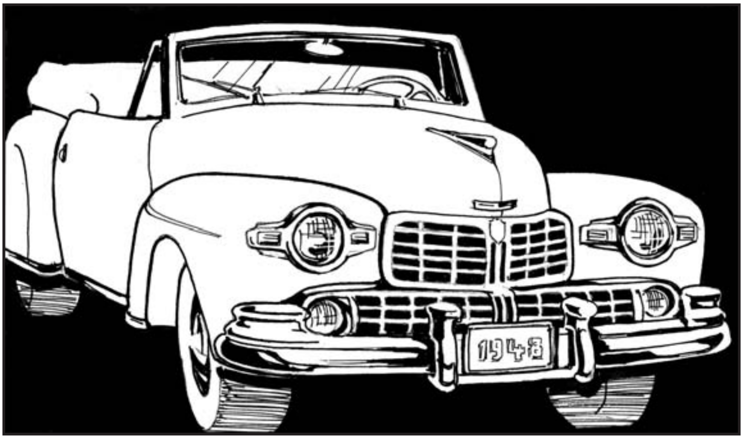

Chapter 1

Basics

Football coaches will tell you that there isn't any use trying to draw up the X's and the O's until the team learns how to block and tackle. Anyone trying to understand automobile financing and leasing needs to know some basics, too.

The articles in this chapter attempt to explain a number of fundamental concepts and to answer some introductory questions:

- What's the difference between a credit sale and a loan, and why does it matter what you call the transaction?
- How does a "precomputed" installment sales agreement differ from an "interest-bearing" (or so-called "simple interest") contract?
- What is the relationship between federal and state law, anyway?
- Who enforces the laws that affect car financing and leasing?
- How does indirect financing work?
- What generally accepted knowledge among car dealers and finance companies is just plain wrong?

We'll look at these and other issues as we employ the fundamentals—the blocks and tackles, if you will—to coach you in the real game of car sales, finance and leasing. With the basics in hand, you're more likely to play the field with wisdom, safety and skill.

To begin with the basics, let's start with negotiating sales: what is advisable and what is not. But don't expect to read a list of hints in these pages. This is no self-help book. Rather, it's a book of stories about what other people did and did not do. Reading their stories, I'm confident you'll figure out the basics. And likely, you'll remember them, too.

Is Subprime a Crime?

October 1997

Can charging too much for a car be a crime? The answer, according to a Massachusetts appellate court, is yes, at least if the facts of the case are bad enough. In 1997, that was the ruling in *Commonwealth v. Reske*, (Mass. App. LEXIS 205, Sept. 18, 1997).

This is the story:

Reske, the general manager of a Chevrolet dealership, was convicted by the trial court of six counts of larceny by false pretenses. The charges were brought because Reske sold six new cars at substantial markups. He also accepted trade-in vehicles that were nearly new at “low-ball” figures.

All of the sales and trade-ins involved the same person: Ronald Nellon. The court described Nellon as “borderline retarded,” “mentally impaired” and as a person “whose subnormal intellectual capacity was readily apparent.” Nellon had inherited a sum of money, and decided to indulge a long-time dream that he had of buying new trucks. Nellon bought the trucks at prices in excess of the Manufacturer’s Suggested Retail Price (MSRP), and agreed to accept amounts for the nearly new trucks he traded in that were characterized by the court as “low-ball” amounts.

Reske defended by asserting that he had made no misstatements of facts. He said that prices were a matter of opinion, and finally that it was “not a crime to gull a willing dupe.” These defenses were unsuccessful at trial, and, when Reske appealed, his conviction was affirmed.

The case may have troubling implications for certain pricing practices of some dealers and subprime finance companies. The markups on the trucks were less than the markups alleged to have been made by dealers in several recent subprime class-action cases alleging that dealers' excessive markups of vehicles are in reality "hidden finance charges."

Perhaps, as the lawyers say, this case can be "distinguished" from the subprime markup cases. Granted, Nellon's mental capacity may have been to blame for making him, in the court's words, a "willing dupe." And few subprime consumers are likely to be able to allege mental impairments.

But, how much of a stretch is it for a court to conclude that a credit-impaired consumer—desperate for a car and willing to pay any price—is a "willing dupe," and that the consumer's agreement to the price does not constitute a defense to the crime of excessive markups as larceny by false pretenses?

That case awaits another day, and, admittedly, it will be harder for a plaintiff to win, especially if the vehicles involved are used, in which case there really could be a variety of opinions about a fair price. Nevertheless, at a time when regulators are looking closely at subprime practices, dealers may want to add the *Reske* case to the things they worry about. Simply put, charging too much can have consequences.

Commonwealth v. Reske, 1997 Mass. App. LEXIS 205 (Sept. 18, 1997).

Federal Law in Conflict: Statutes, Rules and Regulations

January 1999

What happens when a Federal Trade Commission regulation says that finance companies *may be liable for all* consumer claims and defenses against a car dealer, yet a federal statute says that finance companies *cannot be liable for certain types* of consumer claims? The question of how to interpret these two seemingly conflicting federal laws has been addressed by several courts and most have concluded that the statute prevails over the regulation. To say that another way, finance companies aren't always liable, but they are liable sometimes. It just depends.... Read on.

The Federal Trade Commission's "Holder Rule" requires language in all consumer credit sale contracts to inform consumers that any claims or defenses they have against the seller of the goods may be asserted against any "holder" of the credit contract. The Federal Truth in Lending Act (TILA) says that an assignee/holder of a consumer credit contract will be liable for the seller's TILA violation *only if the violation is apparent on the face of the disclosure statement*. In most cases, the TILA violation *is not apparent* on the face of the documents; consequently, TILA provides a lot of protection to consumer credit contract assignees such as finance companies.

In one recent case, the Eleventh Circuit (the federal appeals court for Florida, Georgia and Alabama) joined the Seventh Circuit (the federal appeals court for Illinois, Wisconsin and Indiana), concluding that the FTC Holder Rule does not trump the protection afforded to assignees under the Truth in Lending Act. This decision, which is favorable to finance companies, represents the law in the six states included within these two circuits, unless the United States Supreme Court has something to say on the issue. Lower courts in all states will also be persuaded by this case.

Let's look at the facts before the Eleventh Circuit in a relevant case known as *Ellis v. General Motors Acceptance Corporation*. In this situation, Paul and Peggy Ellis bought a used 1993 Saturn, with an extended warranty at a cost of $1,195. The Ellises later found out that although the contract said $1,195 was paid to a third party, the car dealer actually retained a substantial portion of this amount.

Instead of suing the car dealer, the Ellises brought a class action complaint against General Motors Acceptance Corporation (GMAC). They argued that the car dealer misrepresented the amount paid to others in violation of the Truth in Lending Act (TILA) and pursuant to the Federal Trade Commission (FTC) Holder Rule language in their contract, GMAC waived the assignee protections afforded by TILA. And while the Ellises conceded that a regulation couldn't trump the plain language of a statute, they claimed that GMAC assumed greater liability under the Holder Rule language in the contract. GMAC countered that the FTC mandates this provision of the contract; therefore, there was no voluntary waiver of the protections provided by TILA.

GMAC argued that a contrary finding by the court would elevate the FTC Holder Rule over the protection that Congress provided assignees under TILA. The court agreed, ruling that the contractual language required by the FTC regulation, by itself, could not subject GMAC to liability.

This decision is correct, both as a matter of law and as a matter of public policy. Congress has decided that finance companies should not be subject to TILA claims arising from contracts purchased from auto dealers unless the TILA violation is obvious from the face of the contract. When the Federal Trade Commission decided to require car dealers to include a notice in consumer credit contracts making any holders of such contracts subject to the claims and defenses of car buyers, as a federal agency it should not have been able to overrule the decision of Congress to shield assignees from TILA liability.

The Ellises' argument that GMAC's inclusion of the FTC mandated language in the credit contract was an expression of its intent to assume more liability was a bootstrap attempt to trump a clear congressional decision to limit assignee liability under the Truth in Lending Act. The court was right to reject this argument.

Ellis v. General Motors Acceptance Corporation, 1998 U.S. App. LEXIS 28456 (11th Cir. (N.D. AL) November 13, 1998).

Disclosures

May 2000

For nearly 30 years, I have made my living helping creditors and lessors comply with federal and state disclosure laws. And for nearly 30 years, one thing has really puzzled me.

Somebody, please explain this to me:

Federal law requires that creditors and lessors give all sorts of disclosures when they enter into transactions with consumers. State laws add another level of disclosures in many states. The rationale for requiring these disclosures is that consumers need to have certain credit or lease information before they become obligated, so that they can shop, or at least make an informed decision to enter into the transaction. Fair enough—creditors ought to be required to provide consumers with the information they need in order to shop and/or to make an informed credit or leasing decision. That is a reasonable thing to ask creditors to do.

It's a little less reasonable to require creditors and lessors to comply with detailed and technical rules in making these disclosures. But over time, the industry has become inured to the trouble and expense involved in compliance. So, as a practical matter, the rules probably will not go away.

But what is unreasonable—really outrageous, when you think about it—is that a creditor is liable for disclosure violations, including very technical violations, EVEN WHEN THE CONSUMER DOES NOT READ THE CONTRACT.

That really steams me.

Assume with me for a minute that the creditor has really made an effort to comply with the law, but he has messed up some required disclosure. The consumer signs the contract without reading it and then sues the creditor for a disclosure violation. (You would be surprised how often plaintiffs in reported cases will testify that they did not read the contract—did you really read that stack of paper the last time you bought and financed a house?) For some violations, the consumer does not even have to allege that he or she has been damaged by the disclosure violation in order to "recover" from the creditor.

We're not talking about anything here but disclosure violations. I think that creditors who charge excessive finance charges or late fees, or who take a security interest in additional collateral when prohibited from doing so by state law, could and should be sued by consumers, whether the consumers read their documents or not.

But where disclosure is concerned, wouldn't it be appropriate to require a consumer to read contract and disclosure documents *before* he or she can bring a disclosure lawsuit against a creditor? Wouldn't that type of rule encourage the *objective* of the disclosure laws by providing the consumer with an *incentive* to read what he or she is signing?

I think so. And I ask you, wouldn't that simply be, well, fair?

Wanna Buy Your Lawyer a Yacht?

June 2000

At a recent conference of subprime finance companies and dealers I attended, every agenda item and every speaker seemed to deal with "loans" or "lenders." Finally, I could stand it no longer. When the time came for me to speak, I ranted instead. Why? Because no one at the conference was making loans, and no one there was a lender. And what you call things—the very terms you use—can sometimes matter, and matter A LOT.

In a typical motor vehicle retail installment sales transaction, a dealer extends credit to a consumer. How? The dealer exchanges a perfectly good (we hope) vehicle for a piece of paper containing the consumer's promise to pay for the car over a time period of, say, 36 months. The dealer and the consumer have not engaged in a "loan" transaction, they have engaged in a "credit sale."

The dealer then sells the credit contract to a finance company. (Note that the finance company isn't *lending* money to anyone. It is *buying* a contract from a dealer in what is, in reality, a secondary market commercial transaction.)

There are some exceptions. For example, if you are an Ohio dealer, you may actually be acting as agent for a bank that is really making a loan to your buyer. Also, some Colorado dealers use a very peculiar credit sale form that is titled as a note.

Here, though, I am talking about normal dealers.

To the point: Does anyone (besides blood-sucking lawyers) really care what you call this transaction? Well, you need to care, my friend, unless you feel like paying a lot of money to those blood-sucking lawyers.

Here's the problem. The documents that a dealer uses to complete a credit sale have been designed to comply with state retail installment sales laws and with federal laws regulating *credit sales*. These laws are different from the laws that govern *loans*. The difference opens a door of opportunity for a lawsuit. For example, a plaintiff's class action lawyer looking for a way to sue you may allege that the transaction is not really a credit sale, but rather, a disguised loan.

The lawyer's next step is to argue that the dealer, or the dealer and the finance company, should have complied with the loan laws rather than the credit sale laws. Lawyers call this a "recharacterization" attack—the plaintiff's lawyer is trying to "recharacterize" the credit sale as a "loan." If the judge takes the bait and agrees with this argument, the defendants are in trouble, because the judge's next step will be to declare that all the transaction documents violate the loan laws—laws that the dealer and the finance company never intended to abide by in the first place.

Imagine for a moment that your dealership or finance company is the defendant in one of these suits. What will the plaintiff's lawyer find when he or she reviews your company's internal books and records during the discovery process? Will your internal documents be filled with incorrect references to "loans" and "lenders"? If so, you are manufacturing ammunition for the enemy. These faulty references, by themselves, probably won't be decisive, but you can bet that the plaintiff's lawyer will beat the judge or jury over the head with your own references to "loans" and "lenders."

The plaintiff will argue further that the dealer never carries his own paper, that the dealership would never enter into a credit transaction with a consumer if it had to carry its own paper, and that the dealer doesn't enter into such a transaction with a consumer until some bank or finance company has reviewed the consumer's credit history. The argument that naturally follows is that the dealer is the agent of the finance company or bank and that the finance company is actually a "lender."

Here's the defense. The dealer is the creditor. Sure, the dealer assures that he can sell the consumer's contract before he completes the credit sale. But think about a typical dealer agreement. After the dealer gets an approval from the finance company of the consumer's credit and enters into the contract with the consumer, what happens if the dealer decides not to assign the contract to that finance company? Can the finance company force the dealer to assign the contract? Nope. At least not under any dealer agreement I've ever written or reviewed.

Under most dealer agreements, the finance company has to buy the contract from the dealer if the finance company has approved the consumer's credit and everything else the dealer has represented, but the dealer has no obligation to assign any contracts. In stock market terms, the dealer has a "put," but the finance company does not have a "call."

Let's say that the dealer enters into a contract with every intention of selling that contract to a finance company, but then he decides that rather than selling the contract to the finance company, he'll keep it and collect payments directly from the consumer. (Perhaps the finance charge that results from an 18% APR looks like a pretty good return for his retirement program.) Is there anything the finance company can do about the dealer's change of heart?

Nope. Nothing. Nada. The finance company has no right to force the dealer to assign the contract. If that's so, how can the dealer be the finance company's agent? Once a judge or jury understands this, the dealer should win the case.

The plaintiff's lawyer will scream and jump up and down (the plaintiff's lawyer's refrain—when there's danger, when there's doubt, run in circles, scream and shout), arguing that this scenario is purely theoretical—that the dealer has never held onto a contract and never will. But the dealer's theoretical right to hold the contract is, or should be, controlling.

But let's make it even tougher for the plaintiff's lawyer. You know the saying, "The best defense is a good offense." Let's quit talking about "loans" and "lenders." Let's get those references out of our company's records. Let's train everyone in the company (and for that matter, everyone in the industry) to call these terms by their correct names. Let's deprive the plaintiff's lawyer of the easy evidence. Maybe he'll think twice and not bring the suit.

Doesn't that make a lot more sense than buying a yacht for him, or for your defense lawyer?

Co-signers, Co-buyers, Guarantors and "Other Owners"

June 2000

Who's who in a credit sale transaction involving more than one customer? There's always the "buyer," but those other folks who make appearances in the transaction paperwork, who are they?

Many contracts use a term such as "co-buyer" or "co-maker" to refer to a second person who signs the contract with the intention (and with the creditor or dealer's intention) that the "co-buyer" will be obligated in all the same ways that the "buyer" is obligated; that is, primarily liable to perform all of the undertakings in the contract. However, the truth is, the term "co-buyer," at least in most states, has no statutory definition, and is used with, shall we say, a great deal of imprecision.

When Mr. and Mrs. Smith come in to a dealership, and they both apply for credit, and they both purchase the car on credit, then they are both "buyers" (or "buyer" and "co-buyer" if you must).

There are times when we hear the term "co-buyer" used to refer to someone who is not primarily liable, but who is signing the contract with the intention of agreeing to be obligated on the contract only if the people who are primarily liable don't perform. The correct name for such a person isn't "co-buyer," it is "guarantor."

Guarantors are not "primarily liable" for the performance under the contract, they are secondarily liable: that is, their liability arises only when those who are primarily liable (buyers and co-buyers) don't perform.

Guarantors don't (or at least shouldn't) sign the retail installment sales contract. Instead, they should sign a separate guaranty agreement. When little Bill Smith, Jr., tries to buy a car on credit and can't get credit on his own, the creditor may ask him to obtain a "co-signer." If Bill's father agrees to pay the creditor if his child does not, the senior Smith has become a "guarantor."

The Federal Trade Commission (FTC) muddies the waters with its Trade Regulation Rule on Credit Practices, which requires a notice outlining certain legal rights of a "co-signer" defined as "a natural person who renders himself or herself liable for the obligation of another person without compensation." The FTC could have, and should have, used the term "guarantor" instead of "co-signer," because the same definition (absent the "without compensation" part) applies to a guarantor.

Finally, there's a creature, which sometimes surfaces in sales contracts, called an "other owner." This fellow has some interest in the vehicle, and has granted the creditor a security interest in the vehicle but is not obligated to pay for the vehicle. If those obligated to pay for the vehicle don't do so, the creditor may repossess the vehicle and use the "other owner's" interest in the vehicle to extinguish the obligation. But the creditor cannot pursue a deficiency claim against the "other owner." Why? Because the "other owner" never agreed to pay for the vehicle; he only agreed to give up his or her interest in the vehicle if those obligated to pay did not do so. If Mr. Smith buys a car on credit and decides to title the car in both his and his wife's names, Mrs. Smith might sign the contract as an "other owner." She's not obligated to pay, but she's providing collateral if he doesn't.

We're boring you with all this legal mumbo-jumbo, because a West Virginia Attorney General got his shorts in a knot over the practices in that state of a car dealer who appears to have been treating "guarantors" as "co-buyers." You might think that the path of least resistance for the dealer was to have the other party, whatever his or her relationship to the transaction, sign on the "co-buyer" line, but that practice will make the FTC frown.

As we have learned from this little discussion, what has happened to some people who intended to be secondarily liable, is that they wound up, to their surprise, as primarily liable. That, says the AG, is a no-no.

It might be worthwhile talking this one over with your lawyer. In the final analysis, whether a buyer is a co-signer, a co-buyer, a guarantor or "other owner," can have surprising implications. And you need to watch out. AG actions, like those in West Virginia, are like the measles: They tend to spread.