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A PRIMER ON CONSUMER CREDIT INSURANCE

I. What is Consumer Credit Insurance?

“Consumer credit insurance” (or just “credit insurance”) refers to a group of insurance products or coverages offered in connection with a loan or credit agreement where the policy terms and benefits are related to the specific consumer credit contract or obligation, and the insurance proceeds are used to repay the debt upon occurrence of an insured event.

Credit insurance is sold directly to borrowers, usually at the time and place where the consumer credit is arranged, by “producers.” Producers, which produce the business for the credit insurers, are agents or intermediaries involved in the sale of the credit insurer's product to the borrower. Typical producers include automobile dealerships, mobile home dealers, banks, credit unions, department stores, jewelry stores, furniture and appliance stores, and finance companies. Credit insurers market their products to the producers who sell the insurance, as opposed to the ultimate consumers.

Two main categories of credit insurance involve (1) insurance relating to installment credit or closed-end credit, and (2) insurance relating to credit card debt or open-end credit.

Closed-end credit involves a credit or loan of a specific term where the borrower typically agrees to repay the debt in equal monthly payments over a set term, either in a cash and credit transaction where the debtor receives cash from a lender to buy consumer products by entering into the credit obligation (a loan), or in a retail installment sale transaction where the consumer receives a product by entering into the credit obligation directly with the seller (a credit sale). Most credit insurance sold in connection with a closed-end loan is single premium credit insurance based on the gross amount of the credit obligation, or total of payments.

Open-end credit involves a credit sale or loan, generally without a fixed term, under an arrangement which allows the consumer to borrow additional amounts as desired up to an established credit limit, such as under a credit card or revolving loan. Repayment is normally made based on the current account balance. Credit insurance premiums for open-end credit are paid monthly based on the net monthly outstanding balance (MOB).

Consumer credit is generally offered based on the prospect that the borrower can pay the debt from future income, with earning power in part serving as security for the credit. Death, disability, or unemployment of the borrower can place this security for the credit in jeopardy. As a result, credit insurance on the borrower's life and ability to work was developed to protect the creditor, cushion the borrower's loss, and provide the borrower with “peace of mind.” The market for credit insurance has expanded with the growth of consumer credit.

II. Common Credit Insurance Features

The purchase of most credit insurance products is voluntary and optional. Lenders rarely require a borrower to buy credit life, accident or health insurance to assure payment of a debt, because in that event the premium is deemed a finance charge. [1] If this insurance is required by the creditor as a condition to the extension of credit, then it must be disclosed and included as part of the "finance charge" for TILA purposes. In addition, in some states it is illegal to require the consumer to buy credit life or disability insurance products as a condition to receiving the loan. If the creditor requires *property* insurance (hazard insurance covering the loan collateral), the borrower typically has the option of providing a loss payable endorsement to a homeowners or renters policy, buying credit property insurance from or through the creditor, or supplying some other credit property insurance. For some borrowers, buying the credit property insurance offered through the creditor may be the only real alternative, though the widespread availability of such insurance gives most consumers multiple options.

Generally, a single premium for voluntary credit life, and/or disability insurance relating to closed-end credit is paid when the policy is bought, and the ***53** premium is included in the amount advanced by the lender and is financed with the principal debt. In open-end or credit card credit, cardholders may be solicited to buy a package of coverages when applying for the credit, or later by mail or telephone, and the premium is paid monthly, with coverage continuing month to month.

The first beneficiary of policy proceeds is the creditor, who applies the proceeds to pay off the debt. Any remaining proceeds are paid to the secondary beneficiary, or the insured's estate. The credit insurance terminates when the credit obligation terminates. In the context of a single premium product for closed-end credit, when the credit is repaid prior to the scheduled maturity date, or the policy is cancelled prior to termination of the debt obligation, a refund of the unearned insurance premium is due to the borrower or his lender. [2]

III. Common Credit Insurance Products

Credit life insurance is a type of credit insurance that pays the borrower's outstanding obligation to the creditor upon the borrower's death. Credit life insurance contracts come in different forms tailored to the type of loan transaction and the way the insurance is marketed. Credit life may be written to provide individual or joint coverage, and often is written on a group basis. Frequently, a group policy is issued to the creditor, which enrolls borrowers under the group policy and issues a certificate of insurance to the borrower. Credit life insurance is sold in connection with both closed and open-end credit. A common type of credit life insurance sold with closed-end credit is decreasing (declining) term credit life insurance, where the initial amount of coverage equals the amount borrowed plus the finance charge (the "gross debt"), and the amount of coverage decreases as the balance of the loan declines. Many policy provisions are similar to those in traditional term life insurance policies.

Credit disability insurance (sometimes referred to as credit accident and health insurance, or "A&H") is a type of credit insurance that pays the borrower's monthly loan payments to the creditor when the borrower becomes sick or injured in an accident and suffers a resulting interruption of income. Credit disability insurance is sold in connection with both closed-end and open-end credit. Many policy provisions are similar to those in traditional disability insurance policies, where a monthly benefit is paid if the insured becomes disabled after satisfaction of an initial period of disability. The monthly credit disability insurance benefit typically equals the required monthly credit payment.

Credit involuntary unemployment insurance (sometimes referred to as "IUI") is a type of credit insurance that pays the borrower's monthly loan payments to the creditor when the borrower becomes unemployed due to layoff and suffers a resulting interruption of income. Credit IUI is sold most frequently in connection with open-end credit. These policies may also provide coverage if the employee goes on strike or is fired. (States otherwise provide unemployment insurance benefits which pay only a portion of the unemployed's former salary.) Loss ratios on this product have been criticized by consumer advocates and regulators as being very low.

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Credit property insurance is like a form of homeowner's insurance that provides coverage to protect the creditor against loss of the collateral, *e.g.*, automobile, furniture or a computer, or even a home securing the loan. Credit property insurance usually provides for payment of the lesser of the actual cash value, or the cost to repair or replace, the damaged property serving as collateral for the loan. Creditors may require that the borrower purchase credit property insurance, but if so, the borrower may then select the insurer. [3] Credit property insurance is sold in connection with both closed and open-end credit. As a practical matter, the credit-related aspects of property insurance may be virtually unregulated in some states. Consumer groups have been trying to get the National Association of Insurance Commissioners (NAIC) to draft a model law or uniform regulation to additionally govern credit sales of this product. Unlike credit life, credit disability, and credit IUI products, credit property insurance is not directly related to an event affecting the consumer's ability to pay his or her debt. Instead, it protects the creditor's interest in the collateral. Consumer advocates and some regulators also criticize the loss rations on this product as being very low. However, property insurance is widely utilized outside the credit context, and is often considered a necessity, with or without credit.

A new type of credit insurance product that has been developed and is now being sold in connection with open-end credit is "credit family leave insurance." This type of credit insurance will pay to the creditor the consumer's monthly loan payments when a consumer takes a leave of absence from his or her employment for reasons such as those listed under the provisions of the federal Family and Medical Leave Act of 1993.

In the context of open-end credit, these products (credit life, credit disability, credit IUI, and credit property insurance) are commonly sold together to consumers as a package. Some companies are beginning to add to this package other features such as credit family leave insurance. Some consumer advocates criticize this "bundling" of insurance products, on grounds it does not allow the consumer to individually measure the value and cost of each product. Consumer groups also complain about so-called "phantom coverage" when credit property insurance is sold in conjunction with credit card financing: On credit card ***54** loans, credit property insurance premiums are generally based on the "MOB," or monthly outstanding balance on the credit card. But because this credit property insurance only provides coverage for personal property purchased with the card, "phantom coverage" results when the balance on the account includes charges for services, meals, finance charges and other non-covered items (including premiums for the credit property insurance).

IV. Other Credit-Related Insurance Products

Collateral protection insurance (CPI) is a type of creditor-placed insurance which is purchased unilaterally ("forced placed") by the creditor after the loan origination date to insure against loss to the collateral due to fire, theft, collision or other risks that would either impair the creditor's interest or adversely affect the value of the collateral, upon breach by the debtor of his or her obligation to maintain such coverage. [4] CPI is normally sold on a group basis with the lender as the nominal policyholder and the borrower enrolled in the plan by the lender as a certificate holder. CPI sometimes protects both the borrower's and creditor's interest in the collateral (dual interest), and sometimes protects solely the creditor's interest (vendor single interest or "VSI"), which typically is the outstanding balance due on the loan. [5] A creditor "force places" CPI according to the terms of the credit obligation when the borrower fails to maintain the required insurance, and the cost of the coverage is then charged to the borrower. CPI has been the subject of scores of class actions against lenders and credit insurers, some of which have resulted in multi-million dollar settlements. [6] A number of states currently have or are proposing legislation to specifically regulate force placed insurance, and some are seeking to adopt the model NAIC Creditor-Placed Insurance Act.

Non-filing insurance (NFI) typically is purchased by a secured creditor in the context of small loans to buy furniture, appliances and other household items. NFI insures the creditor against loss resulting from the lender's decision not to protect its security interest by filing a financing statement or otherwise perfecting its lien. NFI products have been the subject of dozens of class actions, particularly in Georgia and Alabama, and especially when used in the context

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of purchase money loans. Two recent federal appellate court decisions have construed NFI issues strongly in favor of consumers. [7] In November 1998, American Bankers Insurance Group announced it would pay $17 million to settle class action suits against it in NFI multidistrict litigation.

"Mechanical breakdown insurance" is a term used to describe a vehicle service agreement in those states where vehicle service contracts are deemed to be a form of insurance that is regulated under state insurance laws.

"GAP insurance" is a type of insurance that pays the remaining amount owed if a borrower's car is damaged or destroyed and the loan balance exceeds the actual cash value reimbursement paid by the car insurer. GAP insurance typically is sold in conjunction with longer-term auto loans or leases, where the value of the vehicle (the amount paid by the consumer's regular auto insurance policy if the vehicle is destroyed) declines faster than the remaining principal owed on the loan or lease. Some states may treat certain lender-offered contractual GAP waiver agreements, or GAP debt cancellation agreements, as "insurance."

Private mortgage insurance (PMI), or mortgage guaranty insurance, is an insurance product typically required by a lender on any conventional residential mortgage loan that exceeds an 80 percent loan-to-value ratio (LTV ratio). [8] PMI insures the mortgage servicer or investor for a certain portion of the loan against a deficiency resulting from the borrower's default. PMI is essentially a type of GAP coverage. Lenders often require PMI so that loans can be sold in the secondary market to entities such as Fannie Mae or Freddie Mac. [9]

V. How Credit Insurance Benefits Creditors

The sale of credit insurance products is an important source of profit for creditors, insurers and producers. For example, according to the National Automobile Dealers Association, the profit on the sale of a new car can double if the dealer also finances the transaction and sells the consumer a vehicle service contract (called "mechanical breakdown insurance" in some states) and credit life and disability insurance.

Lenders and other producers selling credit insurance may receive a commission as high as 40-50 percent of each premium dollar at the front-end, and sometimes receive back-end commissions as well, for their efforts in explaining the product to borrowers and administering the sale. Many states regulate the maximum commission that may be paid to a producer relating to credit insurance sales. [10]

Credit insurance may be sold through a "captive" insurer, which is an insurance company affiliated with or owned by the creditor. Some creditors establish affiliated U.S. or offshore reinsurance companies ("Producer Owned Reinsurance Companies," or PORC's) to ***55** share in underwriting profits. Creditor employees also may receive a portion of all premiums received, or a cash bonus or "spiff" for each credit insurance sale that the employee makes.

In most cases, the purchase of credit life or disability insurance is voluntary, and when property insurance is required the borrower has a choice of insurers, and therefore the cost of the premium is included in the amount financed, but not in the finance charge that is reflected in the disclosed Annual Percentage Rate (APR). [11] This results in an increased dollar interest yield to the lender.

VI. How Credit Insurance Benefits Consumers

Many consumers are uninsured or underinsured, and properly consider additional insurance protection as a benefit when taking on new consumer debt. Lower-income consumers with the least financial security often need, buy, and appreciate the convenience and availability of credit insurance most of all. Consumers in this group are often effectively shut out of

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the individual life and disability insurance market due to high minimum annual premiums and other requirements, and as a result often elect to buy credit insurance. Another group benefitting from credit insurance is that of consumers 40 years of age and older, because traditional individual life insurance is age-rated, while credit insurance is not. Other consumers benefit from credit insurance because it is not “under-written” in the normal sense and contains fewer exclusions or limitations than traditional insurance.

Most consumer credit obligations total less than $25,000, and few traditional insurance products can be bought in such relatively small amounts. Sometimes credit insurance is the only type of insurance convenient or available to consumers to protect them from the risk of being unable to pay their debts upon death, disability or involuntary employment, or loss of the collateral, and to eliminate the prospect of a collection suit or repossession in these circumstances.

VII. Consumer Advocates' View: A “$2 Billion A Year Rip-Off”

In March 1999, the Consumers Union and Center for Economic Justice issued a scathing report (Report) entitled “Credit Insurance: The $2 Billion A Year Rip-Off,” subtitled “Ineffective Regulation Fails to Protect Consumers.” This Report, reflecting the consumer advocates' view of credit insurance, stated that from 1995-1997, more than $17 billion of credit insurance was sold in the United States. The Report reviewed the per formance of state insurance regulators in protecting the consumers of credit insurance, and concluded that ineffective regulation has caused consumers to overpay for credit insurance by $2 billion dollars a year and has failed to protect consumers from unfair sales and market practices.

The Report contends that credit insurance is overpriced due to “unconscionably” low loss ratios. The Report notes that, nationwide for 1997, the loss ratio for all credit insurance products averaged 38.7 percent. (The loss ratio is the percentage of premiums paid out in benefits to insureds.) The Report argues that proper loss ratios for credit insurance products should range from 60-75 percent, as compared to historical loss ratios for group life insurance of 90 percent, group accident and health of 75 percent, and private passenger auto insurance of 70 percent. Using this 60-75 percent loss ratio, as compared to actual loss ratios, resulted in the Report's $2 billion overcharge estimate.

The Report contends that these purported overcharges are caused in part by systemic “reverse competition.” Reverse competition is described in the Report (page iii) as follows:

> The credit insurance policy is a group policy sold to a lender who then issues certificates to individual borrowers. Because the lender purchases the policy, credit insurers market the product to the lenders and not to the borrower—the ultimate consumer who pays for the product. This market structure leads insurers to bid for the lender's business by providing higher commissions and other compensation to the lender. Greater competition for the lender's business leads to higher prices of credit insurance to the borrower.

The Report contends that reverse competition has led to commissions to lenders that are “excessive” because they exceed reasonable costs incurred by the lenders in selling the credit insurance on behalf of the credit insurer. The Report further notes that in many cases the lender owns the credit insurer and realizes additional profits from low loss ratios.

Based on a comparison of what consumers paid from 1986-1997 versus what they purportedly should have paid had “reasonable” and “minimum” standards been met for all types of credit insurance, Consumers Union found the “ten worst” states to be (in order) Louisiana, Mississippi, North Dakota, Alaska, Nevada, Nebraska, New Mexico, Minnesota, South Dakota, and Utah.

The Report's recommendations to state legislators and regulators include: establishing minimum loss ratios; enacting more effective consumer disclosure requirements; enacting additional prohibitions and stronger penalties against credit

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insurers for unfair and coercive sales practices; and providing consumers with the choice of buying individual coverages instead of requiring them to buy a complete package of coverages.

In light of this Report, the NAIC has recently decided to review its prior actions concerning the issues raised by the Report. The Report has also had a ripple effect throughout state insurance regulatory circles around the nation. The NAIC will appoint a working group to review existing and proposed state laws and regulations and current regulatory efforts by states addressing credit insurance products in order to assess the overall effectiveness of the existing regulatory framework and to make recommendations ***56** for areas needing change or improvement.

The Consumer Credit Insurance Association (CCIA) has sharply criticized the Report, asserting that the Report: uses a flawed analysis that lumps all forms of credit insurance together; lacks basic business understanding of distribution and other costs; clings to discredited and unsubstantiated assertions about sales practices; and ignores the fundamental fact that consumers must be, and are, told they can say yes or no to optional credit insurance. The CCIA further stated the Report is unfairly disparaging to both credit insurers and regulators. According to this trade group, a 1998 study reported that 25 percent of Americans have no life insurance of any kind. The CCIA further noted that credit insurance gives consumers: financial security in knowing a specific debt will be paid off in the event of death, disability, involuntary unemployment, or loss of property; insurance that generally does not discriminate in price based on age, health, gender, or other typical insurance criteria; and the opportunity to insure debt to supplement and preserve the full value of other insurance the consumer may have.

VIII. Credit Insurance Sales Dynamics

Credit insurance policies, due to the relatively small amount of consumer credit balances they insure, are smaller in size than most other insurance policies. In a closed-end credit transaction, because the insurance is tied to the specific credit, the producer must offer the option to buy the insurance to the borrower when the credit is extended.

As a result, sales and “finance and insurance” (F&I) department employees of producers such as automobile dealers, finance companies, banks, credit unions, mobile home dealers, and retailers—as compared to specialized, full time insurance agents who sell traditional insurance products—are in the position of presenting, explaining and selling these optional credit insurance products directly to consumers. These consumers may be unsophisticated, and must decide whether to accept or reject the credit insurance offered at the time of the transaction.

State laws generally require that persons who sell traditional insurance products must be licensed in that state. However, many states have simplified or done away with licensing requirements for the sale of credit insurance. In some states a person can become licensed to sell credit insurance without taking a test. Indeed, to some extent a minimalist approach may be necessary, as the small dollar amounts and high turnover among sales staff mean that it is necessary to rapidly and economically train new staff.

Credit insurers and their general agents provide their producers with sales literature, and some operate training schools, to help producers and their employees understand the credit insurance products and improve their selling skills to better explain insurance products and increase sales penetration. In some states, the law deems the creditor/producer to be an agent of the credit insurer, and in other states an agent of the borrower/insured.

Producers are typically compensated by way of a commission or service fee, earning a percentage of the premiums collected. The producer's commission is commonly deducted from the amount collected from the borrower before the net amount is remitted to the insurer. Employees of the producer who directly sell the credit insurance to a borrower sometimes are paid a cash bonus for each policy sold. In closed-end credit, when a consumer debt is extinguished before maturity, or when the borrower cancels the policy before the debt had been repaid, the borrower or lender is entitled to a

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refund of the unearned premium, and the insurer charges back to the producer an amount for the unearned compensation that was paid up front.

IX. What Laws Regulate Credit Insurance Sales?

A. State Insurance Statutes and Regulations

Insurance products and sales are principally governed by state law, and the McCarran-Ferguson Act, 15 U.S.C. sections 1011-1015, preempts the application of certain federal laws to the business of insurance. [12] Most states have separate chapters in their insurance code relating to credit insurance. State insurance codes are primarily directed at and regulate credit insurers (as opposed to creditors), and many are based on the Model Credit Life, Accident, and Health Insurance Act drafted by the NAIC. These state law provisions sometimes do not expressly provide for a private right of action if violated. Most states also have separate statutory or regulatory provisions governing credit insurance with respect to rate structure and restrictions on coverage, and necessary disclosures. Some credit insurance products or coverages may not be specifically regulated under various state insurance codes. [13] Some state insurance departments have been very aggressive in using injunctive and other powers to broadly attack credit insurance products and practices, sometimes on the basis of seemingly technical errors. [14]

***57 B. State Consumer Credit Laws**

Most states also have special usury and consumer credit laws, such as motor vehicle sales finance acts, second mortgage acts, small loan acts or general credit laws, which may apply to credit insurance sales. These laws are primarily directed at and regulate creditors (as opposed to credit insurers), and place limits and restrictions on credit insurance charges that may be financed under those laws. Article 4 of the Uniform Consumer Credit Code (U3C) includes detailed provisions governing credit insurance in transactions subject to the U3C. These provisions often provide for a private right of action against the lender if violated, and generally require that credit insurance be written in compliance with the state's credit insurance code provisions and be properly disclosed. These provisions also often specify the conditions that must be met for the insurance premiums to be excluded from the finance charge (*e.g.*, that the insurance must be voluntary).

C. State Unfair and Deceptive Practices Statutes

Most states have unfair and deceptive acts and practices (UDAP) statutes, and/or unfair insurance trade practices (UNIP) statutes, which may also govern the sale of otherwise-regulated credit insurance products and/or disclosures made in connection with those sales. [15] Many of these statutes offer appealing private remedies for plaintiffs seeking redress for alleged credit insurance transgressions. [16]

D. Federal Truth In Lending Act

The TILA is primarily a disclosure statute, and does not substantively regulate the sales, price or terms of credit insurance. TILA's provisions relating to credit insurance state when the creditor may exclude the premium cost from the calculation of the finance charge for TILA disclosure purposes. Specifically:

> - The premium cost of credit life, disability and IUI coverage may be excluded from the finance charge calculation only if: (1) a written disclosure is made that the purchase of the insurance is optional and is not required by the creditor (insurance coverage of the debtor is not a factor in the creditor's approval of

the extension of credit); (2) the premium for the initial term of insurance coverage is disclosed; and (3) the consumer signs or initials an affirmative written request for the insurance after receiving these disclosures. [17]

- Fees paid voluntarily for contractual GAP waivers or debt cancellation agreements, for cancellation of all or part of the debtor's liability for amounts exceeding the value of the collateral, or in the event of death or disability, may be excluded from the finance charge only if: (1) the optional nature of the product is disclosed in writing; (2) the fee for the initial term of coverage is disclosed (with some other special disclosures depending on the product features); (3) and the consumer signs or initials an affirmative request for coverage after getting the disclosures. [18]

- As to credit property insurance, if required by the creditor, the cost may be excluded from the TILA finance charge calculation only if: (1) the borrower is informed that he or she may choose the insurance provider; (2) and the cost of the insurance, if bought through the creditor, is disclosed. [19] For vendor single interest property insurance to avoid being a finance charge, in addition to these credit property insurance requirements, the insurer must also waive all subrogation rights against the consumer. [20]

- When a package of multiple coverages is offered in connection with open-end credit, if the only choice for the consumer is to buy all or none of the coverages, the creditor arguably need not state a separate cost for each component. [21] However, this issue has been the subject of litigation, and difficult questions are raised when the package includes property insurance, which otherwise requires additional disclosures. [22]

X. Key Federal and State Legislative and Regulatory Initiatives

Based in large part on the effect of the March, 1999 Consumers Union Report criticizing many credit insurance products and marketing practices, [23] there has been a surge in legislative and regulatory activity in this area.

A. Federal Initiatives

In a May 4, 1999 press release, [24] the White House announced its "Plan for Financial ***58** Privacy and Consumer Protection in the 21st Century" (Plan). The Plan proposes legislative and executive action to protect consumers in the "new" information economy, based on five principles: (1) Protect financial privacy; (2) Expand the consumer's right to know; (3) Prevent fraud and abusive practices; (4) Expand access to financial services; and (5) Educate consumers. Credit insurance was addressed in the detailed proposed summary attached to the press release. The paragraph on credit insurance provides:

> End Coercive Sales of Insurance Products. Borrowers buy credit insurance to ensure repayment of their mortgages in the event of death, injury or job loss. However, the economic value to the consumer of these products is dubious. Moreover, credit insurance is frequently marketed in a way that is either explicitly or implicitly coercive—that is, consumers are told or left with the impression that their changes of getting the loan or getting it more quickly would improve if they purchased the insurance. Some creditors collect up-front-lump-sum insurance premiums for the policy term, so consumers cannot cancel. Required disclosures

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appear to be ineffective at deterring these practices. We support legislation barring the advance collection of lump-sum insurance premiums, so that consumers can pay for the insurance one month at a time, so a loan termination automatically cancels both the coverage and liability for insurance payments. In addition, Congress should bar the solicitation of credit insurance until the lender has approved the loan application and communicated approval to the borrower.

B. State Initiatives

North Carolina's Senate Bill 1149 (the "Prohibit Predatory Lending Act")—a response to alleged predatory and high cost mortgage lending practices—views financed single premium credit insurance as part of the predatory lending problem. Passage of this law has led other states, and federal legislators, to pass or consider passing similar laws. This new law [25] prohibits lenders from financing, directly or indirectly, any credit life, disability, or unemployment insurance, or any other life or health insurance. Premiums calculated and paid on a monthly basis are not considered as being financed by the lender. This provision became effective July 1, 2000. The law also requires a study of the benefits to consumers of financing single premium credit life insurance in certain circumstances.

Serious concerns now exist that single premium credit insurance may also be in jeopardy in other states. New York's State Banking Department recently held hearings on subprime lending practices, and proposed a regulation placing restrictions on high cost home loans and containing provisions affecting single premium credit insurance coverage and so-called "packing." Other states, including California Illinois, Kansas, Maryland, Minnesota, Missouri, and Utah have introduced or enacted similar predatory lending bills. And, as noted, Georgia has moved aggressively to prohibit the sale of credit insurance in some circumstances. [26]

The NAIC has recently expressed concerns that regulated sales of credit insurance are being replaced by unregulated sales of debt cancellation and deferral agreements in the marketplace, and if these new products are not addressed and regulated by the NAIC, then its credit insurance oversight will become moot.

XI. Recent Regulatory Enforcement Actions

A. State Regulatory Actions

In a June 1999 Consent Order with the Texas Department of Insurance, and without admitting it violated any laws, Financial Insurance Exchange (FIE) agreed to pay almost $1.3 million to resolve allegations that it engaged in unauthorized sales of "extended credit property insurance" on items consumers bought from the Fingerhut mail-order catalogue company, and to stop selling that coverage. [27]

FIE had sold the extended credit property coverage as one option in a package that also included credit property, credit life, and credit disability insurance. Fingerhut customers signed up for the coverage by checking a box on a form that came with the coupons they used in making their installment payments. Apparently, the extended credit property insurance coverage, which pays if a financed item is lost, stolen, damaged, or destroyed, is supposed to end under Texas law when the item is paid off and the seller or lender no longer has a security interest in it. FIE's coverage, however, allegedly continued after a Fingerhut customer had made all the payments and completely owned the item.

In November 1998, American Bankers Insurance Group, without admitting liability, agreed to pay as much as $15 million to settle allegations that it violated the laws and regulations in multiple states governing the sale of credit insurance. [28]

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American Bankers signed a Consent Order and a Compliance Plan with a number of state regulators following this action, resulting from a multistate investigation of the company.

In March 1998, two units of American Bankers Insurance Group were fined $250,000 in Missouri for selling credit insurance policies to the elderly, the disabled, and students who would not be eligible for coverage benefits. [29] In addition, the company was charged with paying lenders commissions as high as 75 percent where Missouri law limits such payments to 40 percent, and with ***59** using unlicensed telemarketers to sell insurance for credit card companies in the state.

In January 1998, Montgomery Ward and three affiliated insurers, Montgomery Ward Life Ins. Co., Forum Ins. Co., and Montgomery Ward Ins. Co., consented to an enforcement order of the Texas Insurance Commissioner alleging insurance packing in violation of state consumer protection laws, while disputing those charges. [30] Under the settlement, Montgomery Ward credit card customers who bought a "Credit Security Plan," without realizing it was insurance, can cancel the coverage and get back their money with interest. The refunds may total as much as $5 million. The enforcement action contended that the Montgomery Ward insurers sold the Credit Security Plan through retail sales staff who, among other things, allegedly encouraged customers to buy the Credit Security Plan by signing a line on a charge account sales slip without telling them that they were buying insurance, and through telemarketers who called Montgomery Ward credit card holders and failed to fully disclose the nature or cost of the Credit Security Plan.

As noted, there have also been recent regulatory actions in Georgia. [31]

B. The *Levitz* Case

In August 1997, Levitz Furniture Corporation settled by way of a stipulated judgment a state enforcement suit filed against Levitz, American Bankers Insurance Company, and General Electric Capital Corporation for allegedly misleading approximately 30,000 California customers into buying credit insurance on revolving credit accounts they had opened to finance furniture purchases in violation of state law. American Bankers underwrote the credit insurance, and GECC arranged and purchased the credit accounts. Levitz settled the matter for $10 million on behalf of all defendants, which includes $2 million in civil penalties and $6.3 million for court and investigation costs. This judgment, in which the defendants denied any liability, concluded regulatory proceedings against the defendants that began in 1995. [32]

Levitz salesmen allegedly tricked customers into purchasing at the point of sale the "Chargeguard Plus Program" containing credit life, disability, involuntary unemployment, and property insurance by, among other things: having the customer sign the insurance documents without disclosing their purpose ("sign here and sign here"); claiming that the credit insurance wasn't insurance at all; claiming that the insurance would guaranty delivery of the customer's purchase; or hiding the cost of the insurance and claiming that the credit insurance was free.

GECC, which was the first named insured under the policies, allegedly received substantial commissions from American Bankers from the insurance sales, and a GECC subsidiary allegedly reinsured American Bankers on the policies and indirectly shared in underwriting profits. Charges and fees assessed by GECC for servicing the Levitz accounts allegedly were directly related to the penetration rate, or level of customer participation in the Chargeguard Plus Program, with cash incentives allegedly paid by GECC to Levitz stores and employees when penetration rates exceeded 60 percent.

One of the State's contentions was that the defendants "encouraged unfair and deceptive sales practices in the sale of credit insurance" by "providing financial inducements and rewards to sales representatives to sell credit insurance signed up for credit," and by offering Levitz financial benefits to achieve high "penetration rates."

California officials in a press release stated that they were “concerned that this is a practice prevalent throughout the retail industry.” A consumer class action suit was filed arising out of the same alleged conduct against these parties immediately after the California settlement was signed.

C. FTC Actions

In February, 1997 Tower Loan of Mississippi, Inc. agreed to pay to more than $300,000 as part of a proposed settlement of Federal Trade Commission (FTC) charges that Tower Loan violated an earlier 1992 FTC order. The FTC alleged that Tower Loan failed to make full redress payments to consumers as required by the earlier order, and incorrectly described how Tower Loan calculated redress in a report it submitted to this FTC. [33]

The 1992 FTC order arose out of FTC charges that Tower Loan violated the TILA by failing to include the costs of mandatory credit-related insurance when making loan disclosures to consumers. In settling those charges, the FTC ordered that Tower Loan offer customers who had opened accounts during the prior two years the chance to obtain refunds or credits to their accounts if they chose to cancel the credit related insurance written on their loans. Tower Loan incorrectly calculated the redress amounts, credits, and payment reductions it was required to offer and make to consumers, and as a result, Tower Loan made lower refunds, credits, and payment reductions than required under the 1992 order. [34]

XII. “Packing” Cases and Issues

A. Insurance Packing

Critics contend that the profitability of credit insurance has sometimes led to coercive and abusive sales tactics referred ***60** to as “insurance packing,” “payment packing,” “loan packing,” or just plain “packing.” These terms describe the sales practice of deceptively increasing a consumer's credit obligation (and in turn, increasing the creditor's, producer's, and insurer's profits), by padding or “packing” the amount financed through the sale of unnecessary, unrequested and/or unwanted credit insurance products. Other packing practices may include overcharges to borrowers eligible for the insurance coverage under the terms of the policies bought, sales of credit insurance to borrowers ineligible for coverage under the policy terms, and/or sales of policies that provide less or more than the coverage desired. Alleged large scale systematic packing by multi-state lenders first attracted the attention of regulatory authorities and the public in the mid 1980s, and significant litigation ensued.

B. The ITT Cases

One earlier series of cases involved ITT Financial and its finance company and insurance company affiliates, and were not concluded until the early 1990s. A variety of packing practices was alleged in those cases. Many of the ITT Financial cases, brought by both regulatory authorities and consumers, alleged that those companies (usually without the knowledge of its customers) packed various types of expensive optional insurance onto consumer loans along with traditional credit insurance. These cases generally alleged that after the applicant requested a specified loan amount, the lender telephoned back that the loan plus optional insurance had been approved with a stated monthly payment, but never mentioned a total loan amount, and at the closing, all loan and insurance documents were typed and intermingled so that they looked like one transaction. What many ITT Financial customers allegedly had purchased in addition to getting the loan was a combination of credit insurance policies, other insurance policies unrelated to the credit, credit property insurance on household goods that were not collateral on the loan, accidental death and dismemberment policies, and “ITT Thrift Club” memberships giving buyer discounts on various services.

Some of these cases alleged that many debtors never knew that they were purchasing any insurance from ITT Financial, while others alleged that the consumers believed that they were buying just credit insurance, or thought the insurance was required because the papers were already made out. These suits contended that when debtors claimed they didn't want the insurance, and needed the cash right away, loan officers stated that retyping the papers would take three or four days, or that the loan would have to be resubmitted for approval.

C. The *Lemelledo* Case

Another example of alleged packing is described in *Lemelledo v. Beneficial Management Corp.* [35] In *Lemelledo*, the New Jersey Supreme Court held that New Jersey's Consumer Fraud Act applies to highly regulated industries such as insurance and banking, so as to govern a financial institution's sale of insurance in connection with lending and its alleged practice of "loan packing." The court also held that the existence of other statutory schemes to regulate alleged loan packing did not require a limitation on the scope of the state's Consumer Fraud Act so as to prevent it from reaching the lender's sale of credit insurance.

In *Lemelledo*, the plaintiff alleged she applied for a $2,000 loan from Beneficial. When she went to the defendant's office to pick up the check, she alleges, she was surprised to be presented with a loan contract for $2,538.47 and a check for $2,203.19. While it is unclear why she received $203.19 more than she had applied for, the $335.28 difference in the amount in the contract and the amount Lemelledo received was apparently earmarked for credit insurance premiums.

Lemelledo charged Beneficial with loan packing, alleging that Beneficial's borrowers are given a "negative option" to buy the insurance, since all loans are packaged with credit insurance even if the borrower does not request it. Beneficial had provided a form noting that the insurance was not required to obtain the credit, but the company's actions allegedly led Lemelledo to believe that she would not get the loan if she did not buy the insurance.

Beneficial allegedly presented the insurance and the loan agreements in a single contract in one lump sum, did not advise her regarding whether the insurance was appropriate for her, and never discussed the insurance apart from the loan. The plaintiff claimed that she felt pressured to take the insurance because, she contended, had she declined, she would have had to return at a later date to receive the reprocessed loan proceeds. Because Lemelledo had limited available sources of credit, she alleged, these tactics allegedly were particularly effective.

D. How Are Packing Practices Proven?

Packing claims normally must be proven with circumstantial evidence because a creditor who will violate the law will rarely admit that it requires its borrowers to buy credit insurance, and because credit documents contain the standard insurance authorization containing the TILA disclosure that credit life, disability and involuntary unemployment insurance is not required, and that if property insurance is required the borrower can select the insurer.

However, a customer's signature on a contract at the credit insurance authorization box may sometimes not be deemed conclusive, as the parol evidence rule of contract construction does not necessarily preclude the use of extraneous evidence to prove the insurance purchase was not truly optional. Some cases seem to say that if the facts indicate that a lender did in fact misrepresent to customers that insurance is required, even though the loan contracts state clearly that the ***61** purchase of insurance is optional, a TILA violation can be established. [36]

In addition to the credibility of the consumer's and creditor's testimony, other factors the courts will consider in determining whether the consumer was the victim of a packing scheme, or was coerced into purchasing the insurance, include: the creditor's penetration rate (the percentage of loans made which include insurance); the creditor's pecuniary interest in making the sale, including the remuneration to the individual sales persons making the sale; whether the

creditor includes insurance in quoting monthly repayment figures to prospective borrowers; whether the creditor automatically pre-includes insurance premiums in loan documents; whether the sales people place an "X" by the insurance purchase authorization signature line or otherwise indicate that the borrower should sign it; whether the creditor presents pre-typed loan agreements for signature without disclosing the purpose of the signature; whether the creditor suggests the loan may be delayed if the borrower does not purchase the insurance; and whether the sales person's performance is evaluated based on penetration rates.

If a creditor denies that it packed the plaintiff's loan, but otherwise shows a credit insurance sales penetration rate of close to 100 percent, that factor may lead a jury to conclude that the plaintiff's insurance purchase was not voluntary.

E. Class Certification in Packing Cases

Based on the individualized nature of packing conduct, which frequently involves verbal communications with each putative class member, packing class actions typically should not be subject to certification.

For example, in *Elliott v. ITT Corporation*,[37] and *Butler v. Sterling*,[38] the courts in denying certification held that common issues did not predominate over individual issues, and that a class action was not superior.[39]

XIII. The Washington State Loan Packing Cases

In September 1997, the Washington State Attorney General filed actions under the state Consumer Protection Act against motor vehicle dealers and against service contract/credit insurance sales consulting companies alleging that the consulting companies, which conducted F&I department training schools for the defendant dealers, taught the dealers "loan packing" techniques in connection with closed-end credit, including misrepresenting monthly payments to customers in violation of state consumer protection and federal disclosure laws. In September 1997, six defendants signed consent decrees, and agreed to pay more than $10 million dollars in fines and civil penalties. A remaining suit against two credit insurance sales consulting companies was settled in May 1998 for more than $1 million.

Washington officials characterized loan packing in the automotive finance industry as being "wide-spread." In response to the Washington cases, the National Consumer Law Center has called loan packing "one of the most widespread and significant forms of auto fraud today."

These actions focused on the practice of "loading" or "packing" loan payments, where the dealers allegedly quoted a larger monthly payment than was actually needed to purchase the vehicle at an interest rate and term at which the consumer may qualify. (Adding an additional amount to the estimated monthly payment is sometimes called the "push," and the added amount is sometimes called "leg.") The "extra" money was then used to cover the costs of added products such as credit insurance and service contracts.

The defendants allegedly encouraged auto dealer employees to use deceptive sales tactics in combination with the packed payment to reduce the likelihood consumers would object to the inclusion of extra products based on cost. Terms such as "protected" payment, or "it's included," or is "provided," were allegedly used to imply that the product was included or sold at a reduced cost. Consumers, after lengthy negotiations, may have failed to focus on the additional cost for the optional products, even when disclosed in writing, because the payments they were quoted throughout the negotiations never changed.

Some of the specific unfair and improper packing techniques allegedly being taught to and practiced by automobile dealers targeted by the Washington State Attorney General included:

- Calculating inflated monthly payments under an "assumptive close" scheme, which "assumes" credit insurance and other "adds" are wanted and will be purchased, by (1) adding a set dollar amount to the correct monthly payment based on the net amount financed and the applicable interest rate; (2) programing the dealership's computer software to automatically include insurance, service contracts or other "adds" when computing the monthly payment; (3) inflating the applicable interest rate or using a loan term shorter than will eventually be used; or (4) "bumping" up a monthly payment by misrepresenting that the initial monthly payment quoted and agreed to was miscalculated.

- Not disclosing, or not clearly disclosing, that service contract, ***62** credit insurance, and other products are optional.

- Providing canned scripts, cash incentives, or "spiffs" to dealer sales personnel for quoting packed payments and for maintaining the payment misrepresentation during the negotiation process, and establishing programs to "track the pack" to measure and ensure maximum penetration of the add-on products.

- Misrepresenting the actual monthly cost for the "protection" allegedly "included" or "provided" by stating, for example, "You can double your warranty for only $7.00 per month more," when in fact the additional cost is, say, $22 per month, and $15 of the additional cost was already included in the misrepresented payment.

- Preparing sales presentations to exploit the misrepresented monthly payment so the products could be introduced without having to get the consumer to accept an increase in the "agreed to" monthly payment.

- Requiring consumers who refuse to purchase credit insurance to sign a misleading "waiver of protection" form to make the consumer pause to rethink his or her decision to decline coverage.

In its press release announcing the signing of the initial consent decrees, the Washington State Attorney General stated in part as follows:

PACKING OR LOADING

AUTOMOBILE PAYMENTS

> *Packing or loading payments* ... is a slang term used to describe a practice promoted by the credit insurance business and used by the auto industry to get customers to agree to purchase additional products, such as credit insurance, service contracts, chemical protectants, and security devices, without revealing their true impact on their monthly payments.

> *Packing is played out when* ... a customer finances his vehicle through the dealer. It goes like this ... a customer agrees to a purchase price and the dealer quotes a monthly payment approximately $20 to $40 higher than what is needed to cover the price of the vehicle. That creates a "pack" or room in the payment to add in the optional products. Dealership personnel are trained to suggest to customers during the negotiations that the optional products are included "free" or at reduced cost.
>
> *Because the monthly payment doesn't increase and because the customer believes the products are "free" or discounted, most people don't object when the products are included in the final contract*.

XIV. Recent Private Party, Packing Class Actions

A series of private party class actions was filed in 1999 against credit card lender Providian and others, primarily in California and Pennsylvania, alleging, among other things, that consumers with poor credit histories who were issued credit cards were required as a condition of receiving credit to accept mandatory enrollment in Providian's credit protection plan.[40] These suits allege violations of state and federal TILA laws.

It was reported that the San Francisco District Attorney's office was conducting a criminal investigation into Providian's actions, which apparently was prompted by consumer complaints.[41]

The Pennsylvania suit contends Providian violated the TILA when it failed to include the payments made by the cardholder toward the credit protection plan in the calculation of the finance charge (instead of listing the the credit protection plan as a membership fee), and failed to include the charge for the credit protection plan in the calculation of the finance charge, thereby understating the discolosed A.P.R.

In *Justice v. First Liberty Financial Corp., et. al.*,[42] filed in May 1999 in Bibb County, Georgia, a class of consumers alleged that they were forced to pay a $12-$20 premium for VSI insurance when financing auto purchases, even if they had other coverage. The plaintiffs also alleged that the bank had a blanket VSI group policy with unnecessary coverages and failed to disclose in the TIL itemization section of their retail installment contracts that a portion of these charges would be retained by the bank. As a result of these forced insurance charges, the plaintiffs charged that the bank and its codefendant insurer violated TILA's disclosure requirements and the state's little RICO statute. The case subsequently settled.

In June 1998, a private party class action was filed in Florida federal court against Sears Roebuck & Co. and several credit insurers, alleging, among other things, state insurance code and TILA violations in connection with purported packing practices relating to the "Sears Credit Protection Plan," which is a package of credit life, disability, property and unemployment insurance coverages.[43] One issue in the case involves whether adequate disclosure was made of the optional nature of this product, and whether separate disclosures were needed for the ***63** credit property insurance component sold as part of the package of insurance coverages.

XV. Premium Refund Cases and Issues

When credit insurance is terminated prior to the scheduled maturity date (*e.g.*, if the borrower cancels the policy prior to repayment of a closed-end debt, or if the underlying debt is paid off early or refinanced), the unearned portion of the original insurance premium is to be refunded to the borrower or lender. Some states place the legal obligation to

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refund unearned insurance premiums on the creditor, and others on the credit insurer. Complicating this process is the fact that while a creditor's refund of unearned interest may be made under the “Rule of 78,” state statutes or insurance contract provisions may require that the premium refund be calculated on the “actuarial method,” “pro rata method,” or some other basis.

There was a flurry of class action activity involving premium refund claims in the mid-1990s. These cases alleged that unearned premiums were not paid to the consumers upon early termination of their debt, and that the lenders and/or insurers improperly retained unearned premiums or interest. [44]

In October 1997, a Mississippi jury awarded $36 million to a plaintiff who prepaid an auto loan but did not receive a refund of the unearned premium for the credit life insurance policy purchased. Plaintiff Betty Hicks sued GMAC and affiliate MIC Life Ins. Co. under a conspiracy theory to recover $637.97 for the unearned portion of a credit life insurance premium after the plaintiff's husband pre-paid the balance of the loan in 1992. The unearned portion of the credit life insurance premium was not refunded upon early payoff. Suit was filed after the insured's widow submitted the death claim under the policy, and it was denied. The policy premium was $1,044, and the unearned portion amounted to $637.99.

GMAC allegedly sent a form letter to the insured at the time of the loan pay-off, with a copy to the dealer, suggesting that the customer “contact the dealer or the insurance company regarding a possible rebate of the credit life and/or disability premium.” Hicks never contacted the insurance company, and contended GMAC did not notify MIC of the early payoff.

Mississippi law requires *insurers* to refund unearned credit insurance premiums within 30 days of accrual of the refund, apparently without requiring consumers to affirmatively request a refund.

Hicks argued that the terms of the insurance certificate issued to Hicks, and Mississippi state law, both required that the insurer refund the unearned premium, without regard to any duty on the part of the insured to follow up after early payoff. After hearing evidence suggesting that GMAC did not notify MIC of the early payoff, and that MIC made no effort to inform itself of early payoffs in the ordinary course of business, the jury awarded the plaintiff $637.99 in compensatory damages, $30 million in punitive damages against GMAC, and $6 million in punitive damages against MIC.

In June 1998, following post trial motions, an order was entered remitting the punitive damage award against GMAC to $5 million and against MIC to $1 million. The case is now on appeal to the Mississippi Supreme Court.

In January 1998, another consumer filed a class action in Mississippi federal court against these same defendants alleging the same claims seeking the refund and return of all unearned premiums for all Mississippi residents. In July 1998, another suit was filed in Mississippi state court alleging that GMAC conspired with a number of unaffiliated credit insurers to violate the Mississippi premium refund statute, but the plaintiff later voluntarily dismissed that suit.

Similar suits have been filed in other states. Issues also may arise with respect to whom the premium refund must be paid. [45]

XVI. Gross Debt Credit Life Cases and Issues

Most states appear to authorize the amount of credit life insurance and the credit life premiums to be calculated based upon the “total of payments” in the context of a pre-computed credit transaction, called “gross debt coverage.” The insurance premium for gross debt coverage is based on the total of the original loan principal and interest payments, the amount of the insurance premium, and the interest on the insurance premium. This practice has been challenged on

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the theory that it over-insures the loan because this gross amount includes unearned interest, resulting in the premium being based on an amount greater than that for which the consumer is liable to the lender. However, gross coverage is sanctioned by the Uniform Consumer Credit Code and model legislation promulgated by the NAIC.

Gross coverage pays to the creditor the remaining balance owed on the debt, including precomputed interest owed, and refunds the unearned interest to the borrower/insured's secondary beneficiary or estate. A few states expressly require "net coverage" by statute, which covers only the remaining principal owed but excludes unearned interest. This so-called "gross vs. net" issue does not arise in the context of credit disability insurance, which by its definition is based on, and pays out, the gross amount of the consumer's debt.

An early decision finding gross debt coverage lawful is *Winkle v. Grand National Bank*.[46] More recently, in *McCullar* ***64** *v. Universal Underwriters Life Ins. Co.*,[47] a plurality (three justices) of the Alabama Supreme Court held that, contrary to long-standing industry practice and interpretations of the Alabama Department of Insurance and Alabama Banking Department, gross coverage violates the plain meaning of Alabama's Mini Code. The McCullars had claimed they were defrauded because their auto dealer told them that the insurance coverage based on "total of payments" was the amount "needed" to pay off the loan in the event of death. For over one year, *McCullar's* retroactive application exposed all creditors in Alabama to a penalty of forfeiting all interest on every transaction where credit life insurance was written on a gross debt basis, and exposed all credit insurers to damages as well. Many dozens of lawsuits resulted, and one suit alone named 224 credit insurers as defendants.

Two years later in *Gall v. American Heritage Life Ins. Co.*,[48] however, the Alabama federal court held that *McCullar* was decided incorrectly. The plaintiffs in *Gall* bought a car on credit and bought credit life insurance. The premium for the insurance was calculated on the "total of payments" (the gross debt) as opposed to the "amount financed" (the net debt). The plaintiffs alleged claims for violation of the Mini Code, fraud and conspiracy, citing *McCullar*. The District Court granted the defendant's summary judgment motion, noting that the plurality decision in *McCullar* was not binding on it, and held that the *McCullar* court's interpretation of the Mini Code would result in the under-insurance of the insured. Unlike the Alabama Supreme Court in *McCullar*, the District Court in *Gall* relied on the relevant statute's interpretation by the Alabama Insurance and Banking departments, and further held that the *McCullar* court's interpretation of the Mini Code could not be applied retroactively in any event.

In *Robertson v. PHF Life Ins. Co.*,[49] the Florida District Court of Appeal held that it is lawful to sell in Florida credit life insurance on a "total of payments" or "gross" basis. The plaintiffs bought credit life insurance in connection with their car purchase. The amount of credit life they bought was based on the "total of payments," rather than the "outstanding net balance" due under the loan. The plaintiffs claimed that PHF Life's sale of the "total of payments" coverage violated Florida insurance laws and constituted fraud. *Robertson* was one of more than 25 similar cases filed in that state by plaintiffs' counsel against other insurers.

In *Liberty Bank and Trust v. Splane*,[50] an Oklahoma appeals court held that credit life insurance on a financed vehicle could be written in the amount of the total of payments to be made under the installment sales contract, including the finance charge.

A wave of gross debt class actions was filed in 1996 and 1997 in Louisiana federal court alleging that the defendant auto dealers and various credit insurers violated RICO and the Louisiana Motor Vehicle Sales Finance Act by overcharging consumers in connection with the sale of credit life insurance by charging them based on the total of payments. The Louisiana federal court ultimately denied class certification in one of the cases,[51] and following the plaintiffs' voluntary dismissal of their RICO claims, the federal court dismissed the action without prejudice on abstention grounds. In March, 1998, a second wave of similar gross debt class actions was filed in Louisiana alleging violations of the Louisiana Motor Vehicle Sales Finance Act, and instead of naming credit insurers as defendants with the auto dealers, the plaintiffs named

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the lenders who took assignments of the dealers' retail installment contracts. Since then, additional RICO class actions have been filed in Louisiana asserting this theory, including actions naming auto dealers, lenders, and credit insurers as defendants. The Louisiana suits remain unresolved at this time.

XVII. Undisclosed Commission Cases and Issues

A. Recent Cases

Class actions were filed in Louisiana federal court in 1997 against car dealers and credit insurers alleging violations of state and federal law (RICO and TILA) based on the dealers' failure to disclose or to disclose accurately on the face of consumers' retail installment contracts agent commissions paid to or "retained" by the dealers/agents in connection with the dealers'/agents' sales of credit life insurance, credit disability insurance, GAP insurance, and mechanical breakdown insurance products. Additional suits have been filed in other states asserting this theory.

These suits are analogous to the wave of "dealer upcharge" cases involving claims for undisclosed amounts retained by dealers in connection with the sale of extended service contracts.

The undisclosed commission class actions filed in Louisiana specifically alleged that a substantial percentage of the credit life, credit disability, GAP, and mechanical breakdown insurance premiums was "retained" by the dealers/agents as commissions and that consumers buying on credit were defrauded because their retail installment contracts did not disclose that the dealerships earned a commission on these insurance product sales, but instead indicated that all of the premium was being paid to the insurer on the consumer's behalf. As a result, the consumers claimed they did not have the opportunity to shop for more competitive prices or evaluate the true value of the product. The Louisiana cases were dismissed before the court decided the merits.

***65** In a favorable September 1998 ruling in *Lindholt v. Walser Ford, Inc.*, [52] a Minnesota federal court ruled that this type of non-disclosure, even if it is a technical violation of TILA, is not the type of conduct by lenders that TILA was designed to prohibit. The court noted that a reasonable consumer buying a credit life policy would have known that the agent (the dealer) would have been receiving a commission. The court also noted that TILA's limited purpose is to protect consumers from being misled about the cost of credit, whereas an optional product such as credit insurance does not affect the credit terms. This court specifically declined to follow *Gibson v. Bob Watson Chevrolet-Geo, Inc.* [53]

B. The TILA Disclosure Issues Raised by the *Gibson* Decision

These cases are premised in part on the decision of the Seventh Circuit in *Gibson v. Bob Watson Chevrolet-Geo, Inc.*, [54] a dealer upcharge case involving extended service contracts and claims against a dealer and lender. This case asserted TILA "itemization of amount financed" claims by consumers for nondisclosure or misdisclosure of dealer upcharges on, or amounts retained by dealers from, sums paid on behalf of the customer to third parties in conjunction with extended service agreements. The TILA requires that the dealer/creditor accurately disclose on the retail installment contract the amount of money borrowed "that is or will be paid to third persons by the creditor on the consumer's behalf, together with an identification of or reference to the third person." [55]

The consumer in *Gibson* claimed that the originating dealer/creditor violated the itemization of amount financed disclosure requirements of TILA and its implementing provisions found in Regulation Z by incorrectly disclosing that the entire amount of the extended service contract fee was paid to the third-party extended service provider, thereby concealing the fact that the dealer was retaining a portion of the contract fee in the form of a dealer upcharge.

The District Court in *Gibson* found that the dealer's extended service contract fee was proper and complied with the TILA and Regulation Z as interpreted under the Federal Reserve Board's (FRB) Official Staff Commentary (Commentary). [56] The district court applied the literal language of the Commentary as written and held that an originating dealer has the option of disclosing the existence or amount of a dealer upcharge, but there is no requirement that the dealer do so. In reaching this decision the district court relied on the permissive language contained in the Commentary, which states that "[g]iven the flexibility permitted in meeting the requirements of the amount-financed itemization (see the [C]ommentary to [Regulation Z] section 226.18(c)), the creditor in such cases *may* reflect that the creditor has retained a portion of the amount paid to others."

On appeal, the Seventh Circuit refused to recognize the permissive nature of the language in the FRB Commentary para. 18(c)(1)(iii)-2 and held that under the only sensible reading of the Commentary, the dealer is required to disclose the fact that he is retaining a portion of the charge, but is not required to disclose the exact amount retained.

XVIII. Post-Claim Underwriting Cases and Issues

"Post-claim underwriting" (also called "clean sheeting") refers to circumstances where credit insurance was sold to borrowers who were ineligible for the insurance coverage under the terms of the policies that they bought, and who had their claims denied due to lack of coverage when submitted.

For example, credit life insurance policies, which have pre-existing condition exclusions and age restrictions, have been sold to persons who are above the age cutoff and/or who have health problems making them uninsurable.

Another example involves low income borrowers who may be sold insurance to protect against unforseen loss of income under accident and health or involuntary unemployment insurance policies, but whose ability to repay would not be jeopardized by such loss because they are on fixed income, such as social security or AFDC. This kind of coverage provides no benefit because most disability and IUI policies have an "actively at work" clause that effectively excludes persons with a non-wage income from benefits. Involuntary unemployment insurance policies also may be sold to persons who are unlikely to be laid off, such as those in the military.

In a class action suit filed in 1998 in Georgia state court, *Patterson v. CUNA Mutual Insurance Society, Inc.* [57] the plaintiffs contend that a credit insurer and its affiliated credit unions charged borrowers for credit disability insurance, through monthly charges, even after the borrowers passed the age 65 eligibility for coverage, and then later denied their claims under the policy.

In another case, the Alabama Supreme Court upheld a jury verdict for $2 million in punitive damages (before remitter, the jury returned a $5 million verdict) for fraud, against both the creditor and insurer in a "post-claim underwriting" case involving the sale of credit life insurance to a borrower in ill health. [58] The creditor knew of the borrower's ill health, and in turn, ineligibility for insurance, but filled out the insurance application stating that there was no history of prior illness. The insurer denied the claim for credit life benefits upon the borrower's death, and the widow filed suit. The court found that the lender acted as a knowledgeable agent ***66** for the insurer and had a duty to disclose that the benefits might not be payable. The United States Supreme Court later vacated the *Crocker* decision, [59] for further consideration by the Alabama Supreme Court in light of its ruling in *BMW of North America, Inc. v. Gore*, [60] on the issue of punitive damages. On remand, the Alabama Supreme Court held that the award of $2 million dollars was excessive but that an award of $1 million dollars was proper compensation in the case. [61]

XIX. Is the Product "Insurance"? Cases and Issues

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There is an increasing volume of litigation asserting that various consumer financial products that are not called "insurance" are, in fact, properly deemed insurance that is subject to state insurance regulatory, licensing, and other laws. For example, in many states questions exist as to how vehicle service agreements, debt cancellation agreements, GAP waiver contracts, debt deferral agreements, and other similar products are properly classified, and that classification may depend on whether two party or three party agreements are involved. The main purpose of debt cancellation or deferral products is to protect the lender from loan loss risks when the contingency covered by the contract occurs. Under the contract, the lender charges a fee when the loan is made, which is used as a reserve against the possibility of later loan loss. This is similar to the underwriting of credit insurance.

For example, in *Steele v. First Deposit National Bank*, [62] filed in Alabama state court, the plaintiffs alleged that the "Credit Protection" debt deferral product they bought from the bank was really "insurance" that was sold in violation of the state insurance code. The appellate court affirmed the district court's summary judgment in favor of the bank, holding that the national bank properly sold the product under its "incidental powers" pursuant to the National Bank Act, which according to the OCC and *First Nat'l Bank of Eastern Arkansas v. Taylor*, [63] includes the power to enter into debt cancellation agreements, and therefore those products are not "insurance."

Coates v. MS Dealer Service Corp., [64] is a similar class action alleging that the defendant's service contract product was really insurance, which the defendant sold in violation of the insurance code and without a license. The appellate court found in a split decision that the service contracts were not to be deemed "insurance" for licensing purposes.

In June, 1999, a class action captioned *Beemus v. Interstate National Dealer Services, Inc.*, [65] was filed in Pennsylvania state court alleging, among other things, that service contracts are really insurance being sold without a license in violation of state law, or alternatively, if they are not insurance, then their sale violated the law because they are not authorized products allowed to be financed under that state's motor vehicle sales finance act.

In November 1999, the Oregon Attorney General issued an opinion stating, contrary to an earlier opinion, that national banks need not comply with Oregon insurance laws when offering debt cancellation programs. [66] The Attorney General opined that debt cancellation programs offered by national banks in accordance with applicable federal law do not constitute insurance subject to regulation under Oregon's insurance laws.

Also in November 1999, the Alabama Attorney General published an opinion that debt cancellation contracts are not insurance. The Attorney General concluded that: two party agreements issued by a creditor do not constitute insurance subject to regulation by the state's insurance; these agreements are not limited to use by national banks but may be used by any creditor if not otherwise prohibited by applicable regulations; and these agreements can be used in the context of property or casualty loss as well as death or disability.

The Office of the Comptroller of the Currency has recently sought comments on whether it is necessary or appropriate to issue regulations governing bank sales of debt cancellation contracts.

There are growing concerns among some insurance regulatory agencies that lenders will increasingly sell debt cancellation contracts in place of credit insurance, which would in the view of those regulators diminish the scope of their ability to protect consumers.

ARTICLES SOLICITED

The *Quarterly Report* is seeking submission of manuscripts, for possible publication, on the following subjects; consumer protection and litigation, Truth in Lending and Regulation Z; access to consumer financial services (including fair housing, CRA, and equal credit opportunity); credit and debit cards; credit insurance; mortgage lending; auto finance;

UCC case law and revisions; banking law; debt collection and bankruptcy. If you would like to contribute to an article or research project, please contact the Editor of the *Quarterly Report*.

Footnotes

a1 **Anthony Rollo**, a partner resident in the New Orleans office of McGlinchey Stafford, is an attorney who represents credit insurers. lenders and other consumer financial services providers in class action and consumer litigation around the country. He also advises clients regarding Internet law matters, primarily those in highly regulated industries including the finance, insurance and automotive sectors, in connection with litigation, regulatory, licensing and contract aspects of selling services and goods on-line. Anthony regularly speaks to industry groups on these topics.

1 Truth in Lending Act (TILA) § 106(b), 15 U.S.C. § 1605. *See infra* Pt. IX.D.

2 For a more detailed description of basic credit insurance concepts and products, *see* Gary Fagg, AN INTRODUCTION TO CREDIT-RELATED INSURANCE (1997). *See also* FREDERICK H. MILLER, ALVIN C. HARRELL AND DANIEL J. MORGAN, CONSUMER LAW CASES PROBLEMS AND MATERIALS 190-206 (1998); FREDERICK H. MILLER, ALVIN C. HARRELL, JAMES A. MCCAFFREY AND JOSEPH K. HESELTON, THE U3C MANUAL—A USER'S GUIDE TO THE UNIFORM CONSUMER CREDIT CODE Ch. 5 (1994).

3 TILA § 106(c). 15 U.S.C. § 1605. Certain disclosure requirements must also be met. *Id.*

4 *See, e.g.*, Eugene J. Kelley, Jr., John L. Ropiequet, and Jeffrey D. Pilgrim, *Collateral Protection Insurance Current Issues and Defenses*, 54 Consumer Fin. L.Q. Rep. 14 (2000)

5 Though it should be noted that this also protects the borrower, to the extent of his or her liability on the loan.

6 *See* Kelley, Ropiequet and Pilgrim, *supra* note 4.

7 *See* Edwards v. Your Credit. Inc., 148 F.3d 427 (5th Cir. 1998); Adams v. Plaza Finance Company, Inc., 1999 WL 33254 (7th Cir. (Ill.).

8 *See generally* Teresa Rohwedder, Robert Cook and Tim Meredith, *Homeowners Protection Act of 1998—A Brief Summary of the New Federal Private Mortgage Insurance Legislation*, 53 Consumer Fin L.Q. Rep. 164 (1999); Joseph E. Mayk, *The Private Mortgage Insurance Law—An Answer with More Questions?. id.*, 168.

9 For cases discussing PMI related issues, *see* Hinton v. Fed. Natl. Mortgage Ass'n., 945 F.Supp. 1052 (S.D. Tex. 1996); Deerman v. Fed. Home Loan Mortgage Corp., 955 F.Supp. 1393 (N.D. Ala. 1997).

10 *See, e.g.*, Credit Ins. General Agents Assoc. v. Payne, 16 Cal. Rptr.3d 651, 547 P.2d 993, 128 Cal. Rptr. 881 (C.A. 1976); Automobile Trade Assoc. v. Ins. Commissioner of Maryland, 292 Md. 15, 437 A.2d 199 (C.A. 1981).

11 *See supra* this text and notes 1-3.

12 The scope of McCarran-Ferguson Act preemption was most recently addressed by the Supreme Court in Humana, Inc. v. Forsyth. 119 S.Ct. 710 (1999) (affirming 9th Circuit ruling that Act did not preempt application of RICO to business of insurance under Nevada insurance laws). *But see* LaBarre v. Credit Acceptance, 175 F.3d 640 (8th Cir. 1999) (distinguishing *Humana*). *See also* Therese G. Franzén and John H. Bedard, Jr., Case Note: Humana Inc. v. Forsyth—*U.S. Supreme Court Subjects Insurance Industry to Federal Law*, 53 Consumer Fin. L. Q. Rep 70 (1999).

13 For a more detailed analysis of how the various states regulate credit insurance, *see* “The Regulation of Credit Insurance: An Overview” published in 1991 by the NAIC based on a survey of NAIC members

14 *See, e.g., Georgia Proscribes Sales of Credit Insurance*, 3 Consumer Fin. Serv L. Rep. No. 15. Feb. 18, 2000, at 1 (describing *In the Matter of* Associates Financial Life Insurance Co., Nos. 99C-014A, 99C-014B (Office of Insurance and Safety Fire Commissioner of Georgia, Jan. 31. 2000.))

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15 *See, e.g.*, Lemelledo v. Beneficial Management Corp., 696 A.2d 546 (N.J. 1997).

16 *See generally* David Eldridge, *The Consumer Protection Act: Why, Creditor (Banker, Seller, Etc.), When We Owe You Money it is Your Fault*, 52 Consumer Fin. L.Q. Rep. 305 (1998).

17 15 U.S.C. § 1605(b)(1)-(2); 12 CFR § 226.4(d)(1).

18 12 CFR § 226 4(d)(3); McGee v. Kerr-Hickman Chrysler Plymouth. 93 F.3d 380 (7th Cir. 1996).

19 15 U.S.C. § 1605 (c); 12 CFR § 226.4(d)(2).

20 12 CFR § 226 4(d)(2) n.5.

21 RALPH J. ROHNER AND FRED H. MILLER. TRUTH IN LENDING ¶ 3.02[1][h]. ¶ 3.04 (2000); RALPH ROHNER, THE LAW OF TRUTH IN LENDING, ¶ 3.04[2][b][i] and n.201 (1984).

22 *See, e.g.*, Baron v. Best Buy Co., Inc., 1999 WL 1067869 (S.D. Fla.).

23 *See supra* Pt. VII.

24 86 DER T-1, 1999

25 G.S. § 24-10.2(b).

26 *See supra* note 14.

27 "Credit Insurer Agrees to Pay $1.3 Million Penalty." June 3. 1999 Press Release. Texas Dept. of Insurance.

28 *American Bankers Insurance Will Pay Up To $15 Million to Settle Allegations*. Wall Str. J., Nov. 23, 1998.

29 *American Bankers Fined Over Credit Insurance Sales*, Best's Ins. News, 1998 WL 6566660. Mar. 26. 1998.

30 Texas Dept of Insurance, Final Disciphnary Order 98-0098 (Jan. 23, 1998).

31 *See supra* notes 14 and 26.

32 California v. Levitz Furniture Corp. Case No. 787452-5 (Superior Ct., Alameda Co., Stipulated Final Judgment filed Aug. 18, 1997); *see also* Abbott and Schenkan. *New Serutiny of Credit Insurance*, 51 Consumer Fin. L. Q. Rep. 377 (1997).

33 "Mississippi Loan Company Agrees to Settle Charges of Violating Previous FTC Order; will pay $340.000 in Consumer Redress and Civil Penalty." FTC Press Release Feb. 6. 1997.

34 *In the Matter of* Tower Loan of Mississippi, Inc., FTC Docket No. D.9241 (Feb. 10, 1992).

35 696 A 2d 546 (N.J. 1997).

36 *See. e.g.*, Kaminski v. Shawmut Credit Union, 494 F. Supp. 723, 729 (D. Mass. 1980); Mims v. Dixie Finance Corp., 426 F. Supp. 627, 631 (N.D. Ga 1976); Fisher v. Beneficial Finance Co., 383 F. Supp. 895, 899-901 (D.R.I. 1974); *In re* Dickson, 432 F. Supp. 752, 759 (D. N.C. 1977); *but see* Williams v Blazer Financial Services, Inc., 598 F. 2d 1371, 1374 (5th Cir. 1979).

37 150 F.R.D. 569 (N.D. Ill. 1992).

38 No. 3:95 CV7328 (U.S.D.C, N.D. of Ohio, July 25, 1996).

39 *But see* Stewart v. Associates Consumer Discount Company, 1998 U.S. Dist. LEXIS 17379 (E.D Pa) (class action certified. including one claim alleging that class members were obligated to buy "Lender's Security Insurance" and "Credit Life Insurance" from the lender's affiliated insurer).

40 *In re* Providian Credit Card Litigation (Cal. Super. Ct., San Francisco Cty. Consolidated Aug. 3, 1999) (subsequently coordinated as *Providian Credit Card Cases* (Cal. Jud. Council Coordination Proceeding No. 4085).

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41 *See Providian Faces Slew of Lawsuits Over Its Imposition of Late Fees*, Am. Banker, June 14, 1999, at 1, 16.

42 Civil Action No. 46730.

43 Fabricant v. Sears Roebuck & Co., et al., No. 98-1281, United States District Court for the Southern District of Florida.

44 *See* Sousa v. North Central Life Ins. Co., 910 F. Supp. 53 (D.R.I. 1995); Hoban v. USLIFE Credit Life Ins. Co., 163 F.R.D. 509 (N.D. Ill. 1995); Richards v. Combined Ins. Co., 55 F. 3d 247 (7th Cir. 1995).

45 *See* Monroe v. CUNA Mutual Ins. Soc., 1999 U S. Dist. LEXIS 18396 (W.D. Tenn.) (insurers complied with state law by refunding to car dealers, instead of to consumers, unearned credit life premiums after loans were discharged in bankruptcy). Barber v. Balboa Life Ins. Co., 1999 WL 228121 (Miss. App.) (insurer failed to rescind credit life policy because it refunded premium to lender instead of borrower in instance of application misrepresentation).

46 601 S.W. 2d 559 (Ark. 1980).

47 687 So. 2d 156 (Ala. 1996) (opinion issued on reh'g).

48 3 F.Supp. 3d 1344 (S.D. Ala 1998).

49 702 So. 2d 555 (Fla. App 1997).

50 959 P.2d 600 (Okla. 1998).

51 *See* Young v. Ray Brandt Dodge. Inc., 176 F.R.D. 230 (E.D. La. 1997)

52 Lindholt v. Walger Ford. Inc. No. 97-2140 (D. Minn. Sept. 28, 1998).

53 112 F. 3d 283 (7th Cir. 1997).

54 112 F.3d 283 (7th Cir. 1997).

55 15 U.S.C. § 1638(a)(B)(iii).

56 Commentary ¶ 18(c)(1)(iii)-2.

57 Since removed to the United States District Court for the Northern District of Georgia. No 1.98-CV-0983-JOF.

58 Union Security Life Ins. Co. V. Crocker, 667 So. 2d 688 (Ala. 1996).

59 517 U.S. 1230 (1996).

60 517 U.S. 559 (1996).

61 Union Security Life Ins. Co. v. Crocker, 1997 WL 465, 647 (Ala.).

62 1999 WL 50501.

63 907 F.2d 775 (8th Cir. 1990).

64 1999 Ala. Civ App. LEXIS 234.

65 Common Pleas Court. Allegheny County, No. GD98-9583.

66 1999 WL 1019031 (Or. A. G.).

54 CONFLQR 52

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