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The F.T.C. Amends the 'Holder' Rule

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after the concise but comprehensive disclosure requirements set forth in the Model Savings Association Act.\(^{31}\)

The alternative is further proliferation of nonuniform legislation which may not only weaken the existing set of nationwide standards which the federal regulatory agencies have established, but also may result in the application of different standards for federal and state institutions operating within the same state.

It would also seem desirable that any such legislation be uniformly applied to all investment sources which compete for the same consumer dollar, so that not only would savings associations, banks and credit unions be covered, but also institutions such as insurance companies and mutual funds. Such uniform standards would better effect the professed purpose of truth-in-savings legislation, that is, to enable consumers to make intelligent choices about where to invest their money. If strict disclosure standards are imposed on only one segment of the investment market (depository institutions), consumers still will not be able to make intelligent decisions because all choices are not presented in the same disclosure format. In short, if there is to be legislation which imposes a designated standard of truth, it ought to be uniform or it will fall short of its objective.

III. THE FEDERAL TRADE COMMISSION AMENDS THE "HOLDER" RULE—
(By RALPH J. ROHNER)*

The Federal Trade Commission has finally dropped the other shoe with respect to its Trade Regulation Rule on Preservation of Consumers’ Claims and Defenses. In late 1979 the Commission adopted and published for stylistic comment\(^ {32}\) the long-awaited amendment to its 1975 antiholder in due course rule.\(^ {33}\) The amendment extends compliance responsibilities under the Rule to “creditors” in addition to “sellers,” rewrites the mandatory “Notice” for

\(^{31}\) The Act, § 25, would require that rules of account be established for each account classification and be made available to each holder of a savings account. The rules should include at the minimum the following information: the interest or earnings rate, based on a period of one year; the effective interest or earnings rate, based on a period of one year; the method of computing the frequency of compounding and the time factor used in calculating earnings, expressed as a fraction; the date the account begins to earn the interest or earnings; the intervals at which the interest or earnings are credited; the period for which the interest or earnings are fixed, or if the interest or earnings are not fixed, a statement that the rate is an anticipated rate; the minimum balance required to earn the interest or earnings; the minimum term, if any, required for the interest or earnings rate; any penalty or loss of interest for withdrawal, transfer or termination; any provision relating to the interest or earnings to be paid after the conclusion of a fixed term or renewal; any charge which may be imposed on the account and the conditions under which such charge may be imposed; and a description of the evidence of account, if any. The Model Savings Association Act, Legal Bulletin 237, July 1979.

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\(^{32}\) Amendment to Trade Regulation Rule Concerning Preservation of Consumers’ Claims and Defenses, 44 Fed. Reg. 65771 (Nov. 15, 1979).

improved clarity, and adds provisions that will relieve sellers and creditors from the risk of inadvertent violations.

A. Background

The original “Holder” Rule (Holder I) was promulgated in November 1975, effective on May 14, 1976. It was a major FTC effort to uproot the venerable holder in due course doctrine, a doctrine in which negotiable instruments or contractual waiver-of-defense clauses were used to separate the credit buyer’s duty to pay from the seller’s duty to perform—i.e., under the law in many states, an installment buyer whose note or credit contract was assigned to a bank or finance company could be required to pay that financer even though the purchased goods or services were defective. The mechanism of the original rule requires the seller to insert in each credit contract a specified Notice which expressly preserves the buyer’s claims and defenses as a matter of contract.

The original rule also dealt with the cognate “purchase money loan” situation. This refers to a pattern in which the consumer borrows directly from a lender in order to purchase goods or services from a seller who has a continuing working relationship with that lender. The FTC found that this pattern also operated unfairly to cut off consumer claims and defenses arising from the sale, and so the rule provided that the seller could not accept the proceeds of a “purchase money loan” unless the specified Notice appeared in the loan instrument. This would then constitute an agreement by the lender to be subject to sales claims and defenses.

Under the original rule, the entire burden of compliance fell on the sellers, and none on the third-party financiers. That is, while the FTC could prosecute sellers who failed to put the Notice in their credit contracts, or who failed to see that the Notice was included in purchase money loan agreements, there was no responsibility on the part of the financers (who often printed and supplied the dealer’s forms, or, in the case of purchase money loans, took and held the consumer’s note). The Commission therefore published, along with the final version of the original rule, a proposed amendment extending the compliance duty to financiers as well as sellers. It is a modified form of this

34. 16 C.F.R. § 433.2(a) (1979). The “NOTICE” reads as follows:

Any holder of this Consumer Credit Contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained pursuant hereto or with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder.

35. The definition of “purchase money loan” in original 16 C.F.R. § 433.1(d) (1979) refers to loans applied to purchase “goods or services from a seller who (1) refers consumers to the creditor or (2) is affiliated with the creditor by common control, contract or business arrangement.” The terms “contract” and “business arrangement” are further defined in 16 C.F.R. § 433.1(f) and (g) (1979).

36. 16 C.F.R. § 433.2(b) (1979).

amendment (Holder II) which the Commission has now adopted, more than four years after it was first proposed.

B. Scope of the Amended Rule

The principal change in the rule, as amended, is to make it an unfair or deceptive act or practice for a creditor (as well as a seller, under Holder I) to acquire any consumer credit contract which does not have the specified Notice in it. This general proscription applies both in connection with credit sales (where the “creditor” purchases dealer paper) and in connection with purchase money loans (where the “creditor” lends directly to a consumer buyer). For any creditor who has been discounting dealer paper or making purchase money loans, and whose paper already includes the Notice required under Holder I, the amended rule does not increase the creditor’s exposure to consumer claims or defenses; the financer’s position vis-à-vis the consumer is unchanged. But a financer (other than a bank or savings association) is now subject to the enforcement authority of the FTC if the specified notice is omitted.

By virtue of a provision in the Federal Trade Commission Act, the Federal Reserve Board and the Federal Home Loan Bank Board are now required to enact a similar rule for banks and savings associations, respectively, unless those agencies find that financial institutions have not engaged in the deceptive or unfair practices or that a rule would interfere with other essential regulatory functions of those agencies. The Federal Reserve Board had earlier issued a proposed regulation identical to the FTC’s proposal. Now that the FTC has finalized its version (incorporating many of the Federal Reserve staff’s recommendations), it is likely the Federal Reserve and the Bank Board will issue companion rules fairly soon.

C. Other Features

In addition to extending the coverage of the rule to creditors, the amendment makes several other changes.

In order to “make the provision more understandable by consumers without changing its legal significance in any way” the Commission voted to change the specified text to read as follows (in 10-point, boldface type):

This credit contract finances a purchase. All legal rights which the buyer has against the seller arising out of this transaction, including all claims and defenses, are also valid against any holder of this contract. The right to recover money from the holder under this provision is limited to the amount paid by the buyer under this contract.

A claim is a legally valid reason for suing the seller. A defense is a legally valid reason for not paying the seller. A holder is anyone trying to collect for the purchase.

This will no longer be captioned “Notice,” so as to emphasize that it is a contract clause and not merely a disclosure of information. This text may narrow the meaning of the original Notice somewhat. The old version did not limit the consumer’s claims and defenses to those “arising out of this transaction” (although that was clearly the Commission staff’s intent). The insertion of this phrase in the new text should prevent consumers from using unrelated claims against the creditor as setoffs for the credit obligation.42

The amended rule provides a Spanish-language version43 of the text quoted above, for inclusion in any contract “required by law to be written in Spanish.”

The original rule contained a number of ambiguities about “purchase money loans”—what exactly was included in that term; how could a lender assure that loan proceeds were actually used with a specified seller; and what liability attached if a seller or creditor unknowingly engaged in a purchase money loan transaction without including the required Notice? These questions were answered to some degree in an FTC Statement of Enforcement Policy issued in August 1976.44 The amended rule now incorporates several of these answers into the rule itself. The definition of purchase money loan is streamlined, but without change in substance.45 More importantly, the new rule permits a purchase money lender to stipulate that it is subject to claims and defenses only if the consumer purchases from a specifically named seller.46 This should avoid the problem that arises when a consumer tells the lender he intends to purchase goods or services from an affiliated seller but then changes his mind and buys from an unaffiliated merchant. In addition, the rule now

42. An interesting question is whether the holder will be subject to claims for TIL or ECOA violations. The courts have not consistently decided whether such claims “arise out of” the sale transaction. See the TIL (supra at 1197-1222 and 1221-36) and ECOA (supra at 1237-58) articles in this Survey.

43. Id. [proposed new 16 C.F.R. § 433.2(c)].


45. The new definition of “purchase money loan” in amended 16 C.F.R. § 433.1(d) speaks of sellers and creditors who are “affiliated . . . by common control or business arrangement.” Specific mention of “contract” or “referral” relationships is dropped. But the new definition of “business arrangement” [proposed 16 C.F.R. § 433.1(f)] is very broad:

... Any tacit, oral, or written agreement or understanding, formal or informal, between a creditor and a seller in connection with the sale of goods or services or the financing thereof, including cooperative activity between a creditor and a seller in referring consumers to purchase goods or to obtain financing. The term shall not include arrangements, such as inventory financing, maintenance of ordinary checking accounts or joint action engaged in merely to perfect a security interest, which are not directed at the financing of consumer purchases.

The last sentence of this definition restates qualifications adopted by the Commission itself in its 1976 Statement of Enforcement Policy. See n. 13, supra at 34595.

46. 44 Fed. Reg. at 65772 [proposed new 16 C.F.R. § 433.2(d)].
expressly recognizes that there is no violation unless the failure to comply is "with actual knowledge or knowledge fairly implied on the basis of objective circumstances."  

D. Conclusion

The Commission was scheduled to receive comments on possible stylistic language changes in the rule through January 14, 1980. Thus, at the time this is written, the absolutely final version of Holder II has not yet appeared. The Commission will set an effective date only on final promulgation. In sum, the Commission is on the verge of implementing the second part of its attack on holder in due course, by extending the coverage of the Holder Rule to creditors as well as sellers.

IV. FREE PERIODS IN CONNECTION WITH REVOLVING CREDIT ACCOUNTS

—(By CARL D. LOBELL and JOSEPH W. GELB)*

A 1979 decision in New York could have a substantial impact on the nature of the free period normally accorded on revolving charge accounts. That decision involves the revolving charge provisions of section 413(a) of New York’s Personal Property Law, which contains language similar to that in revolving credit statutes of many states.  

A. Imposition of Finance Charges on Revolving Accounts

In Sterberg v. Citicorp Credit Services, Inc., the court dealt with the imposition of a 50¢ minimum finance charge in any month in which a purchase was made on a revolving charge account. The charge was designed partially to compensate for the handling costs involved, and, in imposing the minimum charge, the bank eliminated, at least to the extent of 50¢, the "free period" which had been traditionally granted in connection with purchases on revolving charge accounts.

Prior to the imposition of the 50¢ minimum monthly charge, finance charges on Citibank’s plan were calculated according to a so-called modified average daily balance method. Under that method, a finance charge is computed each month on an amount representing the average daily balance in the account, except that a finance charge is not imposed in any month in which the beginning balance (the prior month’s ending balance) is paid in full or in any month in which there is no beginning balance. In late 1975 Citibank  

47. Id. [proposed new 16 C.F.R. § 433.3].
*Members of the New York bar.
49. 419 N.Y.S.2d 142 (2nd Dep’t 1979).
changed the terms of its plan to provide that finance charges would be imposed in a month in which there was a purchase even where the beginning balance was paid in full or in any month in which there is no beginning balance. Citibank also decided that under such circumstances the finance charge would not be based upon the average daily balance in the account during the month, but that the account would be subject to only a 50¢ minimum finance charge.

The statute involved in Sternberg provides that the holder of a revolving charge account may charge a service charge “computed . . . on the outstanding indebtedness from month to month.” 50 In reaching its conclusion that the minimum monthly charge was unlawful, the court first determined that a minimum finance charge can only be imposed in a month in which a periodic finance charge could otherwise be imposed. It then held that regardless of whether a purchase had been made, the statute did not permit a finance charge in a month in which the beginning balance was paid in full since neither the beginning balance nor the purchase satisfied what the court believed to be the statutory requirement that “the indebtedness has been outstanding from month to month” before a finance charge may be imposed. 51

The court rejected Citibank’s contention that, where a purchase is made, an indebtedness is necessarily carried over from month to month so as to satisfy even the court’s reading of the statute. The court found instead that a purchase does not result in an indebtedness at the time made or when posted to the cardholder’s account but, rather, results in an indebtedness only when a monthly statement is issued reflecting the purchase. In other words, a purchase constitutes an indebtedness only when a bill for that purchase is rendered. 52

B. Implications

The conclusion of the Appellate Division concerning the creation of indebtedness seems at best novel. For years courts interpreting the forebearance language in usury statutes have considered a debt to come into existence concurrently with an extension of credit. Sellers and those who finance sellers consider amounts owed to be assets from the day purchases are made, and credit buyers no doubt consider themselves obligated for purchases when they are made. The logical extension of the Appellate Division’s reasoning is that a customer who makes a purchase has no obligation to pay, express or implied, until a statement is rendered.

In essence the court’s objection to the bank’s minimum finance charge appears based on the fact that it does away with a period of free credit.

51. Supra n. 49, at 147.
52. The support offered by the Appellate Division for this conclusion is that if it were otherwise and if, for example, purchases were not billed for six months, it would be “unreasonable and illogical” to consider the indebtedness outstanding for six months even though “the customer was not in default.”
However, to view the words "outstanding indebtedness from month to month" as mandating a free period for open end credit seems inconsistent with the decision of New York's highest court in *Zachary v. R. H. Macy & Co.*, where the court found that the statutory words merely require that the finance charge "be computed at consistent monthly intervals on the customer's outstanding indebtedness at that time." In addition, the Appellate Division's decision seems inconsistent with the statutory scheme as shown in the provisions regulating closed end credit, which in *Zachary* were noted to contain "certain parallels in treatment." Significantly, the finance charge on a closed end credit transaction is computed, without a free period, from the date of the contract or obligation to the date when the final installment is payable.

Further, the concept of mandated free credit is so unusual as to have required a specific amendment to New York's law providing for certain free periods in connection with revolving accounts maintained by retailers.

The *Sternberg* decision is the first to mandate a free period through interpretation of the words "computed on the outstanding indebtedness from month to month." Should creditors faced with higher costs of maintaining revolving charge programs eliminate the free period, *Sternberg*, if affirmed, will no doubt provide a basis for increased revolving credit litigation throughout the nation.

V. REPOSSESSIONS UNDER THE FEDERAL TRADE COMMISSION ACT—(By CARL D. LOBELL and JOSEPH W. GELB)*

In 1979 the Federal Trade Commission (FTC) accepted a consent order and handed down a decision addressing important questions with respect to the disposition of repossessed collateral. If affirmed on appeal, this decision

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53. 340 N.Y.S.2d 908 (1972). The Appellate Division cited *Zachary* as support for its conclusion. In *Zachary*, the Court of Appeals held that the use of the previous balance method to compute finance charges complied with the statutory mandate for a finance charge computed on the outstanding indebtedness from month to month. The *Zachary* court interpreted the words "month to month" as relating to the frequency of imposition of the finance charge and not, as did the Appellate Division in *Sternberg*, as describing the period of time for which an indebtedness must be outstanding. Indeed, the *Zachary* court expressly rejected a contention that the words "outstanding indebtedness from month to month" meant that a finance charge could only be computed on an amount which had been carried over from one month to another. *Id.* at 917.


55. This amendment, enacted after the Citibank minimum charge was put into effect, provides in § 413(3)(e)(ii):

[N]o seller may impose a service charge for the monthly billing period in which there is no previous balance or during which the sum of the payments received and other credits issued which are attributable to amounts included in the previous balance is equal to or exceeds the amount of such previous balance.

See also, Massachusetts Gen. Laws Ann. 255D, § 27C(3)(a)(ii) (Supp. 1979) ("... a finance charge ... computed upon ... the average daily balance ... excluding purchases."); Me. Rev. Stat. tit. 9-A, § 2.202(5) ("No finance charge may be imposed on purchases or leases ... during the billing cycle, provided that they are paid for not later than 25 days after the closing date of the billing cycle in which the purchase or lease occurred").

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will have a significant impact on the rights and duties of creditors and debtors and on relationships between sellers and their financing sources.

**A. Disposition of Repossessed Collateral**

In February 1976 the FTC instituted three proceedings against the major automobile manufacturers, their affiliated credit companies, and one of each of their franchised dealers. In each of these proceedings the complaint alleged that the disposition of repossessed vehicles by respondents and the subsequent accounting to the defaulting debtor for the proceeds of sale were in violation of section 5 of the Federal Trade Commission Act. In the only proceeding which has been disposed of by the FTC to date, the FTC charged that the Ford dealer, Francis Ford, Inc. (Francis Ford), disposed of certain repossessed vehicles for an amount greater than that which the debtor owed and failed to pay the surplus to the debtor, as required under section 9-504(2) of the Uniform Commercial Code (UCC). The FTC further alleged that Ford Motor Credit Company (Ford Credit), which repossessed the collateral, was also responsible to debtors for surpluses improperly retained by Francis Ford, even though Ford Credit reassigned debtors' credit obligations to dealers pursuant to recourse agreements. Finally, the FTC alleged that Ford Motor Company controlled certain dealerships in which it held majority stock interests and, on the basis of such control, was liable for the failure of such dealerships to remit surpluses to certain defaulting debtors. With respect to the allegations against Ford Credit and Ford Motor Company, after three years of post-complaint discovery and prehearing conferences, Ford Motor Company and Ford Credit entered into a consent order with the FTC resolving the proceeding as against them.

**B. Financer's Responsibility**

A basic legal issue involved between those parties was whether a finance company which repossesses collateral and reassigns the debtor's contractual obligation to the selling dealer pursuant to a recourse agreement, is nevertheless liable to a debtor for a surplus which may result from disposition of the collateral by that dealer. On the basis of section 9-504(5) of the UCC, the Ford respondents contended that they, as opposed to the dealer, had no


57. Neither the Chrysler nor the General Motors proceedings have been heard as yet.

58. The recourse agreements obligated selling dealers to pay Ford Credit amounts approximating the debtors' obligations, if Ford Credit repossessed the collateral and returned such collateral to dealers in a timely manner.


60. That section provides:
obligation to account to debtors in this situation, since the assignee (dealer) is, by the express language of that section, subrogated to "the rights and duties of the secured party." In contrast, the FTC staff contended that section 9-504(5) does not relieve the assignor from liability for any surplus resulting from disposition following reassignment, but merely underscores the assignee's liability as well. The staff also argued that as a matter of policy and fairness under section 5 of the FTC Act, the finance company should remain liable to the debtor for any surplus derived by its assignee because the finance company is the dominant party in the financing transaction, because the finance company can better adapt to and absorb the risk of an assignee's failure to account than the debtor can, and because the finance company undertakes a fiduciary obligation to the debtor when it repossesses the collateral.

Significantly, there is no clear resolution of a reassignment creditor's liability in the consent order. Rather, the order provides that the Ford respondents will instruct reassignment dealers of their obligation to pay surpluses and advise dealers of the manner in which such surpluses are to be calculated. The consent order further requires that for a limited period of time Ford Motor Company will audit selected dealerships to determine whether they are computing and paying surpluses in conformity with the procedures set forth in the consent order. The results of such audits are to be reported to the FTC.  

C. The Dealer's Responsibility

Apparently unable to reach settlement, the dealer, Francis Ford, went to hearing and the Administrative Law Judge rendered a decision on liability and accounting procedures which was affirmed in most respects by the Commission. Francis Ford has indicated that it will appeal the Commission's decision to the United States Court of Appeals for the Ninth Circuit.

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61. In support of this contention, the Ford respondents could cite a number of state cases indicating that a secured party which repossesses collateral is not obligated to account to the debtor for a surplus after the credit obligation has been reassigned. Reeves v. Assoc. Fin. Servs. Co., 247 N.W.2d 434 (Neb. 1976); Community Management Ass'n of Colorado Springs, Inc. v. Tousley, 505 P.2d 1314 (Colo. 1973).

62. With regard to the Commission's claim that Ford Motor Company was liable for the failure of dealerships in which it held an equity interest to remit surpluses, the consent order again does not resolve the issue. Rather, the order simply requires Ford Motor Company to undertake certain auditing responsibilities with regard to the repossession accounting practices of those dealerships and requires the payment of money by certain of those dealerships which repossessed and resold vehicles in the past.

63. 3 Trade Reg. Rep. (CCH) ¶ 21,622 (Sept. 21, 1979). The order of the Administrative Law Judge was rejected insofar as it prohibited Francis Ford from taking waivers of resale rights under § 9-505(2) of the UCC. The Commission allowed such waivers but narrowly interpreted
The issues involved include: (1) whether the failure to remit surpluses in violation of section 9-504(2) of the UCC is also a violation of the fairness standard set forth in section 5 of the FTC Act, and (2) what is the appropriate method by which a surplus or deficiency is to be calculated.

On the first issue—the failure to remit—the Administrative Law Judge and the Commission had little difficulty in finding section 5 liability. The Commission stated:

The failure to account for and refund surpluses (based upon the proceeds of a commercially reasonable resale of collateral by a secured party acting as a fiduciary for the debtor, endeavoring to obtain the best possible price, and deducting only reasonable out-of-pocket expenses attributable to repossession) is contrary to public policy established by the uniform law of 49 states and the District of Columbia. . . . No more certain source of public policy than state law can be imagined.

The failure to accord customers their right to a refund is, as well, oppressive to consumers and the cause of substantial injury to them. . . . For these reasons we hold that the failure to account for and refund surpluses by a party obligated under state law to do so is an unfair practice within the meaning of Section 5 of the Federal Trade Commission Act. 64

On the second issue—the method of computation—Francis Ford argued that the results of an actual sale, if any, should be ignored and that instead the debtor should be credited with the estimated wholesale value of the collateral at the time of repossession. It contended that this figure was the appropriate value to be used in determining a surplus or deficiency since: (1) such estimate is the best measure of the amount the collateral could have been sold for on an "as is" basis at the time of repossession, and (2) the debtor is not entitled to any amount received above the estimated wholesale value since such added value is solely the result of Francis Ford's efforts in repairing, reconditioning and marketing the vehicle.

Both the Administrative Law Judge and the Commission rejected Francis Ford's argument on value, holding that the UCC's standard of commercial reasonableness requires that there be an actual sale and that the secured party must endeavor to obtain the best possible price for the collateral. The Commission held that it was obliged to credit the defaulting debtor with the actual resale price obtained after repairing, reconditioning and selling the collateral through the dealership facilities on the retail market. 65

the UCC provisions to apply only where the creditor "intends to retain the collateral for its own use."

64. Id. at 21,762.

65. The Commission's decision does not prohibit a disposition on the wholesale market by a dealer, although it is likely that under the best price requirement such disposition would have to be justified by the circumstances, including, among other things, condition of the vehicle. Where a
Francis Ford next turned to the issue of allowable expenses, seeking permission to deduct from the sale price all of its costs for repairing, reconditioning and reselling the vehicle, including overhead costs allocable to such tasks and the profit lost by having to resell a repossession rather than another used vehicle. In one of the most significant aspects of its decision, the Commission held that section 9-504(1)(a) of the UCC, which allows a deduction from the proceeds of sale for the "reasonable expenses of retaking, holding, preparing for sale or lease, selling, leasing and the like," did not authorize the secured party to deduct either overhead expense or lost profit opportunity cost. Indicating that it was unable "to discover since enactment of the Uniform Commercial Code [any case which] addresses the question of allowable expenses head on,"66 and acknowledging the existence of respectable economic arguments for allowing overhead and lost profit opportunity cost, the Commission nevertheless expressed the view that as a matter of both precedent and fairness such deductions should not be permitted.

At no point did the Commission indicate that it was establishing new standards for the disposition of and accounting for repossessions under its section 5 powers. On the contrary, wherever possible, it relied on UCC authority. Whatever the Commission's articulated statements, however, it is clear from the manner in which it resolved the overhead and lost profit opportunity cost issues that the Commission will likely interpret UCC provisions so as to conform to the Commission's views of fairness under section 5 of the FTC Act. Such willingness to venture into areas which have traditionally evolved through state court decisions may signify yet further excursions of the Commission into regulation of consumer credit.

VI. TRUTH IN LENDING ENFORCEMENT GUIDELINES—
(By D. EDWIN SCHMELZER)*

A. Introduction

Perhaps the most significant Truth in Lending Act67 event during 1979 was the implementation of the so-called Uniform Guidelines for the Enforcement of the Truth in Lending Act.68 Promulgated effective January 4, 1979, by the five federal agencies that regulate commercial banks, savings and loan associations, and credit unions, these Guidelines require supervised creditors to refund examiner-discovered "overcharges" based on inaccurate Truth in Lending disclosures, principally the annual percentage rate ("APR") or finance charge. In addition, the Guidelines require creditors to provide

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66. Id. at 21,760.
affected customers with a written statement explaining the reason for such refunds. The Guidelines establish a tolerance of \( \frac{1}{8} \) of 1 percent more or less than the actual APR as the measure for determining overcharges.

Within months after the federal supervisory agencies began applying the Guidelines, significant problems developed because of the complexity of Truth in Lending Act and the Guidelines' rigid retroactivity rule which required refunds for all overcharge violations occurring after October 28, 1974.\(^{69}\) The American Bankers Association on August 7, 1979, filed an action challenging the agencies' authority to promulgate the Guidelines.\(^{70}\) On September 7, 1979 the Guidelines were suspended for review, and on October 19, 1979, the Financial Institutions Examination Council published proposed amendments to increase the Guidelines' tolerance for accuracy in disclosure.\(^{71}\) While these proposals were pending, the United States Senate amended the Truth in Lending Simplification and Reform Bill (S.108),\(^{72}\) to establish differing enforcement rules, and attached the amended S.108 as a rider to the Depository Institutions Deregulation Bill (H.R. 4986).\(^{73}\) This legislative package failed to emerge from the first session of the 96th Congress, but was before a Senate-House Conference Committee as this article went to press.

The limited scope of this review does not permit a thorough analysis of the Guidelines as they were first proposed in October, 1977,\(^{74}\) finally adopted in January, 1979, or proposed for further amendment in October, 1979. However, some discussion of these earlier provisions is essential to an understanding of section 108(e) of the Simplification Bill which, whether ultimately enacted or not, is likely to influence the form of future Guidelines or enforcement action.

Section 108(e) is clearly a response by the Senate to the problems encountered during the development and implementation of the agencies' Guidelines.\(^{75}\) While those problems are myriad, the following issues have been the most troublesome.

**B. Authority to Require Refunds**

Do the regulatory agencies have authority to require customer refunds based on errors in the TIL disclosures? This question arises from the absence of any expressed Congressional intent that refund orders were contemplated


\(^{73}\) Truth in Lending Simplification is title IV of H.R. 4986. § 408 (captioned "Restitution") amends § 108 of the Truth in Lending Act (hereinafter referred to as § 108(e)). See, Cong. Rec. H10267 (daily ed. Nov. 7, 1979).


\(^{75}\) For a discussion of the enforcement problems sought to be remedied by § 108(e), see Cong. Rec. S15265, 15266 (daily ed. Oct. 29, 1979) (remarks of Senators Proxmire and Garn).
as an administrative enforcement mechanism under the original act. The question has also been raised whether the agencies have authority to order refunds under their general cease and desist powers. The enactment of legislation such as section 108(e) would dispose of these questions of statutory authority, but whether such authority is constitutionally permissible, particularly as it relates to retroactive applications, may emerge as an issue in future litigation.

C. Retroactivity of Enforcement

The Guidelines adopted a two-part rule for determining the retroactive application of refund orders. All active loans consummated after October 28, 1974 were subject to reimbursement. Inactive (paid off) loans that had been terminated within two years before the examination in which the overcharge was discovered were also subject to refund. In adopting this rule, the regulatory agencies followed the reimbursement provisions contained in the original Truth in Lending Simplification and Reform Bill, S. 2802, ignoring the one-year statute of limitations for private civil actions contained under section 130(e) of the Truth in Lending Act. This rule proved to be particularly harsh for real estate lenders that hold longer term obligations.

Section 108(e) adopts a different approach which may be characterized as the "last clean examination" rule. Depository institutions may be required to refund for violations on loans that have been consummated during the time between the immediate examination and the last preceding examination. However, if overcharge violations were formally cited and not corrected in earlier examinations, refund orders may relate back to the time that the violation was first cited.

For creditors that are not subject to examination (e.g., retailers, finance companies, etc.), refunds may be required for extensions of credit consummated after May 10, 1978.

As a prospective matter, section 108(e) provides that refunds may be ordered only during the life of the credit extension or within two years of its consummation, whichever is later.

76. The agencies asserted statutory authority to effect such remedies based on 12 U.S.C. § 1818(b) (commercial banks); 12 U.S.C. §§ 1464(d)(2) and 1730(e) (savings and loan associations); 12 U.S.C. § 1786(e)(1) (credit unions).
80. § 108(e)(3)(C)(ii). May 10, 1978, was chosen as the cutoff reportedly because it was the date that the Senate first passed S. 2802, thereby alerting the credit industry to the possibility of refund orders.
D. Tolerance for Accuracy in Disclosure

The Guidelines required refunds where the disclosed APR is understated by more than \( \frac{1}{8} \) of one percent.\(^{82}\) This rule created considerable confusion because the APR disclosure tolerance permitted under Regulation Z was widely, but inaccurately, considered to be \( \frac{1}{4} \) of one percent.\(^{83}\) The Guidelines also required refunds if the amount of finance charge was understated by more than $1 or one percent, whichever is lower.\(^{84}\) The tolerance established under the Guidelines was not determinative of the amount to be refunded; once the \( \frac{1}{8} \) of one percent was breached, the entire amount overcharged was subject to refund.\(^{85}\)

Section 108(e) contains a more relaxed set of tolerance rules for APR and finance charge disclosures that would be "phased in" over a two-year period. Once enacted, it would require the regulatory agencies to apply a \( \frac{1}{4} \) of one percent APR tolerance for the first two years. Beyond that, for closed-end credit transactions with a term of up to ten years, a tolerance no greater than \( \frac{1}{4} \) of one percent would be applied in calculating refunds. For transactions with terms of more than ten years, a tolerance of \( \frac{1}{8} \) of one percent would be applied.\(^{86}\) Moreover, the relaxed tolerances under section 108(e) not only measure whether a refundable overcharge exists but also measure the amount of any refund.\(^{87}\) For example, in the first two years following the enactment of section 108(e), refund orders would be limited to that portion of any overcharge that is more than \( \frac{1}{4} \) of one percent above the actual amount that should have been disclosed.

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83. 12 C.F.R. § 226.5(a) and (b) (1979). The Federal Reserve Board staff has interpreted this section as only permitting disclosure of the actual rate or the rate rounded to the nearest quarter of one percent; see FRB Staff Opinion 442, February 25, 1971, 5 Cons. Cred. Guide (CCH) ¶ 30,638.
85. Id. at 1222.
86. § 108(e)(1)(A), (B). The amendment goes on to make three further exceptions at § 108(e)(2). First, with regard to those charges that may be excluded from the finance charge if they are disclosed, no refunds are required. Specifically, disclosure errors related to charges that may be excluded under § 106(c) and (d) of the Act (i.e., property damage insurance premiums, title registration, and licensing fees, and filing fees and nonfiling insurance premiums) would not be considered violations subject to refunds. The same exception would apply to credit life insurance premiums (§ 106(b)); however, errors related to credit life insurance disclosures would be subject to refund beginning two years after the Act's effective date. Second, refunds would not be required in certain cases where the amount of the APR or finance charge disclosed was 10% or less of the proper amount or where the finance charge was in error but the APR was correctly disclosed and vice versa, or where there was a total failure to disclose either the APR or finance charge. Finally, there is a generalized exception at § 108(e)(2)(D) for errors resulting from "any other unique circumstances involving clearly technical and nonsubstantive" errors that do not "adversely affect information provided to the consumer" and do not "mislead or otherwise deceive the consumer."
87. § 108(e)(1).
E. Impact on Safety and Soundness of the Institution

The Guidelines do not specifically address the potential impact of Truth in Lending refund orders on the "safety and soundness" of creditors. Ironically, the cease and desist order authority relied upon by the regulators to enforce refund orders is directed at insuring safe and sound banking practices. During the implementation of the Guidelines, several smaller institutions reportedly were faced with potentially staggering refund orders that in some cases could have rendered them insolvent.

Section 108(e)(3)(A) responds to these concerns by indicating that no refund shall be ordered "if it would have a significantly adverse impact on the safety or soundness of the creditor, but in any such case the agency may require a partial adjustment in an amount which does not have such an impact."

F. Relation to Civil Liability

The Guidelines require that creditors explain to affected customers that the refund is the result of the creditor's failure properly to disclose TIL information. This has posed a substantial problem for creditors: by informing customers that the refund was the result of a Truth in Lending violation, creditors invited civil suits under section 130(a) of the Act. Moreover, the Guidelines clearly indicate that they are not intended to "foreclose the customer's right to bring a civil action to recover for violations of the Act."

Section 415(a)(3) of H.R. 4986 would permit a creditor to foreclose potential civil liability by promptly providing refunds. This section states that creditors have no liability under section 130 if, within 60 days after discovering a violation even by way of a "final examination report" and prior to the institution of a civil action or notification by the customer, they notify affected customers and make proper adjustments to their accounts. However, the proper adjustment under the Act would amount to a refund of any amount more than \( \frac{1}{8} \) of 1 percent of the actual rate. This tolerance differs from the \( \frac{1}{4} \) of 1 percent established for many transactions under section 108(e) and will present a dilemma to creditors faced with future refund orders. If they merely refund amounts over the \( \frac{1}{4} \) of 1 percent tolerance and notify affected customers, they may still face the prospect of civil suits under section 130(a).

G. De Minimis Rule

Except where violations were part of a pattern or practice, willful or due to gross negligence, the Guidelines provide a $1 de minimis limit to refundable

88. E.g., 12 U.S.C. § 1818(b)(1) justifies cease and desist orders where the "appropriate Federal banking agency... has reasonable cause to believe that the bank is about to engage in an unsafe or unsound practice in conducting the business of such bank..."


90. Id. at 1222.
overcharges. The appropriate level for a *de minimis* rule was hotly debated during the development of the Guidelines, but generally proved to be a spurious concern. This is because the accuracy tolerances effectively governed whether a refund would be ordered. In closed-end credit transactions, once these tolerances had been exceeded, the amount of the refund was almost certain to be more than $1. Thus the most common application for the Guideline’s *de minimis* rule was in those cases where late payment fees, prepayment penalties or rebates of unearned finance charges—items not subject to the tolerance—were misdisclosed.

Like the Guidelines, section 108(e) retains a $1 *de minimis* rule. However, the section limits refund orders to errors involving the APR and finance charge, so there will be no refunds involving late payments, prepayment penalties or rebates. Section 108(e)(3)(B) makes one further qualification to the rule: “no refunds shall be ordered if the amount of the adjustment would be less than $1, except that if more than one year has elapsed since the date of the violation, the agency may require that such amount [less than $1] be paid to the Treasury of the United States . . .”

**H. Agency Discretion**

The Guidelines are silent on whether the individual regulators could use discretion in enforcing them, but each regulator reserved to itself the authority to take “alternative action where warranted and [was] in no way precluded from taking enforcement action for violations not covered by the guidelines.”

Section 108 effectively curtails the discretion the agencies may use in future enforcement actions. The section provides that where there is evidence of a “willful violation . . . intended to mislead” the agencies may ignore tolerance rules and order full refunds. However, before any refund may be ordered, the underlying violation must be part of a pattern or practice or gross negligence or, again, a willful violation. Whenever gross negligence or a pattern or practice is evident, refunds are mandated by the section. Still, agency discretion is permitted, even with evidence of gross negligence and pattern or practice, for certain violations of the Act’s rules on insurance, filing fees, 10-percent errors in amount, and nondisclosure or inaccurate disclosure of either the finance charge or APR. Finally, since refund orders will be limited to finance charge and APR violations, the agencies’ powers to require refunds for other dollar-amount charges are eliminated.

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91. *Id.* at 1223.
92. § 108(e)(3)(B).
94. § 108(e)(1).
95. § 108(e)(2).
96. See n. 86, *supra*.
97. § 108(e)(5).
I. Conclusion

The development and attempted implementation of the Guidelines has dramatically illustrated a lack of understanding of Truth in Lending disclosure requirements and consequent creditor noncompliance. The Guidelines have also revealed the inadequacy of Truth in Lending examination procedures employed by the federal agencies prior to 1978, and the difficulty that five regulatory agencies have in enforcing a uniform compliance standard for a statute as technical and demanding of accuracy as Truth in Lending. Hopefully, the standard enunciated in section 108(e) will better define proper creditor compliance in this area of consumer protection.

POSTSCRIPT

On March 31, 1980, President Carter signed H.R. 4986 into law. Its provisions respecting the bank regulatory agencies’ authority to require consumer refunds in the case of overcharge violations of the Truth in Lending Act appear to have remained unchanged from the original Senate-passed measure discussed above, with two significant exceptions: (1) Should a refund order result in a significantly adverse impact upon the safety or soundness of a creditor, the agency may permit the creditor to make partial refund payments over an extended period of time; and (2) APR errors that have occurred between January 1, 1977 and April 1, 1980 that exceed \( \frac{1}{4} \) of one percent of the actual rate will be subject to refund irrespective of the so-called “last clean examination rule.” However, in no event will refunds be required after the later of: the expiration of the term of the credit extension, or two years after consummation of the credit agreement.

98. See n. 15, supra.