Santa Clara Law Review

Volume 14 | Number 3

Article 5

1-1-1974

Credit Reform: Which Way to Go

Santa Clara Law Review

Follow this and additional works at: http://digitalcommons.law.scu.edu/lawreview

Part of the Law Commons

Recommended Citation

Santa Clara Law Review, *Credit Reform: Which Way to Go*, 14 Santa Clara Lawyer 512 (1974).
Available at: http://digitalcommons.law.scu.edu/lawreview/vol14/iss3/5

This Article is brought to you for free and open access by the Journals at Santa Clara Law Digital Commons. It has been accepted for inclusion in Santa Clara Law Review by an authorized administrator of Santa Clara Law Digital Commons. For more information, please contact sculawlibrarian@gmail.com.

CREDIT REFORM: WHICH WAY TO GO?*

Easy credit is everywhere. American consumers borrow money from banks, finance companies, and credit unions. They charge merchandise at large retail stores. And thanks to the ubiquitous credit card, they can eat in exotic restaurants, stay at vacation resorts, and shop in boutiques from Miami to Mozambique without cash in pocket.

The consumer credit phenomenon is startlingly evident in the growth of debt since the end of World War II. From 1945 to 1970, personal income rose only 4.5 times; meanwhile, nonmortgage credit jumped 22 times. In 1973, nonmortgage debt increased at the startling rate of $1.9-billion a month to reach a total of about $180-billion outstanding, an average of about $2600 owed per household.

Along with the comforts of the buy-now-pay-later life, however, have come a number of serious woes: inflation, high finance rates, and personal bankruptcies (about 155,000 a year).[1] These

---

* Copyright 1974 by Consumers Union of United States, Inc., Mount Vernon, N.Y., 10550. Reprinted by permission from CONSUMER REPORTS, May 1974.

1. The cash customer is another victim of the easy-credit ethic. Contracts that stores sign with the issuers of credit cards force cash customers to subsidize credit customers.

Most such contracts require the merchant to pay a fixed percentage of each credit-card sale to the card issuer. This service charge, which ranges from 2 to 8 per cent, is in addition to the interest that card-holders pay on holdover balances, and is in addition to the annual fee required of card-holders by such issuers as Diners Club and American Express. The contracts also require that the merchant charge the card-user the same price as the cash customer.

Thus, a merchant realizes 2 to 8 per cent more when he sells for cash than when he sells on credit card. But his credit-card contract often forbids him to share that little bonus with cash customers through discounts, something he might well do if his contracts allowed it and his cash customers requested it.

A merchant's overhead helps determine his prices. A portion of overhead is the service charge that gives credit-card customers their pay-later privilege. Is it equitable to require cash customers to pay prices that help finance a service they don't use? CU thinks not. Beyond that, we believe contracts that require merchants to discriminate against cash customers are illegal.

To test our view, lawyers at the Center for Law and Social Policy in Washington have filed suits in behalf of CU against American Express Co. and Suburban Trust Company of Maryland, one of a network of banks that issues BankAmericards. Lawyers call these exemplary suits, meaning that other credit-card issuers with similar no-discount provisions will probably heed the outcome.

The suits contend that fixed-price contract provisions constitute price fixing—illegal under Federal antitrust laws. The provisions eliminate price competi-

translate into family crises and social discontent, particularly in low-income areas, whose residents are most easily harassed by easy-credit's constant companion, the bill collector.

For years, the consumer has been the victim of archaic credit laws promulgated by state legislatures, whose members are strongly influenced by financial interests. Recognizing the problem, Congress in 1968 stepped into what had been largely the states' preserve and passed the Truth-In-Lending Act.[2] This laid down for the first time nationwide rules on garnishment of wages and open disclosures of credit costs. At about the same time, spurred by the threat of increasing Federal supervision, the credit industry helped formulate a sweeping proposal for reform. It was called the Uniform Consumer Credit Code (UCCC).[3]

The UCCC was sponsored by the National Conference of Commissioners on Uniform State Laws (sometimes called the Uniform Commissioners), a group made up of lawyers appointed by state governors and sustained by appropriations from state legislatures. The purpose of the UCCC, according to the Uniform Commissioners, was "to abolish the crazyquilt patchwork welter of existing laws on consumer credit and replace them by a single, new comprehensive law" that would provide adequate credit "at reasonable cost and fair conditions to both consumers and creditors."[4] Each state was to overhaul its credit laws by adopting the UCCC.

OPPOSITION—AND AN ALTERNATIVE

The UCCC met heavy opposition from consumer groups, including Consumers Union. Although it did consolidate the maze

---

tion, and they are tantamount to restraint of trade, the suits allege.

If successful, the suits would require American Express and BankAmericard to notify merchants that they are free to offer lower prices to cash customers, and to notify cardholders that discounts for cash are no longer contractually prohibited. Merchants, in turn, would be requested to post a sign informing customers of the change. No merchant would be compelled to lower prices, but would be free to do so—and cash customers would be encouraged to ask about a lower price.

[CU's suit against American Express was recently settled. By the terms of the settlement American Express must notify member businesses that they may now offer their customers cash discounts of three to six percent. Merchants must in turn "clearly and conspicuously" disclose the availability of cash discounts to their customers if they offer the discount; however, merchants are not required to give cash discounts. American Express did not agree to CU's proposal that the company notify all card holders that cash discounts are now possible from some merchants. San Francisco Chronicle, April 18, 1974, at 1, col. 1.]

2. 15 U.S.C. § 1601 *et seq.* (1968).

3. UNIFORM CONSUMER CREDIT CODE (Working Redraft No. 5, 1973). The UCCC can be obtained for $2 from the National Conference of Commissioners on Uniform State Laws, 645 N. Michigan Ave., Chicago, Ill. 60611.

4. *Id.* at (x).

of credit laws that had sprung up over the previous 50 years, the UCCC also authorized legal maximums for interest rates higher than those prevailing in most states and permitted the continuation of all but the most abusive of anti-consumer credit practices that had burgeoned over the years.

The consumer opposition was reasonably successful. Only seven states have adopted the UCCC (Oklahoma, Utah, Colorado, Idaho, Indiana, Wyoming, and Kansas),[5] and some of these have added important amendments favorable to consumers. But the UCCC has not withered and died. The Uniform Commissioners are still pushing state legislatures for their plan, which CU still regards as inadequate to protect the legitimate rights of consumers who need both reasonable access to credit and freedom from unfair collection methods.

The fifth revision of the UCCC, called "the tentative final draft," was released last November.[6] Although this revision contains some obvious concessions to consumer protection, it does not yet deal adequately with a number of serious inequities. On the other hand, state credit laws are certainly in serious need of reform and greater standardization. Where, then, can state legislators and consumer groups look for sound advice? At least some of the answers lie, in CU's opinion, in the Model Consumer Credit Act.[7]

The Model Act is the product of the National Consumer Law Center, an organization funded by the Office of Economic Opportunity and concerned with reform of laws to aid low-income consumers. The Model Act grew out of an earlier bill drafted by the National Consumer Law Center at least partly in response to the inadequacies of the original UCCC. A look at the different approaches taken by the UCCC and the Model Act to the major areas of credit reform will reveal how much more protection is offered the consumer by the Model Act.

How Do You Reach "Fair" Interest Rates?

An underlying assumption of the UCCC is that interest rates should be controlled by competition; that, in turn, requires maximum permissible interest rates substantially higher than those that now prevail in most states. The logic works this way: High ceilings on interest rates are necessary to increase the number of lenders and thus foster competition. But high *ceilings* may not necessarily mean high *interest rates*, because consumers shopping for the best

5. *Id.*

6. *Id.*

7. The complete text of the Model Consumer Credit Act may be obtained for $4 from the National Consumer Law Center, 1 Court St., Boston, Mass. 02108.

rate in a competitive marketplace will force down interest charges for all but the poorest credit risk. Meanwhile, even poor credit risks would be able to get loans, since a creditor would be permitted to charge a high rate of interest for the risk he takes.

The trouble with that logic, say UCCC's critics, is that ceiling rates tend to become standard rates—for everyone. There is wide disagreement on that point among economists, and the data are imperfect enough to support whichever position one cares to take.

There are other troubling unknowns about the regulation of interest rates. Do consumers really price-shop for credit as carefully as they might price-shop for, say, a rib roast? If not, people may wind up paying more for credit than they should have to. Suppose arbitrarily low credit ceilings were imposed on lenders by a state legislature. Would legitimate sources of credit for low-income consumers dry up, forcing them to pay the usurious rates demanded by loan sharks and other illicit lenders?

Such questions cannot be answered with any assurance because much of the data needed for accurate answers are closely kept business secrets.

Not secret, however, is the size of maximum credit charges that would be permitted by the current version of the UCCC. Open-end credit plans (revolving charge accounts and bank credit cards) are now limited to a maximum annual interest rate of 18 per cent in most states and of 12 per cent in a few. The UCCC authorizes a 24 per cent maximum;[8] and if creditors can characterize the transaction as a loan rather than as a sale, the maximum would go up to 36 percent,[9] doubling the maximum rate in most states.

The UCCC would also allow use of the "prior-balance method" of computing finance charges. Under that system, the interest charge is based on the balance at the *beginning* of the billing period;[10] before payments made during the month are deducted. Even if you paid $95 against a $100 bill, for example, you could still be charged $2 interest (a 24 per cent annual rate) when the next month's statement—showing you owed only $5—arrived.

The code would also permit revolving credit agreements under which creditors could increase interest rates that were low when the debt was originally incurred, so long as creditors gave notice twice in the three months before the increase.[11] That could hurt if

8. UNIFORM CONSUMER CREDIT CODE § 2.202 (Working Redraft No. 5, 1973).
9. *Id.* § 2.401.
10. *Id.* § 2.202.
11. *Id.* § 3.205.

you planned—as many people do—to pay off a big balance over a long period.

On fixed-installment credit plans, the UCCC would authorize maximums of 36 per cent interest a year on the first $300, 21 percent on the next $700, and 15 percent on anything over $1000.[12] Such terms would double the maximum rates in most states for financing appliances such as washing machines and TV sets through credit extended by retailers, making retail credit rates as high as rates charged by small-loan companies.

The rival Model Act proposes that state legislatures set maximum rates for each type of credit transaction. However, those rates, and requests for rate increases, would be set after consideration of data that creditors would be required to turn over to a state administrator. Such data would include, among other things, information on the profitability of credit-granting institutions under prevailing rates, on the number of consumers denied credit under prevailing rates and the reasons for denial, on the amount of money spent by lending institutions on lobbying and other activities unrelated to price competition—all information now generally kept confidential by the industry. Given appropriate information, of course, a state legislature might be induced to lower some maximum rates; but such information might also point toward the desirability of higher interest rates on certain types of consumer credit transactions.

Another important difference between the Model Act and the UCCC: In computing finance charges under the Model Act, creditors must use only the balance from which payments and returns have been deducted.

WHEN DEBTORS CAN'T PAY

One complicated part of credit reform is concerned with contract provisions that spell out what a creditor can do when the debtor doesn't pay on time. Creditors have a right to be paid, and the borrower must be obligated to pay his debt. But the very nature of credit requires consumers to obligate payments from future income over which they may have little or no control.

Many people who fall behind in paying debts do so not because the are "deadbeats" but because they have become unemployed or ill, or because unexpected and extraordinary inflation in the cost of life's necessities have left no room in a fixed budget for debt payments. Taking away the cars that people use to go to work, the houses they live in, or the appliances they need to maintain

12. *Id.* § 2.201.

a household creates a further displacement of income and graver social problems.

As a practical matter, many creditors often make an effort to work out alternative arrangements for payment. But the harsh remedies still available to creditors can ruin people in temporarry financial difficulty.

The fifth redraft of the UCCC does show some recognition of this problem. It would protect a higher portion of a wage-earner's pay from garnishment than does Federal law; the UCCC would exempt from garnishment a weekly income of 40 times the Federal minimum hourly wage ($64 a week as of this writing), versus 30 times the minimum wage ($48) under Federal law.[13] The UCCC now also contains relief from default judgments for consumers who don't get notice of court actions or don't realize they are being sued.[14]

On a number of related problems, however, the revised UCCC, while an improvement over earlier versions, still leaves much to be desired. Take, for example, "waiver of defense"[15] clauses and the doctrine of "holder in due course,"[16] legal principles that can force a consumer to continue paying for faulty merchandise or fraudulent or inadequate services. The UCCC does restrict the use of those devices in consumer credit,[17] but its language is so ambiguous that it may not prohibit them entirely. (The Federal Trade Commission is expected to rule shortly on a staff proposal to abolish the holder-in-due-course doctrine in consumer-credit transactions.)

Bank credit cards, moreover, get an important exemption. A consumer who purchased something worth $50 or less with such a card would still have to pay the bank, even if the goods were never delivered or fell apart immediately.[18]

---

13. *Id.* § 5.105.

14. *Id.* § 5.115.

15. In a waiver of defense clause, the buyer waives his right to claim that the merchandise he purchased is defective in any suit against him for payment by a third party to whom the seller has assigned his claim for payment, or by the credit card company if the purchase was made with a credit card or by a lender if the purchase was made by means of a loan taken out to make that specific purchase.

16. Often a buyer signs a note in payment for a purchase and the seller in turn sells the note for immediate cash to a third party, usually a lending institution. The holder in due course doctrine prevents the buyer from suing the third party purchaser of the note if the purchase made with the note is unsatisfactory and requires that the buyer continue paying off the note despite the fact that the item he purchased may be worthless.

17. UCCC section 3.404 prohibits waiver of defense to protect an assignee of the seller; section 3.403 prohibits waiver of defense clauses to protect credit card companies; section 3.405 prohibits those clauses with respect to purchase loans under certain conditions. Section 3.307 prohibits the use of negotiable instruments except checks and thereby precludes the operation of the holder in due course doctrine.

18. UNIFORM CONSUMER CREDIT CODE § 3.403 (Working Redraft No. 5, 1973).

SOME SERIOUS OMISSIONS

The UCCC fails to come to grips with a number of more serious problems. It provides no general homestead protection. Without that, in some states, a debtor's house could be sold at a sheriff's sale to pay off as little as a $100 judgment. Moreover, the UCCC allows an interest rate of more than 28 per cent on second mortgages over $1000.

The UCCC also allows in virtually every transaction financed by a direct loan from a bank the procedure that permits creditors to repossess goods, keep all the payments already made, and still sue the debtor for the balance. That procedure would also be permitted on credit extended in all transactions, including those not involving a bank, when the amount financed exceeded $1750[19]—a provision that would permit automobile dealers, and others who finance cars, to continue to repossess automobiles. CU believes a fair credit law might permit repossession *or* a court judgment against a defaulting debtor—but not both.

Finally, the UCCC denies the use of consumer class-action suits in specific credit grievances.[20] A class-action suit is a procedure that allows a large number of people with a similar grievance to sue a creditor in a single action. It can be an effective tool for aggrieved consumers who could not individually afford an attorney or who would not bother with legal action otherwise.

The Model Act, in direct contrast to the UCCC, is exhaustive in its effort to deal with these problems without involving the consumer in costly legal action. At the same time, it directs attention to issues the UCCC ignores. For example, the Model Act contains wide-ranging prohibitions against discrimination in the granting of credit because of sex[21] or race. The UCCC is silent on that question.

19. *Id.* § 5.103.
20. *Id.* § 5.201.
21. For years, women have complained of credit discrimination. Working women earning good salaries have been denied loans or credit cards unless they could produce a husband's signature. Couples applying for mortgage loans have found that the woman's salary didn't count when it came to figuring out how big a loan the couple could handle; or it counted only after a series of prying questions had established that the couple was following a satisfactory course of birth control.

This form of sex discrimination has begun to crumble. Last December, the Federal Home Loan Bank Board (FHLBB) announced that savings and loan institutions could no longer consider gender as a factor in making mortgage loans. Some 14 states have outlawed at least certain forms of sex discrimination in the credit field.

Nevertheless, credit discrimination based on sex still exists. If you encounter such a problem at a Federally-chartered savings-and-loan association, report it to a regional office of the FHLBB. If the problem occurs at a Federally-chartered commercial bank, try a regional office of the Federal Reserve Board. (The Fed-

The Model Act clearly establishes that consumers must have their day in court before creditors can repossess goods or attach bank accounts or otherwise deny consumers their property. The UCCC is mute on that issue, too, although it guarantees the hearing rights of creditors threatened with punitive action by the state for illegal behavior.

The Model Act also goes into detail on the handling of computer errors, a problem the UCCC does not address Finally, the Model Act strengthens a number of areas already regulated by Federal laws—credit disclosures, credit reporting, and the consumer's liability for lost or stolen credit cards. The UCCC attempts no improvement on Federal credit standards, even though the clear intent of Congress was merely to establish minimum standards.

RECOMMENDATIONS

CU's view remains the same as the one we expressed in March 1969: "We don't think any state, no matter how bad its existing credit laws, should adopt the UCCC without extensive amendments in favor of consumers."

---

eral Reserve Board does not have a formal policy similar to the FHLBB's, but a spokesman told CU: "We might be able to do something informally.")

For problems with state-chartered banks, or with credit cards, a call to the state attorney general's office might help. Don't overlook organized women's groups. Some make it a point to keep up with state laws affecting women's rights. And the pressure they exert can be a lever to pry open coffers of credit that shouldn't have been closed in the first place.