Recent Developments Regarding Interest Rate Regulation and Related Issues

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INTRODUCTION

This Annual Survey of developments concerning federal and state usury laws includes a discussion of one recently enacted federal statute regarding the calculation of interest rebates[1] and two recent noteworthy cases, one regarding the assignability of revolving charge agreements[2] and the other concerning the propriety of "spreading" loan origination fees over the entire term of a loan.[3]

RULE OF 78'S PROHIBITED IN LONG-TERM TRANSACTIONS

More than a decade after first examining the question,[4] Congress limited the use of the Rule of 78's as a method of computing rebates of unearned interest in consumer credit transactions in section 933 of the Housing and Community Development Act of 1992.[5] For all precomputed consumer credit transactions with terms longer than sixty-one months, entered into after September 30, 1993, creditors must use a rebate method at least as favorable to the consumer as the actuarial method.[6] Section 933 further

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1. *See infra* text accompanying notes 4-12.
2. *See infra* text accompanying notes 25-47.
3. *See infra* text accompanying notes 48-57.
4. *Restrict the Use of the Rule of 78: Hearings Before the Subcomm. on Consumer Affairs of the Senate Comm. on Banking, Housing and Consumer Affairs on S. 2002*, 96th Cong., 1st Sess. (1979).
5. 15 U.S.C. § 1615 (Supp. IV 1992).
6. *Id.* § 1615(b). *Consumer* and *credit* are defined by reference to their definitions in the Truth in Lending Act. *See* 15 U.S.C. § 1602 (1988). *Creditor* is similarly defined, but for purposes of this section, it is expanded to include any assignee. *Id.* § 1615(d).

codifies as a matter of federal law the consumer's right to a prompt rebate of any unearned portion of the interest charge[7] upon prepayment in full of any consumer credit transaction, whether by outright payment, refinancing, consolidation, restructuring, or acceleration.[8]

Section 933 also entitles consumers to a statement of the balance necessary to prepay, including any applicable rebate, within five days of a written or oral request.[9] If the request is written, so too must be the response.[10] Although one such statement each year is free,[11] any additional statements may be subject to a reasonable charge to cover the cost, so long as the lender notifies the consumer in advance of that charge.[12]

OPEN QUESTIONS

There are two open questions concerning the operation of section 933. The first relates to calculating the amount of the rebate, while the second concerns potential liability if the section is violated.

Ambiguity concerning calculation of the rebate amount arises from the references in section 933 to "interest charge" in one place, and "finance charge" in another. Any unearned interest charge must be calculated by a method at least as favorable as the actuarial method.[13] The use of the term *interest charge* indicates that prepaid finance charges, such as points, considered earned at consummation, are not subject to the rebate requirement. The definition of *actuarial method*,[14] however, utilizes the term *finance charge*. Because the statute is codified in the Truth in Lending Act (TILA)[15] (although the statute is neither an amendment to the TILA nor technically a part of it[16]) and utilizes other TILA definitions, an argument may be made that the TILA's broader definition of *finance charge*[17] is integral to the mandate of section 933. If accepted, this viewpoint would require prepaid finance charges to be rebated.[18] As the statute is not part of the TILA, the Federal Reserve Board staff has indicated that it does not have interpretive authority to clarify section 933. Various federal agen-

7. *See infra* text accompanying notes 13-16.

8. 15 U.S.C. § 1615(a)(3). No refund of less than $1 need be made. *Id.* § 1615(a)(2). This provision is not limited to long-term transactions. *Id.* § 1615(a)(1).

9. *Id.* § 1615(c)(1)(A).

10. *Id.* § 1615(c)(2).

11. *Id.* § 1615(c)(3).

12. *Id.* § 1615(c).

13. *Id.* § 1615(a)(1), (b).

14. *Id.* § 1615(d)(1).

15. *Id.* §§ 1601-1667e.

16. *Id.* § 1615.

17. *Id.* § 1605(a).

18. *But see* Letter from Thomas J. Noto to Rep. Esteban E. Torres (Mar. 9, 1993); Letter from Rep. Esteban E. Torres to Thomas J. Noto (Mar. 16, 1993) (letters on file with the authors).

cies, however, may issue guidelines, which may adopt the position that interest charge excludes prepaid finance charges.

The second question concerns the extent of liability to which a non-compliant creditor is exposed. A violation of section 933 is outside the direct purview of the TILA's private statutory remedies. A violation, however, indirectly may trigger section 130 TILA liability.[19] In the event that a non-compliant transaction is refinanced, the excess interest included in the pay-off balance clearly would be a finance charge in the subsequent loan.[20] Hence, the finance charge and annual percentage rate on the second loan would be understated. Similarly, the excess interest in the refinanced transaction might "taint" the new obligation under state usury laws, exposing the creditor to any available remedies provided by those statutes as well.[21]

Even if not refinanced, a contract that improperly provided for the use of the Rule of 78's nonetheless might trigger a TILA violation. The contract would not state accurately the legal obligation,[22] and failure to rebate properly upon actual prepayment or acceleration arguably might constitute actual damages under the TILA.[23] Finally, the improper inclusion of the Rule in a contract might expose a creditor to liability under a state unfair and deceptive trade practices statute (UDAP).[24]

NOT ALL REVOLVING CHARGE AGREEMENTS ARE ASSIGNABLE

In *Zachman v. Whirlpool Acceptance Corp.*[25] the Supreme Court of Washington ruled that revolving charge agreements under the Washington Re-

19. 15 U.S.C. § 1640 (1988).

20. 12 C.F.R. § 226.20(a) (1993). As the Rule of 78's is frequently more favorable to the creditor, its use in a transaction subject to the statute means that there likely will be some amount improperly retained when the pay-off is calculated.

21. *See, e.g.*, Sanders v. Barron, 282 So. 2d 237 (Ala. 1973); Harrison v. Arrendale, 147 S.E.2d 356 (Ga. Ct. App. 1966). *See generally* 47 C.J.S. *Interest & Usury* §§ 183-188 (1982 & Supp. IV 1993); NATIONAL CONSUMER LAW CENTER, USURY AND CONSUMER CREDIT REGULATION § 8.2 (1987 & Supp.).

22. 12 C.F.R. § 226.17(c) (1993); *see also In re* Brown, 134 B.R. 134 (Bankr. E.D. Pa. 1991).

23. 12 C.F.R. § 226.18(k)(2) (1993) requires disclosure of whether a rebate will be given in a precomputed transaction. Now section 933 requires that a rebate be given and, for certain transactions, be calculated in a specified way. 15 U.S.C. § 1615(a), (b).

24. *See generally* NATIONAL CONSUMER LAW CENTER, UNFAIR AND DECEPTIVE ACTS AND PRACTICES § 3.2 (3d ed. 1991 & Supp. 1993). Some courts have found illegal provisions to be UDAP violations even if the clause is never invoked. *See, e.g.*, Leardi v. Brown, 474 N.E.2d 1094 (Mass. 1985).

25. 841 P.2d 27 (Wash. 1992).

tail Installment Sales of Goods and Services Act (RISA)[26] may not be assigned to third parties.[27]

The two revolving charge agreements at issue in *Zachman* were executed in connection with plaintiff Zachman's purchase of a clothes dryer (Zachman Agreement) and plaintiff Crossler's purchase of a dishwasher from different independent retailers (Crossler Agreement), and subsequently were assigned by the retailers to Whirlpool Acceptance Corporation (Whirlpool). The Zachman Agreement provided for: (i) issuance of a credit card to the buyer; (ii) the purchase of goods from other sellers; (iii) Whirlpool's approval of purchases; and (iv) assignment of the sales memorandum to Whirlpool. The Crossler Agreement (i) identified the independent dealer as the "seller (creditor)," and (ii) provided for the assignment of the agreement to Whirlpool. Both agreements contained terms consistent with the requirements applicable to revolving charge agreements, but inconsistent with the requirements applicable to retail installment contracts or lender credit card agreements under RISA.[28]

The court held that the agreements did not constitute valid revolving charge agreements.[29] Instead, they constituted retail installment contracts and, as such, violated the disclosure and finance charge requirements of RISA.[30] The court reached this conclusion based on its reading of the statutory definition of *revolving charge agreement*.[31] At the time the agreements were made, RISA defined a *revolving charge agreement* as "an agreement . . . that prescribes the terms of the retail installment transactions which may be made thereunder from time to time."[32] A *retail installment transaction* is a transaction in which "a retail buyer purchases goods or services from a retail seller."[33]

26. WASH. REV. CODE §§ 63.14.010 to .167 (1992).

27. *Zachman*, 841 P.2d at 31-32. The implications of this decision were remedied in Washington by the passage of legislation amending RISA, but continue to present potential concerns in other states, some of which have retail installment sales acts structurally similar to the Washington RISA.

28. RISA defines three mutually exclusive types of agreements: (i) revolving charge agreement (open-end credit); (ii) retail installment contract (closed-end credit); and (iii) lender credit card agreement (a type of open-end credit). WASH. REV. CODE § 63.14.010(3), (9), (10) (Supp. 1993). RISA does not require that revolving charge agreement disclosures include the total credit price as is required in retail installment contract disclosures and, at the time the agreements were executed, RISA permitted a maximum finance charge rate on revolving charge agreements of 18% per annum, as compared to 11.75% per annum for retail installment contracts. *Id.* §§ 63.14.040, 63.14.120, 63.14.130(1), (4). (A subsequent amendment to RISA eliminated this distinction in the finance charge rates until June 30, 1995. 1992 Wash. Laws ch. 193, §§ 1(1), (2).) Also, RISA prohibits the taking of a security interest under a lender credit card agreement. WASH. REV. CODE § 63.14.125.

29. *Zachman*, 841 P.2d at 33.

30. *Id.* at 34.

31. *Id.* at 31.

32. WASH. REV. CODE § 63.14.010(10).

33. *Id.* § 63.14.010(8).

The court interpreted these statutory definitions to mean (i) the parties to a revolving charge agreement are the buyer and the seller, not the seller's assignee,[34] and (ii) a revolving charge agreement is a single agreement under which repeated transactions may be made.[35] The court reasoned that because a retail installment transaction occurs between a buyer and a seller, the revolving charge agreement also must be between the buyer and the seller.[36] The court further reasoned that because the buyer and seller are the parties to a revolving credit agreement, once the seller assigns the agreement to a third party, the buyer no longer can make purchases "thereunder."[37] Consequently, an assignment in effect changes the nature of the agreement so that it no longer conforms to the definition of a revolving charge agreement.[38]

Under this statutory construction, the court found that the agreements did not constitute revolving charge agreements—Whirlpool was not the seller in either agreement, and repeated transactions were not possible under either agreement.[39] The Crossler Agreement named the independent dealer as seller (creditor), thus rendering impossible any further transactions thereunder, i.e., between Crossler and the dealer, following assignment of the agreement to Whirlpool.[40] The Zachman Agreement did not provide for repeated transactions thereunder because each purchase was subject to Whirlpool's approval and Whirlpool was not bound to approve any subsequent purchase.[41] The court found that both agreements contained a cancellation disclosure inconsistent with the concept of a single agreement involving multiple sellers, as the disclosure required the buyer to give notice of cancellation to the seller at his address shown on the charge agreement.[42]

As further evidence that the Zachman Agreement did not constitute a revolving charge agreement, the court observed that it had some characteristics of a "lender credit card agreement."[43] RISA defines a lender credit card agreement as

> an agreement . . . prescribing the terms of retail installment transactions pursuant to which the issuer may, with the buyer's consent, purchase or acquire one or more retail seller'[s] indebtedness of the buyer under a sales slip or memorandum. . . . The issuer of a lender

34. *Zachman*, 841 P.2d at 31.
35. *Id.* at 33.
36. *Id.*
37. *Id.* at 31.
38. *Id.* at 31-33.
39. *Id.* at 33.
40. *Id.* at 32.
41. *Id.* at 32-33.
42. *Id.* at 33.
43. *Id.* at 32-33.

credit card shall not be principally engaged in the business of selling goods or be a financial institution.[44]

The court cited the Zachman Agreement's provisions for issuance of a credit card, Whirlpool's approval of the purchases, and the assignment of the sales memorandum to Whirlpool as more characteristic of a lender credit card agreement than a revolving charge agreement.[45] Because RISA prohibits the taking of security interests under lender credit card agreements, however, both Agreements would have violated RISA if purported to be lender credit card agreements.[46]

RISA, as amended effective May 28, 1993, eliminates the *Zachman* issues in the State of Washington, but these issues still could arise in other states with similar retail installment sales acts. RISA now provides, *inter alia*: (i) a revolving charge agreement prescribes the terms of retail installment transactions "with one or more sellers;" (ii) retail sellers may assign revolving charge agreements or retail installment contracts, and assignment does not change the nature of the agreement or contract; and (iii) no person may pursue any remedy alleging a violation of RISA unless the allegation constitutes a violation of RISA as amended.[47] Few other retail installment sales acts contain such explicit authority for assignment and some may, in fact, be vulnerable to challenges based on *Zachman*.

GEORGIA HIGH COURT INVOKES SPREADING TO SALVAGE GEORGIA HIGH-RATE LOANS

Resorting to the tried-and-true spreading doctrine,[48] the Georgia Supreme Court forestalled a major threat to lenders who charge a large amount of points and up-front charges.[49] At issue were loans that probably looked pretty good to the lender, and safe in a deregulated state like Georgia: a nineteen percent annual interest rate, with an additional twenty-two to twenty-seven percent of the original principal amount in points and origination fees enlarging the amount of the loan. Georgia, however, retained its criminal usury ceiling, with a five percent per month cap.[50] Some Georgia borrowers decided that if creditors consider points and origination fees as earned the first month (and hence non-refundable), then "what's sauce for the goose is sauce for the gander"—the fees should be counted as earned the first month for purposes of measuring the return against

44. WASH. REV. CODE § 63.14.010(3).
45. *Zachman*, 841 P.2d at 32-33.
46. *See* WASH. REV. CODE § 63.14.125.
47. 1993 Wash. Laws ch. 5 (1st Special Sess.) (effective May 28, 1993).
48. For an explanation of spreading, see NATIONAL CONSUMER LAW CENTER, USURY AND CONSUMER CREDIT REGULATION § 4.2.3.6 (1987 & Supp.).
49. Fleet Fin., Inc. v. Jones, 430 S.E.2d 352 (Ga. 1993).
50. GA. CODE ANN. § 7-4-18 (1990 & Supp. 1993).

the criminal usury ceiling as well.[51] There began a series of suits, with conflicting results,[52] finally resolved by the Georgia Supreme Court in *Fleet Finance, Inc. v. Jones*.[53]

In *Jones*, the court simply adopted the spreading doctrine, and held that the total interest earned over the loan term is the relevant measure of usury.[54] In so doing, it noted that as a criminal statute was at issue,[55] any ambiguity must be resolved in favor of the potentially liable party.[56] In ruling these high-cost loans non-usurious, however, the court made it abundantly clear that it did not approve of the lender's practices, and in fact called for legislative reform:

> Although we do not condone Fleet's interest-charging practices, which are widely viewed as exorbitant, unethical, and perhaps even immoral, and suggest that further regulation of the lending industry is needed by our General Assembly to insure the economic survival of individuals like the [borrowers], we are constrained to hold that the loans in question are legal and not usurious.[57]

That reaction raises the question of whether such loans may be vulnerable to challenge under other statutory or common law theories, such as unconscionability or unfair and deceptive acts and practices statutes, in states where credit is within the scope of these theories or statutes.

51. By that measure, the first month's interest rate for the named plaintiff in *Fleet Fin.* would be 23%.

52. *Compare* Dent v. Associates Equity Servs. Co. (*In re* Dent), 130 B.R. 623 (Bankr. S.D. Ga. 1991) and Evans v. Avco Fin. Servs. (*In re* Evans), 130 B.R. 357 (Bankr. S.D. Ga. 1991) (both holding that because the fees accrued the first month and were not subject to rebate, the relevant period for analysis was the month in which the fees were earned, causing the loans to be usurious) *with* Johnson v. Fleet Fin., Inc., 785 F. Supp. 1003 (S.D. Ga. 1992) (not usurious).

53. 430 S.E.2d 352 (1993).

54. *Id.* at 356-57.

55. GA. CODE ANN. § 7-4-18.

56. *Jones*, 430 S.E.2d at 355.

57. *Id.* at 354.