Part IV

Federal Trade Commission

16 CFR Part 444
Trade Regulation; Credit Practices; Final Rule
FEDERAL TRADE COMMISSION

16 CFR Part 444

Trade Regulation Rule; Credit Practices

AGENCY: Federal Trade Commission.

ACTION: Final trade regulations rule.

SUMMARY: The Federal Trade Commission issues a final rule, the purpose of which is to restrict certain remedies used by lenders and retail installment sellers in consumer credit contracts. The remedies affected by this rule are: Confessions of judgment, waivers of exemption, wage assignments, security interests in household goods, and certain late charges. The rule further prohibits misrepresentations of cosigner liability and provides that potential cosigners be furnished a "Notice to Cosignor" which explains in general terms their obligations and liabilities.

This notice contains the rule's Statement of Basis and Purpose incorporating a Regulatory Analysis, and the text of the final rule.

EFFECTIVE DATE: March 1, 1985.

ADDRESS: Requests for copies of the rule, the Statement of Basis and Purpose and Regulatory Analysis should be sent to Public Reference Branch, Room 130, Federal Trade Commission, 6th Street and Pennsylvania Avenue, NW., Washington, D.C. 20580.


SUPPLEMENTARY INFORMATION:

List of Subjects in 16 CFR Part 444

Consumer credit contracts, Cosigner disclosures, Trade practices, Truth in lending.

By direction of the Commission, Commissioner Calvani did not participate.


Benjamin L. Berman,

Acting Secretary.

CREDIT PRACTICES RULE: STATEMENT OF BASIS AND PURPOSE AND REGULATORY ANALYSIS

I. History of the Proceeding

A. Introduction

This proceeding focuses on the relationship between consumers and the institutions from whom they seek and obtain credit for purposes other than the purchase of real estate. It originated as a result of: (1) An extensive survey conducted by the National Commission on Consumer Finance which examined the consumer credit market and reached a variety of conclusions based upon empirical data and econometric analysis; (2) an investigation of the consumer finance industry conducted by the Bureau of Consumer Protection from the Fall of 1972 until the Spring of 1974, to determine whether the use of certain collection remedies was an unfair practice under Section 5 of the FTC Act. The Commission published an Initial Notice of Rulemaking in the Federal Register on April 11, 1975. Written comments were received through August 5, 1977. Comments were received from industry, consumers, legal services, state attorneys general, labor unions, consumer organizations and other interested parties. A Final Notice of Rulemaking was filed on June 24, 1977, setting forth the time and places for public hearings on the proposed rule and enumerating 14 issues which the Presiding Officer designated under § 1.13(d)(1) of the Commission's Rules of Practice. Hearings were conducted in Dallas, Texas; Chicago, Illinois; San Francisco, California; and Washington, D.C., from September 12, 1977, to January 30, 1978. Rebuttal submissions were received until May 1, 1978.

The written comments, the materials placed on the record by the Presiding Officer and the Commission staff, the hearing transcripts and exhibits, and the rebuttal statements comprise the principal evidentiary record of this proceeding. After the receipt of rebuttal statements, reports to the Commission based on the rulemaking record were prepared by the Presiding Officer, who made findings on designated issues, and by the Commission staff, who summarized and analyzed the record evidence and made recommendations to the Commission for a revised Trade Regulation Rule. The Bureau of Economics also submitted comments and recommendations to the Commission for a revised rule. Pursuant to § 1.13(h) of the Commission's Rules of Practice, publication of the Final Staff Report initiated a sixty-day comment period which afforded the public an opportunity to comment on the reports of the Presiding Officer and the staff. This comment period was extended and closed on January 18, 1981. A summary of post-record comments was placed on the public record.

On April 14, 1983, the rulemaking staff's memorandum recommending a final modified proposed rule, and memorandum from the staff of the Bureau of Economics, and the Directors of the Bureau of Consumer Protection and Economics were placed on the public record. On June 6 and 7, 1983, the Commission heard oral presentations from prior rulemaking participants who had been invited to present their views directly to the Commission as provided in § 1.13(i) of the Commission's Rules, 18 CFR 1.13(i).

On June 30, 1983, the Commission met to consider whether to adopt a final rule, and if so, what form the rule should take. Although as to the rule as a whole no final determination was made during that meeting, the Commission deleted the provisions of the staff proposed rule concerning attorneys' fees and deficiency balances and directed the staff to draft proposed disclosures for the remaining provisions of the rule. The Commission further directed the staff to draft alternative proposals for a limitation on household goods security interests and third party contacts. The staff was instructed to draft a modified disclosure for cosigners. The Commission indicated tentative support for a ban on confessions of judgment and wage assignments. The Commission further indicated support for the late

1 Memorandum by Ed Card, Manfield, Bureau of Economics, August 18, 1960.
2 The participants were Commonwealth of Massachusetts, Department of the Attorney General; Credit Union National Association, Inc.; the Legal Aid Society of Cleveland; Professors James Barth and Anthony Yenser; George Washington University; National Automobile Dealers Association; American Financial Services Association; The Major portion of the proceeding this organization was denominated National Consumer Finance Association (NCF/A) and will be so termed in relevant citations in this statement); Consumer Federation of America; George Wallace, Rutgers School of Law; Federal Reserve Board; American Retail Federation and Retail Merchants Association; New Orleans Legal Assistance Corp.; Consumer Bankers Assoc.; American Bankers Association; California Bankers Association, and Independent Bankers Association of America; National Consumer Law Center; and Legal Assistance Foundation of Chicago.
charges provision subject to clarification of the language to focus more clearly on the "pyramiding" problem.

On July 20, 1983, the Commission tentatively adopted the portions of staff's revised proposed rule banning confessions of judgment, waivers of statutory property exemptions, wage assignments, pyramiding late charges and blanket security interests in household goods. The Commission also tentatively adopted staff's revised proposal requiring that potential cosigners to be furnished with a "Notice to Cosigner" which explains their obligations and liability. The Commission rejected the provisions of the proposed rule pertaining to third party contacts and cross collateralization. The Commission determined that the effective date of the rule is to be one year from the date of promulgation.

B. Nature of Evidence on the Record

Publication of the proposed Credit Practices Trade Regulation Rule was preceded by a two-year investigation which culminated in subpoena returns from 12 large national consumer finance companies. The subpoenaed material consists of over 7,000 individual files on delinquent debtors and official company operating manuals and training materials.

In response to the invitation to comment on the proposed rule the Commission received over 1,300 written comments. The comments are divided as follows by source: Banks (475); bank trade associations (19); finance companies (169); finance company trade associations (48); retailers (103); retail trade associations (8); credit unions (96); credit union trade associations (9); savings and loan associations (11); savings and loan trade associations (6); legal aid attorneys (117); consumer groups (23); governmental entities (36); other organized groups (18); and miscellaneous, including individual consumers (207). An additional 356 post-

record comments were received during the 1980-81 reopening for comments on the Presiding Officer and Staff Reports.

Three hundred and nineteen witnesses appeared in ten weeks of hearings held in Chicago, Dallas, San Francisco and Washington from September 1977 through January 1978. The interests they represented were: Finance companies and their trade associations [92]; banks and bank associations (25); retailers and their associations (12); credit unions and their associations [8]; legal services attorneys (67); governmental entities (49); consumers and consumer groups (14); and miscellaneous (15). In all, 508 hearing exhibits were placed on the record.

C. Consumer Credit Market

Approximately 70 percent of household indebtedness is in the form of home mortgages; about 23 percent is in the form of installment consumer credit. About 5 percent of consumer debt is installment consumer credit, that is, 30 day charge credit held by retailers, travel and entertainment companies and single-payment loans at commercial banks for consumer purposes. At the end of December 1981 total consumer installment credit amounted to $78.4 billion. At the end of 1981, consumer installment credit totaled $33.3 billion. Of that amount, 44.8 percent was held by commercial banks, 28.9 percent by finance companies, 13.8 percent by credit unions, 8.9 percent by retailers, 3.5 percent by savings and loan associations, 1.3 percent by gasoline companies, and 0.8 percent by mutual savings banks.

By type of debt, 52.4 billion, or 37.9 percent of installment credit outstanding at the end of 1981, was for the purchase of automobiles. Revolving credit outstanding amounted to $25.3 billion at the end of 1981 (18.9 percent of the total). Commercial banks held $33.1 billion, retailers $25.5 billion and gasoline companies $4.4 billion.

All other consumer installment financing of $23.4 billion comprised 37.6 percent of the total outstanding at the end of 1981. Commercial banks held $46.7 billion, finance companies $40.0 billion, and credit unions $23.5 billion. Retailers (including the wholly owned finance subsidiaries of chain stores) held $4.0 billion, savings and loan associations $8.4 billion, and mutual savings banks $2.8 billion. This "other" category includes installment contract financing of household goods such as appliances and furniture, as well as all personal loans.

II. Legal Basis for the Rule

This proceeding focuses on certain of the terms and conditions that appear in the written contracts that consumers sign when they obtain credit for reasons other than the acquisition of real estate. Its purpose is the evaluation of certain collection remedies and related practices in light of the requirements of Section 5 of the FTC Act. This Chapter of the Statement discusses the Commission's mandate to prescribe unfair or deceptive acts or practices and will serve to place in perspective subsequent discussions of the specific provisions of the rule.

The Commission's authority to promulgate this Trade Regulation Rule is derived from two sections of the FTC Act: Section 16(a)(1)(B) and Section 5(a)(1).6

A. Rulemaking Authority

Section 16(a)(1)(B) of the Federal Trade Commission Act states, in pertinent part, that the Commission may prescribe:

[I] rules which define with specificity acts or practices which are unfair or deceptive acts or practices in or affecting commerce * * * with the meaning of section 5(a)(1) of the FTC Act * * * Rules under this subparagraph may include requirements for the purchase of automobiles. Finance companies held $45.3 billion, most of which consisted of contracts purchased by the subsidiaries of manufacturers—that is, by General Motors Acceptance Corporation (GMAC), Ford Motor Credit and Chrysler Financial Corporation. Credit unions held $22.0 billion in loans made for the purchase of automobiles.

6 Id.

7 NCFA 1982 Finance Facts Yearbook at 42.

8 Id. During the 1970's, the increases varied between $4.4 billion in 1970 and $43.1 billion in 1978. The increase in 1980 was only $1.5 billion.

9 Id.

10 Generally the automobile serves as security for installment contracts which are written by dealers and sold to banks or finance companies, or as security for auto loans made directly to consumers by banks and credit unions. Prior to the time the financing these purchases were commercial banks, with $592.2 billion outstanding of which $353.1 billion was purchased paper and $239.1 billion direct loans

11 See supra note 3.
prescribed for the purpose of preventing such acts or practices. The Commission believes that the record should contain a preponderance of substantial reliable evidence in support of a proposed rule before that rule is promulgated. This belief is based partly on the Commission's perception of its function and partly on statutory and judicial authority. Any rule promulgated by the FTC may be challenged, and may be set aside if "the court finds that the Commission's action is not supported by substantial evidence in the rulemaking record * * * taken as a whole," FTC Act section 18(e)(3)(A). 15 U.S.C. 57(e)(3)(A) (West Supp. 1983). Congress imposed this high standard as a "greater procedural safeguard [.]" because of the "potentially pervasive and deep effect" of FTC rules. American Optometric Ass'n v. FTC, 625 F.2d 896, 905 [D.C. Cir. 1980] (quoting H.R. Rept. No. 1107, 93d Cong., 2d Sess. 45-46, 1974 United States Code Cong. and Ad. News 7702, 7715.) Therefore, the Commission takes seriously its responsibility to determine if there is a preponderance of substantial reliable evidence to support a proposed rule, and to see that any supporting evidence is clearly recorded.

Initially, the Commission requires substantial evidence for the factual propositions underlying a determination that an existing act or practice is legally unfair or deceptive. When substantial evidence both supports and contradicts such a finding, the Commission bases its decision on the preponderance of the evidence. Before promulgating a rule, however, rather than bringing individual cases, the Commission believes the public interest requires answers to the following additional questions: (1) Is the act or practice prevalent? (2) Does a significant harm exist? (3) Will the proposed rule reduce that harm? and (4) Will the benefits of the rule exceed its costs? In analyzing each of these questions, three types of evidence are frequently brought to bear: Quantitative studies, expert testimony, and anecdotes. The Commission has the flexibility to marshal evidence for a rulemaking record that combines the best mix of these three. However, it has a responsibility to see that the best evidence reasonably available is included.

The best evidence will often be surveys or other methodologically sound quantitative studies. Carefully prepared studies can often give a reliable answer to each of the four questions. First, reliable estimates of the incidence of a practice are an integral part of an assessment of prevalence and are frequently well-suited to quantitative methods. Second, the overall harm caused by a problem is best measured by determining both the magnitude of consumer injury when it occurs and the frequency of such an injury. This issue is also well-suited to quantitative analysis. Third, the effectiveness of a proposed remedy can often be shown only by quantitative studies since informally observed changes may be influenced by other, uncontrolled factors, or may be the result of chance (i.e., not statistically significant). Finally, quantitative studies are most helpful when comparing costs with benefits.

In many instances, of course, precise quantitative answers to these questions are not possible, or could be obtained only at a prohibitive cost. In such cases, the Commission will seek alternative ways to conduct a systematic assessment of the benefits and costs of its regulatory proposals. As in considering the merits of a rule, the Commission will balance the benefits and costs of obtaining additional information. Although carefully structured quantitative studies are generally preferred as evidence in a rulemaking record, the Commission believes that it is possible in some instances to support a rule without such studies.

The second type of evidence is expert testimony. The primary use of expert testimony is in providing underlying technical details, such as medical or engineering facts or information concerning state law and procedures. Expert testimony is also useful to address the methodology of quantitative studies, and its possible effects on the results. Finally, experts can give their own opinions regarding the issue facing the Commission. These opinions are usually predictions of what quantitative studies would show. As such, they are less satisfactory than an actual study. When an expert's opinion conflicts with the conclusions of a study, the study itself is generally more reliable, unless deficiencies in the methodology or execution of the study have been established and a better study would, in all likelihood, support the expert's opinion.

A third type of evidence is anecdotes. Narratives of specific consumer injuries are helpful in certain ways. They call attention to a possible problem; they illustrate the contours of a known problem; and they may suggest areas for further inquiry. By themselves, anecdotes are generally good evidence that some harm exists. Without thorough exploration of the details of individual examples, however, anecdotes cannot establish the cause of a problem. Moreover, anecdotes give little evidence of the frequency of the harm, they provide limited evidence for the effectiveness of a proposed rule and virtually no evidence of the balance of benefits and costs. Therefore, anecdotal evidence is rarely sufficient to provide the "substantial evidence" which the Commission requires in the rulemaking record.

B. The Criteria for Unfairness Under Section Five

Section 5(a)(1) of the FTC Act, in turn, states:

Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful. * * *

The Commission's authority to prohibit unfair acts or practices in the marketplace is well established. * * The Commission and the courts have developed an extensive body of law concerning unfair practices.

* Although a majority of the adopted rule provisions are based on the Commission's authority to regulate unfair acts or practices, 16 U.S.C.4(a)(1), which concerns misrepresentations of the nature or extent of consumer liability, is premised on the FTC's jurisdiction over deceptive acts or practices. A discussion of the Commission's authority to identify and correct consumer deception is set forth in Chapter IX, infra.


* When Congress created the Commission's unfairness authority, it deliberately framed that authority in general terms. Congress felt that any attempt to list all "unfair * * * acts or practices" could leave loopholes for evasion of the law. Also, Congress did not intend the meaning of "unfair" to be static. It was expected that the underlying criteria would evolve and develop over time. For a comprehensive discussion of the generality of Section 5, see Statement of Basis and Purpose, Advertising of Ophthalmic Goods and Services, 43 F.R. 30, 4000 (1978).

* See generally, FTC y. R.F. Keppler Bros., 291 U.S. 304, 313 (1934); Statement of Basis and Purpose, Trade Regulation Rule for the Prevention of Unfair or Deceptive Advertising and Labeling of Cigarettes in Relation to the Health Hazards of Smoking, 29 FR
The Wheeler-Lea amendment of 1938, the FTCs and 1980 FTC Improvements Acts, and pending legislation in the Congress constitute legislative recognition that, in an imperfect system, certain commercial practices may impose undue costs and risks on individuals, depriving them of the benefits normally associated with free and vigorous competition. \(\text{[16]}\) In this proceeding, the Commission is exercising its unfairness jurisdiction to determine whether in the consumer credit market there is a market imperfection that is preventing a balancing of costs and benefits to individuals. This proceeding examines the market to determine whether it ensures an efficient allocation of cost and risk between consumers and those who extend credit to them. It is our conclusion that the practices addressed by this rule, as discussed individually in Chapters IV-IX, are within the parameters of unfairness under Section 5.

In December 1980, the Commission prepared a formal statement analyzing the legal basis for the exercise of its Section 5 consumer unfairness jurisdiction. \(\text{[17]}\) That document reviewed the Commission’s prior exercise of its unfairness jurisdiction and clarified the criteria for its future use of this authority.

Consumer injury is the central focus of any inquiry regarding unfairness. Not every instance of consumer injury is unfair, however, because virtually any commercial practice involves a complex mix of benefits and costs. In its statement, the Commission observed that:

To justify a finding of unfairness the injury must satisfy three tests. It must be substantial; it must not be outweighed by any countervailing benefits to consumers or competition that the practice produces; and it must be an injury that consumers themselves could not reasonably have avoided. \(\text{[18, 19]}\)

Pending legislative proposals would give Congressional recognition to this unfairness standard:

An act or practice in or affecting commerce shall be deemed to be an unfair or practice \(\text{[20]}\) if—

(i) Such act or practice causes or is likely to cause substantial injury to consumers; and

(ii) Such substantial injury (I) is not reasonably avoidable by consumers; and (II) is not outweighed by countervailing benefits to consumers or to competition which result from such practice.

Any determination under the preceding sentence regarding whether an act or practice is an unfair act or practice shall take into account, in addition to other relevant factors, whether such act or practice violates any public policy as established by Federal or State statutes, common law, practices in business or industry, or otherwise. \(\text{[21]}\)

The Commission’s unfairness authority does not extend to trivial or speculative harm. “An injury may be sufficiently substantial, however, if it does a small harm to a large number of people, or if it raises a significant risk of concrete harm.” \(\text{[22]}\) Furthermore, except in aggravated cases where tangible injury can be clearly established, subjective types of harm—embarrassment, emotional distress, etc.—will not be enough to warrant a finding of unfairness. Rather, economic or other tangible harm must also be present. \(\text{[23]}\)

Earlier articulations of the consumer unfairness doctrine have also focused on whether plaintiffs had demonstrated the practice in question. \(\text{[24]}\) In its December 1980 statement, the Commission stated that it relies on public policy to help it assess whether a particular form of conduct does in fact tend to harm consumers.

We have thus considered established public policy “as a means of providing additional evidence on the degree of consumer injury caused by specific practices.” \(\text{[25]}\) By “established”, public policy, we mean that: (i) The policy is embodied in “formal sources” such as constitutions, statutes, or judicial decisions, and (ii) it is widely shared by a number of states. \(\text{[26]}\) This is especially true concerning court decisions involving constitutional rights, such as due process guarantees. Where public policy appears to be in conflict, the Commission will “reconsider its assessment of whether the practice is actually injurious in its net effects.” \(\text{[27]}\) The Commission has applied this standard to the creditor practices prescribed by this rule.

In short, consumer injury is the central element in a finding of unfairness. But not every instance of consumer injury will lead to a determination of unfairness. The injury must be found to be substantial, not reasonably avoidable by the consumer, and not outweighed by countervailing benefits to consumers or competition. The record as it relates these criteria to each rule provision will be reviewed in the respective chapters of this statement addressing each rule provision. Chapter III of this Statement contains an examination of the record as it relates to the general question of reasonable avoidance by consumers of creditor remedies. The balance of this Chapter presents an overview of the remaining unfairness criteria as they relate to the rule.

C. Unfairness in Creditors’ Contractual Remedies

1. Substantial Injury

The rulemaking record documents substantial consumer economic or monetary injuries from the use of these creditor remedies. For example, confessions of judgment cause injury by depriving consumers of notice of a suit or hearing and the opportunity to appear and present any meritorious claims or defenses. Once obtained, the confessed judgment can be turned into a lien on the consumer’s real and personal property. \(\text{[28]}\) If the contract also contains...
a waiver of exemption clause, the consumer can lose the basic necessities of life. This would require that the debtor replace these items or face destitution. Third, there is the possibility of becoming a public charge. Blanket security interests in household goods also present this possibility. 

A wage assignment also occurs without the due process safeguards of a hearing and an opportunity to assert defenses or counterclaims. For consumers who may have valid reasons for nonpayment, the injury inherent in the denial of due process protections can be severe. It can lead to job loss, or severely reduced income, either one of which could prevent the consumer from providing for his or her family or cause default on other obligations.

Pyramiding of late charges results in the consumer being unknowingly assessed multiple late charges for a single late payment, even though subsequent payments are timely made. The multiple late charges can add up to 60 percent annual percentage rate in many cases.

The rulemaking record establishes by a preponderance of the evidence that consumers suffer substantial economic or monetary injury from creditors’ use of these practices. This is the primary focus of our unfairness analysis. Although our unfairness standard makes it a subsidiary consideration, the record shows that consumers often suffer substantial emotional or subjective harm as well. For example, wage assignments invade the consumer’s right of privacy, causing embarrassment and humiliation, without a judicial determination of the validity of the creditor’s claim. Although such subjective harm is not easily quantifiable, it is clear that consumers value measures to protect them from such injury.

In assessing particular remedies, our focus has been on the consequences of this remedies for consumers in those cases when the remedy is invoked or threatened. Nonetheless, all consumers will benefit from the rule to the extent that it reduces the adverse consequences of default because it serves, in that capacity, as a form of insurance. At the time a consumer enters into a loan agreement, the likelihood of default is both remote and difficult to assess. Thus, all consumers face some risk of default and will value insurance which reduces the most injurious consequences of default, even if they never need the insurance. In this sense, all consumer debtors will benefit.

2. Not Reasonably Avoidable
A violation of the Section 5 unfairness standard will almost always reflect a market failure or market imperfection that prevents the forces of supply and demand from maximizing benefits and minimizing costs. Normally, we can rely on consumer choice to govern the market. In considering whether an act or practice is unfair, we look to whether free market decisions are unjustifiably hindered. In consumer credit transactions, the rights and duties of the parties are defined by standard-form contracts, over most of which there is no bargaining. The economic exigencies of extending credit to large numbers of consumers each day make standardization a necessity. The issue, however, is whether the contents of these standard form contracts are a product of market forces. Although market forces undoubtedly influence the remedies included in standard form contracts, several factors indicate that competition will not necessarily produce optimal contracts. Consumers have limited incentives to search out better remedial provisions in credit contracts. The substantive similarities of contracts from different creditors mean that search is less likely to reveal a different alternative. Because remedies are relevant only in the event of default, and default is relatively infrequent, consumers reasonably concentrate their search on such factors as interest rates and payment terms. Searching for credit contracts is also difficult, because contracts are written in obscure technical language, do not use standard terminology, and may not be provided before the transaction is consummated. Individual creditors have little incentive to provide better terms and explain their benefits to consumers, because a costly education effort would be required with all creditors sharing the benefits. Moreover, such a campaign might differentially attract relatively high risk borrowers.

For these reasons, the Commission concludes that consumers cannot reasonably avoid the remedial provisions themselves. Nor can consumers, having signed a contract, avoid the harsh consequences of remedies by avoiding default. When default occurs, it is most often a response to events such as unemployment or illness that are not within the borrower’s control.

3. Countervailing Benefits
These creditor practices involve a mixture of costs and benefits, both economic and social. An individual creditor practice will not be considered to be unfair unless it is injurious in its net effects. The potential costs include burdens such as “increased paperwork, increased regulatory burdens, the flow of information, reduced incentives to innovation and capital formation, and similar matters.”

The potential costs of most significance in this proceeding include increased collection costs, increased screening costs, larger legal costs, and increases in bad debt losses or reserves. Increased creditor costs generally would be reflected in higher interest rates to borrowers, reduced credit availability, or other restrictions such as increased collateral or larger down payment requirements.

The possible magnitude of these costs is diminished by the fact that the rule leaves untouched a wide variety of more valuable creditor remedies. Remedies such as repossession, suit, garnishment, acceleration and direct contacts, which are highly valuable by creditors, are not affected by this rule. Thus, for example, the impact of restrictions on wage assignments is limited, given the availability of garnishment to allow creditors to reach a debtor’s income. The remedies subject to the rule must be evaluated in light of their more limited incremental contribution to deterring
default or reducing other creditor costs, given remedies that remain available.

The action we take today based on this record is premised on our finding that the cost of each rule proposal is lower than the costs, to consumers and competition, of the specific practices at which the rule is aimed. For the provisions we adopt, record evidence establishes that the action we take will provide benefits to consumer in excess of any costs. In other cases, the record does not justify the action originally proposed. 23

To the extent that the remedies that the rule prohibits the cost of business for creditors, borrowers as a group benefit from those remedies through greater availability of credit and lower interest rates. However, the Commission believes the overall costs to consumers are greater than these benefits. 24

D. Legal Format of the Rule

We have adopted certain text changes to bring this rule into accord with the decision in Katharine Gibbs School v. FTC 25 (hereinafter Gibbs), which requires a rational connection between the practice found to be violative of Section 5 and the prescribed remedy. In order to make this connection clear, the Second Circuit held that the Magnuson-Moss Act requires the Commission to set forth in the actual text of a rule a description of the underlying unfair or deceptive acts or practices which serve as its basis.

Most of the provisions of this rule require the elimination or restriction of specified contractual terms and conditions, 26 or of identified accounting procedures. 27 The rule defines the use of such clauses or procedures, in so, to be an unfair practice. Because in these instances the direct relationship between the unfair practice and the provision of this practice is apparent on the face of each such provision, there is no reason to set out the two separately.

The only provision to which this analysis does not apply is the requirement of a consignor disclosure notice in § 443.3. In order to comply with the Gibbs ruling, we have modified this section to, first, define the unfair or deceptive practices (misrepresentation of and failure to disclose the nature of extent of consignor liability) and, second, prescribe the remedy (furnishing the required notice). We believe this language meets both the statutory requirement that the unfair practice be described with specificity and the Gibbs imperatives that the identified prescription be rationally related to the defined unfair practice.

E. Regulatory Analysis

Based on unfairness, the legal theory for this rule requires the Commission to examine the benefits and costs of each rule provision to conclude that the practice at issue violates Section 5. This analysis is no different than that embodied in the statutory requirement to conduct a regulatory analysis. 28 For this reason, the Commission has integrated the regulatory analysis with the Statement of Basis and Purpose for the rule. A regulatory analysis for the sections of the original proposal that the Commission decided not to promulgate is included in Chapter XIII.

III. Evidentiary Basis for the Rule as a Whole

As discussed in the preceding chapter, there are three elements in the Commission's consideration of whether the consumer injury associated with a practice reaches the level of legal unfairness. To justify a finding of unfairness, the injury must be substantial, not outweighed by countervailing benefits to consumers or competition, and not reasonably avoidable by consumers.

This chapter discusses our rationale and the evidence relating to the third element—the degree to which injury is reasonably avoidable by consumers. The ability to avoid injury depends in part on the availability of infrumument and lease access to loan contracts without the provisions in question, and in part on whether, having signed a contract containing these provisions, consumers can avoid their implementation. Our analysis deals with the rule as a whole. Discussion of record evidence pertaining to specific provisions is reserved for subsequent chapters.

A. The Market for Creditors' Remedies

In part, consumers' ability to avoid certain remedies depends on their ability to shop and compare the language of different credit contracts. To the degree consumers cannot reasonably obtain contracts without certain provisions, they must accept these provisions if they want a loan.

The record shows that although consumers may be able to bargain over terms such as the price of credit and the number or size of payments, 29 there is no bargaining over the boilerplate contract terms that define creditor remedies. 30 We concur with the Presiding Officer's finding that creditors:

Universally make use of standardized forms in extending credit to consumer. These forms are prepared for creditors or obtained by them, and the completed contract is presented to the customer on a "take it or leave it basis." 31

The consumer credit industry, government officials, legal aid attorneys, and academics concurred with this finding. 32

23 E.g., Gerald Kell, Board of Governors, Federal Reserve System, HX-560 (summarizing bank comments); Paul Stanbury, Valley National Bank, R-(a)-394.
24 E.g., Ronald Kay, Minnesota Consumer Finance Conference, R-(a)-328; Richard Halliburton, Legal Aid & Defender Society of Kansas City, R-(a)-114; Jane Johnson, New Orleans Legal Assistance Foundation, R-(c)-(1)-101; Eugene Throop, Land of Lincoln Legal Assistance R-(c)-(1)-30; Paul Smith, Pennsylvania CPA, R-(c)-(1)-68; Eric Wright, Santa Clara Law School, R-(c)-903; Sam Kelly, Texas Consumer Credit Commissioner, R-(c)-1293, Michigan Bankers Association, R-(a)-(1)-191; Robert Coburn, Delta Bank and Trust Co., R-(c)-(1)-137; Leslie Butler, Consumer Bankers Association, R-(a)-1158; Robert Mallock, Beneficial Finance Company, R-(a)-878; "Remedial and security provisions seem to be standard from one lender to another, and the market very possibly would not reflect bargaining for these provisions since lenders do not compete for delinquent accounts." Royal White, "Mississippi Consumer Finance Association, R-(a)-237.
25 Presiding Officer's Report at 61.
26 E.g., Bankers: Alfred Lapan, Massachusetts Cooperative Bank Leagues, Tr. 314; Paul Pfistermeyer, Cont. Illinois Bank & Trust, Tr. 2337; Russel Friedman, Security Pacific Co., R-(a)-429; Joe Martin, 1st United Bancorporation, Tr. 1132; Hagen & McManus, Ind. of Texas, Tr. 1190; Donald Boudreau, Chase Manhattan Bank, R-(a)-432; Kenneth Larkin, Bank of America, Tr. 1367; Robert Bank, First Republic National Bank of Dallas, R-(a)-672. Finance Companies: Hyman Wehner, Atlantic Finance Co., California Loan and Finance Association, Tr. 949; James Ambrose, International Consumer Credit Association, R-(a)-432; Robert E. Dean, Security Mutual Finance, Alabama Consumer Finance Association, Tr. 155; William A. Layne, Consumer Credit, Tr. 4325; H. E. Smith, Alabama Lenders Association, R-(a)-383; Fred Harvey, Georgia Industrial Loan Association, Tr. 397; Stephen Holstein, Colorado Industrial Bankers Association, Colorado Consumer Finance Association, Tr. 7113; Joseph Park, Community Finance Co., R-(a)-310; Frank J. Ford, Ford Motor Credit Co., R-(a)-811; Retailer: Gordon Wear, Texas Independent Automobile Dealers, Tr. 707; Robert Lewis, Firestone Tire & Rubber Co., R-(a)-690; P. T. Weimer, Sears, Roebuck & Co., R-(a)-427. Credit Unions: James Barr, National Association of Federal Credit Unions, R-(a)-494; Harold Welsh, Illinois Credit Union League, Tr. 8081; Jackson Guyton, South Carolina Credit Union, R-(a)-342. Legal Aid Attorneys: James Haist, Legal Aid of Oklahoma, R-(a)-(1)-4; John Peer, Legal Aid of Hawaii, Tr. 5326; Jonathan Epstein, Essex/Hawaiian
In and of itself, standardization is not an indictment of the consumer loan market. The use of standardized forms is an efficient and practical method of conducting a loan transaction. The costs of negotiating with each customer would surely outweigh the benefits that would result from individually tailored contracts. As the Presiding Officer found, "it is simply not feasible to conduct the transaction any other way." In my view, this testimony indicates that the complex regulatory environment in which most lenders do business makes precise contract wording important, and thereby necessitates the use of standardized contracts.

In a well-functioning market, competition among lenders would tend to produce the mix of standardized contract terms that would best satisfy borrower preferences. Despite the use of standardized contracts, individual creditors have incentives to compete with each other by offering different standard form contracts, provided that a sufficient number of consumers know about the alternatives and prefer one contract to another. In such circumstances, consumers could reasonably avoid undesirable contracts, and there would be no basis for Commission intervention. It is therefore necessary to examine the factors that limit consumer search for more desirable credit contracts.

Record evidence indicates that differences exist in the kinds of contracts offered by different creditors. Finance companies in particular are more likely to use the remedies subject to this rule than are other creditors. Among finance companies, use of some contract terms is relatively low when examined nationally. In particular states, however, where certain remedies are more widely used, the incidence is considerably greater. Moreover, within a local area, contracts offered by creditors of a given class may be substantially identical.


\* E.g., use of wage assignments is most prevalent in Illinois and Indiana. See Chapter VI; use of cognizant is substantially limited in one state—Pennsylvania. See infra Chapter IV.

\* E.g., Steven P. McCabe, Consumer League of New Jersey, Tr. 6723, R-(d)-37; Paul J. Pfleisters, Continental Illinois National Bank & Trust Co., Tr. 2336; Agnes C. Ryan, Legal Aid Bureau, United Charities of Chicago, Tr. 2244; Dunn Johnson, Lane County Legal Aid, Tr. 6005-06; George H. Jones, Association Management Services, R-(a)-72 at 4; Jerrold Oppenheim, Legal Aid Foundation of Chicago, Tr. 3197; Michael Burns, Legal Aid Society of Minneapolis, R-(c)-(c)-96; Carol Knutson, Neighbors Legal Services Association, Pittsburgh, Tr. 110; Robert Erickson, DNA Legal Services, Tr. 1806; A. Stanton City Schools Credit Union, R-(d)-252; Raphael L. Podolsky, Connecticut Legal Services, R-(c)-65; Richard Warren, Alabama Lenders Association, R-(a)-361; Robert Bank, Republic National Bank of Dallas, R-(a)-827; Steven Cohrman, Bexar County Legal Aid, Tr. 1718; Andrew attendees, Consumer Affairs Department, United Auto Workers, R-(d)-62; Hagen McPherson, Independent Bankers Association of Texas, Tr. 1918; Robert Duke, Texas Consumer Finance Association, Tr. 1215; Joe Martin, 1st National Bank, Tr. 1133; Russell Freeman, Security Pacific Bank, R-(a)-629; but see Donald Boudreau, Chase Manhattan Bank, R-(a)-522.

The strong similarity of consumer credit contracts among creditors of a given kind within a local area limits consumers' incentives to search elsewhere for a better contract. If 80 percent of creditors include a certain clause in their contracts, for example, even the consumer who examines contracts from three different sellers has a less than even chance of finding a contract without the clause. In such circumstances relatively few consumers are likely to find the effort worthwhile, particularly given the difficulties of searching for contract terms discussed below.

A second factor also limits the incentives of consumers to search for better credit contracts. Default is a relatively infrequent occurrence, and most often occurs for reasons that are beyond the control of the borrower. Unlike terms such as interest rates or payments, which are relevant in every transaction, the chances are good that the remedial proviso in a particular transaction will never be relevant. Thus, consumers would quite reasonably concentrate their search for credit on terms such as interest rates and payments, rather than alternative remedial provisions.

Consumers' limited incentives to seek out better contracts are compounded by the costs and difficulties of searching for contract language. Borrowers usually cannot understand the technical language used in credit contracts.

\* George Stigler, in a pioneeirig article on the subject of search, shows that "if the dispersion of price quotations among sellers is at all large (relative to the cost of search), it will pay, on average, to canvass several sellers." In contrast, when price dispersion is small and the cost of information acquisition is high, it will not pay to search for additional quotations. The Economics of Information, 89 Journal of Political Economy, 171 at 173 (1981). This argument applies, in general, to any information, not just price quotations. If additional search is unlikely to discover a better alternative, it will not pay to engage in additional search.

\* If 80 percent of creditors chosen at random use a particular term, then the chance that 3 creditors chosen at random all use the term is .6 x .6 x .6 = .216 percent.

\* See infra Section B.

\* E.g., Professor John Spangola, Tr. 6714; Dr. Paul E. Smith, Wharton School, on behalf of the National Consumer Finance Association, Tr. 6466; William S. Ballenger, Director, Michigan Department of Licensing and Regulation, Tr. 5807.

\* E.g., John Lumber, Purdue University, Tr. 9657; cf. William Ballenger, Director, Michigan Department of Licensing and Regulations, Tr. 878.
Some witnesses stated that many provisions are phrased in terms that are virtually impossible for the non-lawyer to understand.\footnote{As the Presiding Officer noted:}

Consumer credit contracts are drafted with a view of making the provisions understandable to the consumer generally and do not contain an adequate explanation of either the consumer's rights or the creditor's obligations.\footnote{No larger share of the loan market.\footnote{No such advertising is reflected in the record, however. Nor does the rulemaking record have specific information on why such advertising fails to occur. The Commission has concluded that consumers do not have a complete understanding of consumer credit contracts.}} \footnote{We concur.}

Nor can consumers seek explanations from lenders, because inquiries by prospective customers regarding remedies may tend to make a creditor wary and hesitant to grant the loan.\footnote{The Presiding Officer concluded that consumers do not have a complete understanding of consumer credit contracts.}

Comparing contracts is also complicated by the lack of standardized terminology among various creditors. Different creditors may use different language to achieve essentially the same results.\footnote{For example, some contracts might refer to a cognovit, which other contracts might describe as a confession of judgment. Particularly given the complex legal terminology often employed, many consumers may find it difficult even to identify substantive differences in contracts. In some cases, comparison is impossible because the creditor refuses to give out the loan contract until the borrower seems ready to sign it.}

In many other markets where comparing products is difficult for shoppers, companies attempt to make such information more easily accessible. Companies with more favorable remedial terms have an incentive to advertise that fact, and thereby attract a larger share of the loan market.\footnote{No such advertising is reflected in the record, however. Nor does the rulemaking record have specific information on why such advertising fails to occur. The Commission has concluded that consumers do not have a complete understanding of consumer credit contracts.}

Adverse selection by borrowers also limits the incentives of creditors to promote remedies that are relatively lenient. Within any group of borrowers that appear identical to the creditor, the true default risk for some is greater than others. If a creditor were to introduce a loan contract with less onerous remedies than those of its competitors, then its contract would become especially attractive to relatively high risk borrowers, because these borrowers have the most to gain from the more lenient remedy. Therefore, a disproportionately greater share of the borrowers attracted to this contract would be those with a relatively high risk of default.\footnote{Thus, a company that promoted more lenient remedy terms might experience a higher rate of borrower default than its competition. Unless its higher rate of interest could fully compensate for this higher rate of default, the company would find these remedy provisions unprofitable, even if consumers would prefer the provisions.}

Ultimately, similar considerations led the Commission to reject an alternative rule that would have required plain English disclosure of contractual remedies. Such a rule would make information more easily accessible to borrowers. However, in so doing it would tend to exacerbate the adverse selection problem. Moreover, disclosure alternatives would deal only partially with limited seller incentives to promote alternative remedies due to the free rider problem, and would not address all consumers' limited incentives to search for information about remedies.\footnote{Although some options exist, and some consumers may search for contract provisions they prefer, the record indicates that in consumer credit markets, comparison of competing contracts is difficult and costly. Moreover, remedies intended to reduce the costs of identifying better contracts are unlikely to succeed. Therefore, the Commission has concluded that consumers cannot reasonably avoid the contract clauses at issue in this proceeding.}

B. Default and its Causes

Even if a contract contains undesirable remedies, borrowers could reasonably avoid injury if they could avoid implementation of remedies. Addressing this possibility requires an examination of the causes of default.

There are two leading studies of the causes of default, one by the National Commission on Consumer Finance\footnote{The study complements each other—the NCCF relied on survey data from creditors but Caplovitz surveyed debtors. Both reach similar conclusions.} and the other by sociologist David Caplovitz.\footnote{"Loss of income" stands out as the leading reason for default in the Caplovitz study. The primary causes of loss of income are "adverse employment change" (including unemployment, loss of overtime, etc.) and "illness to chief wage earner." Findings of the NCCF are similar. Unemployment is ranked as the most important cause of default by all classes of creditors. Overextension is found to be the second most important cause by banks and finance companies, and the third most important cause by retailers.\footnote{These categorizations are necessarily somewhat imprecise. Nevertheless, the results indicate that the precipitating cause of default is usually a circumstance or event beyond the debtor's immediate control. When such events occur, default is generally an involuntary response.}

For a fuller discussion of the disclosure alternative see Chapter XIII.}

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\footnote{For a fuller discussion of the disclosure alternative see Chapter XIII.}

\footnote{NCCF Technical studies, Vol. V, at 5 (1972).}

\footnote{David Caplovitz, Consumers in Trouble: A study of Debtors in Default 94 (1974).}
 Nonetheless, among a minority of debtors, default might have been prevented. Caplovitz found voluntary overextension was given as either a major or contributing cause of default by 25 percent of the debtors surveyed and debtor irresponsibility by 5 percent. The NCCF found overextension to be the second or third most important cause of default (no distinction was made between voluntary and involuntary overextension) and lack of intention to repay as the last or next to the last most important cause of the 8 causes studied. Moreover, some debtors can engage in precautionary behavior that will soften the impact of unfortunate events, and enable them to increase their chances of weathering adversity without defaulting on their obligations. One study on the record provides some insight in this regard. It examines the incidence of seven economically traumatic events in a representative sample of American families over a five-year period. Events studied were firings, unemployment, underemployment, evictions, unpaid expense, unplanned children, and illness resulting in two or more weeks absence from work. The study found that over a five-year period almost all households experience at least one of the listed events. A majority experience four or more.

Default, however, is a far less common experience. Data on automobile loans, for example, indicates a yearly default rate which fluctuates between 3 and 6 percent, depending on the general state of the economy. Robert Shay, Columbia University Business School, testified for NCFA that at any given time about 7 percent of finance company accounts were 60 or more days past due. It is suggested that these borrowers are most likely to be subject to creditor remedies. Creditors other than finance companies have lower delinquency rates than do finance companies. Although most consumers do not default, many defaults nonetheless occur. Moreover, the record demonstrates that among those defaults that occur, the majority are not reasonably avoidable by consumers. Instead, default is a response to events that are largely beyond the consumer’s control. Precautions can reduce the risk of default, but no reasonable level of precautions can eliminate the risk. Moreover, some consumers are unable to take various precautionary steps. Thus, consumers cannot reasonably avoid the harsh consequences of creditors’ remedies by avoiding default.

IV. Confessions of judgment

Section 444.2(a)(1) of the rule provides that it is an unfair act or practice for a lender or retail installment seller to take or receive from a consumer an obligation that constitutes or contains a cognovit, confession of judgment (for purposes other than executory process in the state of Louisiana), a warrant of attorney, or other waiver of the right to notice and the opportunity to be heard in the event of suit or process thereon.

A. Nature of the Practice

The cognovit is a legal device whereby the debtor, by means of a provision included in the contract, consents, in advance to the creditor obtaining a judgment without prior notice or hearing. The debtor either confesses judgment in advance of default or authorizes the creditor or an

For example, Caplovitz interviewed debtors in default and asked: "What were the main reasons why you stopped making payments on the ("merchandise/loan")? A typical response was: "I got sick and didn’t want to...", but there were too many bills to keep up." Is the cause of this default involuntary overextension or illness? Such distinctions are difficult to make and Caplovitz acknowledges that his coding decisions were "somewhat arbitrary." D. Caplovitz, supra note 28, at 49-51. In addition, there may be reasons other than debts to mortgage. People may tend to underestimate their own responsibility in causing default.

See supra note 29.

See supra note 31.

For example, one witness stated that a major cause of default with respect to automobile loans was the uninsured collision. He added that if the car had been insured when damaged, repairs would have been made at the expense of the insurance company, and there would have been no default. Curtis E. McCull, Northeast Ford, Tr. 11351-32.


Reliable data for overall default rates are not available.

American Bankers Association (ABA) Installment Lending Division, "Delinquency Rates on Bank Installment Loans", various years. See also, R-XI-156; R-40 at 48; R-4(4)-84 at 8.

HX-494 at 2A.
attorney designated to the creditor to appear and confess judgment against the debtor.1 Unless the contract so provides, default is not a necessary condition precedent to the entry of judgment. The judgment may be taken by any person holding the note. At common law it operates to cut off the opportunity to contest jurisdiction or venue or to present any claims or defenses that the debtor may have.2 Judgment is rendered for the amount due shown on the face of the note plus any other charges authorized, such as attorney fees and any court costs. It can be converted into a lien on the debtor’s property, which subjects debtor’s property to seizure and sale to satisfy the judgment.

Because the common law cognovit is a drastic remedy, its use today typically is constrained to some extent by statutory safeguards in those states where it is permitted and used. In such states, as at common law, judgment is entered against the debtor by the filing of a confession. The filing creates a lien on the debtor’s property, subjecting it to execution in satisfaction of the debt. Unlike its operation at common law, however, the entry of judgment does not cut off all opportunity to contest the creditor’s claim. The judgment debtor has the right to petition the court and, if the debtor presents a prima facie case, the court will reopen the judgment.3 The debtor may then raise any substantive defenses to the creditor’s claim that could have been used in the debtor’s defense in a trial on the merits.4 The lien of the judgment or of any levy or attachment is preserved while these proceedings are pending.

Although such statutory safeguards provide debtors with some means of protecting their property interests, they fail to provide the full due process protection required by the fourteenth amendment to the constitution. The essence of the due process clause as it relates to property is to protect the individual from wrongful deprivation by, or through the offices of, the government.5 Such protection is achieved by giving individuals notice of the claims against them, and the opportunity to contest those claims at a hearing.6 If the hearing is to achieve its purpose, then, in anything other than an emergency situation it must precede the property deprivation.7

Judgment debtors whose property is encumbered through the existence of a creditor’s lien lose the full use and enjoyment of their property. Debtors are unlikely to be able to sell it, for example, or to use it as collateral while it is subject to a lien. Although the debtor may eventually prevail on the merits and dissolve the lien, the post-judgment rights provided by statute cannot cure the deprivation experienced while the action is pending. Even a temporary and non-final deprivation of the use of one’s property is a matter of constitutional significance and invokes the protection of the due process clause.8 Because state statutory protections governing cognovit are limited only after debtors are deprived of the full use of their property, they cannot guarantee full due process protection. The right to a hearing before deprivation occurs is essential.9

The contractual waiver of one’s right to due process is constitutionally permissible, provided that the waiver is made voluntarily, knowingly, and intelligently.10 Thus, in a commercial context, the use of confessions of judgment has been upheld where the facts demonstrated that this standard had been met.11 A consumer who is unaware of the existence or meaning of a cognovit clause, however, cannot be held to have waived due process rights voluntarily, knowingly, and intelligently by signing a contract that includes such a clause.12

Of the creditor remedies addressed by the rule, confessions of judgment are least likely to be understood by consumers.13 In many cases, consumers, especially low-income consumers, are not aware that cognovit clauses are in their contracts.14 To the extent that they are aware, consumers rarely understand the significance of these clauses because they are worded in obscure technical language and because the concept of judgment by confession conflicts with the common understanding of basic due process rights.15 The record shows that, for these and other reasons (discussed in Chapters II and III above), consumers do not bargain over this provision or shop for contracts without it. The Commission finds, therefore, that consumers cannot reasonably avoid the injury caused by cognovit.

B. State Law

Virtually all states currently impose some statutory restrictions on the use of cognovit clauses. The protection that such statutes provide is far from uniform, however. A number of states either bar the use of confessions of judgment altogether or prohibit their use in connection with any claim arising out of a consumer credit transaction.16 Other states restrict their use in specified classes of transactions, such as retail installment sales contracts, but do not impose a general prohibition on

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2 Presiding Officer’s Report at 70.


4 Id. at 198 (citing a 1906 study conducted by David Caplovitz of 245 confessing-judgment debtors in Philadelphia, only 14 percent of whom knew that the contracts they had signed contained cognovit clauses).

5 E.g., Carolyn C. McTighe, Legal Aid Society of Cleveland, I.R.-[33]-[34]; Jules S. Littman, Middlesex County Legal Service Corporation, R-[4]-[5] at 3: Eugene Throll, Land of Lincoln Legal Assistance Foundation, Tr. 3358.

their use with respect to all consumer transactions.\textsuperscript{18} In addition, a significant number of states prohibit small loan licensees from utilizing confessions of judgment in loan agreements with consumers.\textsuperscript{24} The statutory definition of a small loan licensee varies from state to state, however.\textsuperscript{21} Thus, the protection provided by such provisions affords consumers varies accordingly.

Other states authorize confessions of judgment, but only if they are executed after action on the underlying obligation has been instituted.\textsuperscript{25} The hallmark of the common law cognovit is the waiver of due process rights before the time that the debtor needs their protection. Because such statutes prohibit waiver of these rights before commencement of an action against the debtor, in effect they bar the common law cognovit and the ill traditionally associated with it. Before an action can be commenced the debtor must receive notice, and the right to a hearing necessarily follows. If at this point the debtor chooses to confess judgment, the waiver of the right to a trial on the merits may be assumed to have been made intelligently and voluntarily. A few other states restrict confessions of judgment by requiring that they be made in default,\textsuperscript{26} or rather by than after institution of suit,\textsuperscript{27} requiring that the debtor appear personally in court to confess judgment if he or she chooses.\textsuperscript{28}

Another group of states restricts confessions of judgment by authorizing their use but requiring that the debtor sign a verified statement under oath attesting to the existence of the obligation due or to become due.\textsuperscript{29} Such making loans or advances of money on credit in amounts of $25,000 or less) with Hawaii Rev. Stat. section 409-13 (1976) (licensee is any person engaged in business of making loans of money, credit, goods, or things in action in the amount or value of $25,000 or less).


As a result, confessions of judgment obtained pursuant to such statutes are not prohibited by this rule provision. See infra note 108 and accompanying text.


\textsuperscript{37} See, e.g., Alaska Stat. section 09.30.050, Alaska R. Civ. P. 57 (c) (1971); Cal. Civ. Proc. Code sections 1123-1134 (1961) (cognovit) may be entered only if an attorney independently represents the debtor and the attorney has examined the proposed judgment, has advised the debtor with respect to waiver of rights and defenses and has verified to the court’s satisfaction that the debtor entered into an informed choice.

confsessions of judgment are used relatively frequently in this state. Pennsylvania’s procedural protections are more limited than those of Delaware and Virginia. Pennsylvania’s judgment is entered by the filing of a instrument conferring judgment or authorizing a third party to confess judgment against the debtor. Default is not a necessary condition precedent to the entry of judgment. The court clerk must notify the defendant debtor of the entry of judgment and enclose copies of the documents filed in support of judgment. Such notice is sent by ordinary mail rather than certified mail, however, and no return receipt is required. Thus, the court has no assurance that the debtor has, in fact, received notice. Failure to mail the notice and documents does not affect the lien against the debtor’s property imposed by the judgment. As a result, debtors may be wholly unaware that their property is subject to a lien. Pennsylvania law provides for striking off or reopening of a judgment engaged by confession. To strike a judgment the defendant’s petition must assert defects appearing on the record. To reopen a judgment the defendant’s petition must assert prima facie grounds for relief. The existence of offsetting claims or counterclam that the debtor has against the creditor does not constitute grounds for reopening. All defenses that are not included in the petition are waived. The court determines whether to reopen the judgment on the basis of the defendant’s petition, the plaintiff’s answer, and on testimony, depositions, and admissions. There is no statutory provision for a hearing on the petition to reopen. Only if the pleadings produce evidence that would require submission of the issues to a jury will the court reopen the judgment. Thus, the reopening of a judgment entered by confession involves a preliminary pleading contest in which the debtor has the burden of persuasion.

In the event that the court does reopen the judgment, it is not clear if any of the judgment or any execution issued on it is unimpaired, although the court may stay execution pending final disposition of the proceeding. This is a discretionary matter, however; the court is not required to stay execution. No further pleadings are permitted after reopening. Although these statutory provisions afford some means of contesting a judgment that has been improperly entered, they fail to ensure that debtors’ rights will be protected adequately. This is true because, as noted above, there is no assurance that debtors will receive notice of the entry of judgment. Even when debtors do receive notice of the entry of judgment, the law does not require that they be notified of the right to contest the judgment or the grounds upon which they may do so. Evidence in the rulemaking record shows that debtors may fail to recognize the implication of judgment entered by confession against them, as well as the means that they may use to contest such judgments. Moreover, ignorance of the rights that were waived at the time of confession is not a statutory defense in Pennsylvania. Finally, debtors’ due process rights are inadequately protected by Pennsylvania statute because the law permits encumbrance of their property before, rather than after, a hearing on the merits of the creditors’ claims.

It is also apparent that Pennsylvania’s post-judgment remedies do not provide the procedural equivalent of a trial de novo to debtors. A creditor in Pennsylvania who has not obtained judgment by confession cannot reopen judgment through a civil suit. The action is commenced when the creditor files a complaint. The district justice sets a date for hearing, to occur within sixty days of the filing, and notes it on the complaint. The complaint is then served personally upon the debtor, along with a notice of the right to contest and the time period for doing so. The notice includes a prominent warning that failure to appear will result in the entry of a default judgment. Debtors are informed that they may enter a defense and may also file a complaint raising a cross-claim against the creditor. Such a complaint may assert any claim within the court’s jurisdiction. The district justice who conducts the hearing has authority to subpoena any necessary witnesses. The court issues a judgment within five days after the hearing. Costs are awarded to the prevailing party.

This procedure is simple, straightforward, and expeditious. It ensures service of process upon the debtor. It provides full notice of the debtor’s right to defend, the time and place for doing so, and the consequences of failure to appear. Because depositions and interrogatories are not permitted, the burden and expense of presenting a defense are negligible.

The reopening of a confessed judgment involves a preliminary pleading contest in which the debtor has the burden of persuasion. By contrast, to defend against a creditor’s claim in a trial de novo under the procedures outlined above, the debtor may simply appear and present any defenses to the district justice. No lien may be created upon the debtor’s property until after the debtor has had this opportunity.

Notwithstanding a meritorious defense, the procedural burden of reopening a judgment under Pennsylvania law requires a greater sophistication and expenditure of

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*The placing of this burden upon the debtor is in direct contrast to the burdens in a normal or pre-judgment creditor-debtor action. In those cases instituted by a creditor against a debtor, the creditor is considered the proponent of a claim and the burdens are his.’ Swartz v. Lenox, 314 F. Supp. 1081 (E.D. Pa. 1970), aff’g 405 U.S. 191 (1972).

*See n. 4, supra. Pennsylvania law thus permits encumbrance of their property before, rather than after, a hearing on the merits of the creditors’ claims.*

*See supra note 29 and accompanying text.*

*See, e.g., Henry J. Sommer, Community Legal Services of Philadelphia, Tr. 10695 Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11104; Herschel T. Elkins, Office of the Attorney General of California, HX-213, Tr. 50-91.*

*Bernard A. Podcas, Legal Services of Northwestern Pennsylvania, Tr. 9029. This contrasts with Delaware law, for example, which provides for a preliminary hearing on the issue of waiver. See supra note 29 and accompanying text.*

*The civil procedure discussed in this section is the applicable procedure for claims before Pennsylvania district courts, which have jurisdiction over claims not exceeding $4,000. See Pennsylvania Rules of Civil Procedure Governing Actions and Proceedings Before District Justice Pa. Ct. R. Civ. P. 301-382 (West 1983). Claims that exceed $4,000 must be brought in the Court of Common Pleas.

*If judgment is entered against the debtor, execution may be ordered by the district justice; alternatively, the creditor may file the judgment with the Court of Common Pleas. Creditors wishing to execute upon real property must choose the latter alternative; see id. Pa. Ct. R. Civ. P. 402, 406.*
resources by the debtor than would be required in a trial on the merits in the first instance. For these reasons, Pennsylvania's judgment remedies provide an inadequate substitute for a trial de novo and fail to guarantee that debtors' rights will be protected to the degree that due process requires.

C. Prevalence

There is limited record evidence with respect to the prevalence of cognovit clauses in consumer credit contracts on a nationwide basis. Both legal aid attorneys and members of the finance industry testified to the use of cognovit clauses in Pennsylvania, Illinois, and Louisiana. Other evidence points to frequent use in Pennsylvania, Illinois, and Ohio. There was also testimony that in Maryland, although cognovit clauses are prohibited in many consumer credit transactions, their use in other kinds of consumer contracts remains common.

Some evidence exists concerning the prevalence of cognovit clauses but does not break down the results by state. A survey of its members conducted by the Consumer Bankers Association, for example, shows that approximately 20 percent of banks responding to the survey included cognovit clauses in the majority of their contracts where permitted by law. A survey of legal aid attorneys indicates that, where permitted by law, cognovit clauses were utilized in 20 percent of loan agreements by credit unions, 21 percent by finance companies, 16 percent by banks, and 30 percent by S&Ls. 

A National Consumer Finance Association (NCFA) survey of over 13,000 consumer accounts indicates that cognovit clauses were used in 3.7 percent of consumer credit contracts used by its responding members and that all but one of the contracts came from Illinois or Louisiana. A Commission staff survey of 1,001 consumer account files subpoenaed from twelve large consumer finance companies in thirty-five states found cognovit provisions in seventy-four contracts (2.7 percent). This figure was thought to underestimate the true incidence of cognovit provisions in the sample, however. A more reliable Bureau of Social Science Research (BSSR) survey of 1,001 consumer account files drawn from the same group, but including only nine consumer finance companies in nineteen states, found cognovit provisions in ninety-six contracts or 9.6 percent of the sample. The results of both samples show that cognovit provisions are found in contracts from Colorado, Illinois, Indiana, Louisiana, New Jersey, Michigan, Ohio, Tennessee, and Virginia. Although Louisiana, Illinois, and Ohio account for the majority of the cognovit provisions in the sample, consumer account files from these states are over-represented in the sample. Because the consumer account files were from Ohio, for example, the use of cognovits may be somewhat more widespread geographically than the NCFA survey would indicate. Finally, a 1970 industry survey conducted by the National Commission on Consumer Finance showed that 17 percent of large bank respondents and 17 percent of large finance companies stated cognovit to be a highly valuable provision in contracts for unsecured cash loans. This suggests that, among these respondents, confessions of judgment are employed on a regular basis.

A precise quantification of the extent to which cognovits are used in consumer credit contracts can be made on the basis of record evidence. Evidence demonstrates their use in Pennsylvania, as well as in Louisiana, Illinois and, at least to a limited extent, in several other states. There also is evidence to show that in states where their use is permissible, they are used with some frequency. Beyond this, there is the issue of issue of both faith and credit that must be paid by the courts of one state to the judgments of the courts of another state. To the extent that confessions of judgment are entered on the basis of the laws of a state in which they are permissible, they may be

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44 Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11121 (100 cases in 3 years); Bernard A. Podcas, Legal Services of Northwestern Pennsylvania, Tr. 9850 (3 current cases, perhaps 50 others); William T. Gwennap, Pittsburgh National Bank, Tr. 1222-54 (PNB uses cognovit in home improvement loans; other banks in Pennsylvania also use them); Leslie R. Butler, Consumer Bankers Association, H. 486, Tr. 11587. In Pennsylvania many consumer contracts contain cognovit clauses.

45 Jerrold Oppenheim, Legal Assistance Foundation of Chicago, H. 79, Tr. 2147. Confessions of judgment have since been prohibited in consumer transactions in Illinois.

46 Jane Johnson, New Orleans Legal Assistance Corp., Tr. 407-08; Herschel C. Addock, Louisiana Consumer Finance Association, Tr. 1210 et seq.; Donald S. Wingerter, Louisiana Savings and Loan League, H. 437, Tr. 10900 et seq.

47 See, e.g., Addock, Consumer Finance Association, H. 404 et seq., Tr. 12053.

48 For an explanation of the methodology employed and the results of this and the BSSR survey see R-XI-153 at 4-5. Because of many of the files surveyed by the Commission staff were incomplete, it was not possible to determine in all cases whether a given contract was included. In addition, if a provision was found in all contracts from a given office, the staff did not attempt to code such every instance. For this reason, the BSSR survey, in contrast, used complete files and followed a formal coding procedure.

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11816-17. Although Mr. Slater was unable to present the results on a state-by-state basis, he indicated that the number of respondents was too great to reflect banking practice only in Pennsylvania. Tr. 11587. He noted that a number of the respondents did business in Michigan, Illinois, and New York. Tr. 10642.

49 National Consumer Law Center (NCLC) Survey of Credit Card Practices (1977), H. 497 at 2-4. Although 106 consumer law specialists responded to this survey, confessions of judgment were not lawful in many of the respondents' states. The estimate of prevalence reflects the opinions of the 22 respondents in whose states the practice was permitted, but results were not tabulated by state. Thus, the 20 percent estimate of prevalence may reflect the practice of creditors in a relatively small number of states. See President's Officer's Report at 30-34 for an evaluation of this survey as a whole.

50 Robert P. Shaby, National Consumer Finance Association, H. 404 at 35, Tr. 12053.

51 See R-XI-153 at 4-5. Because of many of the files surveyed by the Commission staff were incomplete, it was not possible to determine in all cases whether a given contract was included. In addition, if a provision was found in all contracts from a given office, the staff did not attempt to code each instance. For this reason, the BSSR survey, in contrast, used complete files and followed a formal coding procedure.

52 Id. at 30.

53 Id. at 30.

54 Id. printout A at 14-21, printout B at 1-8.

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55 See id.

56 Id. at 3 n.4.

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57 Alternatively, the differences in survey results may reflect changes in state law or creditor use of cognovit that took place between 1973, when the Commission gathered its survey data, and 1977, when the NCFA conducted its survey.


59 See, e.g., NCLC survey, supra note 54 and accompanying text; Thomas E. Raleigh, Administrator, Collection Agency Act, Illinois, H. 90, Tr. 2433; Jerrold Oppenheim, Legal Assistance Foundation of Chicago, Tr. 2167; Herschel C. Addock, Louisiana Consumer Finance Association, Tr. 1211; William T. Gwennap, Pittsburgh National Bank, Tr. 12232-34.

60 For a discussion of the applicability of the full faith and credit clause to cognovit judgments, see Hopson, supra note 51 at 143-56; Note, Poverty Law: Judgments by Confession, 90 Tex. L. Rev. 106, 171 (1970).
enforceable in other states where they would not or otherwise be permissible.

On balance, it appears that cognovit clauses are prevalent in Pennsylvania and may be used in other states as well, such as Virginia, where they are permitted.53 Despite the fact that their use has been prohibited or severely restricted in most states, the Commission finds that there is sufficient evidence of continued use of cognovit clauses to warrant a rule addressing that use.

D. Consumer Injury

Although procedures for reopening confessions of judgment exist, the absence of notice and a hearing prior to the entry of the judgment causes significant consumer injury. Cognovit clauses typically are worded in arcane language and may appear in small print.54 Record evidence supports the conclusion that debtors are unaware that they have agreed to such clauses and that they waive due process rights by doing so.55 When debtors receive notice of a judgment entered against them, they may not understand its import or act affirmatively to raise any defenses against it.56 This problem is exacerbated by the fact that many states, including Pennsylvania, do not require notice informing the debtor of the right to contest the judgment or the grounds for doing so.57 As a result the debtor may fail to respond despite having valid defenses to the judgment.58 The rulemaking record shows that judgments entered by confession frequently are invalid on their face.59 It also shows that debtors frequently have some defense to the judgment.60

When debtors are not apprised of their rights and therefore fail to challenge facially invalid judgments or fail to assert valid defenses, the consumer injury is clear. The judgment debtor’s rights may be taken in satisfaction of a claim that would not survive judicial scrutiny at a hearing on its merits. Loss of this property causes economic hardship, since the debtor loses both its use and any equity in it. Moreover, consumers must replace any essential items that are seized, usually at a greater cost than they were credited with for the seized property. The economic injury, therefore, is substantial.61

Alternatively, if they have the resources to do so, consumers may simply pay judgment debts when threatened with execution or garnishment although they dispute the underlying claim.62 Legal aid attorneys estimate that actual or threatened invocation of cognovit clauses results in payment of disputed debts in a significant number of cases.63

Even when debtors understand their right to challenge the entry of judgment, post-judgment remedies of the sort provided by Pennsylvania statute do not make them whole. The procedure for reopening a judgment is complex and debtors are unlikely to succeed without incurring the cost of hiring an attorney.64

Judgment are no longer permitted in Illinois, but this study demonstrates the potential for abuse that exists in states where they are permitted.

* Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11002-03, 11121-22.

* See, e.g., Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11002-03, Jane Johnson, New Orleans Legal Assistance Corp., Tr. 413. See generally Karl B. Friedman, Alabama Consumer Finance Association, Tr. 61; William Ballenger, Michigan Department of Licensing and Regulation, Tr. 8176; Tom McNichol, Director, Idaho Department of Finance, Tr. 5006; Andrew Eiler, Consumer Affairs Department, United Auto Workers, R.-4(d)-42.

* Henry J. Sommer, Community Legal Services of Philadelphia, Tr. 10006.

* Confessions of judgment are more commonly used in unsecured loans, see Robert P. Shay, National Consumer Finance Association, Tr. 84-44 at 84, where collateral is less likely. Nonetheless, 22 consumer law specialists estimated that payment of disputed debts occurred in 23 percent of cases, based on their experiences in serving mainly low-income consumers. NCLC survey, supra note 54, at 46-45. See discussion of Pennsylvania procedures for reopening supra notes 38-42 and accompanying text. Because the procedures in Pennsylvania are especially difficult, the propriety of seeking to use a judgment debtor to prove effectivity post see, e.g., Eugene Throilf, Land of Lincoln Legal Assistance Foundation, Tr. 3072.

In addition to legal fees, sheriff’s costs and deposition and transcript costs are ordinarily required in a proceeding to strike or reopen.65 Such costs are not necessarily incurred in a trial de novo.

In a proceeding to reopen, the debtor may assert the same affirmative defenses that could have been used in defending against an assertion of the underlying claim. However, in a proceeding to reopen the burden and expense of instituting litigation shift from the creditor, where they would lie absent the confession of judgment, to the debtor.66 Because of the relative ease with which confessions of judgment may be entered, creditors may be tempted to use them indiscriminately.67 To the extent that consumers must institute legal action to defend against unwarranted claims, they suffer considerable economic injury through the costs that they must incur.

Although consumers with meritorious defenses may ultimately succeed in vacating judgments against them, they are deprived of the full use of their property during the process. Under Pennsylvania law the entry of judgment creates a lien on the consumer’s property and thus encumbers the right to use it.68 Until such a lien is dissolved, the consumer’s ability to use the property for collateral or to dispose of it is significantly impaired.69 Moreover, because the lien is effective whether or not notice is mailed to or reaches the debtor,70 debtors may learn of its existence only at the precise point at which they seek to use the property for such purposes.71 By the time debtors succeed in dissolving the lien, the opportunity for which they intended to use the property may have passed.

Consumers have no recourse for the economic injury that is suffered as a result. There is no statutory provision for an award of damages to a consumer.


53 Id. at 314 F. Supp. 1095; Bernard A. Podcasy, Legal Services of Northeastern Pennsylvania, Tr. 9829.

54 See NCLC survey, supra note 54, X-467 at 44 (72 percent median success rate in reopening cognovit judgments suggests invalid use of confessions by creditors); see also discussion of potential for abuse of cognovit provisions supra note 57.


58 When a judgment debtor sues two years after its entry, judgment debtors suffer significant practical problems in producing evidence of any defenses they may have. See, e.g., Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11106; Herschel T. Eilkin, Office of the Attorney General of California, Tr. 5200-01.
whose property has been improperly encumbered.

The record demonstrates that economic loss of several different sorts is experienced by debtors against whom confessions of judgment are entered. Injury occurs even when consumers ultimately succeed in overturning a confessed judgment. Accordingly, we find that the use of cognovits causes substantial consumer injury.

E. Offsetting Benefits

Conflicting evidence appears in the rulemaking record with respect to the benefits derived from the use of cognovits. There is testimony indicating that confessions of judgment are considered a particularly useful collection device in Pennsylvania and Illinois. Other evidence suggests that some creditors do not consider them to be of great utility, however.

Those who supported the importance of cognovit clauses suggested that the absolution of confessions of judgment might decrease credit supply or increase credit cost. One commenter suggested that large finance companies and commercial banks might require security for loans more frequently than they currently do if cognovits were abolished.

In contrast, the National Commission on Consumer Finance found that where states had prohibited or restricted confessions of judgment, there had been, in fact, no significant effect on the cost or availability of consumer credit. Other commenters agreed with finding with respect to the extension of credit in their states that testify against a confessed judgment. The principal reason that the abolition of cognovits might increase the cost of credit is that creditors would be required to file suit against defaulting debtors rather than merely filing a confession and obtaining judgment. The costs were described as a more time-consuming and costly procedure by one commentator from Illinois.

Another stated, however, that although instituting suit might impose a thirty or forty day delay in carrying out collection activities, the abolition of confessions of judgment would have no practical significance for creditors.

In fact, it appears that as many as 91 percent of debtors fail to appear to defend when creditors institute suit against them. To the extent that debtors do not answer and defend, creditors do not incur the legal expenses of preparing for and litigating their claims. Thus, although creditors may experience a slight delay in collection activities, it is unlikely that any significant additional costs will be incurred in the vast majority of cases.

Other testimony suggested that creditors might respond to the abolition of confessions of judgment by increasing the use of other more costly remedies that remain available, so that additional costs would transfer to the debtor. On the other hand, commenters note that the use of cognovits imposes additional costs upon debtors who seek to reopen judgments against them, and may force debtors in marginal financial circumstances into bankruptcy. Thus, the costs associated with the prohibition of cognovits appear to balance the costs inherent in their use.

Without cognovits, creditors will be required to litigate their claims against those consumers who choose to appear and defend. In these cases, creditors may ultimately incur greater expenses than they would have through the simple entry of judgment. Presumably, at least some of those same consumers would have petitioned for reopening of the judgment, however. In such cases, the creditor would have incurred the expense of litigation in any event. Thus, except to the extent that debtors who would not otherwise have done so are encouraged to contest creditors’ claims when served with a complaint as opposed to notice of judgment, this provision of the rule will have little economic impact on creditors.

Viewed as a whole, the record demonstrates that confessions of judgment do not produce significant benefits to creditors or, by extension, to consumers. Because the injury associated with their use can be substantial, the Commission finds that any benefits produced by their continued use do not outweigh the injury that they cause to consumers.

F. Alternatives Considered and Modifications Adopted

This rule provision is intended merely to ensure that, before any deprivation of property occurs, debtors will be afforded the basic due process rights of notice and an opportunity to be heard. The proposed rule addressing confessions of judgment originally prohibited the taking or receiving from a consumer in an existing obligation, inter alia, a “power of attorney.” In response to the concerns expressed by many commenters, the phrase “warrant of attorney” has been substituted instead in the final version of the rule.

This revision is designed to ensure that real estate first mortgages and deeds of trust are not affected by this rule.

[Notes and Citations]

7754 Federal Register / Vol. 49, No. 42 / Thursday, March 1, 1984 / Rules & Regulations
provision. Such agreements typically contain powers of attorney for purposes of foreclosure, subject to various state restrictions governing, for example, mortgagors’ rights to cure, equitable rights of redemption, and permissible notice of sale procedures. This rule provision is intended to bar the use of confessions of judgment in real estate-secured second mortgage loan obligations, however, to the extent that the proceeds of such secured loans are used for consumer purchases.100

Similarly, powers of attorney given to expedite the transfer of pledged securities of the dispossessed chattels are not within the scope of this provision. For example, an automobile installment sale contract may include a power of attorney authorizing transfer of title in the event of repossession and sale of the vehicle. A power of attorney for this purpose would not constitute a “waiver by the debtor of any defense to the judgment of his right to be heard in the event of suit or process” as contemplated by § 444.2(a)(1). This applies as well to a power of attorney to transfer ownership of pledged stocks, bonds, or similar instruments.

A power of attorney in an insurance premium finance contract enables prompt cancellation of an underlying third-party insurance agreement in the event of default.101 Such provisions likewise do not fall within the ambit of the rule because they do not entail loss of notice and hearing rights “in the event of suit or process.” Comparable powers of attorney in two-party insurance agreements will be unaffected as well.102

This section of the rule was also revised, in response to testimony and written comments, so as not to apply to the Louisiana Via Executiva process. The state of Louisiana prohibits confession of judgment except for purposes of executory process.103 This civil law executory procedure enables a creditor, when making a loan, to take a mortgage on property that is specifically identified in the mortgage. The mortgage may contain a confession of judgment, which has the effect of creating a security interest in the specified property.104 Thus, the Louisiana confession of judgment operates in rem; it is used only to execute upon property that the debtor has selected to serve as collateral. Unlike confessions of

judgment in common law jurisdictions, it does not operate in personam and, therefore, it does not create a general lien on other property of the debtor.105 In sum, the property that may be encumbered or sold under Louisiana’s executory process appears to be consciously chosen with that possibility in mind by the debtor. To the extent that Louisiana executory process may involve the loss of any due process rights, the Commission lacks sufficient evidence to find that these rights are waived involuntarily or unknowingly.

Finally, confessions of judgment prohibited by this rule provision should be distinguished from the cognizant actionem, or confession acknowledging liability following institution of suit and service of process. Unlike the latter, which is executed in connection with negotiated settlements, the prohibited confessions of judgment involve anticipatory waivers of procedural due process protections in the context of credit obligations.106

V. Wage Assignments

Section 444.2(a)(3) of the rule provides that it is an unfair act or practice for a lender or assignee of a wage to require to take or receive from a consumer an obligation that constitutes or contains a clause that makes and assignment of wages unless the assignment by its terms is revocable at the will of the debtor, constitutes a payroll deduction or preauthorized payment plan, or is an assignment of wages already earned.

A. Nature of the Practice

A wage assignment is a contractual transfer by a debtor to a creditor of the right to receive wages directly from the debtor’s employer. To activate the assignment, the creditor simply submits it to the debtor’s employer, who then pays all or a percentage of debtor’s wages to the creditor.1 The debtor releases the employer from any liability arising out of the employer’s compliance with the wage assignment, and may waive any requirement that the creditor

100 See rule definitions, § 444.1(a), (b), and (d).
101 J. Robert Sweet, Florida Premium Finance Association, Tr. 9753; see also Robert C. Dukes, Texas Consumer Finance Association, Tr. 1813-14.
102 See Jeffrey Voss, National Association of Insurance Agents, R-f-11.
104 Herschel C. Adcock, Louisiana Consumer Finance Association, Tr. 1215-16, 1224.

first establish or allege a default.12 Abstent a statutory restriction, it is not necessary to obtain the employer’s consent to enter into a wage assign. next.9

Wage assignment and wage garnishment are both methods by which a creditor can obtain the debtor’s wages to apply to or satisfy a debt. Procedurally, however, the two remedies are very different. Garnishment requires that the creditor obtain a court judgment before wages can be garnished to collect the debt. The Supreme Court has held that prejudgment garnishment deprives the debtor of constitutional due process rights.1 Wage assignment, on the other hand, does not require a judgment. A creditor can file a wage assignment without any judicial review of the creditor’s claim. The debtor does not have a hearing with an opportunity to assert any defenses. Unlike prejudgment garnishment, prejudgment wage assignment has usually survived constitutional challenge.12 There is no meaningful distinction between the effects of the two remedies, but when

1 Some state statutes prohibit the creditor from filing a wage assignment with an employer unless there is a payment in default. See, e.g., Ill. Ann. Stat. ch. 68, sect. 39.2 (Smith-Hurd 1979).
3 Sniadach v. Family Finance Corp., 395 U.S. 337 (1969). The Wisconsin garnishment statute at issue in Sniadach required that the creditor receive a summons and complaint within 10 days after service of garnishment on the employer. Wages were frozen, however, during those 10 days. 395 U.S. at 339-39. The court found that [The wages] may, it is true, be unfrozen if the trial of the main suit is ever had and the wage earner wins on the merits. But in the interim the wage earner is deprived of half the proceeds of earned wages without any opportunity to be heard and to tender any defense he may have, whether it be fraud or otherwise. 395 U.S. at 339.
4 It is the seizure of wages before notice and hearing that violates due process. Justice Harlan wrote in his concurrence in Sniadach that “due process is afforded only by the kinds of ‘notice’ and ‘hearing’ which are aimed at establishing the validity, at least the justiciable validity, of the underlying claim against the alleged debtor before he can be deprived of his property or its unrestricted use.” 395 U.S. at 343 (Harlan, J., concurring) (emphasis in original).
5 Additionaly, the court considered the nature of the seized property and, in a passage that applies with equal force to wage assignments, wrote: A debtor deals here with a unique type of property presenting distinct problems in our economic system . . . . A prejudgment garnishment . . . is a taking which may impose tremendous hardship on wage earners with families to support. 395 U.S. at 340.
6 But see, e.g., Postmaster’s Application, 23 Pa. D. 588 1970; Interstate Products, Superior Court of Pennsylvania wage assignment statute held to violate state constitution.
7 The Postmaster’s Application referred to wage assignments, not to prejudgment garnishment.
9 See supra Part II.
10 Presiding Officer’s Report at 115. For an example of a typical wage assignment, see Gwyenth D. Gillingham, Legal Aid Society of Kent County, R-f-1(c)-8 at Exh. B.
presented with challenges to wage assignments, courts generally have not found sufficient state action in the assignment to trigger the due process protection of the fourteenth amendment; thus courts have not reached the merits of challenges based on constitutional claims. Some wage assignments are used as a means of making regular payments on a debt prior to delinquency rather than as a collection remedy. These wage assignments are essentially voluntary payroll deductions, and are used most frequently by credit unions and other creditors closely associated with the employer. This record does not indicate that payroll deduction wage assignments cause consumer injury; we therefore have therefore exempted such assignments from the rule. Similarly, preauthorized electronic fund transfers to accounts from wages may be considered to be wage assignments, but they are used as methods of payment rather than as a collection remedy. Thus, they are exempted from the rule because this rulemaking record does not show that they cause consumer injury.

B. State Law

Wage assignments are prohibited in the Uniform Consumer Credit Code States, several other states, and in the District of Columbia. A substantial majority of the remaining states have imposed restrictions on the use of wage assignments. Some of the more common restrictions are: a time limit for the assignment, a requirement that the employer or a spouse consent to the assignment, and an absolute prohibition of assignment in certain kinds of transactions. In addition, some states require that the wage assignment be on a separate document, and some allow the debtor to contest a wage assignment by informing the employer that he or she has a defense. Some states have enacted a limitation (generally 15 percent or 25 percent of the amount of weekly or monthly wages that may be assigned. State provisions are inconsistent, however, and do not always offer adequate protection.


12. E.g., wage assignments prohibited in small
Federal statutory limitations on wage garnishment do not apply to wage assignments. Thus, unless there is a state statutory limitation, creditors are restricted only by the terms of the wage assignment.

C. Prevalence

The rulemaking record shows that wage assignments are used primarily by small loan and finance companies, and most heavily in California, Illinois, Michigan, and New York. The National Consumer Finance Association (NCFA) reported that wage assignments were included in approximately 13 percent of the small loan contracts

surveyed and in approximately 6 percent of purchased sales finance contracts held by surveyed companies. Some record evidence suggests, however, that the percentage of contracts with wage assignments may be significantly higher than the NCFA survey shows. For example, the Secretary of the state of New York State Consumer Finance Association testified that in 1975, wage assignments were included in 73.2 percent of loans made by licensed New York lenders. Wage assignments may be obtained from co-signers and spouses as well as from the principal debtor, and are commonly used with other forms of security. In states that permit wage assignments, consumers cannot reasonably shop around for a contract of wage assignments are actually filed with employers.

Wage assignments in the form of payroll deduction plans are used frequently by state and federal credit unions. As discussed below, payroll deductions are excepted from the wage assignment prohibition in the rules. In sum, the use of and restrictions on wage assignments vary considerably from state to state. Overall, the record shows that wage assignments are used in a significant number of consumer transactions, and they are prevalent in states where they are permitted.

D. Consumer Injury

The preponderance of record evidence establishes that consumers suffer substantial injury when wage assignments are used as a collection device. Wage assignment, unlike garnishment, occurs without the procedural safeguards of a hearing and an opportunity to assert defenses or counterclaims. The use of wage assignments causes interference with employment relationships, pressure from threats to file wage assignments with employers, and disruption of family finances. Wage assignments are particularly harmful because they cause injury to consumers who may have valid reasons for nonpayment.

California permits only the assignment of wages already earned, so that statistics for California are not comparable for figures for other states.


The NCFA reported results on a national basis without providing a state by state breakdown. In addition, in the personal loan area, firms were directed to answer "yes" to the relevant question only if they included wage assignments in "substantially all of your personal loans." Id. at 217. The results of the NCFA survey were as follows:

<table>
<thead>
<tr>
<th>State</th>
<th>Small loans (per cent)</th>
<th>Wage assignments (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>32</td>
<td>55</td>
</tr>
<tr>
<td>Illinois</td>
<td>60</td>
<td>58</td>
</tr>
<tr>
<td>Michigan</td>
<td>58</td>
<td>56</td>
</tr>
<tr>
<td>New York</td>
<td>60</td>
<td>53</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Finance companies</th>
<th>15 percent (personal loans)</th>
<th>1-2 percent (indirect paper)</th>
<th>3-4 percent (depending on nature of the transaction and size of bank)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retailers</td>
<td>3 percent (revolving credit)</td>
<td>1 percent (installment credit)</td>
<td></td>
</tr>
</tbody>
</table>

Id. at 64-65.

4. The rulemaking record shows that wage assignments have also been used in, among other states, New Jersey, Florida, and Virginia. Xi-153 at 38-40. The record also indicates that wage assignments are used, albeit to a lesser extent, by creditors other than small loan and finance companies. Eugene Throld, Treasurer and Managing Director of Lincoln Legal Assistance Foundation, Tr. 3380 (retailers sometimes use wage assignments); Daniel Hodges, Appalachian Community and Defense Fund, Tr. 11358 (company stores use wage assignments).

5. The NCFA survey, supra note 28 at 11-40, citing New York State Banking Department statistics.

6. See, e.g., finance company consumer files R-XI-LIB 345; R-XI-LIB 356; R-XI-LIB 368; R-XI-BEN 13; testimony of Robert Shai, Bank of America, Consumer Finance Corporation, Tr. 5402, and Michael Nelson, Legal Aid and Defender Association of Kent County, Tr. 4615.

7. See finance company consumer files R-XI-CIT 215; R-XI-CIT 217; R-XI-BEN 102; R-XI-BEN 90; R-XI-BEN 92; R-XI-BEN 43; R-XI-BEN 190.

The NCFA survey determined whether finance company loan contracts were secured or unsecured. The questionnaire treated loans secured by only a wage assignment as secured. Id. at 217. (questionnaire). Illinois finance companies reported only 121 secured loans, but 396 loans with wage assignments. Thus, even if we assume that all unsecured loans are subject to wage assignments, a substantial number of reported wage assignment loans were also secured by other property. The same was true in Michigan, where finance companies reported 111 unsecured loans and 269 wage assignment loans, and in New York, where
Additionally and importantly, the record shows that debtors are not aware of the rights provided to them by state law. In Illinois, for example, upon default the creditor must inform the debtor of the right to notify the employer and the creditor of any defense. The creditor must then attest the wage assignment by serving a notarized "notice of defense" to the creditor by registered or certified mail. Although designed to be protective, the statutory scheme does not accomplish its purpose because debtors do not understand the defense and therefore do not know if they have one. As a consequence, despite the existence of state statutes, many wage assignments result in collection by creditors even when there has been a breach of warranty, fraud, or other violation of law that may constitute a defense to payment.

The rulemaking record establishes that wage assignments cause serious and detrimental interference with employment relationships. Employers are hostile to wage assignments, and loss of employment for the debtor is possible. Promotions, pay raises, job assignments, and other employment factors may be adversely affected. Employers resent the added administrative expense of wage assignments, fear that the employee's job motivation will be affected, and view the failure to repay debts as a sign of irresponsibility. The Consumer Credit Protection Act prohibits an employer from dismissing an employee whose wages are garnished for any one indebtedness, but the Act does not apply to wage assignments.

During the proceeding, some creditors argued that state laws adequately protect against consumer injury and make the wage assignment prohibition unnecessary. For example, New York and Illinois prohibit employers from dismissing or suspending employees because of wage assignments. Although there is evidence that these statutes reduce job loss to some extent, the protection offered by state law is limited and the record shows that a number of factors reduce the effectiveness of state protections. For example, in New York reinstatement is discretionary with the court; in Illinois no statutory damages are provided.

Wage assignments also cause serious consumer injury when used as a threat to obtain payment. The pressure from these threats may cause consumers to abandon legitimate defenses to prevent the creditors from contacting the employers. Consumers fear that the wage assignment will result in job loss, and the record indicates that creditors exploit that fear despite the fact that job loss would be economically counterproductive to the creditor. State wage assignment statutes do not offer protection from this type of injury. Most threats are made before the wage assignment is filed, but state statutes usually govern only procedural and post-filing rights.

Wage assignments also cause disruption of the family's finances and make it difficult for the debtor to purchase necessities. This disruption can result in costly refinancing or the imposition of unnecessary obligations in a timely fashion.

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44 The Presiding Officer found that "wage assignment is the contractual equivalent of garnishment except that it permits the seizure of wages without the opportunity for a hearing or an impartial determination of whether or not, under the circumstances, the creditor is entitled to receive payment of those wages." Presiding Officer's Report at 124.

45 See Presiding Officer's Report at 124; Eugene Thrill, Land of Lincoln Legal Assistance Foundation, Tr. 3386-37; Jerrold Oppenheim, Legal Assistance Foundation of Chicago, Tr. 2343-44; Karl R. Flockston, Family Counseling Service of Aurora, Tr. 4647; James Baker, Onondaga Neighborhood Legal Services, Tr. 10783-84.


47 Jerrold Oppenheim, Legal Assistance Foundation of Chicago, Tr. 2344-44.

48 See, e.g., William Ballenger, Michigan Department of Licensing and Regulation, Tr. 8178; Jerrold Oppenheim, Long Island Legal Assistance Foundation of Chicago, Post-Record Comments XV-252 at 5-7; James Baker, Onondaga Legal Services, Tr. 10783-83.

49 In an early study of wage assignments in Chicago, the authors found that 40 percent of the 422 wage assignments investigated by the Legal Aid Bureau of Chicago were legally unenforceable.
In the absence of procedural safeguards, the potential for severe, substantial disruption of employment, the presence of threats to file wage assignments, and the disruption of family finances constitute significant consumer injury. State law is inconsistent and does not offer sufficient protection to prevent this consumer injury.

E. Offsetting Benefits

Commenters who opposed the wage assignment prohibition submitted that wage assignments are important for borrowers who are bad credit risks or who have no other type of security. And that wage assignments keep collection costs down. Other commenters, usually credit unions, maintained that payroll deduction wage assignments are used for the convenience of borrowers and that they reduce handling costs. A few commenters emphasized that instead of a prohibition against wage assignments, employers be against employers who discharge employees because of wage assignments.

The Presiding Officer discussed the importance of wage assignments to borrowers who are bad credit risks or whose paycheck is their only asset. Creditors frequently consider wage assignments to be a form of security analogous to collateral. In states that statutorily limit the amount of an unsecured loan that can be made by a creditor, a wage assignment may be sufficient security to avoid such limitations.12 This wage assignment may allow consumers with no other collateral to obtain a secured loan. Record evidence indicates, however, that in a substantial number of loans secured by wage assignments, other security was also provided.13

Furthermore, in almost every state, garnishment is available as an alternative method of collection.14 Considering that garnishment includes procedural protections not required in wage assignments,15 the benefit of wage assignments is considerably diminished.

Creditors favoring wage assignments argued that they save the cost of going to court.16 That argument does not, however, justify irrevocable wage assignments. In an undisputed case, court costs will be moderate. Although costs are greater in a disputed case, the costs are justified because it is precisely when the debtor has a defense that a court hearing is most valuable. With a wage assignment that is revocable at the will of the debtor, the creditor can choose either to save court costs by allowing the assignment or to revoke the assignment and raise defenses. Even if the debtor does not prevail, he or she will still have the statutory garnishment protections that apply to collection of a judgment.17

Credit unions maintained that wage assignments benefit consumers because they are an important method of keeping transaction costs down.18 If a wage assignment is essentially a payroll deduction payment plan, the benefits outweigh the costs because the potential for the type of injury that this rule seeks to prevent is nonexistent.

The evidence, therefore, supports our finding that consumer and competition do not receive countervailing benefits sufficient to offset consumer injury caused by the use of wage assignments unless the wage assignment is revocable at the will of the debtor or is a payroll deduction plan. Commenters considered that the loss, or fear of loss, of job and the deprivation of procedural protections do not justify the limited usefulness of this remedy.19

Furthermore, existing patterns and practices make clear that banning wage assignments will have little impact on the business of creditors other than those that do not finance companies. Banks and retail trade associations submitted that the rule provision on wage assignments would have little impact on their business.20

There is evidence that a ban on wage assignments will have no effect on the aggregate volume of credit extended,21 but that a ban may lead to an increase in the rejection rate of finance company applications.22 A study of the cost effects of wage assignment restrictions found no statistically significant effects from the restrictions,23 but there is some evidence predicting that a prohibition would affect consumers from whom a

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12 Respondents to the NCLC survey, supra note 38, estimated that the use of wage assignments results in delinquency on other debts 53 percent of the time. HX-468 (question K001H), and results in costly refinancing over one-third of the time. HX-468 (question K009N).


14 See Presiding Officer's Report at 123, citing George H. Brassac, Committees of Consumer Credit, American Bar Association, R-[ii]-[ii]-[ii]-79 at 7; James A. White, Council of State Credit Institutes, HX-401 at 7; Arthur H. Northrup, Indiana Consumer Finance Association, Tr. 3138; Alfred E. Orin, New York State Consumer Finance Association, Tr. 11401.

15 Tilman R. Thomas, Jr., Government Employees Credit Union, Tr. 836-93; Calvin Phillips, Texas Credit Union League, Tr. 562-66; T. J. Ryan, Albuquerque Bell Federal Credit Union, R-[ii]-[ii]-[ii]-7; Steven Kriger, Black Hills Federal Credit Union, R-[ii]-[ii]-[ii]-63; Herman Nickerson, National Credit Union Administration, R-[i]-[i]-[i]-[ii]-7; Jonathan Kindley, Credit Union National Association, R-[i]-[i]-[i]-[ii]-78; William Waysman, Northrup Credit Union, R-[i]-[i]-[i]-[ii]-127; Austin Montgomery, National Credit Union Administration, R-[i]-[i]-[i]-[i]-118; Joan Morn, California Credit Union, R-[i]-[i]-[i]-[i]-78; David White, National Association of Federal Credit Unions, HX-459.

16 See, e.g., Hawaii Credit Union League, Post-Record Comments XV-272; National Association of Consumer Credit Finance Association, Post-Record Comments XV-343 at 132.

17 See supra note 123. See also supra note 53.

18 See supra note 38.

19 See, e.g., Alfred Orin, New York State Consumer Finance Corporation, Tr. 11400-01; Betty Gregg, Credit Union National Association, Inc., Tr. 4002; Consumer file CFT 215 (ledger card with box labeled "secured" filed in "LIFE A&H H12 2WA", meaning that the loan is secured by life and accident and health insurance, household goods, and two wage assignments). See also Harold T. Welsh, Illinois Credit Union League, Tr. 4006-95.

20 Presiding Officer's Report at 122 & n. 37 citing Merle Jewell, Boeing Employees' Credit Union, Tr. 1005-12 (discussing state statutory limitations on unsecured loans by credit unions). See also Harold T. Welsh, Id. at 4006.

21 See supra note 38.

22 Virtually every state has statutory provisions governing garnishment. See CCH Consumer Credit Guide 4000 for an overview of state garnishment statutes.

23 See Prejudgment garnishment is unconstitutional. See supra text accompanying notes 4-7.

24 E.g., Leonard Cohen, Independent Finance Association of Illinois, R-[i]-[i]-[i]-107, Joseph Park, Michigan Consumer Finance Association, Tr. 3188; David Frederickson, Airline Pilots Association Federal Credit Union, R-[i]-[i]-[i]-3; Michael Brown, United Auto Dealers Association, Tr. 2798. See also supra note 98.

25 See supra note 28. The statutory protections will also apply if the debtor allows a default judgment.

26 "G.," Betty Gregg, Credit Union National Association, HX-387; But see Eugene Thrill, Land Title Legal Assistance Foundation, HX-128 and Tr. 3579 (discussing need to assure true voluntariness).

27 With a payroll deduction, the employer is a part of the plan from the beginning of the transaction. Thus, there is no likelihood that the wage assignment will disrupt employment, and threats to file a wage assignment would be meaningless.

28 Presiding Officer's Report at 125, citing Deborah S. Oseran, Assistant Attorney General, Arizona, Tr. 1035; William B. Saller, III, Director, Michigan State Department of Licensing and Regulation, Tr. 8178; and Thomas Credland, Associate Professor of Law, Gonzaga University School of Law, Tr. 10856.

29 James Goldberg, American Retail Federation, Tr. 8115-19 (provision "will have absolutely no effect on the vast majority of retailers."); K. E. Buhmester, New York State Banks Association, R-[i]-[i]-[i]-200 ("The prohibition against wage assignments, while contrary to specific New York statutes, is not repugnant to banks since they generally do not use wage assignments."). An American Bankers Association spokesperson discussed peripheral issues concerning wage assignments but did not argue that they are important to keep a collection device. William Gwennap, American Bankers Association, Tr. 12195-200.

30 Also, at al., Federal Trade Commission Proposal for Credit Card Co-Signing and the Availability of Consumer Credit, HX-10-10 at 83.

31 NCCF Technical Studies, Vol. V, supra note 28 at 131-40. But see Abo, id. at 86-101 for a criticism of the survey from which this conclusion is taken.
wage assignment is required to secure a loan. In addition to formal studies of this issue, there is substantial evidence that wage assignments have been of limited importance. With minor exceptions, the record does not show that finance companies or other creditors do business in a different way, or serve a different clientele, in states that do and do not permit wage assignments. The prohibiting wage assignments will not significantly affect the credit market.

The Presiding Officer found that "so long as the remedy of garnishment is available, creditors could extend credit to the class of consumers from whom a wage assignment is ordinarily required without suffering an undue increase in costs." In fact, there is evidence that wage assignments do not provide a significant savings in legal costs. The record also shows cases where creditors had wage assignments but chose to sue and then garnish the debtor's wages. The fact that creditors voluntarily elect to forego use of wage assignments even when they have them is a strong indication of limited utility.

The Presiding Officer concluded that prohibiting wage assignments "would be of economic benefit to low-income or poor consumers, since it would no longer be possible to use this device as a means for interjecting the creditor into the employer-employee relationship without court action." The preponderance of evidence establishes that the marginal benefit of irrecoverable wage assignments to creditors is limited.

especially with the availability of garnishment as an alternative remedy, and that any effect of banning wage assignments on overall credit availability will be small.  

F. Alternatives Considered and Modifications Adopted

The initial proposed rule would have banned wage assignments entirely. Based on the record, we have made four modifications to the promulgated rule. First, the rule will not apply to wage assignments that by their terms are revocable at the will of the debtor. Second, the rule does not prohibit payroll deduction plans or similar preauthorized payment plans commencing at the time of the transaction in which the consumer authorizes a series of deductions as a method of making each payment. Third, the rule will not apply to wages already earned at the time of the assignment. Fourth, a definition of the term "earnings" is added to the Uniform Consumer Credit Code and added to the proposed rule to clarify its coverage.

The first change is designed to allow consumers to enter into noninjurious revocable wage assignments to minimize transaction costs. To fit within this exception the wage assignment must be revocable by its terms; therefore the wage assignment itself must include language that establishes revocability. The wage assignment also must be revocable at the will of the debtor. This will allow the debtor to stop the wage assignment before injury occurs.

The second change is designed to permit creditors and other employers to use voluntary payroll deduction plans as a repayment device, and to clarify that the rule does not prohibit preauthorized electronic fund transfers. The exception for payroll deduction plans is consistent with the intent of the rule and with the record evidence. The rule is intended to address collection remedies, but a payroll deduction plan is a method of making payments on an obligation. Thus, consumer injury does not result from its use. The record contains substantial support for an exception to the rule for payroll deductions. Some commenters recommended that a definition of wage assignment be included in the rule to clarify that payroll deductions are not affected; we accomplish the same result by the exception we promulgate.

The third change is intended to eliminate a problem in California where certain creditors must take assignments of earned wages or a security interest in personal property to qualify for higher loan interest rates. Small loan companies take assignments of earned wages to qualify as personal property brokers under the state law.

Some legal aid agencies opposed this exemption on the grounds that: (1) Earned wages are part of a low income debtor's subsistence, and (2) debtors have no bargaining power over the terms of wage assignments. We find


For a description of a credit union payroll deduction plan, see Merle B. Jewell, Boeing Employees Credit Union, Tr. 10909.

See supra note 76 and discussion of consumer injury, supra Section B.

See supra note 67. Some credit union policies require a wage assignment to be irrecoverable if the assignment is to constitute security for a loan. Merle B. Jewell, Boeing Employees Credit Union, Tr. 10909; Post-Record Comment XV-101. See also Hawaii Credit Union League, Post-Record Comment XV-172. Both recoverable and irrecoverable payroll deductions are permitted under this rule.


The Constitution of California establishes an interest ceiling of 10 percent but exceptions from the

Continued
that the record demonstrates that consumer injury from assignment of earned wages is minimal, and outweighed by offsets benefits to consumers or competition.

We have also added the U.C.C.C.'s definition of 'earnings' to the initial proposed rule to clarify the types of income to which the provision applies. This responds to industry suggestions that such a definition will facilitate compliance and add certainty to the rule.**

The National Commission on Consumer Finance recommended a ban on wage assignments for credit transactions involving over $300. It advised allowing assignments for transactions of $300 or less, but only for otherwise unsecured loans, and only on the condition that the assignment not exceed the lesser of: (1) 25 percent of the debtor's disposable earnings for any workweek, or (2) the amount by which his or her disposable earnings for the workweek exceed 40 times the federal minimum hourly wage prescribed by section 6(a)(1) of the Fair Labor Standards Act of 1938 in effect at the time.*** The Commission considered this approach, but we rejected it because the record shows that the injury caused by the use of wage assignments bears no relation to the size of the loan.*** Use of an irrevocable wage assignment in small as well as large loans could result in interference with employment, injuries pressure from threats to file the assignment, and disruption of family finances, all without a hearing and an opportunity to assert defenses.

VI. Security Interests in Household Goods

A. Introduction

In return for the credit they receive consumers are often required to give their creditors a security interest in the property they own at the time credit is extended or may obtain after the credit transaction is consummated. Although creditors have made secured loans since the beginning of recorded history, the use of non-possessory liens on personal property is a comparatively recent development. Non-possessory security interests were not recognized at common law. Since the beginning of this century, however, loans secured by non-possessory liens on debtor's household goods and personal effects have become increasingly common.

Specifically addressed by this rule provision is a lien on a consumer's household goods taken in connection with a loan. The security interest in household goods gives rise to a right to seize property from a consumer, with the potential of inflicting a substantial forfeiture on the consumer. The rule at Section 9(a) prohibits the use of security interests in household goods, as defined, in non-purchase money transactions, while permitting the pledge of certain possessions that creditors regard as valuable collateral.

B. State Law

Security interests are creatures of statute, inasmuch as non-possessory liens were not recognized at common law. Prior to the adoption of the Uniform Commercial Code (U.C.C.), a variety of different "security interests" were created by a variety of different statutes. The U.C.C. eliminated all distinctions between security devices that preexisted it, distinguishing only between purchase money security interests and other interests. It accumulated all remedies available to secured creditors and reduced to a minimum the procedural formalities necessary to create a security interest.

Today, Article 9 of the U.C.C. is the predominant law governing uses of security interests in consumer transactions. Article 9 affords creditors with maximum flexibility as to the terms contained in security interests, including coverage, description of property, and circumstances under which seizure may take place. The description of property required is minimal. Creditors can often retain a security interest in all of a debtor's "household goods" by simply checking a box on a standard form.

Statutory limitations on a creditor's capacity to secure a consumer obligation fall into three categories. The first consists of statutes regulating installment sale transactions where seller and initial creditor are the same entity. Most states have enacted statutes restricting installment sellers to a lien on goods sold. In a few states additional limitations have been imposed on direct lenders. Thus, most

We address the question of what happens to an existing purchase money security interest when the loan is refinanced or consolidated infra at note 97.

A. General

The collapse of the housing market has caused many homeowners to default on their mortgage loans. When a mortgagor defaults on the payment of a mortgage loan, the mortgage lender is entitled to foreclose on the security interest granted by the mortgagor. The U.C.C. provides that a creditor may foreclose his lien in accordance with a two-step confession of judgment process. The creditor files a confession of judgment, and the court enters judgment in favor of the creditor. The judgment is then recorded in the applicable state records. If the judgment is not satisfied, the creditor may then proceed to foreclose his lien in accordance with the procedures provided by state law. The U.C.C. does not provide for the taking of a security interest in real property except in connection with the taking of a security interest in personal property.

The U.C.C. does not provide for the taking of a security interest in real property except in connection with the taking of a security interest in personal property. A security interest in real property is not secured by the U.C.C. unless it is expressly created by statute.

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statutory limitations do not address the problem of non-purchase money security interests in household goods in consumer loan transactions, despite a predisposition to limit purchase money creditors to a lien on the goods in credit sales.

C. Prevalence

Based on the rulemaking record, we find that the practice of securing consumer loans with a non purchase money security interest in household goods (HHG) is widespread. Finance companies are the preeminent users, and HHG security interests are found in a majority of finance company loan contracts. However, banks also avail themselves of such security as do credit unions and even, occasionally, savings and loan associations. Although retail installment sales acts tend to restrict retailers to a purchase

money lien on the goods sold, the record also reveals that certain retailers rely on HHG security interests as additional collateral in credit sale transactions.

An HHG security interest may be created by checking a box appearing in the text of a standard form agreement. In such cases the description of covered property is cast only in general terms giving consumers little notice of the nature and extent of the collateral they are pledging to secure the loan. Consumers may thus be unaware, in a given instance, of what is subject to a security interest. Under current interpretations of Article Nine of the U.C.C., the simple inclusion of the term "household goods" is sufficient to encumber all of the personal property owned by the consumer.

On the other hand, there is evidence on the record that many finance companies do list security by preparing an inventory of all of a consumer's household property, sometimes by asking consumers to give a list of the covered items either orally or in writing when the loan papers are filled out. In these cases, and certainly where the consumer gives the inventory, there should be little question either that a security interest has been given or as to the scope of its coverage.

The majority of HHG security interests are taken in connection with extensions of credit made under small loan acts where the amount financed is limited, with the limit generally being between 1200 and 1500 dollars, but HHG security interests are frequently taken to secure smaller extensions of credit. In this connection, HHG security is employed by finance companies which are licensed to lend more than 300 dollars.

The record reflects instances where cosigners as well as the primary debtor pledge all of their household goods when they guarantee the loan of another.

State regulators and officials generally confirmed the widespread use of HHG in the market for HHG security interests in consumer transactions, as did legal services attorneys who appeared in the hearings. Thus, the record strongly supports our finding that the use of HHG security interests is frequent and widespread.

D. Consumer Injury

This record reflects the fact that household goods typically have little economic value in the resale market.

The value of security in the second hand market in most cases is much less than the consumer owns. It would be the exception rather than the rule. Thus, the record strongly supports our finding that the use of HHG security interests is frequent and widespread.

343 at 77; see also Post-Record Comments XV-298, 283, 301 and 342 at 287.

335. The median extension of credit reflected in the NCFA survey for all of the consumer loans surveyed was $1,231.00 for precomputed loans and $1,480.00 for per diem loans. Hx-404.

336. All of the debtors' household goods secure the loan in R-BEN-154 ($275,000 loan); R-GFC-329 ($332,000 loan); R-BEN-152 ($242,000 loan); R-LIB-209 ($106,000 loan); R-GFC-307 ($800,000 loan); R-GFC-146 ($246,000 loan); R-GFC-154 ($84,000 loan); R-AVC-467 ($277,000 loan); R-LIB-33 ($280 loan) and R-GFC-59 ($212,000 loan).

337. James White, Council of State Credit Institutes (trade association for lenders of amounts less than 300 dollars). Tr. 11152.

338. E.g., Hyman Weiner, Atlanta Finance Co. Tr. 6488, R-DIAL-156.

339. E.g., Merwyn Dymally, Lieutenant Governor of California, Tr. 6515; Thomas Huston, Superintendent of Banking, Iowa, Hx-87 p. 48; Irwin Parker, Administrator, Consumer Affairs, South Carolina, Tr. 552; Senator Alan Suman, West Virginia, Tr. 4977-78.

340. E.g., Kathleen Keast, Black Hawk County Legal Aid, Tr. 628; David Terry, Legal Services of Nashville, R-(c)-36; Robert Atkinson, Legal Aid of

Continued
We lend more than the furniture is worth. In this proceeding, a large majority of industry witnesses confirmed that household goods have little, if any, economic value to creditors. Their value to creditors is psychological, as noted in the testimony of Helmut Schmidt, Vice Chairman of Transamerica Financial Corporation:

> There are two very, very important values to the furniture. One is the replacement value. The other is psychological, that may enhance sentimental values in heirlooms being provided and the negative of price, the loss thereof if a repossession takes place, etc. Cetera. I couldn't possibly say whether replacement value or pride is the more important.

The record reflects the fact that creditors rarely engage in actual repossession of household goods. When it does occur, the furniture and other items seized frequently have little or no economic value; occasionally, the act of seizure appears to be undertaken for punitive or psychological deterrent effect.

Although seizure of household goods is rare, when it occurs it can have severe economic consequences. It may occur in the context of divorce, where a wife finds herself financially devastated and deprived of her personal belongings, or without baby furniture, or a refrigerator. Repossessed furniture may be taken to the dump or auctioned for a tiny fraction of its replacement value. For the debtor, the replacement value is a true measure of the cost of the repossession. Thus seizure often imposes a hardship on the consumer which is seriously disproportionate to any benefit the creditor obtains.

In the context of seizure the disproportionate economic impact of non-purchase money security interests is most apparent. Debtors lose property which is of great value to them and little value to the creditor. The value to debtors consists primarily of the replacement cost of the goods seized, together with psychological and emotional value. The debtor, in an economic sense, willing to pay more for the household goods than they are ever worth to the creditor on the resale market. Although creditors are entitled to payment, such security interests offer little economic return to creditors at great cost to the debtor.

**Q. Did you ever have to junk it?**

- **A. Yes.**

**Q. You have to junk some of it?**

- **A. Yes, and do you know why, are you interested?**

**Q. Certainly.**

- **A. Let me pose this as a hypothetical case—it is not hypothetical, it is actual. You have a number of families in one area who will be borrowing from you. If this fellow continues to go down the drain and continues to ignore his obligation and you try every avenue in the world to get him to pay and he is laughing at you and saying—**

**Q. You want to make an example of him for other people?**

- **A. Not necessarily an example. But if you don't you are going to charge off the whole block.**

Carl Woodman, North Carolina Consumer Finance Association, Tr. 10258. The maintenance of credibility was offered as a reason for repossession by other witnesses; e.g., Michael Burns, Legal Aid Society of Minnesota, R-4(c)-98.

Robert Atkinson, Consumer Unit, Legal Aid Service of Portland, Tr. 5918 (woman on public assistance loses furniture).

When consumers run into difficulty, the non-purchase money security interest in household goods also enables a creditor to threaten the loss of all personal property located in the home. This psychological lever, referred to over and over again in this proceeding, together with the cost to the consumer of regaining the security, gives this remedy its value to the creditor.

The preponderance of evidence on the record supports our finding that despite the limited economic value of household goods, creditors rely on the psychological lever to seek payment and to persuade consumers to take other actions the creditors may deem appropriate, such as refinancing or obtaining a cosigner.

If in your discussion with the applicant you find that certain articles have a sentimental value because of the fact that they are family heirlooms or gifts, make a note of this on your appraisal for future use. In this connection, the National Consumer Law Center found that legal aid attorneys considered non-purchase money security interests the single most common basis for threats and harassment of consumers of all the creditors remedies surveyed. The findings of the NCLC survey are borne out by the testimony received in this proceeding.

The consumer files on this record drawn from the offices of major consumer finance companies contain further examples of threats to seize household goods. Such use of psychological security is recorded on the backs of ledger cards which detail the collection contacts engaged by the creditor, and in correspondence appearing in the consumer files.

**Threats may be direct or indirect; they may be made to third parties as well as the principal debtor.**

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**E.g., Earlie Nelson, California Department of Corporations, Tr. 5035; Lawrence Mealer, Dallas Legal Services, Tr. 371-77; Edmund Leong, Hawaii Consumer Affairs Association, Tr. 5413; James Sullivan, Department of Consumer Affairs, Missouri, Tr. 65-98.**

**R-L-5 at 4 (Household Goods—Estimated List, Outside Lookup and Appraisal, New Business #39).**


**E.g., Drew Johnson, Lane County Legal Aid, Tr. 639.**

A clear majority of creditors believe that when the client is in default there is a threat to repossession household goods. **See infra note 51.**

**E.g., R-DIAL-10B: R-BEN-68 (‘‘Work HHG on wife’’); R-GFC-507; R-AVCO-142; R-AVCO-63 (threats to take furniture from welfare family with eight children); R-GFC-467.**

**E.g., R-DIAL-18T: R-ASSOC-62; R-DIAL-108; R-GT-316; R-TA-8; R-DF-1 at 16.**

**See e.g., R-X-185 (Beneficial Finance Company contacted the son of the debtors and***
Certain witnesses testified that such threats were never made. Although the Commission recognizes that certain individual creditors may refrain from threatening to seize household goods, the preponderance of evidence supports a conclusion that such threats are commonplace.

A threat to seize family possessions from the home of a consumer is psychologically debilitating and disruptive. This record demonstrates that such threats are made frequently, and that they are harmful in themselves. In reconditioning that household goods security interests be prohibited, the National Commission on Consumer Finance (NCCF), based on its comprehensive survey of the credit industry, found as follows:

A creditor should not be allowed to take other than a purchase money security interest in household goods.

A creditor should avoid taking a security interest in goods which form the basis of the transaction, but security interests in household goods should not be allowed in any loan or consoliation transaction if the goods were not acquired by the use of that credit. In the event of default, such security interest in household goods and the accompanying right to repossess or threat to repossess such goods have far too disruptive an impact on the family life of the debtor to be in the public interest.

Our view of the record supports our finding on the disruptive and harmful impact of threats to seize household goods. Because the economic stress to the consumer inherent in the seizure of household goods is so large, the threat to seize is correspondingly substantial. Legal services witnesses and others who appeared and commented in the proceeding offered first-hand experience of the harmful impact of creditor threats to seize furniture and personal possessions.

Assistance Foundation, R-1(-19); Martha Elmer, Puget Sound Legal Assistance, Tr. 6038 ("the sheriff will come with us tonight to get the goods.")..

E.g., Clare Rollwagen, Minnesota Consumer Finance Conference, Tr. 3692; Clarence Bleser, Wisconsin Finance Corporation, Tr. 3478; Don Pratt, Hometown Finance Company, Tr. 3101; Kenneth Davis, Key West, Tr. 1547.

E.g., Martha Elmer, Puget Sound Legal Assistance Foundation, Tr. 6039-40; Drew Johnson, Lane County Legal Aid Service, Inc., Tr. 6514-17; Mary Ellen Feely, Legal Aid Services, Inc., Tr. 7344-45; Lane of Lincoln Legal Assistance Foundation, R-1(-19), Case Histories A-C; Legal Aid Society of Metropolitan Denver, R-1(-45), Case History; Mildred F. and Laurie F.; Bexar County Legal Aid Association, R-1(-76) at 2; Robert H., Gann, Legal Aid Society of Mecklenburg County, Tr. 1544; Case History: Glenda J.


E.g., Tucker Trautman, Colorado Department of Law, Tr. 6477; John F. Robert, Louisiana Consumers League, Tr. 1700; George Wallace, University of Iowa Law School, Tr. 11026; Roberty Lohert.

However, the psychological impact of such threats does not define or exhaust the injury they occasion. It is important to acknowledge, as a general proposition, the position in which consumers find themselves when creditors have a lien on personal possessions. Debtors who are in default and on the verge of having their personal possessions seized are under considerable pressure to make repayment arrangements acceptable to the lender who is threatening repossession. To avoid the greater loss of repossession, such consumers are likely willing to take other steps they would not willingly take but for the security interest. Accordingly, such creditors are in a prime position to urge debtors to take steps which may worsen their financial circumstances.

Such steps may include agreements to refinance debts, and diversion of funds needed for other obligations to pay the creditor holding the security interest. Because of the perceived inequity of repossession, debtors may also forego the assertion of valid or meritorious defenses in their rush to complete acceptable repayment agreements.

Actions such as these are not necessarily harmful in and of themselves, nor are they harmful to consumers in all instances. In other situations, the Commission believes consumers will take such actions only if they are in the consumer's self-interest. Faced with the greater loss of a threatened repossession, however, consumers will willingly take steps that avoid immediate repossession, but otherwise worsen the consumer's situation. Faced with a security interest in HFCs, consumers may endure lesser injuries to avoid the greater injury of repossession. Because of the security interest, these injuries cannot reasonably be avoided.

The rulemaking record reflects the fact that threats to seize household goods frequently accompany efforts to compel debtors to agree to refinancings of overdue obligations. A refinancing

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may reduce or defer scheduled monthly payments, but it does so by increasing the overall amount a debtor owes. Although refinancing is appropriate in some instances, it is against the debtor's economic interest in others.48

Threats to seize personal possessions may also lead to payment of the secured creditor's loan in preference to other, perhaps more immediate needs or obligations.49 Fear that creditors will make good their threats to seize personal possessions if debtors do not promptly enter into new repayment agreements may also lead consumers to withhold assertion of legitimate counterclaims or set-offs.49

In the Commission's opinion, the use of blanket security interests to exact an overextended or unemployed consumer to make a decision which may lead to increased financial difficulties has many of the attributes of economic duress.44 Threats to seize the personal possessions of a consumer and his or her family clearly meet many of the criteria for economic duress, especially given the dire financial circumstances in which the consumer finds himself.46 Although the Commission has premised its findings regarding the unfairness of threats to seize household goods on the resulting psychological and economic injury to consumers, as demonstrated by information contained in the rulemaking

Assistance Foundation, Tr. 3364; Carl Woxman, North Carolina Consumer Finance Association, Tr. 10276-257.

46 Id. See also, e.g., Drew Johnson, Lane County Legal Aid, Tr. 8355-67; Lois Wood, Land of Lincoln Legal Assistance Foundation, R-I[ ]-17, Terrace Terracchi, San Mateo Legal Aid, Tr. 7002; Kenneth Levinson, Atlanta Legal Aid Society, HX-330 at 11; David Dubhn, North Louisiana Legal Assistance, Tr. 1460-1; Stephen Hewitt, Lane County Legal Aid, R-II[ ]-251; James Kocher, Lane County Legal Aid, Tr. 8377.

47 See, e.g., Stephen Hewitt, Lane County Legal Aid, R-II[ ]-251 (debtors will give up food and clothing to keep household necessities).

48 James Boyle, Texas Consumer Association, Tr. 28; John Paer, Legal Aid of Hawaii, Tr. 5544; Allison Stiner, Central Mississippi Legal Services, Tr. 1700; Charles DeMars, New Mexico Law School, Tr. 472.

49 In this connection, the common law has long recognized that agreements should be set aside where a weaker party acquires to a contract in the face of a threatened wrong. Such a contract has no effect because the assent of the weaker party is coerced. Golder v. Enoch, 264 Cal. App. 2d 298 (1968); Cal. Rev. Proc. 18 (1977); Sun Maid Raisin Growers v. Papasion, 74 Cal. App. 2d 252, 169 (1952).

50 People ex rel Buell v. Buell, 20 Ill. App. 520 (1915); 158 N.E.2d 104 (1960); Noss v. Leitman, 53 Misc. 2d 461; 224 N.Y.S.2d 446 (1962). The use of unequal bargaining power to force a person in an unusually distressing situation to agree to contract terms that would not be the result of a voluntary and informed consent serious. See also the common law. Oswald v. City of El Centro, 211 Cal. App. 2d 232, 238 (1963). Undue influence has been defined as the use of one party's control, and unfair advantage of another's necessity and distress," Cal. Civ. Code 1783. See also Campbell Soup v. Wenta, 172 F.2d 60, 82 (3d Cir. 1949).

51 See supra Chapter III.

52 Presiding Officer's Report at 130, citing Martha Eller, Puget Sound Legal Assistance, Tr. 6640-42.

53 James White, Council of State Credit Institutes, HX-481.

54 E.g., Alan Simmons, West Virginia State Senate, Owner of small loan company, Tr. 6767; George Premise, Citizens Budget Co., Tr. 6290-91.

55 E.g., Robert Abrahams, Walter E. Heller Company, Tr. 177; Kenneth Davis, Kentucky Finance Co., Tr. 1332.

56 E.g., Lester Sadowick, New Jersey Consumer Finance Association, Tr. 8362.

57 E.g., Alabama Lenders Association, P-1-E[ ]-301.

58 E.g., Richard Van Winkle, Utah Consumer Finance Association, Tr. 7870; Al Brandt, Brandt Finance Company, Tr. 7721; William Martin, Oregon Consumer Finance Association, Tr. 7565; Stephen Hellerstein, Colorado Industrial Bankers Association, Tr. 8060.

59 E.g., David Wood, Dial Financial Corp., R-I[ ]-172; Helmut Schmidt, Transamerica Financial Corporation, Tr. 8480.

60 E.g., Creighton Lynch, Tr. 8959. See also Summary of Post-Record Comments XV-357 at 98, notes 38-38.

61 See supra Chapter III.

62 Presiding Officer's Report at 130, citing Martha Eller, Puget Sound Legal Assistance, Tr. 6640-42.

63 James White, Council of State Credit Institutes, HX-481.

64 E.g., Alan Simmons, West Virginia State Senate, Owner of small loan company, Tr. 6767; George Premise, Citizens Budget Co., Tr. 6290-91.

65 E.g., Robert Abrahams, Walter E. Heller Company, Tr. 177; Kenneth Davis, Kentucky Finance Co., Tr. 1332.

66 E.g., Lester Sadowick, New Jersey Consumer Finance Association, Tr. 8362.

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69 E.g., David Wood, Dial Financial Corp., R-I[ ]-172; Helmut Schmidt, Transamerica Financial Corporation, Tr. 8480.

70 E.g., Creighton Lynch, Tr. 8959. See also Summary of Post-Record Comments XV-357 at 98, notes 38-38.

71 NCLC survey, supra note 48 at 27.

72 E.g., Prepared Statement of Robert R. Slay on behalf of the National Consumer Finance Association, HX-454 at 43, 45.

73 E.g., John Mosley, Mosley Finance Company, Tr. 910; Lester Sadowick, New Jersey Consumer Finance Association, Tr. 8392-93; Burton, Cains, Pennsylvania Consumer Finance Association, Tr. 8430; Richard Van Winkle, Lockhart Company, Tr. 7907-08.

74 William R. Wehner, Household Finance Corp., Tr. 9238. Mr. Wehner acknowledged that recoveries are made on charged-off accounts in some cases. Tr. 9104-06.

75 John Mosley, Mosley Finance Company, Tr. 943. Al Brandt, Brandt Finance Company, Tr. 7870; William Martin, Oregon Consumer Finance Association, Tr. 7565; Stephen Hellerstein, Colorado Industrial Bankers Association, Tr. 8060.
The rule provision we here adopt meets many of the objections of industry by incorporating substantial modifications (discussed in Section G, below) to the original, more sweeping 1975 proposal addressed by the Presiding Officer. The Presiding Officer also based his conclusion in part on a finding that HHG security interests had "usability.""1 In causing the consumer to remain a debtor following bankruptcy," Presiding Officer's Report at 311. Given the changes to the Bankruptcy Code under the Bankruptcy Reform Act of 1978 (after the Presiding Officer's findings), this benefit to creditors would be substantially eroded, if not eliminated entirely. 2

1 E.g., Bernard Cunningham, Windsor Locks Finance Company, Connecticut, Tr. 8531, et seq.; Fernando Negron, Island Finance Company, Tr. 8539. In these cases, however, there is no evidence that the creditor publicized or otherwise made available the information that would employ HHG security interests. This interest is consistent with record evidence showing that, even where differences exist between creditors in the remedies they employ, consumers cannot reasonably differentiate between creditors for purposes of comparing or shopping for different contract remedy terms.

2 E.g., William Owennapp, American Bankers Association, Tr. 12200; John Montgomery, Illinois Bankers Association, Tr. 2321; Michael Milroy, Valley National Bank, Tr. 2310; and Martin, First United Bancorpansion, Tr. 1156; Robert Tobey, Consumer Bankers Association, R-113, Table 1, at 14, United States National Association, Tr. 8900-01; Joan Morton, California Credit Union League, Tr. 7185; G.R. Slater, Harris Bank, R-11-I-42.-132.

foreclosure of "high risk" consumers from the credit market, the rulemaking staff analyzed data furnished by the National Consumer Finance Association (NCF). A review of the secured and unsecured borrower reveals no significant difference between the income levels of such borrowers and no significant difference between the level of indebtedness of such borrowers at the time credit was extended.3 It is important to remember that the rule does not prohibit purchase money security interests or security interests in other than household goods, as defined. Additionally, the testimony of several state regulators, representing states which restrict blanket security interests bears out the statistical evidence that state regulatory schemes that include a restriction on creditors' ability to take blanket security interests in household goods do not have adverse effects on credit cost or availability. Specifically, Thomas Huston, Superintendent of Banking, State of Iowa, testified that the Iowa U.C.C.C. (which, among other provisions, restricts the scope of HHG security interests) had no effect on credit extensions in his state.4 From a creditor's standpoint, the facts about the causes of consumer default in credit obligations suggest that the benefits of blanket security interests as a collection device are limited. Given that the majority of defaults occur for reasons beyond the borrower's control,5 as a threat to seize furniture and personal possessions is of marginal value in cases of serious delinquency. Unemployed debtors, or debtors with sudden and substantial emergency expenses are hardly more able to remit monthly payments because they receive a threat to seize the furniture. E. The California Situation

A special problem was raised by industry witnesses in the State of California. It was argued that the prohibition on blanket security interests in household goods would make it impossible for the consumer finance industry to remain in business, because legal interest rates are tied to the filing of security interest. The California Consumer Finance Association and the Personal Property Broker's Law.6

The industry maintained that prohibiting security interests in household goods and prohibiting wage assignments would amount to a prohibition against small loan companies doing business in California because the applicable statute defines such lenders as those who take such security and/or wage assignments.

We find that the apprehension expressed by the California finance industry is unwarranted. The record indicates that, in practice, any personal property of any kind will suffice as security for the purpose of the statute.7 Lenders comply with the California law by taking a nominal security interest in a fountain pen or a ring.8 They can continue to take similar nominal security interests under the rule we promulgate here. The rule does not require any changes in California statutory law to permit consumer finance companies to remain in business.

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3 See generally, testimony of Carl Nelson, California Department of Corporations, Tr. 3022; George Richter, California Loan and Finance Association, Tr. 5805. California Consumer Finance Association, Post-Record Comments XV-334, at 18-19.

4 George Richter, California Loan and Finance Association, Tr. 5862. See also Staff Report at 238, note 128.

5 If a close examination of these two factors of security will quickly show that they are largely a fiction device to permit this category of lender to function outside the 10 percent interest limitation.

6 Earl Nelson, California Department of Corporations, Tr. 5043, 5044-46; George Richter, California Loan and Finance Association, Tr. 5800. 7 Wage assignments in California, which also qualify as a personal property broker, may only apply to income already earned at the time credit is extended. Such wage assignments are not prohibited by the rule.

Moreover, the rule does not prohibit all security interests in personal property. Purchase money security interests in such property are permitted, as are non-purchase money security interests in other than household goods as defined, such as jewelry. Finally, there are other statutory alternatives in existence in California, which permit lenders to charge rates in excess of the constitutional usury limitations, and which consumer finance companies use. An example is the Industrial Loan Law under which finance companies may operate that afford a return on the interest rate slightly lower than that under the Personal Property Brokers Law. See, e.g., Earl Nelson, California Department of Corporations, Tr. 5043.
F. Conclusion

Evidence of record establishes that non-purchase money security interests in household goods are the products of contracts the terms of which consumers cannot reasonably avoid, and that these are economic in nature. We further conclude, based on the evidence, that such security interests produce injury which is not outweighed by countervailing benefits to consumers or competition. Based on the preponderance of evidence in this record, the Commission therefore finds that the use of non-purchase money security interests in consumer transactions is an unfair practice.

Although the capacity to disrupt the home of a consumer and his or her family has some value to a creditor, the practice elicits minimal benefits in return for substantial injury. This is why the NCCF recommended abolition of non-purchase money security interests in household goods.

The Presiding Officer found that "a grant of a non-purchase money security interest in household goods has the potential and will, in many cases, result in injury far greater than any benefits to be gained through the use of the credit thereby obtained." We concur.

Finally, this provision has been substantially revised to narrow its scope and increase its clarity. This provision responds to the major concerns raised by the industry and discussed by the Presiding Officer. As revised, the rule will prevent the use of non-purchase money security interests in those household goods that the record demonstrates have little economic value to creditors. The revised rule will not affect other kinds of security interests, nor will it prevent the use of purchase money security interests in household goods.

G. Alternatives considered and modifications adopted.

In the course of proceedings on the rule several problems with the text of proposed section [a](4) became apparent. Accordingly, the provision we now adopt contains modifications consistent with the information developed.

As proposed, Section (a)(4) would have restricted creditors to a purchase money security interest in the event that the credit extended was used to purchase consumer goods. No other property could be used to secure the extension of credit. Thus, an automobile loan could not be secured by a second mortgage on real estate or by any collateral other than the automobile itself. The industry maintained that this approach was too restrictive, especially in the second mortgage area, and the rulemaking staff concurred. The purpose of this rule is to prevent the use of non-purchase money security interests in those household goods which constitute necessities and not to prevent consumers from borrowing on the equity in their homes through loans on stocks and bonds, etc., or pledging certain valuable assets if they choose to. The language of the provision we adopt eliminates non-purchase money security interests in household goods as defined while permitting consumers to agree to second mortgages where it is in their interest to do so. It permits the use of non-household goods collateral, in any appropriate credit transaction, but limits household goods security interests to transactions where the credit received was applied to their acquisition.

In reviewing this rule provision the staff noted an ambiguity as to whether the rule applied to possessory security interests, i.e., property held in the possession of the secured party such as a pawnbroker. Under the U.C.C. pawns and pledges are "security interests" but were not intended to be covered by the rule. Thus Section (a)(4) has been revised to make it clear that it only applies to non-possessory security interests. This will eliminate any uncertainty as to whether a consumer can pawn or pledge household items. The record furnishes no evidence that such possessory security interests cause any injury.

The rule does not apply to purchase money interests. When a purchase money loan is refinanced or consolidated, we intend that, for purposes of this rule, the security collateralizing the prior loan continue to secure the new loan, even if the new loan is for a larger amount or in other respects a non-purchase money loan. In enunciating our intent for purposes of this rule, we intimate no opinion with respect to different approaches taken by various jurisdictions in answering questions raised under the Bankruptcy Code. 49

We adopt a further modification to this section of the rule narrowing the definition of "household goods" to more precisely limit coverage to necessities and to allow the pledge of certain expensive possessions which have significant economic value. This modification has been undertaken in response to comment 50 and to narrow the prohibition to the class of goods for which the injury to consumers from a security interest exceeds offsetting benefits.

Specifically, we define "household goods" in terms of a list of common household necessities, together with some items of uniquely personal value, excluding these categories:

1. Works of art;
2. Electronic entertainment equipment (as except one television and one radio);
3. Items acquired as antiques; and
4. Jewelry (except wedding rings).

We define "antique" as any item over one hundred years of age, including such articles which have been available for sale but have been owned by the same person for a period of less than that time. 51

Russell, 298 B.R. 370 (Bkrtcy., W.D. Okla. 1983). We intend that, for purposes of this rule, when a loan is consolidated or refinanced, a creditor can retain an existing purchase money security interest collateral which would otherwise come within the rule's definition of household goods. Thus, analogous "transformation" rules in bankruptcy decisions will have no bearing in determining, for purposes of the rule, the basic character of the collateral at the time of the refinancing or consolidation.

Those jurisdictions that do not follow the automatic transformation rule generally adopt a method of determining the extent of the purchase money interest in the refinanced loan: most often some variant on the first-in-time, first-in-right method specified in the U.C.C. section 9-408. To the extent that this issue arises with respect to our rule, state law should govern the determination of the extent of the security interest. For purposes of determining compliance with the rule, however, we intend that courts should look to the validity of the contract under the rule at the time the contract is signed. Thus, if under applicable state law an interest is in part a purchase money security interest at the time a contract is signed, the contract does not violate the rule, even if the purchase money portion of the interest is exhausted before the end of the contract.

49 Staff Report at 244, note 140.
50 See supra note 56.
51 Presiding Officer's Report at 162.

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We refer to U.S.C. 522(f)[2][A]. This has resulted in litigation over the question of whether consolidated or refinanced loans, secured in part by previous purchase money loans, are eligible for bankruptcy, i.e., whether they are purchase money loans or HHG-secured loans. Different courts have reached different results. Compare, e.g., In re Samuel, 507 F.2d 900 (9th Cir. 1972) with In re Conr. 10 B.R. 454 (Bkrtcy., W.D. Ky. 1982) and In re ---

52 Betty Gregg, Credit Union National Association, Inc. 5096 (jewelry). See also Post-Record Comments XV-330 at 58 (finance company); XV-274 (credit union concerned about "jewelry"); XV-213 (credit union would exclude things held for investment); XV-213 (credit union plan "can retain most of its value for the term of a five year loan while a room full of furniture depreciated to next to nothing").
repaired or renovated without changing their original form or character. (§ 444.1)(1))

“Personal effects” is not defined in the rule; we intend it to have its commonly accepted meaning as “articles associated with a person, as property having more or less intimate relation to the person of the possessor.”[196]

We specifically include wedding rings within the term “personal effects.”

Other items clearly within the ambit of the term include those which an individual would ordinarily carry about on his or her person and possessions of uniquely personal nature, such as family photographs. Thus, the definition of household goods does not cover items such as boats, snowmobiles, cameras and camera equipment (including darkroom equipment), pianos, multiple television sets, home workshops and the like.[197]

We exclude one television and one radio from the term “electronic entertainment equipment” because, in contemporary society, these items have become virtual necessities. For families in rural or isolated areas, a radio is an absolute necessity. For many—especially disabled or infirm persons, or shut-ins—a television may be an equal necessity. We intend that the term “radio” apply to a conventional, self-contained unit (such as a table model radio, or a transistorized portable radio) with its primary function as a radio. The term does not encompass multi-component audio systems, even though one element of such a system is a radio receiver. Nor does it apply to portable, self-contained, multi-function units (tape recorder/player, amplifier, clock), only one element of which is a radio receiver.

We have provided that wedding rings be included within the term “household goods.” This permits consumers to pledge as collateral for non-purchase money loans any items of jewelry, with the exception only of wedding rings, which should be protected because of their unique psychological and emotional value.

To the extent that individual states provide protections substantially equivalent to, or more protective than, this rule provision but do so by specifying a definition of “household goods” that differs in content from that employed in the rule, the exemption provision of the rule (§ 444.5) is available to allow any such state to petition for exemption.

VII. Waivers of Exemption

Section 444.2(a)(2) of the Rule provides that it is an unfair act or practice for a lender or retail installment seller to take or receive from a consumer an obligation that constitutes or contains a waiver or limitation of exemption from attachment, execution or other process on real or personal property held, owned by, or due to the consumer.

A. State Law

At common law, all property of a judgment debtor was subject to execution in order to satisfy the judgment debt. Beginning in the nineteenth century, however, most states and the District of Columbia enacted laws that exempted certain property from judicial seizure and sale. The property exempted usually consisted of a homestead and other necessary items, such as furniture, clothing, family Bible, tools of the trade, animals used in farming, etc. Today, many states retain laws containing lists of exempt personality, while others simply exempt persons up to a specified amount. Several current statutes combine aspects of both approaches.[198]

[197] Alabama, for example, exempts $1,000 of personality. (Ala. Const. Art. 10, section 204 (1901)). Burial plots, church pews, wedding apparel, family portraits, books, and a homestead of up to 160 acres and $2,000 in value. (Ala. Code Tit. 7, sections 628 & 629). North Dakota’s homestead exemption has a ceiling of $40,000. (N.D. Cent. Code section 47-18-01 (Supp. 1973)). Texas, in its personal property exemption, includes 5 cows, 1 bull, 20 hogs, 2 goats, 50 chickens, 30 turkeys, 30 ducks, 30 geese, 30 guineas, farming implements, tools, and athletic equipment and other items up to $30,000 for a family. (Tex. Rev. Stat. Ann. Art. 3932 (1953)). Among other items, Pennsylvania exempts leased pianos, melodeons and organs, loaned, leased or conditionally sold ice cream cabinets, and articles on display at a nineteenth century international exhibition in Philadelphia. (Pa. Stat. Ann. Tit. 12, section 3524 (Purdon’s 1948)). Wyoming variations in the coverage of state exemption statutes precipitated, in part, the federal enactment of a uniform provision for bankruptcy protection (11 U.S.C. 522(d)).

A few states and the District of Columbia apparently have no homestead exemptions (e.g., Connecticut, Delaware, Indiana, New Jersey, Pennsylvania, Rhode Island). NCFA Comment.

The basic reason for exemption laws is to afford minimal protection to debtors and their creditors by enabling them to retain the prime necessities of life, with a view to preserving the family unit and furnishing the insolvent with nucleus to begin life anew.[199]

Under general principles of contract law, it has been considered that the right to claim an exemption is a personal right to be claimed or waived at the discretion of the debtor, unless state law specifically prohibits such waiver. In a number of states, there appears to be no such legal impediment to waiver of statutory exemptions of personality.[200] A number of jurisdictions prohibit waivers of exemption based on the strong public interest in protecting improvement debts and their families.[201] XV-343 at A-9. All states which have homestead exemptions also provide for the waiver of such exemptions when the exempt property is given as security for a loan. See, e.g., XV-343 at A-9.[202]

See Previding Officer's Report at 89 (June 16, 1979) and 3 citing Vukovich, Debtor's Exemption Rights, 62 Geo. L.J. 779, at 782-84 (1974); Mayhugh v. Coon, 400 Pa. 357, 162 A.2d 589 (1960); and these laws parallel one of the basic purposes of the bankruptcy laws, allowing debtors and their families to retain property sufficient for a "fresh start" following a financial setback.

See, e.g., Parsons v. Evans, 44 Okla. 751, 145 P. 1122 (1915).

[199] E.g., Jaiwalla, Idaho, New Hampshire, New Jersey, New Mexico, Rhode Island, South Carolina, Texas, Vermont. The NCFA survey found, however, that only six states—Alabama, Georgia, Kentucky, Louisiana, Maryland and Virginia—allow the homestead exemption to be waived by an executory clause without specifically taking a security interest. R-XII-31 at C-4.

[200] See, e.g., Moore v. Martin, 408 P.2d 905 (Alaska 1970); Lindsey v. Merrill, 38 Ark. 545 (1890); Industrial Loan & Investment Co. of San Francisco v. Superior Court, 143 Cal. 445 (1922); Welty v. Lynch, 79 La. 567, 246 P. 780 (1926); Wellingford v. Bennett, 12 D.C. (1 Mackey) 303 (1916); Sherrill v. Miller Mfg. Co., 89 So. 2d 52 (Fla. 1958); Interuder’s Administration, 390 Ill. 341 (1943); Maloney v. Newton, 85 Ind. 565 (1883); Curtis v. O’Brien, 20 Iowa 376 (1875); Iowa Mutual Ins. Co. v. Coates, 221 Iowa 1114, 263 N.W. 576 (1935); Mooney v. Regan, 73 Ky. 158, 187 (1875); Oxford v. Colvin, 134 La. 1049, 44 So. 1911 (1910); Maxwell v. Roach, 106 La. 123, 39 So. (1911); Benning v. Heeser, 144 Minn. 405, 176 N.W. 492 (1920); Toogoo v. Weeks, 80 Miss. 300, 42 So. 172 (1906); Moyer Bros. Drug Co. v. Bybee, 170 Mo. 364, 78 S.W. 570 (1904); Anaconda Portland Cement Union v. West, 157 Mont. 178, 529 P.2d 899 (1971); Kneistle v. Newcomb, 22 N.Y. 246, (1869); Dennis v. Smith, 125 Ohio St. 120, 190 N.E. 328 (1933); Mayhugh v. Coon, 400 Pa. 128, 131 A.2d 302 (1957); Longley v. Daily, 1 S.D. 327, 66 N.W. 207 (1899); Wille v. Bennett, 94 Tenn. 651, 30 S.W. 748 (1898); Bunken v. Coon, 21 Utah 104, 60 P. 499 (1900); Skyfelt v. Hildreth, 46 Wash. 379, 98 P. 282 (1906); Maxwell v. Reed, 7 W. 493 (1882). Two courts, in dicta, have stated executory waivers are invalid. In re Trustee’s Bank of Sterling v. Hoffer, 168 Neb. 9, 96 N.W. 142 (1903); Deatherage v. Tecon Land & Inv. Co., 40 Wyo. 142, 24 P.2d 702, 703, 40 Wyo. 142, 24 P.2d 702, 703, 40 Wyo. 142, 24 P.2d 702, 703, 40 Wyo. 142, 24 P.2d 702, 703, 40 Wyo. 142, 24 P.2d 702, 703 (1937). (dicta that executory clauses are not void).


Continued
In most states, the homestead exemption that protects real property may be waived by granting a specific interest in the property by way of a mortgage. The Uniform Consumer Credit Code, as well as the laws of some of the other states, however, prohibits the taking of a security interest in real property as security for loans below a stated amount and by certain types of lenders.

Non-purchase money waives of personal property exemptions are treated more stringently by the states, particularly where the personal property consists of necessary household goods. Some states prohibit the taking of non-purchase money security interests in all or certain personal property that the subject of exemptions. In those states where general executory waives of exempt property are permitted, it is generally done on the basis of the legislative intent in creating exemptions, that is, to protect the debtor and the debtor's family from thoughtlessness, extravagance, and improvidence.

State action regarding waives of exemption reveals the costs and benefits associated with the practice itself in its restriction, as viewed by the various jurisdictions. The fact that a relatively large number of states have acted in this area is not, in itself, determinative of the unfairness of a practice. Rather, examining state action aids the Commission in identifying the relevant issues in its own assessment of the unfairness of waives.

B. Prevalence

The rulemaking record establishes that creditors frequently include clauses in their consumer credit contracts that require consumers to waive statutory protections. Although the rulemaking record does not permit a precise determination as to the frequency with which creditors include waivers in consumer contracts, the preponderance of the evidence suggests a finding that the use of general waivers of exemption is prevalent, even in jurisdictions in which such provisions would not be given effect. This permits the use of such clauses as in terrorem collection devices, illustrating the gap in the states that may prohibit execution on waivers of exemption clauses, but not their inclusion in consumer credit contracts.

C. Consumer Injury

Waivers of state statutory exemptions permit creditors to seize, or threaten to seize, possession of, that, by statutory definition, are necessary. Although in contrast to security interests execution on exempt property requires court action, waives are essentially an alternate means to the same end as non-purchase money security interests in household goods. Thus, the consumer injury is essentially the same as that noted above in our discussion of household goods security interests (Chapter VI).

The record shows that much exempt property has little economic value as collateral, but great economic, psychological, and sentimental value to consumers. Generally, waives are coupled with a blanket security interest in household goods; in other cases such a waiver, standing alone, is used to reach property that would be otherwise exempt.

Because of its low economic value, exempt property is rarely seized. The record, however, reflects indications of actual seizures. The record also shows that threats of seizure, in the context of collection, are frequent. The common inclusion of waivers of exemption clauses in consumer credit contracts, especially in jurisdictions where they are not enforceable, suggests their primary use as in terrorem collection devices.

The record also shows that, in some instances, threats to seize exempt property force debtors to pay disputed debts or to waive legitimate claims or defenses that would otherwise reduce or eliminate their debts. Such threats can also disrupt household finances, leading to

11See infra note 10.

12See infra notes 10–13.

13See infra note 10.

14See infra note 10.

15See infra note 10.

16See infra note 10.

17See infra note 10.
to delinquency on other obligations or resulting in costly refinancing. 19 Creditors contended that current state law provides adequate consumer protections. 20 Such laws, however, generally either do not require the inclusion of waiver clauses in forms contracts or they are used for in terrorem purposes. The rule provision is aimed more at these gaps in state consumer protection schemes.

The preponderance of record evidence causes us to conclude that consumers suffer economic injury, as well as more subjective harm, as a result of practices which flow from the inclusion of this provision in consumer credit contracts.

The rulemaking record shows that most consumers are neither aware of the rights they have under exemption statutes nor of the presence or significance of waiver clauses in their contracts. Creditors do not explain these rights to the consumer or to their customers. 21 Consumers would thus find it difficult to bargain over this provision or shop around for contracts without one. 22 Thus, consumers cannot reasonably avoid the injury caused by waivers of exemption clauses.

D. Offsetting Benefits

Some opponents of this provision contended that some exempt property has economic value as collateral, and that waivers of exemption are necessary to threaten debtors with seizure of the property as a means of inducing payment. 23 This contention assumes that debtors fail to pay on time because they are unwilling to do so. The assumption is contradicted by the finding that most debt default is the result of factors beyond the debtor’s control. 24 To the extent that the clause has any value as a collection device, creditors still have a large number of remedies at their disposal. 25

A few witnesses predicted that the effect of prohibiting waivers of exemption would be to increase the cost of credit or restrict its availability. 26 In those states that permit waivers, however, the record shows that they result in actual seizures relatively infrequently; 27 this strongly suggests that creditors themselves consider waivers to be of little value. The Presidenting Officer found that creditors are generally reluctant to effectuate executory waivers even where both the opportunity and statutory authorization to do so exist. 28

Based on the evidence, we conclude that the benefits out weigh the costs for this provision. This is consistent with the Presidenting Officer’s finding that “taken as a whole, the record supports a conclusion that the prohibition on executory general waivers of all homestead and other exempt property in consumer credit contracts would prevent consumer abuses without doing undue harm to creditors.” 29

E. Alternatives Considered and Modifications Adopted

This provision of the proposed rule received wide support throughout the proceeding. Creditor objections focused on a possible ambiguity which could lead to misinterpretation of the rule. Creditors were concerned that this prohibition, as originally proposed, would outlaw security interests in exempt property as well as waivers of the statutory exemptions, because in some jurisdictions a security interest was styled as a waiver of an exemption for the covered property. The provision we adopt has been revised to make it clear that § 444.2(a)(2) does not apply to security interests in such property if otherwise permitted by the rule and by state law.

As enacted, § 444.2(a)(2) prohibits the use of “executory” or “advance” waivers where there is no security interest in the affected property. Many creditors agree with, or at least have no objection to, this provision as modified. 30 The provision will not affect existing state law which prohibits enforcement of executory waivers of exemption. But it will prevent creditors from employing executory waiver clauses in all jurisdictions regardless of their enforceability under state law.

VIII. Late Charges

Section 444.4 of the Rule provides that it is an unfair act or practice for a lender or retail installment seller to use any accounting or other method that results in the assessment of multiple late charges based on a single late payment that is subsequently paid.

A. Nature of the Practice

Late or delinquency charges are those the creditor assesses against the borrower when payment is not made by the due date, although there is usually a grace period of five or ten days before the late charge is imposed. Delinquent or extension charges are made by the creditor for extending the period of time within which the debtor may make one or more payments. Late and delinquent charges both have a dual purpose. The first is to encourage the debtor to make timely payments; the second is to compensate the creditor for additional costs resulting from a failure

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19 See NCLC survey, HX-467 at 34, showing legal aid attorneys believe delinquencies on other obligations occur 40 percent of the time, payments of disputed claims 36 percent, and costly refinancings 30 percent. See also, James Boyle, Texas Consumer Association, Tr. 40.
20 See, e.g., Hrshel Adrock, Louisiana Consumer Finance Association, Tr. 1221; Richard Kohn, Colorado Bankers Association, R-1(a)-(2) 472; Clarence Pigeon, Wisconsin Finance Corp., Tr. 2476; Burton Caine, Pennsylvania Consumer Finance Association, Tr. 8427.
21 E.g., Beny F. Marshall, HX-51 at 4; Kayla Vaughan, NCLC, DFRC, Tr. 964-97; Jonathan Epstein, Essex-Newark Legal Services, Tr. 8048; Herbert L. Beiskin, Charlottesville-Albemarle Legal Aid Society at HX-377 at 8; Kenneth Levin, Atlanta Legal Aid Society, HX-330 at 6. The record contains numerous examples of consumer credit obligations which contain waivers written in nearly incomprehensible language. See, e.g., those presented by Daniel W. Molloy, Legal Aid Society of Mobile County, HX-72, Exhibits 1-3 and 5. Thirty-five of such notes are included in Ex. XI-58, other examples are in the consumer account files subpoenaed by the FTC rulemaking staff, e.g., BEN 0120:029:O35.
23 Indeed, some waivers operate to deny consumer protection by the move to another jurisdiction. See, e.g., BEN-007-05-10: ** ** waive all rights of exemption under the law of this or any other state.”
on the part of the debtor to make payments in accord with the terms of the loan agreement.

The importance of the incentive effect of late charges was emphasized by creditors. Late charges prevent a debtor from converting a precomputed installment contract or a loan into open-end. When a consumer is late in making a payment under a precomputed credit contract, the creditor may receive no income for the period of delay; and the delinquent debtor can effectively pay a lower rate of interest than charged consumers who pay on time.

The rulemaking record demonstrates that creditor efforts to collect delinquent payments result in costs significantly greater than those associated with the maintenance of current accounts. These costs include those attributable to additional notices, letters, telephone calls, and personal contacts. The salaries of personnel engaged in such activities are also substantial. To help recover these costs, almost every consumer credit contract contains a provision for the assessment of late charges.

Pyramiding

The practice addressed by revised §444.4 is known as the "creeping" or "pyramiding" late charge. It comes about by application of an accounting method which results in the assessment of multiple delinquency charges due to a single late payment. The general accounting principle is that payment is first applied to any outstanding late charge, then to the interest charge, and finally to the principal amount of that payment. In "pyramiding" the accounting method works in this fashion: if a consumer's payment is due on the first day of January, for example, and the payment is not made until the 20th day of that month, the creditor assesses a late charge, for example, $5. The February payment and all subsequent payments are made on time. However, by allocating $5 of the February payment to the January late charge and only the remainder to the February payment, the creditor causes the February payment to be $5 "short," hence delinquent. Timely payments in succeeding months are given the same treatment, so that there is a delinquency or late charge for each month. The cumulative impact of repetitive late charges can be substantial.

The staff of the Federal Reserve Board provided another example of late payment:

In some instances when a consumer makes one late payment, the creditor will treat every subsequent payment as being late. For example, where a consumer makes the third monthly payment one month late under an obligation which is to be repaid in six monthly installments, the creditor may then treat the fourth, fifth and sixth monthly payments as one being one month late and collect a late payment charge for each of those payments.

Bankers Association of Colorado and Colorado Consumer Finance Association, FTR 5815.

E.g., Bankers Association of Colorado and Colorado Consumer Finance Association, FTR 5815.

The Rule provision is aimed at only the first example, or "pyramiding." In the FRB example where the monthly payment is late but never made current, the effect may be to allow the consumer unilaterally to extend the term of the loan. The missed payment on the third month may not be made up until the seventh month, one month after the termination period of the contract. There are mechanisms in most state laws for deferring payments, subject to the creditor's right to assess and collect a deferral—as opposed to a delinquency or default charge.

B. State Law

States have imposed limitations on the amount that creditors may assess consumers for late charges and deferral fees. The most frequently used state method is to put a "cap" on late charges equal to 5% of each installment more than ten days late or $5, whichever is less. Some states also set a "floor" of 50¢ or $1 on these charges to partially compensate the creditor for its added expense of collecting the late payment. States that have adopted the Uniform Consumer Credit Code expressly prohibit pyramiding of late charges.

C. Prevalence

The record establishes that consumer credit contracts almost uniformly provide for the assessment of late charges and extension charges, although they may not always be assessed. Such charges can be waived to assist debtors in financial distress or to facilitate settlement of delinquent accounts. Although the precise extent of pyramiding of late charges cannot be ascertained from the record, there is evidence that it occurs in most of the

6 See, e.g., Wis. Stat. § 422.203-204 (1975); USC § 2320, 2320 (1966), and § 2320 (1974); (1974); see generally CCH Consumer Credit Guide 529 at 1401 at sec. 1.

7 Presiding Officer's Report at 193-94.


9 Many witnesses reported that late charges are frequently waived, e.g., Richard E. Edwards, Pennsylvania Consumer Finance Association, Tr. 6505; David White, National Association of Federal Credit Unions, Tr. 11896; John R. Sluman, Florida Consumer Finance Association, Tr. 9757; Joseph C. Park, Michigan Consumer Finance Association, Tr. 3182; Harvey R. Miller, Gateway Loan Corporation, Tr. 2350; Bernard J. Cunningham, Windsor Locks Finance, Inc., Tr. 6502; James M. Hassenegg, Iowa Consumer and Industrial Loan Association, Tr. 3930. See also Robert A. Pinto, Wisconsin Office of Commissioner of Banking, who noted that the large corporations generally operate on a computer system, and the taking of late charges would not likely be left to the discretion of local offices, Tr. 4055.

10 Id. See also, Presiding Officer's Report at 203.
states where it is not specifically prohibited and is sufficiently prevalent to warrant being addressed by this rule.13

D. Consumer Injury

The record contains evidence that pyramiding of late charges results in the assessment of charges far in excess of the amounts, if any, actually expended by creditors to collect the account.14 Indeed the evidence indicates that, where the only delinquency on an account is attributable to a prior late charge, creditors do not persist in collection attempts.15

The problem of pyramiding—where a payment is late but is paid in full on or before the next timely payment—is compounded by the fact that the debtor is usually unaware that the late charges are "pyramiding" until the final payment is made.16 If payments are accompanied by a coupon from a book of coupons given to the consumer at the time the credit is extended the debtor may not receive any periodic statement indicating the amount of late charges as they accrue.

Furthermore, because pyramiding is based on an accounting method, not a contract provision, consumers cannot shop around for credit contracts that do not involve this practice, or otherwise reasonably avoid the injury which flows from its application. This provision will benefit borrowers by reducing late charges assessed for a single late payment.

E. Offsetting Benefits

Only one participant in this proceeding defended the use of pyramiding late charges,17 arguing that

the creditor, seeking to make the account current, incurs collection costs during each period the installment remains unpaid. Because of this continuing effort, the creditor should be permitted to impose a late fee in each period that even a small amount remains unpaid to partially cover the cost of collection efforts during that period.

The evidence, however, establishes that creditors do not persist in collection efforts after a tardy payment is received and the only deficiency is a prior late charge.18 Where a payment is late but subsequently received, creditors make no further efforts to collect. Therefore, they do not need to be reimbursed for collection expenses after the late payment is received.

Pyramiding of late charges is basically the result of an accounting method. It is thus unknown to consumers and could not therefore serve as a useful deterrent to late payments. Because little or no collection effort occurs after a tardy payment is made, the creditor incurs little or no added collection expense. Prohibiting the use of pyramiding will have little, if any, impact on either the cost or availability of credit. Therefore, benefits to consumers or competition are insufficient to offset demonstrated consumer injury from pyramiding of late charges.

F. Alternatives Considered and Modifications Adopted

Some creditors argued that, because the initial proposal did not address the precise issue of pyramiding, no notice was given of this practice.19 This is incorrect, because the proposed rule clearly focused on late charges.20

As initially proposed, the late charge provision would have prohibited the inclusion of terms in consumer credit contracts permitting charges for late or extended payments that exceeded the amount derived from application of the annual percentage rate governing the transaction to any payment which was late or extended. The evidence adduced in the proceeding does not support a finding that late charges in excess of the APR are unfair. However, the Commission is adopting a revised provision to eliminate "pyramiding" of late charges.

Lenders generally demonstrated that permitted late charges do not always compensate them for the added costs of collecting delinquent payments.21 Because of this, it is not an unfair practice for creditors to assess a late charge for each payment period that the delinquent principal or interest payment remains unpaid. However, where a tardy payment is paid, and the only deficiency is a late charge imposed on that payment, the late charge itself should not be a basis for imposing further late charges.

Pyramided charges do not compensate creditors for any costs incurred in collection. Such charges simply permit collection of sums over and above principal and interest due; pyramiding constitutes a windfall to the creditor that inflicts substantial injury on consumers that is not reasonably avoidable, without countervailing benefits to consumers or competition. Pyramiding of late charges, therefore, is an unfair practice.

Retailers suggested that open-end credit be exempted from this provision of the rule because no late charge provision is used in such contracts.22 We adopt a revised proposal which would not affect open-end creditors or any other creditors who do not employ this accounting method.

Several parties argued that late charges should not apply where a partial payment is made. There is inadequate record evidence to justify prohibiting late charges on partial payments. A partial payment, unless it is only partial because of previously due late charges that were "late," is a late payment.

Finally, we have determined that a straight-forward prohibition on the practice of pyramiding is sufficient remedy. Earlier proposals incorporated a requirement that creditors include in each consumer credit contract a clause prohibiting pyramided late charges. We find insufficient record evidence to support such a requirement. Our approach will result in no paperwork burden on creditors and will obviate the need for an unnecessary contract provision as to that substantial body of creditors which does not engage in the practice.

13 See e.g., Professor John Spanogle, State University of New York at Buffalo, Tr. 9745; Robert Higginbotham, Office of the Attorney General of New Mexico, Tr. 10472; Robert C. Fecht, Director, Consumer Credit Division, Connecticut Banking Department, Tr. 11354-56; James L. Brown, University of Wisconsin Center for Consumer Affairs, Tr. 4070-72. See also, R-XI—ASSOC-242 (Washington); ASSOC-379 (South Carolina); GFC-230 (Louisiana); GFC-60, 69 (Texas); DIAL-78 (Connecticut); CTA-66 (Washington); EEN-117, 128 (New York); CIT-292 (Ohio); R-XI-TP-5; 8; 18 at 1460A-B, C (XII-TP-5); SPA-400 (finance company manuals containing instructions regarding "pyramiding" late charges); GMAC Rebuilt Submission, R-XII-33 at 16 and note 17, infra.

14 Note 3, supra. See also Presiding Officer's Report at 196, and note 18, infra.

15 See consumer files cited in note 13, supra; see also note 15, infra.

16 See, e.g., R-XII-36, consumer complaint #3B-77 (South Carolina Department of Consumer Affairs); R-XI-166, memo from Dial Finance Branch Manager to District Manager, April 23, 1975.

17 General Motors Acceptance Corporation, R-XIII-23 at 36, note 70.

18 See Shay, supra, note 18.

19 See Comments on the Presiding Officer's Report and Staff Report at XV-299, XV-348.
IX. Co-signers

Consumers who do not meet a creditor’s standards for creditworthiness are often required to obtain one or more "co-signers" for loans to be liable for the debt. A co-signer is required to pay if the debtor defaults, but the co-signer receives no monetary consideration for undertaking the obligation, which can become onerous.

A. State Law

The term "co-signer" has no precise legal meaning. The rights and obligations of co-signers are defined by reference to the contracts they sign. The status of a co-signer is that of an accommodation party and surety. The co-signer's obligation is generally the same as that of the principal because co-signers waive traditional rights of sureties.

Except for a few reform statutes, the status of consumer co-signers has not been the subject of legislative or judicial consideration. Most reported cases involve commercial interests. Consequently, the law in this area does not reflect the special problems of co-signers in consumer transactions. In most jurisdictions, the creditor has no obligation to give the co-signer a copy of the contract or advise the co-signer of the extent of his or her liability.

In its report the National Commission, on Consumer Finance (NCCF) recommended that:

No person other than the spouse of the principal obligor on a consumer credit obligation should be liable as surety, co-signer, co-maker, endorser, guarantor, or otherwise, unless the creditor provides for its payment unless that person, in addition to signing the note, contract, or other evidence of debt also signs and receives a copy of the separate co-signer agreement which explains the obligations of a co-signer.

Section 3.208 of the 1974 version of the Uniform Consumer Credit Code (U.C.C.C.) followed the NCCF's lead with a similar recommendation. Several states require written notice to co-signers.

B. Use of Co-signers

Co-signers were employed in 2 percent of the cases sampled by the National Consumer Finance Association. Individual small loan companies indicated that they use co-signers from 10 percent to 95 percent of the time. A survey by the Consumer Bankers Association showed that 7 percent of responding banks "occasionally" or "often" encourage co-signers. A survey by the National Consumer Law Center which focused on low-income consumers, reported that legal aid attorneys estimated that finance company creditors use co-signers other than spouses 61 percent of the time, banks use non-spouse co-signers 51 percent of the time, and credit unions use them 20 percent of the time. Finance company files on the record also reflect the use of co-signers. The record establishes that creditors seek and obtain co-signers at the time of initial extensions of credit and to secure delinquent accounts in a significant number of cases. Some witnesses stated that parents are the most frequent non-spouse co-signers. Other relatives, friends and employers are also used.

C. The Unfairness of Failure To Disclose Co-signer Liability

The consumer injury addressed by § 444.3 of the rule is occasioned in some cases by the failure of creditors to inform potential co-signers of their obligations and liability (an unfair
rule. The sudden liability that can result from cosigner status can cause over-extension when a consumer is confronted with a debt, the timing of which cannot be controlled by the cosigner because it is due to nonpayment by the principal debtor. A study by David Capiloutte indicates that 8 percent of all consumer default is due to cosigner liability.

Because of the range of potential liabilities, many consumers might not have become cosigners had they known the likely costs of doing so. When cosigner obligations are explained: A whole bunch of them have said “never looked at it that way.” * * * ain’t no way I’m going to do this.” [Henry Goodman, Arizona Finance Co., Tr. 7783].

Cosigners thus undertake obligations which they might not have undertaken had they understood them, and suffer economic and other hardship as a result when called upon to repay.

2. Reasonable Avoidance

Despite the high likelihood that they will be asked to pay in the event of default, many cosigners are unaware of the nature of the obligation they undertake absent a disclosure. Some believe that they are merely acting as a reference. Legal aid attorneys estimate that only 20 percent of cosigners understand the nature and extent of their obligation. Although some cosigners are aware of the basic fact of liability, even cosigners who realize that they are not merely references are often not fully aware of the extent of their obligation.

At common law, creditors had an obligation to exhaust their remedies against the principal before seeking payment from a cosigner. This requirement was consistent both with the economic role of the cosigner in the transaction and with cosigners’ expectations. Many current cosigner contracts, however, contain a waiver of the requirement that the creditor first pursue the principal. Thus, upon default, the cosigner may be required to pay even if the principal has assets from which the creditor could be paid. Some finance company manuals instruct employees to make cosigners the focus of collection efforts once the principal debtor has become more than minimally delinquent.

NCLC Survey, HX-407 at 36.

E.g., Leslie R. Butler, Consumer Bankers Association, HX-408 at 18; Gaye C. Williams, Legal Aid Society of St. Louis, Tr. 4020-21; Craig James, Idaho Legal Aid Society, Tr. 7071-72; David R. Dahon, North Louisiana Legal Assistance Corporation, Tr. 1400-U-V; Fernando Acevedo, Esq., Tr. 2950.

E.g., Agnes C. Ryan, Legal Aid Bureau of Chicago, Tr. 2233-36; Kayla Vaughan, Missouri Public Research Group, Tr. 6500; Gaye C. Williams, Legal Aid Society of St. Louis, Tr. 5600-12; Jonathan Epstein, Essex-Newark Legal Services, Tr. 6506; Sidney Margolius, columnist, New York, Tr. 11205; Drew Johnson, Lake County Legal Aid Service, Inc., Tr. 6119; Judge Arthur L. Dunn, Cook County, Illinois, Tr. 2738. Some industry members agree that their cosigners do not fully understand the nature of their liabilities; see, e.g., John P. Heider, NCLC, HX-404 at 50-60; Bryce A. Baggett, Oklahoma Consumer Finance Association, Tr. 650-66. See also President’s Report at 272-275.

The common law background of cosigners’ liability is reviewed in detail at pp. 421-424 of the Staff Report.


E.g., see, e.g., R-XI-CTA-62-1; Mary K. Gillespie, San Francisco Neighborhood Legal Assistance Foundation, Inc., Tr. 2001.


Of course, the contract a cosigner signs sets forth the basic fact that the cosigner is liable. Thus, potential cosigners might avoid the injury that stems from the creditor’s failure to disclose or clearly explain the contract document itself. The question is whether, in the circumstances, consumers can reasonably avoid injury by reading and understanding the contract.

The record reveals that in these circumstances they cannot. As noted earlier, consumer credit contracts are written in technical language that is difficult for consumers to understand. The record also indicates that cosigners are no more likely than other consumer borrowers to comprehend technical contract language. Moreover, most cosigners are not provided with copies of the contract or of documents received by the primary debtor. In any event, the entire transaction is often conducted very quickly, leaving little opportunity for the potential cosigner to consider the contract carefully.

In addition, the circumstances under which cosigners are solicited make it unreasonably difficult to present the potential cosigner to read and consider the contract. Consumers who might otherwise be attentive to the nature of agreements they enter into may be less cautious when they agree to be cosigners. Cosigners are often sought under circumstances that may not allow for a decision in the cosigner’s best interest. Many loans in which the creditor seeks a cosigner would not be made if a cosigner is not obtained. Thus, cosigners may be subject to pressure from both the borrower, who may urgently need the loan, and the creditor, who may question the cosigner’s ability to repay if the creditor has hesitated to cosign. In such circumstances, cosigners may be reluctant to fully explore the legal ramifications of their actions. Thus, the record establishes that cosigners often incur liability but are seldom informed of their liability. Because they are frequently not aware of the nature and extent of their obligation, cosigners cannot reasonably rely on their general understanding of the transaction to avoid injury. Because the contract itself is difficult to understand and may be available only briefly, consumers cannot reasonably rely on the contract itself. For these reasons, the Commission concludes that cosigners cannot reasonably avoid the injury that stems from the creditor’s failure to disclose.

3. Offsetting Benefits

This record contains substantial evidence that creditors do not now provide cosigners with the information they need to make informed decisions, and that considerable pressure attends the solicitation of cosigners in connection with the collection of delinquent debts. The detriment to cosigners from the lack of information is not offset by benefits to consumers or competition.

Certain benefits may flow to the consumer who is the principal debtor for a cosigned loan, and there may be benefits to competition from the greater number or size of loans which can be extended when a cosigner shares liability for the debt. The rule, by leaving the use of cosigners unaffected, will have no effect on any such benefits. The rule will insure that an informed decision is made prior to consumption of a cosigner agreement.

The primary offsetting benefit of failing to disclose liability is that creditors thereby avoid the cost of making the disclosure. Testimony based on creditor experience, however, suggests that the cost of providing the cosigner with the required disclosure will not be great. Moreover, some creditors testified that they now provide such notices to the principal debtor or conduct interviews with them. Other creditors stated that they were not opposed to providing a notice and predicted that it can be provided without difficulty.

4. Summary Concerning Unfairness

Failure to disclose produces injury because the extent of liability is a material fact that would likely affect the cosigner’s willingness to undertake the

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42 See supra notes 21-22, 43, 45.
43 E.g., Mel Nestlerode, National Association of Federal Credit Unions and Manager, CCI-Maranquid Federal Credit Union, Tr. 7219-20.
44 The following creditors testified that they presently interview or counsel cosigners concerning their liability: Mel Nestlerode, National Association of Federal Credit Union League and CCI-Maranquid Federal Credit Union, Las Vegas, Tr. 7220-21; Bernard J. Cunningham, Connecticut Consumer Finance Association and Windsor Locks Finance, Inc., Windsor Locks, Connecticut, Tr. 6864. The following creditors stated that they now give a notice similar to that required by the rule: Merced School Employees’ Federal Credit Union, Merced, California, R-III(1)-59; The West Bend Co., Wisconsin, R-III(1)-420; Hyman Weiner, Atlantic Finance Co. and California Loan and Finance Association, Tr. 6467; Marcus A. Brown, Island Finance Corp. of Puerto Rico, Tr. 1350.
45 E.g., J. M. Tapley, The Harter Bank and Trust Co., Gillsburg, R-III(1)-183; City National Bank of Houston, R-III(1)-256. One creditor suggested that providing the notice would ultimately decrease creditor cost:
46 If a cosigner does not have a clear understanding of his obligations and a full and complete acceptance of his obligations, then it makes collection much more difficult and consequently increases collection costs. Accordingly, we commend the language in the proposed notice and suggest that even if it is not adopted in the rule that it would be well for creditors to use it voluntarily.
Vernon Lemons, Jr., Texas Finance Institute, Tr. 1021-1022.

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See infra notes 53.
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Vernon Lemons, Jr., Texas Finance Institute, Tr. 1021-1022.
obligation. Consumers cannot reasonably avoid injury because lenders do not explain or disclose liability and there are no low cost alternative sources of information. Many potential cosigners might choose differently if they had full information on the extent of their obligations and liability. The offsetting benefits of avoiding the cost of disclose are minimal. We conclude, therefore, that failure to disclosure cosigner liability is unfair.

D. Deceptive Representations Concerning Cosigner Liability

The record shows that in some instances creditors misrepresent the nature of cosigner liability. A legal services representative described questionable representations made to his clients when they cosigned:

We have litigated seven cases where cosigners have been sued for payment when the principal defaulted and we have found the scenario runs somewhat like this. At the time of the initial contract the salesman will explain to the principal that their credit is underwriting (underwritten) and that the business needs someone to "vouch" for the principal's honesty, ability to pay, whatever. Onestrand is common, at no time is the cosigner told "you will be liable for payments if the principal defaults." Sometimes the cosigners are told that they are witnesses to the contract, and at any rate the entire transaction is handled very quickly. The note is then discounted and when default occurs, there is only testimony of the cosigner as to what the salesman said at the time of the original signing. Of course, the business is no longer a party and the salesman is most likely gone, (and so then is the cosigner's money).

Similar practices are apparent in the following case history offered by a consumer:

[My husband] was asked by his brother to sign some papers. I said I didn't want to get involved with any cosigning. But Dial Manager and [the debtor] said it wasn't.

**Consumer complaint to Washington State Attorney General, Re: 105-50.**


**In Peacock Buick, the Commission disagreed with respondents' arguments that contract disclosures obviated the possibility of deception. The Commission noted: "It is clear from consumer testimony that oral deception was employed in some instances to cause consumers to ignore the warning in their sales agreements." Peacock Buick, 96 F.T.C. 1532, 1538-9 (1976).**


**See FTC v. Sterling Drug, Inc., 371 F.2d 689, 707 (2d Cir. 1967); Beneficial Financial Corp. v. F.T.C., 642 F.2d 233 (3rd Cir. 1979); American Home Products, supra note 50.**

In the face of affirmative misrepresentations, it is even less likely that consumers will read and understand the nature of the contract. A misrepresentation must also be material to violate Section 5. If misrepresentation is material of if it is likely to affect the consumer's conduct or decision. Express representations, such as a statement that a cosigner is merely acting as a reference for the primary debtor, are presumed to be material, because the creditor's willingness to make the claim reflects a belief that cosigners are interested in it.

Moreover, as discussed above, the liabilities of cosigners are substantial, they can subject cosigners to financial and other hardships, including adverse credit ratings and legal process. Indeed, the nature of liability is a central element to the decision to cosign, a fact that strongly argues that misrepresentations of liability are material. Further, many consumers are likely to choose differently when cosigner obligations are explained.

Express assertions by creditors that misrepresent the nature of this obligation, and therefore mislead consumers with respect to their potential liability, are clearly material.

In those instances in which misrepresentations of cosigner liability occur, there is clearly deception. The misrepresentations are express, and are likely to mislead consumers. There is injury because information concerning liability is material to the consumer's decision to cosign.

E. Remedial Requirements

Based on the record, we here enact a rule designed to remedy the unfair and deceptive practices discussed above.
The rule declares misrepresentation of the nature or extent of cosigner liability to be a deceptive practice, and the failure to disclose cosigner liability to be an unfair practice. To remedy the unfair practices shown on this record, we adopt a requirement that cosigners be informed, prior to becoming obligated on a loan, of the nature of their liability (§ 444.3(a)(2) of the rule). To stem the deceptive practices demonstrated by the record, we impose a direct prohibition on misrepresentations of the nature or extent of cosigner liability (§ 444.3(a)(1) of the rule), and provide that compliance with the preventive requirement is sufficient to avoid charges that a creditor has engaged in misrepresentations in violation of the rule. To prevent both the unfair and deceptive cosigner practices, we require that a disclosure notice, the text of which is set out in § 444.3(b), be given to potential cosigners.

This scheme of remedial provisions is clearly within the Commission’s authority. Section 18(a)(1)(B) provides that Commission rules “may include requirements prescribed for the purpose of preventing” acts or practices declared unfair or deceptive. “It is well established that the remedies selected by the Commission to cure the unfair or deceptive cosigner practices must bear a ‘reasonable relationship’ to the practices demonstrated on the record. In Jacob Siegel Co. v. FTC, the Supreme Court set forth the standard for review of remedial provisions of Commission adjudicative orders: ‘[T]he courts will not interfere except where the remedy selected has no reasonable relationship to the unlawful practices found to exist.’ The purpose of the plaintiff has reaffirmed the Commission’s remedial discretion in adjudicative proceedings.

The disclosure notice mandated by rule § 444.3(b) is intended to remedy the unfair and deceptive practices shown on the record by providing the potential cosigner with basic information about the nature and extent of cosigner liability. The notice is coupled in general terms sufficient to alert consumers to the essential elements of cosigner status. Language such as “guarantee this debt” and “accept this responsibility” serves to make it clear that to be cosigner involves more than merely vouching for the primary debtor or serving as a reference. Language such as “full amount” and “fees or costs which increase this amount” will

make cosigners aware of the magnitude of the potential financial exposure they undertake. Language such as “same collection methods” and “your credit record” will alert the consumer to some of the additional potential consequences of cosigning a loan. Thus, this simple summary of the nature and extent of a cosigner’s potential liability addresses the unfair practices of failing to disclose such information, as well as the deceptive practice of misrepresentation of the role of a cosigner.

Indeed, commenters endorsed the disclosure notice as necessary to remedy cosigners’ lack of awareness of their liability and creditor misrepresentation of the nature of cosigner obligations.

P. Alternatives Considered and Modifications Adopted

Because cosigners can be important in making credit available to consumers without a well established credit record, the rule as proposed did not ban their use. Indeed, the rule originally proposed by the Commission would have imposed the following requirements:

1. Potential cosigners must be given a plain language explanation of their obligation.
2. Potential cosigners must be given a three day cooling-off period before they obligate themselves.
3. Cosigners must be given copies of all documents they sign or that are given to the principal debtor.
4. The contract obligating the cosigner must provide that:
   a. The creditor must employ “due diligence” in attempting to collect from the principal debtor before seeking payment from the cosigner.
   b. The cosigner’s liability is limited to the total of payments owed by the principal debtor at the time the cosigner becomes obligated.
   c. The cosigner must be promptly notified of any default by the principal debtor.

During the preceeding, creditors emphasized the importance of cosigners in making credit available to inexperienced borrowers. They argued that the rule provision would reduce the availability of credit to such borrowers if it made the use of cosigners costly or inconvenient. There was relatively little opposition to the concept of informing cosigners of their obligation. There was strong opposition to the three day cooling-off period on the ground that it would cause serious inconvenience in making cosigner loans. Creditors also objected to the “due diligence” requirement, primarily on the ground that the term was ambiguous. Various objections were registered to the cosigner application to open-end credit. These concerns are addressed by providing that in open end transactions the disclosure notice be supplied only at the time of the initial extension of credit. We have adopted modifications in that portion of the cosigner rule that we promulgate today to reach other concerns raised during the proceeding, such as paperwork burden.

The Final Rule

Although the record before us documents certain problems in connection with the use of cosigners, and although the Staff Report

E.g. D. L. Aldridge, Louisiana Independent Finance Association, R-II(1)-258; Northrup Credit Union, Hawthorne, California, R-II(1)-345.

E.g., most objection to the proposed provision focused on the three day cooling-off requirement. E.g., Paul H. Camerlengo, 1st City National Bank of Houston, R-II(1)-345; Ralph France, Bank of New Orleans, R-II(1)-345; Helmut Schmidt, Transamerica Financial Corp. Tr. 6205; Alfred J. Lapan, South Middlesex Bank and Trust Co., Bank League, Tr. 10493; Gordon Wear, Texas Independent Automobile Dealers Association, Tr. 715; James Goldberg, American Retail Federation, Tr. 8126; Richard C. Durham, Association of Fuertorregidores de Financieros Consumidores, R-II(1)-352; H.E. Smith, Alabama Lenders Association, R-II(1)-353; Larry G. Cardell, Sr., Merchant’s National Bank of Allentown, Pa., R-II(1)-354. See also, Staff Report at 406; President’s Officer’s Report 258-259.

Gene L. Jamerson, 1st International Bancshares, Texas, R-II(1)-352; Melvin Strubinski, Morris Plan of Iowa, R-II(1)-352; John F. Whitehead, National Bank of Oregon, R-II(1)-352; Alan M. Black, Pennsylvania, R-II(1)-352; Jay Deuell, Northern Trust Co., Illinois, R-II(1)-353; W.A. Brown, First National Bank of Boulder, Colorado, R-II(1)-353; R. C. Smith, Florida Bank and Trust Co., R-II(1)-353; John Ross, Third National Bank of Ashland, Texas, R-II(1)-354; David Wood, Dyal Financial Corp., Tr. 6205; Clare A. Rollwagen, Minnesota Consumer Finance Conference, Tr. 6205; Jack W. Woodburn, Cleveland Trust Co., Ohio, R-II(1)-355; Marshall M. Taylor, Lillic, McHose and Charles, Attorneys, Los Angeles, R-II(1)-356. Some creditors also argued that the due diligence requirement was substantively too restrictive. See Staff Report at 672.

Post record comment summary at 106-107 notes 55, 57-58.

D. Dale Browning, Senior Vice President, Rocky Mountain B.A.C. Corp. (BankAmerica), R-II(1)-243; Michigan National Bank, Lansing, R-II(1)-237; Holland and Hart, Attorneys, Denver, Colorado, R-II(1)-237; Larry C. Ross, Assistant Counsel, Vickers Petroleum Corp., Wichita, Kansas, R-II(1)-237; Ronald J. Green, American Express, R-II(1)-236; William T. Copenwain, American Bankers Association, Tr. 10222; Ellis Kuchel, National Retail Merchants Association, Tr. 7041; Carl Felsenfeld, Citicorp, New York, R-II(1)-236; C. Lee Plesser, Washington, D.C., R-II(1)-236. But see Ernst D. Stein, Vice President, R-II(1)-434.
recommended a number of modifications in the rule provision initially proposed by the Commission. We are not persuaded that the benefits of those proposals offset their probable costs. 18 The rule we adopt today, providing a cosigner disclosure, will go a long way toward remedying not only the major problem reflected on the record—lack of consumer awareness of the full significance of becoming a cosigner—but also some of the subsidiary problems that are, to a large degree, also a function of cosigner awareness.

The rule corrects the problems of cosigner lack of information by requiring that a notice be provided alerting the consumer to the obligations and consequences of cosigning. A disclosure requirement received support from creditors, 19 as well as consumer representatives. 20 Robert P. Shay stated that:

"* 1 the high incidence of payment being demanded (from cosigners) lends support to those who would urge some form of disclosure. "* 1 (at 80).

It is also supported by the Presiding Officer who concluded:

"The record of this proceeding supports a requirement that cosigners in consumer credit transactions should be provided by the creditor with a clear and succinct statement of their potential liability." 21

Compliance

This rule does not require that the creditor personally give the notice to the cosigner, but only that it "be given" to the cosigner. Therefore, if the creditor would not otherwise have personal contact with the cosigner, the rule will not require such contact. The creditor may provide the notice through the; borrower or by other means such as the mail. However, the creditor is obligated by the rule to assure that the cosigner does in fact receive the notice prior to becoming obligated. If the creditor asks the borrower to give it to the cosigner and the borrower does not do so, the creditor will be in violation of the rule. Each creditor may adopt procedures of its own choosing for assuring that the notice is actually received.

The rule specifically requires that the notice be provided in a separate document. The purpose of this requirement is to assure that the cosigner will actually be aware of the notice before becoming obligated. Thus, the notice document cannot be affixed to other documents unless the notice document appears before any other document in a package, and it may not include any other statements, with one exception. Several states already require special notices to cosigners. 22 Those states are specifically exempt from § 444.5 of the rule. However, if a state does not apply, or if an exception is not granted, a creditor can still avoid having to provide two separate documents by putting both notices in one, unless the state law forbids it.

Although this is not specifically addressed in the text of the rule, the Commission intends that the notice document may also contain the creditor's letterhead. The information on the letterhead would not distract the cosigner from the notice and, because the notice may very often be the only document retained by the cosigner, such information might prove helpful at a later time. Similarly, if a creditor chooses to assure cosigners obtain the disclosure documents by requesting a signed acknowledgement, the notice document may include a signature line.

We also note that the creditor disclosure should be provided in the same language as that in which the underlying contract is written. Although this is not specifically addressed by the rule itself, failure to provide such same-language disclosures could constitute a separate violation of Section 5.

Open End Credit

Witnesses objected to the cosigner provision in open end credit transactions. They argued that the rule would require a notice upon each extension of credit pursuant to an open end account, making overdraft checking impossible and other forms of open end accounts complicated to administer. 23 The rule we promulgate today has been revised to make it clear that a notice need not be used every time a consumer draws on an open end line of credit. For open end accounts, the cosigner need only be given a single notice at the time that the account is opened. The specific language required by § 444.3(b) of the rule has been revised so that it applies when the cosigner is guaranteeing an open end account and may be liable for an amount less than or equal to the line of credit extended.

Definition of Cosigner

Several creditors stated the rule can be evaded by requiring potential cosigners to become co-applicants for credit. 24 We incorporate in the final rule a definition of "cosigner" that anyone whose signature is obtained after the initial applicant is told that the signature of another person is necessary. Creditors should not seek to evade the rule by designating cosigners as co-applicants.

It was thought by some that the definition of cosigner was so broad as to include the principal debtor or an authorized user of a credit card. 25 Recommendations were also made that "compensation" be defined, 26 or that consideration 27 or some other term 28 be used in the definition. Substitution of the term "accommodation party" for cosigner was recommended, as was revising the definition to make it explicit that one who signs in order that another may receive the benefit of the goods or money is a cosigner. 29 It was also suggested that the definition does not make clear whether a person who hypothecates security of a passbook on a loan but does not personally guarantee the loan is a cosigner for the purposes of

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18 See discussion of rejected provisions in Chapter XII.
19 E.g., Leslie R. Butler, Consumer Bankers Association and First Pennsylvania Bank, Tr. 11582; Vernon Lemos, Jr., Texas Finance Institute, Tr. 1065; John C. White, American Mortgage Bankers Association, R-III(d)-3; and Lacy Caldwell, Farro Nashville Employees Credit Union, R-III(d)-25; Don E. Wolf, York Bank and Trust Co., Pennsylvania, R-III(b)-106; T. J. Ryan, Albuquerque Bell Federal Credit Union, R-III(d)-6.
20 E.g., Robert H. Erwin, Legal Aid of Baltimore, Tr. 10025; Gayle C. Williams, Legal Aid Society of St. Louis, Tr. 4812; Pamela Pfeffer, C.A.M.P. Consumer Action Project, Tr., 6977; Charles Hammord, Arlington County Dept. of Consumer Affairs, Virginia, R-III(b)-126; Lewis Taffler, Alliance for Consumer Progress, Pennsylvania, R-III(d)-4; Ronald A. Gall, Wisconsin Consumers League, Tr. 2607; James L. Sullivan, Director, Department of Consumer Affairs, Missouri, Tr. 4858.
22 See supra note 23.
23 See supra note 74.
24 See supra note 74.
25 See supra note 74.
26 See supra note 74.
27 See supra note 74.
28 See supra note 74.
29 See supra note 74.
30 Paul H. Camerlengo, First City National Bank of Houston, R-III(b)-336; Michael Brown, United Auto Dealers Association, Chicago, Tr. 2706-2709.
31 Technical comments by the staff of the Board of Governors of the Federal Reserve Board, HEX 451 at 18; William B. Johnson, Sun Oil Company, R-III(b)-406; Russell A. Freeman, Security Pacific Corp., Los Angeles, R-III(b)-335; James Goldbett, American Retail Federation, Tr. 6123.
32 Technical comments by the staff of the Board of Governors of the Federal Reserve Bank, HEX 451 at 18; Frederick T. Berkenhe, Administrator Colorado U.C.C., HEX 351 at 7; Thomas Cranwell, Consumer University Law School, Wash., Tr. 10872-10873; Bryce A. Aggett, Oklahoma Consumer Finance Association, Tr. 850.
33 George H. Braasch, Chairman, Subcommittee of the Committee on the Regulation of Consumer Credit—Section of Corporation, Banking and Business Law of the American Bar Association, R-III(b)-230; David H. Poli, Capital Financial Services, Ohio, R-IV(a)-841.
34 T. McLane Griffin, First National Bank of Battle Creek, Michigan, Tr. 10872-10873; I. M. Mehlman, a natural person who without compensation and without an opportunity to obtain credit under the obligations.
35 John P. Winsett and Walter E. Hustedt, National Automobile Dealers Association, R-IV(a)-581; Lois W. Wood, Land of Lincoln Legal Assistance Foundation, R-IV(a)-393.
the rule. Another felt that the rule should be modified by the addition of the phrase "whether or not that person is specifically designated on the contract as being a cosigner."

We have adopted revisions which accommodate these suggestions. The phrase "another person" will avoid confusion between a cosigner and a principal debtor. Clarifying language has been added defining a cosigner as one who enforces the obligation for the benefit of another.

The proposed rule requires use of a notice advising cosigners of their liability. The industry asserted that the original notice was too long, unclear, inconsistent with state and federal law, inconsistent with cosigner's rights under other parts of the rule, inapplicable to open-end credit, and unnecessarily time consuming because of all the blanks to be filled in.

**Modifications to Required Notice**

The proposed rule requires use of a notice advising cosigners of their liability. The industry asserted that the original notice was too long, unclear, inconsistent with state and federal law, inconsistent with cosigner's rights under other parts of the rule, inapplicable to open-end credit, and unnecessarily time consuming because of all the blanks to be filled in.

**X. Analysis or Projected Costs, Benefits, and Effects of the Rule**

As set forth earlier, the Rule comprises six major components—four contract clauses that are prohibited, one accounting practice that is prohibited, and an affirmative disclosure requirement. Each of these elements is, to a certain extent, separable from the whole for the purposes of analyzing project costs, benefits, and effects of the rule.

The proposed rule and a lesser extent, benefits of the rule may not be read directly separable, and therefore are more appropriately attributable to the rule as a whole, rather than to any particular element of the rule. These benefits and costs are likely to arise from the impact on the market of the entire rule, rather than from the impact of any one element.

The costs and benefits attributable to the individual provisions of the rule are discussed in Chapters IV-IX, supra. The costs and benefits of the interrelated parts of the rule as a whole are discussed here.

**A. Costs**

Most commenters who opposed the rule argued that it would increase credit costs by either increasing the price of credit (because consumers would demand more of a more attractive product and creditors would supply less of it) and/or decreasing the availability of credit, especially for the marginal risk (because of stricter screening of credit applicants). These commenters stated that such increases in costs to creditors would outweigh whatever benefits consumers and competition might obtain from the rule. The record for the proceeding establishes, however, that the rule will not have a major impact on either the price or availability of credit.

1. **Econometric Studies**

Comprehensive econometric analyses of creditor remedies, interest rates, and amount of credit extended were prepared for the rulemaking record. The results of these studies were consistent with the experience in the states, described below.

The first study was a detailed and thorough examination of the theoretical economic implications of the rule and the empirical work carried out by the National Commission on Consumer Finance that evaluated these implications with reference to the existing consumer credit market. The study defined the economic issues raised by the rule, evaluated the empirical work that preceded it, defined a microeconomic model of the consumer credit market, and suggested further empirical work in the area to answer the fundamental questions about the effects of restrictions on creditors' remedies on credit cost and availability.

The report contains a variety of important conclusions based on an examination of the data bases compiled by the technical staff of the National Commission on Consumer Finance. It found, for example, that there is no significant relationship between interest rate ceilings and rejection rates. It also found no significant relationship between prohibition of creditor remedies and rejection rates. In short,
there appeared to be no significant correlation between permissible creditor remedies and creditor willingness to extend credit to consumers. In a second study, Professors Barth and Yezers developed a simultaneous econometric model for the consumer credit market. This model relies on individuals rather than the study used for the consumer credit market. This model relies on individual, discrete loan transactions. Having developed the model, Barth and Yezers ran three series of regressions using data obtained from FTC investigations and data obtained from the National Consumer Finance Association. Early problems with compiling an accurate table of state laws were eliminated in later versions of the study, which were presented in hearings on the rule. Using different data sources after new data, Barth and Yezers achieved consistent results. During the hearings, the NCFA introduced a large data base containing recent consumer loans. Barth and Yezers ran a final version of their study using this data base.

In their final study, Professors Barth and Yezers concluded that the percentage point estimate for the rule’s effect is a 39/100 of 1 percent (0.39%) increase in credit costs. Even this estimate may be too high because it compares a hypothetical laissez-faire state having no remedy restrictions with the same state having nearly all of the originally proposed restrictions. As noted, we have determined not to adopt several of the original staff recommendations, and we have significantly modified and refined several of those which we do adopt. Although the specific point estimates with respect to the impact of the rule on credit cost should be viewed as indicating a range or order of magnitude and not a precise estimate, the Barth-Yezers studies demonstrate that the impact of the rule on credit cost will be “clearly negligible.” During the course of this proceeding, the econometric studies—particularly the Barth-Yezers studies—were subject of considerable scrutiny and critical analysis. The Commission looked closely at the overall economic evidence, and focused on the Barth-Yezers work, during our final deliberations on the rule. We are cognizant of the limitations of the econometric studies. The studies represent, however, the most sophisticated analyses available on the record.

We have given careful consideration to the econometric evidence assembled on this record, particularly the latter studies of Professors Barth and Yezers. Our review has led us to consider that the econometric evidence does not, of itself, permit a definitive finding concerning any of the impacts of the rule as a whole. The relatively small magnitude of effects indicated by the econometric evidence does permit us to be reasonably certain that the effect of the rule will not be unduly large in either direction. Our conclusion in this regard has led us to look more closely at the other available evidence on the rule as a whole and as to each provision.

2. Experience in the States

There exists a large body of experience with restrictions on creditor remedies in consumer transactions. Most states already have laws similar to one or more of the provisions of the rule. During the rulemaking proceeding, three states were identified that have legal regimes comparable to or stricter than the rule as it was then proposed.

3. R-XII–39 at 7. Examination of the Barth-Yezers regressions using FTC and NCFA data reveals that the impact of individual provisions of the rule on credit cost is not significantly different from zero. Barth and Yezers consider that all the remedy variables must be viewed together, and that the study demonstrates that individual remedies cannot be evaluated except as a group.

See supra note 5-6.

See, e.g., NCFA Comments, R-TV–343 at 94–96; see also memorandum of April 4, 1963 from Timothy J. Murt, Director, Bureau of Consumer Protection, at 19–24; memorandum of the Bureau of Economics, April 5 and 7, 1963.

Professors Barth and Yezers made oral presentations before the Commission and were questioned by the Commissioners. See “Oral Presentations by Public Representatives,” June 8, 1963, TR 91–121.

See, e.g., Murris memorandum, supra note 6 at 24, citing Staff Report at 357–9.

Wisconsin, Iowa, and Connecticut. Because the final rule has delayed a significant number of the initial proposals and some of the states could now be said to have existing restrictions similar to the final rule.

State experience was examined extensively during the rulemaking proceedings. Statistics on credit markets in different states were submitted by NCFA, state regulators, and other sources. Comparisons were made between market conditions in states with laws similar to the proposed rule and other states. Although there is some state to state variation, these comparisons reveal no systematic differences between states that have restricted remedies and the other states. Interest rates in reform states tend to be lower than in representative states that do not restrict remedies covered by the rule. Borrower income and default rates were lower in reform states than in non-reform states, while borrower debt levels tend to be higher. Overall, there are no apparent negative impacts on cost where credit reform laws have been enacted.

Another source of information on state experience is comments and testimony by state regulators, creditors, and other persons from states that have adopted laws similar to the rule. In some instances these individuals accompanied their testimony with statistics, for example, on market conditions before and after a credit reform law took effect. Although occasional negative effects were noted, the consensus was that the state reform laws had not interfered with creditors’ business. No significant

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13 See especially Staff Report at 525. See also Staff Report at 543 note 177, and 517; R-XIII–38 (state by state breakdown of NCFA survey data).

14 See, e.g., Clarence B. Bleser, Wisconsin Finance Corporation, Tr. 3548–83 (but see Robert P. Shuy, 115–204 at 24); Thomas H. Huston, Iowa Banking Dept., Tr. 3550–81; Triola, Iowa Finance Act, Tr. 3560–81 (reports small increases in collection cost primarily attributable to an Iowa law provision not contained in rule). See also discussion of Credit Research Center Studies of Wisconsin Consumer Act in Staff Report at 544–546.

15 E.g., Richard A. Victor, Wisconsin Department of Justice, Tr. 4015–37; Robert A. Patrick, Office of Wisconsin Commissioner of Banking, Tr. 4037–38, 4015, 4014, R–(d)–100 at 1; Tucker K. Trautman, Colorado Dept. of Law, IX–352 at 24; Edward J. Heise, Jr., Illinois Consumer Finance Act’s, Tr. 3467; James L. Brown, University of Wisconsin, IX–353 at 1–3; Robert C. Focht, Connecticut Banking Dept., Tr. 11282; Diane Coadrin, Connecticut Citizen Research Group, Tr. 1002, cited in this report.

effect on the cost or availability of credit was reported. Creditors, for example, testified that they lent to the same type of consumers and applied the same credit standards after reform laws were passed as before. Other testimony from the three “laboratory” states was consistent with these observations.

3. Other Evidence on Effects on Costs
The record also contains extensive evidence: on the value of individual remedies to creditors. From this evidence we have drawn general inferences concerning the cost to creditors (and thus ultimately to consumers) of banning remedies. All of the remedies addressed by the rule are ones whose importance to creditors is limited. Evidence on the value of each remedy covered by the rule is reviewed in the respective chapter on individual rule provisions. Some examples will illustrate the types of information on which our conclusions are based.

Several important types of evidence on value of remedies relate to all rule provisions. Evidence on causes of default, discussed in Chapter III above, is one example. Another is survey evidence on the importance of various collection methods to creditors. The most important remedies—garnishment, repossession, acceleration of the debt, suit, and direct contacts with debtors—are not restricted by the rule.

The evidence establishing the limited value of the remedies covered by the rule helps to explain the finding that state laws restricting remedies have not had significant disruptive effects on credit markets. It also provides an independent reason for concluding that the rule also will not have such effects.

B. Benefits
A key issue throughout the rulemaking proceeding has been whether the benefits received by consumers from restricting one or more of these remedies would offset any decrease in credit availability or increase in credit costs that may result. Although many of the benefits of the rules were properly addressed in the context of the individual provisions, a general overview can be made.

Because default is largely beyond the debtor’s control, the benefits of the proposed restrictions would be potentially available to any consumer. No one is so free from the possibility of loss of employment, large medical expenses, marital discord, etc., that the rule might never provide benefit. The benefits to all consumers can thus be analogized to insurance, in some respects.

Many of the rule’s benefits are difficult to evaluate monetarily, such as: procedural due process protections; the opportunity to assert valid claims and defenses; less economic distress and disruption of family finances; less embarrassment, humiliation, and anxiety; less interference in employment relations; retaining personal possessions and household goods; protection against coerced settlements; and well informed consignors. Nonetheless, consumers place a value on such benefits (e.g., less emotional distress). Their willingness to pay for contracts that reduce these possibilities is the measure of these benefits.

Other benefits are more susceptible to an estimate of monetary value for individual consumers. These benefits include: fewer costly refinancings; less loss of equity in property; goods remaining in the hands of the party who values them more highly; and fewer additional delinquencies “triggered” by one creditor filing a wage assignment.

C. Summary
In assessing the costs and benefits of this rule, the Commission must be guided by ranges and magnitudes and not precise dollar estimates. There is no means available to prepare precise, dollar point estimates of the costs and benefits of curtailment of creditors’ remedies. This is because these costs and benefits are small, when factored into any precise empirical model that endeavors to define the array of factors which influence credit extension decisions. Moreover, the rule does not affect the most valuable creditor remedies, including garnishment, self-help repossession, direct debtor contacts and the like. Nor does our final rule address several creditor remedies encompassed in the original proposal (and upon which all aggregate impact assessments are based), e.g., deficiencies, attorneys’ fees, etc.

Although any restrictions on creditor remedies have cost implications, factors other than these six remedies predominately determine costs and availability. The most important factors are: (1) The cost of money to the creditor, (2) the consumer’s present income, existing debt level, and capacity to incur further debt, (3) the possibility of the consumer being a repeat customer, (4) the creditor’s opportunity costs, (5) the applicable interest rate ceilings, (6) the availability of other fees and charges, (7) the availability of the most useful creditor remedies, (8) the principal amount of the loan, etc.

Aggregate economic conditions have an effect as well. Thus, any assessment of the rule’s potential effects on credit costs or availability must start from a position that the remedies involved have little effect relative to the major determinants of cost and supply. Although this is not, in itself, evidence of the net effect of the rule, it does provide a context for assessing the expected impact of individual rule provisions, discussed in relevant chapters above.

The benefits of this rule also cannot be quantified precisely. At issue is the treatment of borrowers and their families when serious financial problems occur. The record contains extensive evidence that the specific remedies at issue here are a direct cause of substantial consumer injury, that consumers cannot reasonably avoid such injury, and that the injury is not offset by other benefits, either to consumers or to competition. The record contains evidence of the use of challenged remedies and the effect of such use on consumers and their families. Much of this evidence is quantitative in nature.

XI. Impact on Small Business
In the course of this proceeding certain creditors argued that the rule will injure small businesses.1 Our review

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1 See, e.g., Thomas Rothwell, National Small Business Association, 81-605 Leonard M. Cohen, Independent Finance Association of Illinois, Tr.
of the record reveals no disproportionate impact on small business from federal or state credit reforms. To the contrary, Federal Reserve Board data compiled by the NCFCA show that the number of small finance companies grew from 1970 to 1975, notwithstanding increasing competition from banks and credit unions, the Supreme Court’s decisions in *Fuentes v. Shevin* and *Snidovt v. Family Finance Corporation,* and passage of the Consumer Credit Protection Act of 1967 (which includes, as amended: Truth in Lending, Equal Credit Opportunity, Fair Credit Reporting, and other credit reforms).4

2477; Robert E. Deas,Securitization Mutual Finance Corp., Tr. 181; William Layne, Consumer Loan Co., Tr. 436; Gary Finn, Summit Federal Credit Union, R. 15; Robert B. James, Independent Tire Dealers Association, R. 1(a)-288; G. C. Backhaus, Post Finance Company, R. 1(d)-799; Richard Warren, Alabama Lenders Association, R. 1(e)-381.

427; U.S. 67 (1972).

396; U.S. 337 (1960).

4Relevant data are summarized in the following table:

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<tr>
<td>Companies having short- and</td>
<td>12,124</td>
</tr>
<tr>
<td>intermediate-term credit</td>
<td>628</td>
</tr>
<tr>
<td>outstanding of:</td>
<td>883</td>
</tr>
<tr>
<td>$100,000 to $499,999</td>
<td>952</td>
</tr>
<tr>
<td>$500,000 to $999,999</td>
<td>631</td>
</tr>
<tr>
<td>$1,000,000 to $4,999,999</td>
<td>175</td>
</tr>
<tr>
<td>$5,000,000 to $9,999,999</td>
<td>45</td>
</tr>
<tr>
<td>$25,000,000 to $99,999,999</td>
<td>24</td>
</tr>
<tr>
<td>$100,000,000 and over</td>
<td>10</td>
</tr>
<tr>
<td>Total</td>
<td>8,424</td>
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The distribution of the number of finance companies by dollar amounts outstanding in the years 1960, 1965, 1970 and 1975 indicates sharp decreases in the number of very small firms (less than $1 million in outstanding) from 1950 to 1960, followed by a 7 percent increase in their total number during 1970-75—the period in which the most significant federal and state consumer credit reforms took effect (Truth in Lending became effective in the second half of 1969). While the number of firms in the $500,000-$999,999 category decreased slightly from 432 in 1970 to 415 in 1975, this may reflect upward movement in individual firms’ total outstanding because the $1,000,000-$4,999,999 category grew from 300 to 500 firms in this period.

The total number of finance companies increased from 2,081 in 1970 to 3,376 in 1975. Of these 3,376 firms, the top 80 (outstanding of $100 million and over) operated 1,225 offices, an average of 21 offices per firm. The remaining 2,789 offices in the industry were distributed among 3,289 firms with outstanding under $100 million, an average 2.4 offices per firm. National Consumer Finance

More specifically, with respect to this rule the record contains evidence that many small creditors need to rely less on the contractual provisions and non-contractual practices addressed by the rule than large multi-office firms.

Several operating practices of one and two office finance companies testified on their strong community ties, histories of courteous personal service to successive generations of related customers, and effective “notice and phone call” collection programs. Thus, small finance companies tend to rely less on the practices addressed in the final rule.

On the other hand, major national finance chains have high turnover rates in office personnel, uniform procedures for handling minor delinquencies and serious defaults, and generally deal with their customers on a less personal basis than small independents.4 The more personalized approach to collections that is possible for smaller creditors in many cases can serve as an effective substitute for formal remedies.

The National Consumer Credit Finance Survey results suggest that smaller banks and single-state retailers and finance companies tend to be less dependent upon many of the contractual provisions and practices affected by the rule than larger firms.5 While there has been a long-term declining trend in the role of small finance companies this trend is attributable to causes other than regulations on creditor remedies. The record, taken as a whole, does not indicate that the rule will have a disproportionate effect on smaller creditors.

XII Relation Between The Rule and State Law

The rule has been drafted to be as consistent with existing state laws as possible. Indeed, state laws served as the model for several rule provisions. The rule prohibits practices that are authorized by statute or common law in at least some states. However, none of the rule provisions preempt state law by creating an irreconcilable conflict.

That is, creditors will be able to comply with both state law and this rule.6

Under the law governing preemption, state legislation that imposes requirements not inconsistent with the rule will remain in effect, whether or not states seek exemption. Therefore, where state regulation is more stringent than the rule, compliance with the rule will not immunize creditors from state

Two remedies prohibited by the rule, wage assignments and confessions of judgment, tend to be included more frequently in the form contracts of single-state (compared to multi-state) finance companies and retailers. Id. at 83-85, 86-88. This result may be explained in part by the widespread state restrictions imposed upon these remedies which necessarily limit their importance to any company operating on a national scale. The frequency of inclusion of these two remedies in bank contracts did not differ significantly between large and small banks in the NCCP survey. Id. at 81, 84. Another reason for this phenomenon may be that small creditors cannot afford more expensive, formal collection methods.

Paul Smith, Vice Dean of the Wharton School, identified bank commercial loan interest rates as "the most important" source of difficulty for small finance companies. Tr. 8494. By the same token, Dr. Smith pointed out that large finance companies are able to obtain capital at a lower cost than small firms. Tr. 8495. He also stated that increasing competition from banks and credit unions and economies-of-scale in multi-branch operations have contributed to decreases in the number of independent firms. Tr. 8494-95. In his testimony, Dr. Smith did not allege that regulatory restraints have figured in this trend.

1FTC rules only preempt state law where there is a direct conflict. See, e.g., Statement by the Commission in Hearings on S. 665, 82d Cong., 1st Sess. 66 (1971) at 15; Florida Law v. Avocado Growers, Inc. v. Paul, 373 U.S. 132, 141 (1963). The Commission has held that Federal Trade Commission regulations are preempted for purposes of the 1975 implied federal preemption statute if they conflict with a state statute. See *FPC v. Baderly*, 333 U.S. 614, 625 (1948). The Commission has ruled that if a state statute conflicts with a federal regulation, the state statute is preempted. See *FPC v. Baderly*, 333 U.S. 614, 625 (1948). There is no evidence of a design to preempt the field of creditor remedy regulation is present in either the Federal Trade Commission Act or the rule.
considered by the Commission in determining whether an exemption is warranted—include the resources committed by the state to enforce its provisions, and the extent of any private rights of action available to aggrieved consumers.

Only state governmental entities may request exemptions from provisions of the Commission's rules under §444.5. The grant of an exemption based on state requirement will necessarily place on the state the primary burden to enforce its provision. Therefore, a decision to seek exemption should be made solely by the state entity involved.

In a number of instances, participants in the proceeding indicated that the rule might conflict with state law, or interact with state law in a confusing or unforeseen way. We have adopted modifications to the rule to eliminate these problems.

In response to concerns expressed by state officials 4 and others, 5 the Commission takes this opportunity to make clear that the rule is not intended to occupy the field of credit regulation or to preempt state law in the absence of requirements that are inconsistent with the rule.

XII. Empirical Evidence on the Benefits and Costs of Provisions Considered by the Commission But Not Adopted.

This section discusses the benefits and costs of provisions of the 1975 proposed rule that the Commission considered but did not accept, together with an analysis of what are alternative considered by the Commission during its final deliberations on the rule.

A. Deficiencies

A deficiency arises when repossessed collateral is sold for less than the amount owing on a debt. The Commission has considered but rejected a provision that would have required valuing collateral other than household goods at its retail price for purposes of calculating deficiencies. The provision would have required enforcement of remedies in the case of household goods collateral, requiring creditors to choose between repossession or suit.

1. Prevalence

Sizeable deficiencies occur in the majority of transactions involving automobile repossessions; average automobile deficiencies range from 25 to 50 percent of the balance owing at the time of default. Little evidence addresses deficiencies for other types of collateral. Creditors apparently pursue deficiencies only infrequently, and an average creditor recovers no more than 5 to 15 percent of the deficiency. As the Presiding Officer noted, under these circumstances creditors have an incentive to obtain the best possible price, net of sales costs, for collateral. 6 There is, therefore, insufficient evidence that problems in the valuation of collateral are prevalent.

1 See Mobil Oil Corp. v. Attorney General, 360 N.E.2d 408 (Mass. 1978) in the court held that a state statute banning certain promotional games of chance was not preempted by a Federal Trade Commission rule regulating such games.

2 For purposes of this rule, a state requirement or prohibition could include statutes and formal state regulations. It would not include informal enforcement policy statements.

3 The provisions related to that applied by the Federal Reserve Board in determining state exemptions from requirements of the Truth in Lending Act. See Board of Directors of the Federal Reserve System, Consumer Lending, Truth in Lending: Exemption Application 7, 8, 9, 10, 11 PR 18210, April 15, 1984.

4 For example, we have excluded certain wage assignments and other types of transfers not included in the rule because of possible problems with the California Personal Property Brokers law, clarified Section 6 of the rule as it applies to waivers of exemption to avoid problems with mortgage laws in certain states, and significantly scaled back §444.3 on late fees in such a way as to avoid conflict with state laws on late fees. See generally the sections of this Statement on individual rule provisions.

5 E.g., Tucker Truatman, Colorado Assistant Attorney General, HS-352 at 3-12; Richard Cross, Massachusetts Assistant Attorney General, Tr. 10026; Richard Victor, Wisconsin Assistant Attorney General, HS-351; Robert Patrick, General Counsel, Wisconsin Office of Commissioner of Banking, HS-152 at 8.

6 E.g., National Consumer Law Center, R-15-08 at 10-11; Jonathan Epstein, Essex-Newark Legal Services, Tr. 6207; Michael Burns, Legal Aid Society of Minneapolis, HS-45 at 13; Terry Friedman, Western Center on Law and Poverty, Tr. 6637; Ronald Cull, Wisconsin Consumer League, Tr. 3978-77; Mary Gillespie, San Francisco Neighborhood Legal Assistance Foundation, Tr. 5568-88; James Brown for Consumer Affairs, University of Wisconsin Extension, HS-153 at 12. The Presiding Officer suggested that language should be added to the rule to eliminate conflicts with certain Federal laws or regulations. Presiding Officer's Report at 352. Examination of the testimony cited by the Presiding Officer in support of this recommendation does not reveal any specific conflicts between the rule and Federal law. Although there were no direct conflicts, witnesses were concerned about the relation between various Federal laws and the rule provisions on late charges, waiver of exemption, and restrictions on non-purchase money security interests. We have adopted modifications in these provisions as a compromise of the concerns expressed. In particular we have substantially reduced the scope of the late fees provision, thereby avoiding conflicts with Federal late fees regulation, and have clarified our intent to modify the security interest provision so that they do not effect real property mortgages.


10 E.g., Note, "The No-Interest Rate Market: A View of the Automobile Loan," 247, GMAC, R-61A-15 at 8-10; Bank of America, HS-287 at 8; Security Pacific National Bank, HS-308; Germany, HS-500 at Table 4.

11 Milroy, Tr. 5426-87; Nagel, R-1134-60; Marsh, Tr. 2518.

12 E.g., Schmidt, Tr. 61649; CMAC, R-61A-15 at 10; Brown, Tr. 2777; Marin, Tr. 1143, 1154-50; Marsh, Tr. 2518-20.

13 Presiding Officer's Report at 350.
2. Benefits

The benefits of an election of remedies requirement in repossessions of household goods would be similar in nature if not magnitude to those that would result from the provision to prohibit non-purchaser security interests in household goods. When a deficiency is pursued, a requirement for valuation at the retail price would benefit borrowers, because normally resale would take place at the lower wholesale value. In the event of abuse, resale may take place below wholesale value.

Retail valuation thus raises two issues. The first is the requirement to credit consumers with the retail rather than the wholesale value of repossessed collateral before pursuing a deficiency. The second involves any remaining problem in cases where the consumers are credited with less than the wholesale value of the goods. These issues will be addressed before considering the benefits and costs of the provision.

The difference between retail and wholesale prices is a result of the costs of retailing. The Commission concluded that it is not unreasonable for defaulters to bear the costs of retailing repossessed collateral and that sales at wholesale prices are therefore not inherently unfair. When retailers sell repossessed collateral, they normally sell it on the retail market. The fact that repossessed cars are sold for prices below wholesale book value can often be explained by differences in the condition of repossessed cars and the average “good” used car, and hence there is little basis for concluding that undervaluation of collateral is prevalent.

The record does, nevertheless, reveal some problems in valuation of collateral when the creditor and the buyer are closely related. When the creditor sells the car to itself or in a “sweetheart” deal, there is an incentive to undervalue collateral to the extent that recovery on a deficiency is possible. However, the evidence does not indicate that such undervaluations are prevalent, and they frequently violate existing state law. The U.C.C. requires that collateral be disposed of in a “commercially reasonable manner.” As the President Officer noted, a valuation requirement is not a self-executing remedy. To secure benefits, consumers must resort to the courts just as they must do to insure that sales of collateral under current laws are made in a commercially reasonable manner. In view of reluctance or inability to take this action as shown by the record, the provision will be largely ineffective.

We therefore conclude that a case-by-case approach to enforcement of existing standards of valuation in the event of abuse is preferable to a rule that would restrict the legitimate use of deficiencies.

3. Costs

To the extent that these provisions would reduce recovery on deficiencies or restrict repossession of household goods used as collateral for installment credit or purchase money loans, they would reduce the value of collateral to creditors and hence increase creditors’ costs and losses due to defaults. In addition, the determination of retail value and the allocation of selling costs would involve substantial costs for creditors as well as enforcement agencies. These costs would be especially great if a vehicle required extensive repairs or was resold several times before its eventual retail disposition.

Furthermore, the retail value provision could create perverse incentives. Some debtors might intentionally default on their loans in order to obtain free retailing services, the costs of which would be imposed on creditors. The rule would also create incentives for creditors to enter retailing even though costs might be lower if more efficient retailers were used.

4. Commission Decision

A majority of the Commission decided that this provision would impose costs, and could raise the cost and reduce the availability of credit, in excess of offsetting benefits. Crediting debtors with the wholesale value is not unfair when a higher price is not obtained, there is little evidence of prevalence concerning valuation below the wholesale value, and such valuations are already illegal under current standards. Our decision is consistent with the President Officer’s findings concerning the retail value provision.

B. Attorney’s Fees

The Commission considered but rejected a provision prohibiting credit contract clauses requiring that debtors pay attorneys’ fees incurred by creditor in debt collection. This provision would not have restricted the power of the courts to impose such fees on debtors under state law, however. Consequently, the provision might have had little effect in some states.

1. Prevalence

A large majority of the states permit attorneys’ fees clauses, although some ban them on small loans and/or place limits on the size of the fees. Record evidence indicates that such clauses are included in the great majority of contracts when they are permitted by state law. Attorneys’ fees represent a significant share of the average judgment.

2. Benefits

The rationales offered for this provision were that attorneys’ fees exceed actual costs, that consumer liability for attorneys’ fees discourages the assertion of valid defenses, and that consumer liability reduces creditors’ incentives to minimize their legal costs.

The evidence shows that the attorneys’ fees assessed against debtors generally reflect what attorneys charge creditors for their services. The evidence also shows that, in some specific instances, what attorneys charge creditors for these services bears little relation to the amount of work performed and may appear excessive. However, this is explained by the way attorneys are paid, e.g., a percentage of the unpaid obligation, and does not imply that

18 One version of the provision would have allowed exceptions where attorneys’ fees are paid directly to the prevailing party or require a judicial determination that they are reasonable based on the value of services performed. The Commission rejected this version because it was not supported by the record. A provision that attorneys’ fees are to be paid by the losing party would have little impact, because debtors have default judgments entered against them in the vast majority of cases. Nothing would be gained from a requirement of judicial determination of reasonableness, because the evidence discussed below suggests that attorneys’ fees assessed against debtors are already subject to state requirements of judicial review for reasonableness.

19 President Officer’s Report at 322.

20 NCPA, R.-XII-31 at C-22-23, and President Officer’s Report at 180.


23 The NCLC survey indicates legal aid attorneys believe the average is 25 percent. H.-XIV-30: NCPP, Technical Studies, Vol. IV at 56-68. The record contains references to figures of 5 to 20 percent for individual cases, e.g., Baker, H.-XII-31 at 1-2; Baker, H.-XII-31 at 1-2; Brewer, H.-XII-31 at 1-2; President Officer’s Report at 180.

24 E.g., Heinerstein, H.-XII-31 at 1-2; President Officer’s Report at 180.

25 E.g., Heinerstein, H.-XII-31 at 1-2; President Officer’s Report at 180.
debtors overcompensate creditors. As the
President Officer found, on average, "attorneys' fees, as limited by state
laws, do not fully reimburse creditors
for the amounts they actually expend for
such fees." 20

This provision would benefit
borrowers to the extent that, in the
event of default, it would increase their
bargaining power with creditors and
reduce the size of the judgments against
them.

Because this provision would reduce
the expected cost of defending a
lawsuit, under some circumstances it
would provide benefits by encouraging
the successful assertion of valid
defenses. The record contains evidence of
instances in which a debtor agreed not to assert a defense in return for the
creditor's agreement to waive attorney's
fees. 21 The decision to reach a
settlement reflects a mutual interest in
minimizing legal costs. Although an
attorney's fees clause could affect the
terms of settlement, it would not
necessarily affect the probability of a
settlement. In any event, the
Commission shares the President
Officer's conclusion that the "use of
attorneys' fees clauses to persuade
consumers to pay debts they do not owe
or to forego valid defenses is simply not
supported by the evidence in this
record." 22

The suggestion that this provision
would provide benefits by encouraging
creditors to limit their legal costs is not
sufficiently supported by the record. As
with deficiencies, creditors have an
incentive to minimize attorneys' fees
and other collection costs, because
generally they are not fully reimbursed
by defaulters. 23

3. Costs

As is the case with any measure that
reduces the costs of default to the
borrower, the attorneys' fees provision
might increase creditors' collection and
other costs. In the event of default and
a judgment, what borrowers would gain in
reduced judgments as a result of this
provision, creditors would lose in
reduced recoveries. 24 In addition, if the
provision did encourage the assertion of
defenses, total legal costs would rise.

4. Commission Decision

After weighing the record evidence,
the Commission determined that the
costs of this provision outweigh the
benefits. This is consistent with the
conclusion of the President Officer that

20 President Officer's Report at 171.
21 E.g., Bodron, Tr. 334-39.
22 President Officer's Report at 182.
23 E.g., Greenberg, Tr. 1233-37; Webster, Tr. 3031.
34 * * * the record does not permit an
objective determination that the degree
of consumer injury is sufficient to justify
prohibiting the inclusion of attorneys' fees
clauses in consumer credit
contracts." 25

C. Third Party Contacts

The Commission considered but
rejected a provision to prohibit creditor
contacts with third parties except to
locate the debtor, to determine the
nature and extent of the creditor's income
or property, or as a court permits.

1. Prevalence

Record evidence indicates that many
consumer credit contracts contain
provisions expressly waiving the
debtor's right to privacy or otherwise
committing third party contacts. At the
time credit is extended creditors often
obtain names of employers, relatives,
friends, and neighbors. 25 Fifteen states
limit third party contacts, and two
prohibit them. 26

The NCFA survey of finance company
contacts indicates that third party
contacts with employers in the case of
delinquency occur in 35 percent of
personal loans and 40 percent of sale
finance contracts. 27 The percentage
increases to 5 percent for loans
delinquent 60 days or longer. Some of
these contacts are incident to wage
assignments and garnishments. 28

The NCFA survey shows that contacts
with third parties other than employers
are more frequent, occurring in 12
percent of personal loans and 8 percent
of sales finance contracts, and
increasing to 35 percent of personal
loans which have been delinquent for
60 days or longer. 29 Half of these
contacts are with relatives of the
debtor. The vast majority are to locate
or leave a message for the debtor. Nonetheless,
the survey indicates that about 5 percent
of these contacts are to seek collection
from a third party. 30

The record does not contain evidence of
widespread abusive third party
contacts. In the case of creditor contacts
with a debtor's employer, it is in the
creditor's interest refrain from abusive
conduct because to do otherwise might
jeopardize the debtor's earnings. 31

25 Presiding Officer's Report at 158.
26 E.g., NCLC, HX-407; Avco, R-XI-AVCO-616;
27 NCFA, R-XII-31 at C-20-27.
28 Shays, HX-494 at 89; NCFA, HX-485 at Q11.
HX-409 at Q11, HX-409 at Q11, HX-409 at Q11, HX-409 at Q11, HX-409 at Q11.
NCFA data may underestimate third party
contacts. Avco, Tr. 11891-11904.
29 Shays, HX-494 at 83.
30 NCFA, HX-408 at Q11 and HX-408 at Q11.
31 Id.
32 Curtis, Tr. 2552; Thomas, Tr. 8502.

2. Benefits

This provision would benefit
borrowers to the extent that it would
reduce the ability of creditors to apply
pressure to them in the event of default.
Reduce contacts with employers that
might endanger debtors' jobs, reduce
loss of privacy, deter otherwise reduce
abusive contracts. Examples of such
abuses shown on the record include
threats to reveal information to third
parties, disclosures of information to
third parties that amount to gross
invasion of privacy, threats against
third parties, or threats against debtors
conveyed to third parties.

The provision requiring a contract
clause ruling out third party contacts
would produce few benefits because of
enforcement problems. In the event of a
prohibited third party contact, the
debtor would have the value of breach
of contract, and the remedy would be
limited to actual damages. It is unlikely
that such litigation of this type would
occur, because the large majority of
judgments against debtors are taken by
default. 32

3. Costs

In some cases, the restriction on third
party contacts could work to the
detriment of debtors because these
contacts may currently prevent the use
of more onerous collection methods. 33

This provision would increase
creditors' collection costs and perhaps
losses due to default. Many contracts are
efficient, legitimate business procedures,
e.g., contacts with third parties who
might possess the collateral or contacts
with other creditors for purposes of
instituting bankruptcy proceedings. 34 A
general prohibition on third party
contacts of the type contemplated by
this provision as proposed would
inevitably prevent some useful contacts
because of problems in drawing a clear
cut between abusive and legitimate
contacts.

4. Commission Decision

The majority of the Commission
decided that the costs of this provision
outweigh its benefits. We consider that
a case-by-case approach is more
appropriate to stem abusive third party
contacts without restricting legitimate contacts. In this decision, we departed from the findings of the Presiding Officer, who concluded that any potential benefit from third party contacts was "completely outweighed" by the potential for consumer injury. However, the Presiding Officer did find "a clear necessity for redrafting this provision of the rule so as to permit the creditor use of third party contacts that have a genuine business purpose." We concluded that because of the difficulties of distinguishing contacts that are injurious from those that are beneficial, case-by-case enforcement against contacts that cause injury to consumers is a more cost-effective approach.

D. Late Charges

Another proposed rule provision that we rejected would have prohibited late charges, that is, fees assessed for late payments above and beyond interest on the late payments.

1. Prevalence

Consumer credit contracts almost universally provide for the assessment of late charges, and such charges are usually levied when payments are late. The amounts of these charges are limited by federal and state laws.

2. Benefits

Borrowers would be better off in the event of delinquency if late charges could not be assessed. However, in the absence of pyramiding there is no evidence of creditor abuse in imposing late charges. In general the charges assessed do not fully compensate creditors for the extra costs of handling delinquent accounts.

3. Costs

Late charges serve a dual purpose. They provide an incentive to the debtor to make payments on time, and they partially compensate the creditor for the additional costs involved in collecting delinquent payments. Creditors receive a significant amount of income from late charges.

Without late charges a debtor could effectively convert a precomputed installment credit into open-ended credit. This could create serious portfolio problems for a creditor, and in particular would increase the risks related to changes in interest rates and matching of the terms of assets and liabilities. To prevent this problem, a creditor would have to declare a default and accelerate the entire balance. Such a choice would injure consumers rather than help them.

4. Commission Decision

The Commission concluded that the costs of the proposed provision outweigh the benefits. The benefits to borrowers would not be sufficient to offset the adverse effects on the cost and availability of credit. This is consistent with the findings of the Presiding Officer: "there does not appear to be any economic justification for [this provision of the rule, at least from the standpoint of the consumer]."

E. Cross-Collateralization

Cross-collateralization occurs when goods purchased from a retailer on credit are used to secure credit extended for subsequent purchases until the account is cleared. A provision of the proposed rule which we decided not to promulgate would have restricted cross-collateral clauses in installment sales contracts. Essentially, the provision would have required first-in, first-out accounting for credit contracts covering multiple purchases.

1. Prevalence

Cross-collateral clauses are allowed in all but two states; however, another 18 states mandate a first-in, first-out accounting principle similar to the one specified by the proposed provision. Another 18 states mandate an accounting principle, based on proration of payments, which would have been prohibited by the proposed provision.

The NCLC survey of legal aid attorneys and other evidence suggest that cross-collateral clauses are often used by retailers, particularly by sellers of furniture and appliances, in states where they are permitted. However, this evidence is not systematic, and there is insufficient evidence in the record to permit an estimate of the frequency with which such clauses appear. Also, a majority of the Commission found that there is insufficient evidence that cross-collateral clauses cause any notable degree of consumer injury. There is some evidence that use of such provisions by major retailers has not posed problems for consumers.

2. Benefits

Borrowers would probably be better off in the event of default if cross-collateral clauses were restricted, because the amount of collateral subject to repossession would be reduced. However, little is known about the accounting schemes that would be used by creditors if cross-collateral clauses were prohibited or about their implications for consumer debtors.

3. Costs

This provision could significantly reduce the value of purchase money security interests. No payments would be allocated to reducing the principal owed on the most recent purchase until all earlier purchases are paid off. If preceding purchases were not paid off until a year after the most recent one, for example, the only security for the entire amount of the credit extended for the most recent purchase would then be a year-old appliance or piece of furniture.

4. Commission Decision

In light of the fact that the record does not permit a finding regarding the prevalence of cross-collateral clauses or the prevalence of consumer injury, and because the record does suggest important costs that would result from restriction of security for retail credit sales, a majority of the Commission concludes that the benefits of this provision would not outweigh its costs.

F. Other Cosigner Provisions

One provision of the originally proposed rule that a majority of the Commission decided not to accept would have required a three-day waiting period before cosigners could obligate themselves; another would have limited cosigner liability; another would have required that the creditor provide the cosigner with copies of all documents signed by the cosigner and all documents furnished to the debtor; another would have required the creditor to notify the cosigner whenever the debtor became delinquent.

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11 Presiding Officer's Report at 259.
12 Presiding Officer's Report at 262.
13 Presiding Officer's Report at 268.
14 FHA, 115-428 at 3-24; NCLC, R-1(4)-103 at 94.
15 Presiding Officer's Report at 196, 206.
16 Eg. Shay, 115-424 at 55-59.
17 Eg. Himoto, Tr. 5388; Lapan, Tr. 11470.
18 Presiding Officer's Report at 125.

19 Eg. Tarpley, Tr. 1153-45; Hilliburton, R-1(4)-29 at 6-7.
20 Korten, R-1(4)-280.
21 In this decision, the Commission departed from the conclusion of the Presiding Officer: Presiding Officer's Report at 314-317.
22 In the latest version, this was restricted to cases where the debtor is truly in default. See Staff Report at Appendix A, p. 8.
23 In the latest version, this was restricted to delinquencies of 30 or more days. Id. at 8-9.
3. Documents

In most states, creditors are not required to give cosigners copies of the documents they sign or other documents, and in most cases these documents are not given. Such documents would assist cosigners in presenting defenses when a creditor demands payment from them. The record contains some evidence that such tactics are used, but there is insufficient evidence that their incidence is significant. None of the states appear to require such a waiting period.

The provisions would impose two costs every time a cosigner is used: the credit could be delayed, which could be a serious problem in emergency situations, and a second meeting between the creditor and cosigner would be required. Creditors uniformly and vociferously objected that the three-day waiting period was unreasonable and unnecessary. The Presiding Officer found that "in view of the evidence of delay, inconvenience, and costs accompanying a required three-day cooling-off period for cosigners, it is concluded that the record does not support a requirement for so drastic a remedy." We concur in this determination.

2. Cosigner Liability

It was proposed that the cosigner's liability be limited to the total amount of payments for which the debtor is obligated at the time the cosigner signs. This provision would impose a cost on creditors who would be unable to seek compensation from cosigners for late charges, attorneys fees, and court costs.

The Commission shares the Presiding Officer's conclusion that "there is insufficient justification for the rule's limitation on cosigner liability."
remedies included in loan contracts and their meanings; (2) the disclosure would substantially reduce this ignorance; (3) the cost of the disclosure would not be high; and (4) there are no other important sources of market failure in the market for creditor remedies.

The discussion of benefits and costs presented below focuses on whether these conditions exist. The Commission found that there are in fact other important sources of market failure in the market for creditor remedies, and that consequently the disclosure alternative would not adequately deal with the problems raised by use of certain creditor remedies.

1. Benefits

Although it does not explicitly address a disclosure alternative, the rulemaking record does contain evidence of the extent to which consumers "understand the meaning, legal effect, and financial consequences of the provisions included in contracts used in consumer credit transactions." 60 After reviewing the evidence, the Presiding Officer found that "consumers do not have a complete understanding of consumer credit contracts." 61 He noted that: "Consumer credit contracts are not drafted with a view to making the provisions understandable to the consumer generally and do not contain an adequate explanation of either the consumer's rights or the creditor's obligations." 62 In discussing the individual provisions of the proposed rule, the Presiding Officer's Report often infers evidence of consumer ignorance about contractual creditor remedies as a problem relating to the use of these remedies.

The fact that a significant share of borrowers have incomplete information about available creditor remedies suggests that there is a potential market failure that might be remedied by a disclosure rule. Although there is no direct information on the extent to which a disclosure would reduce consumer ignorance of specific creditor remedies, such a disclosure may well increase general consumer awareness.

If no other market failures restricted consumer choice, improved awareness would increase the ability of consumers to make credit decisions in their best interest and to compare shop on the basis of creditor remedies. If an increased number of consumers made decisions and comparison shopped on the basis of remedies, creditors would have more incentive to compete with each other by offering those remedies that best satisfy consumer preferences. Although it does not bear directly on disclosure of remedies, reliable record evidence on the effects of interest rate disclosures under the Truth in Lending (TIL) Act conducted for the National Commission on Consumer Finance (NCCF) indicates the potential effectiveness of disclosure of credit terms. Before the survey of consumers conducted approximately 15 months after the effective date of the Act, the studies examined consumer awareness of annual percentage rates as well as the extent to which consumers actually shopped for interest rates.

Prior to the TIL Act, a relatively small percentage of borrowers had an accurate perception of prevailing interest rates for installment credit. The Act significantly increased awareness of prevailing interest rates. 63 However, awareness of disclosed information is not sufficient to establish that disclosures are useful. An additional issue is the extent to which consumers actually use the disclosed information to shop for credit. Day and Brandt conducted a survey addressing consumer shopping behavior after TIL became effective. They found that over one-fifth of consumers claimed to have compared rates or postponed purchases based on TIL information. 64 This raises the question whether the level of awareness and the extent of shopping revealed by these studies are sufficient to assure competitive markets. The NCCF concluded:

In terms of fostering viable rate competition among credit grantors, these levels of awareness produced by TIL are probably adequate. Not all consumers need be aware of the APR or shop for credit to bring about effective rate competition. A significant marginal group of consumers who are aware and do shop is sufficient to "police" the market. As Senator Douglas pointed out in the House hearings on HR 11061, "...it is the undecided minority that influences the sellers. So you need only have, in my judgment, about 10 percent cost conscious and they will get the firms competing for that 10 percent." 65

The NCCF found: "In summary then, it appears that 15 months after TIL's effective date a large enough body of consumers in the general market had enough information to force price competition in that market." 66 However, this conclusion is subject to two important qualifications which limit its relevance to the current rulemaking.

First, the NCCF's discussion is concerned with the adequacy of information about interest rate options that are how available to consumers. It does not follow that in other credit areas efficient options will be made available, since there may be other market failures which prevent suppliers from offering them. Indeed, the Commission has concluded that this is the case for restrictions on certain creditor remedies. 67 Second, the NCCF results relate to shopping for interest rates. Consumers are less likely to consider creditor remedies than interest rates when they shop. 68

We also considered a 1977 survey of consumer awareness of APRs conducted by the Federal Reserve Board. 69 The 1977 Federal Reserve Board survey addressed changes in consumer awareness of APRs since the Truth in Lending Act, thus updating the earlier NCCF studies. The survey also addressed consumer shopping behavior when considering credit transactions.

The survey found substantial increases in awareness of APRs between 1970 and 1977, and suggested that disclosures had provided enough information to influence the competitiveness of the credit market for all consumers, including lower income and less educated individuals. The survey, although it showed significant awareness of APRs by consumers, does not establish that levels of knowledge and shopping as a result of disclosure will necessarily be great enough to assure that disclosure of creditor remedies will work. 70 Again, we are most cognizant of the fact that the element which influences consumer consideration of contract terms such as interest rates and those which influence consideration of creditor remedies are so fundamentally different as to make

60 42 FR 32398 (1977).
61 Presiding Officer's Report at 77.
62 Id.
63 Shay and Schober, Consumer Awareness of Annual Percentage Rates of Change in Consumer Installment Credit Before and After Truth in Lending Became Effective, National Commission on Consumer Finance (NCCF), Technical Studies, Vol. I.
66 Id., at 177, emphasis in original.
67 See supra Chapter III, which discusses impediments to competition in the market for creditor remedies.
68 Id., which discusses limitations on consumer shopping for credit remedies.
70 Evidence of the effectiveness of disclosure in other contexts (e.g., mandatory labeling) is inconclusive and of only marginal relevance to our consideration of creditor remedy disclosures. See, e.g., sources cited in memorandum to the Commission from Carol Gramm, Director, Bureau of Consumer Protection, and Wendy L. Gramm, Director, Bureau of Economic, July 1, 1983, at 6-12, nn. 27-32.
generalizations about the efficacy of disclosures somewhat speculative.

Thus, even though the disclosure alternative might have produced some benefits, we concluded that disclosure would provide a less adequate remedy for existing market failures than would the prohibitory rule promulgated by the Commission. Inefficiently high use of costs of creditor remedies results not only from lack of consumer awareness, but from other problems as well. Moreover, lack of consumer awareness of other relevant issues would not be addressed by the disclosure of creditor remedies. For example, some consumers may underestimate the risk of default, and some consumers may not understand legal procedures well enough to grasp the implications of some remedies (e.g., confessions of judgment) even if they are told that such provisions are in the contract.78

2. Costs

The principal cost of a disclosure rule would be the resources needed to provide the forms, individualize them for various consumer contracts, and explain them to borrowers, together with the resources needed to enforce the rule. Unlike the accepted rule, which restricts the use of collateral and collection procedures, the disclosure alternative would not prohibit the use of contract terms between informed borrowers and creditors. As a result, a disclosure alternative would avoid most of the costs of the accepted rule and any resulting effects on the cost and availability of credit.

3. Commission Decision

The Commission concluded that the benefits of the promulgated rule would exceed those of the disclosure alternative. Although the Commission also found that the costs of the promulgated rule would exceed those of the disclosure alternative, it concluded that the net benefits of the promulgated rule would exceed the net benefits that would result from a rule based on disclosures. In particular, a disclosure alternative would not address other impediments to shopping that prevent creditors from competing to supply the creditor remedies which informed borrowers would most prefer.

Accordingly, Title 16 of the Code of Federal Regulations is amended by the addition of new Part 444.

PART 444—CREDIT PRACTICES

Sec.

444.1 Definitions.

444.2 Unfair credit practices.

444.3 Unnecessarily expensive creditor practices.

444.4 Late charges.

444.5 State exemptions.


§ 444.1 Definitions.

(a) Lender. A person who engages in the business of lending money to consumers within the jurisdiction of the Federal Trade Commission.

(b) Retail installment seller. A person who sells goods or services to consumers on a deferred payment basis or pursuant to a lease-purchase arrangement within the jurisdiction of the Federal Trade Commission.

(c) Person. An individual, corporation, or other business organization.

(d) Consumer. A natural person who seeks or acquires goods, services, or money for personal, family, or household use.

(e) Obligation. An agreement between a consumer and a lender or retail installment seller.

(f) Creditor. A lender or a retail installment seller.

(g) Debt. Money that is due or alleged to be due from one to another.

(h) Earnings. Compensation paid or payable to an individual or for his or her account for personal services rendered or to be rendered by him or her, whether denominated as wages, salary, commission, bonus, or otherwise, including periodic payments pursuant to a pension, retirement, or disability program.

(i) Household goods. Clothing, furniture, appliances, one radio and one television, linens, china, crockery, kitchenware, and personal effects (including wedding rings) of the consumer and his or her dependents, provided that the following are not included within the scope of the term "household goods":

(1) Works of art;

(2) Electronic entertainment equipment (except one television and one radio);

(3) Items acquired as antiques; and

(4) Jewelry (except wedding rings).

(j) Antique. Any item over one hundred years of age, including such items that have been repaired or renovated without changing their original form or character.

(k) Co-signer. A natural person who renders himself or herself liable for the obligation of another person without compensation. The term shall include any person whose signature is required as a condition to granting credit to another person, or as a condition for the acceptance of a consumer's obligation that is in default. The term shall not include a spouse whose signature is required on a credit obligation to perfect a security interest pursuant to state law. A person who does not receive goods, services, or money in return for a credit obligation does not receive compensation within the meaning of this definition. A person is a co-signer within the meaning of this definition whether or not he or she is designated as such on a credit obligation.

§ 444.2 Unfair credit practices.

(a) In connection with the extension of credit to consumers or affecting commerce, as commerce is defined in the Federal Trade Commission Act, it is an unfair act or practice within the meaning of Section 5 of that Act for a lender or retail installment seller directly or indirectly to take or receive from a consumer an obligation that:

(1) Constitutes or contains a cognovit or confession of judgment (for purposes other than executory process in the State of Louisiana), warrant of attorney, or other waiver of the right to notice and the opportunity to be heard in the event of suit or process thereon.

(2) Constitutes or contains an executory waiver or a limitation of exemption from attachment, execution, or other process on real or personal property held, owned by, or due to the consumer, unless the waiver applies solely to property subject to a security interest executed in connection with the obligation.

(3) Constitutes or contains an assignment of wages or other earnings unless:

(i) The assignment by its terms is revocable at the will of the debtor, or

(ii) The assignment is a payroll deduction plan or preauthorized payment plan, commencing at the time of the transaction, in which the consumer authorizes or deems payroll deductions as a method of making each payment, or

(iii) The assignment applies only to wages or other earnings already earned at the time of the assignment.

(4) Constitutes or contains a nonpossessionary security interest in household goods other than a purchase money security interest.
§ 444.3 Unfair or deceptive cosigner practices.

(a) In connection with the extension of credit to consumers in or affecting commerce, as commerce is defined in the Federal Trade Commission Act, it is:

1. A deceptive act or practice within the meaning of Section 5 of that Act for a lender or retail installment seller, directly or indirectly, to misrepresent the nature or extent of cosigner liability to any person.

2. An unfair act or practice within the meaning of Section 5 of that Act for a lender or retail installment seller, directly or indirectly, to obligate a cosigner unless the cosigner is informed prior to becoming obligated, which in the case of open end credit shall mean prior to the time that the agreement creating the cosigner's liability for future charges is executed, of the nature of his or her liability as cosigner.

(b) Any lender or retail installment seller who complies with the preventive requirements in paragraph (c) of this section does not violate paragraph (a) of this section.

(c) To prevent these unfair or deceptive acts or practices, a disclosure, consisting of a separate document that shall contain the following statement and no other, shall be given to the cosigner prior to becoming obligated, which in the case of open end credit shall mean prior to the time that the agreement creating the cosigner's liability for future charges is executed:

Notice to Cosigner
You are being asked to guarantee this debt. Think carefully before you do. If the borrower doesn't pay the debt, you will have to. Be sure you can afford to pay if you have to, and that you want to accept this responsibility.

You may have to pay up to the full amount of the debt if the borrower does not pay. You may also have to pay late fees or collection costs, which increase this amount.

The creditor can collect this debt from you without first trying to collect from the borrower. The creditor can use the same collection methods against you that can be used against the borrower, such as suing you, garnishing your wages, etc. If this debt is ever in default, that fact may become a part of your credit record.

This notice is not the contract that makes you liable for the debt.

§ 444.4 Late charges.

(a) In connection with collecting a debt arising out of an extension of credit to a consumer in or affecting commerce, as commerce is defined in the Federal Trade Commission Act, it is an unfair act or practice within the meaning of Section 5 of that Act for a creditor, directly or indirectly, to levy or collect any delinquency charge on a payment, which payment is otherwise a full payment for the applicable period and is paid on its due date or within an applicable grace period, when the only delinquency is attributable to late fee(s) or delinquency charge(s) assessed on earlier installment(s).

(b) For purposes of this section, "collecting a debt" means any activity other than the use of judicial process that is intended to bring about or does bring about repayment of all or part of a consumer debt.

§ 444.5 State exemptions.

(a) If, upon application to the Federal Trade Commission by an appropriate state agency, the Federal Trade Commission determines that:

1. There is a state requirement or prohibition in effect that applies to any transaction to which a provision of this rule applies; and

2. The state requirement or prohibition affords a level of protection to consumers that is substantially equivalent to, or greater than, the protection afforded by this rule;

Then that provision of the rule will not be in effect in that state to the extent specified by the Federal Trade Commission in its determination, for as long as the state administers and enforces the state requirement or prohibition effectively.

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