comprehensive response to the staff's inquiries in 1981, although there was some concern expressed by some members of the council at its April 15, 1981, meeting regarding week-to-week or month-to-month rentals of televisions and other goods.

Congress did not act in 1981 upon the board's recommendations to simplify the act. However, sections 704 and 705 of S.1720, the Financial Institutions Restructuring and Services Act of 1981, introduced on October 7, 1981, by Senator Jake Garn, chairman of the Senate Banking Committee, would respectively change the relation to state laws rules and civil liability provisions of the Truth in Lending Act which apply to consumer lease transactions.

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66. Most of the reported decisions regarding the Consumer Leasing Act and its implementing provisions of regulation Z have focused on week-to-week rental agreements for televisions whereby the consumer would not be obligated to rent the television for more than a week at a time, and in some cases, the consumer would automatically receive title after a certain time. The cases have almost uniformly held that such transactions are not covered by the Consumer Leasing Act (nor by the Truth in Lending Act). See Smith v. ABC Rental Systems of New Orleans, Inc., 491 F. Supp. 127 (E.D. La. 1978), aff'd 618 F.2d 397 (5th Cir. 1980); Dodson v. Remco Enterprises, Inc., 504 F. Supp. 540 (E.D. Va. 1980); Lemay v. Stroman's Inc., 510 F. Supp. 921 (E.D. Ark. 1981).
D. FTC Investigation of Leasing Practices

The Federal Trade Commission announced in August 1980 that it was proceeding with an investigation of the automobile leasing industry to determine whether or not violations of the Federal Trade Commission Act and the Consumer Leasing Act were occurring.68 The investigation has been conducted by the FTC's Seattle regional office.

The focus of the investigation has been on lessors' practices and policies relating to early termination charges, default charges, disposition methods, and equity ownership in the leased property. In this regard it would appear that the staff is concentrating its efforts on whether the limitations of section 183(b) of the Act69 are being observed by the leasing industry. Section 183(b), which is not covered by the Federal Reserve Board's regulations and has yet to be judicially construed, provides that penalties or other charges for delinquency, default, or early termination may be specified in the lease but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the delinquency, default, or early termination, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy.

The FTC's findings and resulting actions in this area could prove to be significant. As of December 1981, the FTC had neither initiated any administrative action against any lessor nor proposed any trade regulation rule proceeding.

III. CREDIT DISCRIMINATION by James N. Rice*

Since the last annual survey70 there have been two significant legal developments under the federal Equal Credit Opportunity Act (ECOA),71 regulation B,72 and related areas of the law. The first is the issuance by the Federal Financial Institutions Examination Council of an interagency policy statement73 and a supervisory enforcement policy74 regarding the enforcement of the ECOA and the federal Fair Housing Act75 by four of the federal agencies that have responsibility for the enforcement of these acts.76 This development, the long anticipated response to issues originally presented in the summer of

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*Member of the Massachusetts bar.
72. 12 C.F.R. § 202 (1980). Regulation B is the implementing regulation under the ECOA.
74. Published under a press release of the examination council dated September 14, 1981.
76. The four agencies referred to in the text are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency.
1978, should lead to a more uniform enforcement effort by the four agencies and to more vigorous enforcement efforts by individuals in private litigation. The second significant development is the affirmance by the Federal Court of Appeals of the opinion, favorable to creditors, of the District Court of New Jersey in *United States v. Beneficial Corporation.*

### A. The Interagency Policy Statement

The Interagency Policy Statement represents the agreement of the four enforcing agencies on the broad parameters of a regulatory enforcement strategy. The statement sets forth the basic enforcement principle that certain ECOA violations will require the violating creditor to take "retrospective action to correct the conditions resulting from the violations." Aside from listing these "serious" violations of ECOA, the statement sets out statute of limitations concepts for regulatory enforcement. In general, creditors will be required to take corrective action only with respect to violations occurring within twenty-four months prior to the discovery of the applicable violation by the appropriate examining agency. Violations involving adverse action notices will only trigger corrective action if they occurred within six months prior to the discovery of such errors by the examining agency. The Interagency Policy Statement closes with the admonition that it neither precludes nor requires the use of any other administrative or private remedy available for ECOA enforcement.

Although specifying those ECOA violations that will give rise to required corrective action, the Interagency Policy Statement does not describe the nature of the corrective action that will be required when these "serious" violations are detected by bank examiners. This description of the types of required affirmative action appears in the supervisory enforcement policy.

Although taking pains to indicate that each bank examining agency retains discretion in fashioning appropriate remedies, the supervisory enforcement policy makes clear that all of the four agencies have agreed that creditors that have made "serious" ECOA violations will be required to adopt written ECOA compliance programs. The supervisory enforcement policy encourages, but does not require, agencies to require violating institutions to adopt

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78. United States v. Beneficial Corporation, No. 81-1235 (3d Cir. 1981). This decision affirms the opinion appearing at 492 F. Supp. 682 (D.N.J. 1980). The district court opinion was thoroughly discussed in Dreyer & Rice, supra note 70.
79. The ECOA violations categorized as serious by the Interagency Policy Statement are discouragement of applicants in violation of the Fair Housing Act or § 202.4 or § 202.5(a) of regulation B; the use of discriminatory credit criteria in violation of the Fair Housing Act or §§ 202.4–202.7 of regulation B; imposing different terms on a prohibited basis in violation of the Fair Housing Act or § 202.4 or § 202.6(b) of regulation B; requiring cosigners and guarantors on a prohibited basis in violation of § 202.7(d) of regulation B; failing to furnish separate credit histories as required by § 202.10 of regulation B; and failing to provide adequate adverse action notifications under § 202.9 of regulation B.
employee training programs, internal control programs, written appraisal standards, and written loan policies.

The major portion of the supervisory enforcement policy lists each of the "serious" ECOA violations followed by suggested remedial action designed to correct the conditions created by the violation. In this fashion, the supervisory enforcement policy recommends to each bank examining agency that creditors that have discouraged applicants on a prohibited basis\(^8\) be required to implement in-house training procedures and marketing techniques designed to solicit applications from discouraged groups. Those creditors that have been found to have used discriminatory credit criteria and credit evaluation techniques\(^8\) will be required to notify affected customers and solicit new credit applications. The credit standards to be used in such a required reapplication program are the earlier credit standards (without their discriminatory elements) or the current credit standards, whichever are more favorable to that customer. Creditors found to have made ECOA violations in the credit approval process may be required to refund application fees, pay for prepayment penalties on alternative credit arrangements, and notify credit bureaus of the inaccuracy of the previously reported rejection. If the creditor's violation involves the imposition of more onerous terms on a discriminatory basis,\(^8\) the supervisory enforcement policy calls for the identification of all such loans by the creditor and the delivery of a notification by the creditor to affected customers within sixty days of the corrective action to be taken by the creditor. If the violation involves nondirect cost terms such as the size of down payments or the amount of required collateral, the violating creditor may be required to offer to change the terms of the account to more favorable "nondiscriminatory" terms. If the violation entails actual cost items such as the amount of the annual percentage rate, creditors will be required to make reimbursements. Similar corrective action is set forth in the supervisory enforcement policy for signature violations, credit reporting violations, and adverse action notification violations.

The problems presented to creditors by the Interagency Policy Statement and the Supervisory Enforcement Policy could be major. For one thing, neither of the policy statements provides for a "pattern or practice" finding prior to the imposition of administrative remedies. A creditor, acting in good faith and using written compliance standards that conform to ECOA, could be required to take affirmative remedial action for an error committed in one or several credit transactions. Another difficult provision of the policy statements is that they require creditors to identify problem loans. A few acts of discrimination by one or several loan officers could require a large banking system to make a system-wide review for other discriminatory acts of the same nature. How such a system-wide check is to be prepared, particularly when

\(^{81}\) Thus violating regulation B, 12 C.F.R. §§ 202.4, 202.5(a).
\(^{82}\) Id., §§ 202.4–202.7
\(^{83}\) Id., § 202.4 or § 202.6(b).
information regarding race, national origin, and other protected bases cannot be obtained or accumulated for non-real estate loans, is not disclosed by the policy statements. Finally, the risk elements presented by the policy statements are great because creditors taking the type of corrective action contemplated by the policy statements will not be insulated from private litigation. This failure to provide for a termination of private civil actions against creditors that take corrective action acting under an administrative order presents a classic double jeopardy situation for affected creditors.

B. Litigation

There have continued to be few cases brought under the ECOA. As indicated at the outset, the most significant decision in the past year was the affirmance by the Court of Appeals for the Third Circuit in the Beneficial case. In this case, the Third Circuit let stand the important holding of the district court that the Attorney General may not sue for the monetary damages suffered by nonparties. This limitation of the power of the Attorney General is quite important because that office would be a likely source of the expertise needed to prepare a successful effects test lawsuit. Stated differently, the type of statistical analysis that is required to bring an effects test case is not likely to be possessed by private plaintiffs.

Other cases that are worthy of note involve a broad cross-section of ECOA issues. In Nguyen v. Montgomery Ward & Co., Inc., the District Court for the Northern District of Texas held that the denial of credit by a creditor because the applicant is not a citizen of the United States is not proscribed by the ECOA. The court made a point of noting that no showing was made that Vietnamese aliens such as the plaintiff were less favorably treated than other groups of aliens. Presumably, had such a showing been made, the court would have found at least an arguable theory of discrimination based on national origin. The Nguyen decision seems to suggest that a creditor may adopt a uniform system excluding all applicants who are not United States citizens. To the extent that the Nguyen decision can be read as permitting such a blanket refusal to deal with non-United States citizens, the decision runs counter to section 202.6(b)(7) of regulation B, a section that seems to indicate that an applicant's immigration status may be considered in evaluating a credit risk, but cannot itself be an absolute barrier to credit.

The decision of the District Court for the Western District of Missouri in Sayers v. General Motors Acceptance Corporation raises interesting issues in connection with the type of adverse action notification that is required by regulation B. In the Sayers case, the GMAC representative apparently

84. This risk of double jeopardy previously existed under the Truth in Lending Act but was substantially eliminated by provisions of the Truth in Lending Simplification Act. See § 130(b) of the Truth in Lending Act, 15 U.S.C. § 1640(b).
misread the plaintiff’s credit report to indicate that she was the subject of a collection action. On being advised by the plaintiff that this reading was incorrect, the GMAC supervisor did not correct the error as anticipated by section 202.9(e) of regulation B and, therefore, GMAC was found to be in violation of regulation B. Since the plaintiff applied to GMAC through an automobile dealer and since this dealer was advised by GMAC of the inaccurate information on the credit report, the Sayers court allowed the plaintiff to recover damages as compensation for embarrassment, humiliation, and mental distress.

The concern of credit applicants should be raised by the decision of the Court of Appeals for the Fifth Circuit in Haynes v. Bank of Wedowee. This decision dealt with a car loan made to a married woman as an individual. The car loan was accelerated on account of the husband’s bankruptcy. The plaintiff and her husband maintained a joint checking account at the defendant bank and, therefore, the husband’s bankruptcy could have resulted in the loss of the checking account balance as a continuing source of protection to the creditor. Even though the applicant did not rely on her husband’s income or assets in connection with her credit application, the court permitted an acceleration of the loan because the creditor had relied on the jointly held account. This shift from looking at the intent of the applicant to the intent of the creditor in determining compliance with the provisions of regulation B that deal with the appropriate treatment of the spouses of credit applicants seems hard to justify.

IV. CREDIT REPORTING by Lewis H. Goldfarb* and C. Lee Peeler**

Since 1971, the Fair Credit Reporting Act (FCRA) has resulted in remarkably little reported litigation compared to other statutes such as the Truth in Lending Act. Recently, however, there has been several significant appellate cases which have provided some important refinements in the interpretation of the act.

A. Permissible Purposes for Use of Consumer Reports

In Heath v. Credit Bureau of Sheridan the Tenth Circuit became the second appellate court to find a cause of action for consumers whose reports are obtained without a permissible purpose. Heath alleged that his union had obtained a credit report on him in order to "embarrass, humiliate and discredit [Heath] in the eyes of the public, and more specifically, in the eyes of

87. 634 F.2d 266 (5th Cir. 1981).
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Authors' Note: The views expressed herein are solely the views of the authors and do not necessarily reflect the views of the Federal Trade Commission, any particular commissioner, or the Commission staff.

89. 618 F.2d 693 (10th Cir. 1980).
his coworkers and brother union members." The district court dismissed the complaint against both the credit bureau and the union for failure to state a claim, on the theory that a report used for this purpose was not a "consumer report" under the act.

In remanding the case for a new trial, the Tenth Circuit followed the lead of the Ninth Circuit in Hansen v. Morgan, finding the credit report subject to the act because it was clearly prepared and expected to be used in connection with consumer credit transactions. Heath, however, had not alleged that the union had used false pretenses to obtain the report and the Tenth Circuit upheld the district court's dismissal of the complaint against the union.

In another significant appellate decision implementing the act's limitations on government access to credit information for law enforcement purposes, United States v. TRW, the Ninth Circuit ruled that a grand jury subpoena did not constitute an "order of the court" for the purposes of section 604(1) of FCRA and therefore a credit reporting agency had correctly refused to provide a credit report in response to a grand jury subpoena. Although there are conflicting lower court decisions on this issue, the Ninth Circuit's opinion is the first guidance from an appellate court.

B. Reasonable Procedures to Ensure Accuracy

Section 607(b) of FCRA, which requires consumer reporting agencies to follow reasonable procedures to assure maximum possible accuracy, has also produced some important new decisions. One potentially significant case, Bryant v. TRW, was recently argued on appeal in the Sixth Circuit. Bryant concerns a mortgage report which the plaintiff alleged erroneously indicated that four of his accounts were delinquent. Moreover, the plaintiff attempted to show that the report was but one of a series of inaccurate reports each containing different and sometimes conflicting information.

In defense, the credit bureau argued, in part, that it had correctly transcribed the information supplied by the credit grantors. Thus, the bureau argued the court should find that as a matter of law the bureau had no liability for the erroneous information. The trial judge, while admitting that the
bureau's argument had "superficial appeal," rejected the defendant's legal position as well as the defendant's motion for judgment notwithstanding the jury's verdict in favor of the plaintiff. The court held that, on the record of the case, it was reasonable for the jury to conclude that the bureau's procedures were "entirely inadequate" for dealing with a consumer who the bureau knew had a history of difficulty with creditors reporting inaccurate information and who had personally alerted the bureau that the information it was about to report was inaccurate.

Because of its unique facts, the Bryant decision itself will have little direct precedential value as to the procedures which should be followed in preparing consumer reports. However, the legal principle established by Bryant, if affirmed on appeal, will establish a significant legal precedent even though most consumer reporting agencies already appear to maintain some procedures to screen out erroneous subscriber input.

A second major appellate decision on section 607(b) involves an appeal by a consumer from an adverse jury verdict. In Colletti v. Credit Bureau Services, the consumer disputed the accuracy of her credit report, obtained a correction, and then again became delinquent in her payments. Upon learning that her report again reflected that she was delinquent, she paid the account in full and filed suit claiming that the bureau had violated section 607(b) of the act by reporting false, inaccurate, and incomplete information and by not taking steps to ensure the accuracy of its reports after being advised that she disputed the information. In reviewing the jury's finding that the bureau had followed reasonable procedure, the court noted that it found ample evidence to support the jury's verdict. Colletti is also notable in that it is the second circuit court to adopt the position that a credit bureau's failure to check the current status of in-file information before making a subsequent report does not violate the Fair Credit Reporting Act.

The broad latitude for jury findings under section 607(b) also emphasizes the need for clear jury instructions. One problem which may arise is illustrated by Thornton v. Equifax, in which the Eighth Circuit reversed a jury verdict awarding the plaintiffs $5,000 in actual damages and $250,000 in punitive damages. The appellate court held that the trial court's instructions had confused the standard for recovery under the FCRA with that provided by Arkansas for common law libel actions.

A final significant development under section 607(b) was the Federal Trade Commission's decision, In re Equifax, which ended an administrative enforcement proceeding begun in 1974. Although the appeal involved alleged

99. Id. at 1240.
100. Id. at 1239.
101. 644 F.2d 1148 (5th Cir. 1981).
102. Id. at 1151.
103. 619 F.2d 700 (8th Cir. 1980), cert. denied 449 U.S. 835 (1980).
104. 96 F.T.C. 844, 5 Cons. Credit Guide (CCH) ¶ 97,270 (1980), appeal pending.
violations of five separate provisions of FCRA, as well as separate allegations under section 5 of the Federal Trade Commission Act, the major focus of the trial and appeal was clearly on the section 607(b) allegations. On appeal the Commission found that the staff had not shown that Equifax's system for requiring its investigators to produce a specified number of reports ("production quotas") violated section 670(b). However, the Commission did find that Equifax's "quality audits" (a system which set objectives for the amount of adverse information the company believed its investigators should be including in their reports) did violate the act. Of particular importance to future cases was the Commission's restatement of section 607(b):

We construe section (607(b) to require reporting agencies to do whatever is reasonable under the circumstances to minimize the chances that consumers will be harmed by inaccurate reporting. If an agency employs a procedure which does not offer the best assurance of producing the most accurate reports, it ought to have a strong justification for doing so.\textsuperscript{106}

The section 607(b) portion of the Equifax case is currently on appeal in the Eleventh Circuit.

\section{Constitutionality of the FCRA}

At the time the Fair Credit Reporting Act was enacted, commercial speech was often thought not to enjoy First Amendment protections. In \textit{Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council},\textsuperscript{106} however, the Supreme Court made it clear that commercial speech was entitled to at least some protection under the First Amendment, and its more recent decision in \textit{Central Hudson Gas and Electric Corporation v. Public Service Commission}\textsuperscript{107} sets out a four-part test under which the constitutionality of laws regulating commercial speech will be evaluated.

The Maine Supreme Judicial Court's decision in \textit{Equifax Services v. Cohen},\textsuperscript{108} a suit seeking to enjoin enforcement of that state's Fair Credit Reporting Act, is the first decision to address the constitutionality of FCRA after the \textit{Virginia Pharmacy} and \textit{Central Hudson} decisions. In Cohen, the Maine court applied the four-part \textit{Central Hudson} test to invalidate provisions of the Maine statute that (1) require users of investigative consumer reports to obtain the consumer's written authorization before obtaining a report; (2) prohibit reporting of information about the consumer's race, religion, color, sexual preference or orientation, or political affiliation; (3) prohibit the reporting of irrelevant information; and (4) prohibit the reporting of specific categories of obsolete information.

\begin{flushleft}
\textsuperscript{105} \textit{Id.} at 1050-51, 5 Cons. Cred. Guide (CCH) at 86,688.
\textsuperscript{106} 425 U.S. 748, 96 S. Ct. 1817 (1976).
\textsuperscript{107} 447 U.S. 557, 100 S. Ct. 2343 (1980).
\end{flushleft}
From the standpoint of the federal law, the *Cohen* case is most significant in invalidating a subsection of the Maine statute that closely parallels the federal statute's restriction on the distribution of obsolete information. In addition, while the *Cohen* court found facially valid a provision of the Maine statute which is almost identical to the federal law's restriction on the permissible purposes for which reports can be used, the court strongly suggested that it might find such restrictions on distribution unconstitutional as applied in a particular case.

The *Cohen* case is, of course, not the last word on the constitutionality of the Fair Credit Reporting Act. The opinion itself readily admits of two limitations. First, the parties in the case agreed that the conduct regulated by the Maine statute was commercial speech so the court was not called on to decide that question. Previous Supreme Court cases dealing with this subject have dealt with advertising rather than the activity of consumer reporting agencies. Secondly, the *Cohen* case was tried before the *Central Hudson* decision which set up its four-part test for the constitutionality of regulations of commercial speech, and the court makes clear that it was basing its decision only on the record before it. Finally, the Maine court adopted a very restrictive view of the scope of a state's interest in preserving its citizens' personal privacy. Nevertheless, the *Cohen* decision is the first to analyze the constitutionality of several major provisions of the Fair Credit Reporting Act and, at the very least, suggests an agenda for future litigation.

V. DEBT COLLECTION by Barbara S. Leonard*

In the fourth year of the Fair Debt Collection Practices Act (FDCPA), judicial interpretations have continued to clarify key substantive provisions, while the Federal Trade Commission (FTC) has somewhat softened its previously vigorous enforcement stance. The most controversial provisions of the act appear to be those regarding liability and damages.

A. Substantive Provisions

Litigation under the substantive provisions remains centered on what conduct constitutes harassment in violation of section 1692d and what are false or misleading representations in violation of section 1692e. Before deciding the legality of specific conduct, one court addressed the relevant standard of debtor susceptibility to collection practices. Looking to legislative history, which the court concluded encompassed FTC rulings prior to the enactment of the FDCPA, the court in *Bingham v. Collection Bureau, Inc.*, applied the standard of "whether it is more likely so than not so that debtors

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on the low side of reasonable capacity who read a given notice or hear a given statement read into the message oppressiveness, falsehood, or threat.112

Applying this test, the court found that fourteen phone calls at reasonable times in one month did not rise to the level of harassment since some payments resulted and the collector was not told to cease communication. Nor does the collector’s mention of the possibility and consequences of a lawsuit violate the FDCPA. But the use of an alias, an immediate call back after the debtor hung up, and an inquiry into personal matters such as the ability to afford children, do have a natural consequence to harass.113 In another case a form letter suggesting a debtor lacks the common sense to handle her financial affairs was found to violate the act when in fact she had called the collector in response to an earlier letter and her call had not been returned.114

The court in Bingham115 also found that when a collection agency sends notices referring to the creditor as “our member” a false implication is made that there is a wide distribution of credit information. However, the phrase “avoid further action” creates no false implications, nor is “final notice-last chance” deceptive when the agency intends to follow the notice with an aggressive telephone effort.116

B. Liability and Damages

The FDCPA permits the awarding of actual damages as well as additional damages of up to $1,000.117 The court must consider, among other relevant factors, the frequency and persistence of the noncompliance by the collector, the nature of the noncompliance, and the extent to which it was intentional.118 A collector may escape liability if it can show that the violation was unintentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid such errors.119

In Harvey v. United Adjusters,120 the plaintiff argued that the statute should be interpreted to provide for statutory damages of up to $1,000 per communication, on the theory that once the initial violative contract is made the collector has no incentive to cease the activity. The court, however, found that the frequency of the noncompliance is a factor in determining the amount of statutory damages and that the $1,000 maximum recovery per action does not defeat the purpose of the act.121

112. Id. at 871.
113. Id. at 873.
116. Id. at 872.
118. 15 U.S.C. § 1692k(b).
121. Id. at 1222.
Another factor affecting the award of damages is the maintenance of procedures reasonably adapted to avoid errors that result in violations. One such acceptable procedure is a program of constant-on-the-job training coupled with telephone monitoring, supervision, and reference to a standardized manual.\textsuperscript{122} According to the court, however, this procedure only showed that the violations were unintentional and not that they were bona fide errors, so liability still attached.\textsuperscript{128}

On the question of actual damages, the \textit{Bingham} court specifically rejected as too weak the testimony of a psychologist based on two hours of observation of the plaintiff which occurred a substantial time after the collection efforts had stopped. The court concluded that the plaintiff had suffered no permanent ill effects, but since she was of the group to be protected and did suffer injury, actual damages of $1,000 were awarded.\textsuperscript{123} The plaintiff's husband was also awarded $100 for loss of consortium. Statutory damages of $400 were assessed because while the violations were not frequent or persistent, they were intentional.

Another court awarded actual damages on the theory that the plaintiff would have been so entitled in an action for the intentional infliction of emotional distress.\textsuperscript{124} The violation, failure to cease communication when so requested by the debtor, involved a statutory provision the court found designed to prevent harassment of the debtor through repeated contacts.\textsuperscript{126} Actual damages of $100 were awarded on the basis that while the defendant lacked the specific intent to inflict emotional distress it did intend to place the calls with the knowledge that the debtor had requested an end to the communications. The court also considered that the plaintiff, a lawyer, was more indignant than distressed. In awarding $250 in additional damages, the court considered, among other factors, the legal advice available to the defendant.

\textbf{C. Federal Trade Commission Enforcement}

Two debt collectors paid civil penalties in early 1981 for alleged FDCPA violations. One New York chain of agencies was assessed a $90,000 civil penalty under a consent judgment for, among other allegations, falsely threatening arrest and property or wage attachment.\textsuperscript{127} The FTC agreed to allow payment over three years, but the agencies are prohibited from using their assets as collateral for loans, making unsecured loans to officers, or filing bankruptcy without notice to the FTC. Another New York agency, Credit

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\textsuperscript{123} Id. at 874. The use of telephone aliases was a bona fide error, however, since the collector assumed it was in compliance with the law on the use of telephone aliases.
\textsuperscript{124} Id. at 875. The injury suffered is not specified.
\textsuperscript{125} Carrigan v. Central Adjustment Bureau, Inc., 502 F. Supp. 468 (N.D. Ga. 1980): No showing of contemporaneous physical harm is necessary in Georgia.
\textsuperscript{126} Id. at 470.
\textsuperscript{127} United States v. Universal Collection Bureau, Inc. (S.D.N.Y. 1981).
\end{footnotesize}
Rating Bureau, Inc., was charged a $10,000 civil penalty and required to change its name, because it allegedly falsely implied that it was a consumer reporting agency in violation of FDCPA section 1692e(16).

The FTC also filed a complaint against the Universal Church of Jesus Christ, its minister Sly, and its bureau of collections, seeking injunctive relief and a refund of "collection fees" that had been imposed on consumer debtors. The complaint charged that the bureau of collections, an unincorporated division of the church, violated several provisions of the FDCPA as well as engaged in a variety of other deceptive practices. The most grievous practice was that of advising debtors that the bureau would negotiate a settlement between them and their creditors, for which a fee of 25 percent of the debt was added.

Additional violations included such practices as sending dunning notices that resembled telegrams or featured a gavel-wielding judge and scales of justice, threatening unintended legal action, and advising consumers that as good Christians they should pay even unjust debts.

Affirming its position that creditors who violate the FDCPA in principle (but who are not debt collectors under the act) may nevertheless be held liable under section 5 of the FTC Act, the FTC signed a consent agreement with the nationwide mail-order retailer, Aldens, Inc., prohibiting Aldens from contacting third parties in its efforts to collect from delinquent customers. A provision to that effect will be added to the company's charge account agreements. Skip-tracing is permitted, but only under the parameters specified in the order. Aldens is additionally prohibited from contacting customers at unusual times or places or when the customers have requested that communications cease.

In advisory action, the FTC announced that in the future more injunctive relief and smaller civil penalties would be sought from FDCPA violators.

An FTC spokesman acknowledged complaints that civil penalties of over $75,000 were out of proportion to the size of the collection agency and indicated that future penalties would be in the $20,000 to $40,000 range. Nor will the FTC attempt to hold creditors liable for their selection of debt collectors. Its enforcement efforts will be concentrated on key provisions of the FDCPA such as creditors posing as independent collection agencies, the imposition of unauthorized collection fees, illegal contacts with third parties, and deprivation of consumers' self-help rights under the Act.

In other staff advisory letters the FTC stated that when employees of a collector work temporarily in a creditor's office using the creditor's name there

129. FTC v. Sly (N.D. Ala. 1981). Since no civil penalties were sought, the FTC filed the complaint in its own name.
130. As reported in Washington Credit Letter, Aug. 3, 1981, at 5-6.
131. FTC 1980 Annual Report to Congress.
132. As reported in the Washington Credit Letter, March 2, 1981.
133. Id.
is little likelihood of deception and the collector is therefore not subject to the act. Similarly exempt is a service company that sends out notices for an attorney unless the attorney is nothing more than a conduit between a creditor and collector. In the latter case, both the attorney and the collector violate the act. In another opinion concerning the attorney-collector relationship, the FTC found that an agency that merely refers claims to an attorney for legal action need not send validation notices to the debtor. The notice must be sent, however, if the attorney is the agent for the collector rather than the creditor. The FTC also warned that an agency lending its name or logo to a creditor may be guilty of creating a false implication that a third party is participating in the collection efforts.

VI. FTC RULEMAKING AND ENFORCEMENT by James K. LeValley*

The past year was frustrating for the Federal Trade Commission insofar as creditor regulation was concerned. The Commission made no progress at the rulemaking level with either its proposed Credit Practices Trade Regulation Rule or with its proposed amendments to the so-called Holder Rule. Its efforts to regulate credit practices by means of the adjudicatory process were also thwarted in the courts.

The Commission did finalize its long-pending used car rule—officially the Trade Regulation Rule on Sale of Used Motor Vehicles—calling for dealers to disclose warranty coverages and to reveal known defects through a window-sticker “buyer’s guide.” But that rule must be submitted for congressional review and possible veto in the second session of the Ninety-seventh Congress. Thus, if the rule survives at all, it will not be effective until late 1982 at the earliest. It is also possible that the FTC will make changes in the rule before it is resubmitted to Congress, in an effort to blunt industry criticisms and draw legislative support.

139. 44 Fed. Reg. 65,771 (1979). The full name of this rule is the Trade Regulation Rule on Preservation of Consumer Claims and Defenses. For a discussion of the proposed amendments, see 35 Bus. Law. 1318 (1980).
Deference to the conservative political mood with which the Congress has been seized since the last elections may explain the Commission's failure to take final action on either the proposed Credit Practices Rule or on its proposed amendments to the Holder Rule. In any event, the Commission did not move either proposal any closer to promulgation during 1981.

The Commission's staff was predicting in November of 1981 that it would make its final recommendation to the Commission on the Credit Practices Rule in February of 1982, with oral presentation scheduled for March of 1982 and Commission consideration set for April of 1982. No date had been projected for final Commission action as of December 1981.

Final Commission action on the proposed amendments to the Holder Rule is tentatively set for March of 1982. If history has any predictive value, however, another postponement seems likely.

The Commission was also frustrated in its efforts to outlaw certain widespread credit practices by use of its adjudicatory powers. In *Ford Motor Co. v. FTC*, the Ninth Circuit set aside a Commission order finding an automobile dealer's repossession practices to be in violation of section 5 of the Federal Trade Commission Act. The court held that the Commission exceeded its authority when it chose adjudication, rather than rulemaking, as its vehicle to establish a broad new standard for repossession and resale practices.

The adjudication began in 1976 as an action against Francis Ford, Inc., an automobile dealer; Ford Motor Company; and Ford Motor Credit Company. Parallel proceedings were commenced against Chrysler Corporation and General Motors Corporation, their finance subsidiaries, and two of their dealers. Eventually, all of the respondents settled with the Commission by means of a consent order, except for Francis Ford. Francis declined to settle and the case proceeded to a full adjudication hearing. At issue was the Ford dealer's practice in accounting to debtors for the value of their repossessed vehicles and any surplus upon resale. Francis Ford, allegedly following industry practices, credited the debtor with the wholesale value of the car, charged for both direct (i.e., refurbishing) and indirect (i.e., overhead and lost profits) expenses connected with the repossession and resale, and retained any surplus realized. The Commission found Francis Ford's practice to be contrary to the Oregon statute corresponding to Uniform Commercial Code section 9-504 and, therefore, an unfair trade practice under section 5.

In setting aside the Commission's order, the court held that issues of such widespread application were more appropriately addressed in a rulemaking forum, where all interested parties could appear and make their views known. The court was wholly unpersuaded by the Commission's argument that the effect of the Francis Ford case was limited to the state of Oregon, noting that

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144. 654 F.2d 599 (9th Cir. 1981).
145. For background, see 35 Bus. Law. 1324 (1980).
the FTC itself had appended a "Synopsis of Determination" to its order advising other automobile dealerships of the results of the adjudication. The court also noted the Commission's pending consideration of the proposed Credit Practices Rule, which would address similar issues related to repossessions in a deficiency context.146 Since forty-nine states had adopted provisions virtually identical to the Oregon statute at issue, allowing the FTC order to stand "would create a national interpretation of U.C.C. Section 9-504 and in effect enact the precise rule the FTC has proposed, but not yet promulgated."

The Ford Motor Co. decision prescribes outer limitations on the ability of the Commission to avoid the procedural, substantive, and political quagmires of the rulemaking process by selective "test case" litigation. As such, it presents a potentially significant obstacle to the Commission in its efforts to maintain an aggressive posture in the area of consumer credit.

146. Ford Motor Co. v. FTC, 654 F.2d at 601. The FTC could have formulated its position on U.C.C. § 9-504 and its application to the credit practices of car dealerships in its proposed trade rule on credit practices. It did not do so. The pending rulemaking proceeding and this adjudication seek to remedy, more or less, the same credit practices. Although the former is directed against the practices, inter alia, of car dealers in their accounting of deficiencies, and the latter is directed against a car dealer by reason of his practices in failing to account for surpluses, both matters are covered by U.C.C. § 9-504. If the rule for deficiencies is thought by the FTC to be "appropriately addressed by rulemaking," it should also address the problem of accounting for surpluses by a rulemaking proceeding, and not by adjudication.

147. Id. at 602.