Modern Consumer Law

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Part Three. Doing the Deal: Terms and Financing

Assignment 9. Unfair or Deceptive Acts or Practices

At the heart of consumers' complaints is often a sense that they have been "scammed" or "ripped off." The most apt legal doctrine for such situations is often the laws that prohibit unfair or deceptive acts or practices. Because the statutes are broad and cover all aspects of a transaction, they always merit consideration—both by a consumer rights litigator and a business lawyer advising on the legality of a practice. Prior assignments have given some consideration to these laws, noting that they may be the basis for liability for misleading advertising, oppressive sales practices, or privacy violations.

This assignment delves into how the unfair or Deceptive Acts and Practices laws (UDAP, pronounced U-dap) apply to the terms of deals and the conduct of businesses. Because U.S. law puts few substantive limits on consumer contracts, UDAP statutes are often the primary tool to achieve a remedy when a consumer has entered into a bad contract or had a business breach a contract. UDAP statutes also provide lower thresholds for plaintiffs to assert that a business engaged in fraudulent activity. In this way, UDAP helps compensate for gaps or shortcomings in common law doctrines. Even when substantive regulation exists, UDAP statutes can be useful because they may have longer statutes of limitations, broader scope of coverage, and more generous remedies.

A. Common Law Actions

The common law of both contracts and torts offer multiple legal theories to challenge practices that a consumer believes are unfair or deceptive. Before the enactment of the UDAP laws, these were the exclusive remedies for consumers. If a business's conduct did not fit into the fairly tight bounds of a common law theory and no specific statute proscribed the behavior, the consumer was out of luck. Even with the UDAP laws permitting a private right of action, common law theories sometimes are still useful given particular facts or situations. Savvy consumer lawyers will nearly always plead a common law action in addition to a statutory UDAP violation.

The equivalent contract doctrines to unfairness and deception, respectively, are unconscionability and misrepresentation. The Uniform Commercial Code's requirement of good faith is also important for contract actions. *See* U.C.C. §1-203; U.C.C. revised §1-304. Warranties may also apply to certain contracts, such as when a consumer has purchased goods. (Warranties are covered in the next Assignment.) In tort, the applicable theories are fraud and its kissing cousins: fraud by omission, negligent or innocent misrepresentation, concealment, and the like. Those variants generally have lesser requirements for pleading and proof than an action for civil fraud.

Consumers trying to use contract and tort theories often face difficulty in proving intent or damages. The law draws distinctions, such as between a statement of fact or an opinion, that often trip up plaintiffs. Another example is the way in which liability differs for an explicit or implicit representation. Courts were sometimes sympathetic to plaintiffs' plight and often condemned defendants' actions, but ultimately were constrained by precedents to dismiss a consumer's lawsuit.

B. Federal Unfair and Deceptive Acts and Practices Laws

Traditionally, the FTC was the leader in the identification and enforcement of unfair and deceptive acts and practices at the federal level. Its statute is longstanding and has been applied to a broad range of conduct. While several financial regulators, such as the Federal Reserve Board, had the authority to determine that banks' practices were unfair or deceptive, they rarely exercised such power. In the wake of the subprime lending meltdown, the Dodd-Frank Act imbued the Consumer Financial Protection Bureau with UDAP authority. Its exclusive consumer focus means that it does not face the agency capture or conflict of interests that prudential banking regulators apparently suffered. Those agencies were focused on safety and soundness—which means profitability of banks—and as you might guess, unfair and deceptive conduct can generate outsized revenue.

The FTC retains its UDAP authority over most businesses and trades, while the CFPB is limited to financial services to consumer financial services or products. Because Dodd-Frank also enhanced the UDAP power available to the CFPB, the two laws are different. There is also more precedent and certainty around the FTC's interpretation and application of the law, given its longer history. For these reasons, the FTC and CFPB are discussed separately below.

1. Federal Trade Commission's UDAP Statute

The federal UDAP statute is mercifully short. It also has not been amended. (Two cheers for law students trying to master this area!) Congress passed the unfair and deceptive part of the statute in 1938, as the federal government was expanding its control of businesses under the Commerce Clause. "Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful." 15 U.S.C. §45(a)(1). Unfair and deceptive are separate elements with distinct meanings, although some conduct may meet the criteria for both categories.

Initially, the statute did not define deceptive. The FTC interpreted the standard generously to consumers. This led some to complain that almost any statement has the capacity to deceive the most gullible consumers and the resulting risk of legal liability was too high. In 1983, the FTC issued a policy statement that established three elements of deception:

1) there must be a representation, practice, or omission likely to mislead consumers;
2) the consumers must be interpreting the message reasonably under the circumstances; and
3) the misleading effects must be material; that is, likely to affect consumers' decisions or conduct.

See Appendix to Cliffdale Associates, 103 F.T.C. 110 (1984). Evidence of actual false belief or evidence that a threshold fraction of consumers hold a certain interpretation are not needed for the second element; the threshold is the likelihood or reasonable possibility that consumers are misled. As to the third element, the Commission assumes that "all express claims are material, and that implied claims are material if they pertain to the central characteristics of the product, such as its safety, cost, or fitness for the purpose sold." *In re Int'l Harvester Co.*, 104 F.T.C. 949 (1984).

Like deception, unfairness initially was undefined in the statute. In 1994, Congress passed the FTC Reauthorization Act, which included a set of principles that bounded what the FTC could declare to be unfair.

> The Commission shall have no authority…to declare unlawful an act or practice on the grounds that such act or practice is unfair unless the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition. In determining whether an act or practice is unfair, the Commission may consider established public policies as evidence to be considered with all other evidence. Such public policy considerations may not serve as a primary basis for such determination.

The Federal Trade Commission Act Amendments of 1994, Pub. L. No. 103-312 §9 (adding a new 15 U.S.C. §45(n) (Aug. 26, 1994)). The legislative history helps flesh out the meaning of the key elements of the test. For example, the criteria of substantial injury can be met through a relatively small harm to a large number of consumers or a grave harm to a lesser number of consumers.

The cost-benefit test imbedded in the unfairness principle is a major difference from the deception standard, as false or misleading statements are assumed to have no benefits. The benefit analysis need not be mathematical or based on quantifiable factors but should reflect a careful evaluation after a collection and consideration of reasonably available evidence. Sen. Rep. No. 130, 103d Cong., 2d Sess. 12 (1994).

Another important distinction between unfairness and deception is that unfairness does not require a misrepresentation or omission. Therefore, unfairness can reach a wider variety of conduct than deception, including post-sale practices that do not involve any communication with a consumer.

The Director of the FTC's Bureau of Consumer Protection explained the logic of the three-element test for unfairness:

> The primary purpose of the Commission's modern unfairness authority continues to be to protect consumer sovereignty by attacking practices that impede consumers' ability to make informed choices.…Thus, the modern unfairness test reflects several common sense principles about the appropriate role for the Commission in the marketplace. First, the Commission's role is to promote consumer choices, not second-guess those choices. That's the point of the reasonable avoidance test. Second, the Commission should not be in the business of trying to second guess market outcomes when the benefits and costs of a policy are very closely balanced or when the existence of consumer injury is itself disputed. That's the point of the substantial injury test. And the Commission should not be in the business of making essentially political choices about which public policies it wants to pursue. That is the point of codifying the limited role of public policy.

J. Howard Beales, III., "The FTC's Use of Unfairness Authority: Its Rise, Fall and Resurrection," https://www.ftc.gov/public-statements/2003/05/ftcs-use-unfairness-authority-its-rise-fall-and-resurrection.

2. CFPB's UDAAP Statute (no, the additional "A" is not a typo; read on)

When the CFPB assumed responsibility for enforcing federal consumer laws related to financial products and services, it inherited authority over many existing laws, such as the Fair Credit Reporting Act and the Equal Credit Opportunity Act. (See Assignment 3 for more discussion.) The CFPB did get some new authority, however, that prior financial regulators had lacked. Can you spot the difference in the below language from the FTC statute?

> The Bureau may take any action authorized under Part E to prevent a covered person or service provider from committing or engaging in an unfair, deceptive, or abusive act or practice under Federal law in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service.

12 U.S.C. §5531(a). The statute created a new federal standard: UDAAP, where the first "A" stands for "Abusive." The addition of abusive may seem subtle, but it produced many sleepless nights for bankers and their lawyers.

The Dodd-Frank law made no effort to define deceptive. Most commentators believe the definition of deceptive developed in the FTC context will be applicable to the CFPB's lawmaking because the definition of unfair is nearly identical to that in the FTC context. On the other hand, perhaps the failure to adopt the FTC's guidance definition of deceptive was an implicit rejection of that standard. Notice too that the definition is worded as a constraint on the CFPB's power, rather than an affirmative authority.

> The Bureau shall have no authority under this section to declare an act or practice in connection with a transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service, to be unlawful on the grounds that such act or practice is unfair, unless the Bureau has a reasonable basis to conclude that—
>
> (A) the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers; and
>
> (B) such substantial injury is not outweighed by countervailing benefits to consumers or to competition.

12 U.S.C. §5531(c). One difference between the language is that the CFPB needs only a "reasonable basis" to support its conclusion that the elements of unfairness are met. Arguably, the FTC statute lacks that qualifier, suggesting that perhaps a greater level of certainty is required to declare a practice unfair.

The term "abusive" does not have a counterpart in the FTC's UDAP law. The addition of abusive to the CFPB's arsenal has provoked considerable debate. Financial service providers argued that the tried-and-true unfair and deceptive standards were sufficient, but they ultimately failed to alter the bill. After its passage, the financial industry switched to complaining that meaning of abusive was unclear, subjecting them to unchecked and roving enforcement. A leading law firm created a client bulletin about the CFPB's abusive power termed "Know It When You See It." Morrison & Foerster webinar, http://www.mofo.com/resources/events/2015/01/150122cfpbudaapaknowitwhenyou seeit (Jan. 22, 2015). Despite these laments, abusive is, in point of fact, defined at length in Dodd-Frank. Like unfairness, it is worded as a check on the CFPB's power.

> The Bureau shall have no authority under this section to declare an act or practice abusive in connection with the provision of a consumer financial product or service, unless the act or practice—
>
> (1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
>
> (2) takes unreasonable advantage of—
>
> (A) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
>
> (B) the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or
>
> (C) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.

12 U.S.C. §5531(d). The CFPB has used its abusive power sparingly, sometimes charging that practices were only unfair and/or deceptive without mention of abusive. Prior to 2015, just five enforcement orders identified the conduct as abusive. The CFPB has begun to use the standard more frequently, as years have now elapsed since it has enacted rules or has exercised supervisory authority over entities. As a general matter, the CFPB seems to charge that conduct is abusive when the consumers are vulnerable or when the company did not

provide consumers with the information needed to understand the product. As of 2015, the CFPB had alleged abusive practices against debt collectors, credit card companies, mortgage servicers, and payday lenders. A central theme of its complaints were that the company interfered with a consumer's ability to understand the product or service; for example, by "burying" a term in a contract or by giving consumers incorrect information about the applicable law. The lynchpin of "abusive" seems to be a business creating and leveraging an information disadvantage to entrap consumers.

Some of the CFPB's actions also suggest that a company need only be negligent to commit a UDAAP violation. In 2015, JPMorgan Chase & Co. paid out approximately $186 million in a settlement with the CFPB and state Attorneys General. The complaint did allege an intention to harm consumers but instead documented the failure of Chase to develop or implement procedural checks and appropriate systems to verify the validity and amount of debts that were sold to debt collectors. The fact that the conduct was not necessarily intentional or willful but was nonetheless challenged as unlawful is a reminder that UDAAP statutes are designed to soften the intent and proof requirements of the common law.

UDAAP litigation generally is rare; settlement via consent order is king. As of July 2015, there was only one case in which a court had ruled on the merits of UDAAP liability. *CFPB v. Chance Gordon*, Minute Order, CV12-6147 (C.D. Cal. June 26, 2013). As more judicial opinions arise, the UDAAP standards may become clearer. The very reason for UDAAP, however, is to have broad authority to challenge new and emerging practices; the authority reflects the dynamic and free market for financial services.

C. State UDAP Laws

The state UDAP statutes are sometimes called mini-UDAPs. This is a misnomer because each of the fifty states' laws are more powerful than the federal UDAP statute in one regard: they permit a private right of action for enforcement, which the FTC Act does not grant.

Each state's UDAP law is different in its scope, level of detail, and its remedies. *See* National Consumer Law Center, *Unfair and Deceptive Acts and Practices* (8th ed. 2012), App. A. State law may directly prohibit certain practices, either in the statute or by regulation. Some of these are themselves fairly general, while others legislate extremely specific practices (residential water treatment sales scams, radon testing, dance studios, vacation promotions, etc.). In addition, some state laws specify that violations of a federal FTC rule or guidance are violations of the state's UDAP law.

If a consumer can show the business committed the specific prohibition in the UDAP's "laundry list" of misbehavior, there is a per se violation. If no specified prohibitions exist or the conduct does not fall into one of the categories, the alternative is trying to prove that the alleged conduct falls under broader contours of unfair and deceptive behavior. Some states laws are exclusively, or nearly exclusively, lists of prohibitions. Others contain only a generalized prohibition against unfair or deceptive behavior.

California is an illustrative example of these two approaches, although it is unusual in having two statutes that are characterized as UDAP laws. Most states have only a single statute, resulting in less reach than California's double-coverage system.

The Consumers Legal Remedies Act prohibits two dozen enumerated practices as unfair or deceptive practices in California. Cal. Civ. Code §1770. Prohibitions include: misrepresenting the source of goods; advertising goods or services without the intent to sell them as advertised; making false or misleading statements about the reasons for, existence of, or amounts of price reductions; representing that a repair is needed when it is not; and inserting an unconscionable provision in a contract. The law applies to any transactions that are intended to result or that do result in a sale or lease of goods or services to a consumer. The major exclusions are definitional. What constitutes a "good or service?" Was the plaintiff a "consumer" in the transaction? There are also a few statutory exclusions. *See* Cal. Civ. Code §§1750-1785. As its name suggests, this statute provides for ample private remedies to consumers: actual damages, punitive damages, injunctions, restitution, attorneys' fees for prevailing plaintiffs, and an ability to bring class actions. *See* Cal. Civ. Code §§1780-1784.

The California Unfair Competition Law applies broadly to prohibit unfair, deceptive, untrue or misleading advertisements or methods of competition. *See* Cal. Bus & Prof. Code §§17200-17594. People often refer to it in shorthand as a "17200 action" or a "UCL" case. This law has no specified exclusions; its scope is sweeping. Private litigants can obtain relief such as injunctions or restitution to remedy harm, and a prevailing plaintiff may be awarded attorneys' fees. Except for certain enumerated prohibited practices for which treble or punitive damages are available, however, a victory for a consumer does not result in the award of actual or statutory damages to consumers. Not surprisingly, then, private enforcement is rare. Section 17200 is the workhorse of public enforcement, including the California Attorney General and certain city officials who are authorized to bring actions under the statute.

Many courts have ruled that a state UDAP statute is to be interpreted expansively. The fact that UDAP statutes were enacted as a remedial tool for consumers who were without common law remedies seems to motivate these more generous readings of the statutes' applicability.

Rhonda Bosland v. Warnock Dodge, Inc.

964 A.2d 741 (N.J. 2009)

HOENS, Justice.

The Consumer Fraud Act (CFA), N.J.S.A. 56:8-1 to -20, affords broad protections to New Jersey consumers. From 1960, when the Legislature first enacted the CFA in its original form and when it only authorized actions by the Attorney General, see L.

1960, c. 39, until its most recent amendment in 2007, L. 2007, c. 14, (amending N.J.S.A. 56:8-1.1 as it relates to transportation for temporary service workers), the history of the Act demonstrates a strong and consistent pattern of expanding the rights of consumers and protecting them from a wide variety of marketplace tactics and practices deemed to be unconscionable.

This matter calls upon this Court to consider whether a plaintiff, prior to instituting litigation pursuant to the CFA, must first request a refund of a claimed overcharge from an allegedly culpable merchant. Our reading of the plain language of the statute and our understanding of the Legislature's overall intent, both in enacting the CFA and in expanding its scope, compels us to answer this question in the negative. We therefore conclude that the CFA does not require a consumer, who has been victimized by a practice which the statute is designed to remedy, to seek a refund from the offending merchant as a prerequisite to filing a complaint.…

The facts that give rise to this dispute are not complicated. On March 13, 2003, plaintiff Rhonda Bosland purchased a new 2003 Jeep Grand Cherokee from defendant Warnock Dodge, Inc. She did not arrange for financing through the dealer, instead paying the full purchase price listed in the Retail Buyer's Order that served as defendant's invoice. That Retail Buyer's Order included a $117 charge that was described only as a "Registration Fee."

Plaintiff asserts that she later learned that the applicable title and registration fees charged by the Motor Vehicle Commission at the time of her purchase were less than the $117 fee the dealer required her to pay. Although there were two ways to calculate what that $117 sum might have represented, plaintiff discovered that the applicable fee could only have been either $77 (comprised of a $74 registration fee and a $3 temporary registration fee) or $97 (representing the sum if an additional $20 title fee could properly be included as a "registration fee"). She therefore reasoned that, regardless of how the $117 charge had been calculated, it must have included an additional documentary service fee that was neither disclosed nor itemized as required by the applicable automobile sales regulations. See N.J.A.C. 13:45A-26B.1, -26B.2(a)(2)(i).

Rather than demanding that defendant refund to her the amount that she had been overcharged, plaintiff filed a complaint, seeking relief both individually and on behalf of a class of similarly situated car buyers. Plaintiff's complaint included three separate causes of action. Two were statutory claims, one asserting that defendant had violated the CFA, and the other relying on the provisions of the Truth-in-Consumer Contract, Warranty, and Notice Act (TCCWNA), N.J.S.A. 56:12-14 to -18. The third cause of action was based upon an alternative quasi-contractual theory of unjust enrichment.

…

We granted defendant's petition for certification in order to decide whether an attempt to obtain a refund from a merchant is an essential prerequisite for a CFA claim. 194 N.J. 262, 944 A.2d 25 (2008). We thereafter granted leave to the New Jersey Coalition of Automotive Retailers, Inc. (NJCAR), the New Jersey Lawsuit Reform Alliance (NJLRA), and the Consumers League of New Jersey (CLNJ) to submit briefs as amici curiae.

II.

Defendant asks us to reverse the Appellate Division's conclusion that a pre-suit demand for a refund is not a prerequisite to a CFA complaint, relying on three arguments. First, defendant urges us to conclude that the Appellate Division erred by departing from the rationale expressed by the court in *Feinberg* and in failing to appreciate that, even though an attempt to secure a refund is not explicitly required under the CFA, there can be no ascertainable loss in the absence of having made that effort. Second, defendant argues that we should reject plaintiff's claimed cause of action on the ground that the alleged $20 overpayment, when compared to the value of the vehicle plaintiff has used and enjoyed without any complaint, is not the type of loss that the CFA was intended to remedy. Finally, defendant contends that the Appellate Division's decision will lead to an inequitable result, contrary to the purposes and goals of the CFA because instead of promoting truth and fair dealing in the marketplace, and instead of providing a remedy for those who have no option but to resort to the court system, it will encourage consumers to litigate, in the hope of obtaining awards of treble damages and attorneys' fees, rather than simply asking for a refund that would make them whole.

Plaintiff responds by arguing that there are only three elements necessary to establish a cause of action for relief pursuant to the CFA, none of which is a requirement that a claimant first ask for a refund. Plaintiff argues that imposing on consumers a pre-litigation requirement that they seek direct relief from an offending merchant would subvert the CFA's purposes, because merchants would be free to violate the CFA, providing refunds only to those consumers savvy enough to request them while reaping unfair profits from unconscionable practices committed against all other consumers without fear of reprisal.

Amicus NJCAR argues that the Appellate Division's analysis would permit the CFA to be used to punish merchants for accidental violations or honest mistakes as opposed to affirmative misconduct, thus expanding the remedies of the statute beyond the scope intended by the Legislature. NJCAR urges this Court to conclude that the remedial purposes of the CFA are most properly effectuated when a consumer is required to make a demand for a refund first because the consumer can then be made whole without the need for court intervention.

...

B.

The CFA, in its original form, authorized only the Attorney General to seek redress for violations of its provisions. As we have explained, "[t]he Legislature enacted the CFA in 1960 to address rampant consumer complaints about fraudulent practices in the marketplace and to deter such conduct by merchants." Thiedemann v. Mercedes-Benz USA, L.L.C., 183 N.J. 234, 245, 872 A.2d 783 (2005).

In 1971, the Legislature amended the CFA, expanding it significantly to include a private right of action through the enactment of L. 1971, c. 247, §7, the provision subsequently codified at N.J.S.A. 56:8-19. That section, which is central to the dispute before this Court, provides as follows:

> Any person who suffers any ascertainable loss of moneys or property, real or personal, as a result of the use or employment by another person of any method, act, or practice declared unlawful under this act or the act hereby amended and supplemented may bring an action or assert a counterclaim therefor in any court of competent jurisdiction. In any action under this section the court shall, in addition to any other appropriate legal or equitable relief, award threefold the damages sustained by any person in interest. In all actions under this section, including those brought by the Attorney General, the court shall also award reasonable attorneys' fees, filing fees and reasonable costs of suit. [N.J.S.A. 56:8-19.]

Although the legislative history surrounding this enactment is sparse, it is clear that the intention was to greatly expand protections for New Jersey consumers. The sponsor of the amendments, then-Assemblyman Thomas H. Kean, was quoted at the time as saying that "the amendments represent an enlightened approach to provide greater protection for the consumer against fraud." Governor's Press Release for Assembly Bill No. 2402, at 1 (Apr. 19, 1971) (issued in support of the introduction of the bill containing amendments). Echoing that sentiment, Governor William Cahill described these amendments to the CFA as being intended to "give New Jersey one of the strongest consumer protection laws in the nation." Ibid. Upon signing the bill into law, the Governor further explained that he believed that the amendments would "provide easier access to the courts for the consumer, [would] increase the attractiveness of consumer actions to attorneys and [would] also help reduce the burdens on the Division of Consumer Affairs." Governor's Press Release, at 2 (June 29, 1971).

There are distinctions between the CFA requirements that govern claims pursued by the Attorney General and those permitted to be brought by private parties. In particular, a private party seeking to recover must demonstrate that he or she has suffered an "ascertainable loss." Meshinsky v. Nichols Yacht Sales, Inc., 110 N.J. 464, 472-73 (1988). In addition, the CFA requires a consumer to prove that the loss is attributable to the conduct that the CFA seeks to punish by including a limitation expressed as a causal link. See id. at 473, 541 A.2d 1063; Daaleman v. Elizabethtown Gas Co., 77 N.J. 267, 271 (1978). In considering these requirements, we have been careful to interpret the CFA, and its prima facie proof requirements, so as to be faithful to the Act's broad remedial purposes.…In particular, we have recognized that "[t]he history of the [CFA] is one of constant expansion of consumer protection." Gennari v. Weichert Co. Realtors, 148 N.J. 582, 604 (1997). Similarly, our Appellate Division has noted that we "construe the [CFA] broadly, not in a crabbed fashion." New Mea Constr. Corp. v. Harper, 203 N.J. Super. 486, 502 (App. Div. 1985).

We have traditionally recognized that CFA claims brought by consumers as private plaintiffs can be divided, for analytical purposes, into three categories. See Cox, supra, 138 N.J. at 17. Broadly defined, the categories are claims involving affirmative acts, claims asserting knowing omissions, and claims based on regulatory violations. Ibid. To some extent, the proofs required will vary depending upon the category into which any particular claim falls. For example, we have concluded that if a claimed CFA violation is the result of a defendant's affirmative act, "intent is not an essential element." Id. at 17-18. Likewise, intent is not an element if the claim is based on a defendant's alleged violation of a regulation, because "the regulations impose strict liability for such violations." Id. at 18; see Fenwick v. Kay Am. Jeep, Inc., 72 N.J. 372, 378 (1977). In contrast, we have required that a plaintiff seeking to recover based on a defendant's omission, "must show that the defendant acted with knowledge, and intent *is* an essential element of the fraud." Cox, supra, 138 N.J. at 18 (emphasis in original). Viewed against this framework, we can evaluate the dispute before us.

C.

We turn then to the nature of the proofs required of plaintiff and their relationship to the need to demand a refund prior to filing suit. Plaintiff's CFA claim is straightforward; it is premised on her assertion that the single, unified charge in the invoice for a "registration fee" exceeded the amount, however calculated, that was permitted to be charged for such a fee and therefore included an undisclosed "documentary service fee" in violation of the applicable regulations. See N.J.A.C. 13:45A-26B.1, -26B.2(a)(2)(i). Because plaintiff's complaint is based on a claimed regulatory violation, she is not required to prove defendant's intent. See Cox, supra, 138 N.J. at 18.

In analyzing claims under the CFA, we have found that there are only three elements required for the prima facie proofs: 1) unlawful conduct by defendant; 2) an ascertainable loss by plaintiff; and 3) a causal relationship between the unlawful conduct and the ascertainable loss. Int'l Union of Operating Eng'rs Local No. 68 Welfare Fund v. Merck & Co., Inc., 192 N.J. 372, 389, 929 A.2d 1076 (2007) (explaining three prima facie elements); see Weinberg, supra, 173 N.J. at 247-48, 801 A.2d 281 (declining to abolish ascertainable loss requirement for private cause of action); Meshinsky, supra, 110 N.J. at 473, 541 A.2d 1063 (recognizing that private plaintiff, unlike Attorney General, must demonstrate "ascertainable loss […] as a result of" unlawful conduct); Daaleman, supra, 77 N.J. at 271, 390 A.2d 566 (explaining that private plaintiff must show that he or she "suffers a loss due to" defendant's unlawful practice). Each of the elements of the prima facie case is found within the plain language of the statute itself; each is, without any question, a prerequisite to suit.

The plain language of the CFA does not, however, impose upon any putative plaintiff the requirement that he or she first seek a remedy directly from the offending merchant. Instead, it refers to the right of "any person who suffers any ascertainable loss…as a result of" defendant's violation of the CFA to file an action. N.J.S.A. 56:8-19. On its face, then, the statute makes no demand upon plaintiff to try to obtain a refund first as a pre-condition of instituting suit. The question, however, is whether the term "ascertainable loss" or the causal nexus requirement embodied in the statutory phrase "as a result of" or the public policy considerations that underlie the CFA suggest that a pre-suit refund demand is implicit in the CFA.

We have previously considered the meaning of the term "ascertainable loss," and have concluded that it means that plaintiff must suffer a definite, certain and measurable loss, rather than one that is merely theoretical. Thiedemann, supra, 183 N.J. at 248. We found it appropriate to resort to the definition of the words, noting that "'[a]scertain' is defined as 'to make (a thing) certain; establish as a certainty; determine with certainty;' and 'ascertainable,' the adjective, is similarly defined as 'capable of being ascertained.'" Ibid. (quoting Webster's Third New International Dictionary 126 (1981)). "The certainty implicit in the concept of an 'ascertainable' loss is that it is quantifiable or measurable." Ibid.

Apart from relying on the definition of the term, we have further considered a variety of issues that relate to the meaning of the "ascertainable loss" requirement. We have held that a consumer who had repairs to a vehicle performed under warranty at no cost did not sustain such a loss. Id. at 251-52, 872 A.2d 783. Nor does it exist for a customer who considered, but never purchased, a product and thus suffered no damages because of a fraudulent loan application submitted by the merchant in anticipation of a sale. Meshinsky, supra, 110 N.J. at 475 n. 4. On the other hand, we have described our understanding of the ascertainable loss requirement generally in terms that make it equivalent to any lost "benefit of [the] bargain." Furst, supra, 182 N.J. at 11-13 (quantifying lost benefit of the bargain by reference to out-of-pocket expenses for purposes of ascertainable loss analysis).

Even so, we have not always equated an ascertainable loss with one that is demonstrated by an immediate, out-of-pocket expense suffered by the consumer. See Thiedemann, supra, 183 N.J. at 248. For example, we have found that a consumer who had not paid for repairs nonetheless suffered an ascertainable loss caused by a home improvement contractor's failure to comply with applicable regulations requiring the work to be inspected. Cox, supra, 138 N.J. at 22. We analyzed the ascertainable loss requirement by evaluating the consumer's proofs about the reasonable cost of repair in the context of damages that had been awarded by the jury. Id. at 22-24. We held that requiring a consumer to actually make the expenditures needed to incur the loss would be contrary to the remedial purposes of the CFA. Id. at 22, 647 A.2d 454. The CFA does not demand that a plaintiff necessarily point to an actually suffered loss or to an incurred loss, but only to one that is "ascertainable."

...

There are sound reasons why a pre-suit demand requirement is not implicit in the CFA. This dispute in particular illustrates how reading such a requirement into the CFA would potentially permit practices, that the statute is designed to deter, instead to continue unabated and unpunished. Plainly, if we require plaintiffs, as a precondition to filing a complaint under the CFA, to first demand a refund, we will create a safe harbor for an offending merchant. A merchant could rely on the pre-suit refund demand requirement, boldly imposing inflated charges at no risk, and planning to refund the overcharges only when asked. Such an analysis of the CFA would limit relief by making it available only to those consumers who are alert enough to ask for a refund, while allowing the offending merchant to reap a windfall. We see in the broad remedial purposes of the CFA a strong contrary expression of public policy. We discern in the CFA a clear expression of the Legislature's intent to empower consumers who seek to secure relief for themselves and for others who may not be aware that they have been victimized. Because reading a pre-suit demand for refund requirement into the CFA would thwart those salutary purposes, we will not endorse it.

The definitions of unfairness and deception under state law are often more generous than the FTC standards. For example, a few states add "unconscionable" as an additional term, presumably giving separate meaning to unfairness. *See e.g.*, Mich. Comp. Laws §445.903. Seventeen states substitute the term "unconscionable" for "unfairness." *See e.g.*, Tex. Bus. & Com. Code Ann. Tit. 2, §17.50. Query whether the intended or actual effect of the substitution is for "unconscionable" to be a higher or lower standard than "unfairness."

In another example, many states have case law adopting the criteria for unfairness in the Supreme Court's decision in *Federal Trade Comm'n v. Sperry and Hutchinson Co.*, 405 U.S. 233 (1972). This approach to unfairness requires substantial injury to consumers, as well as consideration of whether the challenged practice "offends public policy," as outside "at least the penumbra of some common law, statutory, or other established concept of unfairness." Alternatively or in addition, a practice can be appropriately challenged if it is "immoral, unethical, oppressive, or unscrupulous." These criteria are called the "S&H standard" based on the case name in which the phrase first appeared. That standard reflects the FTC's interpretation before the 1994 FTC Authorization Act imposed the more stringent three-prong test. The interplay between federal and state law on unfairness is discussed further in Michael Greenfield, *Unfairness Under Section 5 of the FTC Act and Its Impact on State Law,* 46 WAYNE L. REV. 1869 (2000).

D. UDAP in Context

One of the greatest strengths of UDAP statutes is their flexibility. Rather than legislative efforts at regulating specific scams, which can resemble the game "whack-a-mole," UDAP statutes stand at the ready to challenge emergent practices. Public or private enforcement by alleging UDAP violations provides faster marketplace intervention and corrective remedies than waiting for the legislature to recognize and address the situation.

For students of consumer law, however, the broad applicability of UDAP statutes is a challenge. It is easy to either over- or under-estimate the ways the laws may be useful or it may be difficult to imagine the types of practices that may be addressed with UDAP allegations. This section presents excerpts from several cases to illustrate some of the factual contexts of UDAP litigation. The focus here is more on the factual settings than on the legal standards. The examples do not include any violations based on credit transactions, but as the cases in the upcoming assignments will illustrate, UDAP is frequently a tool to challenge lending or banking practices.

Pierce v. Reichard

593 S.E.2d 787 (N.C. Ct. App. 2004)

HUDSON, Judge.

Plaintiff Ricky Pierce ("Pierce") owns a house located at 107 Beech Street, Roanoke Rapids, North Carolina. On 5 April 1999, defendant Tammy Reichard ("Ms. Reichard") signed a lease in which she agreed to rent the house from Pierce for $300 per month, plus a $300 security deposit. Approximately two weeks after Ms. Reichard moved into the house, the roof over the living room began to leak after a heavy rainfall. Ms. Reichard and her husband immediately taped up the ceiling to try to stop the leaking. After a period of disputing over the leaks and other matters, Pierce filed a complaint for summary ejectment, claiming that Ms. Reichard had not paid her rent, and also sought money damages for repairs to his truck. The Magistrate ruled in favor of Pierce on both issues. Ms. Reichard appealed to district court and filed a counterclaim seeking retroactive rent abatement for Pierce's breach of the implied warranty of habitability and compensation for personal and property damage. After a bench trial, the court awarded Ms. Reichard treble damages of $14,950, property damages of $200 for a broken windshield, a $200 refund of excessive late fees, the return of her $300 security deposit and attorney's fees of $4,085. The trial court awarded Pierce $318.07 for damage to his truck. Pierce appeals. For the reasons discussed here, we affirm in part, vacate in part and remand for further proceedings.

Ms. Reichard testified in district court that she notified plaintiff of the roof leaks right away and that plaintiff said he would get to it as soon as he could. However, Pierce's evidence tended to show that Ms. Reichard first complained about the leaks in August or September of 2000, and that he hired a repair person at that time to apply a coat of "Koolseal" to the roof. Ms. Reichard did not notice any reduction in the severity of the leaks after its application. Ms. Reichard further testified that she complained about the leaks and water damage each time she paid her rent. In August 2001, Pierce had the old roof removed and new shingles installed, but did not repair any of the water damage inside the house.

During the time it took to repair the roof a dispute arose between the parties over damage to Pierce's dump truck, sustained when it was parked in front of the house to contain roof debris. Ms. Reichard admitted that her four-year-old son may have sprayed water into the truck's open gas tank. Ms. Reichard and her husband agreed to siphon all of the gas out of the tank, and put in enough gas to get the truck to a gas station. They also agreed to reimburse Pierce for the cost of refilling the tank, but Pierce claimed that the truck broke down within a few yards of leaving the house and that the repairs cost him over $300. Pierce demanded that Ms. Reichard pay the repair bill, and she refused.

During her tenancy, Ms. Reichard complained to Pierce about a rotten tree on the property that she thought endangered her and her family. After Pierce failed to address this issue, a limb broke off the tree during a storm and damaged Ms. Reichard's car.…After reviewing the entire record, we find competent evidence to support this finding of fact. Ms. Reichard testified that about two weeks after she moved into the two-bedroom house, water leaked through the ceiling in the back bedroom and portions of the living room during a strong rain storm. In an effort to stop the leaks, she and her husband put contact paper and duct tape over the leaks, and notified Pierce about the ceiling's condition. Ms. Reichard also testified that ceiling debris often fell through holes in the ceiling where the water leaked, and that when they took down the old tape to replace it, rotten wood fell from the ceiling. Water leaked into the back bedroom, causing mold on the carpets and ruining a mattress. Ms. Reichard was forced to move her daughter out of that bedroom, which she then used to store "junk."

...

Plaintiff next argues that the trial court erred by awarding defendant treble damages for rent abatement on her claim of unfair and deceptive trade practices. We disagree.

A trade practice is unfair within the meaning of G.S. §75-1.1 "when it offends established public policy as well as when the practice is immoral, unethical, oppressive, unscrupulous, or substantially injurious to consumers." Creekside Apartments v. Poteat, 446 S.E.2d 826, 833 (citations omitted), disc. review denied, 451 S.E.2d 632 (1994). Chapter 75 applies to residential rentals because the rental of residential housing is commerce pursuant to §75-1.1. Love v. Pressley, 239 S.E.2d 574, 583 (1977), cert. denied, 241 S.E.2d 843 (1978).

In *Allen v. Simmons*, 394 S.E.2d 478 (1990), this Court held that a jury could find that plaintiff committed an unfair trade practice where defendant's evidence was that plaintiff leased defendant a house which contained numerous defects throughout defendant's tenancy and which rendered the house uninhabitable. Id. at 484. Plaintiff failed to respond to numerous notices about the uninhabitable state of the house. Despite the condition of the house, plaintiff attempted to collect rent after defendant discontinued payments. We held that plaintiff's behavior can be considered "immoral, unethical, oppressive, unscrupulous, or substantially injurious to consumers." Id. at 484. See also Creekside Apartments, 446 S.E.2d 826, 833; Foy v. Spinks, 414 S.E.2d 87 (1992).

Here, Ms. Reichard testified that she complained about significant leaks in the back bedroom and living room of the house for more than two years and that Pierce continued to collect rent until the day he demanded she vacate the house. Pierce's argument that he had no notice of damage to the interior of the house is to no avail. "[W]here a tenant's evidence establishes the residential rental premises were unfit for human habitation and the landlord was aware of needed repairs but failed to honor his promises to correct the deficiencies and continued to demand rent, then such evidence would support a factual finding…that the landlord committed an unfair or deceptive trade practice." Foy, 414 S.E.2d at 89-90. Here, Pierce was aware that the roof was leaking and that repairs were necessary, yet did not perform necessary repairs until approximately two years after the defective condition was brought to his attention. Thus, as in *Allen* and *Foy*, the trial court correctly concluded that plaintiff's actions in collecting rent after having knowledge of the uninhabitable nature of part of the house constituted unfair trade practices and was thus a violation of G.S. §75-1.1.

Sussman v. Grado

746 N.Y.S.2d 548 (Dist. Ct. 2002)

ASARCH, Judge.

The plaintiff had obtained a judgment against a debtor on November 14, 2001 for $1,472.00. When the plaintiff attempted to enforce the judgment, he learned that there were two joint bank accounts at different banks in the names of the judgment debtor and his wife, for which the Sheriff's Department required a turnover order.

The plaintiff went to the defendant, "an independent paralegal" and president/sole shareholder of Accutech Consulting Group, Inc., and explained what he needed. He paid the defendant $45 for the services. Despite the defendant's claim that she did not know what a turnover order was, she accepted the case and the fee.

The plaintiff alleged that the papers prepared by the defendant were deficient and, as a result, the "Sheriff's Department closed the case." He sues to recover the amount of the judgment plus the fee paid to the defendant (which she admittedly would refund). In fact, by letter dated February 21, 2002, the defendant sent the plaintiff a check for $45 (which he denied receiving), refunding the $45 for the turnover order which "was executed in good faith by this office. You indicated an error and we did not ever refuse to make the correction. This is not a usual type of court order. In fact, the three attorneys that we did speak with about it understood the relevance, but had never heard of it or done such an order." The defendant indicated that because the plaintiff had challenged the "integrity" of the defendant's office, his business "will not be welcome here."…

The defendant testified that she's a graduate from a paralegal certificate program and has been a paralegal for 13 years and she "help[s] a lot of people."

In response to the Court's question: "Do you work under the authority of an attorney?" The defendant answered: "I'm an independent. I assist the general public. I assist attorneys with work. And Mr. Sussman came to me of his own free will and asked me to do this work for him."

To this Court, there is a difference between assisting someone to fill out a form and preparing a form on a subject with which the "assistance" is unfamiliar. Instead of referring this plaintiff to an attorney, the defendant allegedly asked three (3) attorneys about what a turnover order was ("none of them had ever heard of it") and called the Sheriff's office who informed her that "they needed something to direct the bank to research it's [sic] files and find out the assets of the debtor."

"So I prepared for Mr. Sussman the turn over order that you're looking at."

When asked by the Court how she got the form, the defendant answered: "I patterned it based upon what I know of other orders petitioning money from the court."…

The American Bar Association has defined an independent paralegal as "a person who is not supervised by a lawyer, provides services to clients with regard to a process in which the law is involved, is not functioning at the time as a paralegal or a document preparer, and for whose work no lawyer is accountable," Nonlawyer

Practice in the United States: Summary of the Factual Record before the American Bar Association Commission on Nonlawyer Practice (1994). However, New York State bar associations have not recognized the "legal technician/ independent paralegal" for reasons obvious from this case—the independent paralegal, working without the supervision of an attorney, may cross the line between assisting a person in need to hurting a person in need through lack of knowledge and supervision, see e.g. N.Y. County Lawyers Association Ethics Committee opinion 641 (1975), Association of the Bar of the City of New York Ethics Committee opinion 1995-11 ["Supervision within the law firm thus is a key consideration."].…

The defendant has, in this Court's opinion, crossed the line between filling out forms and engaging in the practice of law by rendering legal services, Judiciary Law §478; People v. Jakubowitz, 184 Misc. 2d 559 (Supreme Court Bronx County, 2000). The defendant "was going to attempt to prepare an order that would hopefully affect the bank turning over the portion of the account of [the judgment-debtor]'s assets to Mr. Sussman on his judgment. That was the intention" (defendant's testimony). "The practice of law involves the rendering of legal advice and opinions directed to particular clients (citations omitted)," Matter of Rowe, 604 N.E.2d 728 (1992).…This Court finds that the defendant used independent judgment on a subject with which she had insufficient knowledge. As indicated above, the defendant did not follow proper procedure with respect to the turnover proceeding. Failure to comply with CPLR 5225 and/or 5227 prevented the Court from issuing a turnover order. Such document preparation was not "customary and innocuous practices," Spivak v. Sachs, 211 N.E.2d 329 (1965), nor were the turnover order documents the preparation of legal forms or text simply designed to say what the law is, see New York County Lawyers Association v. Dacey, 234 N.E.2d 459 (1967). Rather, the defendant herein purported to "give personal advice on a specific problem" with respect to the turnover proceeding vis a vis the plaintiff's judgment, Id. at 28 A.D.2d 161 (dissent by Justice Stevens, adopted by the Court of Appeals majority).

Regardless of her intentions to help the plaintiff, this independent paralegal operated without the supervision of an attorney. She tried to create a legal document without the required knowledge, skill or training. As a result the plaintiff may have lost the ability to execute against two bank accounts. Just as a law school graduate, not admitted to practice law, cannot undertake to collect overdue accounts on behalf of prospective clients, so is an independent paralegal barred from attempting to collect a judgment.

There is no doubt that the public needs assistance in navigating the court system. This is one reason for the Chief Judge's work in creating offices for the self-represented in the courts. The hundreds of thousands of hours which the practicing bar devotes annually in voluntary pro bono services also go a long way to protecting the rights of those who cannot afford legal representation. However, the guidance of an attorney and his or her professional staff seems much preferable to an "independent paralegal" who has not gone through law school, has not passed the bar exam and who is not licensed in New York State (it should be noted that an attorney's license to practice law is subject to discipline if ethical standards are not met). Section 484 of the Judiciary Law is designed "to protect the public in this State from 'the dangers of legal representation and advice given by persons not trained, examined and licensed for such work, whether they be laymen or lawyers from other jurisdictions' (citation omitted)," El Gemayel v. Seaman, 533 N.E.2d 245 (1988).

This Court finds that the actions of the defendant constituted a deceptive act "likely to mislead a reasonable consumer acting reasonably under the circumstances," Oswego Laborers' Local 214 Pension Fund v. Marine Midland Bank, 647 N.E.2d 741 (1995) and that "the acts or practices have a broader impact on consumers at large," Id.…[T]he Court finds that the accepting of the assignment was misleading in a material respect to the consumer and that the consumer was injured—he was unable to collect his judgment from the two restrained bank accounts. Accordingly, the Court finds that the plaintiff is entitled to treble damages, Gen. Bus. Law §349(h), in the sum of $135.00.

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3. Towing Practices

Waters v. Hollie

642 S.W.2d 90 (Tex. App. 1982)

JORDAN, Justice

Suit was brought by appellant under the Deceptive Trade Practices Act, and after trial to a jury resulted in a verdict for appellant in the amount of $800.00 actual damages plus attorney's fees through the Supreme Court. Appellant moved for judgment on the verdict and appellee moved the court to disregard the jury's findings and in the alternative for judgment for defendant.…

There is no statement of facts in this case, but the facts, as stated in both briefs, are not in dispute and they are some-what unusual. On or about the night of November 27, 1978, appellant's car broke down on the South Freeway in Fort Worth in the area of East Berry Street as appellant was on her way home from work as a waitress. It was somehow moved the same night to the parking lot of the Treasure City Department Store located at East Berry and the South Freeway. It remained there overnight and the next morning the manager of the store had it towed away by appellee, who operated a wrecking and towing service and storage facility. Appellant's car was then stored at appellee's place of business for over three months, before she learned where it was. Appellant reported her car as stolen to the Fort Worth Police who located the car at Hollie's Garage. Appellee never did notify appellant that he had her car.

When appellant finally saw her car at Hollie's Garage, the contents, consisting of a C.B. radio, tape deck, fish locator, a gold crucifix, a gold medal and various fishing equipment, worth approximately $800.00, were missing. She thereafter filed this suit for recovery of the value of the missing articles under the Deceptive Trade Practices Act only. She did not sue on any common law negligence, conversion, or a bailor-bailee theory.

We disagree with the holding of the trial court that under the facts of this case appellant was not a consumer under [Tex. Bus. & Comm. Code] §17.45(4) of the Act and that she therefore cannot recover thereunder.

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Mouse-Trapping on Internet

FTC Press Release, "Cyberscam Targeted by FTC" (Oct. 1, 2001) *re FTC v. Zuccarini*, Civ. Action No. 02C 7456.C.A. No. 01-CV-4854 (E.D. Pa. filed Sept. 25, 2001)

A cyberscammer who used more than 5,500 copycat Web addresses to divert surfers from their intended Internet destinations to one of his sites, and hold them captive while he pelted their screens with a barrage of ads, was charged by the Federal Trade Commission with violating federal laws. At the request of the FTC, a U.S. District Court enjoined his activities pending further order of the court. The FTC will seek a court order to force the defendant to give up his ill-gotten gains.

"Schemes that capture consumers and hold them at sites against their will while exposing Internet users, including children, to solicitations for gambling, psychics, lotteries, and pornography must be stopped," said Timothy J. Muris, Chairman of the FTC. "In addition to violating the trademark rights of legitimate Website owners, the defendant may have placed employees in peril by exposing them to sexually explicit sites and gambling sites on the job, in violation of company policies. With more than 63 previous law suits against him for the identical practices, we believe the court will shut down the defendant's schemes permanently."

According to the FTC, the scheme works like this: The defendant registers Internet domain names that are misspellings of legitimate domain names or that incorporate transposed or inverted words or phrases. For example, he registered 15 variations of the popular children's cartoon site, www.cartoonnetwork.com, and 41 variations on the name of teen pop star, Britney Spears. Surfers looking for a site who misspell its Web address or invert a term—using cartoonjoe.com, for example, rather than joecartoon.com—are taken to the defendant's sites. They then are bombarded with a rapid series of windows displaying ads for goods and services ranging from Internet gambling to pornography. An FTC investigator entered one of the defendant's copycat domain names, annakurnikova.com, and 29 browser windows opened automatically. In some cases, the legitimate site to which the consumer was attempting to go is also launched, so that consumers may think the hailstorm of ads to which they are being exposed is from a legitimate Web site.

Once consumers are taken to one of the defendant's sites, it is very difficult for them to exit. In a move called "mousetrapping," special programming code at the sites obstructs surfers' ability to close their browser or go back to the previous page. Clicks on the "close" or "back" buttons cause new windows to open. "After one FTC staff member closed out of 32 separate windows, leaving just two windows on the task bar, he selected the "back" button, only to watch as the same seven windows that initiated the blitz erupted on his screen, and the cybertrap began anew," according to papers filed with the court.

These examples show the flexibility and breadth of the UDAP approach to protecting consumers. In some of these instances, the plaintiff could also have used either a subject-matter-specific statute or common law to challenge the conduct. The choice to use UDAP sometimes reflects a desire to avail oneself of enhanced remedies, such as the treble damages referenced in *Pierce v. Reichard*. Other times, the consumer may benefit by alleging something is "unfair" or "deceptive," rather than a violation of an obscure statutory provision because such claims create more grave reputational risks or terrible publicity. The remedial focus and broad sweep of UDAP statutes tend to get the attention of the defendant company's legal department and help provoke a settlement.

Problem Set 9

9.1. Bid Big runs online auctions for new merchandise. Unlike other popular Internet auction sites, Bid Big is selling items that it has purchased specifically for retail sale. The auctions use a novel bidding structure. Every bid is an increment of one penny, with an opening price of one cent. This allows many people to get in on the action, often bidding hundreds of times for the item as time counts down. The ultimate price paid by the winning consumer is often very low in relationship to the value of the item, such as $128 for a tablet computer that retails for $1,199. Bid Big makes profits from such auctions because it charges users 50 cents to place each bid. High-interest items like a Nikon camera attract about 12,000 bids, generating $6,000 in revenue for the company. After Bid Big pays for the camera and its operating costs such as advertising and site hosting, it still handsomely profits.

Bored of the long Massachusetts winter and looking for a distraction, your spouse has been bidding big. He has confessed to placing 100 or more bids each day on various items, which required spending over $1,000 this month in bid fees, while failing to win a single item. You've asked your spouse to stop, but you were met with a pointed allegation that you have some expensive hobbies yourself—golf membership, spa retreats, etc. You plan to call your state's Attorney General and the FTC to try to entice them to investigate Bid Big. Are these practices unfair or deceptive or both? You expect the AG or FTC will be more persuaded if you can analogize to other UDAP suits and if you are versed in the legal standard. 15 U.S.C. §45; Mass. Genl. Law. §93A.

9.2. It took nearly two years for Cassie Grey to land a new job when the call center that employed her was off-shored to cut costs. During that period, Cassie collected unemployment but also spent on credit cards to make ends meet. She now owes more than $33,000 and is struggling to make even the minimum payments on her cards. Her annual salary at her new position is $27,000, which is enough for Cassie to meet ongoing expenses but leaves nothing leftover to pay down her debts or save. She's cut up all her credit cards but needs a solution for the debts. She says that bankruptcy is "absolutely out." Her least-favorite uncle is a bankruptcy trustee in her community and is certain to tell her entire family about her situation. Instead, Cassie has contacted Death to Debt, a company that promotes itself with the following statements:

> "When you are enrolled in our program, you will not have to make payments to all of your creditors anymore."
>
> "We help 100 percent of the people who enter this program attack their debts."

> "Settle your debts for less than half of what you owe and avoid the stigma of bankruptcy."

Cassie obtained a preliminary plan for her debts, reproduced below. She has asked you, her long-time best friend, for your advice on whether Death to Debt is a legitimate operation. Her new job is with a public relations company, and she doesn't want to get mixed up with any "shady deals." Is Death to Debt engaged in an unlawful activity? If you are concerned, where should you report Death to Debt? Consider only federal law. 15 U.S.C. §45; 12 U.S.C. §5531.

Client ID:

** Please Note : *This page must be returned in order for the set up of your file to be completed.*

CSA℠ Estimated Settlement Plan Cost		CSA™ Service Fee Payment Schedule		Estimated Personal Savings Plan for Payments to Creditors	
Total Unsecured Debt:	$ 33,551.23	CSA™ Total Service Fee:	$ 5,032.68	Estimated Settlement (Approx. 40%):	$ 13,420
Estimated Settlement Amount (Approx. 40%)	$ 13,420.49	2 Initial Deposit Payment(s) of:	$ 512.58	Savings Budget During Initial Payments	* Optional *
CSA™ Service Fee:	$ 5,032.68	1 Remaining Deposit Payment(s) of:	$ 380.00	Minimum Savings During 20 Service Fee Payments:	$ 198.62
Adjusted Total Debt Elimination Cost:	$ 18,453.17	CSA Initial Payment Total:	$ 1,405.16	Minimum Personal Savings Deposits After Service Fee Payments:	$ 380.00
Total Debt Savings:	$ 15,098.06	Remaining Service Fee Balance:	$ 3,627.52	Total Payments towards Savings After All Payments:	25
Adjusted Estimated Monthly Budget Payments:	$ 380.00	20 Monthly Service Fee Payments of:	$ 181.38	Estimated DEBT FREE Time Frame	48 Months
		Total Months to Payoff Service Fee:	23		

** NOTE: The estimated saving plan is the minimum suggested for payoff of your enrolled accounts. CSA™ highly recommends that any additional funds, which may become available, be allocated towards your personal savings account. You are encouraged to add as much towards savings as possible, as it is to your advantage to do so. The quicker you save money, the sooner you can get your enrolled debts resolved.

Updated ACH Debit Service Fee Summary / Personal Savings Summary			
Program Start Date:	1/29/2007	2 Initial Payments of:	$ 512.58
Remaining Deposit Payments Start Date:	3/29/2007	1 Initial Payments of:	$ 380.00
Remaining Service Fee Start Date:	4/29/2007	20 Monthly Service Fee Payments of:	$ 181.38
Personal Savings Start Date:	12/29/2008	25 Personal Savings Deposits of:	$ 380.00
Personal Savings During Service Fee:	4/29/2007	20 Personal Savings Deposits of:	$ 198.62
Client Signature:			Date:

** IMPORTANT: The above debit schedule is the updated recommended payment and personal savings budget. Any date changes of your scheduled ACH Debit. CSA™ service fee payments, requires a minimum of five(5) business days notice .

Service Fee Addendum : *I acknowledge and confirm the above tables represents an adjustment of fees to be paid to CSA™ due to an addition and/or deletion of an enrolled account(s). This new fee schedule is hereby incorporated into the Service Agreement by reference. This addendum in no way changes any other provision of the Agreement. All other provisions of the Agreement shall remain in full force and effect.*

Client signature ____________________ Date ____________

Address, City, Zip Code [redacted]

** NOTE : If adding a new account, a Creditor Information Sheet for the new account being added must accompany this page.

9.3. Universal University has operated a top-tier law school for more than 100 years. Its reputation for excellence recently was marred. The school published inaccurate statistics on the grades and LSAT scores of its most recent incoming class and disseminated the statistics by mailing the publication to more than two thousand prospective students for next year. The admissions office obtained the individuals' grades and LSAT scores from an outside organization as part of the application process but itself computed the statistical information on average and 25th and 75th quartiles. The information has not appeared outside of the law school's publication; it was not reported to the American Bar Association or any news organizations. The University has hired you to advise it on how to handle this situation. At your recommendation, it has immediately suspended all admissions staff and sent a letter to all brochure recipients advising them to disregard entirely the grade and score information that "should not have been printed." Are you worried about an unfair or deceptive practices lawsuit? Given that your report will be made to the dean of the law school and the university's general counsel, be prepared to explain your analysis and defend your conclusion. 15 U.S.C. §45(a)(4).

9.4. Identify a practice that you have experienced that left you feeling wronged as a consumer. Look up your state's UDAP statute. (If you have trouble finding the statute and wind up at the library reference desk for help, consider how consumers without attorneys or legal education fare.) Does the practice fit within the reach of your state's UDAP law? Why or why not? What will be the most difficult aspect of using UDAP to address the practice?

9.5. Your partner, Luz, earned a two-year college degree about five years ago. Since then she has worked as a teacher's assistant, supporting your household while you were in law school. In your third year of law school, Luz applied to three colleges for admission to earn a bachelors' degree. She was admitted to a local state university, rejected at an out-of-state public university, and was waitlisted at a private school, Williston College. She has her heart set on Williston because it offers excellent financial aid packages and ranks among the top 25 small private colleges. In late July, Luz refused to enroll in the state university, missing the first deadline for tuition payments and course selection, because she wanted to see if Williston admits her. You return home on August 1 to find her sobbing. She received a rejection letter from Williston and called to ask if there was any chance she could still be admitted. The admission officer explained that the entering class of 415 was fully enrolled at this time, and that they had admitted only 27 students off the wait list all summer. In response to her question about how close she came to being among the admitted students, the officer explained, "We waitlisted 300 students. Those 27 kids are lucky, and I'm sorry you were not one of them. I do wish you the best." Luz is devastated, but you are angry that Luz "waited" with such low odds. Do you think Williston engaged in an unfair or deceptive act or practice? Which is the better legal claim? Outline the elements of the cause of action and the supporting facts.

Assignment 10. Warranties

Like many aspects of consumer law, warranties have origins in both tort and contract law. Products liability law in tort allows recovery for physical injuries to people or property if a product is not made with reasonable care. Breach of contract allow consumers to sue if the good is not as promised and to recover even if the only loss is economic.

Modern warranty law has two major sources. State warranty law primarily consists of Article 2 of the Uniform Commercial Code (U.C.C.), adopted in every state except Louisiana. A federal statute, the Magnuson-Moss Warranty Act, regulates the disclosure of warranties and provides remedies for warranty breaches. Together, they create a framework of warranty law that provides substantially more protection for consumers than common law tort or contract.

A. Uniform Commercial Code

The U.C.C. creates a statutory scheme of warranties that applies to all sales of goods. It codifies the common law ideas of "express" and "implied" warranties.

Article 2 of the U.C.C. applies only to the sale of "goods," U.C.C. §2-102. Goods are broadly defined to include "all things…which are movable at the time of identification to the contract for sale." U.C.C. §2-105(1). The big exclusions are real property, which is not a good, and leases rather than sales, which are governed by U.C.C. 2A, including its warranty provisions. The other important exclusion is services; even if they are "defective" in the sense of highly unsatisfactory, there is no warranty and no U.C.C. coverage. Instead, poor services are often challenged as "unfair acts" under UDAP law. In Texas, for example, the Deceptive Trade Practices Act can be used to sue a cleaning service that bleached areas of carpets. Also, note that the U.C.C. applies to all goods, whether sold for consumer or business purposes, so what you learn here is applicable to nearly all sales of personal property.

The warranty rules are subject to the U.C.C.'s extensive rules on performance, breach, and remedies. These are taught in Contracts, or a specialized Sales course. For consumer law, one of the most important rules is the statute of limitations for breach of warranty. Generally, actions must be commenced within four years after the cause of action accrued—normally when the goods are tendered for delivery and accepted by the consumer. U.C.C. §2-725. Because the U.C.C.'s remedies are limited, some states have expanded the protection. In California, the Song-Beverly Act, allows consumers who demonstrate a breach of express or implied warranties to recover judgments for actual damages (such as the cost of repairs), costs and expenses, attorney's fees based on reasonable actual time expended, and for willful violations, a civil penalty not to exceed two times the actual damages. Cal. Civ. Code §1790 et seq.

1. Express Warranties

An express warranty is one established by the sellers' conduct, rather than by the law. Sellers can create express warranties orally, by advertising, or by product packaging. An express warranty can exist even without the use of the word "warranty" or similar words, and even if the seller had not intent to create an express warranty.

The U.C.C. establishes three types of express warranties. These arise from 1) an affirmation of fact or promise that relates to the goods; 2) any description of the goods; or 3) any sample or model of the goods. U.C.C. §2-313(1). Much of the case law interpreting express warranties arises in the context of auto sales, where statements that a vehicle will be "trouble-free" or in "tip-top" shape have been held to be express warranties.

To be an express warranty, the affirmation, description, or sample must have become part of the basis of the bargain between buyer and seller. This does not require a showing that the buyer actually relied on the warranty. Instead, the basis of bargain approach looks to the overall transaction and the understanding of the parties, focusing on whether the seller's actions created an express warranty. Because express warranties are deemed to be central to the bargain, express warranties cannot be disclaimed. U.C.C. §2-313, Cmt. 1. This rules prevents burying a disclaimer of a salesperson's statements that constituted an express warranty in the fine print of the sales contract.

The following case considers what constitutes an express warranty and the elements of proving a breach of such warranty.

Sanders v. Apple Inc.

672 F. Supp. 2d 978 (N.D. Cal. 2009)

FOGEL, District Judge.

Plaintiffs Chandra Sanders ("Sanders"), Keith Yonai ("Yonai"), and Bonnier Corporation ("Bonnier") (collectively, "Plaintiffs") bring this putative class action on behalf of themselves and all persons who purchased a 2007 twenty-inch Aluminum iMac desktop computer designed, manufactured, and sold by Defendant Apple Inc. ("Apple"). Apple moves to dismiss the complaint pursuant to Federal Rules of Civil Procedure 12(b)(1) and 12(b)(6) and to strike all of the purported class claims. The Court has considered the briefing submitted by the parties as well as the oral arguments of counsel presented at the hearing on November 14, 2008. For the reasons set forth below, the motion will be granted, with leave to amend.

I. BACKGROUND

Apple is a leading manufacturer of personal computers and consumer electronics. One of Apple's most successful products is a personal desktop computer known as the iMac. Since its introduction in 1998, the iMac has undergone numerous revisions and updates. The most recent version of the iMac ("Aluminum iMac") was released in August 2007. Aluminum iMacs are available with a twenty-inch active-matrix liquid crystal display ("20-inch Aluminum iMac") or a twenty-four-inch active-matrix liquid crystal display ("24-inch Aluminum iMac").

The 20-inch Aluminum iMac and the 24-inch Aluminum iMac utilize different technologies to display digital images. All digital images consist of pixels, the smallest components of a digitalized picture. Each pixel is comprised of three "channels," which correspond to the three main colors used to display digital images: red, blue, and green. Every channel contains a certain number of "bits"—the smallest measure of digital information. A bit can take the value of either zero or one, or "on" or "off." The particular combination of "on" and "off" bits in each channel results in the desired color of that pixel. The number of bits in each pixel determines the total number of colors a computer monitor is capable of displaying.

The 24-inch Aluminum iMac utilizes an "eight-bit" monitor, capable of displaying 16,777,216 colors. The previous generation of 20-inch iMacs, which the Aluminum iMacs replaced, also used an "eight-bit" monitor. However, the new 20-inch Aluminum iMac uses a "six-bit" monitor that is able to display only 262,144 colors. To create the same effect as the "eight-bit" monitor, the "six-bit" monitor uses color simulation processes known as "dithering," and "frame rate control" ("FRC"), which causes the brain to perceive a particular color shade by perceiving many nearly identical shades. Specifically, dithering uses a combination of adjacent pixels to produce the desired shade. Through the FRC process, a single pixel displays alternating shades of color that are almost identical to the desired shade. When run at a high speed, these processes give the illusion of the desired color shade. Plaintiffs allege that the "emulation of true colors" through dithering can cause the appearance of transverse stripes in smooth color gradients and can result in flickering on particular images. They also assert that the 20-inch Aluminum iMacs have a narrower viewing angle, less color depth and accuracy, and are more susceptible to washout across the screen. Plaintiffs contend that these flaws are "particularly crippling" when displays that use this technology are used for image and video editing.

Plaintiffs allege that Apple markets both its 20-inch and 24-inch Aluminum iMacs for editing movies and photos and describes the display of both Aluminum iMacs as though they were interchangeable. Plaintiffs assert that at a press conference announcing the new Aluminum Macs on August 7, 2007, Apple CEO Steve Jobs claimed that photos and movies "look way better on these glossy, beautiful, crisp displays." In a press release issued that same day, Apple stated that the new iMac line "featured gorgeous 20-and 24-inch widescreen displays" that provide "incredibly crisp images, ideal for photos and movies…" Plaintiffs also assert that on its website, Apple states that: "[n]o matter what you like to do on your computer—watch movies, edit photos, play games, even just view a screen saver—it's going to look stunning on an iMac." Plaintiffs allege that Apple made each of these representations without revealing that the 20-inch Aluminum iMac uses "a significantly inferior display" to the display found in both the 24-inch Aluminum iMac and the

20-inch prior generation iMac. Plaintiffs also allege that in the "Technical Specifications" for both the 20-inch and 24-inch Aluminum iMacs, the Apple website states: "[m]illions of colors at all resolutions" without disclosing that the 20-inch Aluminum iMac is actually capable of displaying only 262,144 true colors.

Between January and March 2008, Plaintiff Bonnier purchased sixteen 20-inch Aluminum iMacs for various departments of its magazine publishing business. Bonnier asserts that it purchased these computers based on its "positive experience and satisfaction with the two previous generations of iMacs that it owned." Yonai purchased his 20-inch Aluminum iMac in August 2007 for his graphics design business. Yonai alleges that he made his purchase based on "the information presented by…Apple on its website" and recommendations by friends in the graphics arts industry who owned previous generation iMacs. Bonnier and Yonai both allege that after purchasing their 20-inch Aluminum iMacs, they noticed color shifting on the screen. Yonai asserts that this color-shifting caused "problems with his graphics work." Plaintiffs allege that they "would not have acted as they did if they had known of the concealed material facts." Plaintiffs filed the instant action on March 31, 2008 on behalf of themselves and all persons or entities in the United States who own a 20-inch Aluminum iMac, alleging fraudulent concealment, breach of express warranty, violation under Unfair Competition Law ("UCL"), and unjust enrichment. [ED. NOTE—UCL is California's UDAP statute, as discussed in Assignment 9.]

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C. CLAIM FOR BREACH OF EXPRESS WARRANTY

To plead an action for breach of express warranty under California law, a plaintiff must allege: (1) the exact terms of the warranty; (2) reasonable reliance thereon; and (3) a breach of warranty which proximately caused plaintiffs injury. Williams v. Beechnut Nutrition Corp., 185 Cal. App. 3d 135, 142, 229 Cal. Rptr. 605 (1986). A plaintiff also must plead that he provided the defendant with pre-suit notice of the breach. California Commercial Code §2607.

Yonai contends that Apple's representation that the 20-inch Aluminum iMac was capable of displaying "millions of colors" constituted an express warranty between the manufacturer and the Plaintiffs. He alleges that the inability of the 20-inch Aluminum iMac to display "millions of colors" natively is a breach of this warranty, and that his reasonable reliance on this representation proximately caused damages. At issue is whether the phrase "millions of colors" constitutes an express warranty, whether a breach occurred, and whether reliance and notice are required to state a claim.

1. Whether Apple's Representation that the 20-inch Aluminum iMac Displays "Millions of Colors" Constitutes an Express Warranty

Statements constituting "mere puffery" cannot support liability under a claim for breach of warranty. See, e.g. Pulvers v. Kaiser Foundation Health Plan, Inc., 99 Cal. App. 3d 560, 565, 160 Cal. Rptr. 392 (1979). The distinguishing characteristics of puffery are “vague, highly subjective claims as opposed to specific, detailed factual assertions.” Haskell v. Time, Inc., 857 F. Supp. 1392, 1399 (E.D. Cal. 1994).

Apple contends that “millions of colors at all resolutions” is a vague superlative as opposed to a specific, detailed factual assertion. “[C]ourts have held that such comparative claims, often involving large numbers, are puffing because a consumer cannot reasonably believe that there is a test behind the claim.” In re General Motors Corp. Anti-Lock Brake Products Liab. Litig., 966 F. Supp. 1525 (E.D. Mo. 1997), aff’d, 172 F.3d 623 (8th Cir. 1999), see Avon Products, Inc. v. S.C. Johnson & Son, Inc., Case No. 94CIV3958, 1994 WL 267836, *7 (S.D.N.Y. Jun. 15, 1994) (stating that when the alleged representation contains a “round number one advertiser might select at random for the purpose of demonstrating a product’s superiority, (e.g. 100 or 1,000), such a statement constitutes puffery.”) (parenthetical in original). Apple notes that the San Diego Superior Court recently held that “vague superlatives are puffery and not actionable…[and t]his includes statements like MacBook supports ‘millions of colors.’” See Exhibit A: December 13, 2007 San Diego County Superior Court Ruling in Case No. 37-2007-00066199-CBT-CTL.

Yonai asserts that “puffery is distinguishable from misdescriptions or false representations of specific characteristics of a product,” Castrol Inc. v. Pennzoil Co., 987 F.2d 939, 945 (3d Cir. 1993), and that by using the phrase “millions of colors” in the “Technical Specifications” section on Apple’s website, Apple made an actionable statement about the specific characteristics of the 20-inch Aluminum iMac. Yonai notes that other details provided within the technical specifications of the iMac include the amount of memory, processor speed, hard drive size, and electrical and operating requirements. Pl.’s Opp. to Mot. to Dismiss 14. Yonai also points out that the “round numbers” cases cited by Apple involved comparative assertions that a particular product was 100 or 1,000 times better than another product. Such statements were held to be non-actionable puffery because a consumer could not reasonably believe that there was a test behind the assertion that a product was 100 times better than another, see In re GMC, 966 F. Supp. at 1531, or because the comparative claim contained a round number conjured up by an advertiser. See Avon Products, Inc., Case No. 94CIV3958, 1994 WL 267836.

Here, Apple states that its monitors display “millions” of colors in a list of other technical specifications on which the consumer is expected to rely. Although in an advertising context the phrase “millions of colors” might be considered a vague superlative, the fact that the phrase was used in the technical specifications section of Apple’s website transforms it into an express warranty upon which a potential buyer might rely in deciding whether to purchase the computer.

2. Whether a Breach Occurred

A claim for breach of an express warranty requires an actual breach. See Williams, 185 Cal. App. 3d at 142, 229 Cal. Rptr. 605. Yonai argues that Apple breached the express warranty that the 20-inch Aluminum iMac could display “millions of colors” because the computer does not “natively” display millions of colors, and instead can display only 262,144 colors. Yonai also alleges that the process of dithering used in the 20-inch Aluminum iMac monitor can trick the human eye into seeing certain colors and that it is able only to “*approximate* the number of colors possible on an 8-bit display.”

Apple argues that Yonai makes no factual allegation that he cannot *perceive* "millions of colors" on his 20-inch Aluminum iMacs and points to Yonai's concession that the purpose behind Apple's use of dithering is to approximate the number of colors appearing on the "eight-bit" display. Apple contends that it never represented that its monitors could "natively" display anything. Yonai alleges that Apple expressly warranted the capability of its 20-inch Aluminum iMac to display "millions of colors," and that providing the emulation of millions of colors through dithering does not satisfy this warranty. Yonai must allege in greater detail why the emulation of "millions of colors" generated by the dithering process amounts to a breach of the express warranty that the computer displays "millions of colors."

3. Whether Reliance Is Required

Yonai asserts that reliance is not required to support a claim for breach of express warranty, but rather that the statements become "part of the basis of the bargain" under California Commercial Code §2313. See Keith v. Buchanan, 220 Cal. Rptr. 392 (1985). However, another court this district has dismissed express warranty claims brought by a plaintiff who never saw the warranted statement, stating that "California courts have held that '[u]nder the law relating generally to express warranties a plaintiff must show reliance on the defendant's representation.'" Moncada v. Allstate Ins. Co., 471 F. Supp. 2d 987, 997 (N.D. Cal. 2006) (dismissing claim because plaintiffs presented no evidence that they actually read or relied upon the representations in the website). Although Yonai—the only named plaintiff with standing to sue—asserts that he looked at Apple's website, he fails to allege reasonable reliance on any specific representations Apple made with respect to the 20-inch Aluminum iMac.

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Apple contends that Yonai may not base a nationwide class action on fraud and warranty claims because individual issues with respect to reliance overwhelmingly will predominate the litigation. Yonai responds to this argument by asserting that reliance is not a required element of fraudulent concealment or breach of express warranty.

As discussed above, reliance *is* a necessary element of a claim for breach of express warranty.…This requirement inquires into the specific facts surrounding each buyer's transaction, and is functionally equivalent to the "reliance element." If the proposed class were to be certified, the Court would be forced to engage in individual inquiries of each class member with respect to materiality of the statement, whether the member saw Apple's advertisements or visited Apple's website, and what caused the member to make the purchase. Moreover, since Yonai purports to bring a nationwide class action, these individual inquiries very likely would be subject to the differing state laws that may or may not apply.

Courts routinely hold that both fraud and warranty claims are difficult to maintain on a nationwide basis and rarely are certified. See Cole v. Gen. Motors Corp., 484 F.3d 717, 724-30 (5th Cir. 2007) (discussing at length why warranty claims are inappropriate for class treatment); Castano v. Am. Tobacco Co., 84 F.3d 734, 745 (5th Cir. 1996) ("a fraud class action cannot be certified when individual reliance is an issue."). In light of the foregoing, it is not clear that a nationwide class action is the "superior" method for adjudication of rights. Accordingly, the class allegations will be stricken, with leave to amend. The Court urges Plaintiffs to consider whether a more narrowly defined class might be appropriate.

Good cause therefore appearing, the motion to dismiss and to strike is granted, with leave to amend. Any amended complaint shall be filed within thirty (30) days of the date of this order.

The court also ruled that Yonai, the plaintiff, had failed to give notice to Apple, "within a reasonable time after he discover[ed] or should have discovered any breach, [a buyer must] notify the seller of breach or be barred from any remedy." Cal. Civ. Code §2607(3)(A). Under California law, there is an exception to the notice requirement: when a consumer brings an action against a manufacturer, which he or she did not deal with directly. Yonai shopped at Apple's online store and Apple was the manufacturer. Therefore, the court held that he was unable to use the exception. With the rise of Internet sales and the demise of general brick-and-mortar retail, the notice requirement may be applicable to more consumers. While avoiding the "middle man" may sound good, consumers will deal with more manufacturers, triggering the notice requirement.

2. Implied Warranties

In many transactions, both express and implied warranties exist and cover the same aspects of a good. Implied warranties arise regardless of seller conduct. For consumer goods, the two most important implied warranties are those of merchantability, U.C.C. §2-314, and fitness for a particular purpose, U.C.C. §2-315.

The warranty of merchantability applies only when the seller is a merchant, "a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction…" U.C.C. §2-104(1). It imposes a promise that the goods are fit for the ordinary purpose for which they are to be used. In short, the goods cannot be so defective as to not be useful. Factors such as safety, efficiency, and comfort help determine whether goods meet their ordinary purpose.

The warranty of fitness applies to all sellers (not just merchants). It requires the goods to be suitable for the buyer's particular purpose. This warranty is narrower and more precise than the warranty of merchantability; both will often exist. Whereas with express warranties the focus was on the seller's conduct, with the implied warranty of fitness the focus will be on whether the buyer communicated the purpose of the purchase to the seller. The seller needs a "reason to know" of the particular purpose and that the buyer "is relying on the seller's skill or judgment to select or furnish suitable goods." U.C.C. §2-315.

Unlike express warranties, implied warranties can be disclaimed under certain circumstances. In general, the U.C.C. permits disclaimers of implied warranties but requires such disclaimers to be conspicuous and meet other standards. Despite a salesman representing that a car was "a good car" and "reliable," a court held that a sales contract stating that the car was "as is" was sufficient to disclaim the implied warranty of merchantability. The plaintiffs, whose car's engine blew less than a week after the sale, had no U.C.C. remedy. *Lester v. Wow Car Co.*, 2014 WL 2567097 (S.D. Ohio 2014). By contrast, the Magnuson-Moss Warranty Act, discussed below, prohibits the disclaimer of implied warranties if a "written warranty" or a "service contract" is provided.

B. Magnuson-Moss Warranty Act

Along with the UDAP statute, the Magnuson-Moss Warranty Act (M-M Act) is one of the cornerstones of consumer protection law. Like many of these archetypal consumer laws, it was enacted in the 1970s and focuses on empowering consumers by giving them information. For the novice, the major surprise about the M-M Act is that it does not require warranties in any circumstances. This is a major difference between the U.C.C. and the M-M Act. Instead, the M-M Act regulates disclosures by requiring that written warranties—if chosen to be offered—meet certain standards. The key legal concept in the M-M Act is the "written warranty." 15 U.S.C. §2301(6). A written warranty is a form of express warranty; it arises from a written affirmation of fact or written promise, or an undertaking in writing to refund, repair, replace, or provide another remedy if the product fails to meet specifications.

Written warranties must meet myriad requirements to comply with the M-M Act. At the most basic level, a written warranty must be in "simple and readily understood language" and disclose "fully and conspicuously" the terms and conditions of the warranty. 15 U.S.C. §2302(a). The FTC, which writes rules for the M-M Act, has stated that the warranty disclosures must be in a single document. 16 C.F.R. §701.3(a). The warranties also have to lay out made the identity of the parties, the scope of the warranty, the procedures to use the warranty, and the remedies available to the consumer. Note that in contrast to the U.C.C., the M-M Act only applies to consumers who are purchasing "consumer products"—tangible personal property normally used for personal, family, or household purposes. 15 U.S.C. §2301(1).

The M-M Act provides a cause of action for failure to comply with obligations under a written warranty or the failure to comply with an implied warranty created by state law. 15 U.S.C. §2310(d). Disclosure violations may also give rise to liability, although with all M-M Act claims the consumer must show that they were "damaged by the failure" in compliance. The remedies under M-M have some limitations but generally permit individual or class actions.

The M-M Act requires the labeling of written warranties as either "full" or "limited." A particular item may be covered with a full warranty as to some of its aspects and a limited warranty—or even no warranty—as to other aspects. 15 U.S.C. §2305. A full warranty must remedy a defect or malfunction of a consumer product within a reasonable time and without charge. While the full warranty may be only for a certain duration, which must be clearly stated, the offering of a full warranty carries with it the requirement that the seller may not impose any limitation of any implied warranty, such as those arising under the U.C.C. 15 U.S.C. §2304. A limited warranty can curtail the duration of implied warranties.

The case below shows the complex interaction between M-M, the U.C.C., and supplementary state warranty laws, such as California's Song-Beverly Act. Despite all those laws, the plaintiff found herself washed up.

Smith v. LG Electronics USA, Inc.

83 UCC Rep. Serv. 2d 92 (N.D. Cal. 2014)

HAMILTON, District Judge.

This is a case filed as a proposed class action by plaintiff Laury Smith, against LG Electronics U.S.A., Inc., and Sears Holding Corp., asserting claims related to the design, manufacture, sale, and service of six models of top-loading LG brand and Kenmore brand automatic clothes-washing machines (three models of LG brand, and three models of Kenmore brand), which plaintiff alleges are defective.

Plaintiff alleges that the washing machines were labeled and advertised as "High Efficiency" machines featuring "extra high" spin speeds of 1050–1100 RPM, along with a system that prevents or minimizes vibrations, for smooth, quiet operation during use. Plaintiff claims, however, that the washing machines have inherent design defects that cause them to shake and vibrate excessively during use due to unbalanced loads, which in turn causes internal parts to become loose. Cplt ¶2.

Plaintiff alleges that she purchased a Kenmore Elite Model No. 29272 in November 2011, based on defendants' representations that the product was a "High Efficiency" machine, capable of "extra high" spin speed cycles at 1050 RPMs, which would help her dry her laundry faster than washing machines that do not have high efficiency capabilities. Cplt ¶¶6, 40-42.…

Plaintiff asserts that "from the very beginning," she experienced unbalanced loads that caused the machine to shake violently, make banging noises, rock from side to side, and move or "walk" itself away from the wall against which it was positioned. Cplt ¶¶6, 43-44. Indeed, she claims that the "violent movement" of her "defective machine" was so severe that the machine "would actually shift or 'walk itself' away from the wall on which it was positioned." Cplt ¶44. She alleges that to keep the machine from damaging the dryer positioned next to it, she used a plastic trash can as a "buffer" to help absorb the "shock of the shaking machine" and "attempt to keep it in place." Cplt ¶44. Nevertheless, she did not complain to Sears about the alleged defects until more than a year had passed after her purchase of the machine.

On December 18, 2012, the United States Consumer Products Safety Commission recalled the LG/Kenmore washing machines due to the risk of personal injury and property damage as a result of these alleged design defects. The recall announcement stated that "[a]n unbalanced load can cause the washing machine to shake excessively and the drum to come loose during use, posing a risk of injury to consumers and property damage to the surrounding area." The six models of recalled LG/Kenmore washing machines were manufactured between

February 2010 and November 2011, and were sold between April 2010 and December 2012. Cplt ¶¶2-3.

According to the recall announcement, as of the recall date, defendants had sold approximately 457,000 of the allegedly defective machines, and had received at least 343 reports of washing machines vibrating excessively, of which at least 187 involved property damage, and one report of minor injury. Cplt ¶25.

As part of the recall, customers were instructed to immediately contact LG or Sears for a free in-home repair, consisting of the installation of a software "upgrade" on the washing machines. Plaintiff asserts, however, that the software "upgrade" implemented by defendants was not an upgrade at all, but instead "fixed" the problem by capping the spin speed of the washing machines, such that the washing machines were no longer capable of operating at the advertised "extra high" spin speed setting of 1050–1100 RPM. Cplt ¶¶4, 26-27. Plaintiff contends that fast speed cycles are a desirable feature because they remove water from clothing faster, thereby shortening washing machine time, and leave consumers with drier clothes, thus shortening the time the clothes need to spend in the dryer. Thus, plaintiff alleges, the "upgrade" rendered the machines useless for the purpose for which they were advertised. Cplt ¶¶26-31.

Plaintiff asserts further that along with the software "upgrade," consumers were provided with a new caution label to be affixed to the washing machines, listing a number of washables that the washing machines are no longer capable of washing—items such as waterproof or water-resistant clothing, mattress covers, outdoor gear, and plastic mats. Cplt ¶32.

Plaintiff requested an in-home repair after hearing about the recall, and her washing machine was serviced in March 2013. However, she claims that after this repair, her machine no longer functions as represented in the product advertising, marketing, and Use & Care Guide; that it fails to wring out her clothing; and that it can no longer be used to launder certain machine-washable items. Cplt ¶¶45-46.

The washing machines are covered by a limited warranty. The Kenmore Use & Care Guide ("Kenmore Guide") and the LG Owner's Manual ("LG Manual") both provide an express limited warranty that "covers only defects in materials and workmanship," for one year from the date of purchase. The warranty further provides that the customer's exclusive remedy is repair (in the case of the Kenmore models) and repair or replacement at LG's option (in the case of the LG models). Furthermore, the warranty included in both the Kenmore Guide and the LG Manual limits the duration of the limited warranty, where allowed by law, to the shortest period allowed by law.

The Kenmore Guide and the LG Manual also contain specific instructions regarding how to operate the washing machines, including what users should avoid doing. For example, the Kenmore Guide cautions users against loading the washing machines with waterproof items.

Plaintiff filed the present action on September 19, 2013, asserting nine causes of action—(1) violation of the Magnuson–Moss Warranty Act, 15 U.S.C. §2301, et seq.; (2) breach of express warranty; (3) breach of the implied warranty of merchantability; (4) breach of the implied warranty of fitness for a particular purpose; (5) unjust enrichment; (6) violation of the Consumers Legal Remedies Act, Cal. Civ. Code §1750, et seq. ("CLRA"); (7) unlawful, unfair, and fraudulent business practices, in violation of the Unfair Competition Law, Cal. Bus. & Prof. Code §17200, et seq.; (8) false advertising, in violation of the False Advertising Law, Cal. Bus. & Prof. Code §17500, et seq.; and (9) violation of the Song-Beverly Consumer Warranty Act, Cal. Civ. Code §1790, et seq.

Defendants now seek an order dismissing all causes of action alleged in the complaint pursuant to Federal Rules of Civil Procedure 12(b)(6) and 9(b).

...

1. Breach of Express Warranty

Defendants assert that the complaint fails to state viable claims for breach of express warranty (first, second, and ninth causes of action), because the limited warranty does not cover alleged design defects and because plaintiff fails to allege facts sufficient to state a claim for breach of express warranty.

To state a claim for breach of express warranty, a plaintiff must allege that the defendant's statements constituted an affirmation of fact or promise or a description of one of the goods; that the statement was part of the benefit of the bargain; and that the warranty was breached. Weinstat v. Dentsply Int'l, Inc., 180 Cal. App. 4th 1213, 1227 (2010).

Plaintiff contends that her claims in this case are based on the express warranty, not on the limited warranty; at the hearing on the present motion, plaintiff's counsel confirmed that her claims were not based on the limited warranty in the manuals. Instead, plaintiff lists six statements she claims were "express warranties" that defendants breached. These are statements that the washing machines (a) were "High Efficiency" washers and "HE" compliant; (b) were Energy Star® compliant and thus water- and energy-efficient; (c) helped dry clothes faster using the "Extra High" spin cycles of 1050-1100 RPMs; (d) were safe for residential use and fit for everyday laundering needs; (e) "will provide many years of reliable service;" and (f) are "designed and manufactured for years of dependable service." Cplt ¶¶63, 72.

Defendants contend that plaintiff fails to plead facts sufficient to support the requisite elements of a breach of express warranty claim as to any of the six statements. First, defendants argue that the statements that the washers were "High Efficiency," would "provide many years of reliable service," "were designed and manufactured for years of dependable service," and were safe for residential use and fit of everyday laundering needs are non-actionable statements of opinion, not affirmations of fact or promise, or a description of one of the goods.

Under California law, "an affirmation merely of the value of the goods or a statement purporting to be merely the seller's opinion or commendation of the goods does not create a warranty." Cal. Com. Code §2313; Cal. Civ. Code §1791.2(a)(2)(b). Thus, to constitute a warranty and be actionable, the statement must be "specific and unequivocal." Johnson v. Mitsubishi Digital Elecs. Am., Inc., 578 F. Supp. 2d 1229, 1236 (C.D. Cal. 2008). Defendants assert that plaintiff's express warranty claims fail to the extent they are based on such generalized and vague statements of opinion and sales puffery.

Second, defendants contend that plaintiff has failed to plead facts showing that the statements at issue formed "the basis of the bargain." For a statement to form the basis of the bargain, the plaintiff must allege facts showing that she was exposed to the alleged statement prior to making the decision to purchase the product.

Sanders v. Apple Inc., 672 F. Supp. 2d 978, 988 (N.D. Cal. 2009); Moncada v. Allstate Ins. Co., 471 F. Supp. 2d 987, 997 (N.D. Cal. 2006). Here, defendants assert, plaintiff alleges only that the statements were printed in the user guides that accompanied the machines—not that she reviewed the guides and relied on the statements in deciding to make the purchase. Defendants also contend that the statement “High Efficiency” cannot have formed the basis of the bargain because plaintiff does not allege with sufficient particularity that she knew what this statement meant at the time of purchase.

Finally, defendants assert that plaintiff has failed to allege facts sufficient to show that defendants breached any express warranty. For example, they contend that the complaint does not relate to whether the washing machines were “High Efficiency,” able to operate at the “Extra High” spin cycle,” or whether they were Energy Star® and/or HE compliant, and that plaintiff does not allege that these statements were untrue at the time of purchase or during the one-year warranty period. They argue that plaintiff appears to be resting her warranty claims on alleged failures that manifested after the recall repair, and that the claim fails because an express warranty does not cover repairs after the applicable time period has elapsed.

In opposition, plaintiff argues that she has adequately pled facts supporting all elements of the claim of breach of express warranty. First, she asserts that the six statements were affirmations and promises. She concedes that product superiority claims that are vague or highly subjective may amount to non-actionable puffery, but argues that misdescriptions of specific or absolute characteristics of a product are actionable, and in particular, that representations as to the safety of consumer products are generally found to be affirmative statements of fact rather than opinions.

With regard to the representation that the washers would provide “many years of dependable service,” plaintiff contends that this is an affirmative promise that can be objectively verified with the passage of time; and with regard to the representation that the washers were “High Efficiency,” plaintiff asserts that “High Efficiency” is simply the long form of “HE,” and that defendants do not challenge that the use of the “HE” logo has a precise meaning within the industry and can be considered an affirmative promise that constitutes an express warranty.

With regard to the second element—that the affirmation or promise was part of the basis of the bargain—plaintiff contends that affirmations, promises, and descriptions given at the time of purchase (including product manuals and other materials given to the purchaser at the time of delivery) can become part of the basis of the bargain, and can be fairly regarded as part of the contract.

With regard to the third element—that the seller breached the warranty—plaintiff argues that defendants breached the warranties that the machines were “HE” compliant, that they were Energy Star® compliant, that they functioned with a spin cycle of 1050-1100 RPMs, that they were “safe for residential use,” and that they would provide “years of dependable service,” because a design defect caused the washing machines to shake violently and pose a risk of property damage and personal injury. Moreover, she argues, the breach continued following the recall, because the “upgrade” capped the spin speeds at 700 RPMs, which prevented the machines from drying the clothes faster, saving energy, or operating as “High Efficiency” machines.

The court finds that the motion must be granted. Vague statements regarding reliability, dependability, and safety are not actionable express warranties. District courts within the Ninth Circuit have found that words such as "reliable" and "dependable" are inherently vague and general, and therefore are non-actionable, and that words regarding "safety" and "fitness for use" are not the unequivocal sorts of statements that can give rise to contractual obligations. See, e.g., Viggiano v. Hansen Natural Corp., 2013 WL 2005430, at *10-11 (C.D. Cal. May 13, 2013); Casteneda v. Fila USA, Inc., 2011 WL 7719013, at *4 (S.D. Cal. Aug. 10, 2011); Tietsworth v. Sears, 720 F. Supp. 2d 1123, 1136–37 (N.D. Cal. 2010); Johnson, 578 F. Supp. 2d at 1236 (C.D. Cal. 2008); Sanders, 672 F. Supp. 2d at 987.

Thus, statements that the machines were safe for residential use and fit for everyday laundering needs, that they would provide many years of reliable service, and that they were designed and manufactured for years of dependable service—are not statements of affirmation and promise, but rather non-actionable puffery. Such generalized advertisements say nothing about the specific characteristics or components of the machine, and include no guarantee, for example, that the machine will not require a repair within a specified period of time. Virtually identical statements have been found non-actionable by other courts. See, e.g., Oestreicher v. Alienware Corp., 544 F. Supp. 2d 964, 973 (N.D. Cal. 2008) (noting that statements of product superiority based on being "faster, more powerful, and more innovative," "higher performance," and having a "longer battery life" are "non-actionable puffery").

Moreover, of the statements that plaintiff has posited as the actionable "express warranties," she has not alleged facts showing that at the time of sale, the machines were not "High Efficiency," that they were not Energy Star® compliant, or that did not utilize spin cycles of 1050–1100 RPMs. Indeed, it appears from the allegations in the complaint that all these features were in fact present in the machines at the time of sale. Following the recall and the "fix" provided by defendants, the spin speed was lowered. However, this fact does not render false the statements made at the time of sale regarding efficiency and spin speed.

Finally, plaintiff fails to allege facts showing a *breach* of any express warranty. Plaintiff's position as set forth in the opposition appears to be that the statements at issue were independent express warranties with an unlimited duration—not that defendants breached the written express limited warranty. The general rule, however, is that a "seller may limit its liability for defective goods by disclaiming or modifying a warranty," and that an express warranty does not cover defects after the applicable warranty period has elapsed. *See* Daugherty v. American Honda Motor Co., Inc., 144 Cal. App. 4th 824, 830 (2006). In addition, "[w]ords or conduct relevant to the creation of an express warranty and words or conduct tending to negate or limit warranty shall be construed wherever reasonable as consistent with each other." Cal. Com. Code §2316(1).

Here, the only reasonable and consistent reading of the warranty and the alleged express warranty statements is to consider the warranty—including the one-year durational limitation—to apply to limit the duration of the six alleged express warranty statements at issue. The only alternative reading would be that the statements "created an express warranty…of indefinite duration"—which would be "wholly untenable," and "leave [Defendants] susceptible to a breach of warranty claim for every [machine] which, at any time, required repairs.…" Long v. Hewlett-Packard Co., 2007 WL 2994812, at *6 n.4 (N.D. Cal. Jul. 27, 2007).

To the extent that plaintiff's claims are based on what defendants refer to as the "recall efficiency issue"—the alleged reduction in efficiency following the software "upgrade"—plaintiff is alleging defects that first manifested after the recall repair, which resulted in the washing machines operating at slower spin speeds and purportedly neutralizing the benefits of the HE and Energy Star@ designations. See Cplt. ¶31. However, there was no breach as to any of the six alleged express warranties because plaintiff has not alleged that the recall efficiency issue rendered the alleged express warranties untrue during the applicable one-year warranty period.

It is clear from the allegations in the complaint that the recall efficiency issue surfaced only after the one-year warranty period expired. Plaintiff has not alleged that the washing machines did not perform as warranted by the HE logo, the Energy Star@ designation, and the spin speed throughout the warranty period. See Cplt ¶¶3-6 (alleging November 2011 purchase and December 2012 recall). In California, an express warranty does not include malfunctions that occur after the warranty has ended. See Elias v. Hewlett-Packard Co., 903 F. Supp. 2d 843, 850 (N.D. Cal. 2012). Thus, any warranty claim based on the recall efficiency issue fails.

Moreover, plaintiff alleges no facts to support her assertion that the alleged recall efficiency issue warranties were breached at any time. While plaintiff alleges that "High Efficiency" and "HE-compliant" are "affirmative promises" regarding the washing machines' water savings—that is, that they "use from 20% to 66% of the water used by traditional agitator washers," *see* Cplt ¶21 n.3—the complaint contains no allegations of the machines' actual water usage at any time before or after the recall, much less a comparison to "traditional agitator washers." *See* Cplt ¶¶27, 45.

Similarly, although plaintiff claims that the Energy Star@ logo represents that the washing machines "use 40 to 50 percent less energy and about 55 percent less water than standard washers," Cplt ¶21 n.4, she pleads no facts regarding how much energy and water the washing machines consumed either before or after the recall, let alone any facts sufficient to support an inference that the washing machines no longer qualify for the Energy Star® designation.

2. Breach of Implied Warranties

Defendants argue that plaintiff fails to allege facts sufficient to support the elements of a claim for breach of implied warranties (third and fourth causes of action for breach of implied warranty of merchantability and breach of implied warranty of fitness for a particular purpose).

There exists in every contract for the sale of goods by a merchant a warranty that the goods shall be merchantable. Atkinson v. Elk Corp. of Texas, 142 Cal. App. 4th 212, 228 (2006). The core test of merchantability is fitness for the ordinary purpose for which such goods are used. Cal. Com. Code §2314(2); see also Hauter v. Zogarts, 14 Cal. 3d 104, 117-18 (1975) ("merchantability" requires that a product conform to its ordinary and intended use). Thus, to prevail on an implied warranty of merchantability claim, the plaintiff must demonstrate that the alleged defect renders the subject goods unfit for their ordinary purpose. See Southern Cal. Stroke Rehabilitation Assocs., Inc., 782 F. Supp. 2d 1096, 1112 (S.D. Cal. 2011).

To state a claim for breach of the implied warranty of fitness for a *particular* purpose, a plaintiff must allege facts showing that (1) at the time of purchase, the buyer intended to use the product for a particular purpose; (2) the seller had reason to know this; (3) the buyer relied on the seller's judgment to select suitable goods for that purpose; (4) the seller had reason to know that the buyer was relying on seller in this way; and (5) the product failed to suit buyer's purpose and subsequently damaged the buyer. Keith v. Buchanan, 173 Cal. App. 3d 13, 25 (1985).

A "particular purpose" differs from "the ordinary purpose for which the goods are used" in that it "envisages a specific use by the buyer which is peculiar to the nature of his business whereas the ordinary purposes for which goods are used are those envisaged in the concept of merchantability and go to uses which are customarily made of the goods in question." American Suzuki Motor Corp. v. Superior Court, 37 Cal. App. 4th 1291, 1295 n.2 (1995) (quoting Cal. Com. Code §2315, UCC Code Comment 2).

Under California law, implied warranties are "co-extensive in duration with an express warranty" and "in no event shall…have a duration of…more than one year following the sale." Cal. Civ. Code §1791.1(c). Thus, any implied warranties for the washing machines were valid for a period of no more than one year from the date of purchase. See Tietsworth, 720 F. Supp. 2d at 1142; In re Sony Grand Wega KDF–E A10/A20 Series Rear Projection HDTV Television Litig., 758 F. Supp. 2d 1077, 1100 (S.D. Cal. 2010).

Defendants contend that plaintiff has failed to allege facts showing that the washing machines were unfit for their *ordinary* purpose (washing clothes) during the applicable one-year warranty period (or that even if they were, that she notified defendants within a reasonable time); and has failed to allege that the washing machines were unfit for her *particular* purpose because she has pled no facts showing that her purpose was anything other than the ordinary one of washing clothes.

In response, plaintiff contends that the complaint adequately pleads that the washing machines are not merchantable, and that a washing machine that vibrates and makes excessive noise, and does not wring out clothes, is not fit for its intended purpose. She also asserts that the particular purpose for which she purchased the machine was the ability to operate it at 1050-1100 RPMs, and for the benefit of the specified efficiency standards. She argues that her claim is not barred by the one-year limitation on claims for breach of implied warranties, because the alleged defect was "latent" and "hidden from consumers who could not have identified the defect."

The court finds that the motion must be granted. As stated above, in California, implied warranties are "co-extensive in duration with an express warranty," and "in no event shall…have a duration of…more than one year following the sale." Cal. Civ. Code §1791.1(c). Here, plaintiff purchased the washing machine in November 2011. While she alleges that she had problems with the washing machine "from the very beginning," Cplt ¶43, she nonetheless bases her warranty claims on events that occurred more than a year after the date of purchase. She requested an in-home repair well after the one-year period had elapsed, but based on the allegations in the complaint, that request was prompted only by the recall announcement.

In addition, with regard to the claim for breach of the implied warranty of merchantability, the ordinary purpose of a washing machine is to wash clothes. Plaintiff has not alleged facts showing that defendants breach of the implied warranty of merchantability, which requires that a product conform to its ordinary and intended use. As for the claim for breach of the implied warranty of fitness for a particular purpose, plaintiff has identified no "particular purpose" for which she purchased the washing machine. She purchased it to wash her laundry, which is the "ordinary" purpose of a washing machine.

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Perhaps the most important function of the U.C.C.'s warranty provisions are in the shadow of the law. Many retailers have "no-questions-asked" policies that permit exchanges or refunds for goods. As a practical matter, these voluntary responses to unsatisfied consumers dramatically reduce the need for formal legal charges that a product fails to meet the U.C.C. warranties. Similarly, rather than deal with the procedural requirements of making a claim with the manufacturer under the M-M Act consumers simply line up at the customer return counter of a local retailer. The law cannot hold a candle to a merchant's best customer service in terms of remedying problems with products, but it is also true that the law has influenced the rise of such policies.

C. Statutory Warranties

Certain products, usually high-dollar transactions or high-risk goods, have specific statutory warranties. Such laws generally address perceived weaknesses or gaps in coverage of the U.C.C. and the M-M Act and are explicitly pro-consumer. (Recall that the U.C.C. warranty rules apply to both businesses and consumers, and that M-M does not require any warranty at all.)

The classic example of a statutory warranty is a "lemon law," which requires manufacturers to try to repair defective cars, and if that proves ineffective to provide the consumer with a remedy. A car is not a lemon merely because a consumer identifies some flaws. Most statutes require a substantial impairment of value, use, or safety. Lemon laws obligate only the manufacturer, and not the dealer, to provide redress to consumers. The lemon laws typically limit the number of repair attempts that a manufacturer is allowed before the consumer is entitled to the better remedy of replacement or refund.

All fifty states have such laws that cover new cars and other new vehicles; only a half dozen states have lemon or similar laws for used cars. With used vehicles, the major remedies remain the express and implied warranties under the U.C.C. Other examples of products covered by statutory warranties are wheelchairs and other assistive devices, and manufactured homes, which sometimes escape from coverage under the U.C.C. if they are sold as part of a transaction with underlying real property.

The consumer in the upcoming case relied on the multiple warranty laws to seek relief, as did the plaintiff in *Smith v. LG Electronics*. With the addition of the lemon law and M-M Act, however, the plaintiff cruised to victory.

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Milicevic v. Fletcher Jones Imports, LTD

402 F.3d 912 (9th Cir. 2005)

BEA, Circuit Judge.

Defendants-Appellants Fletcher Jones Imports and Mercedes-Benz USA (collectively "Mercedes") appeal from the district court's judgment in favor of Plaintiff-Appellee Marina Milicevic following a bench trial. Milicevic sued for damages due to defects in the Mercedes S-500 automobile she purchased from Fletcher Jones Imports. Her Nevada state court complaint alleged breach of express warranty, breach of the implied warranties of merchantability and fitness, violation of Nevada Revised Statute §§597.600-597.680 (2000) (Nevada's "lemon law"), and violation of the federal Magnuson-Moss Warranty Act, 15 U.S.C. §§2301-2312 (1998). Mercedes removed the case to federal court based on federal question jurisdiction.

The district court found that Mercedes breached its written warranty and violated both the Nevada lemon law and the Magnuson-Moss Warranty Act. The district court awarded Milicevic damages under the Nevada lemon law and attorneys' fees under the Magnuson-Moss Warranty Act.

Mercedes contends the district court incorrectly found a violation of the Nevada lemon law. Mercedes also contends that the district court incorrectly applied the Magnuson-Moss Warranty Act and that its award of attorneys' fees under the act was improper. Milicevic cross-appeals the amount of attorneys' fees awarded as insufficient. She also claims Mercedes' appeal is moot because Mercedes paid the judgment and, therefore, there is no longer a "case or controversy" between the parties. We have jurisdiction and affirm.

BACKGROUND

Milicevic purchased a new Mercedes S-500 from Fletcher Jones Imports on May 11, 2001, for $98,722.25. From day one, the car exhibited a number of aesthetic and mechanical problems. Within the first seven months, the following repairs were made: all four brake rotors were warped and required replacement at 6,000 miles; after locking Milicevic out of the car, the remote entry system was replaced; the motor for the passenger side window was replaced; the passenger side mirror was replaced due to a thumb print in the paint; and the rear window seal and molding were unsuccessfully repaired three times. All repairs were made under Mercedes' limited written warranty. By the end of seven months, the car had spent 55 days at Fletcher Jones' repair shop.

At that point, Milicevic wanted Mercedes to replace the car or to reimburse her for the purchase price and take the car back. Her attorney and then-fiancé, Christopher Gellner, wrote a letter to Mercedes-Benz to that effect, explaining the series of problems and repairs. Aside from a cursory letter notifying Gellner that he would be contacted by a local representative of Mercedes-Benz in the near future, Mercedes-Benz did not respond to Gellner's letter, even though he made a series of unreturned phone calls. Milicevic sued Mercedes-Benz and Fletcher Jones Imports.…

The contested issues addressed at trial were whether: (1) the brakes on Milicevic's car were "defective"; (2) it was necessary for Milicevic to leave the car at Fletcher Jones for an extended period while parts were on order for the rear window repair; and (3) the unsuccessful repair of the rear window was "significant." Ultimately, Milicevic testified at trial that she found the car's use and value impaired: "I feel like I am stranded. I cannot feel comfortable to take the car on a trip. I do not feel comfortable to drive because I don't know what next will come. [E]very day is a new problem."

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NEVADA LEMON LAW

The district court did not commit clear error when it found a violation of the Nevada lemon law. There was sufficient evidence to support the district court's finding that after a reasonable number of attempts at repair had been made, a reasonable person would have found the use and value of the car substantially impaired, as did Milicevic.

The Nevada lemon law states that if an automobile manufacturer, its agent or its authorized dealer is not able to conform a vehicle to its warranty after a reasonable number of attempts to repair the vehicle have been made, and the nonconformity substantially impairs the use and value of the vehicle to the buyer, it must replace the vehicle or give the purchaser a refund of the purchase price, including taxes and fees, less a deduction for the reasonable use of the vehicle. Nev. Rev. Stat. §597.630(1). If within the first year, or within the time the warranty is in effect, whichever is less, the same condition is subject to repair four or more times or the vehicle is out of service for repair more than 30 calendar days for reasons not beyond the control of the manufacturer, its agent or its authorized dealer, it is presumed that a reasonable number of attempts to repair the vehicle have been made. Nev. Rev. Stat. §597.630(2). When the vehicle is out of service more than 30 calendar days, the nonconformity does not have to be ongoing. See id.

Here the presumption that a reasonable number of attempts at repair had been made was appropriate because Milicevic's car was subject to repair four or more times within the first year for the condition both of the brakes and of the rear window, conditions which Fletcher Jones never successfully repaired. Additionally, the district court did not clearly err in finding that Milicevic's car was out of service for repair a cumulative total of 55 days during the first year.

Although Mercedes claims that the vehicle was only "out of service" for repair 24 days, discounting 31 days Milicevic's car was at Fletcher Jones awaiting the arrival of parts needed to fix the rear window seal, Fletcher Jones ordered the wrong part for the repair. When a repair is delayed by the unavailability of a part, the time under section 597.630(2)(b) is not tolled. Cf. Ayer v. Ford Motor Co., 200 Mich. App. 337, 503 N.W.2d 767, 770 (1993) ("To allow a defendant to assert the unavailability of parts as a reason for failing to make timely repairs would defeat the statute's intent to place the risk of inconvenience and monetary loss on the manufacturer rather than the consumer."). Milicevic had no control over the ordering of the parts, nor was she in a position to know how long the necessary parts would take to arrive. She left her car at Fletcher Jones while the parts were on order because she was told the repair would take only a few days. The responsibility for the timeliness of the repair rested with Fletcher Jones.

ATTORNEYS' FEES UNDER THE MAGNUSON-MOSS WARRANTY ACT

A. THE MAGNUSON-MOSS WARRANTY ACT CREATES A FEDERAL PRIVATE CAUSE OF ACTION FOR A WARRANTOR'S FAILURE TO COMPLY WITH THE TERMS OF A WRITTEN WARRANTY

Subject to certain conditions with which Milicevic complied, the Magnuson-Moss Warranty Act creates a federal private cause of action for a warrantor's failure to comply with the terms of a written warranty: "[A] consumer who is damaged by the failure of a warrantor to comply with any obligation under a written warranty may bring suit for damages and other legal and equitable relief in an appropriate district court of the United States." 15 U.S.C. §2310(d)(1)(B). To the extent Mercedes argues to the contrary, the cases on which it relies are inapposite.

First, Mercedes cites the following language from *Skelton v. General Motors Corp.*, 660 F.2d 311 (7th Cir. 1981): "The district court properly rejected plaintiffs' argument that the Act's draftsmen intended in [Section 2310(d)] to create a federal private cause of action for breach of *all* written express warranties." Id. at 316 (emphasis added). The context for the Seventh Circuit's statement, however, is essential. The district court had held that the written promises at issue were not "written warrant[ies]" as defined in Section 2301(6), and the plaintiffs did not appeal that holding. Id. at 316 n. 7. Rather, the plaintiffs argued that all written promises constituted written warranties for the purposes of Section 2310(d)(1). The Seventh Circuit rejected the plaintiffs' argument, holding that the definition of "written warranty" provided in Section 2301(6) applied wherever "written warranty" was used throughout the Magnuson-Moss Warranty Act. Id. at 322. Unlike General Motors' written promises, which the Seventh Circuit presumed not to amount to warranties under Section 2301(6), as we explain below, the express limited warranty given by Mercedes does qualify as a written warranty.

In *Walsh v. Ford Motor Co.*, 807 F.2d 1000 (D.C. Cir. 1986), the D.C. Circuit held: "[E]xcept in the specific instances in which Magnuson-Moss expressly prescribes a regulating rule, the Act calls for the application of state written and implied warranty law, not the creation of additional federal law." Id. at 1012. Again, however, the context is crucial. There, the plaintiffs sought certification of three classes in an action brought under the Magnuson-Moss Warranty Act for breach of written and implied warranties. Id. at 1002. Despite the fact that the plaintiffs resided in several different states and that there were variations in state laws governing the interpretation of written and implied warranties, the district court "apparently believed that the federal Act alone, uncomplicated by 'any State law variations,' covered the class members' 'claims for breach of written warranty,'" id. at 1011, and, as for the claims for breach of implied warranty, interpreted the Magnuson-Moss Warranty Act as mandating a "somewhat looser application of Rule 23." Id. at 1003-05. The D.C. Circuit granted interlocutory appeal on the issue of class certification, concluded the district court improperly construed the Magnuson-Moss Warranty Act, and instructed the district court to reexamine whether the variance in state warranty laws prohibited the finding (required for class certification) that common questions of law predominated.

Id. at 1012. However, at no point did the D.C. Circuit suggest that there was no federal cause of action under the Magnuson-Moss Warranty Act.

Thus, it is clear from the statutory language that the Magnuson-Moss Warranty Act creates a private cause of action for a warrantor's failure to comply with the terms of a written warranty, and none of the cases cited by Mercedes support a contrary position. Finally, in this regard, whether the written warranty is full or limited makes no difference. Although the Magnuson-Moss Warranty Act distinguishes between full and limited warranties, it nonetheless refers to each as a written warranty. 15 U.S.C. §2303(a)(1)-(2). Likewise, Section 2301(6) defines a "written warranty" without limiting it to either full or limited warranties, and Section 2310(d)(1) does not limit its application to either full or limited warranties.

B. Milicevic Had a Limited Written Warranty and the District Court's Findings Support the Conclusion that Mercedes Was in Breach of that Warranty

As defined in the Magnuson-Moss Warranty Act, a written warranty is a writing made by the supplier of a product relating to the nature of the material or workmanship of the product, which warranty promises that the product is defect free or will meet a certain level of performance for a given period of time, or a writing in which the supplier agrees to refund, repair, replace, or take other remedial action in the event that the product fails to meet its specifications. 15 U.S.C. §2301(6). Here, Mercedes supplied such a limited written warranty, which by its terms "warrants to the original and each subsequent owner of a new Mercedes-Benz passenger car that any authorized Mercedes-Benz Center will make any repairs or replacements necessary to correct defects in material or workmanship" at no charge for parts or labor.

The district court did not clearly err in finding that two significant nonconformities—the rear window seal and the brakes—were not corrected. A Fletcher Jones mechanic admitted that the rear window seal was a "factory defect," and Mercedes never corrected the defect. And even after the brake pads and rotors were replaced, Milicevic testified the brakes still did not work properly. The district court also found that all of the defects, conditions and non-conformities complained of by plaintiff, which Fletcher Jones was unable to repair, were covered by Mercedes-Benz's said warranty. We are not firmly convinced this was in error. Even though the warranty provides that "normal maintenance" of items was the owner's responsibility, it also states:

> Our intention is to repair under warranty, without charge to you, anything that goes wrong with your car during the warranty period which is our fault? Please note the difference between "defects" and "damage" as used in the warranty. Defects are covered since we, the manufacturer or distributor are responsible.

The rear window seal and brakes were repaired under warranty at no cost to Milicevic. By attempting to repair the rear window seal and the brakes under warranty, Mercedes admitted the defective nature of these conditions. Thus, when it failed to correct the defects in the rear window seal and brakes, Mercedes breached the terms of its limited written warranty in violation of Section 2310(d)(1).

C. The District Court Did Not Abuse Its Discretion in Its Award of Attorneys' Fees

Having made out a claim for relief under the Magnuson-Moss Warranty Act, Milicevic may be awarded reasonable costs and attorneys' fees. 15 U.S.C. §2310(d)(2). With respect to attorneys' fees, the Magnuson-Moss Warranty Act gives courts discretion to award "reasonabl[e]" attorneys' fees "based on actual time expended." Id. The district court did not abuse its discretion when it concluded that the hourly rate requested by Milicevic's attorneys was not reasonable and, thus, eliminated hours it thought were unnecessarily duplicative. American Law Center PC v. Stanley (In re Jastrem), 253 F.3d 438, 443 (9th Cir. 2001). The evidence in the record supports the conclusion that it was not necessary to have both Gellner and Haley prepare for trial in this case. Mercedes informed Gellner of its intent to call Gellner as a witness in advance of trial. Once Gellner knew he might be called to testify, the district court found Gellner could have turned over to Haley the task of trial preparation. Such a finding was well within the discretion of the district court. Further, the case was not overly complicated and did not require any special expertise. Last, the district court was well within its discretion in reducing the hourly rate and hours upon which Milicevic based her attorneys' fee request.

Conclusion

For the foregoing reasons, we affirm the district court's judgment and its award of attorneys' fees.

The M-M Act provided the attorney with fees. The "actual time expended" language is designed to prevent a cost-benefit analysis of attorneys' fees in which a court concludes that it is not "reasonable" for an attorney to charge ten thousand dollars pursuing a remedy for a car that cost only a few thousand dollars. While purchasing a nearly six-figure car is one way to ensure that the remedy is worth the candle, we cannot all drive a Mercedes. Consumer laws aim to keep people out of lemons.

Problem Set 10

10.1. Willett Bird loves to bargain hunt and frequents yard sales in Brooklyn. These are often called "stoop" sales due to the lack of any real yard and are held on the steps of brownstones. Willett recently came across a top-of-the-line, new model eFone for sale for only $15. He visually inspected the product, noting that it was free of scratches, dents, or other obvious problems. He noticed the eFone did not turn on when he pushed the power button. He asked the seller, Kami, if the eFone worked, saying that he really wanted to replace his Robot phone. Kami explained that it probably had a dead battery but that she had thrown out the charger. Willett asked why she was selling the eFone rather than buying a new charger. Kami explained that the eFone was a gift from her former girlfriend and that she wanted to get rid of everything that reminded her of her lost love—charger, phone, everything. Kami offered to throw in a Yankees T-shirt along with the eFone if Willett made the purchase for $15, reassuring him that the eFone was "fine as far as she knew." Willett paid up and later spent $30 purchasing a charger at a retail store. The eFone, however, only held a charge for 10 seconds, no matter how long Willett allowed it to charge. Willett remembers where Kami lives, and he is not happy that his bargain turned out to be a bust. Does a warranty cover this product? If so, what are Willett's remedies? *See* 15 U.S.C. §§2301 and 2310(d); U.C.C. §§2-104(1), 2-313, 2-314, and 2-315, and 2-608; 2-714(2).

10.2. You are an associate at Virginia's largest plaintiff-side law firm. The senior partner has jetted off (literally, he owns a jet due to the firm's lucrative profit from suing businesses in the last few years) and left you with a research project. TechTown, a big-box retailer, sells consumer electronics. For any purchases over $1,000, TechTown requires consumers to complete a warranty information form at the point-of-sale either using the electronic keypad or if the consumer balks, a paper form. The form collects information about the consumer and clearly states the terms of the warranty, including all information in section 2302(a) of the M-M Act. The warranty is labeled "Full Warranty for 5 Days." Is TechTown violating the law? You know the partner will want your advice on maximizing the firm's recovery in a case against a deep-pocket defendant such as TechTown. *See* 15 U.S.C. §§2302(b); 2304; 16 C.F.R. §700.7.

10.3. About a year ago, Everett was driving his Kruz car home from work when he heard a clunking noise in his car. It's a long commute and the freeway was packed. Fearing a breakdown, Everett pulled over and went to the nearest automobile shop with reliable Internet reviews. The mechanic quickly replaced a part, charged $39.99, and got Everett back on the road. Six months later, when the Kruz would not start, despite an effort to jump the battery, Everett called the Kruz dealer where he purchased the car as a new vehicle two years ago. At the service appointment, the Kruz dealer's mechanic, Kris, explained the problem was with the transmission. He quoted $2,178 to fix it, inclusive of parts and labor. Everett was shocked as the car was covered by a "bumper-to-bumper" three-year warranty. Kris stated that Everett had voided the warranty entirely, and handed him the warranty booklet for his vehicle, pointing to this paragraph:

> Have maintenance and repair work performed by your Kruz dealer. Make sure that all work is noted by the repair person in this booklet. These entries are evidence of your vehicle maintenance and are a requirement for warranty claims.

Everett asked to speak to the dealer's owner and questioned whether the transmission problem was related to the part replacement. "Probably not," replied the Kruz dealer, "but you gotta read the fine print in life. We don't want incompetent mechanics ever touching Kruz cars. It's part of how we track problems and ensure quality." Does Everett have any remedy against Kruz? What is the possible extent of Kruz's liability? 15 U.S.C. §§2302; 2310.

10.4. Sohee loves her boyfriend Brian but their relationship is stuck. Sohee resists spending the night at Brian's house, deeming it unusual for its minimalist furnishings. While Sohee doesn't mind bringing things such as travel size Kleenex and a water cup in her overnight bag, she is grossed out by sharing one towel. When the two got into an argument in the middle of Taco Tuesday at a local restaurant, Sohee whipped out her phone and ordered towels from Happy Home using its mobile site. "Problem solved," she announced, particularly pleased that if three towels were purchased together, the price was only $36 total. When the towels arrived, however, Sohee's bliss disappeared. After one washing, most of the fluff disappeared and the towels became threadbare. Sohee contacted Happy Home but they refused to provide a refund. Happy Home directed her to a section on the bottom right of its homepage entitled "Warranty Information." That link forwards to a webpage with this text: "Happy Home disclaims the warranty of merchantability for all products sold on this site. Goods are never returnable." Are the towels covered by a warranty? Does Happy Home's conduct raise liability under any other laws? See U.C.C. §§2-314, 2-316; 16 C.F.R. §702.

Assignment 11. Usury

In nearly every consumer purchase, price is a key term. With goods, there are generally no limits on what a business can charge, assuming it is avoiding anticompetitive pricing that would violate the antitrust laws. With financial products such as loans, price is nearly always regulated. The interest rate that can be charged prevents expensive borrowing.

If that last statement seems wrong to you, it's likely because you have been living in the United States in the last thirty years. Across history, cultures, and geography, the statement is correct that law limits interest rates. It is flatly wrong, however, with respect to the United States today. In most instances, the price of consumer credit is not curbed. Interest rates reflect what lenders believe that consumers are willing to pay to borrow. The modern U.S. approach of unconstrained credit cost is unusual in historical and comparative context.

Usury is the term to describe charging an illegally (or unacceptably) high interest rate. This assignment examines the usury laws that exist in the U.S. and why they have only narrow applicability. We then look at the ongoing policy debates about usury and the reluctance of lawmakers to limit interest rates directly.

A. Historical and Comparative Contexts of Usury

Usury laws are one of the most ancient and primal forms of consumer protection. Steven Mercatante, *The Deregulation of Usury Ceilings, Rise of Easy Credit, and Increasing Consumer Debt*, 53 S.D. L. REV. 37, 39 (2008). The basic tension is between historical beliefs that charging interest is morally wrong and the fact that money lending is necessary for economic growth. The moral issue came into sharp context because of harsh debt collection laws that allowed a creditor to enslave a borrower. The injunctions against usury date back to at least 3000 B.C., and can be found in the Old Testament. The Catholic Church condemned usurious lending, and indeed charging interest was not clearly legalized in England until the mid 1500s. The rate was capped at 10 percent, and later lowered to 5 percent by the Statute of Anne enacted in 1713. A longstanding example of usury can be found in Sharia law, which is based on Islamic teachings.

Exceptions and workarounds were and are common, however, as lenders want to skirt price limits on credit. Some exceptions drew boundaries based on the borrower. For example, traditionally while one Jew could not charge to lend to another, a Jew could make loans with interest to Christians and other non-Jews. Business people lending to each other also were sometimes exempted from usury limits. Other strategies involved characterizing loans as other kinds of transactions; the "interest" was restructured to be a "fee" or the like. Examples are assignments of rents or investments with guaranteed returns. In his book, *Pious Property: Islamic Mortgage in the United States* (2006), Bill Maurer describes how U.S. consumers who follow Sharia law effectively obtain the equivalent of mortgages at an approximate market rate of interest using lease-to-own arrangements or cost-plus contracts for home purchases.

From the colonial period onward, every U.S. state had some form of law limiting the interest rate on at least some categories of loans. The thirteen colonies had annual rates limits between 5 and 8 percent at the time of the Declaration of Independence. Christopher Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, 92 MINN. L. REV. 1110, 1118 tbl. 1 (2008). Usury laws remain on the books in most states today.

Despite the federalization of many laws governing consumer credit, the United States has never had a federal usury law that applied to all consumers. Most other nations do have such a law. Examples are South Africa and Thailand. A useful comparison point for the U.S. is the European Union. At least 14 member states have ceilings on contractual interest rates; these states as well as several others also cap default or penalty interest rates. The maximum rate is usually based on a reference rate that fluctuates with economic conditions, including the nation's central bank policies. The rates also often vary by credit product, from low ceilings in the single digit for mortgages to double digits for shorter-term loans or loans without collateral.

Usury statutes can be civil or criminal. The latter approach reflects the hefty moral component to these laws. Canada has a national usury law that limits the interest rate to 60 percent per year. Canada Criminal Code R.S.C. 1985, c. C-46. An offense is a crime punishable by imprisonment for a term not exceeding five years, or a fine of up to $25,000 or to imprisonment not exceeding six months or both, if found liable on summary conviction. Violating a usury statute, civil or criminal, also typically results in courts refusing to enforce collection of the debt, or at least eliminate the interest component of the debt. Because usury is a defense to the legality of a loan, it is usually raised by people who have not paid. Most violations of usury requirements are not detected, however, because people simply pay the stated rate. It is particularly difficult to enforce usury laws in informal lending, or consumer-to-consumer loans. Ask yourself what rate you charged the last time you agreed to make a loan to your youngest sibling?

B. State Statutes

Most states do have usury laws, but these statutes have a sharply limited reach. The following case describes the Supreme Court decisions that dismantled state usury protections and shows a court trying to look elsewhere in the law to address a perceived wrong that amounts to charging too high of a price for credit.

Citibank (South Dakota), N.A. v. Rosemary Walker DeCristoforo

28 Mass. L. Rptr. 139 (Jan. 4, 2011)

CORNETTA, Judge.

INTRODUCTION

The plaintiff, Citibank (South Dakota), N.A. ("Citibank"), filed the current action for account stated to recover a debt the defendant, Rosemary Walker DeCristoforo ("DeCristoforo"), purportedly owes it with respect to two delinquent credit card accounts. In response, DeCristoforo filed a counterclaim, alleging Citibank charged her interest in an amount greater than allowed by federal law. The matter is currently before the court on the parties' cross motions for summary judgment.…

FACTUAL BACKGROUND

The material facts do not appear to be in dispute. Citibank is a national banking association located in South Dakota. DeCristoforo is an individual residing in Beverly, Massachusetts.

On October 1, 1984, DeCristoforo opened a credit card line of credit with Citibank, which has a current account number ending in 8960 (the "1984 Account"). Almost ten years later, on March 14, 1994, DeCristoforo opened a second credit card line of credit with Citibank, which has a current account number ending in 6865 (the "1994 Account"). DeCristoforo used the 1984 and 1994 Accounts to obtain credit from Citibank to acquire goods, services, and/or cash advances.

Citibank mailed periodic billing statements for the 1984 and the 1994 Accounts to the address DeCristoforo provided. The last payment posted to the 1994 Account on August 14, 2008 in the amount of $316.15. The last payment posted to the 1984 Account on August 20, 2008 in the amount of $812.36. As of March 12, 2009, the outstanding balance on the 1994 Account, as reflected on its monthly statement, was $8,465.69. As of May 7, 2009, the outstanding balance on the 1984 Account, as reflected on its monthly statement, was $25,870.44.

With respect to all unpaid amounts owed under the 1984 Account, as asserted in monthly statements to DeCristoforo, dated January 8, 2001 thru May 7, 2009, Citibank charged interest at annual rates of no less than 14.4% and no greater than 32.24%, exclusive of late fees and other charges. With respect to all unpaid amounts owed under the 1994 Account, as asserted in monthly statements to DeCristoforo, dated July 13/August 13, 2001 thru February 12/March 12, 2009, Citibank charged interest at annual rates of no less than 10.65% and no greater than 54.7333%, exclusive of late fees and other charges.

DISCUSSION

...

In support of summary judgment on her counterclaims, DeCristoforo argues 12 U.S.C. §85 ("Section 85") caps interest at seven percent and that Citibank violated this provision by charging interest, on the 1984 Account, between 14.4% and 32.24%, and on the 1994 Account, between 10.65% and 54.7333%. In response, Citibank contends Section 85 is not applicable in this case because, in accordance with the Supreme Court's holding in *Daggs v. Phoenix Nat'l Bank*, 177 U.S. 549 (1900), this provision only applies where the bank's home state does not allow for any interest. Since Citibank is headquartered in South Dakota and South Dakota allows interest at any rate agreed upon in writing, according to Citibank, it can charge interest at any rate agreed upon between it and its credit card customers. This dispute highlights an issue of national concern—mounting credit card debt and unregulated interest rates, which make paying that debt next to impossible.

A. Section 85

To help finance the Civil War, in 1861, then Treasury Secretary, Salmon P. Chase, recommended the federal government establish a national banking system whereby national banks could be chartered by the federal government and authorized to issue bank notes secured by government bonds. This idea came to fruition a few years later, in 1864, when the National Banking Act was enacted. Section 85 was included in the National Banking Act to protect against usurious interest rates.

Section 85 provides, in relevant part, that

> [a]ny association may…charge on any loan…or upon…other evidences of debt, interest at the rate allowed by the laws of the State…where the bank is located…and no more, except that where by the laws of any State a different rate is limited for banks organized under State laws, the rate so limited shall be allowed for associations organized or existing in any such State under title 62 of the Revised Statutes. When no rate is fixed by the laws of the State…the bank may…charge a rate not exceeding 7 per centum…

12 U.S.C. §85. No decisions interpreting this provision, pertinent to the resolution of the current dispute, were decided until 1900 when the Supreme Court decided *Daggs*.

In *Daggs*, a national bank located in Arizona sought to enforce promissory notes bearing a ten percent interest rate. Id. at 549. In response, Daggs argued Section 85 limited the interest rate to seven percent, if no rate was "fixed" by the laws of the state or territory where the national bank was located. Id. at 554. Because, in Arizona, the interest rate was not "fixed" by the laws of the territory, but by the parties to the notes, Daggs contended the notes were usurious. Id. The Supreme Court disagreed. Id. at 555.

The Supreme Court concluded that the phrase "fixed by the laws," from the second sentence of Section 85, should be construed to mean "allowed by the laws." Id. It reasoned that the "national banks 'were established for the purpose, in part, of providing a currency for the whole country, and in part to create a market for the loans of the general government. It could not have been intended, therefore, to expose them to the hazard of unfriendly legislation by the states, or to ruinous competition with state banks.'" Id. at 555, quoting Tiffany v. National Bank, 18 Wall. 409, 85 U.S. 409 (1873). Under this interpretation, Section 85's interest rate cap is only applicable when the laws of the bank's home state allow no interest rate. See Hawkins v. Citicorp Credit Servs., Inc., 665 F. Sup. 2d 518, 523 (2009).

For all practical purposes, *Daggs* eliminated the protections afforded by Section 85. Following *Daggs*, the national banks were able to charge interest at whatever rate was allowed by the state in which they were located and there was very little uniformity from state to state. Interest rates were lower in states concerned with consumer protection, but much higher in states trying to lure large commercial banks into doing business within their borders. This went on until 1978, when the Supreme Court decided *Marquette v. First Omaha Serv. Corp.*, 439 U.S. 299 (1978).

Marquette involved two banks: Marquette National Bank of Minneapolis ("Marquette"), where the state's usury law capped interest rates for loans at twelve percent; and the First National Bank of Omaha ("First National") in Nebraska, where state laws allowed an interest rate of up to eighteen percent. Id. at 301-03. To make up for the low cap in Minnesota, banks in Minnesota could charge an annual fee, which Marquette did. Id. at 304-05. First National then started marketing its credit cards to Minnesota residents as "no-fee" cards. Id.

Perceiving itself to be at a disadvantage, Marquette sued First National, arguing it was violating Minnesota's usury law. Id. The Supreme Court made two important rulings. First, it concluded that state usury laws do not apply to nationally chartered banks based in other states. See id. at 308. Second, it decided that nationally chartered banks can "export" the interest rates allowed in their home states to customers throughout the country. Id. at 313-14. Under this holding, when a bank from a state without limits on interest issues credit cards to people living in states, which cap credit card interest, the costumer can be charged any rate of interest. See id.

The *Marquette* decision caused unprecedented expansion in the consumer credit industry as large national banks relocated to states with lender-friendly interest rate provisions. Today, all of the major credit card companies are located in a handful of states such as South Dakota, Utah, Arizona, and Delaware where the interest rate caps are either extremely high or nonexistent. Citibank is no exception.

In 1980, during a time of great economic strife in South Dakota, Citibank executives approached the then governor, William Janklow, with a plan. Citibank would move its headquarters to South Dakota, providing hundreds of high-paying white-collar jobs, if South Dakota quickly passed legislation eliminating its interest rate cap. South Dakota responded by passing a new interest rate provision, which provides, in pertinent part, that "[u]nless a maximum interest rate or charge is specifically established elsewhere in the code, there is no maximum interest rate or charge, or usury rate restriction, between or among persons, corporations… associations, or any other entities if they establish the interest rate or charge by written agreement. A written agreement includes the contract created [between a card holder and a card issuer]."

Thereafter, Citibank relocated from New York to South Dakota. Ultimately, this arrangement succeeded beyond the parties' expectations. Citibank's agreement with South Dakota brought 3,000 high-paying jobs to the state and enabled Citibank to become a credit card giant, exporting South Dakota's unregulated interest rate provision to customers around the country, including DeCristoroforo. Merely because Citibank is able to charge interest premised on South Dakota law, which does not cap interest, does not, however, mean Citibank can charge any interest rate. Citibank's interest rate must still comport with common-law concepts of fairness such as unconscionability.

In this case, the parties have not provided the court with a contract identifying a choice of law provision. Thus, the court must use the factors set forth in the Restatement to determine whether South Dakota or Massachusetts has the most significant relationship to the transactions at issue. None of the above factors weigh in favor of applying South Dakota law. Citbank purposely chooses to market its credit card products to Massachusetts residents. DeCristoforo is a resident of Massachusetts. Any contract or agreement between Citibank and DeCristoforo would have been executed in Massachusetts. Most importantly, Massachusetts has a strong public policy interest in ensuring its residents are protected against predatory lending practices, which is more significant than any countervailing interest South Dakota may have in the current dispute.

B. Unconscionability

"The doctrine of unconscionability has long been recognized by common law courts in this country and in England." Waters v. Min Ltd., 412 Mass. 64, 66, 587 N.E.2d 231 (1992), and cases cited. As the Appeals Court aptly explained more than three decades ago:

> Historically, a bargain was considered unconscionable if it was "such as no man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other." Hume v. United States, 132 U.S. 406, 411 (1889), quoting 38 Eng. Rep. 82, 100 (Ch. 1750). Later, a contract was determined unenforceable because unconscionable when "the sum total of its provisions drives too hard a bargain for a court of conscience to assist." Campbell Soup Co. v. Wentz, 172 F.2d 80, 84 (3d Cir. 1948).

Covich v. Chambers, 8 Mass. App. Ct. 740, 750 n. 13, (1979).

Unconscionability is a matter of law decided by the court and must be determined on a case-by-case basis. Zapatha v. Dairy Mart, Inc., 381 Mass. 284, 291, 408 N.E.2d 1370 (1980). Particular attention is addressed to "whether the challenged provision could result in oppression and unfair surprise to the disadvantaged party." Waters, 412 Mass. at 68, quoting Zapatha, 381 Mass. at 292-93, 408 N.E.2d 1370. "The principle is one of prevention of oppression…and not of disturbance of [the] allocation of risks because of superior bargaining power." Zapatha, 381 Mass. at 292, quoting U.C.C. §2-302, cmt. 1. "Oppression" is a matter of the substantive unfairness of the contract; "unfair surprise" means procedural unfairness in the manner in which the contract was concluded. See Id. at 293-95.

Substantive unconscionability occurs when contract terms are unreasonably favorable to one party. See Gilman v. Chase–Manhattan Bank, N.A., 73 N.Y.2d 1 (N.Y. 1988) (stating the question of substantive unconscionability "entails an analysis of the substance of the bargain to determine whether the terms were unreasonably favorable to the party against whom the unconscionability is urged…"). When "a provision of the contract is so outrageous as to warrant holding it unenforceable," unconscionability can be based on the substantive component alone. Id. Meanwhile, procedural unconscionability "requires an examination of the contract formation process and the alleged lack of meaningful choice." Id. at 828.

Although the facts pertaining to the formation of DeCristorforo's credit card agreements are not set forth in the record, the court can fully grasp the one-sided nature of those proceedings. Nevertheless, even putting procedural unconscionability aside, the court concludes this is an instance where unconscionability can be based on the substantive component alone. Id. at 829. The court acknowledges that Citibank's interest rate charges are not always unreasonable. For example, at times, Citibank charged DeCristoforo as little at 10.65%. As time went by, however, Citibank continually increased its rate, especially as DeCristoforo began to fall behind with her payments, until it reached rates as high as 54.7333%. Substantial interest rate hikes such as this have greatly contributed to the consumer credit crisis in America.

With interest rates as high as forty and fifty percent, a significant portion of the debtor's monthly payment goes toward paying interest without touching the underlying debt. At these rates, individuals must make monthly payments for years before putting a dent in their debt, especially when one owes credit balances in excess of $25,000, as is the case with DeCristoforo. Interest charges at these rates drain needed resources and slow economic growth. Citibank's charges, in excess of eighteen percent, "drives too hard a bargain for a court of conscience to assist." Campbell Soup Co., 172 F.2d at 84. The court concludes interest rate charges above eighteen percent are unconscionable and "so outrageous as to warrant holding [them]…unenforceable." Gilman, 537 N.Y.S.2d 787 at 829.

...

Here, it is undisputed that Citibank mailed, to DeCristoforo, monthly statements for the 1984 and the 1994 Accounts. Further, DeCristoforo does not appear to dispute that she made the purchases or accepted the cash advances listed on the account statements. At an initial glance this would seem to support summary judgment in Citibank's favor. However, in her counterclaim, which is discussed above, DeCristoforo objects to the interest rate Citibank charged. Although DeCristoforo is clearly liable for the goods, services, and/or cash advances she incurred under each account, there is no agreement between the parties as to what DeCristoforo actually owes Citibank. Therefore, Citibank's Cross Motion for Summary Judgment will be DENIED.

While unconscionability—that pesky common law—remains a theoretical threat to lenders, as a practical matter, it has not taken hold as a remedy to high credit costs. In response to the above decision, and the court's subsequent judgment against the plaintiff consumer, Citibank appealed. Not content with the principal (the $28,000 awarded), Citibank pursued the principle of the matter. The appellate court noted that the plaintiff had not pleaded unconscionability as an affirmative defense and that the court, acting *sua sponte*, had not even reviewed the credit card agreement (noting without irony that an action for "account stated" does not even require a creditor to produce the debt contract). *Citibank (S.D.) v. DeCristoforo*, 2013 Mass. App. Unpub. LEXIS 576; 2013 WL 2111637, *8 (Mass. App. 2013) (unpublished decision that per court rules may be cited as persuasive but is not precedential).

The court vacated the court's finding that the interest rate charges were unconscionable and remanded for entry of a judgment calculated using the credit card's 18 percent interest rate. Citibank collected $6,000 in additional debt but the moral victory was "priceless" for credit card companies that could return to business as usual.

The current regime still allows nationally-chartered banks to charge what the market will bear for loans, credit cards, and the like to most consumers. But of course, not all loans are made by national banks. The Supreme Court's decision in *Marquette* was an interpretation of the National Banking Act; many smaller lenders are outside its scope. What about state-chartered financial institutions, credit unions, and others? Do state usury laws substantially curb the interest rates they can charge?

A handful of states, including Delaware, Nevada, South Dakota, and Utah, have repealed their usury laws entirely, but most states have some law that limits interest rates. The two statutes below illustrate the framework of usury regulation.

VA. Code. Ann. §6.2-1817. Rate of interest, loan fee, and verification fee.

> A. A licensee may charge and receive on each loan interest at a simple annual rate not to exceed 36 percent. A licensee may also charge (i) a loan fee as provided in subsection B and (ii) a verification fee as provided in subsection C.
>
> B. A licensee may charge and receive a loan fee in an amount not to exceed 20 percent of the amount of the loan proceeds advanced to the borrower.
>
> C. A licensee may charge and receive a verification fee in an amount not to exceed $5 for a loan made under this chapter. The verification fee shall be used in part to defray the costs of submitting a database inquiry [of the borrower's payday loans].

N.C. Gen Stat. §53-173.

> (a) Maximum Rate of Interest.—Every licensee under this section may make loans in installments not exceeding three thousand dollars ($3,000) in amount, at interest rates not exceeding thirty-six percent (36%) per annum on the outstanding principal balance of any loan not in excess of six hundred dollars ($600.00) and fifteen percent (15%) per annum on any remainder of such unpaid principal balance. Interest shall be contracted for and collected at the single simple interest rate applied to the outstanding balance that would earn the same amount of interest as the above rates for payment according to schedule.
>
>> (a1) Maximum Fee.—In addition to the interest authorized in subsection (a) of this section, a licensee making loans under this section may collect from the borrower a fee for processing the loan equal to five percent (5%) of the loan amount not to exceed twenty-five dollars ($25.00), provided that such charges may not be assessed more than twice in any 12-month period.
>>
>> (b) Computation of Interest.—Interest on loans made pursuant to this section shall not be paid, deducted, or received in advance. Such interest shall not be compounded but interest on loans shall (i) be computed and paid only as a percentage of the unpaid principal balance or portion thereof and (ii) computed on the basis of the number of days actually elapsed; provided, however, if part or all of the consideration for a loan contract is the unpaid principal balance of a prior loan, then the principal amount payable under the loan contract may include any unpaid interest on the prior loan which

> have accrued within 90 days before the making of the new loan contract. For the purpose of computing interest, a day shall equal 1/365th of a year. Any payment made on a loan shall be applied first to any accrued interest and then to principal, and any portion or all of the principal balance may be prepaid at any time without penalty.

While these statutes seem pretty sweeping, their scope is limited. One limit comes from the definition of "licensee" found in both laws. Licensee in this context refers to a person (individual or business) who has registered with the state to be in the business of making small-dollar loans. The statutes also permit a variety of charges other than interest. "Processing fees" and "loan fees" are excluded from the rate calculation. Functionally, these charges to consumers increase the return on the loan. Just like interest, they compensate the lender for the cost of originating and extending the loan.

The Supreme Court also waded into the fee-for-all (sorry). It clarified fees charged by lenders are "interest" under the National Banking Act. *Smiley v. Citibank (South Dakota) N.A.*, 517 U.S. 735 (1995). Banks could therefore charge consumers living in all states the fees that would be permissible in the state of their headquarters. The Court included as "interest" a large swath of fees, including late fees, annual fees, over-the-limit fees, cash advance fees, and non-sufficient funds fees. In reaching this conclusion, the Court noted that it was reviewing—with appropriate deference—the regulatory guidance of the Office of the Comptroller of the Currency, the national bank's prudential regulator for safety and soundness. As discussed earlier, fees drive profits, and the OCC was—at best—conflicted on whether curbing fees was sound policy.

Another limit comes from "parity" rules. Arguing that the little guy was getting worse treatment, lenders that were not covered by the National Banking Act, such as state-chartered banks and credit unions, lobbied hard. Through a series of maneuvers, these financial institutions got what they wanted. In 1980, Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), 12 U.S.C. §1735f-7a(a)(1). It stated that the constitution or laws of any State that limited the interest rate or other charges shall not apply to first-lien residential mortgages. The FDIC chimed in with a General Counsel Opinion that DIDMCA allowed federally insured (but state-chartered) institutions to charge the same interest rates as a national bank could. State-chartered banks can now charge a customer whatever interest rates the national banks could charge. Gramm-Leach-Bliley was the final nail in the coffin of state usury laws. It allows a state-chartered bank to charge the greater of the state usury limit or the rate charged by an out-of-state bank that has a branch in Arkansas. Under current law, if a national bank headquartered in South Dakota was charging 38 percent interest to a credit card customer living in Arkansas, a state-chartered bank based in Arkansas can charge the same rate. Despite a state usury statute that capped rates at 17 percent, the state-chartered bank could charge double the rate to an Arkansas resident, simply because a South Dakota-based national bank could charge that rate.

These changes were enacted without a significant public debate about whether usury laws were necessary in a modern consumer credit market. But because parity laws kept intact usury laws (they just dramatically limited their applicability), legislatures can say they did not change the usury limit. They can simply point to the incorrigible Supreme Court and rascally Congress. The result has been described as a *trompe l'oleil*, a deception. James J. White, *The Usury Trompe l'Oleil*, 51 S.C. L. REV. 445 (2000).

The difficulty in creating a debate about usury laws has another dimension: the ways in which the laws are written. Christopher Peterson explains his concept of "salience distortion."

> Because currency is numerical, in any statute that caps the price of a loan, the legislature must at some point pick a number or numbers. While this is true of every usury law, the specific number a legislature chooses only has meaning in relation to other variables associated with the law in question. For example, one legislature might adopt a usury limit of 8% per year while another might adopt a cap of 8% per month. Both legislatures would have chosen to feature the same number in the language of the statute, but the latter cap is twelve times higher than the former because there are twelve months per year.…The point here is simply that if it chooses to do so, a legislature can pick a small number and create a relatively high price limit. Or, it can pick a large number and create a relatively low price limit. Legislatures can feature whatever number they want in a usury law.

Christopher Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, 92 MINN. L. REV. 1110, 1136 (2008). To see this effect, compare the Virginia and North Carolina usury laws on the preceding pages. Which rate cap is lower? Is it possible to answer in the abstract?

In his article, Peterson calculates the annual percentage rate of interest for a $325 payday loan in all states and looks at how the cost of credit would differ from the most prominent (that is, salient) number in the statute. He concludes that "[t]odays' legislature refuse to use numbers transparently reflective of actual credit prices," because triple-digit figures would offend the moral and social norms that have long animated usury laws. *Id.* at 1150.

C. Federal Law

The United States does have a federal usury law that applies to only one group of consumers: servicemembers on activity duty and their dependents. It restricts the cost of credit for loans made on or after October 1, 2007, when the statute and the Department of Defense regulations became effective. The Talent-Nelson amendment, enacted as part of a defense appropriations bill, caught lenders by surprise, although there were a number of reports and hearings focused on predatory lending to servicemembers. National Consumer Law Center, *In Harm's Way At Home: Consumer Scams and the Direct Targeting of America's Military and Veterans* (2003). One particular concern is that financial trouble, such as filing bankruptcy or collection suits, can prevent or eliminate national security clearance. The ostensible fear is that financially-troubled servicemembers are at risk of being bribed to commit treason or similar crimes to scrape up money to pay debts.

The statute imposes a 36 percent cap, called the “military annual percentage rate.”

> (a) Interest. A creditor who extends consumer credit to a covered member of the armed forces or a dependent of such a member shall not require the member or dependent to pay interest with respect to the extension of such credit, except as —
>
> (1) agreed to under the terms of the credit agreement or promissory note;
>
> (2) authorized by applicable State or Federal law; and
>
> (3) not specifically prohibited by this section.
>
> (b) Annual Percentage Rate. A creditor described in subsection (a) may not impose an annual percentage rate of interest greater than 36 percent with respect to the consumer credit extended to a covered member or a dependent of a covered member.

10 U.S.C. §987(i). Congress gave authority to the Department of Defense to define “consumer credit” but made clear that mortgages and car loans were to be excluded from the rate limit. The latter restriction was a source of controversy since used-car lots ring military bases and often charge much higher interest rates than what is typically available farther from base. But without a car at all, it is hard for servicemembers to shop in areas distant from base. In its regulation, the Department of Defense limited “consumer credit” to mean only closed-end loans. 32 C.F.R. §232.3. The difference between closed-end and open-end credit is complex, but essentially open-end credit is freely available at will up to a certain dollar limit. The balance goes up and down, as the account stays open. The credit card is the classic example. The regulations went on to exclude any purchase-money loans from the term “consumer credit.” Purchase-money transactions are when the loan is being taken out to buy an item, and the item is securing the loan as collateral. U.C.C. §9-103.

Consumer advocates were displeased at this narrow definition. The Department of Defense revised its definition to include all forms of credit other than home mortgages and purchase money loans. The new definition is effective on October 1, 2016, except that credit card lenders have another year to comply (and a possible loophole whereby the Secretary of Defense has discretion to further extend the time before credit cards are subject to the MAPR).

In another respect though, the Department of Defense went much further than the statute arguably required. It not only capped the rate at 36 percent, it also prohibited securing the loan by a check, automobile title, bank account or military allotment. Effectively, payday loans and car title loans, which are the subject of upcoming assignments, are completely banned for servicemembers and their dependents. While it is possible that the industry would not have been willing to offer payday or title loans at 36 percent, Congress foreclosed an experiment with what the market would bear. If Congress had stayed silent on the rate and payday or title loans were not profitable at 36 percent, the Department of Defense could have adjusted the rate cap incrementally to the point at which credit became available. Instead, Congress enacted the rate cap structured as a hard limit, without the ability for the Department of Defense to adjust it. Perhaps it would have been better to for Congress to have crisply and broadly defined "consumer credit," which reflects more of a policy choice than the exact appropriate number for an interest rate.

D. Usury as Economic and Social Policy

The moral concerns about interest center on a belief that it is ungodly and uncharitable to profit from another person's need for money. Note the assumptions in this approach: that the lender and borrower are individuals, that the interest rate would be sufficiently high to generate a profit, and that a borrower is a person in dire financial straits. None of these assumptions may hold in the modern U.S. consumer finance market. Most families carrying a credit card balance, and paying 25 percent interest, earn incomes well above the poverty line. Nevertheless, the concerns about high interest rates leaving people mired in chronic poverty continue. Payday loans are a focal point of debate because of eye-popping annualized percentage rates that result from an expensive short-term loan. Nathalie Martin, *1,000% Interest—Good While Supplies Last: A Study of Payday Loan Practices and Solutions*, 52 AZ. L. REV. 563 (2010).

The morality debate about usury also continues, albeit with some twists. Despite the Biblical traditions disfavoring lending money at interest, usury restrictions are non-existent or minimal in locations with states that are politically conservative. As a result, payday lenders thrive in the places where evangelical churches are concentrated, lending to people who are particularly committed to Biblical values. Christopher L. Peterson & Steven M. Graves, *Usury Law and the Christian Right: Faith-Based Political Power and the Geography of the American Payday Loan Regulation*, 57 CATHOLIC UNIV. L. REV. 637 (2008).

At the heart of the debate are two questions: Do usury laws reduce credit, and if so, is this an undesirable outcome? Several studies have examined the first question, which is purely empirical in nature, and the weight of the evidence is that interest rate caps—at least at some level—do limit credit. One solution proffered is to make the usury law a floating cap, set a certain percent above a baseline rate. As the baseline changed, the usury rate would move. While this addresses the serious problem that occurred in the 1970s when interest rates skyrocketed and usury laws remained unchanged, it does not answer the question about the optimal level for a cap.

Setting a usury limit ultimately involves a judgment about the amount of credit that consumers should be able to access. Usury laws likely will limit credit, at least to some degree. But is less borrowing a bad or a good outcome? Some have argued that usury functions as a crude social insurance scheme, protecting people from becoming irretrievably mired in debt. Edward L. Glaeser & Jose Scheinkman, *Neither a Borrower Nor a Lender Be: An Economic Analysis of Interest Restrictions and Usury Law*, 41 J.L. & ECON. 1 (1998). Creditors are not willing to lend to high-risk consumers at a cost that does not cover the risk of nonpayment and generate a profit. Usury laws can substitute for underwriting guidelines that require an assessment of a consumer's ability to repay. Post to

Credit Slips blog by Adam J. Levitin, *Usury Laws Are Dead. Long Live the New Usury Laws. The CFPB's Ability to Repay Mortgage Rule*, Jan. 11, 2013, at http://www.creditslips.org/creditslips/2013/01/usury-laws-are-dead-long-live-the-new-usury-law-the-cfpbs-ability-to-repay-mortgage-rule.html. Rather than looking at creditworthiness on a scale that is matched to price, lenders would simply not make loans when the usury limit did not exceed the anticipated risk and desired profit.

A major study of European Union interest rate regulations found that concerns about reduced access to credit are overreliant on US-based studies where usury laws were not benchmarked to a market rate and were quite low. Study on interest rate restrictions in the EU, Final Report for the EU Commission DG Internal Market and Services, Project No. ETD/2009/IM/H3/87, iff/ZEW (2010). European states typically set rates with reference to a publicly available rate. The EU study also concluded that there is "no convincing" evidence that usury laws lead to a growth in illegal lending or loan sharking, or result in higher default rates. One of the authors summed up the challenge with usury:

> It's about the level at which the ceiling is set. The art or science of this policy issue revolves around establishing an interest rate ceiling sufficiently high to permit borrowers with little security to obtain access to credit but sufficiently low so that lenders do not lend to the most fragile borrowers whose precarious position would be made worse by a larger amount of interest to repay.

Ultimately, the usury debate is probably more normative than empirical, although better empirical evidence about how low-income or financially distressed families use and perceive credit would be helpful. One study found that fifty low-income women had "a profound ambivalence towards the relationship between access and usury caps" and that these consumers were more interested in designing credit products that allowed them to self-direct their use of credit than in the price of credit. Angela Littwin, *Beyond Usury: A Study of Credit Card Use and Preference Among Low-Income Consumers*, 86 TEX. L. REV. 451 2008.

Congress has made very clear that it disdains usury. The Dodd-Frank Act passed in 2010 prohibits the Consumer Financial Protection Bureau from enacting an interest rate limit applicable to state banks and specifies that the current system for national banks of interest rate exportation is undisturbed. *See* §§1027(o); 1044(a).

As discussed in the next assignments, the focus of the current U.S. legal environment is on price disclosure, not price limits. Notwithstanding that, the problems below show that usury can still trip up lenders and their lawyers. Usury is likely to remain a battleground for consumer protection in upcoming decades. Timothy Goldsmith & Nathalie Martin, *Interest Rate Caps, State Legislation, and Public Opinion: Does the Law Reflect the Public's Desires?* 89 CHICAGO KENT L. REV. 115 (2013). While Ohio repealed its usury law in 1995, the legislature reinstated the cap in 2008. In response, lenders sought alternative licenses that let them avoid the 28 percent usury limit. In part because of these evasive tactics and in part because of online lending, scholars continue to point to a federal usury law as a comprehensive and sensible strategy. Brian M. McCall, *Unprofitable Lending: Modern Credit Regulation and the Lost Theory of Usury*, 30 CARDOZO L. REV. 549 (2008).

Problem Set 11

11.1. You take your younger sister Annie out for dinner, and after a couple of cocktails, she blurts out that she needs a loan. You would never charge a family member interest or require a written contract, but you felt compelled as an older sibling to poke into her shenanigans. She confessed that she ran up a number of large credit card bills a couple of years ago when she was “wardrobing” herself for her new job as a photographer’s assistant. After juggling minimum payments for a while, her boyfriend Willow offered to lend her $20,000 to pay off the debts so she could “hang” and “chill” with him without being stressed about the debts. Annie and Willow split up, however, when his family summoned him back to become Ward, the scion of a family-owned private equity firm run. Things have soured between them, and Ward is threatening to sue Annie if she doesn’t return the $20,000. She produces what appears to be a copy of a cocktail napkin, upon which is scrawled “In exchange for $20,000, Annie Chang will repay to Ward Elliot 12 percent per month for 12 consecutive months beginning 12 months from the date below as an investment profit.” Does Annie have a way out of repaying this debt? Your state’s usury statute (Florida) is below.

> Unless otherwise specifically allowed by law, any person making an extension of credit to any person, who shall willfully and knowingly charge, take, or receive interest thereon at a rate exceeding 45 percent per annum, or the equivalent rate for a longer or shorter period of time, whether directly or indirectly, or conspires so to do, commits a felony of the third degree to take interest exceeding 45 percent per annum.

Florida Statute §687.071.

11.2. You are the legislative director for a newly elected Senator, Monica Mendieta, who is planning her first-term agenda. Financial services companies of various types, such as brokerage firms and mutual fund companies, are a major employer in your home state. The Senator breezed in yesterday and dropped an article with this introduction on your desk:

> “Independence Bank’s only branch in Nevada, opened last month, is tucked into the end of a run-down strip mall next to an auto parts store. It has just one ATM, four employees, and is open only Monday to Friday, 9 A.M. to 3 P.M. It will now be the Independence Bank’s official address for ‘regulatory reasons.’”

You avoided the Senator yesterday but you know she’ll be back. Independence Bank has its name on the stadium in your state’s largest city, and a shiny office building downtown. It employs more than 20,000 people and is the largest depository financial institution. In fact, Senator Mendieta’s account and her election account are held there. (You bank at a credit union.) Prepare at least four talking points for the Senator on this issue, including one statement that you would offer to her communications director for media use. Is this legal? Is it moral? Is it politically wise?

Assignment 12. Credit Cost Disclosures

As substantive limits, such as usury, have receded, laws mandating disclosures of the cost of credit have multiplied. The Truth in Lending Act (TILA) is the cornerstone of consumer credit law. It was enacted in 1968 with the hope of improving consumers' knowledge of the cost of borrowing and allowing them to shop on price when borrowing. The statute is primarily designed to be preventative. With a better understanding of the deal before them, consumers can make well-informed decisions and avoid credit problems. Lenders face substantial compliance burdens to complete and disseminate TILA disclosures, but should be rewarded with a more competitive market. Additional information should promote robust competition by letting consumers choose the best loan for their circumstances.

TILA represents a major shift in the orientation of consumer lawmaking. Its focus on disclosure reflects a vision of consumers as empowered actors who can shape a marketplace with their behavior. The goal of law is not to place substantive bounds on credit products but to improve the borrowing process. This approach resists substantive regulation as paternalistic and welfare-reducing and instead focuses on consumers as rational actors who should be allowed to make their own decisions. The role of the law is to ensure that consumers have the necessary information to make their own choices, not to limit their options.

A lively debate exists about the efficacy of disclosure statutes, including TILA, and whether substantive limits such as bans on certain fees or product terms accomplish better outcomes. Consumer advocates and lenders are not necessarily on opposite sides of the disclosure issue. Some advocates advance disclosure as an important consumer remedy, while others see it as a distraction from "real" regulation of credit. Similarly, the financial industry has sometimes proffered additional disclosures in response to consumer protection concerns, while other times lamented disclosure as costly and useless.

A. Basic Concepts in Truth in Lending

Despite a so-called "simplification amendment," TILA remains among the most complex consumer law statutes. It is long, dense, and hard to apply in certain contexts. Because of this, the rules that implement TILA, Regulation Z, are particularly important and useful. Regulation Z includes more than a dozen appendices; the most important of these are model disclosures and permissible language. A substantial body of commentary, most importantly in the form of Official Staff Commentary, also exists for TILA. Upon its creation, the CFPB assumed rulemaking responsibility for Regulation Z, previously held by the Federal Reserve Board. The numbering of Regulation Z was basically kept intact, with only the initial digits changing. So, for example, 12 C.F.R. §226.1 became 12 C.F.R. §1026.1; §226.2 became §1026.2, etc. The cases in this Assignment predate the CFPB and so cite the Federal Reserve Board's Regulation Z and refer to the Federal Reserve Board's authority. Remember that now the CFPB is the agency with TILA authority.

Assignment 3, on the scope of consumer law, examined an important aspect of TILA, which is how it limits its scope to consumer credit transactions. Briefly, the limitations are exclusionary; all credit transactions are subject to TILA unless they are extended "primarily for a business, commercial, or agricultural purpose" or to "other than a natural person." 15 U.S.C. §1603. Large transactions, even to individual persons acting as consumers, also are exempt from TILA, although lenders may comply for the avoidance of any doubt. The dollar threshold is adjusted annually based on an inflation index. The start point for adjustment, doubled in 2010 from its original limit that endured from the passage of TILA in 1968, is now $50,000 for non-mortgage credit. All loans that relate to a consumer's principal dwelling are covered, regardless of amount.

TILA contains different rules for the two major kinds of credit: closed-end and open-end borrowing. It also contains special rules for certain types of loans, most notably home mortgages and credit cards. Part A of TILA, 15 U.S.C. §§1601-1615, provides the key tools for disclosing the cost of credit. It defines the price aspects of credit using three fundamental concepts: finance charge, amount financed, and annual percentage rate.

1. The Finance Charge

The finance charge is the cost of credit as a dollar amount. One can understand it as the price tag for a loan. The other key aspect of a loan is the amount financed. This can be thought of as a price tag for the merchandise (here, a loan) that is being purchased. For example, if I borrow $10,000, that is the amount financed. If the loan is provided at 10 percent simple interest, calculated and payable one year from the loan's origination, the finance charge is $1,000. TILA regulates what goes in each category; the finance charge and the amount financed are mutually exclusive categories. The result is a standardized way of assessing loans and their costs.

A finance charge is defined broadly as "sum of all charges, payable directly or indirectly by the [borrower], and imposed directly or indirectly by the creditor as an incident to the extension of credit." 15 U.S.C. §1605; 12 C.F.R. §1026.4(a). The definition is broad, so as to capture nearly all the costs of the credit. The finance charge reflects both the interest rate and other charges for the transaction. It is a more complete measure of the expense of a loan than the interest rate by itself. The focus is on the borrower's cost, not the creditor's recovery. Charges by third parties (not the creditor) are to be included in the finance charge if the creditor requires the use of a third party for the credit extension or retains a portion of the third-party charge. 12 C.F.R.

§1026.4(a)(1). Regulation Z gives a long list of examples of things that are finance charges. 12 C.F.R. §1026.4(b). The list is illustrative, not exclusive.

Regulation Z also gives a long list of things that are *not* finance charges. 12 C.F.R. §1026.4(c)-(e). These are not examples but rather definitive exclusions. Items not on the list are usually finance charges if the basic definition applies. The simplest way to exclude something from the finance charge is to determine that the cost would be "payable in a comparable cash transaction." 15 U.S.C. §1605. This is redundant, however, because the definition of a finance charge requires that the charge be imposed as an "incident to the extension of credit." *Id*. Examples of charges that would be imposed by the creditor in either cash or credit sales are sales tax and a license fee for the purchase of a vehicle. These are not finance charges (although keep reading to see how they appear in a TILA disclosure).

The definitional boundaries of the finance charge remain contested. Forty years after the enactment of TILA, such disputes still make their way to the Supreme Court.

Household Credit Servs. v. Pfenning

541 U.S. 232 (2004)

THOMAS, Justice.

Congress enacted the Truth in Lending Act (TILA), in order to promote the "informed use of credit" by consumers. 15 U.S.C. §1601(a). To that end, TILA's disclosure provisions seek to ensure "meaningful disclosure of credit terms." Ibid. Further, Congress delegated expansive authority to the Federal Reserve Board (Board) to enact appropriate regulations to advance this purpose. §1604(a). We granted certiorari, 539 U.S. 957 (2003), to decide whether the Board's Regulation Z, which specifically excludes fees imposed for exceeding a credit limit (over-limit fees) from the definition of "finance charge," is an unreasonable interpretation of §1605. We conclude that it is not, and, accordingly, we reverse the judgment of the Court of Appeals for the Sixth Circuit.

I.

Respondent, Sharon Pfennig, holds a credit card initially issued by petitioner Household Credit Services, Inc. (Household), but in which petitioner MBNA America Bank, N. A. (MBNA), now holds an interest through the acquisition of Household's credit card portfolio. Although the terms of respondent's credit card agreement set respondent's credit limit at $2,000, respondent was able to make charges exceeding that limit, subject to a $29 "over-limit fee" for each month in which her balance exceeded $2,000.

TILA regulates, *inter alia*, the substance and form of disclosures that creditors offering "open end consumer credit plans" (a term that includes credit card accounts) must make to consumers, §1637(a), and provides a civil remedy for consumers who suffer damages as a result of a creditor's failure to comply with TILA's provisions, §1640. When a creditor and a consumer enter into an open-end consumer credit plan, the creditor is required to provide to the consumer a statement for each billing cycle for which there is an outstanding balance due. §1637(b). The statement must include the account's outstanding balance at the end of the billing period, §1637(b)(8), and "[t]he amount of any finance charge added to the account during the period, itemized to show the amounts, if any, due to the application of percentage rates and the amount, if any, imposed as a minimum or fixed charge," §1637(b)(4). A "finance charge" is an amount "payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by the creditor as an incident to the extension of credit." §1605(a). The Board has interpreted this definition to exclude "[c]harges…for exceeding a credit limit." See 12 C.F.R. §226.4(c)(2) (2004) (Regulation Z). Thus, although respondent's billing statement disclosed the imposition of an over-limit fee when she exceeded her $2,000 credit limit, consistent with Regulation Z, the amount was not included as part of the "finance charge."

On August 24, 1999, respondent filed a complaint in the United States District Court for the Southern District of Ohio on behalf of a purported nationwide class of all consumers who were charged or assessed over-limit fees by petitioners. Respondent alleged in her complaint that petitioners allowed her and each of the other putative class members to exceed their credit limits, thereby subjecting them to over-limit fees. Petitioners violated TILA, respondent alleged, by failing to classify the over-limit fees as "finance charges" and thereby "misrepresented the true cost of credit" to respondent and the other class members. Petitioners moved to dismiss the complaint pursuant to Federal Rule of Civil Procedure 12(b)(6) on the ground that Regulation Z specifically excludes over-limit fees from the definition of "finance charge." 12 C.F.R. §226.4(c)(2) (2004). The District Court agreed and granted petitioners' motion to dismiss.

On appeal, respondent argued, and the Court of Appeals agreed, that Regulation Z's explicit exclusion of over-limit fees from the definition of "finance charge" conflicts with the plain language of 15 U.S.C. §1605(a). The Court of Appeals first noted that, as a remedial statute, TILA must be liberally interpreted in favor of consumers. 295 F.3d 522, 528 (6th Cir. 2002). The Court of Appeals then concluded that the over-limit fees in this case were imposed "incident to the extension of credit" and therefore fell squarely within §1605's definition of "finance charge." Id., at 528-529. The Court of Appeals' conclusion turned on the distinction between unilateral acts of default and acts of default resulting from consumers' requests for additional credit, exceeding a predetermined credit limit, that creditors grant. Under the Court of Appeals' reasoning, a penalty imposed due to a unilateral act of default would not constitute a "finance charge." Id., at 530-531. Respondent alleged in her complaint, however, that petitioners "allowed [her] to make charges and/or assessed [her] charges that allowed her balance to exceed her credit limit of two thousand dollars," putting her actions under the category of acts of default resulting from consumers requests for additional credit, exceeding a predetermined credit limit, that creditors grant. The Court of Appeals held that because petitioners "made an additional extension of credit to [respondent] over and above the alleged 'credit limit,'" id., and charged the over-limit fee as a condition of this additional extension of credit, the over-limit fee clearly and unmistakably fell under the definition of a “finance charge.” 295 F.3d, at 530. Based on its reading of respondent’s allegations, the Court of Appeals limited its holding to “those instances in which the creditor knowingly permits the credit card holder to exceed his or her credit limit and then imposes a fee incident to the extension of that credit.” Id., at 532, n.5.

II.

Congress has expressly delegated to the Board the authority to prescribe regulations containing “such classifications, differentiations, or other provisions” as, in the judgment of the Board, “are necessary or proper to effectuate the purposes of [TILA], to prevent circumvention or evasion thereof, or to facilitate compliance therewith.” §1604(a).…[T]wice since the passage of TILA, Congress has made this intention clear: first by providing a good-faith defense to creditors who comply with the Board’s rules and regulations, 88 Stat. 1518, codified at 15 U.S.C. §1640(f), and, second, by expanding this good-faith defense to creditors who conform to “any interpretation or approval by an official or employee of the Federal Reserve System duly authorized by the Board to issue such interpretations or approvals,” 90 Stat. 197, codified as amended, at §1640(f). 444 U.S., at 566-567.

Respondent does not challenge the Board’s authority to issue binding regulations. Thus, in determining whether Regulation Z’s interpretation of TILA’s text is binding on the courts, we are faced with only two questions. We first ask whether “Congress has directly spoken to the precise question at issue.” Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842 (1984). If so, courts, as well as the agency, “must give effect to the unambiguously expressed intent of Congress.” Id., at 842-843. However, whenever Congress has “explicitly left a gap for the agency to fill,” the agency’s regulation is “given controlling weight unless [it is] arbitrary, capricious, or manifestly contrary to the statute.” Id., at 843-844.

A.

TILA itself does not explicitly address whether over-limit fees are included within the definition of “finance charge.” Congress defined “finance charge” as “all charges, payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by the creditor as an incident to the extension of credit.” §1605(a). The Court of Appeals, however, made no attempt to clarify the scope of the critical term “incident to the extension of credit.” The Court of Appeals recognized that, “‘[i]n ascertaining the plain meaning of the statute, the court must look to the particular statutory language at issue, as well as the language and design of the statute as a whole.’” Id., at 529-530 (quoting Kmart Corp. v. Cartier, Inc., 486 U.S. 281, 291 (1988)). However, the Court of Appeals failed to examine TILA’s other provisions, or even the surrounding language in §1605, before reaching its conclusion. Because petitioners would not have imposed the over-limit fee had they not “granted [respondent’s] request for additional credit, which resulted in her exceeding her credit limit,” the Court of Appeals held that the over-limit fee in this case fell squarely within §1605(a)’s definition of “finance charge.” 295 F.3d, at 528-529. Thus, the Court of Appeals rested its holding primarily on its particular characterization of the transaction that led to the over-limit charge in this case.

The Court of Appeals' characterization of the transaction in this case, however, is not supported even by the facts as set forth in respondent's complaint. Respondent alleged in her complaint that the over-limit fee is imposed for each month in which her balance exceeds the original credit limit. If this were true, however, the over-limit fee would be imposed not as a direct result of an extension of credit for a purchase that caused respondent to exceed her $2,000 limit, but rather as a result of the fact that her charges exceeded her $2,000 limit at the time respondent's monthly charges were officially calculated. Because over-limit fees, regardless of a creditor's particular billing practices, are imposed only when a consumer exceeds his credit limit, it is perfectly reasonable to characterize an over-limit fee not as a charge imposed for obtaining an extension of credit over a consumer's credit limit, but rather as a penalty for violating the credit agreement.

The Court of Appeals thus erred in resting its conclusion solely on this particular characterization of the details of credit card transactions, a characterization that is not clearly compelled by the terms and definitions of TILA, and one with which others could reasonably disagree. Certainly, regardless of how the fee is characterized, there is at least some connection between the over-limit fee and an extension of credit. But, this Court has recognized that the phrase "incident to or in conjunction with" implies some *necessary* connection between the antecedent and its object, although it "does not place beyond rational debate the nature or extent of the required connection." Holly Farms Corp. v. NLRB, 517 U.S. 392, 403, n. 9 (1996) (internal quotation marks omitted). In other words, the phrase "incident to" does not make clear whether a substantial (as opposed to a remote) connection is required. Thus, unlike the Court of Appeals, we cannot conclude that the term "finance charge" unambiguously includes over-limit fees. That term, standing alone, is ambiguous.

Moreover, an examination of TILA's related provisions, as well as the full text of §1605 itself, casts doubt on the Court of Appeals' interpretation of the statute. A consumer holding an open-end credit plan may incur two types of charges—finance charges and "other charges which may be imposed as part of the plan." §§1637(a)(1)-(5). TILA does not make clear which charges fall into each category. But TILA's recognition of at least two categories of charges does make clear that Congress did not contemplate that *all* charges made in connection with an open-end credit plan would be considered "finance charges." And where TILA does explicitly address over-limit fees, it defines them as fees imposed "in connection with an extension of credit," §1637(c)(1)(B)(iii), rather than "incident to the extension of credit," §1605(a). Furthermore, none of §1605's specific examples of charges that fall within the definition of "finance charge" includes over-limit or comparable fees. See, e.g., §1605(a)(2) ("[s]ervice or carrying charge"); §1605(a)(3) (loan fee or similar charge); §1605(a)(6) (mortgage broker fees).

As our prior discussion indicates, the best interpretation of the term "finance charge" may exclude over-limit fees. But §1605(a) is, at best, ambiguous, because neither §1605(a) nor its surrounding provisions provides a clear answer. While we acknowledge that there may be some fees not explicitly addressed by §1605(a)'s definition of "finance charge" but which are unambiguously included in or excluded by that definition, over-limit fees are not such fees.

B.

Because §1605 is ambiguous, the Board's regulation implementing §1605 "is binding in the courts unless procedurally defective, arbitrary or capricious in substance, or manifestly contrary to the statute." United States v. Mead Corp., 533 U.S. 218, 227 (2001).

Regulation Z's exclusion of over-limit fees from the term "finance charge" is in no way manifestly contrary to §1605. Regulation Z defines the term "finance charge" as "the cost of consumer credit." 12 C.F.R. §226.4 (2004). It specifically excludes from the definition of "finance charge" the following:

> "(1) Application fees charged to all applicants for credit, whether or not credit is actually extended.
>
> "(2) Charges for actual unanticipated late payment, *for exceeding a credit limit*, or for delinquency, default, or a similar occurrence.
>
> "(3) Charges imposed by a financial institution for paying items that overdraw an account, unless the payment of such items and the imposition of the charge were previously agreed upon in writing.
>
> "(4) Fees charged for participation in a credit plan, whether assessed on an annual or other periodic basis.
>
> "(5) Seller's points.
>
> "(6) Interest forfeited as a result of an interest reduction required by law on a time deposit used as security for an extension of credit.
>
> "(7) [Certain fees related to real estate.]
>
> "(8) Discounts offered to induce payment for a purchase by cash, check, or other means, as provided in section 167(b) of the Act." §226.4(c).

The Board adopted the regulation to emphasize "disclosures that are relevant to credit decisions, as opposed to disclosures related to events occurring after the initial credit choice," because "the primary goals of the [TILA] are not particularly enhanced by regulatory provisions relating to changes in terms on outstanding obligations and on the effects of the failure to comply with the terms of the obligation." 45 Fed. Reg. 80 649 (1980). The Board's decision to emphasize disclosures that are most relevant to a consumer's initial credit decisions reflects an understanding that "[*m*]*eaningful* disclosure does not mean *more* disclosure," but instead "describes a balance between 'competing considerations of complete disclosure…and the need to avoid…[informational overload].'" Ford Motor Credit Co., 444 U.S., at 568 (quoting S. Rep. No. 96-73, p. 3 (1979)). Although the fees excluded from the term "finance charge" in Regulation Z (*e.g.*, application charges, late payment charges, and over-limit fees) might be relevant to a consumer's credit decision, the Board rationally concluded that these fees—which are not automatically recurring or are imposed only when a consumer defaults on a credit agreement—are less relevant to determining the true cost of credit. Because over-limit fees, which are imposed only when a consumer breaches the terms of his credit agreement, can reasonably be characterized as a penalty for defaulting on the credit agreement, the Board's decision to exclude them from the term "finance charge" is surely reasonable.…

Congress has authorized the Board to make "such classifications, differentiations, or other provisions, and [to] provide for such adjustments and exceptions for any class of transactions, as in the judgment of the Board are necessary or proper to effectuate the purposes of [TILA], to prevent circumvention or evasion thereof, or to facilitate compliance therewith.” §1604(a). Here, the Board has accomplished all of these objectives by setting forth a clear, easy to apply (and easy to enforce) rule that highlights the charges the Board determined to be most relevant to a consumer’s credit decisions. The judgment of the Court of Appeals is therefore reversed.

It is so ordered.

The court’s opinion illustrates the deference to Regulation Z that is typical in TILA litigation. With the CPFB now in charge of TILA, these regulations may change in ways that are more favorable to consumers. The emphasis on a rule that is easy to apply seems likely to persist, however, given the huge number of transactions and creditors to which TILA applies.

As a reminder, TILA does not limit the amount of a finance charge. It can be low or high; it must only be accurately calculated and correctly disclosed to the consumer.

2. Amount Financed

The “amount financed” is the second key component of TILA’s price disclosures. TILA suggests labeling the amount financed as “the amount of credit provided to you.” 12 C.F.R. §1026.18(b). The principal of the loan is usually the largest component of the amount financed. But in the same way that the interest rate is part of the finance charge but not fully equivalent to that term, the principal amount of a loan is not the entirety of the amount financed. A simple construction of the amount financed is that it is the principal loan amount plus financed fees that are not part of the finance charge. An example of charges that are included in the amount financed (and excluded, as noted earlier, from the finance charge) are sales tax and license fees that are being financed as part of a vehicle purchase. Other aspects of a transaction that are not part of the amount financed are down payments or trade-in value, or any prepaid finance charges.

3. Annual Percentage Rate

The annual percentage rate (APR) is derived from the finance charge, the amount financed, and the payment schedule. It is a mathematical transformation of those numbers into the cost of the credit expressed as a yearly rate. The APR will almost never be identical to the stated interest rate in a promissory note because charges other than interest are included in the finance charge upon which APR is based. While some people explain the APR as the finance charge expressed as a percentage, that definition is not accurate. The amount financed and the payment schedule both influence APR. In its *Truth-in-Lending Examination Manual* (April 2015), the CFPB offers an illustrative example of how APR is not merely a transformation of the finance charge.

- For loan 1, the amount financed is $5,000 with a payment schedule of 36 equal monthly payments of $166.07 each.
- For loan 2, the amount financed is $4,500, and the payment schedule is 35 equal monthly payments of $152.18 and 1 final payment of $152.22.

Begin by calculating the finance charge for each loan. (Hint: For loan 1, take 36 x 166.07, and subtract 5,000 from the result. Repeat process for loan 2.) Notice anything? (If what you are noticing is feelings of anxiety about math, rest assured that this is about the deepest this book goes into credit calculations.)

The amount financed for each loan is identical ($978.52). But if you were to calculate the APR for each loan, it would be different. It would be 12 percent for loan 1, but 13.26 percent on loan 2. The difference reflects the amount being financed and the payment schedule, specifically when the loan would be amortized (the balance brought to zero through payments). The determination of APR is complex enough that federal banking regulator, the Office of the Comptroller of the Currency, offers an entire downloadable program to calculate it, and many vendors sell APR software to lenders. Because today nearly all creditors use computer programs to calculate APRs, errors in APR disclosures usually mirror an underlying error in determining the finance charge or the amount financed, rather than a mathematical mistake.

B. Distinguishing Closed-End Credit and Open-End Credit

The disclosure requirements differ for closed-end and open-end credit. Generally, more information is required to be disclosed in a closed-end transaction and the disclosure gives consumers a more detailed and complete breakdown of the loan's cost.

TILA does not use the term "closed-end" credit; instead, it refers only to credit "other than open-end credit." If the finance charge can be conclusively determined at the time of the transaction, it is a closed-end loan. To be open-end credit, the credit plan must provide for a finance charge that may be computed from time to time on an outstanding unpaid balance. TILA also defines open-end credit to arise when a creditor "reasonably contemplates" repeated transactions. 15 U.S.C. §1602(i). A creditor cannot simply deem something to be open-end credit to reduce its compliance burden. Rather, it is a question of fact whether a transaction is open-end or closed-end. 12 C.F.R. §1026, Supp. I, §(a)(20)(3).

Closed-end credit transactions require the disclosure of six main items. Three of these are discussed above: the finance charge, the amount financed, and the APR. The other three items are the payment schedule, the total of the payments, and information about a security interest, if applicable because the creditor is taking collateral on the loan.

Open-end credit transactions require initial disclosures and periodic disclosures. Because at the time of the account opening, it is not known how much credit the consumer will use, the open-end disclosures provide a less definitive price tag for borrowing than closed-end disclosures. The terms and structure of open-end loans tend to vary significantly, and TILA requires disclosure of items only if applicable to the transaction. 12 C.F.R. §1026.6. The following should be disclosed in an initial disclosure on an open-end loan:

1) The conditions under which a finance charge may be imposed, including whether there is a grace period for a consumer to pay to avoid a finance charge and if so, the length of that period;
2) the method of determining the balance upon which the finance charge will be imposed;
3) the method of determining the amount of the finance charge;
4) all "periodic rates," and the corresponding nominal annual percentage rates, and the balance amounts that trigger the applicability of a particular rate; and
5) other charges that may be imposed, such as penalty fees, account fees, and minimum finance charges.

As with closed-end credit, if a security interest is being taken as part of the transaction, that fact and information about the security interest must be given.

The periodic statements for open-end credit provide detail on the state of the open-end credit plan in the prior period and where it stands as of the billing date. 12 C.F.R. §1026.7. For example, the statement shows the beginning and ending balance, the due date, and the creditor's address. Detail on the amount and date of each credit extension also is required. 12 C.F.R. §1026.8.

The accuracy of the finance charge and APR calculations need not always be perfect. The threshold for errors varies for open-end and closed-end credit. Here are a few of the most important rules. With regard to the finance charge, it must be completely accurate with regard to open-end credit, while for closed-end credit, the finance charge is accurate if it is within $10 in either direction of the exact finance charge if the amount financed exceeds $1,000 and within $5 in either direction if the amount financed is less than or equal to $1,000. 12 C.F.R. §1026.18(d)(2). For APR, the rules are even more complicated, in part because there are tolerances for both open-end and closed-end credit, as well as special tolerances for mortgage loans (which are covered in Assignment 16). The easiest rule is that for an open-end account the disclosed APR is accurate if it is within 1/8th of one percentage point of the correctly calculated APR. Closed-end credit is more complicated, distinguishing between "regular" and "irregular" transactions. The general proposition is that there is a higher tolerance for irregular loans because the APR calculation is more complex. 15 U.S.C. §1606(c); 12 C.F.R. §1026.22(a)(2).

C. Disclosure Design and Delivery

For closed-end credit, the APR and the finance charge must be disclosed "more conspicuously" than other disclosures required by TILA. 12 C.F.R.

§1026.17(a)(2). While you may wonder how something becomes *more* conspicuous, TILA mandates that all its disclosures should be "clear and conspicuous." 15 U.S.C. §1632(a); 12 C.F.R. §1026.17(a)(1). The idea is that these two key price-tag disclosures stand out. For open-end credit, the finance charge need only be garden-variety conspicuous, rather than more conspicuous. 12 C.F.R. §1026.5(a)(1). This rule is simple enough for the law student who need only memorize the different standard for the exam; the tough part is for creditors to figure out how to actually design and deliver disclosures that are in compliance. Then there is the seemingly simple process of delivering the disclosure to the consumer, even if all the numbers are calculated correctly.

Smith v. Cash Store Mgmt., Inc.

195 F.3d 325 (7th Cir. 1999)

FLAUM, Circuit Judge.

Valerie Smith sued The Cash Store, Ltd.; The Cash Store Management, Inc.; and The Cash Store Management, Inc.'s officers and directors (collectively "Cash Store") on behalf of a putative class for violations of the Truth in Lending Act ("TILA"), 15 U.S.C. §1601 et seq., and Illinois state contract law and consumer fraud statutes. This is an appeal from the district court's dismissal of Smith's suit for failure to state a claim under TILA. For the reasons set forth below, we affirm in part and reverse in part.

BACKGROUND

Cash Store operates at least sixteen loan establishments in Illinois. These establishments specialize in making short-term, high interest "payday loans," typically two weeks in duration and carrying annual percentage rates greater than 500%. When a Cash Store customer is granted a loan, the customer writes out a check, post-dated to the end of the loan period, for the full amount that he is obligated to pay. At the end of the two-week period, the customer has the option of continuing the loan for an additional two-week period by paying the interest.

Between June 13, 1998 and September 19, 1998, Smith obtained eight such loans from Cash Store. On each occasion she signed a standard "Consumer Loan Agreement" form. Each loan agreement stated an annual interest rate of 521%. Each loan agreement also contained the statement: "Security. Your post-dated check is security for this loan." Upon entering into or renewing each loan, Cash Store stapled to the top of the loan agreement a receipt which labeled the finance charge in red ink as either a "deferred deposit extension fee" or a "deferred deposit check fee," depending on whether the transaction was a renewal or an original loan.

The details of the loan agreement are important because the content and presentation of such agreements are regulated under TILA, 15 U.S.C. §1601 et seq., and implementing Federal Reserve Board Regulation Z ("Regulation Z"), 12 C.F.R. §226. Congress enacted TILA to ensure that consumers receive accurate information from creditors in a precise, uniform manner that allows consumers to compare the cost of credit from various lenders. 15 U.S.C. §1601; Anderson Bros. Ford v. Valencia, 452 U.S. 205, 220 (1981). Regulation Z mandates that: "The creditor shall make the disclosures required by this subpart clearly and conspicuously in writing, in a form that the consumer may keep. The disclosures shall be grouped together, shall be segregated from everything else, and shall not contain any information not directly related to the [required] disclosures.…" 12 C.F.R. §226.17(a)(1). The mandatory disclosures, which must be grouped in a federal disclosure section of a written loan agreement, include, among other things, the finance charge, the annual percentage rate, and any security interests that the lender takes. 12 C.F.R. §226.18.

On March 16, 1999, Smith filed a class action complaint, amended on April 6, 1999, against Cash Store in the United States District Court for the Northern District of Illinois. She sued on behalf of a putative class for violations of TILA, for relief from an unconscionable loan contract, and for violations of the Illinois Consumer Fraud Act. The district court dismissed with prejudice the TILA claims for failure to state a claim upon which relief can be granted, Fed. R. Civ. P. 12(b)(6), and then exercised its discretion to dismiss without prejudice the remaining supplemental state claims, as permitted by 28 U.S.C. §1367(c)(3).

DISCUSSION

Smith argues on appeal that two of Cash Store's practices violate TILA, and that the district court's dismissal of the claims was therefore erroneous. The first practice relates to the receipts that Cash Store routinely stapled to the top of Smith's loan agreements. Smith contends that the receipts physically obscured the required federal disclosures and that they characterized the finance charges in a misleading way. The second practice relates to the security interest disclosures, which Smith contends were inaccurate. We address each of these allegations in turn.

THE RECEIPT CLAIM

TILA requires that a creditor make the required disclosures "clearly and conspicuously in writing.…" 12 C.F.R. §226.17. Smith alleges that the cash register receipt that Cash Store stapled to the upper left-hand corner of the loan agreements physically covered up some of the required disclosures. Furthermore, on her receipts were printed, in red, the terms "deferred deposit extension fee" or "deferred deposit check fee," whereas the term "finance charge" is used in the federal disclosure box. Smith argues that both of these practices render the required disclosures on the loan agreement neither "clear" nor "conspicuous."

The district court dismissed the claim relating to the Cash Store receipt on the ground that the allegations did not state a cause of action. It held that neither Cash Store's stapling of a receipt to the loan documents nor the printed contents of the receipt violated TILA, having found that "Cash Store's practice of stapling a small receipt to its TILA disclosures could not reasonably confuse or mislead Smith as to the terms of the loan." Smith v. Cash Store Mgmt., Inc., No. 99 C 1726, (N.D. Ill. June 8, 1999).

A complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts to support his claim which would entitle him to relief. Conley v. Gibson, 355 U.S. 41, 45-46 (1957).…As we recently stated, "Rule 12(b)(6) should be employed only when the complaint does not present a legal claim." Johnson v. Revenue Mgmt. Corp., 169 F.3d 1057, 1059 (7th Cir. 1999). Because the district court may not dismiss the complaint under Rule 12(b)(6) unless it is legally insufficient, we review that decision de novo. Caremark, 113 F.3d at 648.

As noted above, Regulation Z requires that "[t]he creditor shall make the disclosures required by this subpart clearly and conspicuously." 12 C.F.R §226.17. The "sufficiency of TILA-mandated disclosures is to be viewed from the standpoint of an ordinary consumer, not the perspective of a Federal Reserve Board member, federal judge, or English professor." Cemail v. Viking Dodge, 982 F. Supp. 1296, 1302 (N.D. Ill. 1997).

Whether or not Cash Store's practices run afoul of Regulation Z is a factual issue, and the district court therefore erred in dismissing the receipt claims under Rule 12(b)(6). In her amended complaint, Smith contends that the stapled receipt contradicted and obfuscated the required disclosures. Am. Compl., ¶19. Her claim may fail on the facts, "but assessing factual support for a suit is not the office of Rule 12(b)(6)." Johnson, 169 F.3d at 1059. Although our holding does not preclude Cash Store from arguing, at the summary judgment stage, that Smith cannot prove her claims, Smith's complaint alleging that the stapled receipt obscured the disclosures and that the printed contents of the receipt were confusing or misleading states a valid legal claim under TILA, and that is sufficient to pass Rule 12(b)(6) scrutiny.

The Security Interest Claim

Smith also contends that the district court erred in holding that Cash Store's statement, "Your post-dated check is security for this loan," was a lawful disclosure under TILA. TILA requires creditors to disclose accurately any security interest taken by the lender and to describe accurately the property in which the interest is taken. 15 U.S.C. §1638; 12 C.F.R. §226.18. Regulation Z defines "security interest" as "an interest in property that secures performance of a consumer credit obligation and that is recognized by state or federal law." 12 C.F.R. §226.2(a)(25). Smith contends that Cash Store's statement in the loan agreement violates TILA because, under Illinois law, the check does not serve as security.

Subject to narrow exceptions, "hypertechnicality reigns" in the application of TILA. Cowen v. Bank United of Texas, FSB, 70 F.3d 937, 941 (7th Cir. 1995). Regulation Z specifies that certain federal disclosures must be grouped together in the loan agreement and also directs that the agreement "not contain any information not directly related to the [required] disclosures." 12 C.F.R. §226.17(a)(1). In Bizier v. Globe Financial Services Inc., the First Circuit explained that overinclusive security interest disclosures "cannot be dismissed as de minimis or hypertechnical." Overinclusive disclosures might deter a borrower's "future borrowing or property acquisition out of an exaggerated belief in the security interest to which they would be subject, or [give] a lender an apparent right which, even if ultimately unenforceable, could serve as a significant bargaining lever in any future negotiations concerning rights or obligations under the loan." 654 F.2d 1, 3 (1st Cir. 1981); see also Tinsman v. Moline Beneficial Fin. Co., 531 F.2d 815, 818-19 (7th Cir. 1976) (holding that an overbroad disclosure of security interests violated TILA). All TILA disclosures must be accurate, Gibson v. Bob Watson Chevrolet-Geo, Inc., 112 F.3d 283, 285 (7th Cir. 1997), and lenders are generally strictly liable under TILA for inaccuracies, even absent a showing that the inaccuracies are misleading, Brown v. Marquette Savings and Loan Assoc., 686 F.2d 608, 614 (7th Cir. 1982). Smith contends that if the check that Smith handed over upon agreeing to the loan does not give Cash Store a security interest, then its statement to that effect violates TILA.

Cash Store first responds that the check acts as "security" because it gives Cash Store alternate routes to collect its debt. The check might facilitate payment because the loan agreement provides that Cash Store may deposit it on the loan due date if another form of payment is not made. If the check were to bounce, Cash Store could sue Smith under Illinois "bad check" statutes. According to Cash Store, the check then "secures" the loan by making repayment easier or by placing Cash Store in a stronger litigating position under Illinois law if Smith does not pay back the loan. Hence, the statement "Security: Your post-dated check is security for this loan" is accurate, and perhaps even required under TILA.

This argument, standing alone, is incomplete because it confuses "security" with "security interest." True, Cash Store may be in a better position with the check than without it, and in that sense it may regard its loan as more "secure." But this is a broader sense of "security" than that contemplated by Regulation Z. The regulations define "security interest"—which is a term of art referring to a specific class of transactions—as "an interest in property that secures performance of a consumer credit obligation and that is recognized by state or federal law." 12 C.F.R. §226.2(a)(25). Illinois commercial law, in turn, defines it as "an interest in personal property… which secures payment or performance of an obligation." 810 ILCS 5/1-201(37). By creating a security interest through a security agreement, a debtor provides that a creditor may, upon default, take or sell the property—or collateral—to satisfy the obligation for which the security interest is given. 810 ILCS 5/9-105(1)(c) ("'Collateral' means the property subject to a security interest, and includes accounts and chattel paper which have been sold"). Because TILA restricts what information a lender can include in its federal disclosures, the question before us is not simply whether the post-dated check makes repayment more likely ("security") but whether it can meet the statutory requirements of "collateral" ("security *interest*").

Cash Store also maintains that Article 9 of the Illinois Uniform Commercial Code ("Illinois U.C.C."), which governs secured transactions, applies "to any transaction (regardless of its form) which is intended to create a security interest in personal property…including…instruments." 810 ILCS 5/9-102(1)(a). Because the check is an instrument, it can be used to create a security interest by the terms of the Illinois U.C.C. See In re Brigance, 234 B.R. 401, 404-05 (W.D. Tenn. 1999) (holding that, under Tennessee's U.C.C., a borrower's personal check can serve as collateral in which a security interest can be obtained).

We again believe that this argument is incomplete. While Article 9 of the Illinois U.C.C. generally authorizes the use of instruments as collateral to secure a loan, it is not immediately clear whether this provision applies to a post-dated check issued by the *borrower.*

Neither the ease of recovery in the event of default nor the simple fact that a check is an instrument are sufficient to create a security interest. It is the economic substance of the transaction that determines whether the check serves as collateral. Cf. Cobb v. Monarch Finance Corp., 913 F. Supp. 1164, 1177-78 (N.D. Ill. 1995) (distinguishing between a mechanism set up to facilitate repayment of a loan and an interest that secures a loan in the event of default). Therefore, in turning to our resolution of whether Cash Store took a security interest, our analysis must focus on the economic substance of Smith's pledged check.…

Smith argues that, having already promised contractually through the loan agreement to pay the amount printed on the check, the pledged check gives Cash Store no interest that it did not already have. The Illinois U.C.C. expressly provides that a check does not operate as an assignment of the bank account on which it is drawn. 810 ILCS 5/3-408. And the check itself has no intrinsic value beyond the minuscule value of a scrap of paper. According to Smith, then, the post-dated check does not secure the loan because it merely restates the promise to pay already contained in the loan agreement. Hitner v. Diamond State Steel Co., 176 F. 384, 391-92 (C.C.D. Del. 1910) ("It hardly admits of discussion that the mere duplication or multiplication of a promise to pay or of an acknowledgment of liability to pay a certain sum representing the total real indebtedness to a creditor, whatever may be its effect in furnishing in certain exigencies alternative or cumulative evidence of the real demand, cannot constitute collateral security.").

Smith may be correct that a second promise to pay, identical to the first, would not serve as collateral to secure a loan, because the second promise is of no economic significance: in the event that the borrower defaults on the first promise, the second promise to pay provides nothing of economic value that the creditor could seize and apply towards repayment of the loan. In this case, however, the post-dated check is not merely a second, *identical* promise. It is, indeed, a promise to pay the same amount as the first, but it has value to the creditor in the event of default beyond the value of the first promise. That is because a holder of both the loan and the check has remedies available to him that a holder of only the loan agreement does not. For example, the holder of the check has available remedies created by the Illinois bad check statute, 810 ILCS 5/3-806, which mandates that if a check is not honored, the drawer shall be liable for interest and costs and expenses incurred in the collection of the amount of the check.

Smith's own statement that the check is of no intrinsic value is instructive: it is its extrinsic legal status and the legal rights and remedies granted the holder of the check, like the holder of a loan agreement, that give rise to its value. Upon default on the loan agreement, Cash Store would get use of the check, along with the rights that go with it. Cash Store could simply negotiate it to someone else. Cash Store could take it to the bank and present it for payment. If denied, Cash Store could pursue bad check litigation. Additional value is created through these rights because Cash Store need not renegotiate or litigate the loan agreement as its only avenue of recourse.

It is not important that, as Smith argues, by the time Cash Store gets use of the check it might be clear that Smith would not or could not make good on a promise for that amount. Cash Store's likelihood of, for example, successfully pursuing bad check litigation goes to the issue of valuation of the check (one might roughly calculate it as its face value plus supplementary awards created by the bad check statute, discounted by the probability of successfully pressing the claim) not the issue of whether the check has *any* value beyond the promise contained in the original loan agreement. In the same way, there is the chance that Smith would call her bank and cancel the post-dated check before the loan's due date, but this potentiality, depending on how the loan agreement might affect her legal right to do so, goes to how much holding the check is worth, not whether it has any value at all. Some additional value is created by the bad check statute and other legal provisions governing instruments.

This is not to say that by putting up a check as collateral, a lender like Cash Store necessarily takes a security interest in the *amount* printed on the face of the instrument. Rather, the rights created by state commercial law can, and in this case do, create some value in the instrument. We are therefore satisfied that Cash Store could lawfully assert under TILA that Smith's post-dated check was security for the loan.

CONCLUSION

For the reasons stated above, we affirm the district court's dismissal of the security interest claim, and we reverse and remand the district court's dismissal of the receipt claim for further proceedings consistent with this opinion.

MANION, Circuit Judge, concurring in part and dissenting in part.

I certainly agree with the court regarding the security issue. The Cash Store did not violate the Truth in Lending Act by informing Smith that it was holding her post-dated check as security for her loan. While possessing a post-dated check does not create a "security interest" as that term is usually understood, possession of the check nevertheless provided the Cash Store with added security for the loan. Although the Cash Store was not obligated under TILA to inform Smith that it held this check as security, lenders that seek to provide more information than is necessary under TILA should not be penalized for following the spirit of the statute. Thus, this court correctly affirmed the district court on this, the most substantive issue before this court on appeal.

The court's decision to reverse the district court on Smith's "receipt" claim is a concern. It is important to note that there are two facets to this claim. Smith asserts that stapling a small receipt to "the top of the 'Consumer Loan Agreement'" violated TILA by (1) contradicting the TILA-mandated disclosures; and (2) obscuring the required disclosures. Complaint ¶19. Smith possibly stated a claim regarding the "obfuscation" assertion because there could be a fact question as to exactly where the receipt was stapled and what it specifically obscured. But on its face the receipt clearly does not "contradict" the finance charge and the annual percentage rate, and it should cause no confusion regarding the terms of the agreement itself.

With respect to Smith's contention that the receipt obscured the required disclosures, for starters it appears that no court has ever held that obstructing a borrower's immediate view of the TILA disclosures violates TILA. The text of the statute and the regulations interpreting the statute do not indicate that this constitutes a violation. This is literally a matter of first impression, on a claim that is weak at best. For that reason alone the district court's dismissal of this claim has merit. See 15 U.S.C. §1638; 12 C.F.R. §226.17(a)(1) & n. 37 ("The disclosures may include an acknowledgment of receipt.…"). That aside, the documents attached to Smith's complaint include an 8.5 × 11 inch disclosure form and a 4.5 × 3 inch receipt that supposedly obstructed some of the mandated disclosures. Perhaps there is a plausible set of facts regarding the obstruction claim that could require looking beyond the complaint to determine if Smith would be entitled to any relief. The complaint states that the receipt was stapled to the "top" of the agreement. The court's opinion refers to stapling to the "upper left-hand corner." The district court noted that the staple mark was on the upper left-hand corner of the receipt and the loan document itself had no marks. If "top" could mean "front" and if Smith could show that the receipt was consistently stapled in the middle of the page covering the boxes boldly labeled "Annual Percentage Rate" and "Finance Charge," perhaps she would have a claim. But if this relatively small receipt is routinely stapled to the upper left-hand corner with the lowest part barely covering one of the boxes and which could easily be lifted, there would not be any material obscuring of the TILA disclosures. More importantly, even assuming that an unsophisticated borrower would not lift up the receipt to see the small portion of the loan agreement covered by the receipt, such a borrower would still be able to clearly see the portions of the loan agreement which specify the annual percentage rate, the finance charge, the amount financed, the total of payments, the payment schedule, the security posted for the loan, the penalty for late payment, and a notice telling the borrower to examine the other side of the agreement for important information. Congress enacted TILA to ensure that consumers had access to this information so that they could comparatively shop for loans. See Walker v. Wallace Auto Sales, Inc., 155 F.3d 927, 930 (7th Cir. 1998) (citing Brown v. Marquette Sav. & Loan Ass'n, 686 F.2d 608, 612 (7th Cir. 1982) (Congress enacted TILA to "provide information to facilitate comparative credit shopping and thereby the informed use of credit by consumers.")). So by clearly communicating these terms, the Cash Store complied with the Act. The two pieces of information that the receipt would obstruct (if stapled to the upper left-hand corner), the lender's name and the borrower's own name, are not material to comparing interest rates and the like (and the names were printed on the receipt anyway). Accordingly, unless the Cash Store attached the small receipt to the middle of the loan agreement, implicitly to purposely obstruct and prevent an easy review of this information, there is no violation of TILA's requirements that the mandated disclosures be clear and conspicuous, and plaintiff fails to state a claim under the Act.

Smith also contends that the contents of the receipt contradicted the TILA-mandated disclosures. An obvious contradiction of a material term would constitute a violation of TILA. See Rodash v. AIB Mortgage Co., 16 F.3d 1142, 1146 (11th Cir. 1994). Thus, when a lender informs a borrower of his right to rescind, but also contradicts this notice by telling the borrower that he had waived his right to rescind, the borrower may state a claim under the Act. Id. But Smith has not made such an assertion here. In assessing a complaint under Rule 12(b)(6) we again look at the exhibits attached to the complaint, and the receipts attached to Smith's complaint on their face do not contradict the disclosures in the loan agreement. The receipts here contain the amount borrowed on the same line as the words or word fragments: "DEFERRED CHECKS" or "DEFERRED DEPOSIT EXTENSION." As there are no assertions made in the receipt, these words in no way contradict the information contained in the loan agreement. Furthermore, as the district court stated:

> The receipt is an insignificant and unofficial-looking document in comparison with the attached loan document. The "deferred deposit check fee" is a single, small entry on the receipt. The loan agreement, on the other hand, disclosed the finance charge and interest rate in large, boldface type in a conspicuous position on the front of the loan document. Even an unsophisticated borrower, receiving the two documents together, could not be confused as to the terms of the loan.

Perhaps the 500% interest rate is an "unconscionable" exploitation of the needs of the unsophisticated consumer as Smith's claim under state law asserts. As with the purchase of lottery tickets or cigarettes, consumers of payday loans likely know a bad deal when they see it but ignore the risks and take the loan anyway. A new state or federal law could eliminate these loans regardless of market demand. Until then TILA should not be stretched beyond its terms to restrict a product sophisticated consumers don't like. Because Smith's complaint and the exhibits attached thereto indicate that there was no contradiction (much less an obvious contradiction of a material term), she has failed to state a claim under TILA. Accordingly, the district court also correctly dismissed this part of the claim under Rule 12(b)(6).

While the *Smith* court ruled that the clarity of disclosure is a question of fact and some courts have agreed, *see Roberts v. Fleet Bank (R.I.) N.A.*, 342 F.3d 260 (2003), a split of authority exists. *See Rubio v. Capital One Bank*, 613 F.3d 1195 (9th Cir. 2010) (holding as a matter of law that Capital One had failed to show that its APR disclosure was made in a reasonably understandable form and readily noticeable to the consumer). Even the Seventh Circuit seems to be unclear on the question of clarity. In *Hamm v. Ameriquest Mortg. Co.*, 506 F.3d 525 (7th Cir. 2007), it held that whether a TILA disclosure is clear and conspicuous is a question of law.

For both closed- and open-end credit, the disclosures must be written and given in a form that consumers can retain. Model forms exist for many typical transactions in the Appendices to Regulation Z, but the creditor still has the obligation to choose the appropriate form, complete it correctly, and deliver it timely. 15 U.S.C. §1604(b). Many of the disclosures for open-end transactions, including account-opening forms credit or charge card applications, and change-in-terms notices, must be made in tabular form, with the information presented in boxes in a prescribed order. 12 C.F.R. §1026.5(a)(3).

The disclosure applicable in closed-end credit must be given "before the credit is extended," 15 U.S.C. §1638(b)(1), or in the parlance of Regulation Z, "before consummation." 12 C.F.R. §1026.17(b). Similarly, the initial disclosure for open-end credit must occur before the first transaction that obligates the consumer to repay an amount. 12 C.F.R. §1026.5(b)(1).

This Assignment gives the general rules for credit disclosure. The special requirements for certain types of transactions, such as credit cards and home mortgage loans, are considered in upcoming Assignments. As with other topics considered in the book, the enforcement options and liability rules are considered in Part IV of this book. This Assignment focuses the general and enduring concepts of lending disclosure—such as the APR term and the distinction between open-end and closed-end credit and highlights disclosure as a workhorse of consumer protection.

Despite its legal importance, the research on credit disclosure is surprisingly sparse. Back when TILA was enacted, a few studies exploited the new requirements to see if consumers' knowledge of loan terms increased. A measurable fraction of consumers had improved awareness of the interest rate, but still only just more than half of consumers had an accurate understanding of the cost of the loan. *See e.g.*, Lewis Mandell, *Consumer Perception of Incurred Interest Rates: An Empirical Test of the Efficacy of Truth-in-Lending Laws*, 26 J. OF FIN. 1143 (1971). Part of the issue is a widely-held (although perhaps incorrect) belief that more information is always beneficial, so there was relatively little questioning of whether disclosure works as desired. Remember that the goal of TILA is not just to increase knowledge, but to prompt consumers to comparison shop for credit using that information. Behavioral economics, which emphasizes what people actually do—rather than what a perfectly rational actor can be assumed to do—suggests that disclosures may be of limited value. The book *More Than You Wanted to Know* surveys the evidence before concluding that mandatory disclosure rarely works, in part because disclosures are complex, obscure, and dull. Omri Ben-Shahar & Carl E. Schneider, *More Than You Wanted to Know: The Failure of Mandated Disclosure* (2014). Provocatively, the authors conclude that plain English and improved design cannot solve the ultimate issues—that the transactions at issue are complex and that consumers make decisions by stripping away information to lower the cognitive burden. This new research continues to fuel the controversy about the relative merits of disclosure to substantive regulation.

Problem Set 12

12.1. Auto Advance makes loans to people purchasing used cars. It offers borrowers the option of purchasing life insurance that runs for the length of the car loan. Over 99 percent of borrowers purchase this life insurance. The cost of the policy is added to the loan and paid for in the regular monthly installments. Auto Advance gives the consumer an insurance information sheet that gives the amount of the premiums and makes clear that Auto Advance's subsidiary, Insure Advance, is the insurance company that will provide the insurance. Does Auto Advance have to include the insurance premiums in the finance charge? *See* 12 C.F.R. §1026.4.

12.2. Arnie Winger is the best salesmen at BottomsDown, a store specializing in high-end home office furniture for the Silicon Valley telecommuter set. He has taken a real interest in mentoring the store's new salesperson, Sally Roberts. Arnie keeps joking about how he has taken Sally "under his wing" and is teaching her the tricks of the trade. Part of Arnie's success is that he convinces nearly all customers to finance their furniture purchase. The problem is that Arnie likes to talk, not to write, and so is constantly leaving Sally with a big stack of paperwork to finish up in the evening. Today, he asked her to complete a TILA disclosure for a customer that looked at a desk, a chair, and other office furniture components and has promised to come back first thing tomorrow morning to finalize the deal. How should Sally complete the disclosure that Arnie started? What, if anything, goes in the missing boxes?

ANNUAL PERCENTAGE RATE The cost of your credit as a yearly rate.	FINANCE CHARGE The dollar amount the credit will cost you.	Amount Financed The amount of credit provided to you or on your behalf.	Total of Payments The amount you will have paid after you have made all payments as scheduled.	Total Sale Price The total cost of your chase on credit, including your downpayment of $ 1500.00
14.84 %	$ 1496.80	$	$ 7604.30	$ 9104.30

You have the right to receive at this time an itemization of the Amount Financed.

☐ I want an itemization. ☒ I do not want an itemization

Your payment schedule will be:

Number of Payments	Amount of Payments	When Payments are Due
36		Monthly, starting 10/1

12.3. Haynes always has been the most financially responsible (and morally superior) of his five siblings. The other day, his sister Clarice, asked him for advice. She received a credit card solicitation and is about to get her first credit card. Clarice is 23 years old and employed full-time at her first job as a sales associate at an auto dealer. Having heard Haynes rib their siblings for foolish financial and investment decisions, Clarice asks Haynes to choose between the two cards offered to her in a solicitation. Which card should Haynes recommend, assuming that Clarice identifies her priorities as a card with the lowest cost and the least risk of fees?

12.4. You are deputy compliance counsel for a non-bank mortgage lender, Upworthy Loans. Your role is to prepare the lender for state and federal examinations to determine if Upworthy is following all consumer laws. Last week, the CFPB released a new mortgage loan disclosure, including a model form for a fixed-rate loan (reproduced below). While the operations team has been working hard to deploy the new form before its effective date in three months, Upworthy's general counsel has given you a side project. She explains that she heard from a former CFPB employee, who now works for a competing lender, that CFPB "improved the law itself" with its form. "Of course, Upworthy will use the new form," she says, "but just in case an examiner finds an 'opportunity to improve' and we catch regulatory fire, I want to have some ammunition to challenge the required disclosure." What is your analysis? Focus on the three main elements of TILA disclosure. 15 U.S.C. §§1632(a); 1638(a); 12 C.F.R. §§1026.17(a); 1026.19(f); 1026.38.

Credit Card Disclosure		
	Kryptonite Card	**Titanium Card**
Interest Rates & Charges		
Annual Percentage Rate (APR) for Purchases*	**13.9%**	**7.75%** Variable Rate**
Balance Transfers APR*	**4.9%*** **	**4.9%*****
Cash Advance APR*	**13.9%**	**17.75%**
How to avoid paying interest	To avoid paying interest, simply pay the entire New Balance shown on your monthly statement within 25 days from the closing date of that statement.	
Minimum Finance Charge	None	None
Fees		
Annual Fee	None	$99
Balance Transfer Fee	None	$12 up to $10,000 transferred; otherwise $20.
Late Payment Fee	**5%** Or a minimum of $20	**10%** Or a minimum of $38
Returned Check Fee	$28	$47
International Transaction Fee	2.5% of transaction	1% of transaction
Cash Advance Fee	None	None
To obtain information about shopping for and using Credit Cards	To learn more about factors to consider when applying for or using a cred card, visit the website of the Consumer Financial Protection Bureau at: www.consumerfinance.gov/credit-cards.	
Interest and Fee Information for Checks		
APR for Check Transactions*	**13.9%**	**17.75%****
Use by Date	You must use the check within one year.	
Paying Interest	We will begin charging interest on these checks on the transaction date.	
Billing rights: Information on your rights to dispute transactions and how to exercise those rights is provided in your account agreement.		
***How We Will Calculate Your Balance**: We use a method called "Average Daily Balance, including New Purchases". See your account agreement for more details		
****Variable Rate:** The Variable rate is calculated by adding 4.50% to the Prime Lending rate in the Wall Street Journal, and will not exceed 18%.		
*****Balance Transfers:** This rate will apply for the first six months and then standard purchase rates will apply thereafter.		

Closing Disclosure

This form is a statement of final loan terms and closing costs. Compare this document with your Loan Estimate.

Closing Information

Date Issued	4/15/2013
Closing Date	4/15/2013
Disbursement Date	4/15/2013
Settlement Agent	Epsilon Title Co.
File #	12-3456
Property	456 Somewhere Ave Anytown, ST 12345
Sale Price	$180,000

Transaction Information

Borrower	Michael Jones and Mary Stone 123 Anywhere Street Anytown, ST 12345
Seller	Steve Cole and Amy Doe 321 Somewhere Drive Anytown, ST 12345
Lender	Ficus Bank

Loan Information

Loan Term	30 years
Purpose	Purchase
Product	Fixed Rate
Loan Type	☒ Conventional ☐ FHA ☐ VA ☐ ____________
Loan ID #	123456789
MIC #	000654321

Loan Terms

Loan Terms		Can this amount increase after closing?
Loan Amount	$162,000	**NO**
Interest Rate	3.875%	**NO**
Monthly Principal & Interest *See Projected Payments below for your Estimated Total Monthly Payment*	$761.78	**NO**
		Does the loan have these features?
Prepayment Penalty		**YES** • **As high as $3,240** if you pay off the loan during the first 2 years
Balloon Payment		**NO**

Projected Payments

Payment Calculation	**Years 1-7**	**Years 8-30**
Principal & Interest	$761.78	$761.78
Mortgage Insurance	+ 82.35	+ —
Estimated Escrow *Amount can increase over time*	+ 206.13	+ 206.13
Estimated Total Monthly Payment	$1,050.26	$967.91

Estimated Taxes, Insurance & Assessments *Amount can increase over time* *See page 4 for details*	$356.13 a month	**This estimate includes**	**In escrow?**
		☒ Property Taxes	**YES**
		☒ Homeowner's Insurance	**YES**
		☒ Other: Homeowner's Association Dues	**NO**
		See Escrow Account on page 4 for details. You must pay for other property costs separately.	

Costs at Closing

Closing Costs	$9,712.10	Includes $4,694.05 in Loan Costs + $5,018.05 in Other Costs – $0 in Lender Credits. *See page 2 for details.*
Cash to Close	$14,147.26	Includes Closing Costs. *See Calculating Cash to Close on page 3 for details.*

CLOSING DISCLOSURE PAGE 1 OF 5 • LOAN ID # 123456789

Closing Cost Details

Loan Costs		Borrower-Paid		Seller-Paid		Paid by Others
		At Closing	Before Closing	At Closing	Before Closing	
A. Origination Charges		**$1,802.00**				
01 0.25 % of Loan Amount (Points)		$405.00				
02 Application Fee		$300.00				
03 Underwriting Fee		$1,097.00				
04						
05						
06						
07						
08						
B. Services Borrower Did Not Shop For		**$236.55**				
01 Appraisal Fee	to John Smith Appraisers Inc.					$405.00
02 Credit Report Fee	to Information Inc.		$29.80			
03 Flood Determination Fee	to Info Co.	$20.00				
04 Flood Monitoring Fee	to Info Co.	$31.75				
05 Tax Monitoring Fee	to Info Co.	$75.00				
06 Tax Status Research Fee	to Info Co.	$80.00				
07						
08						
09						
10						
C. Services Borrower Did Shop For		**$2,655.50**				
01 Pest Inspection Fee	to Pests Co.	$120.50				
02 Survey Fee	to Surveys Co.	$85.00				
03 Title – Insurance Binder	to Epsilon Title Co.	$650.00				
04 Title – Lender's Title Insurance	to Epsilon Title Co.	$500.00				
05 Title – Settlement Agent Fee	to Epsilon Title Co.	$500.00				
06 Title – Title Search	to Epsilon Title Co.	$800.00				
07						
08						
D. TOTAL LOAN COSTS (Borrower-Paid)		**$4,694.05**				
Loan Costs Subtotals (A + B + C)		$4,664.25	$29.80			

Other Costs		Borrower-Paid		Seller-Paid		Paid by Others
		At Closing	Before Closing	At Closing	Before Closing	
E. Taxes and Other Government Fees		**$85.00**				
01 Recording Fees	Deed: $40.00 Mortgage: $45.00	$85.00				
02 Transfer Tax	to Any State			$950.00		
F. Prepaids		**$2,120.80**				
01 Homeowner's Insurance Premium (12 mo.) to Insurance Co.		$1,209.96				
02 Mortgage Insurance Premium (mo.)						
03 Prepaid Interest ($17.44 per day from 4/15/13 to 5/1/13)		$279.04				
04 Property Taxes (6 mo.) to Any County USA		$631.80				
05						
G. Initial Escrow Payment at Closing		**$412.25**				
01 Homeowner's Insurance $100.83	per month for 2 mo.	$201.66				
02 Mortgage Insurance	per month for mo.					
03 Property Taxes $105.30	per month for 2 mo.	$210.60				
04						
05						
06						
07						
08 Aggregate Adjustment		– 0.01				
H. Other		**$2,400.00**				
01 HOA Capital Contribution	to HOA Acre Inc.	$500.00				
02 HOA Processing Fee	to HOA Acre Inc.	$150.00				
03 Home Inspection Fee	to Engineers Inc.	$750.00			$750.00	
04 Home Warranty Fee	to XYZ Warranty Inc.			$450.00		
05 Real Estate Commission	to Alpha Real Estate Broker			$5,700.00		
06 Real Estate Commission	to Omega Real Estate Broker			$5,700.00		
07 Title – Owner's Title Insurance (optional)	to Epsilon Title Co.	$1,000.00				
08						
I. TOTAL OTHER COSTS (Borrower-Paid)		**$5,018.05**				
Other Costs Subtotals (E + F + G + H)		$5,018.05				
J. TOTAL CLOSING COSTS (Borrower-Paid)		**$9,712.10**				
Closing Costs Subtotals (D + I)		$9,682.30	$29.80	$12,800.00	$750.00	$405.00
Lender Credits						

CLOSING DISCLOSURE

PAGE 2 OF 5 • LOAN ID # 123456789

Calculating Cash to Close — Use this table to see what has changed from your Loan Estimate.

	Loan Estimate	Final	Did this change?	
Total Closing Costs (J)	$8,054.00	$9,712.10	**YES**	• See **Total Loan Costs (D)** and **Total Other Costs (I)**
Closing Costs Paid Before Closing	$0	– $29.80	**YES**	• You paid these Closing Costs **before closing**
Closing Costs Financed (Paid from your Loan Amount)	$0	$0	**NO**	
Down Payment/Funds from Borrower	$18,000.00	$18,000.00	**NO**	
Deposit	– $10,000.00	– $10,000.00	**NO**	
Funds for Borrower	$0	$0	**NO**	
Seller Credits	$0	– $2,500.00	**YES**	• See Seller Credits in **Section L**
Adjustments and Other Credits	$0	– $1,035.04	**YES**	• See details in **Sections K and L**
Cash to Close	$16,054.00	$14,147.26		

Summaries of Transactions — Use this table to see a summary of your transaction.

BORROWER'S TRANSACTION

K. Due from Borrower at Closing				**$189,762.30**
01	Sale Price of Property			$180,000.00
02	Sale Price of Any Personal Property Included in Sale			
03	Closing Costs Paid at Closing (J)			$9,682.30
04				
Adjustments				
05				
06				
07				
Adjustments for Items Paid by Seller in Advance				
08	City/Town Taxes		to	
09	County Taxes		to	
10	Assessments		to	
11	HOA Dues	4/15/13	to 4/30/13	$80.00
12				
13				
14				
15				
L. Paid Already by or on Behalf of Borrower at Closing				**$175,615.04**
01	Deposit			$10,000.00
02	Loan Amount			$162,000.00
03	Existing Loan(s) Assumed or Taken Subject to			
04				
05	Seller Credit			$2,500.00
Other Credits				
06	Rebate from Epsilon Title Co.			$750.00
07				
Adjustments				
08				
09				
10				
11				
Adjustments for Items Unpaid by Seller				
12	City/Town Taxes	1/1/13	to 4/14/13	$365.04
13	County Taxes		to	
14	Assessments		to	
15				
16				
17				
CALCULATION				
Total Due from Borrower at Closing (K)				$189,762.30
Total Paid Already by or on Behalf of Borrower at Closing (L)				– $175,615.04
Cash to Close ☒ From ☐ To Borrower				**$14,147.26**

SELLER'S TRANSACTION

M. Due to Seller at Closing				**$180,080.00**
01	Sale Price of Property			$180,000.00
02	Sale Price of Any Personal Property Included in Sale			
03				
04				
05				
06				
07				
08				
Adjustments for Items Paid by Seller in Advance				
09	City/Town Taxes		to	
10	County Taxes		to	
11	Assessments		to	
12	HOA Dues	4/15/13	to 4/30/13	$80.00
13				
14				
15				
16				
N. Due from Seller at Closing				**$115,665.04**
01	Excess Deposit			
02	Closing Costs Paid at Closing (J)			$12,800.00
03	Existing Loan(s) Assumed or Taken Subject to			
04	Payoff of First Mortgage Loan			$100,000.00
05	Payoff of Second Mortgage Loan			
06				
07				
08	Seller Credit			$2,500.00
09				
10				
11				
12				
13				
Adjustments for Items Unpaid by Seller				
14	City/Town Taxes	1/1/13	to 4/14/13	$365.04
15	County Taxes		to	
16	Assessments		to	
17				
18				
19				
CALCULATION				
Total Due to Seller at Closing (M)				$180,080.00
Total Due from Seller at Closing (N)				– $115,665.04
Cash ☐ From ☒ To Seller				**$64,414.96**

CLOSING DISCLOSURE

PAGE 3 OF 5 • LOAN ID # 123456789

Additional Information About This Loan

Loan Disclosures

Assumption
If you sell or transfer this property to another person, your lender
☐ will allow, under certain conditions, this person to assume this loan on the original terms.
☒ will not allow assumption of this loan on the original terms.

Demand Feature
Your loan
☐ has a demand feature, which permits your lender to require early repayment of the loan. You should review your note for details.
☒ does not have a demand feature.

Late Payment
If your payment is more than *15* days late, your lender will charge a late fee of *5% of the monthly principal and interest payment.*

Negative Amortization (Increase in Loan Amount)
Under your loan terms, you
☐ are scheduled to make monthly payments that do not pay all of the interest due that month. As a result, your loan amount will increase (negatively amortize), and your loan amount will likely become larger than your original loan amount. Increases in your loan amount lower the equity you have in this property.
☐ may have monthly payments that do not pay all of the interest due that month. If you do, your loan amount will increase (negatively amortize), and, as a result, your loan amount may become larger than your original loan amount. Increases in your loan amount lower the equity you have in this property.
☒ do not have a negative amortization feature.

Partial Payments
Your lender
☒ may accept payments that are less than the full amount due (partial payments) and apply them to your loan.
☐ may hold them in a separate account until you pay the rest of the payment, and then apply the full payment to your loan.
☐ does not accept any partial payments.
If this loan is sold, your new lender may have a different policy.

Security Interest
You are granting a security interest in
456 Somewhere Ave., Anytown, ST 12345

You may lose this property if you do not make your payments or satisfy other obligations for this loan.

Escrow Account
For now, your loan
☒ will have an escrow account (also called an "impound" or "trust" account) to pay the property costs listed below. Without an escrow account, you would pay them directly, possibly in one or two large payments a year. Your lender may be liable for penalties and interest for failing to make a payment.

Escrow		
Escrowed Property Costs over Year 1	$2,473.56	Estimated total amount over year 1 for your escrowed property costs: *Homeowner's Insurance* *Property Taxes*
Non-Escrowed Property Costs over Year 1	$1,800.00	Estimated total amount over year 1 for your non-escrowed property costs: *Homeowner's Association Dues* You may have other property costs.
Initial Escrow Payment	$412.25	A cushion for the escrow account you pay at closing. See Section G on page 2.
Monthly Escrow Payment	$206.13	The amount included in your total monthly payment.

☐ will not have an escrow account because ☐ you declined it ☐ your lender does not offer one. You must directly pay your property costs, such as taxes and homeowner's insurance. Contact your lender to ask if your loan can have an escrow account.

No Escrow		
Estimated Property Costs over Year 1		Estimated total amount over year 1. You must pay these costs directly, possibly in one or two large payments a year.
Escrow Waiver Fee		

In the future,
Your property costs may change and, as a result, your escrow payment may change. You may be able to cancel your escrow account, but if you do, you must pay your property costs directly. If you fail to pay your property taxes, your state or local government may (1) impose fines and penalties or (2) place a tax lien on this property. If you fail to pay any of your property costs, your lender may (1) add the amounts to your loan balance, (2) add an escrow account to your loan, or (3) require you to pay for property insurance that the lender buys on your behalf, which likely would cost more and provide fewer benefits than what you could buy on your own.

CLOSING DISCLOSURE PAGE 4 OF 5 • LOAN ID # 123456789

Loan Calculations

Total of Payments. Total you will have paid after you make all payments of principal, interest, mortgage insurance, and loan costs, as scheduled.	$285,803.36
Finance Charge. The dollar amount the loan will cost you.	$118,830.27
Amount Financed. The loan amount available after paying your upfront finance charge.	$162,000.00
Annual Percentage Rate (APR). Your costs over the loan term expressed as a rate. This is not your interest rate.	4.174%
Total Interest Percentage (TIP). The total amount of interest that you will pay over the loan term as a percentage of your loan amount.	69.46%

Questions? If you have questions about the loan terms or costs on this form, use the contact information below. To get more information or make a complaint, contact the Consumer Financial Protection Bureau at **www.consumerfinance.gov/mortgage-closing**

Other Disclosures

Appraisal
If the property was appraised for your loan, your lender is required to give you a copy at no additional cost at least 3 days before closing. If you have not yet received it, please contact your lender at the information listed below.

Contract Details
See your note and security instrument for information about
- what happens if you fail to make your payments,
- what is a default on the loan,
- situations in which your lender can require early repayment of the loan, and
- the rules for making payments before they are due.

Liability after Foreclosure
If your lender forecloses on this property and the foreclosure does not cover the amount of unpaid balance on this loan,

☒ state law may protect you from liability for the unpaid balance. If you refinance or take on any additional debt on this property, you may lose this protection and have to pay any debt remaining even after foreclosure. You may want to consult a lawyer for more information.

☐ state law does not protect you from liability for the unpaid balance.

Refinance
Refinancing this loan will depend on your future financial situation, the property value, and market conditions. You may not be able to refinance this loan.

Tax Deductions
If you borrow more than this property is worth, the interest on the loan amount above this property's fair market value is not deductible from your federal income taxes. You should consult a tax advisor for more information.

Contact Information

	Lender	Mortgage Broker	Real Estate Broker (B)	Real Estate Broker (S)	Settlement Agent
Name	Ficus Bank		Omega Real Estate Broker Inc.	Alpha Real Estate Broker Co.	Epsilon Title Co.
Address	4321 Random Blvd. Somecity, ST 12340		789 Local Lane Sometown, ST 12345	987 Suburb Ct. Someplace, ST 12340	123 Commerce Pl. Somecity, ST 12344
NMLS ID					
ST License ID			Z765416	Z61456	Z61616
Contact	Joe Smith		Samuel Green	Joseph Cain	Sarah Arnold
Contact NMLS ID	12345				
Contact ST License ID			P16415	P51461	PT1234
Email	joesmith@ ficusbank.com		sam@omegare.biz	joe@alphare.biz	sarah@ epsilontitle.com
Phone	123-456-7890		123-555-1717	321-555-7171	987-555-4321

Confirm Receipt

By signing, you are only confirming that you have received this form. You do not have to accept this loan because you have signed or received this form.

Applicant Signature Date Co-Applicant Signature Date

Assignment 13. Home Purchases

A home is the largest purchase that most consumers make. Homeownership is a vehicle for building wealth and promoting stable neighborhoods. For decades, the federal government has encouraged homeownership as a matter of policy. For these reasons, you might expect robust laws for consumers as they buy and finance homes. Historically, that has not been the situation. Until very recently, the laws that govern homeownership were a patchwork of uneven protection. In some areas, such as warranty, home buyers have even fewer consumer protections than apply to less expensive purchases. With regard to credit, consumer protection also was curtailed. Most usury laws never applied to home mortgages, for example. Concerns about providing access to credit held sway in shaping consumer laws for mortgages because homeownership was seen as socially and economically beneficial. Additionally, regulatory oversight for mortgages was fractured among federal and state agencies, and further complicated by the roles of entities such as Fannie Mae.

The financial crisis that began in 2008 essentially shut down the residential real estate and lending markets. While the liquidity problems of large institutions such as Lehman Brothers, Bear Stearns, and AIG involved complexities such as repo/swap agreements, shadow banking, and capital requirements, a root cause was home mortgages. The Financial Crisis Inquiry Commission Report explains:

> In this report, we detail the events of the crisis. But a simple summary, as we see it, is useful at the outset. While the vulnerabilities that created the potential for crisis were years in the making, it was the collapse of the housing bubble—fueled by low interest rates, easy and available credit, scant regulation, and toxic mortgages—that was the spark that ignited a string of events, which led to a full-blown crisis in the fall of 2008. Trillions of dollars in risky mortgages had become embedded throughout the financial system, as mortgage-related securities were packaged, repackaged, and sold to investors around the world. When the bubble burst, hundreds of billions of dollars in losses in mortgages and mortgage-related securities shook markets as well as financial institutions that had significant exposures to those mortgages and had borrowed heavily against them. This happened not just in the United States but around the world.

p. xvi. http://fcic.law.stanford.edu/report. In the decade preceding the onset of the financial crisis, an increasing proportion of loans were "subprime." This undefined term generally means loans of lower quality than "prime" loans; in fact, the lack of definitional clarity and data on subprime loans hampered careful monitoring of the mortgage market. Businesses "peddled a cornucopia of risky nontraditional mortgage products to borrowers during the housing bubble: hybrid ARMs (adjustable-rate mortgages), interest-only loans, pay-option ARMS, and loans with negative amortization." Kathleen C. Engel &

Patricia A. McCoy, *The Subprime Virus* 34 (2011). Underwriting standards loosened too, giving rise to some colorful monikers. A "NINJA" loan was funded without lender verification of a consumer's financial prospects. These no-income, no-job, no-asset loans were later called "liar's loans," although it is likely that both borrowers and mortgage professionals were engaged in misconduct. Some people who took out home mortgages were in default less than a year later—or never made a single payment. By 2006, over 80 percent of home loans were to refinance previous loans, not to help a family into a house.

In 2010, the Dodd-Frank Act fundamentally reshaped the laws relating to home purchase and finance for consumers. Congress enacted new laws, amended dozens of existing statutes, and directed the CFPB to issue new regulations. The new homeownership laws were complex to write and to implement. The most important rules became effective in 2015. Other issues, such as the federal government's role in financing the mortgage market, still remain unsettled as of 2016. It is an understatement to say that the law is uncertain; case law is essentially non-existent and will take years to develop.

In the meantime, however, consumers continue to want homes, and businesses continue to want to sell and lend. This book describes the legal landscape with an eye to the future, but there is a certain amount of educated guessing about how the market will evolve. To make learning more manageable, coverage of homeownership is divided. This assignment discusses how consumers get homes and their rights in a purchase transaction. A primary goal is understanding the actors, vocabulary, and structure of the homeownership market. The next assignment covers the rules on home mortgages and repayment.

A. Anatomy of a Home Purchase

Most consumers lack the cash to buy a home outright. If a consumer is so lucky (aka rich, or the "1 percent"), the issues that might arise are largely limited to choosing a home, negotiating the price and terms with the seller, and trying to ensure against problems with the house. These issues are covered later in this section.

For the rest of us (let's say, the "99 percent"), buying a home is inextricably linked with financing the purchase price. This means that many consumers start by looking for credit, and then select a home that is priced in the range of the loan for which they qualify. This section lays out a typical home purchase in some detail but it does not cover the law that governs underwriting mortgages. That is saved for the next assignment, after you have more background on residential real estate.

1. Qualifying for a Mortgage

After deciding that they want a home, consumers need to figure out what they can afford to spend. Instead of checking their wallets for cash or their credit card limits, consumers have to make a prospective ask to lenders. Will you give me a home loan, and if so, for how much money? As a practical matter, many consumers rely on lenders to determine what they can afford, rather than making an independent calculation. Recognizing this reality and to curb some of the unaffordable loans of the 1990s and 2000s, federal law now has underwriting requirements. Lenders today must assess a potential mortgage borrower's "ability to repay." This legal standard is detailed in the next assignment.

Perhaps the most important factor in the cost of the loan is the interest rate—and the biggest driver of this is nothing particular to consumers. It is the lender's cost of funds. Most lenders borrow money in order to lend money (or have to pay interest on deposits, which they can then lend out). The market rate of interest is always their starting point in pricing a loan. The other key factors are the type of loan that the consumer requests or is offered. This varies along several parameters, each of which changes the cost of the loan—and the lender's profit and risk.

- Fixed- or adjustable-rate of interest. A fixed rate of interest will not change, providing certainty that principal and interest payments will be steady. Adjustable-rate loans may be lower than fixed-rate loans initially but may change. Often the rate changes based on a market index (commonly the LIBOR, the London Inter Bank Offer Rate); there is usually a rate floor and cap.
- Points. These are costs paid at the time of the home purchase and are expressed as a percentage of the loan amount (normally less than 1 percent). They are essentially prepayment of interest, in return for a lower interest rate on the loan. Consumers can pay points in cash at closing or the lender can pay points but then credit the consumer that amount toward closing costs. A zero-point loan means that the consumer just pays the stated interest rate and any costs to actually close the loan (see next section of this assignment).
- Fully amortizing or balloon payment. Amortization means that the amount owed is paid down to zero by the end of the loan term. Negative amortization occurs when the payments are not sufficient to even cover interest and fees, leading to an increasing balance over time. Sometimes the loan payments are calculated as if the loan is fully amortized over a long term but the loan itself is shorter. This produces a balloon payment, often quite large, at the end of the loan term.
- Prepayment penalty. Usually mortgage loans can be paid off at the consumer's will for the payoff balance—the outstanding principal and accrued interest since the last payment. A prepayment penalty is an additional fee that is owed if the loan is paid off earlier than the loan term (or a determined period, such as the first ten years of the loan). A prepayment penalty can apply upon refinance or home sale. It compensates the lender for the profits from the lost interest that would have been earned if all payments were made over time.
- Down payment. This is the amount of money that a consumer pays to the seller at the time of the home purchase. It is usually expressed as a percentage of the home's value. A traditional residential loan requires a 20 percent down payment. Some government programs, such as the

Veterans Administration, permit 0 percent down loans. When the down payment is less than 20 percent, some lenders will require the consumer to pay for private mortgage insurance (PMI). This covers the lender's loss if the consumer fails to pay the mortgage.

An "originator" arranges, assists, or offers a consumer a home loan or a home loan application in expectation of direct or indirect compensation or monetary gain. 12 C.F.R. §1026.36. Mortgage originators are required to be registered and licensed by either state or federal law. 15 U.S.C. §1639(b). Originators can be large depository banks, non-banks, or individual people. A person who shops for a loan to present to a consumer is commonly called a "mortgage broker" while a person who works for a financial institution that offers a loan to a consumer is often called a "mortgage banker" or "loan officer."

There is no law that requires a consumer to be offered the best or lowest-priced loan for which he or she may qualify. Consumers can choose who originates their loan and select from any offered loan. This is why consumers are urged to shop for loans, either online or in person, and either on their own or with help. Originators are prohibited from steering or directing consumers to a particular lender or loan because the originator will receive greater compensation. 15 U.S.C. §1639b(c). Generally, originators must show consumers at least three types of loans. Often consumers will get "pre-qualified" or "pre-approved" with a lender to get an idea of the amount of loan that is likely to be made. The lender is not required to make a particular loan at a particular rate to that consumer but is doing some underwriting on the consumer, such as checking a credit score and verifying income.

A real estate broker, unless also being compensated for the loan, is not a mortgage originator. While brokers sometimes recommend lenders, that is not their primary function and they are not to be compensated by lenders. The job of a real estate broker is to sell a house that is listed for sale. A real estate broker is compensated by the seller based on a percentage of the house's sale price. A higher-priced home generates more revenue for the real estate broker. Real estate brokers also help buyers locate homes for sale. A related term, real estate salesperson, usually connotes someone who works for a broker or who has less experience in real estate sales. *See, e.g*. Fla. Stat. §457.17 (requiring a person seeking to be licensed as a broker to have had at least 24 months of an active real estate license as a sales associate). Real estate brokers are not mere middlemen but the exact nature of their duties is often misunderstood.

Horiike v. Coldwell Banker Residential Brokerage Co.

225 Cal. App. 4th 427 (2014)

KRIEGLER, Appellate Judge.

A broker represented both the buyer and the seller in a real property transaction through two different salespersons. The buyer brought several claims against the broker and the salesperson who listed the property for sale, including breach of fiduciary duty. The trial court granted a nonsuit on the claim for breach of fiduciary duty against the salesperson on the ground that the salesperson who listed the property did not have a fiduciary duty to the buyer. The court also instructed the jury that the broker had no liability for breach of fiduciary duty based on the salesperson's acts. The jury returned a verdict in favor of the defense on the remaining causes of action.

The buyer contends that the salesperson had a fiduciary duty equivalent to the duty owed by the broker, and the trial court incorrectly granted the nonsuit and erroneously instructed the jury. We agree. When a broker is the dual agent of both the buyer and the seller in a real property transaction, the salespersons acting under the broker have the same fiduciary duty to the buyer and the seller as the broker. The buyer was prejudiced by the erroneous rulings, because the jury's findings of fact did not resolve the omitted issues concerning breach of fiduciary duty. Therefore, we reverse the judgment and remand for a new trial.

FACTS

Defendant Chris Cortazzo is a salesperson for defendant Coldwell Banker Residential Brokerage Company (CB). In 2006, the owners of a residential property in Malibu engaged Cortazzo to sell their property. The building permit lists the total square footage of the property as 11,050 square feet, including a single-family residence of 9,224 square feet, a guest house of 746 square feet, a garage of 1,080 square feet, and a basement of unspecified area.

Cortazzo listed the property for sale on a multiple listing service (MLS) in September 2006. The listing service provided Cortazzo with public record information for reference, which stated that the living area of the property was 9,434 square feet. The listing that Cortazzo created, however, stated the home "offers approximately 15,000 square feet of living areas." Cortazzo prepared a flier for the property which stated it "offers approximately 15,000 square feet of living areas."

In March 2007, a couple made an offer to purchase the property. They asked Cortazzo for verification of the living area square footage. Cortazzo provided a letter from the architect stating the size of the house under a current Malibu building department ordinance was approximately 15,000 square feet. Cortazzo suggested the couple hire a qualified specialist to verify the square footage. The couple requested the certificate of occupancy and the architectural plans, but no architectural plans were available. In the real estate transfer disclosure statement, Cortazzo noted from his visual inspection that adjacent parcels were vacant and subject to development. He repeated his advice to hire a qualified specialist to verify the square footage of the home, stating that the broker did not guarantee or warrant the square footage.

When the couple learned architectural plans were not available, they requested a six-day extension to inspect the property. The sellers refused to grant the extension and the couple cancelled the transaction at the end of March 2007. In July 2007, Cortazzo changed the MLS listing to state that the approximate square footage was "0/O.T.," by which he meant zero square feet and other comments.

Plaintiff Hiroshi Horiike was working with CB salesperson Chizuko Namba to locate a residential property to purchase. Namba saw Cortazzo's listing for the

Malibu property and arranged for Cortazzo to show the property to Horiike on November 1, 2007. Cortazzo gave Horiike a copy of the flier stating the property had 15,000 square feet of living areas. Escrow opened on November 9, 2007. Cortazzo sent a copy of the building permit to Namba. Namba provided a copy of the permit to Horiike with other documents.

The parties to the transaction signed a confirmation of the real estate agency relationships as required by Civil Code section 2079.17. The document explained that CB, as the listing agent and the selling agent, was the agent of both the buyer and the seller. Cortazzo signed the document as an associate licensee of the listing agent CB. Namba signed the document as an associate licensee of the selling agent CB.

Horiike also executed a form required under Civil Code section 2079.16 for the disclosure of three possible real estate agency relationships. First, the form explained the relationship of a seller's agent acting under a listing agreement with the seller. The seller's agent acts as an agent for the seller only and has a fiduciary duty in dealings with the seller. The seller's agent has obligations to both the buyer and the seller to exercise reasonable skill and care, as well as a duty of fair dealing and good faith, and a "duty to disclose all facts known to the agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of, the parties."

The second type of relationship, which is not at issue in this case, involves the obligations of an agent acting for the buyer only. An agent acting only for a buyer has a fiduciary duty in dealings with the buyer. A buyer's agent also has obligations to the buyer and the seller to exercise reasonable care, deal fairly and in good faith, and disclose material facts.

The third relationship described was an agent representing both the seller and the buyer. "A real estate agent, either acting directly or through one or more associate licensees, can legally be the agent of both the Seller and the Buyer in a transaction, but only with the knowledge and consent of both the Seller and the Buyer." An agent in a dual agency situation has a fiduciary duty to both the seller and the buyer, as well as the duties to buyer and seller listed in the previous sections.

Horiike signed the disclosure form as the buyer and Cortazzo signed as an associate licensee for the agent CB. In the visual inspection disclosure that Cortazzo provided to Horiike, he noted adjacent vacant lots were subject to building development. He did not add a handwritten note of advice to hire a qualified specialist to verify the square footage of the home, as he had in the previous transaction. Horiike completed the property transaction.

In preparation for work on the property in 2009, Horiike reviewed the building permit. He asked Cortazzo to verify that the property had 15,000 square feet of living areas. Horiike's expert testified at trial that the living areas of the home totaled 11,964 square feet. The defense expert testified the home's living areas totaled 14,186 square feet.

PROCEDURAL BACKGROUND

On November 23, 2010, Horiike filed a complaint against Cortazzo and CB for intentional and negligent misrepresentation, breach of fiduciary duty, unfair business practices in violation of Business and Professions Code section 17200, and false advertising in violation of Business and Professions Code section 17500. The parties agreed that the claims based on violations of the Business and Professions Code would be determined by the court following the jury trial.

After the presentation of Horiike's case to the jury, Cortazzo moved for nonsuit on the cause of action for breach of fiduciary duty against him. The trial court granted the motion on the ground that Cortazzo had no fiduciary duty to Horiike.…

The trial court determined the jury's findings resolved the remaining claims in favor of Cortazzo and CB. Therefore, on October 30, 2012, the court entered judgment in favor of Cortazzo and CB. Horiike filed a motion for a new trial on the ground the verdict was internally inconsistent, which the court denied. Horiike filed a timely notice of appeal.

DISCUSSION

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Duty of a Salesperson Acting for a Dual Agent

Horiike contends that Cortazzo, as an associate licensee of CB, owed a fiduciary duty to him equivalent to the fiduciary duty owed by CB. We agree.

The duties of brokers and salespersons in real property transactions are regulated by a comprehensive statutory scheme. Civ. Code, §2079 et seq. Under this scheme, an "agent" is a licensed real estate broker "under whose license a listing is executed or an offer to purchase is obtained." Id., §2079.13, subd. (a). An "associate licensee" is a licensed real estate broker or salesperson "who is either licensed under a broker or has entered into a written contract with a broker to act as the broker's agent in connection with acts requiring a real estate license and to function under the broker's supervision in the capacity of an associate licensee." Id., subd. (b). "'Dual agent' means an agent acting, either directly or through an associate licensee, as agent for both the seller and the buyer in a real property transaction." Id., subd. (d).

"The agent in the real property transaction bears responsibility for his or her associate licensees who perform as agents of the agent. When an associate licensee owes a duty to any principal, or to any buyer or seller who is not a principal, in a real property transaction, that duty is equivalent to the duty owed to that party by the broker for whom the associate licensee functions." Civ. Code, §2079.13, subd. (b).

"[A] broker's fiduciary duty to his client requires the highest good faith and undivided service and loyalty." Field v. Century 21 Klowden-Forness Realty, 73 Cal. Rptr. 2d 784 (1998). "[A] dual agent has fiduciary duties to both the buyer and seller." Assilzadeh v. California Federal Bank, 98 Cal. Rptr. 2d 176 (2000).

CB acted as the dual agent of the buyer and the seller in this case, as was confirmed on the disclosure forms provided to Horiike. The disclosure form explicitly stated that a dual agent has a fiduciary duty of utmost care, integrity, honesty, and loyalty in dealings with either the seller or the buyer. See Assilzadeh v. California Federal Bank, supra, 82 Cal. App. 4th at p. 414. Cortazzo executed the forms on behalf of CB as an associate licensee. Under Civil Code section 2079.13, subdivision (b), the duty that Cortazzo owed to any principal, or to any buyer who was not a principal, was equivalent to the duty owed to that party by CB. CB owed a fiduciary duty to Horiike, and therefore, Cortazzo owed a fiduciary duty to Horiike.

Miller & Starr explains: “When there is one broker, and there are different salespersons licensed under the same broker, each salesperson is an employee of the broker and their actions are the actions of the employing broker.…When one salesperson obtains the listing and represents the seller, and another salesperson employed by the same broker represents the buyer, they both act as employees of the same broker. That broker thereby becomes a dual agent representing both parties.” 2 Miller & Starr, Cal. Real Estate (3d ed. 2011) §3:12, p. 68. Miller & Starr notes: “Salespersons commonly believe that there is no dual representation if one salesperson ‘represents’ one party to the transaction and another salesperson employed by the same broker ‘represents’ another party to the transaction. The real estate industry has sought to establish salespersons as ‘independent contractors’ for tax purposes, and this concept has enhanced the misunderstanding of salespersons that they can deal independently in the transaction even though they are negotiating with a different salesperson employed by the same broker who is representing the other party to the transaction.” Id. at fn. 29.

Cortazzo, as an associate licensee acting on behalf of CB, had the same fiduciary duty to Horiike as CB. The motion for nonsuit should have been denied and the cause of action against Cortazzo for breach of fiduciary duty submitted to the jury. The jury was also incorrectly instructed that CB could not be held liable for breach of fiduciary duty based on Cortazzo’s actions.…

“A broker’s fiduciary duty to his client requires the highest good faith and undivided service and loyalty. ‘The broker as a fiduciary has a duty to learn the material facts that may affect the principal’s decision. He is hired for his professional knowledge and skill; he is expected to perform the necessary research and investigation in order to know those important matters that will affect the principal’s decision, and he has a duty to counsel and advise the principal regarding the propriety and ramifications of the decision. The agent’s duty to disclose material information to the principal includes the duty to disclose reasonably obtainable material information.’” Assilzadeh v. California Federal Bank, supra, 82 Cal. App. 4th at pp. 414-415, quoting Field v. Century 21 Klowden-Forness Realty, supra, 63 Cal. App. 4th at pp. 25-26.

“A fiduciary must tell its principal of all information it possesses that is material to the principal’s interests. A fiduciary’s failure to share material information with the principal is constructive fraud, a term of art obviating actual fraudulent intent.” Michel v. Moore & Associates, Inc., 67 Cal. Rptr. 3d 797 (2007).

“‘Constructive fraud is a unique species of fraud applicable only to a fiduciary or confidential relationship.…Most acts by an agent in breach of his fiduciary duties constitute constructive fraud. The failure of the fiduciary to disclose a material fact to his principal which might affect the fiduciary’s motives or the principal’s decision, which is known (or should be known) to the fiduciary, may constitute constructive fraud. Also, a careless misstatement may constitute constructive fraud even though there is no fraudulent intent.’” Salahutdin v. Valley of California, Inc., 29 Cal. Rptr. 2d 463 (1994).…

A trier of fact could conclude that Cortazzo was aware of material information that he failed to provide Horiike, even though he did not have a fraudulent intent. Cortazzo knew the square footage of the property had been measured and reflected differently in different documents. When a potential purchaser sought to confirm the square footage, Cortazzo gave handwritten advice to have the square footage verified by a specialist. He subsequently changed the listing for the property to reflect that the square footage required explanation. He did not explain to Horiike that contradictory square footage measurements existed. A trier of fact could conclude that although Cortazzo did not intentionally conceal the information, Cortazzo breached his fiduciary duty by failing to communicate all of the material information he knew about the square footage. He did not even provide the handwritten advice given to other potential purchasers to hire a specialist to verify the square footage.…

The judgment is reversed. Appellant Hiroshi Horiike is awarded his costs on appeal.

Not all states permit “dual agency,” in part because of concerns about conflicting duties. *See e.g.,* Fla. Stat. §§475.278; 275.272. A buyer will want to pay the lowest price for the home but a broker is compensated based on a percentage of the sales price, creating a potential conflict. As with warranty law, the more information that a consumer provides, the higher the duty to disclose.

2. Closing on a Home

When a consumer is interested in a home, he or she makes a written offer. There will be conditions to the offer, such as the buyer obtaining a loan or the seller perhaps making certain repairs. The offer will normally be accompanied by “earnest money,” essentially a very small down payment toward the purchase price to indicate that the buyer is serious. The seller then must accept the offer—just like you learned in first-year law school. At this point, the parties have a tentative deal. Before the home is actually purchased, there are additional steps each party must take. If the buyer fails to do the required steps, the earnest money may be forfeited to the seller, who took the property off the market to allow the buyer to proceed.

The consummation and transfer of ownership will occur at the “closing.” This is when the parties will sign and exchange all necessary documents, and everybody either pays or gets paid—as befits the situation.

There are several distinct documents related to a home purchase. These are greatly simplified definitions but even at this level, they expose some of the complex aspects of home purchase.

- Loan Estimate. This disclosure must be given to a consumer no later than the third business day after he or she submits a loan application and at least four business days prior to the consumer’s being committed to the loan (called “consummation”). The form provides key information on the loan terms, projected payments, and closing costs. 12 C.F.R. §1026.37.
- Deed. This is the real estate document that transfers ownership of the home from the seller or the buyer. It is recorded in the county land records. The statute of frauds and other state laws impose formalities, such as a notary or witnesses, on the signing of deeds.

- Promissory Note. This is the contract to borrow money. It is signed by the lender and the borrower (the buyer of the house). It will set forth the key loan terms, such as the amount borrowed, the length of the loan, and the interest rate. The note is usually a "negotiable instrument," which means it can be transferred to others who can then collect on it.
- Mortgage or Deed of Trust or Security Instrument. The particular type of document used depends on state law but each document has the same purpose. When signed by the homeowner/borrower, it grants the lender a contingent, non-possessory security interest in the home. The mortgage will cause the house to be collateral for the loan, specify the terms of default, and give the right to foreclose (to take ownership) of the house if the loan is unpaid.
- Closing Disclosure. The Truth in Lending Act and the Real Estate Settlement Procedures Act require a disclosure of all costs related to the mortgage loan and to closing the transaction. 12 C.F.R. §1026.38. These are integrated into a Closing Disclosure. Creditors must provide the document no later than three business days before "consummation" of the loan. See Problem 12.4 in the preceding assignment for an example.

The CFPB has promulgated sample loan estimates for compliance purposes with Regulation Z, which implements the Truth in Lending Act. An example, Ficus Bank, is on the next page.

FICUS BANK
4321 Random Boulevard • Somecity, ST 12340

Save this Loan Estimate to compare with your Closing Disclosure.

Loan Estimate

DATE ISSUED	2/15/2013
APPLICANTS	Michael Jones and Mary Stone 123 Anywhere Street Anytown, ST 12345
PROPERTY	456 Somewhere Avenue Anytown, ST 12345
SALE PRICE	$180,000

LOAN TERM	30 years
PURPOSE	Purchase
PRODUCT	Fixed Rate
LOAN TYPE	☒ Conventional ☐ FHA ☐ VA ☐ ____________
LOAN ID #	123456789
RATE LOCK	☐ NO ☒ YES, until 4/16/2013 at 5:00 p.m. EDT *Before closing, your interest rate, points, and lender credits can change unless you lock the interest rate. All other estimated closing costs expire on* ***3/4/2013*** *at 5:00 p.m. EDT*

Loan Terms		**Can this amount increase after closing?**
Loan Amount	$162,000	**NO**
Interest Rate	3.875%	**NO**
Monthly Principal & Interest *See Projected Payments below for your Estimated Total Monthly Payment*	$761.78	**NO**
		Does the loan have these features?
Prepayment Penalty		**YES** • **As high as $3,240** if you pay off the loan during the first 2 years
Balloon Payment		**NO**

Projected Payments

Payment Calculation	**Years 1-7**	**Years 8-30**
Principal & Interest	$761.78	$761.78
Mortgage Insurance	+ 82	+ —
Estimated Escrow *Amount can increase over time*	+ 206	+ 206
Estimated Total Monthly Payment	$1,050	$968

Estimated Taxes, Insurance & Assessments *Amount can increase over time*	$206 a month	**This estimate includes** ☒ Property Taxes ☒ Homeowner's Insurance ☐ Other: *See Section G on page 2 for escrowed property costs. You must pay for other property costs separately.*	**In escrow?** YES YES

Costs at Closing

Estimated Closing Costs	$8,054	Includes $5,672 in Loan Costs + $2,382 in Other Costs – $0 in Lender Credits. *See page 2 for details.*
Estimated Cash to Close	$16,054	Includes Closing Costs. *See Calculating Cash to Close on page 2 for details.*

Visit **www.consumerfinance.gov/mortgage-estimate** for general information and tools.

LOAN ESTIMATE PAGE 1 OF 3 • LOAN ID # 123456789

Note that unless the buyer is paying cash for the home or the seller is financing the purchase (both rare), there are two important contractual relationships being created. The first is between the current owner of the home (seller) and its new owner (buyer); the second is between the lender (mortgagee) who is financing the transaction and the borrower (buyer/mortgagor). The Closing Disclosure contains information about both contracts. It describes the principal, interest rate, length of loan, and the like. It also describes the costs of certain closing transactions and who is being paid for the work, such as the recording fee for the deed, the appraisal fee, etc. Because both closing costs and financing costs affect the price of a home, consumers can review only one document (albeit five pages) to see the key terms in both contracts.

There are a number of other participants, at least in the background, at closing. A title company representative might attend, or at least will have prepared a title report. This is an examination of the history of ownership of the property. A "clean" title report means that the seller has the right to transfer the property, as described, subject to any listed obligations—such as the seller's own mortgage company. Types of title problems can include a problematic past conveyance in the chain of title, or a previously undiscovered but valid lease, easement, or similar encumbrance on the land. Lenders usually require title insurance as protection if someone later challenges ownership or asserts a superior right to the property. Sometimes, particularly in the Western United States, owners also may have title policies to protect themselves.

A buyer may have the home inspected between making the offer and closing, and have made the closing contingent on a satisfactory inspection. This is for the buyer's benefit in assessing the home's condition, and can include specialized inspections such as for radon or lead paint. The appraiser, on the other hand, is largely for the lender's benefit. The appraiser is to exercise judgment to estimate the home’s value. A buyer may be paying more or less than the appraisal, depending on market conditions and the down payment. The most visible person at a closing is called, handily enough, a “closing agent.” This person may work for either the lender or the title company or may be the buyer’s realtor, all depending on state law. The easiest way to recognize a closing agent is to see who is constantly proffering a pen to the homebuyer for signatures.

One final term of art with regard to homeownership is “escrow.” This is a way of handling payments that are required for the home purchase, other than the principal and interest due on the promissory note. For any given home, there will be property taxes, homeowner’s insurance, specialized flood or earthquake insurance, and mortgage insurance. With escrow, the borrower makes advance payments to the lender, who in turn is responsible for paying these obligations. The benefit to the borrower of escrow is one simplified payment; the benefit to the lender is that it ensures that these bills are being timely paid, which reduces its risk if the borrower defaults or calamity strikes.

The rules surrounding escrow, and closing generally, as found in the Real Estate Settlement Procedures Act (RESPA), 12 U.S.C. §2601 et. seq., and its corresponding Regulation X. The major purpose of RESPA is to provide transparency in pricing around closing real estate deals. It prohibits kickbacks from lenders to companies that provide closing services, including title insurance or appraisals. The consumer is allowed to select the most important services, such as the title insurer, rather than being steered to a particular insurer, who overcharges and then returns part of the overcharge to the lender as a “nice doing business with you” treat. Lenders typically provide suggested companies, however, which is partly why the Closing Disclosure breaks down costs into “Services Borrower Did Not Shop For” and “Services Borrower Did Shop For.” The idea is presumably to remind the borrower that overcharges could be occurring if the consumer did not question or compare costs.

Consumer lawyers, as you may be gathering, need to be vocabulary and acronym whizzes to navigate homeownership transactions. If you are feel overwhelmed, consider how a non-English speaking, non-college-educated, first-time homebuyer might feel during closing. It is precisely these feelings of confusion and information overload that prompt consumers to rely—sometimes to their detriment—on mortgage and real estate professionals to “sum it up” or “point to where to sign.”

3. Housing Finance System

As a consumer is unpacking moving boxes, rearranging furniture, and throwing a housewarming party, the lender is only halfway done with its work. Very few home loans remain owned by the originating lenders. Instead, they are sold on the secondary market. This process generates immediate cash (and profit) to the originating lender, which can then use to fund more lending. The housing finance system, which includes public, quasi-public, and private actors, is the economic engine that makes homeownership possible.

The reasons that lenders sell loans are myriad. A major reason, especially for stand-alone mortgage companies, is simply to generate additional funding for another round of loans. Other important reasons that mortgage loans are usually not held in the originator’s portfolio including the need to diversify risks and balance short- and long-term obligations. One obvious risk for anyone holding a mortgage loan is default. Even in the best of times, unemployment and family break-up make it impossible for some people to pay their mortgages. To mitigate such risk, especially on loans with low down payments, lenders sometimes require mortgage insurance. Private mortgage insurance (PMI) is offered by companies for a fee and adds to the consumer's monthly payment on the loan. The government also insures mortgage loans. In the simplest form, the lender can make a claim to be reimbursed for its losses if a loan goes to foreclosure. This is how Federal Housing Administration (FHA) and Veterans Administration (VA) loans work. To make a reimbursement claim, the lender certifies to the government that it carefully followed all rules and procedures in originating the loans. In the years after the foreclosure crisis, FHA became more aggressive in challenging banks' claims, sometimes pursuing them for False Claims Act liability on the grounds that defects in the origination process made the loan ineligible for government reimbursements that lenders sought and were paid.

One major reason that depository institutions sell the mortgages that they originate is the tremendous interest-rate risk with a typical fixed-rate mortgage. If a bank makes a 30-year loan at 5 percent interest, but only five years later is paying out 7 percent to its depositors as interest, there is a problem. It's called losing money, and it's not something we want from our banks. To hedge against this risk, and others such as the consumer paying off the loan early (and therefore eliminating a lot of the interest that the bank expected to make on the loan), lenders sell the loans.

This market for mortgages is called the "secondary market." The government was the original player, beginning in 1930s with a panoply of institutions such as the Federal Home Loan Banks, which continue to provide liquidity to mortgage lenders today. Government support of funding for homeownership evolved to focus on two quasi-private institutions, Fannie Mae and Freddie Mac. Known as "government sponsored enterprises" (GSEs), these entities purchase mortgage loans and sell them to investors. In 2015, Fannie and Freddie function a lot like Coke and Pepsi in the market for soda (or pop, for those from certain parts of the country); they are a duopoly that controls the market. The other important player, which functions like a button that dispenses all the other brands of soda pop, is Ginnie Mae. Its system creates mortgage securities for investors from loans originated by the VA, USDA, FHA, and similar government agencies. In 2015, mortgages implicitly or explicitly guaranteed by the government are 90 percent of all loans originated, compared with about two thirds before the 2008 financial crisis.

Fannie and Freddie originally purchased mortgage from private lenders and held them in their portfolios. Pension funds and others invested in mortgages by purchasing bonds issued by Fannie and Freddie. While these organizations had features of private corporations, including shareholders, they were federally chartered. Investors believed that the federal government would stand behind their bonds, as it explicitly does with U.S. Treasury bonds. In the 1970s, Fannie, Freddie, and Ginnie began to "securitize" mortgage loans, a finance tool that further increased liquidity for homeownership investment.

> The agencies would purchase home mortgages, deposit large numbers of them in "pools," and sell participation in the pools to investors on Wall Street. With these new pass-through investment vehicles, investors could hold a share of large (and diversified) numbers of mortgages insured by the government in the case of Ginnie Mae, or guaranteed by the large stable government sponsored enterprises (GSEs) in the case of Freddie Mac and Fannie Mae. Because the

> agencies still guaranteed the principal and interest income of their securities even when mortgagors defaulted, investors saw the securities as a low risk investment.…

Christopher L. Peterson, *Fannie Mae, Freddie Mac, and the Home Mortgage Foreclosure Crisis*, 10 LOYOLA J. OF PUBLIC INTEREST L. 149, 156 (2009). Private institutions, such as investment banks, saw the profit potential of creating mortgage-backed securities for loans outside the GSE's bailiwick. These included "jumbo" loans that exceed the GSE's "conforming loan limits" and subprime loans that did not meet the underwriting guidelines for purchase by the two GSEs. In the 1990s and 2000s, the types and terms of mortgage loans increasingly deviated from the 30-year, fixed-rate rate, 20 percent down payment loans of the GSEs. Professor Peterson continues the story of securitization of non-conforming loans.

> [I]nvestment banking firms developed pricing models that allowed prospective investors to anticipate the value and liquidity of private-label mortgage backed securities. Investment banks also began partitioning risk into different investments with a variety of credit risks, all drawing on the same income stream from a pool of mortgages. Where earlier residential mortgage backed securities would merely pass through income to investors, *tranched* securities divided payments into different income streams suited to the time and risk preferences of investors.…

Id. at 159. In 2003, Fannie and Freddie began to invest in these private-label securities, giving them exposure to the profits—and perils—of riskier mortgages. These bets were losers, and in 2008, the federal government put the GSEs into conservatorship and created a new stronger regulator, the Federal Housing Finance Agency. At this time, Congress has not acted with regard to the future of the GSEs. Some have called for their dismemberment, arguing their functions can and should be provided by private institutions. Others have doubled-down on the public option, arguing that there should be an explicit government guarantee of mortgage-backed securities. In the meantime, the Federal Housing Finance Agency has focused on updating its technology and creating a common securitization platform, which produce a "single security" that puts Fannie and Freddie on parity with each other in the bond market. It also provides the potential for private label securitizers to eventually use the same infrastructure. As of 2016, private securitizations remain rare, however, and the government is the exclusive secondary market for mortgages.

The fact that loans are sold, and ultimately owned by trusts as part of the securitization process, creates confusion among homeowners. A consumer may have dealt with Lender Q, but any effort to get in touch with Lender Q when there are problems with repayment is met with "we sold your loan." When the consumer calls the trust, a chipper receptionist explains that the trust is a "passive entity" and that the homeowner must call the loan servicer. These companies are on the front lines of dealing with consumers, and as a result are the subject of much consumer and regulatory ire. Servicing is discussed at length in the next assignment, but mentioned here because it is the secondary market for mortgages that creates the need for a company to work with the consumer. The real loan owners are hundreds or thousands of investors in tranched securities who each own only a sliver of the loan.

B. Liability for Homes

Shopping for a home is fundamentally different from buying personal property. A primary reason is that homes are not sold by retailers as inventory, but by owners as a one-off transaction. Shopping is much more involved than walking down an aisle and browsing products, or even reading reviews on a website. The law treats a piece of real property as unique, rather than as a fungible good. The U.C.C. rules on warranties do not apply, and state law is not uniform. In general, consumers have many fewer rights with regard to home quality than any other purchase. While that legal rule may have made sense when what was being purchased was bare land for use in farming or ranching, few consumers can reliably assess construction or property defects when buying a home.

1. Caveat Emptor

"The maxim 'caveat emptor' (let the buyer beware) expresses a rule of the common law applicable to sales of property which implies that the buyer must not trust blindly that he will get value for his money, but must take care to examine and ascertain the kind and quality of the article he is purchasing, or, if he is unable to examine it fully or intelligently, or lacks the knowledge to judge accurately of its quality or value, to protect himself against possible loss by requiring an express warranty from the seller." *McClurkin v. DeGaigney*, 251 S.W. 617, 619 (Ky. 1923). Quoting this language nearly a century later, the court put the rule of liability for real property more succinctly: "The Court Will Not Protect Unwise Decisions." *Manning v. Lewis*, 400 S.W.3d 737, 741 (2013). Even for sales to unsophisticated first-time home buyers, the general rule is caveat venditor, or "seller beware." From a consumer protection standpoint, it is a harsh rule.

Douglas v. Visser

295 P.3d 800 (Wa. Ct. App. 2013)

APPELWICK, Judge.

FACTS

In 2007, Nigel and Kathleen Douglas were looking for a home in Blaine, Washington. They are Canadian citizens and wanted a second home in the area. In the course of the search, they discovered a property owned by Terry and Diane Visser. Terry Visser is a licensed real estate agent and listed the property himself.

The Vissers purchased the property in 2005. At the time, it needed significant work. The Vissers intended to renovate and rent the property. They demolished bungalows that were located on the property. In the main house, they renovated the bathroom, repaired portions of rot, insulated the exterior walls, fixed wall paneling, insulated the ceiling, installed Styrofoam ceiling tiles, and replaced the exterior bellyband. During the course of repairs, the Vissers realized that the renovations would take more time and money than they expected, and they decided to sell the house.

After the Douglases made an offer, the Vissers filled out a seller disclosure statement. But, they answered "don't know" or simply failed to respond at all to many questions that the Douglases felt should have had a clear "yes" or "no" answer. Perplexed, the Douglases sent a list of follow-up questions. In addition to seeking clarification, they requested a copy of the inspection report prepared before the Vissers purchased the property. Diane Visser handwrote responses to the questions, but the Douglases continued to think the answers were inadequate. The Vissers never provided a copy of the inspection report. Nevertheless, the Douglases did not ask for any further clarification.

Dennis Flaherty performed a prepurchase inspection for the Douglases. He discovered a small area of rot and decay near the roof line, and caulking that suggested a previous roof leak in the area. Beneath the home, he found an area of rotted sill plate that sat below the section of water damaged exterior siding.…In his inspection report, he noted that those areas did not pose a structural threat but should be repaired if the condition degraded rapidly.

The Douglases did not discuss the report with Flaherty or the Vissers. They purchased the house without discussing the issue of rot with the Vissers. The sale closed in April 2007. The parties agreed on a purchase price of $189,000. The Douglases paid $40,000 cash and gave the Vissers a promissory note secured by a deed of trust for the remaining $149,000. The total amount was due on August 1, 2008.

After purchasing the house, the Douglases began to notice a damp smell and a constant presence of potato bugs around the perimeter of the house and in the bathroom. In an effort to keep out the potato bugs, they caulked the baseboards in the bathroom. Eventually, they noticed that the ceiling tiles were gradually separating in the living room, master bedroom, and second bedroom.

Flaherty returned to inspect the home again. When he removed a ceiling tile, insulation and water came down from behind it. In response to what they found, the Douglases requested a bid from a mold abatement company. The company was unable to guarantee the removal of all mold because of the house's pristine mold-growing conditions. Without a guarantee, the Douglases elected to take no action.

In July 2008, the pay-in-full date was quickly approaching. Because it was uninhabitable, they requested an additional month to investigate the extent of the mold. The promissory note's due date was pushed back to September 1.

In the meantime, the Douglases removed the bellyband. They discovered substantial rot and pest issues underneath. In fact, there was virtually nothing behind the bellyband and they did not encounter any resistance in removing the boards. The Douglases defaulted on the promissory note.

In September 2008, Flaherty returned to the house a third time. He determined that the rim joists had 50 percent to 70 percent wet rot and pest damage that could not be seen from the crawl space without removing insulation. Similarly, he concluded the sill plate had 50 percent to 70 percent wet rot and pest damage. He opined that "installation of the siding was within the last two years and the extent of damage to the sill and rim joist could not have occurred since the installation of the skirt boards siding. Therefore, whoever installed the skirt board siding would have known that structurally damaged portions of the framing would have been concealed." He further stated, "It is my professional opinion that the installation of the pink fiberglass insulation in the crawl space stud bays between the floor joists and firmly packed against the rim joists may have been installed to reduce the probability that damaged rim joists and sill would be discovered during a standard home inspection."

Another inspector, Kirk Juneau, also inspected the damage. He determined that a new trim was used on the house's exterior that is intended only for interior use. The trim covered and concealed damage, and had been installed within the previous two to three years. In the house's interior, he noted that where subflooring had been replaced the person who made the patches should have discovered the damage beneath. Beneath the house, he determined that some joist damage was visible, because it was not covered by insulation, and that once insulation was removed more damage was visible.

The Douglases shut off the water, drained the lines, and turned off the electricity. They obtained a bid from a contractor who determined it would cost more to repair the home than to tear it down and rebuild.

The Douglases sued the Vissers. They claimed fraudulent concealment; negligent misrepresentation; violation of the Consumer Protection Act, ch. 19.86 RCW; breach of contract; and violation of Terry Visser's statutory duties as a real estate agent.

Kelly Hatch, who assisted Visser with some of the repairs, testified that he had difficulty fixing the floors in the bathroom, because the wood was too soft to install screws. When he advised Terry Visser to rip out the plywood to inspect the joists underneath, Visser said he could not put any more into it and told Hatch to find a way to attach the wood. On the house's exterior, Hatch discovered that wood underneath the bellyband was rotted. Visser instructed him to cover it up with trim. Specifically, Visser said they could cover it in caulking, use a bunch of nails, paint it, and seal it. When Hatch nailed the trim up, it was so rotted that he could not get the nails to stay in. Visser himself testified that he added a new piece of wood to a rotted joist, although he asserted he could not see the rot.

Flaherty explained that the rot he discovered in the first inspection was "[n]ot necessarily" a sign that the building's whole sill plate was rotted. He testified that the concealed rot he discovered in his last inspection was the worst he had ever seen. Juneau testified that at the time of the Douglases' purchase there was readily observable damage that warranted further inspection or inquiries.

The trial court found that the Vissers discovered significant wood rot to the sill plate and rim joist, as well as to the floor joists. It determined that, instead of correcting the defects, the Vissers made superficial repairs and concealed the damage. It ruled in favor of the Douglases on all claims. The court awarded the Douglases $103,000 to tear down and rebuild the house; $3,000 to cover the cost of inspections; $1,500 in moving expenses; $12,000 for emotional distress; and $25,000 as treble damages pursuant to the Consumer Protection Act. It also awarded the Douglases their fees and costs in the amount of $49,838. It offset those damages against the principal and interest the Douglases still owed on the promissory note. Judgment was entered for the Douglases in the amount of $24,245.

DISCUSSION

...

The Vissers challenge several of the trial court's findings that are central to its conclusions. Specifically, they argue that there is no substantial evidence to support findings that the Vissers discovered and concealed defects before selling the home or a finding that the defects were unknown and undiscoverable to the Douglases.

The trial court found:

> During the course of renovating the house, the Vissers discovered significant wood rot to the sill plate and rim joist that connects the concrete foundation to the frame.

It further found:

> Rather than correct these defects, the Vissers or their hired help made superficial repairs to the visible damage and covered up the rest.

Two inspectors independently concluded that extensive damage was covered up during the period of time that the Vissers owned the house. Flaherty determined that the damage could not have occurred after the repair work, and Juneau determined that damage beneath the flooring should have been discovered when the subflooring was repaired. Hatch corroborated the inspectors' reports. He testified that he and Terry Visser covered rot with new trim and new subflooring. The inspection reports, together with Hatch's testimony, amply support the trial court's findings that the Vissers discovered and concealed rot.

The trial court also found:

> The defects were unknown to the Douglases and were not discoverable by a careful and reasonable inspection.

When a buyer is on notice of a defect, it must make further inquiries of the seller. In *Puget Sound Service Corp. v. Dalarna Management Corp.*, an apartment building had chronic water leaks. 752 P.2d 1353 (1988).… We concluded that where "an actual inspection demonstrates some evidence of water penetration, the buyer must make inquiries of the seller." Id. at 215. The buyer knew there was a defect but did not make any inquiries or establish that inquiries would have been fruitless. Id. The extent of the damage itself was not a separate defect, and it was no defense that the defect was worse than the buyer anticipated. Id. at 214-15. Accordingly, its claim could not proceed. Id. at 215.

In contrast, in *Sloan v. Thompson* the buyers had extensive knowledge of various defects. 128 Wn. App. 776, 781 (2005). Before they purchased it, the Sloans rented the home for three years and discovered that the roof leaked, the decks were rotted, some electrical outlets did not work, and the toilets did not flush properly. Id. After the sale was completed, an earthquake revealed that the septic tank was defective and the foundation was structurally unsound due to "'extremely faulty construction.'" Id. at 782, 786. Because the defective septic tank and structurally unsound foundation were separate defects from the extensive problems the buyers knew of, the buyers succeeded on their claim for fraudulent concealment. Id. at 789, 791.

Here, Flaherty identified an area of rot and decay near the roofline, an area of rotted sill plate, and sistered floor joists. The Douglases and their inspector were on notice of the defect and had a duty to make further inquiries. The Douglases argue that "they had no idea that 50 to 70% of the sill plate and rim joist were destroyed" and that the area of rot that Flaherty discovered was not unusual. That, however, is the precise argument we rejected in *Dalarna*. Once a buyer discovers evidence of a defect, they are on notice and have a duty to make further inquiries. They cannot succeed when the extent of the defect is greater than anticipated, even when it is magnitudes greater.

The Douglases suggest, without citation to the record, that they did in fact make further inquiries, asserting that "[n]either a reasonable inspection, *nor the Douglases' reasonable questions*, put them on notice" of the extent of damage. (Emphasis added.) But, Nigel Douglas explicitly testified that after the prepurchase inspection report, which was the source of notice of the defects, he did not ask the Vissers or Flaherty any questions about the rot that Flaherty identified. Instead, they were content to let the report speak for itself.

Prior to the inspection, the Douglases asked follow-up questions to the Vissers' perplexing responses in the seller disclosure statement. But none of those questions expressly addressed the rot issue, and the Douglases did not ask any specific questions about rot or the house's foundation. More significantly, both the seller disclosure statement and the Vissers' responses to the Douglases' inquiries predate the prepurchase inspection report. Inquiries made before the prepurchase inspection cannot be construed as inquiries regarding the rot discovered during the inspection.

As in *Dalarna*, there is no evidence that the Douglases made further inquiries once they were on notice of the defect. *Dalarna* recognizes that further inquiry is not necessary where it would have been fruitless. 51 Wn. App. at 215. While the Vissers' overt attempts to cover up the defects prior to listing the property and their preinspection evasiveness may support an inference, if not a conclusion, that such inquiry would have been fruitless, the trial court did not enter any such findings. Accordingly, despite the egregious nondisclosure and concealment by the Vissers, an essential element of each of the Douglases' claims is not satisfied.

A claim for fraudulent concealment exists when (1) the residential dwelling has a concealed defect, (2) the seller has knowledge of the defect, (3) the defect presents a danger to the property or health or life of the buyer, (4) the defect is unknown to the buyer, and (5) the defect would not be disclosed by a careful, reasonable inspection by the buyer. Alejandre v. Bull, 159 Wn.2d 674, 689 (2007). A statutory claim for breach of a real estate agent's duties exists when the agent does not disclose all material facts known to the agent that are not apparent or readily ascertainable. RCW 18.86.030(1)(d). A claim for negligent misrepresentation exists when (1) the seller makes a false statement, (2) to induce a business transaction, and (3) the buyer justifiably relies on the false statement. Amtruck Factors v. Int'l Forest Prods., 59 Wn. App. 8, 18 (1990). A violation of the Consumer Protection Act exists when there is (1) an unfair or deceptive act or practice, (2) occurring in trade or commerce, (3) with a public interest impact, (4) that proximately causes, (5) injury to a plaintiff in his or her business or property. Svendsen v. Stock, 143 Wn. 2d 546, 553 (2001); Indoor Billboard/Wash., Inc. v. Integra Telecom of Wash., Inc., 162 Wn. 2d 59, 83-84 (2007).

Because the Douglases were on notice of the defect and had a duty to make further inquiry, it cannot be said that the defect was unknown to the Douglases, that it could not have been discovered by a reasonable inspection, that the Douglases justifiably relied on the Vissers' misrepresentations, or that the Vissers committed an unfair or deceptive act that caused the Douglases' injury. The Douglases breach of contract claim was based upon fraudulent concealment and negligent misrepresentation claims. When those claims fail, so does the breach of contract claim.

The Vissers' efforts in concealing the defects of the house they were selling are reprehensible, even more so because Visser is a licensed real estate agent. Nonetheless, the law retains a duty on a buyer to beware, to inspect, and to question. We caution that the Douglases did not have a duty to perform exhaustive invasive inspection or endlessly assail the Vissers with further questions. They merely had to make further inquiries after discovering rot or at trial show that further inquiry would have been fruitless. The only evidence of when the Douglases first learned of rot in the house is the report issued after Flaherty conducted his prepurchase inspection. Despite that discovery, on top of the Vissers' previous evasive and incomplete answers and the Vissers' ongoing failure to provide their own prepurchase inspection report, either of which should have caused concern and further inquiry, there is no evidence that the Douglases made any inquiries whatsoever after the inspection. They obtained no finding from the trial court that further inquiry would have been fruitless. Under *Dalarna*, the Douglases' failure means they were not entitled to maintain these claims.

The Douglases defaulted on the promissory note. The interest rate in the event of default is 18 percent. The Douglases owe the principal and interest at 18 percent. Further, the purchase and sale agreement provides an attorney fee provision. When an action in tort is based on a contract containing an attorney fee provision, the prevailing party is entitled to attorney fees. Brown v. Johnson, 109 Wn. App. 56, 58 (2001). We award the Vissers their reasonable attorney fees.

We reverse.

Where should a consumer buy a dream home? Hawaii? Florida? California? If what you seek is protection from home defects, the answer is clear: Louisiana. It has a unique cause of action, "redhibition," that applies when a property has a defect or "vice" that renders the home useless or so inconvenient that a buyer would not have purchased it had the defect been known. *See Jessup v. Ketchings*, 482 F.3d 336, 342 (5th Cir. 2007). While defects that were known or could have been discovered are excluded, consumers seem to fare better in Louisiana under its civil law tradition than at common law.

2. Warranties on New Property

If Louisiana isn't your place, the other way to obtain more protection is to buy a new home. You get a warranty and that new paint smell (along with the fun of having to install towel racks and curtain rods and an endless other number of items you rarely give thought to.)

Davencourt at Pilgrims Landing Homeowners Ass'n v. Davencourt at Pilgrims Landing LC

221 P.3d 234 (Utah 2009)

DURHAM, Chief Judge.

...

Davencourt at Pilgrims Landing (the Project) is a planned unit development. The Project is the result of the design and development efforts by Davencourt at Pilgrims Landing, LC (Developer)…

In selling the units, the Developer used a standard form real estate purchase contract for residential construction in each transaction. Also, the Developer represented and warranted that the Project (1) complied with the building code and had been inspected for such; (2) consisted of high-quality structures; (3) was in good condition and properly and fully maintained; (4) had no faulty workmanship; (5) had no water intrusion, moisture problems, or other material defects; and (6) the Association's budget and monthly assessments were accurate and adequate for future maintenance, repair, and replacement.

A few years after turnover of the Association to the Unit Owners, the Association learned of significant problems with the Project. Water began to seep into the buildings through the foundation, floors, porches, stucco, sidewalls, exterior walls, doors, windows, window boxes, and roofs. The water intrusion caused damage to the buildings in the form of dryrot, mold, staining, and degradation of the stucco. Upon hiring a building envelope specialist, the Association learned that the water intrusion and resulting damage stemmed from faulty design, faulty workmanship, defective materials, improper construction, and/or noncompliance with building codes. The building envelope specialist informed the Association that these flaws and defects, evident in all the buildings, were present in several latent construction defects, including: improper installation of stucco; improper stucco termination points at slabs and foundations; window boxes designed without a drainage plane, allowing water into the building cavity; improper integration of the stucco; missing or inadequate control joints in the stucco to prevent cracking; missing or improper flashings; and missing, incomplete, or improperly installed waterproofing at the foundations and walls of the units.

The Association also learned that before construction began, the Developer and the Builder had obtained a geo-technical study on the soil and subsurface soils of the Project. The report from the study warned that the Project would rest on collapsible subsurface soils that would cause land subsidence without proper preparation. Following construction, the land subsided. This land subsidence caused severe structural defects to the stucco and cement work and contributed to the water intrusion through the foundation, floors, porches, stucco, sidewalls, exterior walls, windows, window boxes, and roofs.

The Association repeatedly requested that the Developer and the Builder repair the defects, but they refused to do so.

...

ANALYSIS

The Association next asserts that the district court erred by dismissing the claim for breach of implied warranties. The district court correctly noted that this court has yet to recognize such a claim in the sale of a new residence; we do so now.

Utah courts have historically refused to recognize an implied warranty of workmanlike manner and habitability in the context of new residential sales. In *American Towers Owners Ass'n v. CCI Mechanical, Inc.*, the court explained its refusal:

> The main policy reasons behind extending an implied warranty of habitability to residential leases are the unequal bargaining position of the parties and the prospective tenant's limited ability to inspect and repair the property. *These policy reasons are not present to the same degree in the purchase of residential property.* The purchaser has the right to inspect the house before the purchase as thoroughly as that individual desires, and to condition purchase of the house upon a satisfactory inspection report. Further, if there are particular concerns about a home, the parties can contract for an express written warranty from the seller. Finally, if there are material latent defects of which the seller was aware, the buyer may have a cause of action in fraud. Therefore, *the circumstances presented to the purchaser of a residence are not closely analogous to those of a relatively powerless lessee.*…

930 P.2d 1182, 1193 (Utah 1996) (omission in original) (quoting Maack v. Res. Design & Constr., Inc., 875 P.2d 570, 582–83 (Utah Ct. App. 1994)).

After reviewing the state of the case law from around the country, we conclude that our rule has become an anachronism.

During the first half of the twentieth century, the doctrine of caveat emptor in new residential construction led courts to reject implied warranties. Underlying this almost universal doctrine was the theory of equal bargaining power in contract and the ability and opportunity to inspect. 12 Thompson on Real Property §99.06(a)(2) (David A. Thomas ed., 2d Thomas ed. 2008). With the boom in post-World War II construction, the tide changed. Id. In the late 1950s, the first American court recognized an implied warranty in the sale of a new home. Vanderschrier v. Aaron, 103 Ohio App. 340 (1957). Other courts followed suit in the 1960s. By the 1980s, the minority became the majority. See Conklin v. Hurley, 428 So. 2d 654, 656 n.2 (Fla. 1983) (citing to thirty-three states that recognize an implied warranty of habitability of new homes).

Today, by common law or statutory law, an overwhelming majority of jurisdictions recognize an implied warranty in the purchase of new residential property. Forty-five states have adopted an implied warranty in some form and Hawaii appears to have done so in dicta. Forty-three states provide for an implied warranty of habitability. Besides the four states that do not recognize any implied warranty, only Delaware, Nebraska, and Ohio expressly reject the implied warranty of habitability; yet those three states each provide for an implied warranty of workmanlike manner. Out of the four states that have not adopted any implied warranty, two states, New Mexico and North Dakota, have not directly addressed or answered the issue. The two remaining states, Georgia and Utah, have expressly rejected implied warranties. But Georgia does so because it allows recovery under negligence theory. This leaves Utah in a minority of one.

Although the implied warranties adopted by courts "are known by various names such as 'habitability,' 'quality,' 'workmanship,' or 'fitness,'" courts rely on similar reasons and public policy considerations in adopting the warranties. Courts recognize that "[b]uilding construction by modern methods is complex and intertwined with governmental codes and regulations." Tavares v. Horstman, 542 P.2d 1275, 1279 (Wyo. 1975). For a builder-vendor or developer-vendor engaged in the business of selling houses, the construction and/or sale of a new home is a daily event, whereas for a buyer the purchase of a new home is a significant and unique transaction. See Bethlahmy v. Bechtel, 415 P.2d 698, 710 (1966) ("The purchase of a home is not an everyday transaction for the average family, and in many instances is the most important transaction of a lifetime. To apply the rule of caveat emptor to an inexperienced buyer, and in favor of a builder who is daily engaged in the business of building and selling houses, is manifestly a denial of justice."). Given these modern realities and this disparity, "[a] home buyer should be able to place reliance on the builder or developer who sells him a new house." Tavares, 542 P.2d at 1279. Some courts reason that the implied warranty will "inhibit the unscrupulous, fly-by-night, or unskilled builder and…discourage much of the sloppy work and jerry building that has become perceptible over the years." Capra v. Smith, 372 So. 2d 321, 323 (Ala. 1979) (internal quotation marks omitted). An implied warranty also takes into account the equitable consideration that between two innocent parties, the one in the better position to prevent the harm ought to bear the loss. See Chandler v. Madsen, 642 P.2d 1028, 1031 (1982).…Hence, in protecting the innocent home purchaser by holding the responsible party accountable, the law has come to recognize that no longer does the purchaser of a new residence stand on an equal bargaining position with the builder-vendor or developer-vendor.

Moreover, the concept of an implied warranty is "consistent with the expectations of the parties." Sloat v. Matheny, 625 P.2d 1031, 1033 (Colo. 1981). "[T]he essence of the transaction is an implicit engagement upon the part of the seller to transfer a house suitable for habitation." Yepsen v. Burgess, 525 P.2d 1019, 1022 (1974). If the purchaser expected anything less, there would be no sale. See Sloat, 625 P.2d at 1033. The creation of an implied warranty, therefore, causes "no more uncertainty or chaos than the warranties commonly applied in sales of personal property." Bethlahmy, 415 P.2d at 707. Also, we are not convinced that an express written warranty provides sufficient protection where concerns regarding latent defects exist. "A buyer who has no knowledge, notice, or warning of defects, is in no position to exact specific warranties. Any written warranty demanded in such a case would necessarily be so general in terms as to be difficult to enforce." Id.

These sound reasons and policy considerations "lead[ ] logically to the buyer's expectation that he be judicially protected." Tavares, 542 P.2d at 1279. Although we rejected an implied warranty in *American Towers*, we agree with the following statement.

> The law should be based on current concepts of what is right and just and the judiciary should be alert to the never-ending need for keeping its common law principles abreast of the times. Ancient distinctions which make no sense in today's society and tend to discredit the law should be readily rejected.…

Schipper v. Levitt & Sons, Inc., 207 A.2d 314, 325 (1965). Recognizing that *American Towers* no longer represents what is right and just as to implied warranties in the purchase of a new residence, we now join the overwhelming majority of states. Under Utah law, in every contract for the sale of a new residence, a vendor in the business of building or selling such residences makes an implied warranty to the vendee that the residence is constructed in a workmanlike manner and fit for habitation.

We recognize that "[t]he expansion of implied warranties has resulted in a blurring of the 'distinction, if any, between an implied warranty of habitability and an implied warranty of good quality and workmanship…in decisional law throughout the country.'" Albrecht, 767 N.E. 2d at 45 n. 7. Some courts define the implied warranty of workmanlike manner as "'the quality of work that would be done by a worker of average skill and intelligence.'" Id. Other courts define the implied warranty of habitability in the sense that if a new residence does not keep out the elements because of a defect of construction, such a residence is not habitable or that the new residence must "provide inhabitants with [a] reasonably safe place to live, without fear of injury to person, health, safety, or property." Id. In Utah, the scope of the implied warranty should be construed broadly to comport with the public policy considerations.…Nor can the implied warranty "be waived or disclaimed, because to permit the disclaimer of a warranty protecting a purchaser from the consequences of latent defects would defeat the very purpose of the warranty." Albrecht, 767 N.E.2d at 47.

The implied warranty, however, does not require perfection on the part of the builder-vendor/developer-vendor or "make them an insurer against any and all defects in a home." Id. "No house is built without defects," Bethlahmy, 415 P.2d at 711, and the implied warranty does not "protect against mere defects in workmanship, minor or procedural violations of the applicable building codes, or defects that are trivial or aesthetic." Albrecht, 767 N.E.2d at 47. Nor is the implied warranty intended to alleviate purchasers of their due diligence and opportunity to inspect a residential construction or the incentive to negotiate for express warranties.

Therefore, to establish a breach of the implied warranty of workmanlike manner or habitability under Utah law a plaintiff must show (1) the purchase of a new residence from a defendant builder-vendor/developer-vendor; (2) the residence contained a latent defect; (3) the defect manifested itself after purchase; (4) the defect was caused by improper design, material, or workmanship; and (5) the defect created a question of safety or made the house unfit for human habitation. See id.

The implied warranty is not infinite. A claim for breach of the implied warranty must be brought in accordance with Utah Code section 78B–2–225. That section imposes periods of limitation and repose for "all causes of action by or against a provider arising out of or related to the design, construction, or installation of an improvement." Utah Code Ann. §78B-2-225(2)(e) (2008). "An action by or against a provider based in contract or warranty shall be commenced within six years of the date of completion of the improvement or abandonment of construction." Id. §78B-2-225(3)(a).

Finally, we emphasize that this implied warranty does not abrogate the doctrine of caveat emptor in the sale of existing or used residences. See Utah State Med. Ass'n v. Utah State Employees Credit Union, 655 P.2d 643, 645 (Utah 1982) ("The doctrine [of caveat emptor] has eroded in the sale of new residential housing.

However, the doctrine appears to prevail in the sale of used property whether homes or commercial.”).

We now turn to the Association’s claim for breach of the implied warranty. We hold that because Utah now recognizes the implied warranty of workmanlike manner and habitability, the district court erred in dismissing the Association’s claim for breach of the implied warranty.…Accordingly, because Utah now recognizes an implied warranty of workmanlike manner and habitability, we reverse the district court’s dismissal of the Association’s claim.

...

All fifty states recognize an implied warranty in the sale of a new home. The warranty is usually framed as requiring either “habitability” or “built in a workmanlike manner.” The latter is broader, encompassing defects that an ordinarily prudent builder would not have created. It is similar to malpractice, requiring that the construction was done with customary skill and care in accordance with accepted standards. Many successful cases focus on major problems, such as a lack of proper site preparation or a defective foundation. *See, e.g., Hildebrand v. New Vista Homes II, LLC*, 253 P.3d 1159 (Colo. App. 2010).

A few states, notably California, have statutory implied warranties for new homes. Cal. Civ. Code §§896-945.5. These are often limited to one year for most defects but up to ten years for structural defects. *See, e.g.,* N.J. Stat. §§46:3B-2, 46:3B-3 (permitting actions for up to ten years for major defects identified in the statute). An advantage of the common law warranty for a new home is that these are of uncertain duration, often held to extend for a reasonable time or a similarly flexible standard.

3. Manufactured Homes

Over 17 million Americans live in manufactured homes; these are no longer called “mobile” homes, in recognition of the fact that many are never, in fact, moved from their sites. Depending on the circumstances and state law, a manufactured home may be either real or personal property. Regardless, TILA covers manufactured homes that are a consumer’s principal dwelling regardless of real or personal property designation. The applicability of other laws, such as RESPA, is less clear. Whether a manufactured home is real or personal property is particularly important if a consumer alleges a warranty problem. Common manufacturing defects include leaking roofs (such as where the two halves of a double-wide mobile home are sealed), improperly installed windows or doors, sagging roofs and ceilings, and defective flooring. The Department of Housing and Urban Development (HUD) has issued nationwide standards for quality building of manufactured homes. 42 U.S.C. §§5401-5426. Manufacturers often offer a one-year home warranty, and about half of states provide such protection through statutes. While these are of short duration, they provide more protection during that period than the real property rules discussed above, particularly for resale homes.

The distinction between real and personal property is also critical if the homeowner defaults. As discussed *infra* in the Assignment on creditors' rights, real property requires many more procedural steps for a creditor to exercise the right to possession and sale than personal property. About three-quarters of states have statutes that elaborate a procedure by which a consumer may convert a manufactured home from personal to real property. Consumers generally enjoy greater consumer protections if they take this step.

Problem Set 13

13.1. Emily Ling prides herself on attention to detail. In her role as a compliance officer for a mortgage lender, she deals every day with questions about procedure. Alberto, a loan officer working in Albuquerque asked her to review his process for providing mortgage loan disclosures for home purchases, based on a recent transaction with Pam and Bubba Kirk. On Wednesday, December 30th, he met in person with potential borrowers and collected a mortgage application. It included estimates of the value of the home to be purchased and the amount of the loan needed. When he returned to the office on Monday, January 4th, he mailed two copies of the completed Loan Estimate to the Kirks. The Kirks decided to proceed with the loan, so Alberto emailed them the Closing Disclosure on Friday January 15th. The Kirks immediately replied back to that message, "Thanks! See you at the closing Tuesday." On January 19th, Tuesday, the Kirks signed the promissory note and mortgage, and the lender funded the loan. Did Alberto comply with the disclosure rules for a closed-end mortgage? *See* 12 C.F.R. §§1026.2(a)(3) and (a)(6); 1026.19(e)(1) and (f)(1).

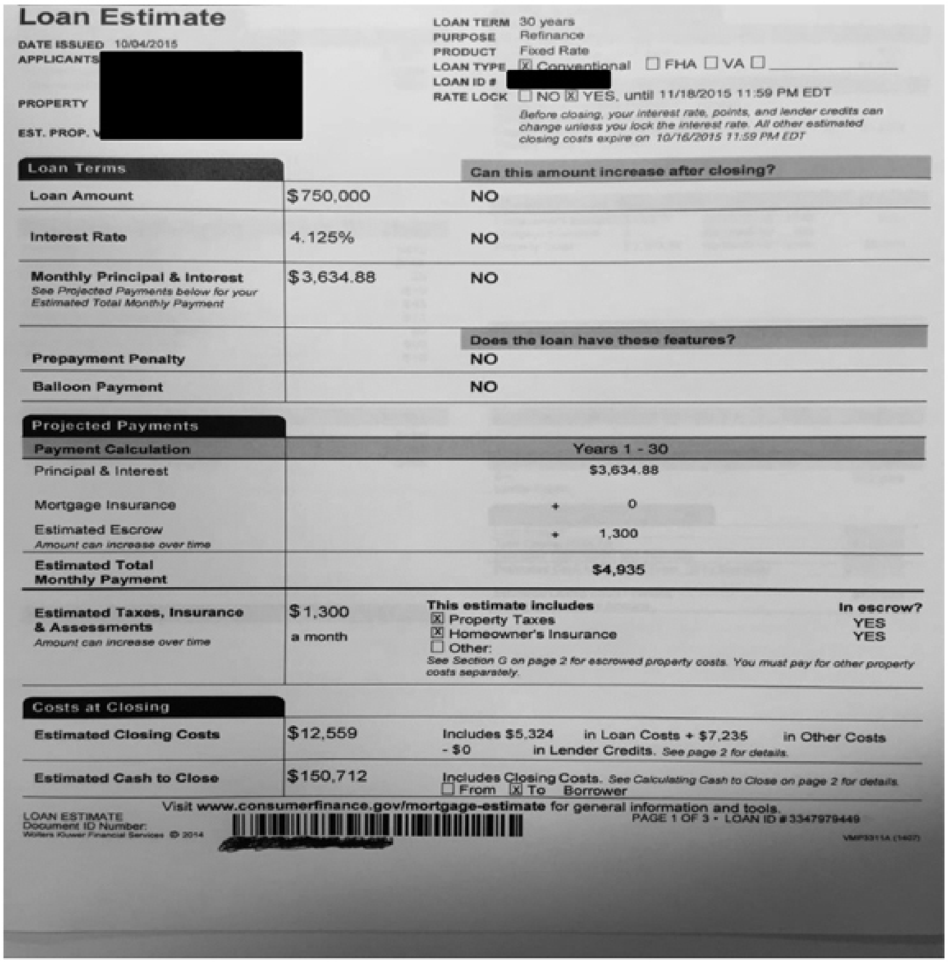
13.2. Barret and Amanda's family is growing, and they have decided to purchase a bigger home. They found a three-bedroom on a half-acre in a lovely suburban development. As tidy people, Barret and Amanda particularly liked the covenants that required identical mailboxes and a neutral paint palette. Their agent, Hillary, works for Clinton Realty. Hillary and Amanda are friends from volunteering at the local animal shelter and are constantly swapping pictures of their numerous, adopted "fur babies."

The home was listed with Clinton Realty with Bill as the selling agent. Bill and the seller, Hubert, are poker buddies. Notwithstanding the kind of friendship that develops in late-night poker, Bill was careful to have Hubert sign all paperwork, including a Disclosure Agreement that required Hubert to "disclose matters reasonably discoverable affecting the property value or desirability." When the parties agreed on a sale price, both buyers and sellers signed a Consensual Dual Agency Agreement that acknowledged that one Clinton Realty agent was representing the buyer and another Clinton Realty agent was representing the seller. The agreement also provided that Clinton would disclose all "material defects" in the property.

At closing, Barret and Amanda were devastated to note that the title opinion disclosed a restrictive covenant on the property limiting dog ownership to one per property. Barret and Amanda could not bear the thought of giving up one of their four dogs and walked away from the deal. Hubert was furious, asking

Bill and Hillary why this didn't come up earlier. Who, if anyone, is liable for the deal falling through and on what theory?

13.3. Alan Suspinsky is the best consumer financial services lawyer in America, at least if you are a "covered person" subject to the CFPB. He has relentlessly pointed out problems and warned of the dangers of overregulation. Today, when you saw Alan in the hallway, he was purple with rage. He shook the form below under your nose.



Loan Estimate

DATE ISSUED 10/04/2015
APPLICANTS [redacted]
PROPERTY
EST. PROP. V

LOAN TERM 30 years
PURPOSE Refinance
PRODUCT Fixed Rate
LOAN TYPE ☒ Conventional ☐ FHA ☐ VA ☐ ____________
LOAN ID # [redacted]
RATE LOCK ☐ NO ☒ YES, until 11/18/2015 11:59 PM EDT
Before closing, your interest rate, points, and lender credits can change unless you lock the interest rate. All other estimated closing costs expire on 10/16/2015 11:59 PM EDT

Loan Terms		Can this amount increase after closing?
Loan Amount	$750,000	NO
Interest Rate	4.125%	NO
Monthly Principal & Interest *See Projected Payments below for your Estimated Total Monthly Payment*	$3,634.88	NO
		Does the loan have these features?
Prepayment Penalty		NO
Balloon Payment		NO

Projected Payments	
Payment Calculation	**Years 1 - 30**
Principal & Interest	$3,634.88
Mortgage Insurance	+ 0
Estimated Escrow *Amount can increase over time*	+ 1,300
Estimated Total Monthly Payment	**$4,935**
Estimated Taxes, Insurance & Assessments *Amount can increase over time*	$1,300 a month — **This estimate includes** ☒ Property Taxes (In escrow? YES) ☒ Homeowner's Insurance (YES) ☐ Other: *See Section G on page 2 for escrowed property costs. You must pay for other property costs separately.*

Costs at Closing		
Estimated Closing Costs	$12,559	Includes $5,324 in Loan Costs + $7,235 in Other Costs - $0 in Lender Credits. *See page 2 for details.*
Estimated Cash to Close	$150,712	Includes Closing Costs. *See Calculating Cash to Close on page 2 for details.* ☐ From ☒ To Borrower

Visit **www.consumerfinance.gov/mortgage-estimate** for general information and tools.

LOAN ESTIMATE
Document ID Number: [redacted]
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PAGE 1 OF 3 • LOAN ID #3347979449
VMP33114 (1407)

"Do you see the error? Do you? How can a lender do business with disclosure rules like this!" he sputtered. Not wanting to seem dumb, you nodded along. "Every number is correct!" he screeched. "But now VestCo won't buy our client's mortgages because they could be sued by a consumer years from now even after the loan is securitized," Alan continues. "I'm calling Congress members and I want a solution." And off Alan went, mumbling to himself about the demise of democracy as the Founders intended it.

Safely back in your office, you pull up the client's disclosure from the firm's file. What is the purported error that VestCo has identified? (Hint: Do a visual comparison with the model Loan Estimate in the assignment and look at 12 C.F.R. §1026.37(o)(3).) If there is a problem, what is the tolerance for liability? Why doesn't Alan's client just fix the Loan Estimate to look the way VestCo believes that it must? 12 C.F.R. §1026.19(e)(3); 15 U.S.C. §1640(a).

Assignment 14. Home Mortgages

The law on home loans changed dramatically in the wake of the foreclosure crisis. Federal law now requires lenders to consider a consumer's ability to repay a residential mortgage. The new underwriting standards, along with the rules on mortgage broker compensation and improved loan disclosures discussed in the prior assignment, were designed to eliminate the egregious practices that preceded the foreclosure crisis.

Because most homes are financed with long-term loans, the consumer laws stretch into the years that follow the initial purchase. The process of collecting payments, and if necessary, addressing defaults in payment is called mortgage servicing. If a homeowner does not pay a mortgage loan, the lender can foreclose causing the family to lose the home. High default and foreclosure rates revealed serious problems in mortgage servicing and sparked reforms to encourage foreclosure prevention. Servicers that deal with homeowners must adhere to extensive standards of conduct.

Because homes are so important to a family's social and financial security, consumers are particularly likely to seek legal help in avoiding foreclosure. Mistakes in underwriting are often only recognized or addressed as defenses to foreclosure. In mortgage lending, *finis origine pendet*. After you brush up on your Latin, consider how this phrase is true both for the consumer in terms of home retention and the lender in terms of liability.

A. Making Mortgage Loans

In the prior assignment, the lender was portrayed as basically an agreeable sort who was happy to dole out money and spent time fretting about disclosure and closing forms. That was a caricature, for certain. Lenders today must carefully consider loan applications. This new environment comes, in part, from strict new rules and tougher regulatory scrutiny. But it also comes from the market. Investors want to avoid the losses of the foreclosure crisis and scrutinize the behavior of all actors: real estate agents, mortgage brokers, appraisers, underwriters, investment banks, government sponsored enterprises, servicers, and certainly, not least, consumers. The excerpt below is the kind of cautionary tale that undergirded efforts to tighten underwriting.

> Lacey Phillips and Erin Hall are a couple. Phillips is a hairdresser, Hall a barber. In the spring of 2006, just as—unbeknownst to them—the housing bubble was deflating, they found a house they wanted to buy priced slightly below $250,000. Like countless American couples during the housing bubble they

mistakenly believed they could afford the house they wanted. They had never owned a house, had only a high-school education (Hall had some college but no degree), and were financially unsophisticated.

They applied to Associated Bank for a mortgage. The bank turned down their application because Hall had a recent bankruptcy and because the bank deemed the couple's joint monthly income of $3,800 too meager to justify the loan of more than $200,000 that they needed. After this rebuff Hall turned to a mortgage broker named Brian Bowling whom he knew and admired (Hall had been Bowling's barber) for help in obtaining a mortgage loan. Bowling—a crook who brokered fraudulent loans (but there is no indication that either Phillips or Hall knew or suspected that he was a crook)—steered the couple to a federally insured bank of dubious ethics named Fremont Investment & Loan. Had Fremont been the bank that had turned the defendants down the first time, this might have shown that they realized they didn't meet the bank's criteria for a loan and so would be able to obtain a loan only by lying. But it was of course a different bank that had previously turned them down.

Associated Bank was a reputable bank. Fremont was not. See *Commonwealth v. Fremont Investment & Loan,* 897 N.E.2d 548, 551-55 (2008). Fremont's specialty was making "stated income" loans—known to the knowing as "liars' loans" because in a stated-income loan the lender accepts the borrower's statement of his income without trying to verify it. Such loans, which played a significant role in the financial collapse of September 2008—the doleful consequences of which continue to plague the U.S. and world economies—were profitable despite the high risk of default because lenders sold them as soon as they'd made them. Many of the loans were repackaged by the buyers into ill-fated mortgage-backed securities whose holders lost their shirts. This was musical-chairs financing.

Fremont went broke when the music stopped in June 2008. Its collapse was a harbinger of the worldwide financial collapse that occurred three months later when Lehman Brothers suddenly declared bankruptcy. "[The] very terms [of Fremont's loans]—short-term interest rates followed by payment shock, plus high loan-to-value and high debt-to-income ratios—were likely to lead to default and foreclosure." Megan Woolhouse, "Lender Settles with State for $10m," *Boston Globe,* Business, p. 7, June 10, 2009, www.boston.com/business/articles/2009/06/10/subprime_lender_settles_suit_with_mass_for_0m/ (visited Sept. 3, 2013) (quoting Attorney General of Massachusetts).

The defendants soon lost their home, being unable—despite valiant efforts to keep up their mortgage payments by working second jobs—to make the monthly payments of principal and interest required by the terms of the mortgage. The interest rate was adjustable; it reset automatically after two years, doubtless at a higher rate. "A large majority of Fremont's subprime loans [the loan to the defendants was subprime] were adjustable rate mortgage (ARM) loans, which bore a fixed interest rate for the first two or three years, and then adjusted every six months to a considerably higher variable rate for the remaining period of what was generally a thirty-year loan." *Commonwealth v. Fremont Investment & Loan, supra,* 897 N.E.2d at 552. Though hapless victims of Bowling, the defendants were convicted in part on the basis of his testimony; for he turned state's evidence and was rewarded for helping to convict his victims by being given a big slice off his sentence.

United States v. Hall, 731 F.3d 649, 650-651 (7th Cir. 2013) Although the Seventh Circuit went on to reverse the consumer's conviction for making false statements to a federally insured bank, the facts illustrate that the fallout from the mortgage crisis spread far and wide. The foreclosure crisis wreaked havoc on consumers but also on businesses, government, communities, courts, and the economy.

1. Underwriting the Loan (QM)

The next decade of mortgage lending will be a sharp break from the practices in the late 1990s and early 2000s. The contours of that future, however, are unknown. The law has created some lines that cannot be crossed when underwriting a loan, and other paths that can be traversed but that carry more risks.

Congress imposed an obligation on mortgage lenders to consider the likelihood of repayment for most residential mortgage loans. 12 C.F.R. §1026.43(a). The requirement does not apply to reverse mortgages, time-shares, bridge or construction loans of 12 months or less, and home equity lines of credit. “Ability to repay” is an absolute that allows creditors to make loans only after a reasonable and good faith determination that the consumer is likely to be able to repay. 15 U.S.C. §1639c(a). Sounds simple enough but regulatory lawyers—always the type to jump in with commas and clauses—have added hundreds of pages to Regulation Z. The rule provides a minimum of eight underwriting factors that must be considered but does not proscribe a particular underwriting model or specify how the factors should be weighted.

Ability to repay is only one of two key terms in mortgage underwriting. As an alternative to assessing and documenting ability to repay, lenders may make a “qualified mortgage.” 15 U.S.C. §1639c(b). These “QM” loans enjoy protection from challenge as failing the ability-to-repay standard. A qualified mortgage must have or avoid the following characteristics:

- A loan term of not greater than 30 years
- No negative amortization
- No interest only loans
- No balloon payments
- Documentation of borrower’s income and assets
- Underwriting at the fully amortized rate
- Total points and fees that are not more than 3 percent of the total loan amount
- A borrower debt-to-income ratio of 43 percent or less (measured off monthly pre-tax income)

15 U.S.C. §1639c(b)(2).

These rules sound pretty exciting, with lots of potential work for lawyers. But as of early 2016, the system is a snooze. With no private secondary market, mortgage lenders make loans that the government sponsored agencies will buy. The CFPB created a years-long “temporary” exemption until 2021 that deems as a qualified mortgage any loan that is eligible for purchase, guarantee, or insurance by a GSE, FHA, VA, or USDA under those entities’ underwriting standards. The exemption holds regardless of the debt-to-income ratio, which is widely considered the most difficult criteria for most consumers to meet. (If the GSEs exit federal conservatorship or a federal agency issues its own qualified mortgage rules before January 10, 2021, then those actions trump this "GSE-QM" category). The GSEs do have affordable lending products that permit down payments below the traditional 20 percent and relax income eligibility requirements. *See, e.g.*, Lisa Prevost, Fannie Mae Revamps Mortgage Program, N.Y. TIMES, Sept. 4, 2015, http://www.nytimes.com/2015/09/06/realestate/fannie-mae-revamps-mortgage-program.html?_r=0.

Non-qualified mortgages exist but they are rare. Their infrequency, combined with the fact that these rules went into effect in January 2014, means that there is no litigation testing what a reasonable, good-faith determination of a consumer's ability to repay actually is. Agency loans are deemed QM loans, and QM loans presumptively meet the ability-to-repay standard. The CFPB is examining institutions on non-QM loans, but today most ability-to-repay loans are jumbo loans (for expensive houses for which the loan exceeds the GSE's conforming loan limit) to borrowers with excellent credit and high percentage down payments. These prime non-QMs have not had early defaults and would probably satisfy ability to repay, even if challenged. At this time, ability to repay is likely sound policy on paper and a hot mess in practice.

The unknown—and potentially profitable—category of loans is subprime loans that do not meet the QM definition. Assuming these loans do not meet the eligibility standards for sale to a GSE or for insurance by a government agency, they must be underwritten for ability to repay. This is a tricky task for lenders who want to serve subprime customers. Most commonly, these loans will have payments that trigger the 43 percent limit on debt-to-income ratio, or will be made to those with volatile incomes, such as medical residents, small business owners, and the self-employed. The non-prime, non-QM market is very small as of 2016, and it is uncertain whether lenders will expand the credit box to make more subprime loans. More clarity on the ability to repay standard is a likely prerequisite for subprime QM.

Lenders face substantial liability for underwriting errors. First, lenders stay on the hook, even if the loan is assigned if the violation is apparent on the face of the disclosure documents. No longer can lenders sell loans in the secondary market and enjoy freedom from future litigation over origination practices. Liability is joint and several with the originating mortgage company and the assignee of the loan at the time of challenge.

Regular QM and GSE-QM loans have a safe harbor from liability; they are conclusively presumed to comply with the ability-to-repay requirement. 12 C.F.R. §1026.643(e). There is also a lesser protection for "higher-priced covered transactions." The definitional trigger is if the otherwise-qualified mortgage's APR exceeds the APOR by 1.5 percentage points for first liens, and 3.5 percentage points for Subordinate liens. 12 C.F.R. §1026.43(b)(3). APOR is the average prime offer rate for a comparable transaction as of a given date, as published by the CFPB. In easier language, the loan has a relatively high interest rate but otherwise meets the qualified mortgage rules. These higher-cost QM loans enjoy a "rebuttable presumption" that the creditor satisfied the ability-to-repay requirement. 15 U.S.C. §1639c(b). The consumer may later argue that the consumer's income and debt obligations were insufficient for ability to repay when the loan was made, but this litigation will be riskier and costlier for the consumer who has an uphill climb. Because of the overlap between qualified mortgages and ability to repay, the smart money (and we all hope the too-big-to-fail people are smart money this time around) will underwrite these higher-cost covered loans with care. That likely requires meeting both the QM standard (to enjoy the rebuttable presumption) and the ability-to-repay standard (in case the consumer defeats the presumption and the lender must demonstrate the sufficiency of its underwriting process).

2. Special Rules for High-Cost Mortgages (HOEPA)

Even in the early days of subprime mortgage lending, there were rules that intended to protect subprime borrowers. *See* Cathy Lesser Mansfield, *The road to 'HEL' Was Paved with Good Congressional Intentions*, 51 S. CAR. L. REV. 473 (2000). The Home Ownership and Equity Protection Act of 1994 (HOEPA) forbade certain terms in higher-cost loans such as prepayment penalties. The problem was that virtually nothing turned out to be a higher-cost loan. For starters, the pre-Dodd-Frank HOEPA statute only applied to nonpurchase, closed-end mortgages (i.e., refinances). But even among those loans, the definition was easy to evade by adjusting other terms. The result was that there were gaping holes in HOEPA, and lenders easily avoided its application.

Some states enacted laws to guard against predatory mortgage lending to shore up HOEPA's weaknesses. Raphael W. Bostic et al., *State and Local Anti-Predatory Lending Laws: The Effect of Legal Enforcement Mechanisms*, 60 J. ECON. & BUS. 47 (2008). These laws were relatively limited because the federal government asserted that its role as prudential banking regulator preempted most underwriting laws. The case below is an example of a state statute that attempted to curb lending practices and illustrates how the common law was applied to predatory lending.

Bishop v. Quicken Loans, Inc.

2011 WL 1321360 (S.D. W. Va. 2011)

COPENHAVER, JR., District Judge.

I. BACKGROUND AND PROCEDURAL HISTORY

Plaintiff William Bishop is a veteran and retired coal miner. His wife, plaintiff Juanita Bishop, was primarily a homemaker, raising the couple's six children. Both Mr. and Mrs. Bishop are high school graduates. They earn a fixed monthly income of approximately $4,165, consisting of retirement pensions and Social Security benefits.

In 1994, plaintiffs purchased their home in Beckley, West Virginia, for $60,000. Plaintiffs co-own the Beckley property. They refinanced the property twice with Bank One Corporation, once in 2002 and again in 2004 (the “Bank One Loans”). From May 2005 to December 2006, plaintiffs refinanced their home three times with defendant Quicken Loans. Each time only Mr. Bishop signed the note or notes, but both Mr. and Mrs. Bishop signed the deed of trust securing the obligation.

Plaintiffs’ dealings with Quicken Loans are at the center of this dispute. Four counts are alleged in the second amended complaint. In Count I, Unconscionable Conduct, plaintiffs ask that the third Quicken loan be declared unconscionable. In Count II, Illegal Loan, plaintiffs allege that Quicken (1) imposed illegal origination and investigation fees twice within a twenty-four month period and (2) issued two mortgage loans (the second and third loans) that exceeded the fair market value of plaintiffs’ property. Count III, Fraud, relates to the rate of interest imposed on the third loan. Count Four, Fraud, relates to an inflated appraisal furnished by an appraiser from Quicken Loans’ sister corporation for the second and third loans.

A. The May 2005 Notes

In the spring of 2005, after seeing an advertisement on television, Mrs. Bishop (who handled the couple’s finances) contacted Quicken Loans about refinancing the Beckley property. Plaintiffs were current on their mortgage payments at the time but indicated to Quicken Loans that they were interested in paying off their credit card debt and lowering their monthly mortgage payments. To facilitate plaintiffs’ attempt to refinance, Quicken Loans obtained an appraisal from appraiser William Whitehair of Whitehair Appraisals, Inc., an independent appraisal company located in Elkins, West Virginia. On April 21, 2005, Mr. Whitehair valued plaintiffs’ property at $112,500.

On May 18, 2005, Mr. Bishop executed two Quicken Loans promissory notes in order to refinance the Beckley property (the “May 2005 notes”). The first was a Fixed Rate Note in the amount of $84,000, payable in 360 monthly installments beginning in July 2005 with an interest rate of 6.375%. Exclusive of tax or insurance escrows, plaintiffs’ monthly payment under the Fixed Rate Note was $524.06. The second note was a Fixed Rate Balloon Note in the amount of $15,000. The Fixed Rate Balloon Note had a fixed interest rate of 6.80%, resulting in a monthly payment of $97.79 and a balloon payment of $11,113.63 due after fifteen years. The May 2005 notes were secured by deeds of trust on the Beckley property executed by both plaintiffs.

By refinancing, plaintiffs satisfied their preexisting mortgage loan in the amount of $66,870.93, as well as certain unsecured debt in the amount of $1,840. Plaintiffs also secured a lower interest rate as compared to their prior mortgage loan and obtained $26,910.97 in cash. The settlement charges incurred by plaintiffs in connection with the May 2005 notes totaled approximately $3,700.

B. The July 2006 Notes

In 2006, John Snively of Quicken Loans contacted plaintiffs by e-mail about refinancing their property. Mr. Snively, who e-mailed plaintiffs approximately once per month, apparently indicated to plaintiffs that they could obtain a lower monthly mortgage payment by refinancing the May 2005 notes. After plaintiffs expressed interest, Quicken Loans requested that TSI Appraisal Services ("TSI"), an appraisal management company, arrange for a full appraisal of plaintiffs' property. TSI, which, like Quicken Loans, is a subsidiary of Rock Holdings Inc., arranged for an appraisal of plaintiffs' property to be completed by Kirk Riffe of Mountaineer Appraisals. On April 20, 2006, Mr. Riffe prepared an appraisal of the property, indicating that its fair market value at the time was $153,000. Quicken Loans reviewed and approved Mr. Riffe's appraisal and conditionally approved plaintiffs' loan application.

On July 6, 2006, Mr. Bishop again executed two Quicken Loans notes (the "July 2006 notes"), totaling $122,400. The first was an Interest First Note in the amount of $112,400 with an interest rate of 6.5%. The Interest First Note provided for interest-only payments in the amount of $608.83 per month for the first 120 months, followed by monthly payments of $838.03 for the next 240 months. The second note was a Fixed Rate Balloon Note in the amount of $10,000 with a fixed interest rate of 9.375%. The Fixed Rate Balloon Note had monthly payments of $83.18, with a balloon payment of $8,104.43 due after fifteen years. The July 2006 notes were secured by deeds of trust on the Beckley property executed by both plaintiffs

Plaintiffs used the proceeds from the July 2006 notes to satisfy the balance of the May 2005 notes and certain unsecured debt in the amount of $9,885. Plaintiffs also received $5,536.28 in cash. The settlement charges accompanying the July 2006 notes totaled approximately $8,300.

C. The December 2006 Note

In September 2006, Mr. Snively called Mrs. Bishop about refinancing the property for a third time. Mr. Snively represented to Mrs. Bishop that by obtaining an adjustable rate note, plaintiffs could lower their mortgage payment to approximately $450 per month. Mrs. Bishop explained that she and her husband did not want an adjustable rate note, to which Mr. Snively responded that Quicken Loans would refinance the home again before the interest rate on the proposed note would increase. Based on Mr. Snively's representations, plaintiffs applied for another mortgage loan. On September 12, 2006, plaintiffs were conditionally approved for a seven-year, adjustable rate loan in the amount of $131,600. On September 24, 2006, Kirk Riffe prepared another appraisal of the property for Quicken Loans, again indicating that its fair market value was $153,000.

On November 15, 2006, Mrs. Bishop expressed concern that the proposed seven-year loan included private mortgage insurance, which would protect Quicken Loans in the event of default by plaintiffs and result in higher monthly payments. As a result, on December 15, 2006, Mr. Bishop instead obtained from Quicken Loans a thirty-year Option Adjustable Rate Note in the amount of $133,600, with an initial interest rate of 6.250% (the "December 2006 note"). The December 2006 note, signed by Mr. Bishop only, gave plaintiffs the option to select among a variety of payment methods, including a fully amortizing repayment structure calculated over fifteen-and thirty-year terms, as well as the option of making a minimum monthly payment of $361.83. Quicken specified in the December 2006 note, however, that the loan was subject to "negative amortization," such that a minimum monthly payment "will not be sufficient to pay interest at

[6.250%]" and that the deferred interest will both increase the loan balance and accrue additional interest. Both Mr. and Mrs. Bishop executed the deed of trust securing the December 2006 note.

The proceeds from the December 2006 note satisfied the balance of the July 2006 notes; plaintiffs also received $1,265.35 in cash. The settlement costs accompanying the December 2006 note amounted to approximately $8,300.

D. The Procedural History of this Action

Plaintiffs began making monthly payments on the December 2006 note of approximately $450, which equaled the minimum monthly payment plus escrow payments. At some point in 2008, they learned that the minimum monthly payment under the December 2006 note "would more than double within 5 years" after the adjustable interest rate increased. In March 2008, plaintiffs contacted Quicken Loans and attempted to refinance their property to reduce the monthly payment. In April 2008, Brett Brotherton of the Southern West Virginia Appraisal Group prepared an appraisal of plaintiffs' property for Quicken Loans, indicating that the value of the house was $137,000. Inasmuch as the balance on the December 2006 note exceeded the property's appraised value, Quicken Loans denied plaintiffs' 2008 loan application.

Plaintiffs allege that they learned the "true value" of their property in 2009. Specifically, in June 2009, plaintiffs hired Robert Wilson of Wilson and Associates, Inc., to perform a retrospective appraisal of the property. On June 30, 2009, Mr. Wilson provided plaintiffs with his appraisal, which retrospectively valued the property at $100,000 as of December 2006.

Plaintiffs instituted this action in the Circuit Court of Kanawha County on September 2, 2009. Quicken Loans removed on October 2, 2009, invoking the court's diversity jurisdiction.

…

ANALYSIS

A. Count I: Unconscionability

Count I of the complaint seeks a declaration that the conduct engaged in by Quicken Loans was unconscionable, rendering the December 2006 note void and unenforceable. In addition to actual damages, plaintiffs seek civil penalties under §46A-5-101 of the West Virginia Consumer Credit and Protection Act.

In West Virginia, the basic test for unconscionability is:

> [W]hether, in the light of the background and setting of the market, the needs of the particular trade or case, and the condition of the particular parties to the conduct or contract, the conduct involved is, or the contract or clauses involved are so one sided as to be unconscionable under the circumstances existing at the time the conduct occurs or is threatened or at the time of the making of the contract.

Arnold v. United Cos. Lending Corp., 204 W. Va. 229 (1998).

[Ed. Note—The court ruled that the evidence did not demonstrate indisputably that the Bishops were sophisticated customers, despite Quicken's assertion that they had refinanced their home five times in four years. The court also noted that rapid escalation in refinance fees from $3,700 in May 2005 to $8,300 for both the July and December 2006 notes could support a finding of excessive fees that were unreasonably favorable to Quicken. Finally, the court noted that evidence of the 36 percent increase in property value between the appraisals in April 2005 and April 2006 raised at least a question of fact concerning the fairness of the transaction. It ruled that summary judgment was inappropriate on the count of unconscionability.]

…

B. Count II: Illegal Loan

1. West Virginia Code §31-17-8(d)

Plaintiffs first allege in Count II that, within a twenty-four month period, Quicken Loans twice imposed loan origination fees and investigation fees upon them, in violation of West Virginia Code §31-17-8(d). That provision prohibits lenders from imposing such fees twice within a twenty-four month period, "unless the new loan has a reasonable, tangible net benefit to the borrower considering all of the circumstances, including the terms of both the new and the refinanced loans, the cost of the new loan, and the borrower's circumstances." W. Va. Code §31-17-8(d). Quicken Loans does not dispute that it imposed origination and investigation fees twice within a twenty-four-month period. Rather, it contends that plaintiffs received a tangible net benefit from the loans, precluding liability under §31-17-8(d).

Without question, plaintiffs received a reasonable, tangible net benefit from the May 2005 notes. Specifically, plaintiffs received $26,910.97 in cash and the payment of $1,840 in unsecured debt out of the loan proceeds, compared to settlement charges totaling approximately $3,700. Whether plaintiffs received a similar net benefit from the second and third Quicken loans remains in question. The settlement costs accompanying the July 2006 notes increased significantly to $8,300, or more than half of the amount plaintiffs realized in cash and debt relief ($15,421.28) from the July transaction. Similarly, the settlement costs incurred as a result of the December 2006 note totaled approximately $8,300, yet plaintiffs received only $1,265.35 in cash from that loan. To be sure, a cost-benefit analysis of a consumer loan must consider more than simply settlement costs. A borrower may well benefit from a loan, despite the presence of such high fees, if the loan, for example, secures a lower interest rate or more affordable payment terms for the borrower. As a result of the July 2006 and December 2006 notes, however, plaintiffs were forced to pay higher interest rates and, according to their deposition testimony, face increasing payments that will soon be unaffordable.

In such circumstances, the court cannot conclude at this juncture that plaintiffs received a reasonable, tangible net benefit from the second and third Quicken loans. Accordingly, there remains a question of fact as to whether Quicken improperly imposed origination and investigation fees twice within a twenty-four month period. Summary judgment on plaintiffs' §31-17-8(d) claim is thus not appropriate.

2. West Virginia Code §31-17-8(m)(8)

Plaintiffs also allege in Count II that Quicken Loans violated West Virginia Code §31-17-8(m)(8). That provision prohibits mortgage lenders from securing "a primary or subordinate mortgage loan in a principal amount…that exceeds the fair market value of the property." The statute provides that a lender

> may rely upon a bona fide written appraisal of the property made by an independent third-party appraiser, duly licensed or certified by the West Virginia real estate appraiser licensing and certification board and prepared in compliance with the uniform standards of professional appraisal practice.

W. Va. Code §31-17-8(m)(8). In Count II, plaintiffs contend that Quicken Loans violated this provision by granting them a loan that far exceeded the market value of the property. To support this claim, plaintiffs proffer the retrospective appraisal performed in 2009 that reached a lower value than the appraisals performed in 2006 by Mr. Riffe. In its motion for summary judgment, Quicken Loans apparently does not dispute that the 2009 retrospective appraisal raises a question of fact as to the market value of the house in 2006. Nevertheless, Quicken Loans contends that summary judgment on the §31-17-8(m)(8) claim is appropriate, inasmuch as Quicken Loans relied on the 2006 appraisals of Mr. Riffe, an independent, third-party appraiser who complied with the uniform standards of professional appraisal practice.

In contending that Mr. Riffe was an independent, third-party appraiser, Quicken Loans emphasizes Mr. Riffe's affidavit, wherein he attests that he "did not, at any time, speak with Quicken Loans, Inc. or any representative thereof, or the mortgage banker assigned to the loans relating to [plaintiffs'] property." Mr. Riffe further asserts that he was never "told what value [he] should reach in [his] appraisal of the property." From his affidavit, Quicken Loans asserts that Mr. Riffe was independent and that plaintiffs' §31-17-8(m)(8) claim must be dismissed.

Notwithstanding Mr. Riffe's assertions, the court cannot conclude from this record that he was unquestionably an independent, third-party appraiser. Plaintiffs have introduced evidence indicating a relationship between Quicken Loans and Mr. Riffe's employer, TSI. Specifically, Mr. Clint Bonkowski, a divisional vice president of Quicken Loans, testified that his company and TSI share a parent corporation known as Rock Holdings, Inc. That fact, in and of itself, raises a material question as to whether Mr. Riffe was an independent appraiser.

Even assuming Mr. Riffe's independence, plaintiffs have also presented evidence suggesting that his appraisal did not comply with the uniform standards of professional appraisal practice. Specifically, plaintiffs proffered an appraisal examination conducted by Troy Sneddon, who concluded that Mr. Riffe's 2006 appraisals violated several provisions of the Uniform Standards of Professional Appraisal Practice ("USPAP"). For instance, Mr. Sneddon noted that Mr. Riffe's appraisals failed to include the actual dimensions of the site; misstated the property's acreage; failed to specify the zoning classification; failed to correctly identify the FEMA Special Flood Hazard Area; and failed to note the portion of the property's basement that was finished. According to Mr. Sneddon, these deficiencies contravened at least nine separate provisions of the USPAP, including Standard Rule 1.1(b), which provides that an appraiser must not commit a substantial error of omission, and Standard Rule 2.1(a), which requires that an appraiser's report clearly and accurately set forth the appraisal in a manner that will not be misleading. Mr. Sneddon concluded that, collectively, the deficiencies in Mr. Riffe's appraisals indicate that the appraisals lack credibility and "lack the necessary information for USPAP compliance."

Whether the appraiser was independent and whether the cited failures constitute substantial error remain to be evaluated. Inasmuch as there is are disputed questions of fact as to whether the appraisals relied upon by Quicken Loans complied with industry standards, the court concludes that summary judgment as to plaintiffs' §31-17-8(m)(8) claim is not appropriate.

C. Count III: Fraud

In order to establish a claim for fraud, plaintiffs must prove: (1) that the act claimed to be fraudulent was the act of Quicken Loans or was induced by it; (2) that the act was material and false, and that plaintiffs relied upon it and were justified under the circumstances in relying upon it; and (3) that plaintiffs were damaged because of this reliance. See Kidd v. Mull, 215 W. Va. 151 (2004); Lengyel v. Lint, 167 W. Va. 272 (1981). In the complaint, the Count III fraud allegations, which appear to relate only to the December 2006 note, are as follows:

> 39. At the time of inducement and even at closing, [Quicken Loans] misrepresented and suppressed specific rates and terms to Plaintiffs in the loan, and represented the loan would be refinanced before the Plaintiffs' payments increased.
> 40. Defendants intentionally misrepresented these facts and suppressed the true cost/rate for the purpose of inducing the Plaintiffs to contract.
> 41. The Plaintiffs reasonably relied upon their belief as to the low rate promised.
> 42. Said misrepresentation and suppressions were material.

As a result, plaintiffs allege that they were "damaged by the misrepresentation and suppressions."

As an initial matter, plaintiffs have presented insufficient evidence to demonstrate that Quicken Loans misrepresented or suppressed any specific material terms of the December 2006 note itself. Mrs. Bishop testified during her deposition that she advised Mr. Snively that she and her husband did not want an adjustable rate mortgage. Mr. Snively apparently responded by assuring her that, although the December 2006 note included an adjustable interest rate, Quicken Loans would refinance the mortgage before the initial interest rate expired. Mr. Snively's assurances in this regard were not included in the December 2006 note, which squarely alerted plaintiffs that the initial interest could increase after sixty months. Mrs. Bishop was thus aware that the December 2006 note contained an adjustable interest rate. Furthermore, although plaintiffs allege that they were unaware of the payment options associated with the December 2006 note and the consequences of making only the minimum payment, the mortgage documents that Mr. Bishop signed explain his payment options and the consequence of each. For example, a document entitled "Fixed/Adjustable Rate Note with Payment Options," which Mr. Bishop signed, described each payment option and cautioned as follows:

> The principal balance on your loan will not be decreased by making [the minimum payment]. Additionally, because your [minimum payment] is less than the interest

> that has actually accrued on your Note, the Note Holder will subtract the amount of your monthly payment from the amount of the actual accrued interest and will add the difference to your unpaid principal (this is referred to as "negative amortization").

Plaintiffs thus knew or should have known that their loan balance would increase if they paid only the minimum amount.

Nevertheless, plaintiffs have presented sufficient evidence that Quicken Loans materially misrepresented that it would refinance the December 2006 note to a fixed-rate loan before the adjustable interest rate could increase. Ordinarily, fraud "cannot be based on statements which are promissory in nature or which constitute expressions of intention." Croston v. Emax Oil Co., 195 W. Va. 86 (1995). Only if the plaintiff can show that the defendant did not intend to fulfill the promise at the time it was made may a promissory statement serve as the basis of fraud. Id. Here, in response to concerns raised by Mrs. Bishop, Mr. Snively assured plaintiffs that the December 2006 note would be refinanced to a fixed-rate loan before any increase in the adjustable interest rate. That Mr. Snively failed to incorporate this promise into the official loan documents surrounding the December 2006 note (which, of course, bound plaintiffs to pay an adjustable interest rate) raises a question of material fact regarding Quicken Loans' intentions to fulfill the promise at the time it was made. See England v. MG Invs., Inc., 93 F. Supp. 2d 718, 722 (holding that lender's failure to include oral promise concerning interest rate into written loan documents raised question concerning lender's intent to abide by promise). Accordingly, summary judgment as to Count III is inappropriate.

D. Count IV: Fraud

Count IV of the complaint alleges that Quicken Loans intentionally arranged for an inflated market value of plaintiffs' property for the purpose of inducing them to refinance their property. Plaintiffs further allege that Quicken Loans' reliance upon the inflated appraisal was intentional and material, and that plaintiffs "reasonably relied upon the origination of the loan being consistent with prudent lending practices."

Evidence presented to the court in support of Count IV is sparse. One might argue that the wide variance in the Riffe appraisal and the retrospective appraisal conducted in 2009 raises a question of fact not only as to the accuracy of the former but also whether it is so far off the mark as to be a materially false representation of the value of the property.

Even so, plaintiffs have failed to establish a claim for fraud based on an inflated appraisal. As mentioned, plaintiffs must demonstrate that they reasonably relied upon the false representation. See Kidd v. Mull, 215 W. Va. 151 (2004). Although it is "not necessary that the fraudulent representations complained of…be the sole consideration or inducement moving the plaintiff," the representations must at least "contribute [ ] to the formation of the conclusion in the plaintiff's mind." Horton v. Tyree, 104 W. Va. 238 (1927). Plaintiffs have failed to introduce any evidence that the Riffe appraisals materially affected their decision to enter into the December 2006 note. Indeed, plaintiffs testified that they never saw any appraisal and did not know what the property had appraised for in connection with the Quicken Loans notes.

Inasmuch as plaintiffs have failed to introduce evidence as to a necessary element of their fraud claim, namely, that they relied on a materially false representation concerning the value of their property, summary judgment on Count IV is appropriate.

...

IV.

Pursuant to the foregoing analysis, it is ORDERED as follows:

1. That Quicken Loans' motion for summary judgment be, and it hereby is, granted insofar as it seeks dismissal of Count IV and the claims of plaintiff Juanita Bishop in Counts I and II, and denied in all other respects;

2. That Count IV be, and it hereby is, dismissed;…

The CFPB amended Regulation X to expand the types of mortgage loans that are subject to HOEPA's rules. 12 C.F.R. §1026.32. These were previously often called "high-cost" loans but now with the new QM "higher cost covered transactions," the more clear terminology is "HOEPA loans." HOEPA now applies to nearly all mortgages that meet one or more of three triggers. The first trigger is a prepayment penalty test. It has two separate components. Can the lender charge a prepayment penalty more than three years after the loan's origination? Or can the prepayment penalty exceeds more than 2 percent of the amount prepaid? If so, the loan is a HOEPA loan. The second trigger is set off if the APR for the loan exceeds the APOR (remember, "average prime offer rate") by more than 6.5 percentage points for a first-lien mortgage, or 8.5 percentage points for a subordinate-lien or personal property dwelling (manufactured home) mortgage. The third trigger is based on total points and fees. If they exceed 5 percent of the total loan for any loan of $20,000 or more, the transaction is covered by HOEPA. Note to the unwary, this dollar threshold adjusts based on the consumer price index each January 1. For smaller loans, the points and fees cannot exceed 8 percent or HOEPA applies.

Because they are relatively costly, the law provides more consumer protections when a borrower takes out a HOEPA loan. Certain fees are forbidden entirely: prepayment penalties, balloon payments, late fees that exceed 4 percent of the regular payment, and a few others. Appraisers of homes that will be collateral for a HOEPA loan also must be certified or licensed, inspect the interior of the home, and provide a free copy of the appraisal to the borrower. Although there are yet even more exceptions, most HOEPA loans also must be managed with escrow accounts, at least for the first five years of the loan. For HOEPA loans, Regulation X (RESPA rules) requires pre-counseling from a statutorily prescribed housing counselor, who cannot be in the employ of the lender. 12 C.F.R. §1024.20.

3. Creditor Defenses and Borrower Liability

Because the mortgage underwriting rules are part of Regulation Z, liability arises under the general TILA statute. 15 U.S.C. §1640. It provides for actual and statutory damages, and the recovery of attorneys' fees and costs. This statute is discussed in more detail in the upcoming assignment on enforcement but there are special rules for mortgages to note now. A lender may be held liable for "enhanced" damages for violating the ability-to-repay requirement. 15 U.S.C. §1640(a)(4). These damages can equal the sum of all finance charges and fees paid by the consumer on the loan, which especially in the early years of a loan is a huge fraction of the monthly payments. The lender can escape these damages if it can show that its failure to comply is not material. As of now, there are no cases defining and applying "material" in this context. The result for lenders—depending on your perspective—is complete paranoia or strict adherence to consumer law.

A consumer may bring an affirmative lawsuit for monetary damages for up to three years from the loan origination date. If the consumer is in foreclosure, however, the period for asserting violations is not limited. If a creditor, assignee, or anyone acting on their behalf initiates a judicial or non-judicial foreclosure, the borrower may assert, as a defense by set off or recoupment, that the orginating lender did not properly determine ability to repay as a defense. 15 U.S.C. §1640(k). While lenders may prevail in such litigation, it is a powerful weapon for consumers (and their lawyers) to have an ability-to-repay violation that can be a defense to foreclosure.

B. Mortgage Servicing

Mortgage servicing is the collection of payments from borrowers and the disbursement of those payments to the appropriate parties, such as lenders, investors, taxing authorities, and insurers. The rise of servicing as a distinct industry resulted from the widespread use of securitization in the mortgage market. As explained in Assignment 13, securitization is the process of creating debt instruments (bonds or securities) by pooling mortgage loans, transferring those obligations to a trust, and then selling fractional interests in the trust's right to receive payments from the mortgages to investors. Servicers act as intermediaries between the borrower and the other parties to the securitization. A "pooling and servicing agreement" sets out the servicer's responsibilities for collecting and remitting the mortgage payments. It also obligates the servicer to take steps to foreclose in the event of default. The participation of servicers complicates the debtor-creditor relationship and creates the need for specific consumer protections.

Mortgage servicers do not have a customer relationship with homeowners; they work, via the trust, for the investors in the mortgage-backed securities. Borrowers cannot shop for a loan based on the quality of the servicing, and they have virtually no ability to change servicers if they are dissatisfied with the servicers' conduct. The only exit strategy for a dissatisfied borrower is refinancing the mortgage, and even then, the homeowner may find the new loan assigned to the prior servicer—or an even worse entity. This creates what the CFPB's first director, Rich Cordray, called a "deadend," a market in which consumers cannot vote with their feet to address indefensible or unfair tactics.

In fact, servicers have some financial incentives to impose additional fees on consumers. Servicers often are permitted to retain all, or part, of any default fees, such as late charges, that consumers pay. In this way, a borrower's default can boost a servicer's profits, although the costs of servicing a defaulted loan can be very high and exceed the fixed servicing fee, often between 0.25 percent and 0.5 percent of the notes' principals. Because of the revenue structure, a servicer's incentives upon a homeowner's default may not align with investors' incentives or a consumer's needs.

A consumer is only obligated to pay charges if they are permitted by the terms of the mortgage and by state and federal law. To validate such charges, consumers must know how the servicer calculated the amount due and whether such fees are consistent with their loan contracts. Mortgage servicers can exploit consumers' difficulty in recognizing errors or overcharges by failing to provide comprehensible or complete information. Permissible default charges and processes vary by state law, the loan note and mortgage, and the type of loan (GSE, FHA, etc.). The result is a thicket of fees.

Spiking foreclosure rates worsened problems with mortgage servicing. Consumers grew frustrated with customer service representatives who were difficult to reach or provided conflicting information, with poor document handling practices, and with impenetrable statements or letters. Falling real-estate prices also changed the profit calculus of foreclosure. It became clear that at least some investors were better off by modifying the loan rather than foreclosing. The federal government's umbrella of programs, Making Homes Affordable, encouraged lenders to contact delinquent borrowers and provided modest financial incentives to servicers for modifying delinquent loans. Facing political and financial pressure, lenders and servicers struggled to develop cost- and time-effective strategies for helping homeowners. The legal woes of mortgage companies also mounted as consumers and regulators began to challenge servicing practices.

The federal government recently established new stronger protections for servicing, creating a floor that some state laws exceed. The new rules are a recognition that mortgage servicing is a crucial part of the homeownership process. Some rules focus on current borrowers, while others provide procedural protections to delinquent borrowers.

1. Payment Collection

Even in tough times, most homeowners are current on their mortgages. The main job of servicers is to calculate, solicit, and apply payments. The Real Estate Settlement Procedures Act (RESPA) not only governs "settlement" at origination but also imposes ongoing duties on servicers. The CFPB extensively amended RESPA's Regulation X in 2013. It creates both general and specific duties. Section 1024.38 requires servicers to have objective-based policies and procedures to provide timely and accurate information to consumers and to ensure compliance with the detailed rules for servicer transfer and loss mitigation.

Servicers must credit periodic payments as of the date of receipt. 12 C.F.R. §1024.36(c). If a consumer makes less than the amount needed to cover the outstanding principal, interest, and escrow, the servicer may hold that payment in a suspense account. To curb abuses when servicers let thousands of dollars of consecutive payments accumulate in such accounts, leaving the consumer delinquent and subject to late fees or insufficient payment fees each month, Regulation X requires that when a suspense account balance is sufficient to cover a periodic payment, the money to be applied to the consumer's account. Consumers are also entitled to receive an accurate payoff balance no later than seven business days after a servicer receives a written request. In the past, consumers would have to make repeated requests for such statements, often needed for refinancing, and by the time statements were received, they were woefully miscalculated.

The content, timing, and form of billing statements for mortgages are proscribed by Regulation Z, implementing TILA. The billing statements inform consumers of the amount due, fees imposed, transaction activity, and servicer's contact information. 12 C.F.R. §1026.41. Servicers also must notify consumers of interest-rate adjustments in advance and provide an estimate of the new payment. These rules may seem duplicative of those covered with regard to the Fair Credit Billing Act, but until the CFPB acted in 2013, there were no parallel obligations on mortgage servicers. Consumers had to make a "qualified written request" under RESPA if they needed information. If the servicer did not respond, however, the consumer had no right of action to force compliance or create liability. It literally was nothing more than a request.

Servicers have expanded duties with regard to consumer inquiries under the new rules. They have only five days to acknowledge a consumer's request for information or a notice of error, and must respond after investigation within 30 to 45 days. 12 C.F.R. §§1024.35; 1024.36. The servicer can require these requests or notices to be in writing and specify an address for receipt, but they cannot charge for responding or make adverse credit reports based on a notice. Creditors must also exercise care before imposing property insurance on consumers. This force-placed insurance is more expensive than consumer-shopped coverage, and to prevent abuse—such as servicers farming out insurance to affiliates with high rates—the insurance price must bear a reasonable relationship to its actual cost. 12 C.F.R. §1024.37.

2. Default and Loss Mitigation

Functionally, default servicing was the final resting place for illegally originated loans. With no ability to track down the originator lender or mortgage broker or appraiser or realtor, consumers threatened with foreclosure hurled ire at servicers. And in fairness to consumers, servicers were ill prepared to handle the task. For the first few years of the foreclosure crisis, servicers struggled to manage the defaults during the foreclosure crisis. While most companies had home retention departments, there was little communication with foreclosure departments. Consumers suffered the consequences, while servicers pocketed fees and had little regulatory oversight. *See* Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. 121 (2008).

A few of the key default rules are highlighted below, but it should be a telltale sign to you about the comprehensiveness—and comprehensibility—of the rules that the CFPB's own best effort to educate *consumers* on loss mitigation exceed 50 pages. CFPB, *Help for Struggling Borrowers* (Jan. 28, 2014) http://files.consumerfinance.gov/f/201402_cfpb_mortgages_help-for-struggling-borrowers.pdf. Some would say these rules are a poster child for government being unduly prescriptive; others would say that when an industry commits serious and systemic violations that a detailed schema of reform is necessary. These extensive rules may be an effort to paper over a more subtle but serious problem. Investors, not consumers, still control the servicing market, and the law creates absolutely no right to a loan modification. Servicers must follow many rules to implement foreclosure prevention programs, but after the expiration of federal programs, such as HAMP, loan modifications may disappear or be replaced with the less generous forbearance and recapitalization programs.

The key theme of the CFPB's servicing rules is early intervention. As soon as a borrower fails to make a single payment sufficient to cover principal, interest, and any escrow payment, the servicer has the obligation to reach out and try to stay in contact. 12 C.F.R. §1024, Supp. I, Cmts. 39(a)-1(i); 39(b)(1)-1 and 40(a)(3). While the legal standard is a "good faith effort" to reach the borrower by telephone or talk to the borrower in-person, 12 C.F.R. §1024.39(a), the CFPB encourages servicers to make multiple efforts. Leaving a voicemail does not satisfy the good faith effort; the calls must continue.

Once the borrower is reached, the servicer must tell the borrower about loss mitigation options available—with the notable caveat that the servicer may use "reasonable discretion" to decide if it is appropriate to give the consumer such information. 12 C.F.R. §1024, Supp. I, Cmt. 39(a)-3. This information can be in writing, and usually is delivered that way to allow the servicer to prove this requirement was met. The servicer must also facilitate "continuity of contact" by assigning a designated representative, called a single point of contact, to the borrower. 12 C.F.R. §1038(a). This requirement is meant to eliminate the problems consumers experienced during the foreclosure crisis with receiving inconsistent information; essentially, hearing different answers each time they called the servicer. The single point of contact has enumerated duties. 12 C.F.R. §1040(a) & (b). The focus is on assisting the borrower in submitting an application for loss mitigation.

If the application is received 45 days or more before any scheduled foreclosure sale, the servicer must send an acknowledgment to the borrower within five days of its receipt of the documents. That letter must also inform the borrower what documents are needed to complete the application. 12 C.F.R. §1024.41(b)(2)(i)(B). If the application is received fewer than 45 days before the scheduled foreclosure, the servicer does not have to send the five-day acknowledgment but must still "exercise reasonable diligence in obtaining documents and information to complete a loss mitigation document." 12 C.F.R. §1024.41(b). Until the application is complete, however, the foreclosure process can continue. When the application is complete—an endpoint left to the servicer to define—the foreclosure process must halt. The servicer must evaluate the borrower for all appropriate loss mitigation options, explain its decision, and give time to appeal. If the complete application is received 37 days or fewer before the scheduled sale, the servicer does not have to follow the loss mitigation requirements. 12 C.F.R. §1024, Supp. I, Cmt. 41(g)-4.

Some states, most notably California, have loss mitigation statutes. The California Homeowner Bill of Rights was enacted after the nation's attorneys general achieved a $25 billion settlement against the five largest mortgage servicers. One of its primary purposes was to broaden the protections of the settlement to all mortgage servicers and to make the most important protections permanent (the settlement reforms had a three-year window). The statute was also acted before the CFPB promulgated its servicing rules. This is an example both of a state being more nimble but also now of the compliance difficulties for companies that have federal and state rules that are not perfectly aligned.

Valbuena v. Ocwen Loan Servicing, LLC

188 Cal. Rptr. 3d 668 (2015)

GOODMAN, Appellate Judge.

Plaintiffs Amado and Myrna Valbuena sued Ocwen Loan Servicing, LLC (Ocwen), following their lender's purchase of their residence at a nonjudicial foreclosure sale. They allege that Ocwen violated Civil Code section 2923.6, the prohibition on "dual tracking" contained in the Homeowner Bill of Rights, when it conducted a foreclosure sale of their property while their loan modification application was pending. The trial court sustained Ocwen's demurrer, ruling that plaintiffs' failure to allege tender of the loan balance defeated their claims. We disagree, and so reverse the judgment.

FACTUAL AND PROCEDURAL BACKGROUND

Plaintiffs purchased the real property located at 360 East 238th Place in Carson (the property) in 2004. In August 2006, plaintiffs obtained from American Brokers Conduit a $485,000 loan secured by the property; that loan was assigned to Deutsche Bank in September 2011. At that time, plaintiffs were behind in their mortgage payments, having suffered financial difficulties.

On September 26, 2011, T.D. Service Company, as trustee, recorded a notice of default and election to sell under deed of trust on the property. The notice of default stated that plaintiffs were $21,181.11 in arrears as of September 30, 2011. A notice of trustee's sale was recorded on December 22, 2011, setting a foreclosure sale for January 17, 2012. A second notice of trustee's sale was recorded on February 15, 2013, setting the foreclosure sale date for March 14, 2013; the sale was later postponed until March 25, 2013. The lender acquired the property at the foreclosure sale on that date. A trustee's deed upon sale was recorded on October 15, 2013.

As of March 1, 2013, after the second notice of trustee's sale was recorded, Ocwen took over the servicing of plaintiffs' mortgage loan. Ocwen sent plaintiffs a letter dated March 13, 2013, which plaintiffs received on March 18, 2013, stating: "[A]s your loan servicer, we are committed to helping YOU. We offer a full range of mortgage assistance programs, and actively participate in the Obama Administration's Home Affordable Mortgage Program (HAMP). You may be able to lower your monthly payments—APPLY NOW to find out what options are available to you!" The letter explained the application process, and promised "a thorough review of your financial situation." The letter continued: "While we consider your request, we will not initiate a new foreclosure action and we will not move ahead with the foreclosure sale on an active foreclosure as long as we have received all required documents and you have met the eligibility requirements. In the event that a foreclosure sale has been set and is within 30 days from this request for a HAMP application, the foreclosure sale will not be stopped and the sale will take place on the scheduled date unless a complete HAMP application with all required attachments and signatures is delivered to Ocwen no later than 7 business days prior to the scheduled foreclosure sale date."

On March 21, 2013, plaintiffs responded to this letter by submitting paystubs, a W-2, and bank statements to Ocwen. On March 23, 2013, after speaking with an Ocwen representative, plaintiffs submitted additional financial documentation in support of their loan modification application. By letter dated March 25, 2013, the date of the foreclosure sale, Ocwen notified plaintiffs that they were not eligible for a loan modification because "[a]s of the date of this letter your loan has a confirmed sale date within 7 days."

[ED. NOTE—The operative version of plaintiff's complaint on appeal alleged causes of action for breach of contract, negligent misrepresentation, promissory estoppel, unlawful business practices, breach of the implied covenant of good faith and fair dealing, fraud, and violation of the Homeowner Bill of Rights.]

Ocwen again demurred, contending that the second amended complaint failed to state a cause of action upon which relief could be granted. The trial court agreed, stating in its minute order that its grant of leave to amend did not authorize plaintiffs to allege the new causes of action for negligence and intentional infliction of emotional distress, and that the remaining causes of action were defective due to the absence of "pleading of tender or exception to tender requirement even though this is post-foreclosure." The court sustained the demurrer without leave to amend, and subsequently entered judgment in favor of Ocwen.

Plaintiffs timely appealed the judgment of dismissal.

DISCUSSION

"A demurrer tests the legal sufficiency…in a complaint. We independently review the sustaining of a demurrer and determine de novo whether the complaint alleges facts sufficient to state a cause of action or discloses a complete defense. McCall v. PacifiCare of Cal., Inc. 25 Cal. 4th 412, 415 (2001).…

Plaintiffs frame the issue in this appeal as follows: "[W]hether the Trial Court erred in sustaining the Respondent's Demurrer…concluding that the entire case—which, among other things, alleges several statutory violations of the California Homeowner's Bill of Rights ('HBOR')—should be dismissed with prejudice because

Plaintiffs/Appellants did not allege tender of their entire loan balance in their amended complaint."

The Homeowner Bill of Rights (HBOR), effective January 1, 2013, was enacted "to ensure that, as part of the nonjudicial foreclosure process, borrowers are considered for, and have a meaningful opportunity to obtain, available loss mitigation options, if any, offered by or through the borrower's mortgage servicer, such as loan modifications or other alternatives to foreclosure." Cal. Civ. Code §2923.4, subd. (a). Among other things, HBOR prohibits "dual tracking," which occurs when a bank forecloses on a loan while negotiating with the borrower to avoid foreclosure. See Cal. Civ. Code §2923.6. HBOR provides for injunctive relief for statutory violations that occur prior to foreclosure (Cal. Civ. Code §2924.12, subd. (a)), and monetary damages when the borrower seeks relief for violations after the foreclosure sale has occurred (Cal. Civ. Code §2924.12, subd. (b)).

Section 2923.6, the "dual tracking" prohibition in HBOR which plaintiff maintains Ocwen violated, provides in pertinent part as follows:

> (b) It is the intent of the Legislature that the mortgage servicer offer the borrower a loan modification or workout plan if such a modification or plan is consistent with its contractual or other authority.
>
> (c) If a borrower submits a complete application for a first lien loan modification offered by, or through, the borrower's mortgage servicer, a mortgage servicer, mortgagee, trustee, beneficiary, or authorized agent shall not record a notice of default or notice of sale, or conduct a trustee's sale, while the complete first lien loan modification application is pending. A mortgage servicer, mortgagee, trustee, beneficiary, or authorized agent shall not record a notice of default or notice of sale or conduct a trustee's sale until any of the following occurs: (1) The mortgage servicer makes a written determination that the borrower is not eligible for a first lien loan modification, and any appeal period pursuant to subdivision (d) has expired. (2) The borrower does not accept an offered first lien loan modification within 14 days of the offer.…
>
> (h) For purposes of this section, an application shall be deemed 'complete' when a borrower has supplied the mortgage servicer with all documents required by the mortgage servicer within the reasonable timeframes specified by the mortgage servicer.

Cal. Civ. Code §2923.6.

HBOR provides remedies for violation of the foregoing statutory provision in section 2924.12: "If a trustee's deed upon sale has not been recorded, a borrower may bring an action for injunctive relief…," which injunction shall remain in place "until the court determines that the mortgage servicer…has corrected and remedied the violation or violations giving rise to the action for injunctive relief." Cal. Civ. Code §2924.12, subd. (a)(1)-(2).) After a trustee's deed upon sale has been recorded, a borrower may sue for "actual economic damages." Cal. Civ. Code §2924.12, subd. (b). A material violation found by the court to be intentional or reckless, or to result from willful misconduct, may result in a trebling of actual damages or statutory damages of $50,000. Ibid. "A court may award a prevailing borrower reasonable attorney's fees and costs in an action brought pursuant to this section." Cal. Civ. Code §2924.12, subd. (i).

Nothing in the language of HBOR suggests that a borrower must tender the loan balance before filing suit based on a violation of the requirements of the law. Indeed, such a requirement would completely eviscerate the remedial provisions of the statute. Moreover, the rationale for the tender rule, “[I]t would be futile to set aside a foreclosure sale on the technical ground that notice was improper, if the party making the challenge did not first make full tender and thereby establish his ability to purchase the property,” United States Cold Storage v. Great Western Savings & Loan Assn. 165 Cal. App. 3d 1214, 1225 (1995), has no application here, where plaintiffs’ lawsuit is not based on the premise of a defect in the giving of notice but on the statutory grounds laid out in HBOR, and seeks monetary damages. Ocwen’s citation to case law predating the enactment of HBOR to create a pleading requirement not contained in the statute is unavailing. In short, we agree with plaintiffs that a tender of the amount due under the loan is not required to state a cause of action under section 2923.6.5

Ocwen also contends that the loan modification application submitted by plaintiffs was neither timely nor complete. It argues, “an application is only deemed ‘complete’ ‘when a borrower has supplied the mortgage servicer with all documents required by the mortgage servicer within the reasonable timeframes specified by the mortgage servicer.’ Here, [plaintiffs] admit that they did not supply servicer Ocwen with all the documents required per the timeframe specified in the March 13, 2013 Letter (“Offer Letter”).” Thus, Ocwen asserts that plaintiffs’ allegation that they submitted a “complete” loan modification application is a conclusory allegation insufficient to survive a demurrer, and that the untimeliness of the application is established by the offer letter.

In their second amended complaint, plaintiffs alleged that, after receiving the offer letter on March 18, 2013, they responded by submitting the requested documentation to Ocwen on March 21, 2013. Also around this time, they received notice that the foreclosure sale previously scheduled for March 14, 2013, had been postponed until March 25, 2013. On March 23, 2013, plaintiffs spoke with Ocwen’s representative by telephone, and were informed that they “just need to submit some more documents to make their loan modification application ‘complete.’” The Ocwen representative did not tell them that, due to the pending sale date, it was already too late to apply for a loan modification. Plaintiffs mailed the additional financial documents requested by Ocwen on that same day, and requested no further documents thereafter. Based on the forgoing facts, plaintiffs alleged that their loan modification application was “complete.”

Ocwen relies on the statute’s definition of a “complete” submission—that is, all documents required by the mortgage servicer within the reasonable timeframe specified by the mortgage servicer; see Cal. Civ. Code, §2923.6, to argue that the modification application was not complete because it was not received seven or more days before the scheduled foreclosure sale. However, the complaint alleges that the offer letter, dated March 13, 2013, by its own terms required plaintiffs to submit a completed application by March 18, 2013, the same day they received the offer in the mail. Plaintiffs contend that these facts at best create a triable issue of whether Ocwen provided plaintiffs with a “reasonable timeframe” for submission of a complete application, an issue not suitable for resolution on a demurrer. We agree. In short, we conclude that by alleging the submission of the loan modification application three days after receipt of the offer letter, and the transmittal of the additional documents requested by Ocwen on the date of request, plaintiffs have sufficiently alleged that a complete loan modification application was pending at the time Ocwen foreclosed on their home in violation of section 2923.6.

[E]ach of plaintiffs' remaining causes of action (for breach of contract, breach of the implied covenant of good faith and fair dealing, promissory estoppel, fraud, negligent misrepresentation and violations of Bus. & Prof. Code, §17200 et seq.) were dismissed based upon the improper application of the tender rule. Because the sufficiency of the factual allegations to support these causes were not considered below, we reverse the trial court's ruling on demurrer as to each of them.

3. Rescission

Violations of TILA or HOEPA carry a potent remedy: rescission of the mortgage. As a refresher from contracts, rescission means the unwinding of the transaction to return the borrowers to the position before the loan was made. Rescission is a complete defense to foreclosure because it voids the security interest, without which there is nothing to foreclose. Rescission is available only for non-purchase-money mortgages in a consumer's principal dwelling. The case below describes rescission rights and provides a discussion of the process for asserting rescission.

Paatalo v. JPMorgan Chase Bank

__ F. Supp. 3d __, 2015 WL 7015317 (Or. 2015)

AIKEN, Chief Judge.

Plaintiff William J. Paatalo seeks a declaratory judgment deeming null and void the 2009 foreclosure of his home loan and trustee's sale of the property securing the loan. Defendant JPMorgan Chase, the purchaser of the property at the trustee's sale, moves to dismiss. For the reasons set forth below, defendant's motion is denied.

BACKGROUND

In 2006, plaintiff refinanced the loan on his property ("the property") in Yachats, Oregon. He obtained a $880,000 "Option Arm" loan and a nearly $110,000 (later increased to $155,000) home equity line of credit ("HELOC") from Washington Mutual Bank, F.A. ("WaMu"). Both loans were secured by deeds of trust on the property.

Plaintiff alleges WaMu misapplied payments and reported false derogatory information to credit reporting agencies on the HELOC account. After disputing those actions with WaMu, plaintiff alleges he began to suspect fraud. He alleges WaMu inflated the appraised value of his property, falsified plaintiff's income on his loan application without his knowledge or consent, and committed numerous violations of the Truth in Lending Act ("TILA"), 15 U.S.C. §§1601 et seq., including "fail[ing] to provide proper 'Notices of Rescission' on the 2006 loans[.]" Plaintiff further alleges he sent a written "Notice of Rescission" on both loans to WaMu on or about March 29, 2008. Plaintiff asserts WaMu sent him a letter declining his rescission and attaching a "payoff quote" of just under one million dollars. According to plaintiff, the letter stated he could not rescind unless he first paid off the amount of the debt in full—something he was unable to do. In July 2008, plaintiff filed suit against WaMu.…

Plaintiff alleges on April 2, 2009, WaMu recorded a "Notice of Default and Election to Sell" in connection with the property.…At the trustee's sale, defendant purchased the property for $410,000 cash, and on August 18, 2009, a Trustee's Deed was issued to defendant for the property.…

On July 12, 2011, while the unlawful detainer action was still being litigated, defendant sold the property for $285,000. [ED. NOTE—Take a look back up at the loan amount to get a sense of why "loss severity" is a term that strikes terror into bankers.]

In February 2015, the United States Supreme Court decided Jesinoski v. Countrywide Home Loans, __ U.S. __, 135 S. Ct. 790 (2015). After *Jesinoski* was decided, plaintiff alleges he sent defendant a notice memorializing the March 29, 2008 rescissions. Plaintiff asserts *Jesinoski* makes clear "[t]he loan and contracts were void as of March 29, 2008, and must be cancelled as a matter of law."

Plaintiff filed this action on July 29, 2015. He asks this court to declare (1) plaintiff is the sole owner of the property; (2) the foreclosure of the Deeds of Trust was null and void; and (3) all documents recorded on or against title to the subject property after the March 29, 2008 notices of rescission are null and void. Defendant moves to dismiss for failure to state a claim.

...

DISCUSSION

Defendant argues the complaint should be dismissed for two reasons. First, it asserts plaintiff never completed the steps required to rescind the loans under TILA. Second, it contends even if plaintiff rescinded the loans in March 2008, any rights plaintiff had to the property were cut off by the trustee's sale.

I. RESCISSION UNDER TILA

"Congress enacted TILA 'to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit, and to protect the consumer against inaccurate and unfair credit billing and credit card practices.'" Hauk v. JP Morgan Chase Bank USA, 552 F.3d 1114, 1118 (9th Cir. 2009) (quoting 15 U.S.C. §1601). "To effectuate TILA's purpose, a court must construe 'the Act's provisions liberally in favor of the consumer' and require absolute compliance by creditors." Id. (quoting In re Ferrell, 539 F.3d 1186, 1189 (9th Cir. 2008)). TILA provides special rescission rights for loans secured by a borrower's principal dwelling.

15 U.S.C. §1635(a); Semar v. Platte Valley Fed. Sav. & Loan Ass'n, 791 F.2d 699, 701 (9th Cir. 1986). TILA's "buyer's remorse" provision grants buyers the right to rescind within three days of either "the consummation of the transaction or the delivery of the information and rescission forms required under this section together with a statement containing the material disclosures required under this subchapter, whichever is later[.]" 15 U.S.C. §1635(a). The right to rescind expires "three years after the date of consummation of the transaction or upon the sale of the property, whichever occurs first." Id. §1635(f).

The effect of this provision is to create two separate rescission rights. The first is an "unconditional" right to rescind, good for three business days after the transaction. Jesinoski, 135 S. Ct. at 792. The second is a "conditional" right. Id. If more than three days have passed since the transaction was consummated, the right to rescind exists only if the lender has failed to provide the required information, forms, and disclosures. This conditional right "does not last forever"; it expires after three years or upon the sale of the property "[e]ven if a lender never makes the required disclosures." Id.

Under the statute, rescission triggers an unwinding process. TILA provides "[w]hen an obligor exercises his right to rescind…, he is not liable for any finance or other charge, and any security interest given by the obligor, including any interest arising by operation of law, becomes void upon such a rescission." 15 U.S.C. §1635(b). Within 20 days after "receipt of notice of rescission," the lender must "return to the obligor any money or property given as earnest money, downpayment, or otherwise, and shall take any action necessary…to reflect the termination of any security interest created under the transaction." Id. At that point, the borrower is required to "tender the property to the creditor." Id.

Plaintiff alleges because WaMu failed to provide the required notices, he possessed a conditional right to rescind in March 2008, and he timely delivered written notice of his intent to rescind as required by 15 U.S.C. §1635(a). He further alleges WaMu told him he would have to tender the full payoff amount of the loan in order to rescind, contrary to 15 U.S.C. §1635(b), which instead required WaMu to take the first steps to unwind the loan.

It is undisputed more than three years have passed since the consummation of plaintiff's 2006 loans and plaintiff's right to rescind, if not yet exercised, has expired. Thus, the viability of plaintiff's claim that WaMu's security interest in his property was voided in March 2008 hinges on the effect of the notices of rescission to WaMu. Taking the allegations in the complaint as true, if those notices actually rescinded the loan, plaintiff's complaint will survive the motion to dismiss. If, on the other hand, notice of intent to exercise the conditional right of rescission did not actually effect the rescission, defendant is entitled to dismissal. The Supreme Court answered this question in *Jesinoski*. A unanimous Court declared "rescission is effected when the borrower notifies the creditor of his intention to rescind." Jesinoski, 135 S. Ct. at 792. Thus, if—as plaintiff alleges—WaMu failed to provide the required disclosures and plaintiff delivered written notice of rescission in March 2008, the rescission was effected and the security interest in plaintiff's property voided at that time.

Defendant disputes this reading, arguing *Jesinoski* concerns the time period in which a borrower must provide written notice of his intent to exercise a right to rescind. The court agrees *Jesinoski*'s holding concerns the three-year life of the rescission right. The question, however, was whether a borrower can exercise her rescission right by sending written notice of rescission within three years, or whether she must also file a lawsuit within that time period to enforce her rescission right. Jesinoski, 135 S. Ct. at 791. The Court had to determine when rescission actually occurred in order to answer that question:

> The language of [the statute] leaves no doubt that rescission is effected when the borrower notifies the creditor of his intention to rescind. It follows that, so long as the borrower notifies within three years after the transaction is consummated, his rescission is timely.

Id. Thus, the *Jesinoski* holding rested on the Court's determination, as a matter of statutory interpretation, that written notice actually effects the rescission. Defendant correctly notes a number of federal appellate courts, prior to *Jesinoski*, distinguished between notice of intent to exercise the rescission right and the rescission itself. See, e.g., Gilbert v. Residential Funding, LLC, 678 F.3d 271, 277 (4th Cir. 2012) ("We must not conflate the issue of whether a borrower has exercised her right to rescind with the issue of whether the rescission has, in fact, been completed and the contract voided."). That distinction, however, cannot survive the Court's clear statement "rescission is effected" at the time of notice. Jesinoski, 135 S. Ct. at 792.

Defendant argues this reading of *Jesinoski* cannot be correct because it means "a borrower's mere notice of rescission automatically converts a secured lender into an unsecured lender, leaving the lender with no other remedy but to file suit to challenge the validity of a borrower's rescission." Essentially, defendant argues rescission cannot be the default rule. Taken to its logical conclusion, defendant's argument would require borrowers to file suit to enforce their right to rescind, rendering no rescission the default rule. The Supreme Court implicitly rejected defendant's argument when it declared "rescission is effected" at the time of notice, without regard to whether a borrower files a lawsuit within the three-year period. Jesinoski, 135 S. Ct. at 792; Alexandra P. Everhart Sickler, And the Truth Shall Set You Free: Explaining Judicial Hostility to the Truth in Lending Act's Right to Rescind a Mortgage Loan, 12 Rutgers J.L. & Pub. Pol'y 463, 481 (Summer 2015) ("As a practical consequence of [the *Jesinoski*] ruling, a lender now bears the burden of filing a lawsuit to contest the borrower's ability to rescind.").

This reading of *Jesinoski* does not, as defendant asserts, amount to holding "the process of unwinding a loan is automatic and complete upon a borrower's written notice of rescission." After WaMu received plaintiff's notice of rescission, it had two options. It could have begun the unwinding process by returning plaintiff's down payment or earnest money and taking action to "reflect the termination of [the] security interest," pursuant to 15 U.S.C. §1635(b). Those actions would, in turn, have triggered plaintiff's obligation to tender a payoff of the remaining loan amount. In the alternative, WaMu could have filed a lawsuit to dispute plaintiff's right to rescind the loan. Plaintiff alleges WaMu did neither of those things. The question here is what happens when the unwinding process is not completed and neither party files suit within the TILA statute of limitations. In such circumstances, *Jesinoski* directs that the rescission and voiding of the security interest are effective as a matter of law as of the date of the notice.

Finally, defendant argues even if *Jesinoski* means rescission is effective upon a borrower's notice, that holding cannot be applied "retroactively" to 2008. But there is no retroactivity issue here. When a court interprets a statute, it is not 'retroactive' to apply the decision to transactions already entered into, because the court is determining what the law has always meant.…

[B]ecause plaintiff has adequately alleged (1) he had a conditional right to rescind in 2008; and (2) he exercised that right, he has stated a claim for at least some of the relief he seeks—a declaratory judgment deeming the foreclosure of the Deeds of Trust null and void.…

To finalize the rescission, debtors will usually have to find alternate lenders to finance the tender of the loan proceeds, less any prepaid finance charges and loan payments to date, to the creditor. While voiding the security interest frees up the house as collateral, without a lawyer hooked up to a community development lender, consumers may not navigate rescission. Nonetheless, rescission is a crucial example of a self-effectuating, non-judicial consumer remedy—at least to a certain degree.

Problem Set 14

14.1. Badar Khan is counsel to a fintech company (that is "financial technology" for those outside the industry). The company's computer programmers write complex underwriting programs to help loan officers assess whether a loan meets the CFPB's underwriting rules. The programmers have worked since 2013, when the CFPB released rules on the program. About to deliver the product to three large mortgage companies, they are running error traps in the beta software. For each of the loans below, Badar needs to verify if the program correctly categorized the loan. Did it? If there is a problem, identify it. 15 U.S.C. §§1639b and 1939c; 12 C.F.R. §1026.43.

a. A 40-year mortgage loan for $160,000, with 2 percentage points and fees, which is fully amortized in its payments. The program considered and verified the borrower's mortgage-related obligations, income and assets, employment, other loans and debts, and family support obligations. The borrower has a 750 credit score (on a scale of 800) and the debt-to-income ratio is 42.89 percent. Program result: Qualified Mortgage.
b. A 15-year mortgage loan for $800,000, with no points or fees, and an adjustable interest rate that starts at 5 percent and grows each of the first ten years by .025 percent. The borrower will make a downpayment equal to 50 percent of the collateral. The program did the underwriting based on the maximum rate at the 10-year mark and considered the borrower's mortgage-related obligations, income and assets, employment, other loans and debts, and family support obligations. The borrower has a 690 credit score (on a scale of 800) and the debt-to-income ratio is 37 percent. Program result: Qualified Mortgage
c. A 10-year mortgage loan for $275,000, with 2.5 percentage points and fees, that has a fixed interest rate of 7 percent. The loan payments will be less than necessary to bring the balance to year at the end of the term of the

loan, so a final payment of $75,000 will be due. The program considered the borrower's mortgage-related obligations, income and assets, employment, other loans and debts, and family support obligations. The borrower has no credit score because she recently moved to the United States. The debt-to-income ratio is 18 percent. Program result: Ability to Repay.

d. A 30-year mortgage loan for $500,000 with a fixed interest rate of 6.25 percent. Points and fees are equal to 3 percent of the loan. The program considered the borrower's mortgage-related obligations, income and assets, employment, other loans and debts, and family support obligations. The borrower has a credit score of 682 (on a scale of 800); the debt to income ratio is 38 percent. Program result: Qualified Mortgage.

14.2. Felipe Cordwin is a registered lobbyist and lawyer. His client is the nation's largest bank. After the foreclosure crisis, the last thing it wants is bad publicity, including litigation over something as ugly-sounding as problems with "ability to repay." That said, the business line of the bank is insistent that ability-to-repay (ATR) (non-QM) loans can produce good money (query if there such a thing as "bad money" to a banker). The bank's mortgage counsel, Joyce Palazzo, has halted the launch of an ATR loan program because she believes that even if an ATR loan never defaults or goes to foreclosure, a consumer could kick up trouble just to generate money. She notes that these damages could easily erase all bank profits on the loan, plus impose litigation costs. The bank has asked you to conduct outside research. Is Joyce correct on the law? 15 U.S.C. §§1639b(d); 1639c; 1640(a)(4).

14.3. Starbright Co. has rocketed upward in the last few years, fueled by hedge fund money and the desire of larger banks to escape the reputational risk of foreclosing on homeowners. Starbright purchases mortgage servicing rights on defaulted loans and then runs homeowners through its StarSaver program of foreclosure alternatives. The company recently received an inquiry from Middle State's Attorney's General Office about its practices. The inquiry letter alleges consumers have complained that the transfer of servicing—and the concomitant triggering of the StarSaver program—disrupts homeowner's pending loan modification applications with their prior servicer. As general counsel to Starbright, Roger Rood believes the StarSaver program is the most generous in the business in terms of loan modifications but he admits that it requires additional documentation. He notes that Starbright uses the CFPB's model "Notice of Servicing Transfer" letter. The Attorney's General Office stated that the model was deceptive because it stated that "[n]othing else about your mortgage loan will change" upon transfer except a new servicer will collect payments. 12 C.F.R. §1024.33; Appendix MS-2; and 12 C.F.R. §1024.41(a). Is the letter deceptive? If so, what should Starbright change about its practices?

14.4. Maeve Zinner is one of the best consumer lawyers in California, and he takes pride in dozens of pictures of families in front of homes saved from foreclosure. But Maeve also has a file of "failures" where homes were lost, and they haunt her. The problem that Maeve faces is establishing when a "complete" application has been submitted. She is disappointed in how the CFPB addressed the issue and wants to amend the California Homeowner Bill of Rights to do better. What would you suggest? 12 C.F.R. §1024.41(b)(1); Cal. Civ. Code §2924.28(d).

Assignment 15. Credit Cards

About three of four adult Americans have at least one credit card, with the typical consumer having an estimated 3.5 active cards. Credit cards also are important because they are particularly likely to be used for high-dollar transactions. Each year, Americans charge about $2 trillion in purchases. Much of the law that governs credit card transactions is contractual; this is particularly true about the relationships between card issuers and merchants and others in the card processing industry. Consumers have contracts with issuers called card agreements. The terms of such agreements, however, are limited by numerous provisions of the Truth in Lending Act (TILA). The Credit Card Accountability Responsibility and Disclosure Act of 2010 (CARD Act) added protections to TILA, addressing many practices with regard to penalty fees that were subject to public enforcement or consumer advocacy.

A. Credit Card Transactions

Credit cards are unusual products because they combine two distinct features: the ability to pay and the ability to borrow. From the consumer's perspective, the merchant is effectively paid at the time the card is swiped, just as if the consumer had handed the merchant cash. It is weeks later when the consumer receives the bill that the consumer decides whether to pay off the entire balance or to finance the purchase by paying only a portion of the balance. This pay-now, buy-later feature of credit cards means that they raise two consumer protection concerns: as a payment system and as a loan.

What most of us think of as a "credit card company" is called an issuer. This is the business, usually a financial institution, that gives the card to the consumer. The issuer develops and advertises card products, solicits consumers to open accounts, and makes initial disclosures. TILA regulates all of these processes. Unlike with mortgages, issuers nearly always service the credit card accounts that they originate. Issuers send consumers monthly statements, apply payments, address billing disputes, and collect from delinquent consumers. TILA also proscribes the rules for these ongoing issues that occur with payment and open-end credit.

Although the consumer deals primarily with the issuer, credit card transactions involve several other parties. When a merchant accepts the card, it uses a card processer to submit the transaction for authorization and payment. These card processors are called "acquirers" because they receive transactions from a merchant and process the transaction to obtain payment from the issuer. The acquirer submits the payment back to the merchant, who is paid for the transaction. Acquirers receive payment, usually a fraction of one percent, of the total purchase price as payment for their work as intermediaries. The best known entities in the credit card world—Visa and Mastercard—are not issuers or acquirers; instead they provide networks and technology for processing that merchants and acquirers use to obtain authorization for transactions and to receive payments from issuers. Visa and Mastercard and issuers also get a fraction (one or two percent) of the total purchase price of credit card transactions. Generically, these costs are called "interchange fees." Like the money that merchants pay to acquirers, the fees to Visa, Mastercard, and similar companies are costs borne by merchants. Ultimately, credit card processing costs are added into the cost of goods and services, despite usually being invisible to consumers.

Although the technology and processing of the payment to the merchant is similar, the borrowing aspect of a credit card distinguishes it from debit cards and charge cards. Debit cards result in immediate or near-immediate deductions from consumers' bank accounts. Charge cards, unlike credit cards, are supposed to be paid in full at the end of each month; the credit extended is limited to the billing cycle. TILA defines a credit card broadly as "any card…or other credit device existing for the purpose of obtaining money, property, labor, or services on credit." 15 U.S.C. §1602(k). This obviously sweeps in both cards issued by financial institutions or retailers on the Visa or Mastercard networks, and cards issued by entities with their own processing networks, such as American Express. Regulation Z expands the definition of credit card to make TILA applicable to charge cards. 12 C.F.R. §1026.2(a)(15). The definition of "creditor" with regard to credit cards is also more stringent. Even if finance charges are not frequently imposed, an issuer is covered. 12 C.F.R. §1026.2(a)(17)(iii).

Credit cards are generally subject to many of the laws covered in prior assignments. This includes credit reporting and lending discrimination laws and UDAP statutes. TILA imposes additional rules on credit card advertising and solicitations. One example, which was described in Problem 5.4, is the limitations on credit card marketing on college campuses. Another example is the prohibition on mailing of unsolicited cards; cards must be issued only "in response to a request or application" from a consumer. 15 U.S.C. §1664. Because of these rules, the protections of other laws like those that help consumers deal with unordered merchandise that arrives at their doorstep, are not needed in the credit card context. Similarly, the general framework for false advertising is less useful in challenging the tactics of credit card issuers. The issuers argue that TILA already circumscribes the boundaries of their actions in soliciting consumers. While TILA does not preempt these other actions, courts frequently seem to agree with credit card companies. As a practical matter, if TILA permits the company's actions, that seems to insulate the card company from liability for violating other applicable laws, including UDAP statutes.

The TILA provisions on open-end disclosures apply to credit cards. Disclosures must be given at the time of account opening and included in periodic statements. Such disclosures should be clear and conspicuous and focus on the costs of credit cards. As with mortgages, credit cards have specialized disclosures. Of particular note is the requirement that disclosures in direct mail solicitations for cards contain disclosures using a tabular format. 12 C.F.R.

§1026.5a(a)(2). These disclosures, nicknamed the "Schumer" box after the Senator involved in the legislation, include a requirement that the APR be disclosed using 16-point font.

B. Limitations on Fees and Other Product Terms

TILA imposes significant additional limitations on fees, even if fully disclosed and agreed to in a card agreement. Beyond the usual concerns about adhesion contracts and whether consumers read the fine print, the complexity of cards creates lengthy and difficult contracts. Even when they try, consumers often do not understand the terms of credit cards. For example, one study found that even when offered a choice between just two cards with only two varying terms, consumers chose the suboptimal card 40 percent of the time. Sumit Agarwal et al., *Do Consumers Choose the Right Credit Contracts?*, 4 REV. CORP. FIN. STUDIES 239, 242 (2015). Also some provisions were so flexible and open-ended as to make it impossible for consumers to shop for a good deal among issuers without a crystal ball to perceive the issuers' future decisions. Professor Ronald Mann has called these "unpriceable" terms; other scholars have more colorfully suggested that when many such terms are included, as they typically have been in credit card contracts, the result is "bullshit promises"—defined as promises that are not made with an intention to deceive but nonetheless are insincere because they reserve the right for the company to do as it wishes, which is a complete disregard for norms of honest promise-making. Curtis Bridgeman & Karen Sandrik, *Bullshit Promises*, 76 TENN. L. REV. 379 (2009). The CARD Act took aim at a number of aspects of credit cards that permitted issuers to redesign the product repeatedly and without limitation. For example, TILA now requires that an issuer that offers a "fixed rate" actually provide a fixed rate, which is defined as a rate that "will not change or vary for any reason over the period specified clearly and conspicuously in the terms of the account." 15 U.S.C. §1637(m). If this kind of detailed legislation seems unnecessary, consider that lawsuits trying to challenge "fixed rates" that could change at any time for any reason under the terms of the card agreement under the unfair and deceptive practices laws were unsuccessful.

1. Late Fees and Other Penalty Fees

Late fees are imposed when a consumer fails to make a timely payment, as defined under the card agreement. For many decades, there were virtually no specific rules on the amount of late fees or when late fees could be imposed. Fees increased significantly in the late 1990s and 2000s, with the typical fee charged by a large issuer reaching $39. Such fees generated substantial revenue for card issuers. Before the effective date of the CARD Act, issuers collected about $900 million in such fees each month. The CARD Act reduced late fees substantially, halving them to $427 million in November 2010 in the wake of the legislation.

The premise for charging a late fee is that issuers incur costs from a delay in payment. At least some of these costs are presumably distinct from the cost of money loaned out for a longer than anticipated period, as that it is the purpose of interest being charged on the account. Of course, when a consumer is delinquent, the issuer may worry about the consumer's creditworthiness, and a late fee may be an alternative to increasing the interest rate immediately and without notice, which TILA prohibits. Consumers who pay late also increase servicing costs for issuers, who need to send reminders or initiate a review of the consumer's creditworthiness. A study by the Center for Responsible Lending found only a weak relationship between the imposition of late fees and actual credit losses, however, which suggests that many late fees result from mistakes or disorganization rather than from financial distress. The Center for Responsible Lending, *A Just Fee or Just a Fee? An Examination of Credit Card Late Fees,* (June 8, 2010), http://www.responsiblelending.org/credit-cards/research-analysis/A-Just-fee-or-Just-a-Fee.pdf (last visited Oct. 26, 2015).

The law curbs the imposition of late fees in two ways, both of which reflect concern about whether such fees are appropriately calibrated to their purported purpose. First, issuers are required to use consistent billing practices that could minimize the incidence of late fees resulting merely from consumer confusion. Credit card bills must be due on the same date each month, and that day must give consumers at least 21 days to pay their bills. Payments received by 5:00 p.m. on the due date must be treated as timely, 12 C.F.R. §1026.10(b)(2)(ii), although many a West Coast resident has learned the expensive way that this can be 5:00 p.m. Eastern Time. Before these laws, a due date for a given month might vary by 7 or 10 days, making it hard for the consumer to remember the due date. Or consumers might get tripped up by a late fee even though they made their payment on that month's specified due date, merely because they failed to note the payment was due by 9am, noon, or some other time.

The second change to the law limits late fees and other penalty fees to an amount that is "reasonable and proportional to the omission or violation to which the fee or charge relates." 15 U.S.C. §1665d(a). The implementing rule provides guidance on the costs that issuers may consider in setting a fee. Issuers are excluded from passing along the costs of higher rates of losses from nonpayment (that is credit risk and should be covered by the interest rate) but may include in the fee amount any collection costs, such as sending delinquency notifications and negotiating payment plans. As an alternative to justifying costs, issuers can charge fees below the amount of "safe harbor" fees. Section 1026.52(b) of Regulation Z permits the imposition of a $25 penalty fee for the first violation and a $35 fee for any additional violation of the same type during the next six billing cycles. These amounts, set in 2010, adjust annually based on the Consumer Price Index. If an account becomes seriously delinquent, defined as no payment or less than the required payment for two or more consecutive billing cycles, the late payment fee may be increased to equal 3 percent of the delinquent balance.

TILA also restricts overlimit fees, which like late fees were a major source of industry profit before the CARD Act of 2009. In many ways, the approach to overlimit fees is similar to late fees, eliminating common practices decried as abuses at the time of the legislation. Overlimit fees also must be "reasonable and proportional" in amount and cannot exceed the transaction itself (so if the transaction that puts the consumer over the limit is a $2 charge for coffee; the overlimit fee cannot exceed $2). 12 C.F.R. §1026.52(b). The law also limits when overlimit fees may be imposed. Issuers may not charge more than one overlimit fee per billing cycle, regardless of the number of times the consumer exceeds the limit. The justification for this approach is that the issuer could decline to approve further transactions once learning that the customer has exceeded the limit, and that if the issuer wishes to authorize such transactions, it should not be at additional expense to the consumer.

To give consumers an additional tool to control the imposition of overlimit fees, the law requires issuers to obtain the express consent of the issuer to impose overlimit transactions. Such "opt-ins," so-named because the default rule is that without consent there may not be overlimit charges applied to accounts, may be revoked at any time by the consumer. 15 U.S.C. §1637(k). One year after the CARD Act's effective date, these legal changes have dramatically reduced—if not virtually eliminated—overlimit fees in the credit card industry. The number of accounts charged an overlimit fee dropped from approximately 12 percent to 1 percent. Many issuers decided not to bother with trying to convince consumers to opt-in, instead forgoing the right to charge overlimit fees (although such issuers may still allow consumers to exceed their limits).

2. Rate Changes

Credit cards are open-end, revolving loans. While there is a set credit limit, the amount of credit used each month varies, and the card may have been issued years prior to the instant charges. A major weapon that card issuers have to protect themselves against changes in market conditions, such as their cost of funds, and against erosion of a consumer's creditworthiness, is changing the APR. Until recently, the norm in the industry was "any time, any reason" repricing. This practice was criticized for being unfair. It made it nearly pointless for a consumer to shop for credit because it was uncertain if and under what conditions issuers might reprice. The changes also were retrospective, effectively changing the cost of the toaster bought on a credit card with a balance after the consumer decided to buy the toaster.

Despite an outcry from the card industry, Congress enacted limits on when issuers can increase interest rates. TILA prohibits retrospective rate increases. A higher APR can be applied only to new purchases; the old balance is protected from the rate increase. If the cardholder has missed two consecutive payments, however, she loses this protection. If the cardholder makes six consecutive timely payments of at least the minimum amount, she can earn back the prior rate on the remaining protected balance. 12 C.F.R. §226.55(b)(4). This complicated scheme reflects the policy tension at issue. Issuers assert that the flexibility to increase rates is a crucial reason that they can extend ample credit to a range of consumers, including those whose creditworthiness may erode over time. For consumers, however, the changes can translate into escalating fees and rates that make repayment increasingly difficult and can spiral into serious financial distress.

Issuers must give cardholders notice of a rate increase 45 days before it takes effect. 15 U.S.C. §1637(i). The prior law required 30 days of notice. The 45-day notice rule also applies to changes to certain fees, including annual fees and cash advance fees. In the notice of the increase, issuers must tell cardholders that they have a right to cancel the card, rather than be subject to the rate increase. If a cardholder chooses to cancel the card instead of accept the higher fee, an issuer can close the account and increase the monthly payment to accelerate the balance being brought to zero. 12 C.F.R. §1026.55(c). TILA also requires issuers to consider resetting rates downward beginning six months after a rate increase. The law requires creditors to reduce the APR if a reduction is "indicated" by the review but also states that no specific amount of reduction is required. 12 C.F.R. §1026.59.

C. Defenses to Liability for Charges

In the early years of credit cards, there was considerable concern about the potential of the products to harm consumers. Cards were new compared to cash and checks, and the mysterious "swiping" and electronic payment processing was less tangible. Whereas in recent years that harm has focused on fees, interest rates, and the role of cards in consumers' accumulating unmanageable debt, the initial regulation of credit cards focused on their use as payment devices and on fraud. These laws, described below, generally make credit cards more favorable to consumers than cash, checks, or debit cards.

1. Claims Against Merchants

TILA allows cardholders to withhold payment from the card issuer for a transaction for which the cardholder has a defense that it could assert against the merchant that accepted the card. 15 U.S.C. §1666i. This means that if a person purchases defective merchandise using a credit card, the person may refuse to pay the amount of the credit card bill that pertains to the defective merchandise. The law does impose several limitations to this right. As a prerequisite, TILA requires cardholders to make a "good faith attempt to obtain satisfactory resolution of an agreement or problem relative to the transaction from the person honoring the credit card." 15 U.S.C. §1666i. The transaction must have exceeded $50 in amount and have occurred in the cardholder's state of residence or within 100 miles thereof. More subtly, the law limits the time by which the cardholder can use the provision to her advantage. TILA gives a right to withhold payment, not to seek a refund from the issuer at a later date after the bill has been paid. This means that those who carry card balances (and pay interest on them, of course) will have a longer period to assert a defense.

These legal protections are undoubtedly of real benefit to consumers. VISA and Mastercard and card issuers have gone out of their way to educate consumers about these advantages of credit cards to encourage their adoption and use. Indeed, issuers in the card agreements may allow consumers to dispute charges without meeting these requirements. This is one instance in which the law seems to be setting a floor for consumer protection that businesses have exceeded as a matter of providing customer service and competition. While hundreds, if not thousands, of consumers contact card companies to dispute charges every day, there are only a few dozen court opinions on this TILA provision. *See, e.g.*, *Citibank (South Dakota), N.A. v. Mincks*, 135 S.W.3d 545 (Mo. Ct. App. 2004); *Hyland v. First USA Bank,* 1995 WL 595861 (E.D. Pa. Sept. 28, 1995). Accessing the TILA protections against merchants is only a toll-free call to the card issuer away, as compared to many consumer protections that require learning about the law, hiring a lawyer, filing a suit, and prevailing on the merits.

2. Unauthorized Charges

As with all payment systems, credit cards create risks of errors or fraud. These are not just, or even mainly, consumer protection problems. Merchants, acquirers, and issuers all need to prevent erroneous or unauthorized charges to reduce the costs of the system. While the other parties protect themselves through allocation of loss using contracts, TILA focuses on the risk of harm to cardholders. Part D of TILA, enacted as the "Fair Credit Billing Act," permits a consumer to challenge credit card charges. The first step is that the consumer alleges a "billing error" on a statement. Billing errors, as the name suggests, are primarily errors—the creditor failed to credit a payment, a merchant made a mistake in transmitting the amount of a charge, etc. A different challenge comes from unauthorized charges. The problem is not innocent error but malfeasance. The case below begins with a consumer who did not keep track of the whereabouts of his card. Many disputes concern situations when someone lent a card to another person, often a friend or family member, who goes on a spending spree well beyond what the cardholder intended to authorize.

Crestar Bank, N.A. v. Cheevers

744 A.2d 1043 (D.C. 2000)

REID, Associate Judge.

The central issue presented in this case is whether, under the Truth in Lending Act ("TILA"), 15 U.S.C. §§1601 et seq. (1994), a credit cardholder is required to avail himself of the billing dispute procedures of 15 U.S.C. §1666 by notifying the creditor of disputed charges, in order to invoke the liability protections of 15 U.S.C. §1643 against unauthorized charges to a credit card. Appellant Crestar Bank ("Crestar") filed a civil action against appellee Eric L. Cheevers alleging that Mr. Cheevers owed an outstanding credit card balance of $4,231.76, plus interest. Mr. Cheevers claimed that he did not make or authorize most of the charges alleged. The trial court concluded that the disputed charges were “unauthorized” within the meaning of 15 U.S.C. §1643, and thus, Mr. Cheevers was not liable for them. We affirm, concluding that §1666 imposes no mandatory notification requirement on the credit cardholder, and that Crestar failed to satisfy its burden of proof under §1643 by showing that the charges on Mr. Cheevers’ credit card were authorized, or that if unauthorized, the statutory conditions imposed on Crestar were not met.

FACTUAL SUMMARY

The evidence at trial established that on April 3, 1992, Mr. Cheevers entered into an agreement with Crestar for use of a Visa credit card. At the time, he resided in the 1600 block of Kenyon Street, N.W., but notified Crestar in December 1992 of his move to another address. Crestar received regular and timely payments from Mr. Cheevers from April 1992 until December 1993. Mr. Cheevers made additional charges on his account in January, February and April 1994. After his April 1994 charge, he took the credit card out of his wallet to avoid further use because he was experiencing financial difficulties. He could not recall what he did with the card, but thought it may have been lost during his move from Kenyon Street.

When Mr. Cheevers’ account became two months past due in June 1994, Crestar blocked the account from further transactions and mailed Mr. Cheevers a statement informing him that his privileges had been suspended. Despite the block on Mr. Cheevers’ account, in October and November, 1994, charges totaling $3,583.92 were posted to Mr. Cheevers’ card from Amtrak automated ticket machines.

In August 1994, Mr. Cheevers moved again and filled out a postal forwarding address card. On November 29, 1994, Crestar sent Mr. Cheevers a billing statement which included the charges from October and November. Mr. Cheevers testified that he never received the statement. Crestar’s litigation department also sent a letter to Mr. Cheevers, but the letter was returned by the postal service to Crestar on December 14, 1994. At that time, Crestar charged the matter off as bad debt, turned it over to its attorneys, and stopped mailing monthly statements to Mr. Cheevers.

Sometime around November 1994, Crestar contacted the Amtrak Police Department about the charges on Mr. Cheevers’ credit card. Raymond E. Wright, then a criminal investigator with the Amtrak Police, investigated the matter. He testified that the machines used to purchase the Amtrak tickets required no signature nor other identifying information, and took no photograph of the purchaser. He stated that the transactions amounting to thousands of dollars on Mr. Cheevers’s card were unusual. He concluded that the ticket transactions were irregular and fraudulent.

In the early part of 1995, Crestar continued its efforts to collect from Mr. Cheevers the sums charged to his account. On March 8, 1995, an entry made by the Crestar collector assigned to the account stated: “This is probably fraud, no idea, real mess.” On March 22, 1995, Crestar’s attorneys called Mr. Cheevers and left a message on his machine. When they called back on April 8, 1995, the number was disconnected. On April 26, 1995, the attorneys contacted Mr. Cheevers’ place of employment but were informed that he had been fired. On May 2, 1995, Crestar filed suit against Mr. Cheevers.

Mr. Cheevers testified that after changing jobs in April 1995, which resulted in his making more money, he contacted Crestar on July 24, 1995, without knowledge either of the October and November charges on his credit card or the lawsuit against him, because he wanted to pay off his balance which he believed was about $400. When the Crestar representative told him that the balance was about $4,500, Mr. Cheevers “became very alarmed and asked her why the amount was so high.” The Crestar representative stated that fraud was suspected and suggested that he call Amtrak and Crestar’s attorneys. Mr. Cheevers called Officer Wright and the attorneys. Subsequently, in January 1996, he notified Crestar, the bank’s attorneys, and the Amtrak Police in writing that he disputed the October and November 1994 charges. He testified that he did not make the Amtrak charges, that he did not receive any benefit from the charges, that neither he nor his family traveled during that period of time, that he did not give tickets to anyone, and that he does not know who made the charges.

After the bench trial, the trial court ruled “for Mr. Cheevers as to all of the matters in dispute” and in favor of the bank for the undisputed amount of $617.84, plus prejudgment interest from September 1994. In particular, the court concluded that Crestar had failed to carry its burden of proof to show that the charges made on Mr. Cheevers’ credit card were authorized,[1] and that Mr. Cheevers could not be assessed the statutory $50 fee “because the bank ha[d] not provided a method whereby the use[r] of the card can be identified as the person authorized to use it with respect to the charges that were incurred.” Relying on Stieger [v. Chevy Chase Sav. Bank, F.S.B., 666 A.2d 479 (D.C. 1995),] the trial court also determined that TILA precluded “a finding of apparent authority where the transfer of the card was without the cardholder’s consent as in cases involving theft, loss or fraud.”

ANALYSIS

Crestar cites 15 U.S.C. §1666, known as the Fair Credit Billing Act (“FCBA”), and contends that the trial court erred by ruling that Mr. Cheevers was not liable for the disputed charges on his credit card, and that §1666 obligated him to notify Crestar, in writing, within sixty (60) days of receipt of the billing statement that the October and November 1994 charges were unauthorized. Moreover, Crestar argues, Mr. Cheevers had a contractual and common law duty to notify the bank that his credit card had been lost or stolen. In response, Mr. Cheevers argues that §1666 does not bar him from raising an unauthorized charge defense under 15 U.S.C. §1643 of TILA, and that Crestar failed to sustain its burden of proof under §1643, the credit agreement and the common law, to show that the disputed charges were authorized.

At the outset of this opinion, we set forth certain principles that guide our decision. We recognize that: "The Truth-In-Lending Act was enacted 'in large measure to protect credit cardholders from unauthorized use perpetrated by those able to obtain possession of a card from its original owner.'" Stieger, supra note 2, 666 A.2d at 482 (quoting Towers World Airways Inc. v. PHH Aviation Sys., Inc., 933 F.2d 174, 176 (2d Cir.), cert. denied, 502 U.S. 823 (1991)). Moreover, "[TILA] is to be liberally construed in favor of the consumer." Martin v. American Express, Inc., 361 So. 2d 597, 600 (Ala. Civ. App. 1978). In keeping with Congress' intent to protect cardholders, §1643(b) of TILA places the burden of proof on the card issuer, in this case Crestar bank, to show that the disputed charges were authorized: "In any action by a card issuer to enforce liability for the use of a credit card, the burden of proof is upon the card issuer to show that the use was authorized.…" If certain statutory conditions are met, the limit of liability for unauthorized charges is $50 under §1643(a)(1)(B). "However, [TILA] does not limit liability for the cardholder for third party charges made with 'actual, implied or apparent authority.'" Stieger, 666 A.2d at 482 (quoting 15 U.S.C.A. §1602(o)). While §1666 of the FCBA refers to a sixty day notice to the bank of a billing error and the steps the bank must take if a cardholder notifies it of a billing error, notice of such billing error by the cardholder is not required to trigger the protections of §1643. See Regulation Z, 12 C.F.R. §226, Supp. I, at 354 (1999). Indeed, "the legislative history of…[the FCBA] shows that it amended [TILA] for the purpose of protecting the consumer against 'unfair and inaccurate credit billing and credit card practices.'" Jacobs v. Marine Midland Bank, N.A., 124 Misc. 2d 162, 475 N.Y.S.2d 1003, 1005 (N.Y. Sup. Ct. 1984); see also Saunders v. Ameritrust of Cincinnati, 587 F. Supp. 896, 898 (S.D. Ohio 1984) ("Section 1666 sets out the mechanisms by which an obligor is to notify a creditor of a billing error, and the steps a creditor must take once it receives notice of a billing error.").

We turn first to Crestar's argument that: "In its simplest form, 15 U.S.C. §1666 (1998) requires cardholders to inform card issuers of any errors on their statements, in writing, within sixty (60) days of the receipt of the statement." Crestar seeks to impose a notification requirement on Mr. Cheevers that does not exist either under the plain words of §1666 or its legislative history. Rather, §1666 requires the bank or a creditor to take certain action after the cardholder notifies it of a billing error.[2] Thus, §1666 recognizes that a cardholder may inform the bank of a billing error, but does not mandate such notification. See Gray v. American Express Co., 240 U.S. App. D.C. 10, 13 (1984) ("'If the [cardholder] believes that the [billing] statement contains a billing error…, he then may send the creditor a written notice setting forth that belief, indicating the amount of the error and the reasons supporting his belief that it is an error.'") (quoting American Express Co. v. Koerner, 452 U.S. 233, 235-36 (1981)). In addition, §1666 imposes on the card issuer or the bank an obligation to acknowledge and investigate the alleged billing error. Id.

This reading of the statute is consistent with the legislative history of §1666 which reveals Congress' intent to protect the consumer against the creditor's unfair and inaccurate billing practices. Moreover, it is consistent with Federal Reserve Board staff interpretation of the unauthorized use provision of §1643 and the billing error provision of §1666 of Regulation Z, 12 C.F.R. pts. 226.12 and 226.13, regulations promulgated by the Board of Governors of the Federal Reserve System to implement TILA. In interpreting the notice to card issuer provision, the staff of the Board stated:

> Notice of loss, theft, or possible unauthorized use need not be initiated by the cardholder.…
>
> The liability protections afforded to cardholders in §226.12 do not depend upon the cardholder's following the error resolution procedures in §226.13. For example, the written notification and time limit requirements of §226.13 do not affect the §226.12 protections.

12 C.F.R. §226, Supp. I, at 354. Courts must give deference to agency interpretations of TILA and its implementing regulations. See Anderson Bros. Ford v. Valencia, 452 U.S. 205, 219 (1981) ("[A]bsent some obvious repugnance to [TILA], the Board's regulation implementing this legislation should be accepted by the courts, as should the Board's interpretation of its own regulation."); Ford Motor Credit Co. v. Milhollin, 444 U.S. 555, 565 (1980) ("[D]eference is especially appropriate in the process of interpreting the Truth in Lending Act and Regulation Z."). Consequently, we conclude that §1666 imposed no requirement on Mr. Cheevers to notify Crestar of a billing error before he could invoke the protections of §1643. We turn now to §1643.

Crestar maintains that Mr. Cheevers' "failure to object to the [disputed] charges within a reasonable time, even if not his, constituted ratification and acceptance of those charges," and that under contractual and common law, "if the cardholder fails to notify the bank of any dispute within a reasonable period, he is deemed to have admitted the authenticity of the charges." In essence, Crestar reads into §1643 a presumption that if the cardholder fails to notify the bank that the disputed charges are not his, they will be deemed to have been authorized by the cardholder. This presumption is at odds with the plain words of §1643 which impose on the bank the burden to show authorized use of the card, or liability of the cardholder for unauthorized use. As the trial court concluded, nothing in the record demonstrated that Mr. Cheevers authorized the charges on his credit card in November and December 1994. In fact, he emphatically denied authorizing the purchase of any Amtrak tickets on his credit card. Nor was there any evidence in the record that Mr. Cheevers voluntarily transferred his card to a third person. "'[TILA] clearly precludes a finding of apparent authority where the transfer of the card was without the cardholder's consent as in cases involving theft, loss, or fraud.'" Stieger, 666 A.2d at 482 (quoting Towers World Airways Inc., 933 F.2d at 177). Similarly, the record in this case provided no support for the proposition that Mr. Cheevers transferred his card to a third person who had apparent authority to charge the Amtrak tickets. Therefore, we agree with the trial court that Crestar failed to carry its burden of proof to show that the disputed charges were authorized.

The only other way Crestar could prevail under §1643(a)[3] is to show that the conditions of liability for unauthorized use of Mr. Cheevers' card have been met: "[I]f the use was unauthorized, then the burden of proof is upon the card issuer to show that the conditions of liability for the unauthorized use of a credit card…have been met." 15 U.S.C. §1643(b). Six statutory conditions are imposed upon the card issuer or the bank. We agree with the trial court that Crestar did not satisfy at least one of these conditions, §1643(a)(1)(F): "The card issuer has provided a method whereby the user of such card can be identified as the person authorized to use it." Mr. Wright, the Amtrak Police criminal investigator in this matter, testified that the machines used to purchase the Amtrak tickets required no signature, took no photograph of the purchaser, and did not identify the purchaser by any other means. In fact, it was impossible to determine who had used Mr. Cheevers' credit card to purchase the Amtrak tickets. Consequently, no evidence was introduced at trial to show that Crestar "provided a method whereby the user of [Mr. Cheevers'] card can be identified as the person authorized to use it," and thus, Crestar did not sustain its burden to show that it met the conditions for Mr. Cheevers' liability for unauthorized use of his credit card.

Accordingly, for the foregoing reasons, we affirm the judgment of the trial court.

D. Payments from Consumers

The Assignment previously discussed some of the rules pertaining to processing payments from cardholders, including the rules on late fees. The law also controls how issuers bill and collect from consumers. It generally requires that issuers apply any payment in excess of the minimum required payment to the balance carrying the highest interest rate. This helps consumers reduce the amount of interest that they accrue while they are carrying a balance. Issuers are also prohibited from using a practice called "double-cycle billing," in which interest was imposed on amounts owed during both the current and prior billing cycles. In simple form, the law caps the interest cost to a single month for those who only sporadically carry a balance (or who may carry a balance inadvertently by missing a payment date).

The monthly billing statements are peppered with required disclosures. Credit card statements must contain warnings about making late payments and illustrations of the costs of paying off a balance over time. The law requires the issuer to show, if the cardholders made only the required minimum payment, how much interest would be charged and how long it would take to pay off the balance. These calculations presume the cardholder does not make any additional charges. The same disclosures are then made under a proposed faster payment schedule, showing the amount needed to be paid to reduce the balance to zero in three years and the estimated savings from this payment schedule as opposed to the minimum payment. 15 U.S.C. §1637(b)(11).

The early research on the effectiveness of these changes is mixed. A study commissioned by the Consumer Financial Protection Bureau found that 77 percent of consumers noticed the late payment warnings and that 70 percent of consumers noticed the disclosures about the costs of minimum payments. If consumers react to those warnings in the expected fashion is less clear. One study of credit union customers found that while more cardholders began making payments the amount on the statement that corresponded to eliminating the balance in three years, that the people attracted to that three-year schedule made smaller payments than a similar cohort of cardholders before the disclosure, who began to pay down balances even faster. The three-year schedule seemed to be an anchor that attracted some consumers but those consumers may have put themselves on even more stringent payment plans without such a disclosure. *See* Consumer Financial Protection Bureau, *CARD Act conference: Key findings*, http://www.consumerfinance.gov/credit-cards/credit-card-act/card-act-conference-key-findings (last visited Oct. 26, 2015).

A further practical problem with the new disclosures exists. Under the existing regulation, the three-year payment amount is recalculated each month; this means that if the consumer keeps paying the amount shown as the "three-year amount," they will remain three years away from a zero balance. To give an example, a cardholder with a 15.32 percent APR carrying a balance of $3900 who makes no new charges and pays the disclosed three-year amount each month will take 150 months to eliminate the debt, not the 36 months that seem to be contemplated by the disclosure. This issue highlights the difficulty of designing credit disclosures that are accurate and effective for credit products with many moving parts. Credit cards are the poster child for the complexity in financial products; the law mirrors that complexity in its myriad regulations.

Problem Set 15

15.1. After a grueling year of practice, you joined a consulting firm that specializes in helping businesses identify and exploit "strategic market opportunities." The firm has put you in charge of coming up with ideas to help its financial services clients use the changes imposed by the CARD Act to their advantage. Your research has revealed that in advance of the CARD Act, issuers hiked rates on cards and are now less willing to issue cards because of the limitations on future rate increases and penalty fees. You also have read that consumers are feeling the pinch of the economic downturn and are struggling to make ends meet.

Your idea is to develop a specialty line of cards for high-risk consumers, including the unemployed or those with foreclosures on their credit reports. To offset credit risk, the issuer would collect an upfront fee of \$150 for every \$500 of credit line that it approved for a consumer. The issuer would not open the account or issue a card until the upfront fee was paid in full. The issuer would implement special servicing procedures to handle its high-risk customer base, including the ability to text, call, or email its customers on a daily basis if they became delinquent or engaged in other behavior that seemed to indicate a decline in creditworthiness. The issuer would charge a late fee of \$50 but not permit consumers to go over the pre-set limit unless the consumer contacted the issuer by telephone and agreed to a \$50 overlimit fee. You are pretty sure this product will make money. Your remaining question is whether it violates the law. Does it? *See* 15 U.S.C. §1637(n); 12 C.F.R. §§1026.51, 52, and 56.

15.2. Pamela Simmons travels a great deal for her job as a sales consultant. To maximize the perks of the job, she has used her More for Me Mastercard for her purchases for the last decade. The More for Me card gives her a variety of rewards, combining a cash back feature and travel rewards points rather than making her choose between these rewards. The APR on the card is 18.99 percent, a variable rate pegged to the prime rate of the U.S. Treasury. Pamela has been late a few times in recent years when travel caused her to be away from home when the statement arrived. The issuer of More for Me never increased her rate but she did pay some late fees and accumulated interest charges. After she noticed in 2011 that her due date was the same date each month, Pamela set up her account to have her entire credit card statement balance paid automatically out of her checking account one day before the due date.

On one of her recent short stays in her own home, Pamela opened her More for Me Mastercard bill and found a notice that her interest rate is increasing to 28.99 percent effective immediately as of the date of the letter. There was also a paragraph in the letter advising that the company is eliminating the airline rewards aspect of the card but that any earned rewards remain valid to the extent of the airline's expiration policy. The notice justified the rewards change based on consolidation in the airline industry making the cost of providing the rewards more expensive to the issuer. It did not provide any reason for the increase but it did tell Pamela that she could cancel her card. Pamela had previously paid the entire balance off by auto-debit from her bank account and she rarely carries a balance. Nonetheless, she is incensed that More for Me Mastercard seems to be out to get more for itself, and finds its behavior particularly distasteful given her years as a loyal More for Me cardholder. Has More for Me violated the law in making or implementing these changes? *See* 15 U.S.C. §1637(i); 12 C.F.R. §§1026.9(c)(2) and 1026.55.

15.3. Roger Holt lives in El Paso, Texas. He recently purchased a kit from Honey Heaven to grow bees for honey production and plans to sell the honey at local farmers' markets. Holt made the purchase online, paying the $89 cost with his bank-issued credit card. While he was waiting for the kit to arrive, he saw a report on television that Honey Heaven, located outside of Austin, Texas, was shut down by animal control after weeks of demonstrations by animal rights activists concerned about the ethical treatment of bees. Holt tried to contact Honey Heaven but the emails keep bouncing and the phone message says that Honey Heaven is closed "indefinitely." It has been two weeks, and the kit has not arrived. Holt's credit card bill, on the other hand, is in his hand and due in three weeks. Holt contacted his credit card company and told them that he disputes the charges. The card company apologized for this inconvenience but informed him that they were not obliged to remove the charges by law. They admitted that they used to remove such charges as a courtesy but said that in this tough economic environment, it was all the bank could do to make ends meet by complying with the tons of regulations that apply to it. Holt has a bee in his bonnet, so to speak, about the bank refusing to remove the charge. Has the bank violated TILA in this situation? *See* 15 U.S.C. §1666(i), 12 C.F.R. §§1026.12 and 13.

15.4. Lydia Gomez bought a used scooter from Slim's Scooters for $3,700. Neither the salesman nor the sale paperwork made any mention of warranties. She paid using her Wish credit card, which had no balance on it at the time of the scooter purchase. Two weeks after she bought the scooter, when she was riding it to work, one wheel fell off. Lydia was thrown to the ground and suffered a head injury, requiring $300 in doctor's bills and medical treatment. She also had to pay $400 to Ronny's Repair to have the wheel reattached to her scooter. Lydia is furious at Slim's Scooters. She phoned up Slim, the owner of Slim's Scooters, yelling that she wants her $3,700 back. Slim told her, "I already got paid," and when she wouldn't calm down and have a conversation, he eventually hung up on her. Frustrated, Lydia has written to the address provided on her Wish credit card and explained the issue in great detail. Her letter described the accident with the scooter wheel and her shouting match with Slim, and then stated:

> "It is a mistake to bill me $3,700 for a scooter that was defective. I refuse to pay anything for the scooter."

You represent Wish, the card issuer. It has asked you the following questions: Is the above-quoted statement by the consumer correct? If so, under what authority? Can the consumer refuse to pay the entire $3,700? What, if anything, must the issuer do now or avoid doing now? *See* 15 U.S.C. §1666; 12 C.F.R. §§1026.12 and 13.

Assignment 16. Automobile Transactions

Car ownership is an important indicator of economic success. Research has indicated that car ownership is linked to higher employment and earnings, lower absenteeism, better health, and improved access to goods and services. Buying a car has long been the largest purchase most Americans will make short of buying a home. In April 2015, the average price of a new car was $33,560. Used car prices were at their highest in 2014, with the average price reaching $16,800.

Car buyers use one of three methods (or a combination thereof) of paying for these big-ticket purchases: self-financing (i.e., saving money to pay the purchase price or borrowing from a family member), direct lending (when the consumer arranges for a loan from a bank, credit union, or finance company without the involvement of the automobile dealer), or dealership financing (when the dealership either provides the financing, or more commonly, serves as an intermediary between a buyer and a lender). Dealership financing can take the form of a loan or a lease.

The combination of the expense of automobiles and the importance of car ownership results in a keen need for consumer protection. Laws regulate car quality, sales practices, and vehicle financing. At the federal level, the main laws are the federal UDAP statute and the Truth in Lending Act, although laws such as the Fair Credit Reporting Act and the Equal Credit Opportunity Act also apply to car financing. The auto industry successfully lobbied Congress to exclude automobile dealers from the purview of the CFPB. 12 U.S.C. §5519. The CFPB does regulate car loans made by large banks and credit unions, and under its so-called larger participant rule, it has extended its authority to nonbank auto finance companies that make, acquire, or refinance 10,000 or more loans or leases annually. These companies, often affiliates of auto manufacturers, provide much of the credit to dealerships, so that the CFPB now indirectly reaches most mainstream dealerships. With fewer responsibilities for consumer protection after the CFPB's creation, the FTC also may be able to devote more resources to consumer complaints about automobile dealers. Used car dealerships, particularly when they provide financing for customers, are perhaps the least regulated actors in the industry and yet prompt the most concerns about consumer protection. Some of these are "buy-here, pay-here" dealerships, named because consumers are required to return in person, with the car, to make payments. One in four borrowers defaults. A three-part series on the industry covers the economies and customer base, including the investors in these dealerships. Ken Bensinger, *A Vicious Cycle in the Used-Car Business*, L.A. Times (Oct. 30, 2011).

A. Automobile Sales

Car purchases are large-dollar transactions for both the salesperson earning a commission and the consumer spending thousands of dollars. This can lead to high-pressure sales tactics and concerns about unfair and deceptive practices. This section considers two specific legal responses to sales practices of cars. In one situation, the remedy is disclosure. In the other, it is a right to unwind the deal.

1. Odometer Laws

Federal law mandates certain disclosures to consumers shopping for a car. The Automobile Information Disclosure Act (the Monroney Act) requires labels on all new vehicles for sale, disclosing such information assembly location, price, and safety data. 15 U.S.C. §1232. To the extent consumers read these disclosures and find the information useful, these disclosures can improve the efficiency of the automobile market. However, at least one court has held that while the law carries criminal penalties, it does not imply a private right of action. *Reiff v. Don Rosen Cadillac-BMW, Inc*., 501 F. Supp. 77, 80 (E.D. Pa. 1980).

Dealers also are obliged to disclose the mileage of cars. The Federal Odometer Act requires an accurate written disclosure of the mileage. 49 U.S.C. §32701 *et seq*. The statute's reach is arguably broader than that, however, as this case illustrates.

Owens v. Samkle Automotive Inc.

425 F.3d 1318 (11th Cir. 2005)

Per Curiam.

Glendale Owens appeals the dismissal of her amended complaint alleging that Samkle Automotive violated the federal Vehicle Information and Cost Savings Act (the "Odometer Act" or the "Act"), 49 U.S.C. §32701 et seq. [It] permits a private party to recover treble damages or $1,500, whichever is greater, from "[a] person who violates [the Odometer Act] or a regulation prescribed or order issued under [the Odometer Act], with intent to defraud[.]" 49 U.S.C. §32710(a). The parties do not dispute that Owens properly alleged that Samkle violated the Odometer Act, and that it did so with the intent to defraud her. However, Owens did not allege that Samkle intended to defraud her specifically with respect to the vehicle's mileage, a fact the district court found fatal to her Odometer Act claim. The district court held that "recovery under the Odometer Act is permissible only when a plaintiff can allege and prove intent to defraud with the respect to a vehicle's mileage."

Owens argues that the plain language of §32710(a) contains no such restriction, and an allegation of intent to defraud in connection with an Odometer Act violation sufficiently states a claim under that subsection. We agree, and accordingly reverse and remand this case to the district court for further proceedings.

I. BACKGROUND

Owens' amended complaint alleges the following facts. Samkle operates a car dealership in Miami, Florida, known as "Marlin Mazda," from which Owens sought to purchase a used car. Salespersons at the dealership showed her a 2002 Mazda 626, and told her that the vehicle was in "excellent" condition. Based on this representation, Owens bought the car.

At the time of sale, the dealership required Owens to sign a battery of forms—a power of attorney, an odometer disclosure statement, a motor vehicle reassignment supplement, and an application for certificate of title (collectively, the "Transfer Forms")—but not the car's original title, as required by the Odometer Act. See 49 U.S.C. §32705(a); 49 C.F.R. §580.5. The Transfer Forms were not the official, secured forms issued by the State of Florida as required by the Odometer Act, see 49 C.F.R. §580.4, and did not contain certain mandatory disclosures. See id. §580.5. By having Owens sign the Transfer Forms, Marlin Mazda transferred ownership of the car to Owens without ever showing her the car's original title.

Owens alleges that the dealership used the Transfer Forms, and not the original title, to transfer ownership of the car because it sought to conceal what the title would have revealed—that the car was previously a short-term rental vehicle owned by Hertz. She alleges that she would not have bought the car at $25,858.00 had she known it had been a Hertz rental vehicle.

II. DISCUSSION

We review a district court's grant of a motion to dismiss *de novo*, taking as true the facts as they are alleged in the complaint. Sosa v. Chase Manhattan Mortgage Corp., 348 F.3d 979, 983 (11th Cir. 2003).

The Odometer Act allows private parties to recover money damages from those that violate its provisions with the intent to defraud: "A person that violates this chapter or a regulation prescribed or order issued under this chapter, with intent to defraud, is liable for 3 times the actual damages or $1,500, whichever is greater." 49 U.S.C. §32710(a). There is no dispute that Owens has properly alleged violations of the Odometer Act. The complaint alleges that Marlin Mazda, with the intent to defraud Owens, violated a "regulation prescribed… under" the Odometer Act. Specifically, Owens alleged the violation of 49 C.F.R. §580.5(c), which provides that "[i]n connection with the transfer of ownership of a motor vehicle, each transferor shall disclose the mileage to the transferee in writing *on the title.…*" (emphasis added). The Act defines "title" as "the certificate of title or other document issued by the State indicating ownership." 49 U.S.C. §32702(7). Thus, the complaint alleged all of the necessary elements required for a private cause of action pursuant to this statute: (1) that the defendant violated the Act or its regulations, (2) with intent to defraud.

Samkle argues that although it may have acted "with intent to defraud" Ms. Owens when it concealed the title from her, the complaint still fails to state a cause of action because the fraud referenced in the statute can only relate to the vehicle's mileage. However, to accept this argument would violate the first canon of statutory construction, which requires that courts give effect to the plain and unambiguous language of a statute. 525 U.S. 432, 438 (1999).…

On its face, this statute's meaning is direct, clear and unambiguous. No language limits the meaning of the clause "with intent to defraud." Absent any such limitation, the statute's meaning is clear—if you violate the Odometer Act, and you do so with the intent to defraud your victim in any respect relating to the Odometer Act or the regulations passed pursuant to it, you are liable. Thus, the statute's plain language does not admit to the district court's limiting construction, which reads words into the statute that do not exist. U.S. v. Fisher, 289 F.3d 1329, 1338 (11th Cir. 2002) ("If the statute's meaning is plain and unambiguous, there is no need for further inquiry. The plain language is presumed to express congressional intent and will control a court's interpretation."). To augment the statutory language with an additional element, never mentioned by Congress, that the fraud must be "with respect to the vehicle's mileage" violates the cardinal rule of statutory construction.[1]

Nor do we agree with Ioffe's construction of the "intent to defraud" language of §32710(a) as a "shorthand designation for specific acts or omissions which violate [the regulation]." Id. (citing U.S. v. Int'l Minerals & Chem. Corp., 402 U.S. 558 (1971)). In *Int'l Minerals*, the Supreme Court held that, in order to preserve the rule that ignorance of the law is no excuse, a statute punishing the "knowing" violation of the regulation in question (covering description of transported hazardous material) must be construed to apply not to knowledge of the regulation but to knowledge of facts which violated the statute or regulation. Under §32710(a), however, "intent to defraud" does not fall within the same "narrow zone" in which the "mens rea" issue was raised in *Int'l Minerals*. See id. at 560. In this case, "intent to defraud" is not an element of the prohibited conduct, but an independent requirement for a private claim arising out of the violation.

We do note, however, that a plain-language reading is also consistent with the general principle that the Odometer Act is remedial legislation that should be "broadly construed to effectuate its purpose," Ryan v. Edwards, 592 F.2d 756, 760 (4th Cir. 1979) (construing the predecessor to §32710(a)), and a plain reading is not inconsistent with the Act's stated purposes. Title 49, section 32701 of the United States Code ("Findings and purposes") indicates that the Odometer Act, as its title suggests, is aimed at preventing odometer tampering and odometer fraud:

> (a) Findings. Congress finds that—
>
> (1) buyers of motor vehicles rely heavily on the odometer reading as an index of the condition and value of a vehicle;

(2) buyers are entitled to rely on the odometer reading as an accurate indication of the mileage of the vehicle;

(3) an accurate indication of the mileage assists a buyer in deciding on the safety and reliability of the vehicle; and

(4) motor vehicles move in, or affect, interstate and foreign commerce.

(b) Purposes. The purposes of this chapter are—

(1) to prohibit tampering with motor vehicle odometers; and

(2) to provide safeguards to protect purchasers in the sale of motor vehicles with altered or reset odometers.

49 U.S.C. §32701.

Consistent with these purposes and findings, Congress established a remedial scheme that not only punished violators, but also deterred would-be violators through a complex regulatory system that made even sophisticated odometer fraud difficult to attempt unnoticed. The regulations include, as one would expect, a flat prohibition on odometer tampering. 49 U.S.C. §32703. However, Congress also mandated standardized disclosure requirements and record-keeping procedures formulated to provide consumers with transparent information about a vehicle's background, to ease investigation and prosecution of violators, and to prevent would-be violators from taking advantage of titling and registration loopholes to perpetrate odometer fraud. See, e.g., 49 U.S.C. §32705 (setting forth disclosure requirements for transferring ownership of a motor vehicle); 49 C.F.R. §580.1 et seq. (specifying, among other things, the content of odometer information disclosures and record keeping procedures, and requiring titles and power of attorney forms to be printed using a secure printing process); *see also* 49 U.S.C. §32706 (conferring investigatory authority and the power to require car dealers or distributors to keep records of motor vehicle sales available for inspection by the Secretary of Transportation).

In particular, the disclosure and title regulations that Samkle allegedly violated aim in part to thwart "title laundering," a practice unscrupulous sellers employ to falsify the mileage listed on a car's title to conform with an altered odometer reading:

> Title laundering is a scheme commonly used by dealers involved in odometer fraud. The main purpose of title laundering is to get a low mileage title from a State motor vehicle titling office in exchange for a high mileage title. The most basic form of title laundering is to simply alter the high odometer reading on the title to a low odometer reading and apply for and receive a title containing the lower reading. A more sophisticated scheme involves sending the high mileage title to a State not requiring odometer readings on title documents and obtaining a new title which does not contain an odometer reading.

Odometer Disclosure Requirements, 52 Fed. Reg. 27022, 27023 (proposed July 17, 1987).

Requiring mileage disclosures to be made on a securely printed title proved critical to fighting title laundering. Prior to the 1988 revisions establishing the present-day regulations, federal law required mileage disclosure only on a "federal odometer statement." Odometer Disclosure Requirements, 52 Fed. Reg. at 27023. A piece of paper separate from the title, the odometer statement could be easily altered or discarded and did not travel with the title. Id. Consequently, it did not warn subsequent purchasers about the vehicle's mileage and ownership history, and did little to curb title laundering. Id. at 27022-23. On the other hand, when the title itself must contain the mileage disclosure and be shown to the buyer, a seller will find it difficult to conceal the vehicle's history and true mileage. Id. Also, to require the mileage disclosure directly on the title establishes a "paper trail" for consumers and law enforcement to deter potential violators and help apprehend sellers that break the law. Id. Similarly, the rule that requires sellers to print titles and power of attorney forms using a secure process, and states to issue power of attorney forms by the state, see 49 C.F.R. §580.4, makes alteration or forgery of titles more difficult and creates an official paper record tracing the vehicle's ownership.

In other words, the regulations at issue in this case are the "safeguards" designed "to protect purchasers in the sale of motor vehicles with altered or reset odometers" that are contemplated by the Act's purposes. See 49 U.S.C. §32701(b)(2). They prevent unscrupulous dealers from using their own procedures to mislead a purchaser about a vehicle's mileage—not only with respect to the actual number of miles driven, but *where* those miles were driven and *by whom.* See 49 C.F.R. §580.2 ("The purpose of this part is to provide purchasers of motor vehicles with odometer information to assist them in determining a vehicle's condition and value.…"); Yazzie v. Amigo Chevrolet, Inc., 189 F. Supp. 2d 1245, 1248-49 (D.N.M. 2001) (holding that allegations of specific intent to defraud with respect to the vehicle's mileage are not required to bring suit under §32710(a) when a dealer manipulated title procedures in violation of the Odometer Act to hide the identity of the vehicle's prior owner). The identity of former owners, of critical import to the consumer, is also critical to law enforcement, who rely on the chain of title to ascertain the true ownership and mileage of a vehicle. See Odometer Disclosure Requirements, 53 Fed. Reg. at 29468-69 ("Congress noted that '[o]ne of the major barriers to decreasing odometer fraud is the lack of evidence or "paper trail" showing incidence of rollbacks[.]'…Under [the title disclosure requirements], the integrity of the paper trail has been maintained since the disclosure will be on the title and consumers will be able to see the disclosures and examine the titles for alterations, erasures, or other marks. Furthermore, consumers will learn the names of previous owners that appear on the title.") (quoting H.R. Rep. No. 99-833, at 18 (1986) (committee report for the Truth in Mileage Act of 1986, Pub. L. No. 99-579, (1986), which modified the original federal odometer laws in the Motor Vehicle Information and Cost Savings Act of 1972, Pub. L. No. 92-513, §§401-13).

Thus, the success of the complex remedial scheme Congress has created depends on compliance with a multitude of interdependent and seemingly "technical" provisions, such as those Samkle allegedly violated. Violations of these "technical" regulations can defeat the entire remedial scheme—even if they are not committed with the intent to defraud with respect to the vehicle's mileage—by creating gaps in the vehicle's "paper trail" that: (1) thwart investigation of future violations; and (2) make it difficult for future purchasers of a vehicle to spot odometer fraud by preventing them from accurately assessing the vehicle's ownership history.

Moreover, the language of §32710(a) reflects Congressional intent to use civil suits by private individuals to enforce compliance with even the most "technical" provisions of the Odometer Act. To be sure, violators are subject to both civil and criminal penalties for "technical" violations even if they commit them without intent to defraud, see 49 U.S.C. §32709(a)-(b), as well as to suits for injunctive relief by the United States and the fifty States. Id. §§32709(c), (d)(1)(A). But, as the former Fifth Circuit recognized, “unless a violation of the [Odometer] Act can lead to [private] civil liability, the Act is toothless.” Nieto v. Pence, 578 F.2d 640, 643 (5th Cir. 1978); see also H.R. Rep. No. 99-833, at 18 (1986) (justifying making odometer fraud a felony because “[t]he Department of Transportation (DOT) believes that evidence indicates that current criminal penalties for odometer tampering are not a sufficient deterrent. According to DOT, many prosecutors are reluctant to prosecute misdemeanor offenses and place very low priority on odometer cases because they are misdemeanors.”). Although a violator faces potential punishment from the government, “such relief, although theoretically available, is unlikely. Private prosecution is needed to make the Act effective.” Nieto, 578 F.2d at 643. Accordingly, Congress provided a private civil remedy to punish violators of the Odometer Act, so that it would be “largely self-enforcing.” H.R. Rep. No. 92-1033, at 20 (1972).

Therefore, to limit private civil suits under §32710(a) only to instances where the defendant intended to defraud the victim with respect to the vehicle’s mileage runs counter to the purposes of the private civil remedy-to compensate victims for harm suffered, *and* to ensure strict compliance with the Odometer Act’s provisions. Both purposes are also reflected in the text of §32710(a). The violator must make the victim whole, but also must pay an additional price—either double the actual damages or up to $1,500—as a penalty for violating the Act. 49 U.S.C. §32710(a). It would therefore be inimical to the private civil remedy’s function as the Act’s primary enforcement mechanism to limit its reach to instances where the defendant intended to defraud his victim “with respect to the vehicle’s mileage.” Such a reading neither comports with the statute’s plain language, nor accords with its remedial purpose.

Consequently, the district court erred when it required Owens to “allege and prove intent to defraud with respect to a vehicle’s mileage.” Owens has alleged violations of the Odometer Act committed with the intent to defraud, and that is enough to state a claim under §32710(a).

Some states have enacted statutes that expand the federal protection from odometer fraud. Washington, for example, requires knowledge rather than intent to defraud, making it easier for consumers to win actions. *See Quinn v. Cherry Lane Auto Plaza, Inc.*, 225 P.3d 266, (Wash. App. 2009). Other states, like Ohio, treat it as a strict liability offense, removing any question of dealer motive. *See State v. Burrell*, No. 1-07-52, 2008 WL 1700417 (Ohio App. 2008).

2. Lemon Laws

Even if lenders make the required disclosures and consumers digest them, the transaction can go awry for the consumer if the car fails to perform as expected. All fifty states and the District of Columbia have some form of “lemon law.” This term references the car ownership experience souring for the consumer when the car has persistent, serious defects. The typical statute requires the consumer to give notice to the manufacturer of the problem, and if the car cannot be made reasonably serviceable after a specified number of attempts at fixing the problems, to replace the motor vehicle with a comparable “non-lemon” or to return the purchase price to the consumer.

Most lemon laws are limited to new vehicles, although some are slightly broader, sweeping in things like demonstration vehicles. And there is the issue of what is a covered motor vehicle—do motorcycles, motor homes, or all-terrain vehicles fall under the statute? The basic elements of a lemon law claim are a violation of an applicable warranty *and* a nonconformity that results in a substantial impairment of the vehicle’s value, use, or safety. Examples of such problems include cars that routinely fail to start, that have structural defects in the chassis that leak fluid, and the like.

Only a handful of states apply their lemon laws to used vehicles. However, the usual warranty laws, including the Magnuson-Moss Act that were discussed in Assignment 10, apply to the purchase of new or used cars.

B. Automobile Financing

Most Americans do not pay cash for a car but instead finance its purchase. Either method of financing—borrowing or leasing—raises issues of consumer protection. One major concern with financing is the cozy relationship of dealers and financers at the expense of consumers. The result can be dealer markups, which less charitably are viewed as kickbacks. The Center for Responsible Lending estimates that dealer markups increase the cost of automobile loans by $25.8 billion over the lives of the loans. Center for Responsible Lending, *Under the Hood: Auto Loans Interest Rate Hikes Inflate Consumer Costs and Loan Losses*, 2 (2011), http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/Under-the-Hood-Auto-Dealer-Rate-Markups.pdf. Dealer markups come in two main flavors: dealer reserves and loan packing.

1. Dealer Reserves

“Dealer reserves” refers to the practice of a dealer submitting a customer’s financial information to a lender, which replies with a quote of the lowest terms and maximum loan the customer is qualified to receive. The lender and the dealer have an arrangement by which the dealer is compensated for “brokering” the loan for the lender, and additional compensation for negotiating a higher interest rate with the customer, often 2 to 2.5 percent higher. The dealer knows what rate the customer is qualified for, but the customer does not. If the dealer is able to negotiate a higher rate, the dealer and the lender typically share the resulting overage on the interest rate. This often goes by the innocuous description of “dealer participation.”

Beaudreau v. Larry Hill Pontiac

160 S.W.3d 874 (Tenn. Ct. App. 2004)

SUSANO JR., Judge.

This is a class action lawsuit filed by a consumer, Patrick Beaudreau, against a car dealer, Larry Hill Pontiac/Oldsmobile/GMC, Inc. (“Hill Pontiac”). Beaudreau purchased an automobile from Hill Pontiac and the purchase was financed through General Motors Acceptance Corporation (“GMAC”). Beaudreau alleges, inter alia, that Hill Pontiac violated the Tennessee Consumer Protection Act and the Tennessee Trade Practices Act (“the TTPA”) in that it failed to reveal to Beaudreau that it had an arrangement with GMAC by the terms of which Hill Pontiac received a portion of the interest rate charged to Beaudreau. The trial court dismissed Beaudreau’s claims. Beaudreau appeals. We affirm.

I.

On April 12, 1999, Beaudreau agreed to purchase an automobile from Hill Pontiac in Sevierville. In order to purchase the vehicle, Beaudreau obtained financing—with the help of Hill Pontiac representatives—through GMAC. The Hill Pontiac representatives informed Beaudreau that the financing would be subject to a per annum interest rate of 13.5%, which Beaudreau accepted. Sometime later, Beaudreau learned that GMAC had quoted Hill Pontiac an interest rate of 11.25% and that Hill Pontiac had added 2.25% to that rate, thus arriving at the 13.5% interest rate. This practice of a car dealer receiving a certain percentage of the financing it arranges for its customers is commonly referred to as the “dealer reserve” or a “dealer participation” agreement.

On March 8, 2000, Beaudreau filed a complaint against Hill Pontiac, alleging that Hill Pontiac’s practice of dealer reserve violated the Tennessee Consumer Protection Act. As additional grounds, Beaudreau raised the issues of unjust enrichment, money had and received, and civil conspiracy, among others. In his complaint, Beaudreau sought class certification for all Hill Pontiac customers similarly situated.

...

Finding that the cases relied upon by Beaudreau were easily distinguishable from his case, and holding that an unpublished California trial court opinion provided good insight, the trial court reasoned that there was nothing unlawful about the practice of dealer reserve.

From this ruling, Beaudreau appeals.

II.

As previously stated, the trial court granted Hill Pontiac’s motion to dismiss Beaudreau’s claims. Hill Pontiac’s motion was premised on the failure of the complaint to state a claim upon which relief can be granted. See Tenn. R. Civ. P. 12.02(6). “Such a motion challenges the legal sufficiency of the complaint.” Trau-Med of Am., Inc. v. Allstate Ins. Co., 71 S.W.3d 691, 696 (Tenn. 2002). Our role on this appeal is clear. We “must construe the complaint liberally, presum[e] all factual allegations to be true and giv[e] the plaintiff the benefit of all reasonable inferences.” Id. A complaint should be dismissed only if “it appears that the plaintiff can prove no set of facts in support of [its] claim that would entitle [it] to relief.” Cook v. Spinnaker’s of Rivergate, Inc., 878 S.W.2d 934, 938 (Tenn. 1994). Our review is de novo with no presumption of correctness attaching to the trial court’s judgment, Trau-Med, 71 S.W.3d at 696-97, because the question before us is one of law: Does the complaint state a cause of action?

III.

The plaintiff raises four issues on appeal, which can be succinctly stated as follows:

1. Did the trial court err in finding that Beaudreau failed to state a cause of action under the Tennessee Consumer Protection Act?
2. Did the trial court err in finding that Beaudreau failed to state a cause of action for civil conspiracy?
3. Did the trial court err in finding that Beaudreau failed to state a cause of action under the TTPA?
4. Did the trial court err in finding that Beaudreau failed to state a cause of action for unjust enrichment and/or money had and received?

IV.

A.

Beaudreau first asserts that the trial court erred in finding that he failed to state a cause of action under the Tennessee Consumer Protection Act. Specifically, Beaudreau claims that Hill Pontiac had a duty to disclose the “real” interest rate, i.e., the 11.25% rate, to him. We disagree.

The Tennessee Consumer Protection Act was enacted, in part, “[t]o protect consumers…from those who engage in unfair or deceptive acts or practices in the conduct of any trade or commerce…within this state.” Tenn. Code Ann. §47-18-102(2). Beaudreau alleges that Hill Pontiac’s practice of “secretly inflating the real interest rates consumers are charged when financing their car purchases” is a deceptive practice under the meaning of the Tennessee Consumer Protection Act and is thus unlawful. (Emphasis in original omitted). See Tenn. Code Ann. §47-18-104(b)(27) (stating that engaging in an act that is deceptive to the consumer is unlawful). In support of his position, Beaudreau points to the following allegations in his second amended complaint:

> During the course of the transaction, [Beaudreau] was told by Hill Pontiac representatives that financing for him could and would be arranged by Hill Pontiac through GMAC “at the lowest rates offered” by GMAC. Financing of [Beaudreau’s] vehicle was ultimately provided by GMAC. When the Hill Pontiac representative, who at all times was acting as [Beaudreau’s] agent, returned with what he characterized as “the best rate they could give us,” [Beaudreau] believed he had negotiated the “best rate” with GMAC on his behalf.

> However, Hill Pontiac secretly, and without [Beaudreau's] knowledge, added 2.25 percentage points to [Beaudreau's] real interest rate (consequently arriving at the 13.50% rate). [Beaudreau] was specifically told by Hill Pontiac representatives, including the salesman and finance department personnel, that Hill Pontiac had dealt with GMAC on [Beaudreau's] behalf and that the 13.50% rate was the best rate GMAC could offer. However, Hill Pontiac knew GMAC had agreed to finance [Beaudreau's] purchase at a rate lower than 13.50%, which would have consequently led to lower monthly payments.
>
> [Beaudreau] was never told and did not understand that Hill Pontiac was going to receive any of the 13.5% interest rate that he was charged. The real interest rate was never disclosed to [Beaudreau]. Specifically, [Beaudreau] also did not know that the interest rate at which the automobile was financed—and which he paid—was *secretly* inflated by and for the economic benefit of Hill Pontiac by utilizing the dealer reserve scheme described herein.
>
> GMAC arranges for its automobile dealers to act as intermediaries between the consumer and GMAC in order to finance the sale of automobiles. This arrangement is set out in a "dealer participation" agreement between Hill Pontiac and GMAC. According to the agreement between GMAC and Hill Pontiac, the dealership is specifically authorized by GMAC to overcharge consumers by inflating the interest rate charged.

(Numbering in original omitted) (emphasis in original).

This is an issue of first impression in Tennessee. While the issue of dealer reserve was involved in the case of Pyburn v. Bill Heard Chevrolet, 63 S.W.3d 351 (Tenn. Ct. App. 2001), that case centered solely on the issue of an arbitration agreement; the issue of whether the practice of dealer reserve violated the TCPA was never reached. Beaudreau relies upon the unreported case of Adkinson v. Harpeth Ford-Mercury, Inc., No. 01A01-9009-CH00332, 1991 WL 17177 (Tenn. Ct. App. M.S., filed February 15, 1991), in which the concept of dealer reserve, among many other issues, was involved. In *Adkinson*, the court made the following finding with respect to dealer reserve:

> We are also of the opinion that *under the circumstances* it was proper for the jury to base a finding of unfair or deceptive acts and practices on the evidence at trial which shows that Harpeth kept for itself 2.5% of the 16.5% annual percentage rate financing which plaintiff was led to believe was charged by [Ford Motor Credit Company] to finance the transaction. Harpeth told plaintiff that FMCC was financing the transaction but failed to disclose to plaintiff that it had secretly imposed the 2.5% additional charge.

Id., at *7 (emphasis added). Relying upon this language, Beaudreau advances the position that the Court of Appeals has "specifically held that the practice [of dealer reserve]…violates the TCPA." However, Beaudreau overlooks the limiting language of "under the circumstances." In *Adkinson*, the court found evidence of oral misrepresentations that induced the plaintiff into signing a written contract, as well as evidence that the dealership "used high-pressure tactics" to pressure the plaintiff into purchasing a car when she simply wanted to pay off her lease of the vehicle. Id. Based upon these events, the court went on to find that "[t]here is substantial material evidence that Harpeth engaged in unfair or deceptive acts or practices under the [TCPA] and that it also made negligent misrepresentations to plaintiff." Id. The court did state that the jury could have based its findings on the "deceptive act" of dealer reserve—*under the circumstances* of the case, which included numerous acts which were clearly deceptive under the TCPA. Id. Indeed, this court has previously interpreted this language to mean that "a dealer's failure to disclose 'dealer reserve' was actionable *when the dealer engaged in a pattern of deceptive conduct.*" Harvey v. Ford Motor Credit Co., 8 S.W.3d 273, 275 (Tenn. Ct. App. 1999) (emphasis added). By contrast, there are no allegations of such deceptive or misleading acts in the instant case—the only allegation is that Hill Pontiac engaged in the practice of dealer reserve. We find that the facts in *Adkinson* are distinguishable from those in the case at bar. Accordingly, we conclude that *Adkinson* does not have precedential value in the instant case.

Beaudreau also relies upon another unreported case, *Baggett v. Crown Auto. Group, Inc.,* No. 01A01-9110-CV00401, 1992 WL 108710 (Tenn. Ct. App. M.S., filed May 22, 1992), to support his position that the practice of dealer reserve is unlawful. This case contains evidence of the dealership engaging in egregious fraudulent conduct, which included the dealership making alterations to the original sales contract without the plaintiff's knowledge. Id., at *7. When the plaintiff signed the sales contract on the purchase of his automobile, he agreed to an annual percentage rate of 14.75%. Id., at *3. However, when the dealership realized that Ford Motor Credit Company was not going to approve the financing on the terms agreed upon by the plaintiff and the dealership, the dealership unilaterally increased the annual percentage rate to 15.3% in order to obtain the financing. Id., at *3-*5. The dealership then induced the plaintiff's wife to sign a new contract, in the absence of the plaintiff, without telling her of the changes in the contract. Id., at *4-*5. This court held that increasing the interest rate without informing the plaintiff constituted an unfair or deceptive act as contemplated by the TCPA. Id., at *10. However, the actions by the dealership in increasing the rate of interest in the *Baggett* case do not constitute the practice of dealer reserve such as we have in the instant case. Further, as in *Adkinson*, the actions of the dealership in *Baggett* were clearly deceptive, as well as fraudulent. We have no such conduct in the case at bar.

The only other instance in which dealer reserve has been addressed in Tennessee is in the case of *Harvey v. Ford Motor Credit Co.,* 8 S.W.3d 273 (Tenn. Ct. App. 1999), in which we held that the plaintiff's complaint did not state a cause of action against Ford Motor Credit Company for a violation of the TCPA, based upon the practice of dealer reserve. Id. at 276. Because the plaintiff filed suit against the automotive financing company only and not the dealership involved, we did not reach the issue of the dealership's liability, if any, for engaging in the practice of dealer reserve. Id. However, in our opinion on Harvey's petition for rehearing, this court held as follows:

> Although the Amended Complaint alleges that the plaintiff was "required to pay hidden fees," he was clearly informed of the total interest rate, which he was free to accept or reject. Regardless of how payment was allocated between the dealer and defendant, the plaintiff was aware of what his overall payment and total interest rate would be.

Harvey v. Ford Motor Credit Co., No. 03A01-9807-CV-00235, 1999 WL 486894, at *2 (Tenn. Ct. App. E.S., filed July 13, 1999). The court went on to point out that the plaintiff was "free to seek financing from other sources." Id. There is no allegation in the instant case that Hill Pontiac prevented Beaudreau from considering other financing options.

Because there is no case that is squarely on point in Tennessee, we have looked to the case law outside of our jurisdiction for guidance. While our research has revealed that only a handful of jurisdictions have addressed the legality of dealer reserve, the cases in those jurisdictions are indeed instructive.

The United States Court of Appeals for the Seventh Circuit addressed the issue of dealer reserve in the context of the plaintiff's allegation that the dealership was acting as his agent when it arranged the financing:

> [A]n automobile dealer is not its customers' agent, obviously not in selling cars but only a little less obviously in arranging financing. If the buyer pays cash and arranges his own financing, the dealer is not in the picture at all. If the buyer wants to buy on credit, he recognizes that his decision does not change the arms' length nature of his relation to the dealer. He knows, or at least has no reason to doubt, that the dealer seeks a profit on the financing as well as on the underlying sale.
>
> ...
>
> [T]here is no suggestion that the dealer here represented that he would act as the buyer's agent in dealing with the finance company, no indication therefore that an agency relationship was created. If there were such a relationship it would mean that the buyer could tell the dealer to shop the retail sales contract among finance companies and to disclose the various offers the dealer obtained to him, and no one dealing with an automobile dealer expects that kind of service.

Balderos v. City Chevrolet, 214 F.3d 849, 853-54 (7th Cir. 2000).

The Alabama Supreme Court adopted similar reasoning when it addressed the issue of dealer reserve:

> Although this case specifically involves lenders and interest rates, interest is nothing other than the cost or price of borrowing money. The [dealer reserve] agreement at issue here is nothing more than [the dealership's] profit on the loan transaction, which had a wholesale price and a retail price. We decline to recognize a common law duty that would require the seller of a good or service, absent special circumstances, to reveal to its purchaser a detailed breakdown of how the seller derived the sales price of the good or service, including the amount of profit to be earned on the sale.

Ex parte Ford Motor Credit Co., 717 So. 2d 781, 787 (Ala. 1997) (internal citation omitted).

Finally, the California Court of Appeal has made the following statements with respect to the legality of dealer reserve:

> The [plaintiffs] effectively assert that payment of the dealer reserve is deceptive merely because it is not disclosed to consumers. However, disclosure is not required by law, and indeed the Federal Reserve Board long ago rejected the proposition that

> such disclosure would be useful to consumers.[2] Moreover, the [plaintiffs] allege no facts suggesting why a reasonable person would believe that the financing rate in his or her contract with the dealer is the same rate at which a lender would make a direct loan. Indeed, a reasonable person would likely believe the opposite; the Federal Reserve Board thought so, and several courts have agreed.…Accordingly, we conclude payment of the dealer reserve as alleged in the complaints does not constitute a fraudulent business practice.
>
> ...
>
> The claim that consumers pay higher interest rates than they would if no dealer commission existed may be true, but that is scarcely unfair. Dealers, like any other retailer, seek a profit on the credit services they provide. We are compelled to agree with [the defendant] that the "unfair" prong of the unfair competition law was not intended to eliminate retailers' profits by requiring them to sell at their cost, whether the product is automobiles or automobile financing. In short, we discern no offense to public policy, and no unfairness to be weighed. Payment of the dealer reserve is not an unfair practice under the unfair competition law.

Kunert v. Mission Fin. Servs. Corp., 110 Cal. App. 4th 242 (2003) (internal citations omitted); see also Geller v. Onyx Acceptance Corp., No. 728614, 2001 WL 1711313, at *2, *6 (Cal. Superior, filed November 13, 2001) (noting that the practice of dealer reserve has been "an integral part of the indirect auto finance market since at least the 1960's" and finding that dealer reserve does not constitute an unfair or deceptive business practice).

We find the approach to dealer reserve followed by these other jurisdictions to be well-reasoned and adopt it as our own. Each of the aforementioned cases holds, in essence, that a reasonable consumer should be aware that a for-profit retailer, in arranging for financing for a consumer, would expect to receive some sort of remuneration for its efforts; that the consumer is free to seek financing elsewhere if he or she is unhappy with the terms quoted by the dealer; that the practice of dealer reserve need not be disclosed to the consumer, as previously found by the Federal Reserve Board; and that the practice of dealer reserve is in no way unlawful. It appears that this court was contemplating a similar reasoning in *Harvey*, when it noted that the plaintiff was "free to accept or reject" the quoted interest rate and that the plaintiff was no doubt aware of the total payment and interest rate. Harvey, 1999 WL 486894, at *2.

There is no factual predicate in the complaint before us which gives rise to a legal duty on Hill Pontiac to disclose to the plaintiff that it is to receive a portion of the interest charged by GMAC. The plaintiff was aware that his contract called for interest at the rate of 13.5% per annum. There is nothing in the complaint indicating that this information or the amount of his monthly payment was hidden from him. Regardless of whether GMAC was to receive all or only a portion of the stated interest of 13.5%, the fact remains that the plaintiff knew that he was paying 13.5% interest to borrow the money to finance the purchase of his car. He was, at all times, free to reject GMAC financing and look elsewhere for a loan to pay for his vehicle.

Accordingly, we find, in the instant case, that Hill Pontiac's dealer participation agreement with GMAC does not constitute a deceptive act or practice and that Hill Pontiac had no duty to disclose the existence of the agreement to Beaudreau. We conclude that the practice of dealer reserve, standing alone, does not violate the TCPA.

...

C.

Next, Beaudreau argues that the trial court erred in finding that he failed to state a claim under the TTPA. With respect to this issue, Beaudreau specifically asserts that Hill Pontiac conspired with lenders "to lessen competition and/or to advance the costs of auto financing."

The TTPA provides, in pertinent part, as follows:

> All arrangements, contracts, agreements, trusts, or combinations between persons or corporations made with a view to lessen, or which tend to lessen, full and free competition in the importation or sale of *articles* imported into this state, or in the manufacture or sale of *articles* of domestic growth or of domestic raw material, and all arrangements, contracts, agreements, trusts, or combinations between persons or corporations designed, or which tend, to advance, reduce, or control the price or the cost to the producer or the consumer of any such *product or article,* are declared to be against public policy, unlawful, and void.

Tenn. Code Ann. §47-25-101 (2001) (emphasis added).

Despite Beaudreau's attempts to argue that Hill Pontiac provided a product when it arranged the financing for Beaudreau's automobile, the transaction at issue clearly involves a service. This court has previously held that the TTPA is not applicable to workers' compensation insurance premiums, "which [are] an intangible contract right or service" rather than a product or article. Jo Ann Forman, Inc. v. Nat'l Council on Comp. Ins., Inc., 13 S.W.3d 365, 373 (Tenn. Ct. App. 1999); see also McAdoo Contractors, Inc. v. Harris, 439 S.W.2d 594, 597 (1969) (holding that the TTPA does not apply to the award of a building construction contract). Likewise, the arranging of financing constitutes a service, not a product. We therefore hold that the TTPA has no applicability in the instant case. Furthermore, even if the arranging of financing was deemed to fall under the purview of the TTPA—and we do not believe that it does—we find that the practice of dealer reserve is not an arrangement made to lessen "full and free competition," as contemplated by the statute.

D.

Finally, Beaudreau contends that the trial court erred in finding that he had not stated a cause of action for unjust enrichment and/or money had or received. We disagree.

In order to recover under a theory of unjust enrichment, the plaintiff must prove the following: "A benefit conferred upon the defendant by the plaintiff, appreciation by the defendant of such benefit, and acceptance of such benefit under such circumstances that it would be inequitable for him to retain the benefit without payment of the value thereof." Paschall's, Inc. v. Dozier, 407 S.W.2d 150, 155 (1966). While the first two prongs of this test have been satisfied, Beaudreau cannot prove that it would be inequitable for Hill Pontiac to retain the 2.25% dealer reserve commission. Indeed, as discussed earlier in this opinion, a consumer cannot expect a dealership to assist that consumer in obtaining financing without receiving some sort of payment for its services. Under the circumstances, we cannot say that it was inequitable for Hill Pontiac to retain the 2.25% dealer reserve.

With respect to the claim of money had and received, such an action "may be maintained where one receives money or its equivalent under such circumstances that in equity and good conscience he ought not to retain and in justice and fairness it belongs to another." Steelman v. Ford Motor Credit Co., 911 S.W.2d 720, 724 (Tenn. Ct. App.1995) (citing Interstate Life & Accident Co. v. Cook, 86 S.W.2d 887, 891 (1935)). Again, we find that there is nothing inequitable in allowing Hill Pontiac to retain the dealer reserve. Accordingly, Beaudreau's claims for unjust enrichment and money had and received must fail.

As *Beaudreau* illustrates, courts seem to bless the practice of dealer markups, absent additional issues or additional inappropriate dealer conduct.

The legal landscape on dealer markups may be poised to change. In 2012, the CFPB began investigating and warned several companies of potential lawsuits. The focus was on credit discrimination. Customers with lower credit scores likely have higher rate markups. This could be a sign that dealers are targeting the customers with the least bargaining power—those who are worried they won't be approved for any loan and who thus have less leverage to negotiate a lower rate. Because the law does not require the collection of data on the race of auto loan borrowers (see Assignment 8), any evidence would have to rely on proxies for race such as surnames and addresses. The U.S. Department of Justice Office of Civil Rights and the CFPB recently reached a settlement valued at an estimated $25 million with Honda Finance that included an agreement to lower the amount that dealers could mark up a loan. Despite these suits, the CFPB has said that it does not consider dealer markups to be intrinsically unlawful. Consumers or state attorneys general, however, may go after dealer markups on grounds other than discrimination such as UDAP statutes. Challenges to dealer markups may have more success now that Congress has prohibited the analogous practice in mortgage loans—yield spread premiums that let mortgage loan brokers capture as profit the additional money paid when homeowners took on higher cost loans than lenders' best offers.

2. Loan Packing

Loan packing refers to the practice of adding additional items or services on top of the price of the automobile, thereby increasing the amount of the loan. The dealer and the lender may have an arrangement that incentivizes the dealer to increase the loan amount. If these items are then financed, the profit from the additional finance charge on the loan goes to the lender. The dealer also increases its profit because the additional items or services that are bundled with the vehicle sale are typically priced significantly above market rates. *See Guinn v. Hoskins Chevrolet*, 361 Ill. App. 3d 575 (Ct. App. Ill. 2005) (car dealership and bank not required to disclose participation in shared profit arrangement under Truth in Lending Act, dealership sufficiently disclosed that it was retaining a portion of life insurance premium, dismissal of unjust enrichment claim was warranted).

3. Leases

The alternative route to acquiring a car, leasing, carries its own potential problems for consumers. Open-end leases are structured to compensate the lessor for the vehicle's depreciation with, of course, a profit on the transaction as well. This potentially benefits the consumer because monthly payments are typically lower than in a conventional financing sale. For example, a dealer might offer a $20,000 car on a four-year lease. If the dealer estimates the vehicle will be worth $8,000 at the end of the lease, the dealer would be expected to base its open-end lease on the depreciation ($12,000), not the full new value of the vehicle ($20,000). This lowers the monthly payments, even at the same interest rate, because the equivalent "amount financed" is lower in a lease. At the end of the lease's term, however, the consumer has zero equity and no car. The vehicle still belongs to the dealer that can sell it again, hopefully with profitable used-car financing.

Evaluating the economics of leasing requires an accurate estimation of the vehicle's end-of-term value. However, under typical leases, if the vehicle's actual end-of-term value is lower than the estimate, the consumer is responsible for the difference. The opposite is also true; if the vehicle's actual end-of-term value is higher than expected, the lessee is entitled to a refund of the excess. This virtually never happens because the dealer has an incentive to inflate the estimated end-of-term value to lower the monthly payments and further entice the customer. Altering the above example, the dealer might state that the vehicle's estimated end-of-term value is instead $10,400, resulting in expected depreciation of $9,600, allowing for monthly payments of $200. When at the end of the lease term the vehicle is actually worth only $8,000, the consumer has to come up with the extra $1,600, at a time when she likely also needs to buy or lease a replacement vehicle.

By the end of the transaction, the dealer is not receiving any more or less money by inflating the estimated end-of-term value, except for the likelihood that a consumer will lease a vehicle she could not afford without the artificially-lowered payments. If she realized she would be responsible for a large balloon payment at the end of the lease, she might not sign the lease, so the primary problem with these contracts is one of information. This issue is among those addressed by Regulation M, which implements the consumer leasing provisions of the Truth in Lending Act. The laws try to address the risks of leasing using three main strategies:

1. Warning consumers before they sign leases about potential liability at the end of the term;
2. Giving consumers the right to challenge lessors' end-of-term estimates of residual value (if the vehicles are not sold to establish such value) with professional independent appraisals; and
3. Making it financially unprofitable for lessors to sue consumers for "unreasonable" end-of-term liability.

Regulation M effectuates these strategies in many ways, including disclosure requirement. If the consumer is liable at the end of the lease term for the difference between the residual value of the car and its realized value, the consumer gets informed of certain rights. For example, the consumer must be given a statement that the lessee and lessor are permitted, after termination of the lease, to make any mutually agreeable final adjustment regarding excess liability. 12 CFR §213.4(m). The consumer also must be told about the law's intervention in setting residual value. Regulation M creates a rebuttable presumption that the residual value of the leased property is unreasonable and not in good faith to the extent that the residual value exceeds the realized value by more than three times the base monthly payment. Regulation M is unusual in tackling the leverage that businesses have over consumers in taking enforcement action. It provides that the lessor cannot collect the excess amount above the rebuttable presumption amount unless the lessor brings a successful court action and pays the lessee's reasonable attorney's fees. There is an important exception if the excess of the residual value over the realized value is due to unreasonable or excessive wear or use of the leased property. This leads to heated battles about what is reasonable wear and tear. This is a concept consumers can grasp, however, and debate with lessors to reach a fairer outcome.

The rebuttable presumption in Section 2 is an important consumer protection. It provides that any overage at the end-of-lease is unreasonable if it is greater than three times the monthly payments. Thus, in the hypothetical example above, the dealer would only be able to collect $600 (three times the $200 monthly payment) of the $1,600 overage without going to court and showing that the overage was not unreasonable. That is a pretty tough standard for lessors. *See Wilson v. World Omni Leasing, Inc.*, 540 So. 2d 713 (Ala. 1989) (where consumer's truck was destroyed in an accident, unreasonability presumption is rebutted because difference between actual value and estimated residual value was caused by damage beyond reasonable wear and use).

C. Title Loans

Automobile loans, like mortgage loans of recent years, have a subprime market and a prime market. The interest rate spread is even greater in car loans, in part because the collateral depreciates more rapidly, and in part because unlike a house and the land it sits on, cars can disappear. A specialized kind of car loan with very high interest rates is a title loan. These do not help consumers purchase cars but rather give a consumer who owns a car access to cash in return for offering up the car's title as collateral. The description below illustrates how a title loan works and its economics.

> In her complaint, the plaintiff alleges that she is a Pennsylvania resident who traveled to Claymont, Delaware, where, on November 9, 2009, she borrowed $800 from defendant Dominion. [The debtor, in April 2009, borrowed a similar amount from Dominion, on identical terms. She repaid this loan, with interest, prior to November 2009.] This loan was secured by a lien on her vehicle: a 1997 Jeep Grand Cherokee. Under the terms of this loan, the debtor was obligated to repay monthly at least the accrued interest on the loan, which interest rate was disclosed at 0.9863% daily and 360% annually. Interest accrues at the rate of $7.8904 per day. Monthly interest is thus $236.71. The debtor further alleges that she tendered monthly payments to Dominion for approximately one year with little or no principal reduction. Interest payments for one year would be $2,840.54 unless some principal reduction payments were made. Thereafter, she stopped tendering payments (she asserts that Dominion informed her that she could do so) and her vehicle was repossessed in Pennsylvania without notice.

In re Pfeiffer, 2011 WL 4005504 (Bankr. E.D. Pa. 2011). Why did the consumer travel to Delaware to borrow $800? The answer is that Pennsylvania sharply limits the interest rates on small dollar loans, whereas Delaware has no usury law. For individuals with risky credit profiles, loans are more readily available in Delaware. This consumer filed bankruptcy as a result of her financial problems—at that point, she had paid 3.5 times the amount that she borrowed ($800) and had lost her car.

Some of the objections to title loans parallel their unsecured cousin in the high-yield lending market, payday loans (the subject of the next Assignment). The rates are high, disclosures may be ineffective in revealing the costs and risks of the loans, and consumers may find themselves in a cycle of debt because of the loan. The additional harm of title loans, however, is that the loss of a car can often mean the loss of a job, particularly in places where there is no public transportation. People are often so desperate to get a new car after losing one to repossession that they are willing to buy from unscrupulous dealers. The data on the auto title lending's effects on consumers are contested. *Compare* Kathryn Fritzdixon, Jim Hawkins & Paige Marta Skiba, *Dude, Where's My Car Title?: The Law, Behavior and Economics of Title Industry Markets*, 2014 U. ILL. L. REV. 1013 (2014) *with* Susanna Motezemolo, *Car-Title Lending*, Center for Responsible Lending (July 2013). Part of the disagreement is about how to interpret the data. Because many title loans are rolled over each month (which technically creates a new loan), the repossession rate looks much lower if calculated based on the number of loans as compared to the number of borrowers. The Center for Responding Lending reports that 17 percent of borrowers incurred a repossession fee, although some of these may have scraped up the cash to get their car back. *Id.* at 8. The Fritzdixon, Hawkins & Skiba paper estimates a 10 percent repossession rate.

In most states, title lenders operate with the protection of the law. There are some state laws that sharply limit auto-title loans, usually by imposing interest rate caps of 36 percent or below. *See, e.g.*, Iowa Code §537.2403 ("A lender shall not contract for or receive a finance charge exceeding twenty-one percent per year on the unpaid balance of the amount financed for a loan of money secured by a certificate of title to a motor vehicle used for personal, family, or household purpose except as authorized under chapter 536 or 536A."). Even when the law places limitations on auto title lenders, however, they have proven adept at evading regulation. Many transactions are restructured to disguise the loans in order to exploit loopholes in existing laws—for example calling the loans "pawns" or "motor vehicle equity lines of credit" or setting them up as a sale to the lender with a leaseback to the consumer.

Problem Set 16

16.1. BDD is an automobile manufacturer that focuses on mid-price vehicles. After several successful products, it expanded its line to a high-end vehicle, loaded with the latest technology. Jack Tutz purchased the Opal from the Bluebell BDD dealership for $57,539. After about ten months, the Opal began to have warning lights flash. Each time Jack returned the car to Bluebell, it reset the lights and assured him everything was fine but "this extremely sophisticated technology is very sensitive."

The other day when a low tire sensor came on, Jack ignored it as another false alarm. Thirty miles later, he had a blow out on the freeway. While the Opal was undamaged, Jack's swerving caused another car to hit the median, with a concussion for its driver. The car was towed to Bluebell, and a livid Jack really let Bluebell's sales manager, Evan, have it. When Jack produced a sheaf of repair slips from the Opal's glove box and mentioned a lawsuit for a defective car, Evan offered him a solution. Bluebell would credit Jack with $2,000 toward any car on the lot plus the market value trade-in on his Opal. Jack accepted, and left happy.

Two days later, after a thorough evaluation and repair of the Opal's central computer, Bluebell sold the Opal that formerly belonged to Jack to Amber, a young law firm associate making her first vehicle purchase. Amber was delighted to find such a low-mileage luxury vehicle, as she worried about the mechanical problems that come with used cars and the sales tactics of used car dealers but she could not afford a brand-new car. Amber paid $43,000 cash for the car, and received a copy of the dealership's certificate of quality—a list of all the aspects of the car that were checked and in working order at the time of the sale. Amber parked the Opal at her firm next to her supervising partner, Jack Tutz, who exclaimed, "I can't believe you bought a lemon! I thought you had better judgment." Amber has identified the following lemon statutes. Did Bluebell BDD or BDD Manufacturing violate the law? Tex. Occ. Code Ann. §2301.601 et seq.

16.2. Cathy Cho's small business in Reno went bust, and in her mind she lost "everything," including the car that she had offered as collateral on a bank line of credit for the business. On Monday morning, she starts a new job with a stable but low income but needs a car to avoid an unpredictable and lengthy commute. On Saturday afternoon, Cathy visited Wonder Wheels, a local used car dealer and selected a “well-loved” (a.k.a. high-mileage, beat-up) Civic. The finance guy, Hubert, collected details on Cathy’s new job and income on the credit application, and said he was confident that “it would all work out” despite Cathy’s poor credit. The written sales contract disclosed a 17 percent APR and contained a clause that Wonder Wheels “would exercise all due diligence to obtain financing as stated and to consummate the transaction.” Cathy paid the required $500 downpayment in cash, signed the contract, and drove off in the Civic.

On Monday morning, Hubert presented Cathy’s loan to his boss, who frowned a lot while flipping through the paperwork. He had Hubert offer the loan to several buyers, all of whom declined to purchase the loan at a rate that would be profitable for Wonder Wheels. Hubert was instructed to call Cathy back, tell her that the financing had “fallen through” and give her a choice: she could sign a new contract agreeing to a loan with a 24 percent APR (and correspondingly higher payments) or give up the car and her downpayment. Cathy is devastated to get Hubert’s call. That downpayment was her last cash, and if she returns the car, she has no way to get to work. Does Cathy have any options? Nevada Rev. Stat. §482.554.

16.3. You are outside counsel to a small chain of used car dealerships in Alaska. It takes cars on trade for the majority of sales. The dealership believes that consumers often fail to disclose damage to the cars that they offer for sale or trade. It buys about 50 percent of its cars from a Hawaiian wholesaler that ships in used cars on a container ship. Does the dealership have any liability to consumers who purchase the cars and later learn, upon a mechanic’s inspection or the like, that the car was previously damaged? What would you recommend to the dealership as strategies to limit its liability? Alaska Stat. §45.25.465; Haw. Rev. Stat. §481J-4.

16.4. You are a lawyer working for a labor union that represents low-to-moderate income service employees in a Midwestern state. You have been asked by a member of the state legislature whether the labor union believes this statute would help its members. Assume that there is no state law on point at all, but that the state does have a UDAP Act that covers “unfair and unconscionable acts and practices.”

A title loan lender shall not:

I. Make more than one outstanding loan that is secured by one title.

II. Make a title loan without providing the borrower within the title loan agreement the right to cancel the title loan at any time before the close of business of the next business day following the date of the transaction by repaying to the lender in cash the amount advanced to the borrower.

III. Offer, advertise, or make a loan with a rate of interest that is lower in the original period than in subsequent renewals.

IV. Make a loan to a borrower who currently has an outstanding or who has had an outstanding payday or title loan within the previous 60-day period. As part of its application process for such a loan, a lender shall obtain a written statement under oath from the borrower certifying the borrower does not currently have an outstanding and has not had an outstanding payday loan or title loan within the previous 60-day period.

V. Charge interest at higher than 25 percent per month, however actual costs incurred by the lender may be passed through to the borrower.

Assignment 17. Payday Loans

The prior assignments have focused on financial products that are widely used by American families such as mortgages, credit cards, and car loans. While recent years have seen significant segmentation in these markets, these products are generally thought of as mainstream or middle class. In contrast, there are "fringe" credit products. These are usually designed for and used by people who may lack access to mainstream credit products, may prefer them for particular reasons, or may be steered to use them. Fringe products nearly always carry high interest rates and charge high fees. For this reason, some people refer to this market as "high-yield" lending because it can generate significant revenue for lenders. Others categorize some or all fringe credit products as "predatory," a considerably less favorable moniker. Examples of fringe products are rent-to-own transactions, automobile title loans, and pawn loans.

This assignment focuses on payday loans as an exemplar of the legal issues presented by high-cost credit. Payday loans illustrate a variety of approaches to consumer protection strategies and are the locus of a fierce debate about which approach is most effective. Payday loans also highlight the policy tensions in credit, including the difficulty of determining whether consumers benefit from legal protections if the consequence is a significant reduction in access to credit.

A. Payday Loan Industry

Despite being categorized as fringe credit, payday loans are not rare. There are at least 22,000 storefront payday lenders nationwide, more than many ubiquitous retail establishments such as McDonald's or Starbucks. Chris Peterson & Steve Graves, *Predatory Lending and the Military: The Law and Geography of 'Payday' Loans in Military Towns*, 66 OHIO ST. L.J. 653 (2005). Analysts estimate that payday lenders extend somewhere between $25 billion and $40 billion in loans each year. It is difficult to get reliable estimates on the popularity of payday loans at the household level. In a 2013 survey, only 4.2 percent of families said they had taken out a payday loan in the last year. Federal Reserve Bulletin, Changes in U.S. Family Finances from 2010 to 2013: Evidence from the Survey of Consumer Finance 30 (Sept. 2014), http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf. Other research estimates the number of payday borrowers at 19 million, which would be closer to 8 percent of adults.

Payday borrowers are disproportionately female and are often single women with dependent children. Amy Schmitz, *Females on the Fringe: Considering Gender in Payday Lending Policy*, 89 CHICAGO-KENT L. REV. 65 (2014). Payday lenders tend to have less income and fewer assets than families without payday loans, but notably they also have less debt. One-quarter of payday borrowers identified themselves as savers, compared to half of those who did not recently take out a payday loan. *See* Amanda Logan & Christian Weller, *Who Borrows From Payday Lenders?* 12 (2009), at http://www.americanprogress.org/issues/2009/03/pdf/payday_lending.pdf.

The demographic profiles of payday borrowers have more meaning when one understands how the product works. The key aspects of payday loans are that they are small dollar and short term. In return for the loan, the borrower gives the lender a post-dated check or an authorization for a bank account withdrawal called an automated clearing house (ACH). If the consumer does not repay the loan, the lender could cash the check or debit the consumer's bank account. An example of a typical product would be a $400 loan for 14 days with a $100 transaction or processing fee. The consumer would receive $400 and authorize a $500 bank withdrawal on the borrower's payday. The lender would exercise the withdrawal unless the borrower paid the $500. If the consumer gave a check instead, postdated to payday, this is called a deferred presentment because the lender will wait to seek payment from the consumer's bank on the check. If the borrower does not pay or want the check cashed / debit made, the loan is sometimes renewed or rolled over into a new loan, as explained below.

The process for obtaining such a loan is fairly simple and quick. A borrower will complete a short application form and be asked to provide proof of identification, evidence of income such as a recent paystub, and a bank statement. The lender may use a software program to check the borrower's history with the lender or consult a database for bad checks or other collection activity, but FICO scores are not widely used the way they are for mortgages or cars.

B. Regulatory Approaches to Payday Loans

A number of federal consumer laws apply to payday loans, including federal unfair and deceptive acts and practices laws, the Truth in Lending Act, and the Fair Debt Collection Practices Act. These are generally applicable to most credit, however, and do not take aim at the specific practices of payday lending. Historically states have been active in regulating payday loans and have used approaches from disclosure requirements to product limitations to outright bans. Lenders chafe at the variety of tactics used by state regulators and attorneys general. Certainly, the heteroge of state laws increases compliance costs and creates greater uncertainty about litigation risk for payday lenders.

Payday loans have not yet been regulated at the federal level. The Consumer Financial Protection Bureau put out preliminary proposed regulations, but as of December 2015, these have not yet been moved into the rulemaking process; they are only released for study on their potential impacts on small businesses. Consumer Financial Protection Bureau, *Outline of Proposals Under Consideration and Alternatives Considered (2015*), http://files.consumerfinance.gov/f/201503_cfpb_outline-of-the-proposals-from-small-business-review-panel.pdf. The next few years may see a major reform of payday loans by the federal government.

The *Quik Payday* case below illustrates the creativity of the lawyers for the payday industry in challenging the boundaries of state regulation. The case centers on a constitutional challenge to a consumer lending law but is included here for its useful overview of a payday loan business and the types of state laws that apply to it.

Quik Payday, Inc. v. Stork

549 F.3d 1302 (10th Cir. 2008)

HARTZ, Circuit Judge.

Quik Payday, Inc., which used the Internet in making short-term loans, appeals from the district court's rejection of its constitutional challenge to the application of Kansas's consumer-lending statute to those loans. Defendants were Judi M. Stork, Kansas's acting bank commissioner, and Kevin C. Glendening, deputy commissioner of the state's Office of the State Bank Commission (OSBC), both in their official capacities.

Quik Payday argues that applying the statute runs afoul of the dormant Commerce Clause by (1) regulating conduct that occurs wholly outside Kansas, (2) unduly burdening interstate commerce relative to the benefit it confers, and (3) imposing Kansas requirements when Internet commerce demands nationally uniform regulation. We disagree. The Kansas statute, as interpreted by the state officials charged with its enforcement, does not regulate extraterritorial conduct; this court's precedent informs us that the statute's burden on interstate commerce does not exceed the benefit that it confers; and Quik Payday's national-uniformity argument, which is merely a species of a burden-to-benefit argument, is not persuasive in the context of the specific regulation of commercial activity at issue in this case. We have jurisdiction under 28 U.S.C. §1291 and affirm the district court.

I. BACKGROUND

From 1999 through early 2006, appellant Quik Payday was in the business of making modest, short-term personal loans, also called payday loans. It maintained an Internet website for its loan business. The prospective borrower typically found this website through an Internet search for payday loans or was steered there by third-party "lead generators," a term used for the intermediaries that solicit consumers to take out these loans. In some instances Quik Payday sent solicitations by e-mail directly to previous borrowers.

Once on Quik Payday's website, the prospective borrower completed an online application form, giving Quik Payday his or her home address, birthdate, employment information, state driver's license number, bank-account number, social security number, and references. If Quik Payday approved the application, it electronically sent the borrower a loan contract, which the borrower signed electronically and sent back to Quik Payday. (In a small number of cases these last few steps took place through facsimile, with approved borrowers physically signing the contracts before faxing them back to Quik Payday.) Quik Payday then transferred the amount of the loan to the borrower's bank account.

Quik Payday made loans of $100 to $500, in hundred-dollar increments. The loans carried $20 finance charges for each $100 borrowed. The borrower either paid back the loans by the maturity date—typically, the borrower's next payday—or extended them, incurring an additional finance charge of $20 for every $100 borrowed.

Quik Payday was headquartered in Logan, Utah. It was licensed by Utah's Department of Financial Institutions to make payday loans in Utah. It had no offices, employees, or other physical presence in Kansas.

Between May 2001 and January 2005, Quik Payday made 3,079 payday loans to 972 borrowers who provided Kansas addresses in their applications. Quik Payday loaned these borrowers approximately $967,550.00 in principal and charged some $485,165.00 in fees; it collected $1,325,282.20 in principal and fees. When a Kansas borrower defaulted, Quik Payday engaged in informal collection activities in Kansas but never filed suit. [ED. NOTE—This is different than the Uniform Commercial Code.]

Kansas regulates consumer lending, including payday lending, under its version of the Uniform Consumer Credit Code. See Kan. Stat. Ann. §§16a-1-101 through 16a-9-102 (KUCCC). The KUCCC defines payday loans, or "supervised loans," as those on which the annual percentage interest rate exceeds 12%. Id. §16a-1-301(46). Under the KUCCC a payday lender (other than a supervised financial organization—in essence, a bank with a federal or state charter) must obtain a license from the head of the consumer-and-mortgage-lending division of the OSBC before it can make supervised loans in Kansas. See id. §§16a-1-301(2), 16a-2-302. Obtaining a license requires paying an application fee of $425 (and a further $325 to renew each year), posting a surety bond costing approximately $500 per year, and submitting to a criminal-background and credit check. Supervised lenders may not charge more than 36% per annum on unpaid loan balances of $860 or less, and may not charge more than 21% per annum on unpaid balances of more than $860. See id. §16a-2-401(2). Supervised lenders are required to schedule installment payments in substantially equal amounts and at substantially regular intervals on loans of less than $1,000 and on which the finance charge exceeds 12%. Id. §16a-2-308. When such loans are for $300 or less, they must be payable within 25 months, while such loans of more than $300 must be payable within 37 months. Id. §16a-2-308(a)-(b). Quik Payday was never licensed to make supervised loans by the OSBC.

In 1999 Kansas amended the provision of the KUCCC that governs the statute's territorial application. See id. §16a-1-201. Before that year a consumer-credit transaction was deemed to have been "made in th[e] state," and to come under the KUCCC, if either (a) the creditor received in Kansas a signed writing evidencing the consumer's obligation or offer, or (b) "the creditor induces the consumer who is a resident of this state to enter into the transaction by face-to-face solicitation in this state." 1993 Kan. Sess. Laws ch. 200 §3. The 1999 legislation amended paragraph (1)(b) to say that the transaction is deemed to have been made in Kansas if "the creditor induces the consumer who is a resident of this state to enter into the transaction by solicitation in this state by any means, including but not limited to: Mail, telephone, radio, television or any other electronic means." Kan. Stat. Ann. §16a-1-201(1)(b). No party or amicus questions that the catch-all "other electronic means" includes the Internet.

Under the KUCCC a consumer's residence is the address given by the consumer as his or her address "in any writing signed by the consumer in connection with a credit transaction." Id. §16a-1-201(6). The statute does not define "solicitation." Defendants conceded in district court, however, that merely maintaining a website accessible in Kansas that advertises payday loans is not solicitation in Kansas under §16a-1-201(1)(b). See Quik Payday, Inc. v. Stork, 509 F. Supp. 2d 974, 982 n. 7 (D. Kan. 2007).

In June 2005 the OSBC received a complaint from a Kansas consumer about a loan transaction with Quik Payday. The agency responded by ordering Quik Payday, which was not on its list of licensed supervised lenders, to produce documents regarding its loans to Kansas residents. Quik Payday submitted the requested documents, which revealed the above-mentioned 3,079 payday loans to 972 Kansas residents. On March 13, 2006, the OSBC issued a summary order that required Quik Payday to stop all payday lending to Kansas residents, halt any collections on outstanding loans, pay a civil penalty of $5 million, and return to the borrowers the interest, service fees, and profits from the 3,079 loans. The order also barred Quik Payday from applying in the future to become a licensed payday lender in Kansas. Quik Payday timely requested an administrative hearing to challenge the order.

On May 19, 2006, shortly before the scheduled date of the administrative hearing, Quik Payday filed this lawsuit under 42 U.S.C. §1983 against Defendants in the United States District Court for the District of Kansas. (Quik Payday requested and was granted a stay of the administrative hearing; as a result, no final order has been entered in that proceeding.) Quik Payday's complaint in district court sought a declaratory judgment that Kansas could not regulate Quik Payday's loans and an injunction barring such regulation. It claimed that both Kan. Stat. Ann. §16a-1-201(1)(b) itself and Kansas's application of its consumer-credit laws to Quik Payday under this provision of the statute are unconstitutional under the Commerce Clause and Due Process Clause.

Quik Payday moved for summary judgment, offering three arguments under the dormant Commerce Clause: (1) the statute is an impermissible extraterritorial regulation; (2) the statute impermissibly burdens interstate commerce under the balancing test of *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970); and (3) the statute subjects Internet lending to inconsistent state regulations. On the same day, Defendants moved for summary judgment on Quik Payday's constitutional claims, including its contentions under the Due Process Clause that Kansas lacked the power to regulate it and that Kan. Stat. Ann. §16a-1-201 is unconstitutionally vague and overbroad. (Quik Payday did not seek summary judgment on these due-process claims.) The parties stipulated to the facts to be considered by the district court in deciding their motions.

The district court denied Quik Payday's motion for summary judgment and granted Defendants' cross-motion. It rejected each of Quik Payday's three Commerce Clause challenges to the Kansas statute and its application to Quik Payday. It rejected the contention that Kansas was seeking to regulate conduct entirely outside its borders because the Kansas statute is triggered only if there is both solicitation in Kansas and a loan to one of its residents. Quik Payday, 509 F. Supp. 2d at 981. With regard to *Pike* balancing, the court cited our decision in Aldens, Inc. v. Ryan, 571 F.2d 1159 (10th Cir. 1978), for the proposition that "a state's regulation of the cost and terms on which its residents borrow money from an out-of-state creditor is not outweighed by the burdens on interstate commerce." Quik Payday, 509 F. Supp. 2d at 979. And as to national uniformity, the court determined that Quik Payday had not shown that "internet payday lending specifically represents the type of commerce that should only be subject to nationally-uniform standards," id. at 983; its regulated conduct was aimed specifically at Kansas and did not necessarily implicate other states or their regulations. The court also entered summary judgment for Defendants on Quik Payday's due-process claims. Id. at 984-85.

Quik Payday appeals the district court's grant of summary judgment to the Defendants and the denial of summary judgment to itself. It does not challenge the district court's due-process rulings but only those regarding the Commerce Clause.

II. DISCUSSION

We review a district court's decision to grant summary judgment de novo, viewing all facts in the light most favorable to the party opposing summary judgment. See Jacklovich v. Simmons, 392 F.3d 420, 425 (10th Cir. 2004). We will affirm a grant of summary judgment if there is no genuine issue of material fact and the prevailing party is entitled to judgment under the law. See id. At 426; Fed. R. Civ. P. 56(c). Likewise, we conduct de novo review of legal issues, including challenges to the constitutionality of statutes. See Hoffmann-Pugh v. Keenan, 338 F.3d 1136, 1138 (10th Cir. 2003).

A. The Dormant Commerce Clause

The Supreme Court "long has recognized that th[e] affirmative grant of authority to Congress [to regulate interstate commerce] also encompasses an implicit or 'dormant' limitation on the authority of the States to enact legislation affecting interstate commerce." Healy v. Beer Inst., 491 U.S. 324, 326 n. 1 (1989); see Dennis v. Higgins, 498 U.S. 439 (1991) ("[T]he Commerce Clause does more than confer power on the Federal Government; it is also a substantive restriction on permissible state regulation of interstate commerce."). State statutes may violate the dormant limitation in three ways:

> First, a statute that clearly discriminates against interstate commerce in favor of intrastate commerce is virtually invalid per se and can survive only if the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism. Second, if the statute does not discriminate against interstate commerce, it will nevertheless be invalidated under the *Pike* [397 U.S. at 142] balancing test if it imposes a burden on interstate commerce incommensurate with the local benefits secured. Third, a statute will be invalid per se if it has the practical effect of extraterritorial control of commerce occurring entirely outside the boundaries of the state in question.

KT & G Corp. v. Att'y Gen. of Okla., 535 F.3d 1114, 1143 (10th Cir. 2008).

Although Quik Payday treats the need for national uniformity as an additional ground for determining that a state law violates the Commerce Clause, concerns about national uniformity are simply part of the *Pike* burden/benefit balancing analysis. When assessing the burden of a state law on interstate commerce, “the practical effect of the statute must be evaluated not only by considering the consequences of the statute itself, but also by considering how the challenged statute may interact with the legitimate regulatory regimes of other States and what effect would arise if not one, but many or every, State adopted similar legislation.” Healy, 491 U.S. at 336. For example, in Southern Pacific Co. v. Arizona ex rel. Sullivan, 325 U.S. 761 (1945), the Supreme Court declared that states may not “regulate those phases of the national commerce which, because of the need of national uniformity, demand that their regulation, if any, be prescribed by a single authority.” Id. at 767. But its holding that a state law could not limit train lengths was supported by what amounts to *Pike* balancing—namely, (1) a thorough analysis of the problems that would be created for interstate railroad transportation if each state could regulate train lengths and (2) an assessment that such state regulation would confer little, if any, local benefit. Id. at 771-79; cf. ACLU v. Johnson, 194 F.3d 1149, 1160 (10th Cir. 1999) (“[T]he Supreme Court has long recognized that certain types of commerce are uniquely suited to national, as opposed to state, regulation.”).

Quik Payday does not argue that the Kansas statute discriminates against interstate commerce in favor of the local variety. Rather, it challenges the Kansas statute only under the extraterritorial-impact and *Pike*-balancing tests. To the extent that it also argues what it terms the “national unity” test, we will treat that issue as part of the balancing process.

B. EXTRATERRITORIALITY

Quik Payday argues that the Kansas statute regulates interstate commerce that happens entirely outside Kansas. It contends that the Kansas statute reaches cases in which a Kansas resident is “solicited” while using a work computer in Missouri and accepts the loan through the same computer. In support, it points to census data on the number of Kansas residents who work in metropolitan Kansas City, Missouri, and thus likely use computers that lie in Missouri. Additionally, it asserts that “lenders, having no ability to determine the physical location of the consumer at the time of the solicitation, are forced as a practical matter to abide by the K[U]CCC for all transactions with Kansas residents or refuse to lend to such residents altogether.” Aplt. Br. at 43.

Defendants, however, have stipulated that such a transaction would not be governed by the Kansas statute. In district court they conceded that a website advertisement does not trigger application of Kan. Stat. Ann. §16a-1-201(1)(b), even though the website is accessible in Kansas. See Quik Payday, 509 F. Supp. 2d at 982 n. 7.…

Quik Payday has failed to show that this possible extraterritorial effect of the statute is more than speculation. It has provided no evidence of any loan transaction with a Kansas resident that was effected totally outside Kansas. Even if the Kansas resident applied for the loan on a computer in Missouri, other aspects of the transaction are very likely to be in Kansas—notably, the transfer of loan funds to the borrower would naturally be to a bank in Kansas. Although the Kansas statute would not apply to such a loan transaction (because the solicitation was not in Kansas), the transaction would not be wholly extraterritorial, and thus not problematic under the dormant Commerce Clause. Moreover, Quik Payday has not explained how it would be burdensome to it simply to inquire of the customer in which state he is located while communicating with Quik Payday. In this circumstance, we will not hold that the KUCCC has a prohibited effect on extraterritorial commerce.…

C. *PIKE* BALANCING

A state law that does not discriminate against interstate commerce may still be invalidated under the dormant Commerce Clause if it puts a burden on interstate commerce that is “clearly excessive in relation to the putative local benefits.” Pike, 397 U.S. at 142. Although evidence regarding a particular company may be suggestive, the benefit-to-burden calculation is based on the overall benefits and burdens that the statutory provision may create, not on the benefits and burdens with respect to a particular company or transaction. “[T]he [Commerce] Clause protects the interstate market, not particular interstate firms, from prohibitive or burdensome regulations.” Exxon Corp. v. Governor of Md., 437 U.S. 117, 127-28 (1978); see Pharm. Research & Mfrs. of Am. v. Concannon, 249 F.3d 66, 84 (1st Cir. 2001).

...

Aldens governs the analysis under the *Pike* test in this case. To begin with, we note that our review of the KUCCC is limited. Although Quik Payday might be burdened by statutory provisions regarding interest rates, repayment schedules, and loan renewals, we need not concern ourselves with provisions that have never been applied to Quik Payday (and which, because Quik Payday no longer operates as a payday lender, never will be). Perhaps some of those unapplied provisions are unconstitutional and must be stricken. But striking them would not entitle Quik Payday to relief if the provisions that were applied withstand a Commerce Clause challenge. Here, the sanction imposed on Quik Payday was based solely on its failure to obtain a license as a lender of supervised loans. Thus, we address only the burdens and benefits of the license requirement.

The stipulated facts show that the burden of obtaining a license is limited to a $425 fee, a surety bond whose annual cost would be roughly $500, and a criminal-background check, for which there is no fee. Quik Payday presented no evidence of other expenses that it would incur. The burden on Quik Payday of obtaining a license would not be materially greater than the burden on *Aldens*. Aldens, Inc. v. Ryan, 571 F.2d 1159 (10th Cir. 1978). And on the other side of the ledger, Defendants point to significant benefits from the licensing requirement: the criminal-background check protects Kansas consumers from providing felons their financial data and access to their bank accounts; and the surety-bond requirement ensures that Kansas residents will have a meaningful remedy if they are harmed by a lender. We follow our decision in *Aldens* in holding that the burden of acquiring a license does not outweigh the benefit from that requirement.

Quik Payday tries to distinguish *Aldens* by suggesting that regulating Internet lending cannot, as a practical matter, protect Kansas residents, because such lenders can go offshore to avoid the reach of the state’s law. In support, Quik Payday relies on our opinion in *Johnson*. That case involved constitutional challenges to a New Mexico statute that criminalized “dissemination of material that is harmful to a minor by computer.” 194 F.3d at 1152. The challenged statute defined the offense as

> the use of a computer communications system that allows the input, output, examination or transfer of computer data or computer programs from one computer to another, to knowingly and intentionally initiate or engage in communication with a person under eighteen years of age when such communication in whole or in part depicts actual or simulated nudity, sexual intercourse or any other sexual conduct.

N.M. Stat. §30-37-3.2(A) (1998).…

Our case is readily distinguishable from *Johnson* in this respect. An offshore lender may well have incentives to comply with Kansas law. *Johnson* did not involve credit transactions. One who sent pornography to New Mexico from Amsterdam needed nothing in the future from the New Mexico resident. Payday lending, however, would not be very profitable if the borrowers refused to repay, or were prevented from repaying, their loans. Regulators can educate borrowers regarding their rights not to repay loans, and they may have authority to control lenders by seizing assets (such as a bank account) from which a lender expects to be repaid. We are not persuaded that Kansas would be powerless to protect its residents from offshore payday lenders who refused to comply with applicable Kansas laws.

Quik Payday also relies on national-uniformity arguments to support its Commerce Clause challenge. It contends that the nature of the Internet requires any regulation of Internet operations to be national in scope, not state-by-state.…Quik Payday also quotes our comment in Johnson that “[t]he Internet, like rail and highway traffic, requires a cohesive national scheme of regulation so that users are reasonably able to determine their obligations.” Johnson, 194 F.3d at 1162 (ellipses and internal quotation marks omitted).

But Quik Payday reads too much into these statements. The courts have not held that certain modes of interstate commerce always require uniform regulation. They have examined particular types of regulation and made individual determinations. For example, the Supreme Court has not held that all regulation of interstate railroads must be national in scope. In Southern Pacific the Court held that the length of interstate trains could not be regulated state by state, see 325 U.S. at 781-82, but it did not retreat from its prior decisions allowing individual states to impose some safety measures, such as limitations on the size and composition of crews on interstate trains, see id. at 779, 782.

...

Thus, we turn to Quik Payday’s argument based on the specifics of the KUCCC. It contends that subjecting it to regulation by multiple states will in fact create inconsistency that would unduly burden interstate commerce. Quik Payday’s briefs present a compilation of payday-loan laws in various states that, in its view, reveal how unmanageable its business would be if Kansas and other states could each enforce its own rules. Our review of those laws raises doubts about the merits of Quik Payday’s argument. But we need not resolve the matter. Quik Payday is not being penalized by Kansas for the way it renews loans, or even for the interest rate it charges. Its misconduct was a simple failure to get a Kansas license. And requiring a license in each state does not impose an undue burden. The Supreme Court rejected an analogous argument in American Trucking Associations, Inc. v. Michigan Public Service Commission, 545 U.S. 429 (2005). In that case, interstate trucking firms challenged Michigan's flat fee on trucks engaged in intrastate hauling (i.e., point-to-point deliveries within Michigan) under the dormant Commerce Clause. See id. at 431-32.…The Supreme Court rejected the challenge on several grounds, among them that every state could legitimately assess such a fee without putting interstate commerce at a disadvantage:

> We must concede that here, as [the challengers] argue, if all States did the same, an interstate truck would have to pay fees totaling several hundred dollars, or even several thousand dollars, were it to "top off" its business by carrying local loads in many (or even all) other States. *But it would have to do so only because it engages in local business in all those States.*

Id. At 438 (emphasis added). If some future Internet payday lender were to point to potential inconsistency among the states in some other component of the KUCCC—say the handling of renewals—then a court could address whether the Commerce Clause bars this type of regulation. For this case, however, we need not undertake that task.

III. CONCLUSION

We AFFIRM the judgment of the district court.

How did you like Quik Payday's revenue from lending to Kansans? Based on the numbers in the opinion, Quick Payday charged fees in an amount equal to 50 percent of the total principal it lent. Put another way, on average, for every $2 a consumer borrowed from Quick Payday, he or she incurred a $1 fee.

1. Disclosure Requirements

The Truth in Lending Act (TILA) applies to payday loans to require the disclosure of the amount financed, the finance charge, and the APR. See Turner v. E-Z Check Cashing of Cookeville, TN, Inc., 35 F. Supp. 2d 1042, 1047 (M.D. Tenn. 1999) ("Courts that have addressed the issue have held, without exception, that deferred presentment transactions are extensions of 'credit' under TILA."). As noted in Assignment 12, however, the fact that a consumer is given a cost disclosure does not mean that it was used to shop for the lowest cost credit, or that it was even reviewed or understood. In her study of consumers exiting payday lenders in New Mexico, researchers found that customers selected the lender based on convenient location rather than price. *See* Nathalie Martin, *1,000% Interest—Good While Supplies Last: A Study of Payday Loan Practices and Solutions*, 52 ARIZ. L. REV. 563 (2010). Most customers also were unable to give the APR on their loans, even as they held freshly minted

TILA disclosures in their hands. Another separate concern is that the APR may be an ineffective way to describe the cost of a payday loan. An annual rate may confuse consumers in the context of short-term loans with a maturity of only one or two weeks. A 5 percent interest rate for a loan of a week sounds reasonable but annualized that is a triple-digit rate. Additionally, businesses may be particularly motivated to skirt compliance because the high APR figures would deter consumers or tarnish their reputations. Indeed, it is hard to imagine businesses competing with signs advertising, “Avoid that 300 percent APR; we offer 250 percent. Rush in today for this great offer.” APRs may be inapt for loans lasting only a fraction of a year, despite the benefit of standardizing rates.

2. Limits on Interest Rates and Costs

With such high interest rates, usury laws might seem an obvious obstacle to payday lenders. As noted in Assignment 11, a handful of states have repealed their usury laws, while others have set limits on interest rates that are very high. As a result, payday lending continues with little differentiation between states based on usury laws. Many states have carved out exceptions for payday lending in their usury laws, often making rate caps inapplicable to payday loans, which are described in the statutory exceptions by less-recognizable names, such as “cash advance loans” or “presentment transactions.” For example, Michigan has a usury law that caps interest at 10 percent but characterizes the charges related to payday loans as “service fees” rather than interest, such that the usury law is inapplicable.

Another strategy to limit the application of usury restrictions is to make only small-dollar loans. Many states have minimum threshold amounts below which the usury law does not apply. The logic here seems to be that even though the interest rate may be high, if the dollar amount of the loan is small, then the financial harm of payday loans is moderated. The payday lenders’ trade association has a model bill that includes a provision limiting a loan to $500. Of course lenders themselves may not want to risk more than $500 on any one consumer transaction. That is, this model law may merely parrot the state of the market, in which $500 is already the maximum available payday loan, rather than affirmatively curb the market.

3. Limits on Numbers of Transactions

Although any given payday loan is short-term in nature, the practical reality of this type of borrowing is different. Many consumers seem to routinely renew existing loans, or more commonly, take out new loans that follow immediately upon the expiration of a prior loan. These “rollovers” can create a cycle of debt, with consumers paying fees for each renewal. They never eliminate the underlying debt, which grows with each rollover. The financial effect of rollovers is to dramatically drive up the costs; a consumer might pay $360 to maintain a $100 debt over a period of six months. Every two weeks at payday when the consumer renews the loan, she would pay a $30 fee; none of that amount would reduce the $100 of outstanding debt. On the other hand, in this form of rollover, the debt does not negatively amortize. The consumer will have paid many dollars in fees but even after a dozen rollovers still only has $100 in outstanding principal. This can make payday loans look as safe as a preschool toy compared to the standard credit card that requires only a 3 percent minimum monthly payment and continues to accrue interest at a much higher rate; the result is that the total owed balloons over time.

The problem is partially one of framing. At each transaction, the consumer may focus on the $30 fee, perceiving it as a reasonable charge. But as the example above illustrates, the cost of the loan over time can mushroom well beyond the benefit to the consumer. In dollar terms, a consumer has paid three times the loan amount. Because of these concerns, the majority of states have limits on repeated transactions. These are typically designed in one of two ways. They either limit rollovers of the same loan to a fixed number, or more restrictively, attempt to prohibit any subsequent back-to-back loan.

These laws seem to have limited effect. A study by the FDIC found that about 46 percent of all payday loans are either renewals of existing loans or new loans that immediately follow the payoff of a prior loan. Mark Flannery & Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?* 1 (2005), *at* http://www.fdic.gov/bank/analytical/cfr/2005/wp2005/CFRWP_2005-09_Flannery_Samolyk.pdf. To get around the latter problem, some states have enacted cooling off periods that must elapse before a consumer can take out a new payday loan. Nearly all of these are much shorter than two weeks, however, meaning that consumers can still have every payday check encumbered by a loan. Consumers themselves may skirt the rollover bans by going from lender to lender. If a rollover is not available from Payday Store 1, the consumer simply takes out a loan from Payday Store 2, crosses the street and pays off Payday Store 1. There is no financial difference between this strategy and merely rolling over the loan at Payday Store 1. Consumers simply are doing some additional work to manage their loans. Lenders may respond to this flip-flop strategy by flouting the law on rollovers; what business wants to embrace a law that sends its customers to a competitor on a regular basis? The emerging solution that may more effectively regulate rollovers is state-wide databases of all payday loans outstanding at any time. Before a lender can make a loan, the law requires it to check whether the consumer has any existing loan, from any lender, or that the cooling off period has elapsed from a prior loan. Thus far, a small handful of states have such databases, and some consumers cross state lines to evade these “protections.”

4. Bans on Payday Lending

In response to the perceived danger of lenders preying on desperate consumers, some states have taken legislative steps to restrict payday lending. Thirteen states have set low interest rate caps on small value loans, limiting the profits a lender can obtain by offering payday loans. North Carolina’s Consumer Finance Act illustrates the typical approach:

> (a) Maximum Rate of Interest.—Every licensee under this section may make loans in installments not exceeding three thousand dollars ($3,000) in amount,

> at interest rates not exceeding thirty-six percent (36%) per annum on the outstanding principal balance of any loan not in excess of six hundred dollars ($600.00) and fifteen percent (15%) per annum on any remainder of such unpaid principal balance. Interest shall be contracted for and collected at the single simple interest rate applied to the outstanding balance that would earn the same amount of interest as the above rates for payment according to schedule.
>
> > (a1) Maximum Fee.—In addition to the interest authorized in subsection (a) of this section, a licensee making loans under this section may collect from the borrower a fee for processing the loan equal to five percent (5%) of the loan amount not to exceed twenty-five dollars ($25.00), provided that such charges may not be assessed more than twice in any 12-month period.

N.C. Gen. Stat. §53-173. While this may look like a rate cap, the effect has been to eliminate payday lending. The industry has ceased to do business in these states, asserting that the rate cap prevents them from being profitable.

A few of these thirteen states have gone one step further and have expressly banned the practice of making loans on the basis of post-dated checks. These states include Maine (with an exemption for "supervised lenders"), Massachusetts, New York, New Jersey, and Pennsylvania.

While capping interest rates on small loans and banning payday lending outright has intuitive appeal, some researchers are less optimistic that state regulation of payday loans—even outright bans—can effectively prevent lenders from charging excessive interest fees. Because state statutes usually target loans with certain characteristics (e.g. loans for $3000 or less, issued for a period of 14 to 31 days, using a post-dated check as collateral), payday lenders circumvent the statutory restrictions by tweaking the loan to bring it just outside the scope of the regulation (e.g. by issuing it for 32 days, or not requesting a post-dated check but instead using a bank account withdrawal authorization). New Mexico's attempt to curb payday lending serves as a cautionary tale:

> The New Mexico law, like many other [states] around the country, capped interest rates at a generous 417%, yet payday lenders regarded this as an insufficient return. In order to reclaim the "tremendous profits" to which it had become accustomed, the industry invented new products such as the payday loan without the post-dated check and the installment loan…which earn higher lender fees. One conclusion resonates strongly from this game of legislative cat-and-mouse, namely that these types of legislative efforts do not reduce short-term lending, interest rates, or fees for such loans. While the payday lending industry itself claims that payday legislation *can* effectively protect consumers, the industry's actions tell a different story. The new products offered by short-term lenders suggest what the industry denies, namely that the only type of regulation that really ends the abusive practice of charging 500% or more in interest over long periods of time is an absolute interest rate cap. Any other solution is subject to further end runs.

Martin, *1000% Interest*, at 23. Martin's proposal for a federal usury law is explicitly barred by the Dodd-Frank Act. It would take Congressional action to reverse that position and that seems very unlikely. A bill in the House, H.R. 1214, the Payday Loan Reform Act of 2009, did not include a usury cap, focusing instead on expanding TILA disclosures for payday loans. Even that bill died in committee. Advocates objected it was too weak, and the industry was not going to lobby for more paperwork.

States have continued to actively regulate payday loans, however, and much of the advocacy is at state capitols. The laws change frequently, and some states have bills introduced by consumer advocates and by industry nearly every legislative session. The takeaway is that payday loans are likely to be the subject of lively debate and state lawmaking in future years. This is all on top of the CFPB's movement toward regulation of small-dollar loans that was described earlier in the assignment. The most certain thing that can be said about payday loans is that the legal landscape is certain to change.

C. Policy Debates on Payday Lending

The policy debate about payday and other fringe credit is fierce. Part of that is typical industry versus advocate but there are a number of points of empirical disagreements that impede consensus. This section looks at three of the most contentious issues. While these issues apply to all credit, the payday loan context deepens the disagreement.

1. Product Substitution

A ban on payday loans does not, of course, provide extra income to families who run short on cash or guard against unexpected expenses exploding the family's budget. If payday loans are not available, what will consumers do?

A frequent point offered in defense of payday loans is that they are better for consumers than the alternative options. Lenders or staunch critics of regulation often suggest that but for payday loans, families would be borrowing from unsavory loan sharks who may have criminal ties—or more obliquely put, an interesting relationship with the law. Consumer advocates respond that such characterizations are a matter of perspective. They may see storefront payday lenders themselves as unsavory establishments whose practices routinely flaunt the law. Not surprisingly, few people list "loan sharks" as their occupation on tax returns or Census forms, making it impossible to even guess at the availability of such lenders to the families who currently use payday loans. In her study of the credit practices of low-income women in Boston, Professor Angela Littwin found that credit cards, a type of borrowing strongly associated with mainstream or middle-class credit, were viewed more negatively than fringe alternatives like pawn shops. *See* Angela K. Littwin, *Testing the Substitution Hypothesis: Would Credit Card Regulations Force Low-Income Borrowers into Less Desirable Lending Alternatives*, 2009 ILL. L. REV. 403, 442 (2009). Because her study was in a state that prohibited payday loans (Massachusetts), we do not know how payday lenders would fare in such comparisons. More of this kind of research may produce data to help untangle the product substitution issue.

Another product substitute for payday loans is bounced checks. These also are expensive and poorly understood by consumers, the very same criticisms that are made of payday loans. The policy goal is not just to switch consumers to another product but to move them to a better product. One possible strategy is enlisting credit unions and other financial institutions serving low-income consumers (such as community development financial institutions) to offer lower-cost alternatives to payday loans. This is a market-driven solution that rests upon consumers becoming aware of these alternatives and choosing them, despite perhaps their requiring more paperwork or travel to a less convenient location.

Reduced availability of payday loans could also lead to deprivation for financially-strapped consumers. The alternative to payday loans may be doing without. Whether this is a serious policy problem depends to a large degree on what people do with the proceeds of payday loans. If people use payday loans to obtain medical care or to repair cars that are needed to travel to jobs, the elimination of such loans could worsen the situations of consumers. One study found that consumers used them primarily to meet regular, recurring expenses—or to pay off other payday loans. Emergency purposes were less common. *See* Martin, *1,000% Interest*, 52 ARIZ. L. REV. 563 (2010). One's perspective on the "necessity" of payday loans to help families in tough situations also may depend on the perceived availability and adequacy of the social safety net, including access to free health care, subsidized housing, food stamps, and other types of benefits to prevent severe hardships.

2. Relationship of Payday Lending to Financial Distress

People who take out payday loans are in worse financial condition than the typical American, with lower incomes and net worths. The research suggests a correlation between payday borrowing and debt problems. A study found that "relative to all U.S. adults, three times the percentage of payday loan customers are seriously debt burdened and have been denied credit or not given as much credit as they applied for in the last 5 years." Michael A. Stegman, *Payday Lending*, 21 J. ECON. PERSPECTIVES 169, 173 (2007). The same study found that "[p]ayday loan customers are also four times more likely than all adults to have filed for bankruptcy." Id.

These are correlations, however, and do not necessarily show causation. On that question, academic researchers disagree. An examination of states banning payday lending found that consumers in those locations experience a higher rate of chapter 7 bankruptcy filings, bounce more checks, and file more complaints with the Federal Trade Commission against lenders and debt collectors. *See* Donald P. Morgan & Michael Strain, *Payday Holiday: How Households Fare After Payday Credit Bans* 26, (Fed. Reserve Bank of N.Y. Working Paper, Paper No. 309, 2008), *available at* http://newyorkfed.org/research/staff_reports/sr309.pdf. Researchers have asserted a causal link between payday loans and bankruptcy, finding that "for first-time payday applicants near the 20th percentile of the credit-score distribution, access to payday loans causes chapter 13 bankruptcy filings over the next two years to double." *See* Paige M. Skiba & Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?*

1 (2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id= 1266215.

On the other hand, payday loans may decrease the incidence of bankruptcy by providing desperate debtors with a final source of funds after they have exhausted their alternative resources. A study has failed to find evidence that the availability of payday lending increases the rate of bankruptcy. *See* Petru S. Stoianovici & Michael T. Maloney, *Restrictions on Credit: A Public Policy Analysis of Payday Lending* 1 (2008), *available at* http://ssrn.com/abstract=1291278 (concluding, based on their study of state data collected between 1990 and 2006, that there is no empirical evidence to support the proposition that payday lending leads to more bankruptcy filings). These conflicting findings could be partially explained by differences in methodology between the various studies. The studies finding no causation between payday loans and bankruptcy tend to focus on state-level trends (e.g. contrasting the total number of bankruptcies filed in states with and without payday lenders), while the studies that support a connection usually rely on a case-by-case analysis of individual bankruptcy debtors in a particular jurisdiction and their shared characteristics. Given the present state of research, those opposing or supporting payday loans can find studies to support their views.

3. Regulatory Arbitrage

The lack of federal regulation and the wide variation in state approaches has led to a situation of regulatory arbitrage for lenders. The most egregious situation was pejoratively called “rent-a-charter,” in which payday lenders partnered with national banks to avoid state usury laws by taking advantage of the preemption standards applicable to federal banks. Regulators shut this practice down by 2006, however, and it seems very unlikely to spring back up with the CFPB responsible for examining national banks for consumer law compliance and able to pressure banks’ prudential regulators.

Online payday lenders present even greater regulatory challenges. It is difficult to learn much about these providers, including their states of incorporation or whether banks are involved in providing financing. As Professors Jim Hawkins and Ronald Mann note, “the only information of significance about the lawfulness of the transactions is an assertion that the transactions are governed by the law of the lender’s location.” Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 870 (2007). The FTC and several states have targeted online payday lenders with enforcement actions but the low costs of setting up such a business make it relatively easy for new providers to spring up in the wake of shuttered sites. As commerce becomes more global, off-shore payday loans may increase, adding to enforcement difficulties.

Problem Set 17

17.1. Alba Gonzales enters Money Madness, a payday lender operating in Salinas, California to obtain a $300 loan. She needs to get an infected tooth removed, and her dentist requires cash payment at the time of the procedure.

Money Madness tells her that the fee for such a loan will be $45, plus a $5 registration and background check fee. Money Madness gives Alba a written contract that states this is a deferred deposit transaction and lays out these costs. She also receives a Truth in Lending disclosure that shows an APR of 260 percent. Alba writes a check to Money Madness to cover the cost of the transaction; the check is dated 20 days from today's date on her next payday. You are an attorney with the California Department of Business Oversight who is reviewing this transaction as part of the licensing renewal of Money Madness. Did either Alba or Money Madness violate the law? *See* California Civil Code §§1789.30-1789.38.

17.2. Staid Bank is a nationally-chartered depository bank. It has branches in three New England states but is headquartered in the community of Thayer, Massachusetts, a seaside hamlet. Thayer is an old-fashioned company town; over 80 percent of the adult population works for the "Factory," a manufacturer of paperclips. The company has tried to treat its employees well, but the reduction in paper caused by email and increased competition from binder clips have eroded profits. Today, the average worker gets a take-home paycheck of $2,000 every month, an amount that is lower in real dollars than workers at the factory earned thirty years ago. As a result of the low wages and rising costs for essentials such as gas and health care, many of Staid Banks' customers struggle to save money. They lack a cushion against unexpected expenses, a problem the bank has noticed as it tracked a sharp uptick in overdrafts on accounts in recent years.

To address this problem, Staid Bank is offering a new product called Tomorrow Now. Account holders who are employed at the factory and have their paychecks directly deposited can contact Staid Bank by phone and obtain an instant line of credit up to $1,000. When the factory deposits the customer's next paycheck, Staid Bank will repay itself by deducting the loan balance, plus a fee of $19 for every $100 of the loan used by the customer. You are the new risk and compliance officer for Staid Bank. Assuming all disclosures are properly designed and delivered, does Tomorrow Now violate any federal or state consumer law that is applicable to Staid Bank? Does it pose any other risks that to Staid Bank's general business approach? *See* Regulation E, 12 C.F.R. §1005.10; Mass. Gen. Laws ch. 140, §96; and Office of the Comptroller of Currency, Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance Products.

17.3. You are Vice President for Strategic Operations for Fun Funds, a large national payday lending operation. You are increasingly worried that the CFPB will take action to make payday loans unprofitable and you continue to be distressed at the inability to operate in all fifty states because some states such as New York have laws that limit interest rates on payday loans below profitability. You were recently approached by Rosanna Ayer, the chief of a federally recognized tribe of Native Americans. The Tribe would like to buy Fun Funds to take advantage of its technology infrastructure, customer service staff, and brand recognition. The proposed sale agreement that you are reviewing makes clear that all employees—including senior staff such as yourself—get guaranteed employment contracts after the sale. It also contains a clause that allows the deal to be unwound within the first five years after the sale date if the Tribe becomes "subject to any payday lending laws that are not currently enacted in any state or by the federal government." The Board of Directors of Fun Funds would like your recommendation on whether they should sell the company. They have been clear that they will concern themselves with an accurate valuation of the company in relation to the sales price. What they want to know is whether they should worry about the sale being unwound. If they sell the company and cash out, they want to walk away into the sunset. In your opinion, will the Tribe be subject future payday lending laws?

Assignment 18. Student Loans

You may be wondering why there is a chapter on student loans when it seems your legal education is a three-year study of the topic. For many currently in college, federal and private student loans may seem to be the norm. However, prior to World War II, American students typically received financial aid directly from the colleges. National Consumer Law Center, *Student Loan Law* 3 (2015). Congress has enacted and phased out several laws in the last fifty years that collectively have significantly increased the degree to which higher education is a debt-driven experience. Adjusting for inflation, the average cost of tuition and fees for a public four-year college have increased 225 percent since the 1984-1985 academic year. For the private four-year college, the average has increased 146 percent. Student loans are the second largest component of consumer debt, surpassed only by mortgages. The volume of outstanding federal student loan debt has gone from $516 billion in 2007 to greater than $1.2 trillion in the third quarter of 2015. *Id.* at 8. While this is a huge figure, student loans are unlikely to be the source of systemic risk that mortgages were in 2007. Jonathan Glater, *Student Debt and the Siren Song of Systemic Risk* (Oct. 15, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2674718. Student loans have peculiar qualities compared to most consumer debt, in part because they are an investment in education, which should be an appreciating asset. (Compare to the depreciation on a new car when you drive it off the lot. One hopes your mind continues to grow during higher education.)

Over 41 million Americans have student debt, and most of these consumers are in the early or middle years of their careers. Americans under age 39 are responsible for 65 percent of outstanding student loans. Consumer Financial Protection Bureau, *Student loan servicing: Analysis of Public Input and Recommendations for Reform* 3 (2015), http://files.consumerfinance.gov/f/201509_cfpb_student-loan-servicing-report.pdf. On some level, the policy crisis is about public investment in higher education and changing labor demographics, not borrowing. Although the Bureau of Labor Statistics found in 2012 that only 27 percent of jobs require an associate degree or higher, employers increasingly seek college graduates for positions that traditionally did not require one. Patricia Cohen, *For-Profit Colleges Accused of Fraud Still Receive U.S. Funds*, N.Y. TIMES, Oct. 12, 2015, http://www.nytimes.com/2015/10/13/business/for-profit-colleges-accused-of-fraud-still-receive-us-funds.html?_r=0. With tuition on the rise and their parents facing the financial consequences of the economic recession that began in 2008, students are increasingly relying on student loans to finance their educations and their futures.

This assignment is organized along the central divide between public and private student loans. The two types of credit differ in their costs, risks, and use, and, of course, are the subject of different laws and regulatory actors.

A. Federal Student Loans

Compared side-by-side, federal student loans are hands-down the better financial decision than private loans. Federals loans do not look at the student's creditworthiness but instead have eligibility requirements that apply to all borrowers. The rate and other terms also are favorable to the borrower as a matter of higher-education policy. With private loans, the lender underwrites the loan to reflect the perceived risk from an individual's credit history. For both students and parents, the terms of the loan and most importantly the interest rate are determined by creditworthiness. The worse an individual's credit, the less favorable the terms of the loan. For students with poor credit or students whose parents have poor credit, private loans are either not an option or an exorbitantly expensive option.

1. Types of Federal Student Assistance

Federal student loans can be subsidized or unsubsidized. With a subsidized loan, the student, the borrower, is not charged any interest before the repayment period begins on the loan, or during deferment. For unsubsidized loans, interest is charged from the time the loan is disbursed and continues until it is paid in full. Subsidized federal student loans are awarded based upon the student's financial need, whereas unsubsidized loans are not.

Ignoring federal loans made before 1994 and the designated-for-extinction Perkins Loan Program, there are two main types of federal student loans: Stafford and PLUS. These loans are available through the Direct Loan Program, which means the government itself makes the loan without an intermediary funder. Prior to 2010, some Stafford or PLUS loans made may be a Federal Family Education Loan (FFEL) and not a Direct Loan. FFEL loans differ in repayment options, but are otherwise identical in loan limits, deferment, and cancellation provisions.

Stafford loans can be subsidized or unsubsidized, and are available to both undergraduate and graduate students. The annual borrowing limits are determined by the Department of Education and, as of July 1, 2012, graduate and professional students are not eligible for subsidized loans. PLUS loans offer higher loan limits and are available to a larger slice of the population. A parent or legal guardian wishing to borrow for a dependent undergraduate student who is enrolled in school at least part time can take out a PLUS loan to fund the child's education. Graduate students and professional students are also eligible for PLUS loans, although annual limits cap the maximum loan amount.

Both Stafford and PLUS loans can be consolidated. A student can consolidate some or all of his loans without limit to the size of the consolidated loan. But there are limitations on consolidation, including the ability to ‘reconsolidate’—consolidating a loan that has previously been consolidated. The benefits of consolidation are procedural and substantive. Consolidation means one monthly payment, which eases the administrative burden on the student. Consolidation also reduces the interest rate. This does not necessarily save the student money, however, because consolidation may extend the term of some loans such that with the added years of interest the total amount repaid is more than it would have been without consolidation. Also, consolidation of federal loans together with private loans results in the loss of many of the options and protections federal loans provide.

In addition to federal student loans, a student can apply for a federal grant. The Federal Pell Grant Program provides grants to low-income students. The grant amount varies based upon the amount the student’s family can contribute, the cost of attendance, whether the student is full-time or part-time, and the length of the student’s attendance. Unlike student loans, grants are not repaid. They are essentially need-based scholarships from the public. There are a number of federal grant programs, in addition to the Pell grant, including “specialty grants” with study and work requirements. An example is the TEACH grant that requires the borrower to agree to teach full-time in a high-need subject in a school that serves low-income students.

2. Loan Limits, Interest Rates, Fees, and Disclosures

Under the Higher Education Act the federal government limits the amounts that students can borrow in federal loans. These limits vary depending on the type of the loan. For Stafford loans, the limits are different for students who are classified as dependent versus those who are independent. 34 C.F.R. §685.203. The Higher Education Act also sets the interest rates for federal student loans. Before July 1, 2006, loans could have variable rates with an upper limit of 8.25 percent. Most federal student loan rates are now fixed under the Bipartisan Student Loan Certainty Act of 2013, which uses a formula to determine the interest rate. But once determined, the rate is fixed for the life of the loan. Unlike mortgages, borrowers cannot refinance their loans if the market interest rates fall. The Higher Education Act preempts usury laws, with the exception of the Servicemember Civil Relief Act.

In other assignments we have discussed origination fees, late charges, and prepayment penalties. These are important aspects of determining the cost of a loan. As of July 1, 2010 (when the government became the direct lender), federal student loans no longer have origination fees. If all or a portion of the monthly loan payment is not paid, a late charge of up to six cents for each dollar that is late may be charged. Although these late fees are in the loan contracts, the servicing contracts, as of 2014, state that these fees should not be assessed “at this time.” The servicing contracts are instructions from the lender, the federal government, to the private companies about how to interact with borrowers. Prepayment penalties are not allowed. These consumer-friendly terms are a major advantage of federal loans over private student loans as you will see when we discuss private student loans below.

In one consumer protection aspect, student loans are arguably less protective than other products. Federal student loans are exempt from TILA and state disclosure laws.[1] Instead, federal student loans are governed by the Higher Education Act. 20 U.S.C. §1001 et seq. Disclosures must be provided in "simple and understandable terms, in a statement provided to the borrower at or prior to the beginning of the repayment period," with additional disclosures made at least 30 days, but not more than 150 days before the first payment is due. 34 C.F.R. §682.205. This differs from TILA, which requires disclosure before credit is extended.

The initial disclosure must include:

> (i) The lender's name, a toll-free telephone number accessible from within the United States that the borrower can use to obtain additional loan information, and the address to which correspondence with the lender and payments should be sent;
>
> (ii) The scheduled date the repayment period is to begin, or a deferment under §682.210(v), if applicable, is to end;
>
> (iii) The estimated balance, including the estimated amount of interest to be capitalized, owed by the borrower as of the date upon which the repayment period is to begin, a deferment under §682.210(v), if applicable, is to end, or the date of the disclosure, whichever is later;
>
> (iv) The actual interest rate on the loan;
>
> (v) An explanation of any fees that may accrue or be charged to the borrower during the repayment period;
>
> (vi) The borrower's repayment schedule, including the due date of the first installment and the number, amount, and frequency of payments based on the repayment schedule selected by the borrower;
>
> (vii) Except in the case of a Consolidation loan, an explanation of any special options the borrower may have for consolidating or refinancing the loan and of the availability and terms of such other options;
>
> (viii) The estimated total amount of interest to be paid on the loan, assuming that payments are made in accordance with the repayment schedule, and if interest has been paid, the amount of interest paid;
>
> (ix) A statement that the borrower has the right to prepay all or part of the loan at any time, without penalty;
>
> (x) Information on any special loan repayment benefits offered on the loan, including benefits that are contingent on repayment behavior, and any other special loan repayment benefits for which the borrower may be eligible that would reduce the amount or length of repayment; and at the request of the borrower, an explanation of the effect of a reduced interest rate on the borrower's total payoff amount and time for repayment;
>
> (xi) If the lender provides a repayment benefit, any limitations on that benefit, any circumstances in which the borrower could lose that benefit, and whether and how the borrower may regain eligibility for the repayment benefit;

> (xii) A description of all the repayment plans available to the borrower and a statement that the borrower may change plans during the repayment period at least annually;
>
> (xiii) A description of the options available to the borrower to avoid or be removed from default, as well as any fees associated with those options; and
>
> (xiv) Any additional resources, including nonprofit organizations, advocates and counselors, including the Department of Education's Student Loan Ombudsman, the lender is aware of where the borrower may obtain additional advice and assistance on loan repayment.

34 C.F.R. §682.205 (a)(2). Compare these disclosure requirements to those required by TILA (see Assignment 12). Do they strike you as more or less consumer friendly?

Once the loan enters repayment, additional disclosures are required, and if the student is struggling to make repayments, there are specific disclosures required based upon the difficulty. 34 C.F.R. §682.205(c). For example, for a student who is 60 days delinquent in making a payment, a disclosure describing the options available to avoid default must be sent within 5 days of the date the student becomes 60 days delinquent. 34 C.F.R. §682.205(c)5.

3. Postponing Repayment

You've finished up school, you're looking for a job in a highly competitive market, and you have thousands, if not tens or hundreds of thousands, of dollars of student loan debt. The first bit of good news in this scenario is what is called a "grace period." For Stafford loans, the borrower has six months to begin repayment either 1) after graduation, 2) after a student leaves school, or 3) after the student is less than part-time enrolled in school. 34 C.F.R. §§682.207, 685.209. Remember, however, that with unsubsidized loans, however, remember that interest has been accruing since the loan was disbursed and continues to accrue during this grace period.

The law explicitly contemplates that borrowers will not even be able to make their first payments. (This might tip you off to why student loans present serious consumer protection concerns.) Depending on the type and size of the loan, deferment is available as an option to avoid default. For subsidized loans, the deferment delays not only payment of the loan but also accrual of interest. For unsubsidized loans, the borrower is still liable for the interest during the deferment period, and the lender may capitalize it after the deferment period ends. Capitalization means adding the accrued interest to the loan balance and recalculating the payments to reflect the higher amount due. When a borrower seeks deferment, the lender must notify the borrower of the option to pay the accruing interest or cancel the deferment and make loan payments.

Once a borrower is in default, deferment is not an option. But if you aren't yet in default, how do you defer repayment of your student loans? It is done by requesting deferment and providing documentation. Eligibility and qualification requirements vary based upon the type of deferment sought. Unemployment, military service, economic hardship, and in some cases continued education and graduate fellowships are all circumstances that may qualify a borrower for deferment.

Forbearance is when a loan holder agrees to a temporary hold on payments, an extension of time for making payments, or an acceptance of smaller payments. This is normally either a last resort before default, or a way of hopefully giving the defaulted borrower a little breathing room, after which hopefully payment will resume. When the borrower is already in default, the loan holder has the discretion to stop collection actions. Although a useful tool for some borrowers needing short-term relief, the interest in both federal and private loans continues to accrue, and may be capitalized, with forbearance. Again, capitalized means that the outstanding balance can grow during forbearance leading to further financial problems down the road.

4. Servicing

"Servicers manage borrowers' accounts, process monthly payments, and communicate directly with borrowers." Consumer Financial Protection Bureau, *Student loan servicing: Analysis of public input and recommendations for reform* at 11. Essentially, "[a] loan servicer…handles the day-to-day management of loans." William J. Cox, *The Student Borrower: Slave to the Servicer?* 27 LOY. CONSUMER L. REV. 189 at 191 (2015). The servicer is not necessarily the lender. "[T]he federal government originates all federal loans while contracting out servicing work to the largest student loan servicers." *Id*. Further, the company acting as the servicer, for both federal and private student loans, can change. This is something the borrower has little to no control over.

The Department of Education and the Consumer Financial Protection Bureau (CFPB) regulate the federal student loan servicers. The Department of Education has oversight due to the contracts between the federal government and the servicers. The CFPB has oversight authority under the Dodd-Frank Act. 12 U.S.C. §5514. Despite the regulatory framework in place for federal student loans, "there is no existing, comprehensive federal statutory or regulatory framework providing consistent standards for the servicing of all student loans." Consumer Financial Protection Bureau, *Student Loan Servicing: Analysis of Public Input and Recommendations for Reform* at 11.

In 2015 the CFPB and the Department of Education launched a public inquiry into student loan servicing practices, and received more than 30,000 comments. *See generally* Consumer Financial Protection Bureau, *Student Loan Servicing: Analysis of Public Input and Recommendations for Reform*. The CFPB issued a report describing existing servicing practices and how they affect repayment, while also considering how protections, such as those in place for consumers with mortgages and credit cards, could be used in the student loan market. *Id.* The report found significant problems in servicing stemming from a lack of consistency, clarity and oversight. Id.

Consumers complained to the CFPB about difficulties in receiving objective counseling about options, getting basic account information, consolidating loans, and even just ensuring payments were applied to their loans. Unlike credit cards and mortgages, there are few laws protecting borrowers from servicer misconduct. The Higher Education Act requires due diligence in servicing a loan, but speaks to FFEL loans and not to Direct Loans. 34 C.F.R. §682.208. This section includes notice requirements for when a loan is assigned or transferred to another servicer. 34 C.F.R. §682.208(e). These regulations do not necessarily apply to Direct Loans. The Direct Loan program has benefits for consumers, but it is a no-man's land for servicing protections.

Even things as basic as access to original loan document or a payment history are left to the whims of servicers. For medical records and consumer lending, there are record retention laws. No federal regulations exist regarding record retention for student loans servicers following a servicing transfer. Even the accuracy of the information provided to the borrower by the servicer is unregulated. Consumer Financial Protection Bureau, *Student Loan Servicing: Analysis of Public Input and Recommendations for Reform* at 64.

If a borrower fails to make a payment when it is due, and fails to make these payments or to meet other terms of the federal loan agreement for 270 days, the borrower is in default. 34 C.F.R. §685.102(b). During this roughly nine-month period, the borrower should be working with the servicer to avoid default.

5. Repayment Programs

With federal student loans, a student has many repayment options. Unless a student chooses another option, the student will be automatically enrolled in the standard repayment plan. Certain consolidated loans aside, standard repayment plans have the highest monthly payments. Those payments are usually the same amount each month, with some variety if there is a variable interest rate. Under the standard repayment plan, the borrower has ten years to repay the loan.

Graduated repayment plans start out at a low monthly payment and increase over the life of the repayment period. Graduated repayment plans still have a repayment period of ten years. The rationale with graduated repayment is that the borrower will see a marked increase in earnings within a few years. Extended repayment plans are available for those with outstanding principal and interest over $30,000. The extended repayment plan allows repayment over a longer period of time, not more than 25 years. Typically the monthly payments in an extended repayment plan are less than the standard plan, but the borrower pays much more in interest over the life of the loan.

Income-based repayment (IBR), income-contingent repayment (ICR), pay as you earn (PAYE), and income-sensitive repayment (ISR)[2] are four types of repayment plans tied to the borrower's income. These repayment plans calculate the monthly payment using the borrower's income but they differ in the formula used to determine the payment. Monthly payment amounts are governed by statute. These plans generally require a minimum monthly payment that is a percentage of the borrower's discretionary income. "Discretionary income" is the amount the borrower's adjusted gross income exceeds the poverty guidelines about in the borrower's state of residence. U.S. Department of Education, Federal Student Aid Glossary, https://studentaid.ed.gov/sa/glossary#Discretionary_Income. Like with other repayment options with lower monthly payments, income-based repayment plans take longer to payoff and may cost the borrower more in interest. These options are designed to prevent default, but the percentage of borrowers taking advantage of these repayment plans remained low through 2013, with only 6 percent of federal borrowers enrolled in an IBR plan. David Leonhardt, *A Quiet Revolution in Helping Lift the Burden of Student Debt*, THE N.Y. TIMES (Jan. 24, 2015), http://nyti.ms/1uHSdtB. By the end of 2014, 11.8 percent of federal borrowers were enrolled in an IBR, indicating a growing awareness by borrowers of the options available. *Id*.

These repayment options have existed in some form since the 1990s, when borrowers had the option to enroll in a repayment plan limiting the month payments to 20 percent of the borrower's income. After 25 years, the remaining balance of the loan was forgiven. In recent years, the repayment plans have been revamped to allow for even lower monthly payments, capping at 15 percent beginning in 2007, and 10 percent beginning in 2016. The law governing federal loan forgiveness has changed as well and is discussed later in this assignment.

Borrowers are not always aware of the changes in the federal student loan law and are often unaware of their options. Lack of oversight and transparency in student loan servicing coupled with uninformed borrowers has created an opportunity for some third-party "debt relief" companies to profit off of struggling borrowers. These companies offer to enroll the borrower in income-based repayment plans and other free federal programs for a high one-time upfront charge, or monthly payments. Consumer Financial Protection Bureau, *Student Loan Servicing: Analysis of Public Input and Recommendations for Reform* at 99. The CFPB has taken steps to end these scams, largely by raising awareness that they are scams and by attempting to educate borrowers of their repayment options. *Id*. at 100.

B. Private Student Loans

For the student needing to borrow more than the federal loan limits, there are private student loans. For private loans, the student can go directly to a bank and avoid involving the school in the process as the recipient of funds. For federal loans, schools are required to provide counseling to students. For private loans, a student usually only needs to involve their schools to verify enrollment.

Generally private student loans are subject to even less oversight than their federal cousins, and thus less consumer protection. The CFPB does have some authority over private student loans. The Higher Education Act (HEA) does not apply to private student loans. This is both good and bad news. HEA protections such as the grace period are not available. But state laws are no longer specifically preempted, and borrowers can find protections and remedies under TILA.

1. Disclosures

TILA defines "private education loans" as a loan provided by a private education lender that is not made, insured or guaranteed under title IV of the Higher Education Act, and is issued expressly for postsecondary educational expenses. *See* 15 U.S.C. §1650(a)(7). TILA requires special disclosures for private student loans. *See* 15 U.S.C. §1638(e). The Higher Education Opportunity Act of 2008 also includes disclosure requirements for private student loans. 12 C.F.R. §§1026.5-1026.9. Additionally, some states have enacted their own requirements.

TILA requires different disclosures at the following stages of the loan process: application and solicitation; loan approval; and final disclosure before disbursement of funds. With each disclosure, the lender must provide information about federal student financial assistance, including the interest rates available on federal loans. The idea here is to encourage students to exhaust federal borrowing before private borrowing by revealing the fact that the federal rates are lower. The lender must also notify the borrower of the right to accept the terms of the loan within 30 days of the offer, and that during this time the rates and terms of the loan cannot be changed. 15 U.S.C. §1638(e)(1)(O).

2. Repayment

The multitude of repayment options available for federal student loans has no parallel with private student loans. Borrowers are left to negotiate with the bank—or more likely their loan servicers—if they find themselves in financial trouble. Despite the lack of federal law requiring private student loan creditors to offer deferments or forbearances, many lenders previously provided in-school deferment of payments. National Consumer Law Center, *Paying the Price: The High Cost of Student Loans and the Dangers for Student Borrowers* (Mar. 2008), available at www.studentloanborrowerassistance.org. Of course, during many of these "deferments," interest was accruing. *Id*. Since the financial crisis in 2008, the availability of forbearance has been restricted. Fitch Ratings, *Private Education Loans: Time for a Re-Education* 6 (Jan. 28, 2009). Some lenders allow for cancellation of the loans in the event of the borrower's death, or permanent and total disability, but generally this is done on a case-by-case basis requiring documentation. A loan modification or restructured payment plan is typically only an option if the borrower is in default and after extensive process.

C. Default and Collections

The definition of default varies depending on the type of student loan. For federal student loans under the FFEL or Direct loan programs, default occurs if the borrower fails to make required payments for 270 days for loans for monthly installment loans, or 330 days for loans on a less-than monthly repayment schedule. 34 C.F.R. §§682.2000, 685.102(b). In private student loans, default is defined by the loan contract. That nearly always means a shorter period. Typically private student loans are in default when the borrower fails to make a payment for 120 days, or 3 months. Consumer Financial Protection Bureau, *What does it mean to "default" on my private student loans?* (July 4, 2012), http://www.consumerfinance.gov/askcfpb/665/what-does-it-mean-default-my-private-student-loans.html. The entire balance of the private student loan becomes due in full, immediately, upon default.

The ramifications of default vary depending on if you have a federal or private student loan. For all the protections a federal student loan affords the borrower before default, the federal government's power to collect once the borrower is in default is far greater than a private lender's. After 2008 the default rate on student loans has increased. This increase has been more significant in the private sector, largely because of the lack of options available to struggling borrowers. In recent years, as the economy has recovered, the default rates have stabilized. The default rate for federal student loans dropped from 14.7 percent for students entering repayment in the 2010 fiscal year to 13.7 percent for the 2011 fiscal year. U.S. Department of Education, *New Data Shows a Lower Percentage of Students Defaulting on Federal Student Loans* (Sept. 24, 2014), http://www.ed.gov/news/press-releases/new-data-shows-lower-percentage-students-defaulting-federal-student-loans.

There are many reasons borrowers default on their student loans. There is a dearth of research attempting to predict which borrowers are more likely to default. There is a correlation between students completing their education and earning a degree, and paying back their loans. "A study of student loan debtors who entered repayment in 2005 found that 33 percent of those who did not earn a credential became delinquent and another 26 percent defaulted." Katherine Porter, *Broke* 95 (2012) (citing Alisa F. Cunningham and Gregory S. Kienzl, *Delinquency: The Untold Story of Student Loan Borrowing*. Washington, DC). In fact, this seems so obvious it hardly seems worth noting. But determining the risk that a borrower will fail to graduate, as well as determining the default risk of those who do graduate, is complicated.

The federal government has far-reaching avenues for collecting on a defaulted student loan. The Department of Treasury states that it uses demand letters, telephone calls, wage garnishment and the Treasury Offset Program (to retain your tax refund for example) before resorting to private collection agencies. U.S. Dept. of the Treasury, *Private Collection Agencies: Debt Collection Contract*, available at fmsq.treas.gov/debt/pca.html. Private student loan creditors generally rely upon third-party debt collectors. If unable to collect through a debt collector, private student or federal creditors can sue the borrower to obtain a judgment. In both federal and private student loans, the creditor can seek to recover reasonable fees associated with the collection process. These fees should be related to the actual expenses incurred for collection. *See Bottoni v. Sallie Mae, Inc.*, 2011 WL 635272 (N.D. Cal. Feb 11, 1011) (denying summary judgment because there was a genuine dispute about whether Sallie

Mae would add 25 percent of the outstanding principal and interest, regardless of the actual collection cost incurred, to the loan balance before sending the loans to a third-party debt collector.)

In the following case, a creditor attempted to assess collection costs against a borrower who had previously defaulted on her loan, but then entered into a repayment agreement, which the borrower satisfied. The court also discusses a recurring claim by creditors that the HEA preempts state laws that give rise to private causes of action such as breach of contract.

Bible v. United Student Aid Funds, Inc.

799 F.3d 633 (7th Cir. 2015)

HAMILTON, Circuit Judge.

Plaintiff Bryana Bible obtained a student loan under the Federal Family Education Loan Program. She defaulted in 2012 but promptly agreed to enter into a rehabilitation agreement that required her to make a series of reduced monthly payments. She timely made all of the payments that were required of her under this agreement, and she remains current on her loan payments. Although Bible complied with her obligations under the repayment agreement, a guaranty agency assessed over $4,500 in collection costs against her. [ED. NOTE—A guaranty agency repays the loan if the borrower does not, but in return has the rights under the loan to recover from the borrower.]

The terms of Bible's loan were governed by a form document known as a Federal Stafford Loan Master Promissory Note (MPN). This form has been approved by the U.S. Department of Education and is used in connection with many student loans across the country. The MPN incorporates the Higher Education Act and its associated regulations. In pertinent part, the MPN provides that Bible must pay "reasonable collection fees and costs, plus court costs and attorney fees" if she defaults on her loan. As we will see, "reasonable collection fees and costs" are defined by regulations issued by the Secretary of Education under the authority expressly conferred by the Higher Education Act. The MPN provided that Bible would owe only those collection costs that are permitted by the Higher Education Act and its regulations.

Bible sued the guaranty agency (defendant United Student Aid Funds, Inc.) alleging breach of contract and a violation of the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §1961 et seq. Her breach of contract theory is that the MPN incorporated federal regulations that prohibit the guaranty agency from assessing collection costs against her because she timely entered into an alternative repayment agreement and complied with that agreement. Her RICO claim alleges that the guaranty agency, in association with a debt collector and a loan service provider, committed mail fraud in violation of 18 U.S.C. §1341 and wire fraud in violation of 18 U.S.C. §1343 when it assessed collection costs of more than $4,500 against her despite its representations that her "current collection cost balance" and "current other charges" were zero and that these costs would be "reduced" once she completed the rehabilitation process.

The district court granted the guaranty agency's motion to dismiss [on the grounds] that both claims were "preempted" by the Higher Education Act. It reasoned that both claims depend on alleged violations of the Act and should not be permitted because the Act does not provide a private right of action. The district court held in the alternative that the amended complaint failed to state a claim that is plausible on its face. It concluded that the breach of contract claim failed because both the MPN and the Higher Education Act expressly permit imposing collection costs against borrowers who default on their loans. The district court also concluded that the RICO claim failed because Bible's amended complaint "has not shown participation in a scheme to defraud; commission of an act with intent to defraud; or the use of mails or interstate wires in furtherance of a fraudulent scheme." Bible v. United Student Aid Funds, Inc., No. 1:13-CV-00575-TWP-TAB, 2014 U.S. Dist. LEXIS 33320, 2014 WL 1048807, at *10 (S.D. Ind. Mar. 14, 2014).

We reverse. Neither of Bible's claims is preempted by the Higher Education Act. Bible's state law breach of contract claim is not preempted because it does not conflict with federal law. The contract at issue simply incorporates applicable federal regulations as the standard for compliance. Accordingly, the duty imposed by the state law is precisely congruent with the federal requirements. A state law claim that does not seek to vary the requirements of federal law does not conflict with federal law.

We apply the Secretary of the Education's interpretation of the applicable statutes and regulations, which is consistent with Bible's. (The Secretary accepted our invitation to file an *amicus* brief addressing the question.) The Secretary interprets the regulations to provide that a guaranty agency may not impose collection costs on a borrower who is in default for the first time but who has timely entered into and complied with an alternative repayment agreement. Nor is Bible's RICO claim preempted. RICO is a federal statute and thus is not preempted by another federal statute, and we see no conflict between RICO and the Higher Education Act. On the merits, both the breach of contract and RICO claims satisfy the plausibility standard under Rule 12(b)(6).

...

A. The Higher Education Act and Regulatory Background

Congress enacted the Higher Education Act of 1965 (HEA or the Act), now codified as amended at 20 U.S.C. §1001 et seq., "to keep the college door open to all students of ability, regardless of socioeconomic background." Rowe v. Educational Credit Management Corp., 559 F.3d 1028, 1030 (9th Cir. 2009); see also 20 U.S.C. §1070(a) (identifying purpose of the statute). Among other things, the Act created the Federal Family Education Loan Program (FFELP), "a system of loan guarantees meant to encourage lenders to loan money to students and their parents on favorable terms." Chae v. SLM Corp., 593 F.3d 936, 938-39 (9th Cir. 2010). The Secretary of Education administers the FFELP and has issued regulations to carry out the program.

...

In 1986 Congress amended the HEA to require guaranty agencies to assess collection costs against borrowers to prevent these costs from being passed on to federal taxpayers. See Black v. Educational Credit Mgmt. Corp., 459 F.3d 796, 799 (7th Cir. 2006). The relevant statutory provision provides simply that "a borrower who has defaulted on a loan…shall be required to pay…reasonable collection costs." 20 U.S.C. §1091a(b)(1). Congress chose not to define the meaning of "reasonable collection costs" in the statute and instead "left it up to the Secretary [of Education] to interpret that term through regulations." Black, 459 F.3d at 799; 20 U.S.C. §1082(a)(1) (delegating authority to the Secretary of Education to "prescribe such regulations as may be necessary to carry out the purposes" of FFELP).

The regulations define "reasonable collection costs." Two regulations are central to this lawsuit. We describe these regulations in detail below, and we ultimately agree with the interpretation of the Secretary of Education, which is consistent with Bible's. In short, 34 C.F.R. §682.405 provides that guaranty agencies must create loan rehabilitation programs for all borrowers who have enforceable promissory notes, and 34 C.F.R. §682.410 establishes fiscal, administrative, and enforcement requirements that a guaranty agency must satisfy to participate in the FFELP. One requirement is that a guaranty agency must give a borrower who has defaulted notice and the opportunity to enter into a repayment agreement before it assesses collection costs or reports the default to a consumer reporting agency. 34 C.F.R. §682.410(b)(5)(ii)(D). The guaranty agency is not permitted to charge collection costs to the borrower if (1) this is the first time the borrower has defaulted, (2) she enters into a repayment agreement within 60 days of receiving notice that the guaranty agency has paid the default claim, and (3) she complies with that agreement. Imposing collection costs on a borrower under these circumstances would be "unreasonable" within the meaning of 20 U.S.C. §1091a(b)(1).

B. Bible's Loan, Default, and Decision to Enter into the Rehabilitation Agreement

In June 2006, Bible obtained a student loan. The written agreement governing her loan is the Federal Stafford Loan Master Promissory Note (MPN), which identifies Citibank as the "Lender" and defendant United Student Aid Funds (USA Funds) as the "Guarantor, Program, or Lender."…

The contract term covering "late charges and collection costs" states:

> The lender may collect from me: (i) a late charge for each late installment payment if I fail to make any part of a required installment payment within 15 days after it becomes due, and (ii) any other charges and fees *that are permitted by the Act for the collection of my loans*. If I default on any loans, I will pay reasonable collection fees and costs, plus court costs and attorney fees.

The "governing law and notices" term provides: "The terms of this MPN will be interpreted in accordance with the applicable federal statutes and regulations, and the guarantor's policies. Applicable state law, except as preempted by federal law, may provide for certain borrower rights, remedies, and defenses in addition to those stated in this MPN."

In 2012, Citibank determined that Bible was in default and transferred the debt to USA Funds, which paid Citibank's default claim. To comply with its obligations under the HEA and its associated regulations, USA Funds, through its agent General Revenue Corp. (GRC), mailed Bible a form letter dated April 12, 2012 saying that her loan was in default and identifying several options for resolving her debt, including the opportunity for loan rehabilitation.…The letter noted that Bible's current total amount due was $18,062.60.

Between April 12 and April 25, Bible and her attorney spoke to GRC on the phone three times to negotiate a loan rehabilitation agreement. Bible and GRC agreed on a rehabilitation plan requiring monthly payments of $50. On April 27, GRC faxed Bible a form rehabilitation agreement. Bible promptly signed the agreement and returned it by fax on April 30, 2012.

The rehabilitation agreement included [a] table.…

The agreement also said that Bible's current total amount due was $18,112.85. Accumulating interest accounted for the $50.25 increase in Bible's total balance. The figures for her "current collection cost balance" and "current other charges" remained at all times $0.

Five paragraphs above the signature line, toward the end of the rehabilitation agreement, the following language appears:

> Once rehabilitation is complete, collection costs that have been added will be reduced to 18.5% of the unpaid principal and accrued interest outstanding at the time of Loan Rehabilitation. Collection costs may be capitalized at the time of the Loan Rehabilitation by your new lender, along with outstanding accrued interest, to form one new principal amount.

The paragraph immediately above the signature line states: "By signing below, I understand and agree that the lender may capitalize collection costs of 18.5% of the outstanding principal and accrued interest upon rehabilitation of my loan(s)."

After signing the rehabilitation agreement, Bible made nine on-time payments of $50. Although she fully complied with her obligations under this agreement, USA Funds assessed collection costs against her in the amount of $4,547.44. It applied her monthly payments toward the collection costs rather than the principal. When Bible filed this lawsuit, she had not completed the rehabilitation process. (Her loan had not yet been sold to an eligible lender.) She remains current on her loan under the terms of the rehabilitation agreement.

...

II. ANALYSIS

We conclude that (A) Bible has stated a viable breach of contract claim under Indiana law; (B) federal law does not preclude Bible from pursuing this state-law claim; and (C) Bible has stated a viable RICO claim under federal law, though it remains to be seen whether she can support that claim with evidence of fraudulent intent.

A. Breach of Contract Claim

"Under Indiana law, the elements of a breach of contract action are the existence of a contract, the defendant's breach thereof, and damages." U.S. Valves, Inc. v. Dray, 190 F.3d 811, 814 (7th Cir. 1999). The parties agree that the MPN is a valid contract and that it governs the terms of Bible's loan, including the consequences of her default. They disagree, however, about whether the amended complaint has adequately pled a breach of the MPN and resulting damages.

1. Breach

a. Incorporation by Reference

Bible alleges that USA Funds breached the MPN by assessing collection costs even though she timely entered into a repayment agreement and complied with her obligations under that agreement. She argues that the MPN incorporated federal regulations that prohibit guaranty agencies from imposing collection costs against first-time defaulters who promptly agree to repay their loans within 60 days of receiving notice from the guaranty agency that it has paid the lender's default claim and who have complied with that agreement. She relies on 34 C.F.R. §§682.405 and 682.410 and language in the MPN to the effect that the guaranty agency can collect from the borrower only "charges and fees that are permitted by the Act."

We agree with Bible that the MPN incorporated the HEA and its associated regulations. "Other writings, or matters contained therein, which are referred to in a written contract may be regarded as incorporated by the reference as a part of the contract and, therefore, may properly be considered in the construction of the contract." I.C.C. Protective Coatings, Inc. v. A.E. Staley Mfg. Co., 695 N.E.2d 1030, 1036 (Ind. App. 1998). The page of the contract that sets out the terms of the loan refers to the HEA and its regulations no fewer than 16 times, though once would be enough. [T]he specific term covering "late charges and collection costs" states that "[t]he lender may collect from me…any other charges and fees that are permitted by the Act." And the contract defines "the Act" as the HEA "and applicable U.S. Department of Education regulations."

USA Funds relies on a sentence in the MPN granting it the right to impose "reasonable collection fees and costs, plus court costs and attorney fees." USA Funds reads this language in isolation to mean that it can impose collection costs at any time after the borrower has defaulted. This interpretation fails to give weight to the preceding sentence, which limits the lender's power to impose only those charges and fees "that are permitted by the Act." Basic principles of contract law require a court to consider a contract's provisions together and in a way that harmonizes them. E.g., Hinc v. Lime-O-Sol Co., 382 F.3d 716, 720 (7th Cir. 2004) (Indiana law). If USA Funds charged Bible collection costs in violation of the HEA and its regulations, then it breached the contract.

b. Requirements for Imposing Collection Costs

Bible has plausibly alleged a breach of the MPN by alleging that USA Funds assessed collection costs that were not authorized by the Higher Education Act and its regulations. This conclusion is supported by two independent grounds.…

i. The Statutory and Regulatory Requirements

Beginning with interpretation without deference to the agency, Bible acknowledges that guaranty agencies are required to impose collection costs on borrowers who have defaulted in certain circumstances. Both the HEA itself and the implementing regulations make this clear. See 20 U.S.C. §1091a(b)(1) ("[A] borrower who has defaulted on a loan…shall be required to pay…reasonable collection costs."); id. §1078-6(a)(1)(D)(i)(II)(aa) (upon successful rehabilitation, a guaranty agency may, in order to defray collection costs, "charge to the borrower an amount not to exceed 18.5 percent of the outstanding principal and interest at the time of the loan sale"); 34 C.F.R. §682.410(b)(2) ("[T]he guaranty agency shall charge a borrower an amount equal to reasonable costs incurred by the agency in collecting a loan."). Bible argues, however, that the regulations prohibit USA Funds from imposing collection costs in her circumstances: a first-time defaulter who she promptly agreed to enter into a rehabilitation agreement within 60 days of receiving notice that USA Funds had paid her lender's default claim, and who has complied with that agreement. She contends that imposing collection costs in these circumstances is "unreasonable" under 20 U.S.C. §1091a(b)(1).

Two key regulations define the phrase "reasonable collection costs" in §1091a(b)(1). The first regulation, 34 C.F.R. §682.405, requires guaranty agencies to create loan rehabilitation programs for all borrowers that have enforceable promissory notes. These programs are designed to give eligible borrowers an opportunity to rehabilitate defaulted loans so that, upon successful rehabilitation, the loans may be purchased by eligible lenders and removed from default status. 34 C.F.R. §682.405(a).

A loan is considered rehabilitated only after two requirements are met: (1) the borrower has timely made nine out of ten payments required under a monthly repayment agreement, and (2) the loan has been sold to an eligible lender. 34 C.F.R. §682.405(a)(2)(i)-(ii). Subsection (b) of this regulation then establishes specific requirements for terms that must be included in the rehabilitation agreement. For example, the guaranty agency must provide the borrower with a written statement confirming the borrower's "reasonable and affordable payment amount" and "inform[ing] the borrower of the amount of the collection costs to be added to the unpaid principal at the time of the sale." 34 C.F.R. §682.405(b)(1)(vi).

The second regulation, 34 C.F.R. §682.410, is even more specific. It establishes fiscal, administrative, and enforcement requirements that a guaranty agency must satisfy to participate in the FFELP. Paragraph (b)(2) addresses collection costs:

> Collection charges. Whether or not provided for in the borrower's promissory note and subject to any limitation on the amount of those costs in that note, the guaranty agency shall charge a borrower an amount equal to reasonable costs incurred by the agency in collecting a loan on which the agency has paid a default or bankruptcy claim. These costs may include, but are not limited to, all attorney's fees, collection agency charges, and court costs. [Subject to certain exceptions not relevant here], the amount charged a borrower must equal the lesser of—
>
> (i) The amount the same borrower would be charged for the cost of collection under the formula in 34 C.F.R. [§]30.60; or
>
> (ii) The amount the same borrower would be charged for the cost of collection if the loan was held by the U.S. Department of Education.

34 C.F.R. §682.410(b)(2). This paragraph makes clear that guaranty agencies must charge a borrower reasonable collection costs, and it establishes a cap on the

maximum *amount* that can be charged by the guaranty agency. Paragraph (b)(2), however, does not specify the *circumstances* under which these costs may be assessed. That issue is addressed by other portions of §682.410, which create procedural safeguards for student borrowers.

First, some context. Guaranty agencies have two primary ways of pushing student-borrowers to repay their defaulted loans: (1) reporting the delinquent account to a consumer reporting agency (which lowers the borrower's credit rating) and (2) assessing collection costs against the borrower. Because the Department of Education was concerned about recent graduates facing these adverse consequences without first being given an opportunity to cure their defaults, it created protections in §682.410(b)(5)(ii).…

Subparagraph (b)(5)(ii) effectively creates a safe harbor for borrowers who find themselves in default for the first time. When a borrower is first notified that a guaranty agency has paid a default claim on her loan, she has a 60-day window to request administrative review of the debt or to enter into a repayment agreement with the agency. If she does not take either action, the guaranty agency can then take collection actions against her, report her default to a consumer reporting agency, and assess collection costs against her in the amount specified by §682.410(b)(2).

To be sure, subparagraph (b)(5)(iv)(B) mentions the opportunity to request administrative review of the loan obligation, not the opportunity to enter into a repayment agreement with the agency. But that is not a problem for Bible. Her point is that subparagraph (b)(5)(ii) requires the guaranty agency to provide the borrower with all four things before reporting the debt to a consumer reporting agency or assessing collection costs, and one of those things (administrative review) triggers a waiting period of at least 60 days. The regulations do not force the borrower to choose between requesting administrative review and entering into a repayment program. The borrower has a right to request administrative review and then to decide whether to enter into a repayment agreement. Accordingly, the borrower has at least 60 days to enter into an alternative repayment agreement. That Bible did not request administrative review of her loan obligation in this case is beside the point; she had at least 60 days to do so, and before that time ran out, she entered into the rehabilitation agreement.

This understanding is confirmed by §682.410(b)(6)(ii), which requires the guaranty agency to inform the borrower "that if he or she does not make repayment arrangements acceptable to the agency, the agency will promptly initiate procedures to collect the debt," such as garnishing her wages, filing a civil suit, or taking her income tax refunds. 34 C.F.R. §682.410(b)(6)(ii). What would be the point of warning the borrower that declining to make repayment arrangements would trigger costly debt collection activities if the guaranty agency could initiate these procedures and assess those costs regardless of whether she agrees to repay?

That the regulations create this sort of safe harbor is not surprising. Under USA Funds' interpretation of the regulations, a guaranty agency could assess collection costs against a borrower even though it was *never* forced to "initiate procedures to collect the debt." This would allow the guaranty agency to charge for costly actions that it might never need to take, such as wage garnishment or filing a civil suit. This case illustrates the point. USA Funds assessed over $4,500 in collection costs even though it merely sent one letter, sent and received one fax, spoke to Bible and her attorney on the phone several times, and cashed Bible's monthly checks.

The safe harbor of subparagraph (b)(5)(ii) also creates an incentive for first-time defaulters to rehabilitate their loans by voluntary repayment. If first-time defaulters knew that they would face collection costs regardless of whether they agree to repay, they would have less incentive to enter into the repayment program voluntarily. These regulations are designed to reward cooperation.

...

Subparagraph (b)(5)(ii) discusses credit reporting and the assessment of collection costs in the exact same way: "but before it reports the default to a consumer reporting agency or assesses collection costs against a borrower.…" USA Funds has given us no persuasive reason to treat one of the stated adverse consequences of default (a bad credit report) differently from the other (collection costs). Yet that is precisely what its interpretation of the statutory framework and related regulations would do.

This conclusion is based on the text of the applicable statutory provisions, regulations, and the MPN itself. USA Funds does not squarely address the textual basis of Bible's claim but responds with three arguments. First, it argues that §682.410(b)(2) allows it to impose collection costs, and the regulations do not explicitly prohibit the imposition of collection costs against a borrower who has defaulted but promptly entered into a repayment agreement. This argument is not persuasive. Paragraph (b)(2) merely establishes the background rule that the guaranty agency must assess "reasonable collection costs" against the borrower and establishes the cap on the maximum amount of costs that can be charged. It does not say anything about the circumstances under which these costs can be imposed. As explained, other parts of the regulation such as subparagraph (b)(5)(ii) impose more specific requirements about the circumstances in which collection costs may be assessed.

Second, USA Funds contends that Bible's interpretation of §682.410(b)(5)(ii)(D) ignores the fact that the repayment agreement must be "on terms satisfactory to the agency." It appears to argue that under this language the guaranty agency retains the discretion to assess collection costs whenever it wants. But this interpretation is inconsistent with the introductory paragraph of the regulation, which makes clear that the agency must provide the borrower an opportunity to enter into a repayment agreement *before* collection costs are assessed. Guaranty agencies do not have unfettered discretion to impose whatever collection costs they want, whenever they want, as the argument suggests.

Contrary to USA Funds' arguments, Bible's interpretation still gives meaning to the phrase "on terms satisfactory to the agency." Under her theory, USA Funds retained the discretion to set the terms of the repayment agreement. After all, it transmitted the form document to Bible that became the rehabilitation agreement. It could have insisted on higher monthly payments, for example. USA Funds had the power to set the initial terms of its offer and to reject any proposed counteroffer. It did not have the power, though, to impose collection costs in contravention of §682.410(b)(5)(ii).

Third, USA Funds points to another provision in the MPN: "If I default, the guarantor may purchase my loans and capitalize all then-outstanding interest into a new principal balance, and collection fees will become immediately due and payable." This provision, however, does not displace the guaranty agency's obligations under

34 C.F.R. §682.410. The collection fees become "immediately due and payable" only after the guaranty agency has first provided the borrower with (1) written notice that meets the requirements spelled out in subparagraph (b)(5)(vi), (2) an opportunity to inspect and copy agency records pertaining to the loan obligation, (3) an opportunity for administrative review of the enforceability or past-due status of the loan obligation, and (4) an opportunity to enter into a repayment agreement. See 34 C.F.R. §682.410(b)(5)(ii)(A)-(D). Interpreting the provision as USA Funds suggests would contradict §682.410(b)(5)(ii). Recall, moreover, that USA Funds had told Bible that she owed zero collection costs when she first defaulted. It was not until after she signed the rehabilitation agreement that she finally learned about the costs.

ii. Deference to the Secretary of Education's Interpretation

Even if the preceding analysis does not provide the best interpretation of the statutory framework and accompanying regulations…the same result would still be correct based on the deference we owe to the Secretary of Education, who is tasked with administering the FFELP and issuing the implementing regulations.

...

The Secretary's interpretation of "reasonable collection costs" in 20 U.S.C. §1091a(b)(1) is reasonable. The Secretary interprets "reasonable" to mean that similar costs must be assessed against borrowers who are at similar stages of delinquency. Under the Secretary's view, a borrower who promptly enters into a voluntary repayment agreement and complies with that agreement, thereby obviating the need for the guarantor to initiate costly debt collection procedures, is not similarly situated to someone who does not, thereby forcing the guarantor to undertake costly debt collection procedures.…

To summarize, Bible has alleged sufficiently that USA Funds breached its contract with her by assessing over $4,500 in collections costs after she timely entered into and complied with a monthly repayment agreement, in violation of the applicable regulations that were incorporated into the parties' contract.

2. Damages

We next address whether Bible has adequately pled damages. USA Funds argues she has not because she defaulted on her loan and continues to owe money on that obligation. This argument is meritless. Of course Bible continues to owe money under her loan obligation. That does not mean she has not been damaged by USA Funds' imposing over $4,500 in unauthorized collection costs. These costs represent new charges that have been added to her accrued interest and principal, thereby increasing the total amount she owes on her account. Because these charges were not permitted by her contract, she has plausibly alleged damages, even if the remedy might take the form of a credit to her account rather than cash in her pocket. Bible has plausibly alleged a viable breach of contract claim under state law.

B. Preemption & the "Disguised Claim" Theory

We next examine whether federal law preempts or otherwise displaces Bible's state law claim. "Preemption can take on three different forms: express preemption, field preemption, and conflict preemption." Aux Sable Liquid Products v. Murphy, 526 F.3d 1028, 1033 (7th Cir. 2008). USA Funds relies on conflict preemption. It also argues that the breach of contract claim is nothing more than a "disguised claim" for a violation of the Higher Education Act and is thus "preempted" by the HEA. Neither theory has merit. Federal law does not preempt or otherwise displace Bible's breach of contract claim.

1. Conflict Preemption

Conflict preemption can occur in two situations: (1) when "it is impossible for a private party to comply with both state and federal requirements," or (2) when "state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." Freightliner Corp. v. Myrick, 514 U.S. 280, 287 (1995) (citations and internal quotation marks omitted). USA Funds does not contend that it would be impossible, without violating federal law, for it to comply with the state law duty Bible's suit seeks to impose. Instead, it invokes the second species of conflict preemption known as "obstacle" preemption. USA Funds argues that entertaining Bible's breach of contract claim would frustrate Congress's goal of "uniformity" because it would require many state and federal courts to interpret HEA regulations in potentially inconsistent ways. We reject this contention.

...

The real question is whether entertaining Bible's breach of contract claim actually conflicts with the HEA and its associated regulations. It does not. We begin with *Wigod v. Wells Fargo Bank, N.A.*, 673 F.3d 547 (7th Cir. 2012), where we dealt with a nearly identical issue in the context of the federal Home Affordable Mortgage Program (HAMP). In *Wigod*, the plaintiff brought state law claims against her mortgage service provider, including a breach of contract claim alleging that the defendant breached a written agreement that incorporated the HAMP requirements. Like USA Funds in this case, the defendant in *Wigod* argued that the state law claims were preempted by the federal guidelines under principles of conflict preemption. We rejected the argument. 673 F.3d at 577-81.

Although *Wigod* dealt with a different regulatory framework, its reasoning applies directly here. Bible's claim is that USA Funds breached the MPN by acting contrary to the federal regulations incorporated into the contract. Just as in *Wigod*, "the state-law duty allegedly breached is imported from and delimited by federal standards." *Wigod*, 673 F.3d at 579. In this situation, federal law simply provides the standard of compliance, and the parties' duties are actually enforced under state law. See id. at 579-80. There is no conflict.

The Fourth Circuit reached the same conclusion regarding the HEA in *College Loan Corp. v. SLM Corp.*, 396 F.3d 588 (4th Cir. 2005). In that case, the plaintiff sued Sallie Mae and its affiliates under state law, alleging that they had a contract that incorporated the requirements of the HEA and its regulations. The district court held that the state law claims were preempted. The Fourth Circuit reversed. The court held that the plaintiff's state law claims were not preempted even though they relied on establishing a violation of the HEA and its regulations:

> This point is particularly obvious in relation to [plaintiff's] contract claim. As parties to the Agreement, [the parties] voluntarily included federal standards (the HEA) in their bargained-for private contractual arrangement. Both *expressly agreed* to comply with the HEA. In that context, [defendants'] argument that enforcement of the Agreement's terms is preempted by the HEA boils down to a contention that it was free to enter into a contract that invoked a federal standard as the indicator of compliance, then to proceed to breach its duties thereunder and to shield its breach by pleading preemption. In this case at least, federal supremacy does not mandate such a result.

Id. at 598 (citations omitted). The Fourth Circuit's reasoning applies with equal force here.

Unable to distinguish *Wigod* or *College Loan Corp*. in meaningful ways, USA Funds seeks help from *Chae v. SLM Corp.*, 593 F.3d 936 (9th Cir. 2010). But *Chae* actually reinforces our conclusion. There, borrowers sued Sallie Mae under state law for its handling of their student loans. Applying principles of conflict preemption, the Ninth Circuit held that the claims were preempted by the HEA because "[p]ermitting varying state law challenges across the country, with state law standards that may differ and impede uniformity" would pose an obstacle to Congress's purpose in creating the FFELP. Chae, 593 F.3d at 945. The Ninth Circuit, however, carefully distinguished *College Loan Corp.* on grounds directly applicable here, saying that the plaintiff in *College Loan Corp*. had "sought to enforce FFELP rules, not to vary them." Id. at 946, citing 396 F.3d at 591-94. In *Chae*, though, the plaintiffs were "not seek[ing] to buttress the FFELP framework, but rather to alter it in their home state." Id. They were asking the court to impose a higher standard of compliance than was required by federal law. Such claims are preempted, held *Chae*, but that reasoning does not apply here.

Like the plaintiff in *College Loan Corp*. and unlike those in *Chae*, Bible is not attempting to require more of the defendant than was already required by the HEA and its regulations. She seeks only to enforce the federal standards that the parties agreed to in their contract. This case is therefore not different from *Wigod*, where we held that state law claims attempting to enforce the requirements of the HAMP guidelines were not preempted by federal law. In *Wigod*, *College Loan Corp*., and now this case, the plaintiffs' state law claims were complementary to, not in conflict with, the federal requirements. Bible's claim is not preempted by federal law.

2. The "Disguised Claim" Theory

In addition to its formal preemption argument, USA Funds argues that Bible's state law claim is "preempted" because it is nothing more than a "disguised claim" for a violation of the HEA, and the HEA does not provide a private right of action. We considered and rejected this same theory in *Wigod*. There the defendant-lender referred to it as an "end-run" theory rather than a "disguised claim" theory. The difference is merely semantic. The defense theory in both cases is that the lack of a private right of action under a regulatory statute necessarily preempts or otherwise displaces a state law cause of action that makes the violation of that regulatory statute an element of the claim. This theory is mistaken at its core: “The absence of a private right of action from a federal statute provides no reason to dismiss a claim under a state law just because it refers to or incorporates some element of the federal law. To find otherwise would require adopting the novel presumption that where Congress provides no remedy under federal law, state law may not afford one in its stead.” Wigod, 673 F.3d at 581.

...

We reiterate the lesson from *Wigod*. The absence of a private right of action under federal law provides no reason to dismiss a state law claim just because the claim refers to or incorporates some element of the federal law. Congress’s decision not to supply a remedy under federal law does not necessarily mean that it also intended to displace state law remedies. The lack of a private right of action under the HEA itself does not preclude Bible’s breach of contract claim.

...

CONCLUSION

Neither of Bible’s claims is preempted or otherwise displaced by federal law, and she has plausibly alleged all of the elements of both claims. The judgment of the district court is REVERSED and the case is REMANDED for further proceedings.

D. Discharging Student Loans

1. Statutory Discharge

Absent from the following discussion of statutory discharge is private student loan debt. As you will see, statutory discharge is only available for federal student loans. The HEA allows for discharge, or cancellation, of a federal student loan in six instances, three of these are school related discharges. 34 C.F.R. §§682.402, 674.33(g), 684.214. The other three relate to the borrower and can be sought if the borrower dies, suffers a permanent and total disability, or if the borrower’s profession—teaching, or military or public service—qualifies the borrower for discharge. Obtaining statutory discharge under the HEA can be a lengthy and complicated process, sometimes with unforeseen drawbacks. For instance, under the Public Service Loan Forgiveness Program, it is possible for a person to have a significant portion of their debt discharged, but when the debt is discharged, it can be taxed as income. For a public servant earning $38,000 a year, having $100,000 of student loan debt forgiven could result in ten or twenty thousand dollars of taxes.

The Public Service Loan Forgiveness Program only applies to Direct Loan borrowers. *See* 34 C.F.R. §682.219. To qualify, borrowers must not be in default and must have made 120 monthly payments on their loans after October 1, 2007. 34 C.F.R. §682.219(c). Public service employment that qualifies for this program includes a federal, state, local, or tribal government organization, agency or entity, certain non-profit organizations, a tribal college or university, or certain private organizations providing specific public services. 34 C.F.R. §682.219(b).

When a school closes, falsifies the certification of the borrower's eligibility, or fails to pay a refund owed to a student, then the borrower can seek to have the debt discharged under the HEA. 34 C.F.R. §§682.402, 684.33(g), 684.214. These statutory remedies do not apply equally to all loans. In the case of Direct Consolidated loans, relief is more complicated, as discharge may apply to part but not all of the loan. The school closure discharge is not as straightforward as it may seem. Discharge is available only if the borrower was unable to "complete the program of study for which the loan was intended because the school…closed, or the borrower withdrew from the school not more than 90 days prior to the date the school closed." 34 C.F.R. §682.402(d). If the *program* closes, but the school continues to provide other educational instruction, then the school has not "closed" and this provision does not apply. *Id*.

A borrower can seek discharge if the school: 1) falsified the certification of the borrower's eligibility for a FFEL Program with regard to the ability of the borrower to benefit from the schools' training and the student did not meet the statutory requirements; 2) signed the borrower's name without authorization on the loan application or promissory note; or 3) certified the borrower's eligibility for a FFEL program loan as a result of identity theft, in some situations. 34 C.F.R. §682.402(e). When a school, opened or closed, fails to pay a borrower an owed refund, the borrower can seek discharge, although the process to apply for discharge differs depending on whether the school is currently open or closed. *See* 34 C.F.R. §682.402(l).

All of these statutory discharge options require the borrower to apply and supply various types of documentation. As with any application, there is a chance of denial. If the application for discharge was dismissed for lack of evidence, and there is new evidence available, the borrower can resubmit an application with the new documentation. In some cases, the applicant can, or must, seek administrative review of the denial before seeking judicial review of the decision.

2. Bankruptcy

Bankruptcy is an important consumer remedy and is covered in Assignment 22 The treatment of student loan debt in bankruptcy, however, is quite unusual compared to most consumer debts. Bankruptcy law imposes a general rule that student loans are nondischargeable. 11 U.S.C. §523(a)(8). The rule applies equally to public and private student loans. A consumer in bankruptcy can ask the court to discharge student loans, which has the effect of permanently barring the creditor or servicer from making any collection efforts or even inquiring about voluntary payment. To get this relief, the consumer must litigate to prove that the repayment of the student loans would impose an "undue hardship" on the debtor or dependents. 11 U.S.C. §523(a)(8). While undue hardship is an undefined standard in the statutes, and courts give it varying interpretations, the consensus is that it is a high standard. Many courts require that a consumer show that she has made good faith efforts to repay the loans, that the debtor cannot maintain a "minimal" standard of living, and that the debtor's financial situation is likely to persist for a significant portion of the repayment period. *Brunner v. New York State Higher Education Services Corp.*, 831 F.2d 395 (2d Cir. 1987). As much as consumers have difficulty winning a discharge, the bigger effect of the standard may be to discourage bankruptcy as an option to address unmanageable student loans. Jason Iuliano, *An Empirical Assessment of Student Loan Discharges and the Bankruptcy Undue Hardship Standard*, 86 AM. BANKR. L.J. 495 (2012) (finding that 39 percent of student loan borrowers were, in fact, successful in receiving a full or partial discharge of student loans). The limitations on bankruptcy relief have increased the need for effective non-bankruptcy remedies for student loan debt.

E. For-Profit Schools

1. Scholarship Scams and Diploma Mills

The College Scholarship Fraud Prevention Act is aimed at creating national awareness by requiring an informational website. 20 U.S.C. §1092d. The law targets the scholarship scams in which companies take advanced payment from a student, or their families, in exchange for finding a scholarship or grant with private companies. Another problem facing consumers are unaccredited schools offering specialty degrees or certificates with little or no education or training. These businesses are called "diploma mills," a pejorative that now is incorporated into federal law. 20 U.S.C. §1003(7). Some students are directed to diploma mills by for-profit schools if they lack a high school diploma. The diploma mills will generate a "high school diploma" after the student takes an online test, all for a fee of course. Often these diplomas are invalid. These services tend to prey upon non-English speaking students or immigrants, who might not know that the diploma is invalid.

2. Government Discharge and Reimbursement Programs for School Misconduct

As discussed above, borrowers can seek statutory discharge of their student loan debt for school-related problems. When statutory discharge is not available, a borrower may find relief from state tuition recovery funds that may reimburse a defrauded borrower. These programs, and their requirements and regulations, vary by state. Some states also have bond programs, but both may be used to reimburse a defrauded borrower. While California is a notable example of a state tuition recovery fund. If a borrower would be entitled to reimbursement under the fund, the borrower also likely would be entitled to a statutory discharge.

3. Legal Claims

For-profit schools have been cropping up in the news as the Department of Education, the CFPB, and state attorneys general crack down fraudulent schools receiving federal funding. To receive federal funds, for-profit schools must be approved or licensed by the state where they operate. Each state has its own regulatory framework for the oversight of private higher education institutions, so borrowers victimized by a fraudulent or bad-acting institution may have state law remedies. The federal government has the ability to pull the purse-strings of many for-profit schools through regulation by refusing to extend federal aid to its enrollees, but for the borrower who is the victim of school fraud, that step offers no debt relief. The HEA sets out standards, violations of these standards, and misrepresentation, are not grounds for private right of action.

Borrowers wishing to challenge a school generally must proceed under a state unfair and deceptive acts and practices law (UDAP), or a Fair Debt Collection Practice Act violation. (The latter is the subject of Assignment 23.) There are a handful of other laws that can support a UDAP claim or provide an avenue for relief. The Federal Trade Commission has guidelines concerning the representations made by private vocational and distance education schools. 16 C.F.R. §254.0-254.7. A violation of these guidelines may strengthen a borrower's UDAP claim or be a per se violation as defined in a state's UDAP law. The Racketeer Influenced and Corrupt Organization Act (RICO) is another option for recovering damages in a private action against a school. A RICO claim may be particularly useful because of the amount of damages the borrower can recover. For a more thorough discussion of RICO, see the omitted sections of the *Bible* case. As occurred in *Bible,* borrowers often are confronted with the federal preemption argument from lenders. The HEA does explicitly preempt some state laws, such as usury laws, statutes of limitation, and disclosure requirements, to name a few. Most courts have ruled that these specific preemptions do not support a determination that the HEA preempts *all* state laws.

State common law contract and tort claims, such as misrepresentation, breach of contract or fraud, also may be valid courses of action against schools that engage in misconduct. But even if the borrower prevails in a lawsuit against a private educational institution that does not necessarily mean the borrower will then be "made whole" by having the debt erased or paid. This suit could yield money damages that are less than the debt. Therefore finding a claim that supports punitive damages is vital to pay off the debt.

A borrower also can file a private suit against a school under the False Claims Act (FCA) in the name of the United States if the school made false or fraudulent claims to the federal government in receiving federal aid. Typically FCA cases assert theories of promissory fraud or false certification of various regulatory requirements that are prerequisites for funneling federal loans to students.

Problem Set 18

18.1. Four years ago your cousin Bobby Copper received a glossy course catalogue from Premier Protection College, a for-profit school touting a three-year program preparing its elite students for careers in law enforcement, including jobs as police officers, sheriffs, correction officer and FBI agents. On the third page of the mailer were statistics about Premier Protection College's alumni. Bobby was excited to see that 90 percent of alumni found work in criminal justice jobs within one year of graduation. The college boasted that its career development team had connections in the FBI, the CIA, and several top-notch private security firms.

Premier Protection College's three-year degree program came with the hefty price tag of $75,000, but Bobby was able to take out a subsidized federal loan as well as a private loan from Western Coach Bank. Since graduating from Premier Protection College, Bobby hasn't been able to secure a job beyond working part-time as a security guard in a local mall. His current job barely pays his rent, let alone his multiple student loan payments.

A few nights ago, while sitting in the security office located near the bathrooms in the basement, Bobby received an email from a fellow alumni complaining about the job placement rates for Premier Protection College. According to an article attached the email, only 4 percent of Premier Protection College graduates are employed as sworn law enforcement officers or correctional officers. In fact, the most common job for Premier Protection College grads are retail store guards like Bobby's. In the wake of this bad publicity, enrollment has plummeted. Now it seems Premier Protection College may file for bankruptcy. The article states that the school received over $100 million in federal aid in the last school year.

Bobby calls you up, livid. He's heard that the government is cracking down on for-profit schools under a new rule requiring school graduates to achieve "gainful employment." He knows you have your own student loan worries as a law student, but wants to know if there is any way out of his debts using this "gainful employment rule." *See* 34 C.F.R. §§668.401-.403.

18.2. After law school, you accept a position working for the California Office of the Attorney General. A few weeks into your new job, you go out at lunch with some co-workers, including your legal assistant Darren. Come to find out, Darren went to law school in Louisiana seven years ago before chasing his aspiring actress girlfriend—you've already heard all about her toothpaste commercial—to California. Although Darren had intended to take the bar exam years ago, he finds working for the Attorney General less stressful than a corporate gig and it lets him catch the surf before sundown.

While discussing the outrageous living expenses in Los Angeles, Darren tells you that he plans to work a few more years for the AG and then use the Public Service Loan Forgiveness Program to wipe out his significant student loan debt. Darren explains he borrowed as much as he possibly could during law school and currently has three different loans with names he can't remember.

Something about FFEL, another is Direct something, and then a ‘regular old’ loan from his bank. Once he doesn’t have student loan debt hanging over his head, he plans to start saving some money and stop living paycheck to paycheck. As you walk back to work, Darren asks you what you think of his plan. *See* 20 U.S.C. §1087(e)(m); 34 C.F.R. §685.219.

18.3. National United Bank has decided to expand its lending to include student loans. Hoping to grab market share, the head of marketing has created a direct mail advertisement that features a nearby state university’s mascot and school seal near the bank’s logo. The flier announces that National United Bank is offering competitive rates for student loans. For National United Bank customers with existing checking accounts, variable interest rates can be as low as 2.95 percent APR and fixed interest rates start at 5.2 percent.

Before sending out the new glossy brochure, the CEO of the bank wants legal’s stamp of approval before marketing sends the flier design to the printer. He lets slip that the flier may boast interest rates far below those actually projected to be offered to most customers. As deputy corporate counsel, do you have legal concerns about the mailer? *See* §§12 C.F.R. 1026.47(a); 1026.48(a)&(b); Official Interpretation to 47(a)(1)(i).

18.4. Student loan debt is the second largest amount of consumer debt in the U.S. economy. It totals an estimated $1.2 trillion. Mortgage debt is first. In the years after the 2008 housing crisis, policymakers began to discuss the country’s outstanding student loans as a “bubble” or a looming crisis. These alarms pointed to regulation and reform that could limit the overall damage of the rising default rate on student loans. The annual three-year national cohort default rate in 2014 was 11.8 percent. U.S. Department of Education, *Three-year Official Cohort Default Rates for Schools*, http://www2.ed.gov/offices/OSFAP/defaultmanagement/cdr.html (last visited Nov. 18, 2015). Are you persuaded that today’s student loan debt is similar to the mortgage debts that pushed the economy to near-collapse? What are the similarities and differences between student loan debts and mortgage debts? Consider things such as underwriting, securitization, government backing or guarantees, the nature and amount of debt, and the like.

Assignment 19. Banking Transactions

The last several assignments examined the laws that govern different types of borrowing: mortgages, car loans, credit cards, and payday lending. Of course, not every purchase is financed. Many consumers pay using cash, check, debit cards, or other forms of payment. While these are immediate transactions that lack the "buy now, pay later" feature of credit, consumer issues still arise. Banking transactions are every day and routine, which may lead to consumers paying insufficient attention to the costs and risks. Banking transactions also have a complex infrastructure that may be invisible or confusing to consumers. Finally, technology has prompted innovations in payments that have introduced new conveniences, but also loopholes in the consumer protection law.

"Banks" are creatures of law, not unlike corporations or public utilities in the sense that the designation carries with it both benefits and burdens. This Assignment uses bank as shorthand for companies that perform payment functions, although many of these companies are not legally "banks." The central concern of banking law is safety and soundness, and this is the traditional focus of banking regulators. For example, the Federal Deposit Insurance Corporation (FDIC) provides deposit insurance on accounts that insure consumers against the bank being unable to provide deposits back upon customer demand.

This Assignment focuses on payment law—the how, what, and when of a consumer making a payment to another. It explores how the law allocates responsibility for fraud, theft, mistake, accounting error between banks and consumers, and it also studies the approach to regulating fees and costs. The checking account remains the foundational product, even though paper checks are declining sharply in use. Debit cards and other means of electronic fund transfers now dominate. New payment tools such as mobile payments and gift cards illustrate how consumer protection in banking continues to confront issues of transparency and fairness, regardless of platform.

A. Bank Accounts

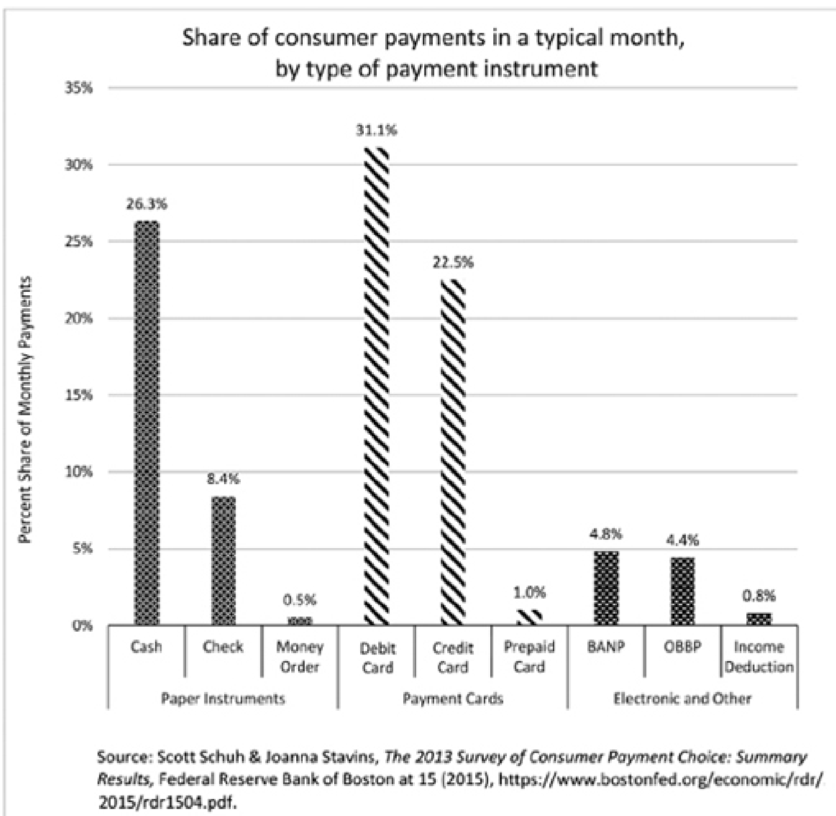
Deposit and payment functions are newer businesses for banks than lending. Traditionally, banks were creatures of the nation-state and had issuing and backing money currency as their primary responsibility. This idea of payment processing as a public good remains today, although banks themselves are private, for-profit institutions. The Federal Reserve, the FDIC, and the U.S. Treasury have vital roles in banking, and by extension in consumer protection. In part because of a perceived conflict between protecting consumers and banks profiting from them, the Consumer Financial Protection Bureau

(CFPB) now has authority over the aspects of banking that are "consumer protection functions." 12 U.S.C. §5581. Included in the CFPB's enumerated "federal consumer financial law" are the Electronic Funds Transfer Act, the Truth in Savings Act, and the part of the Federal Deposit Insurance Act that proscribes disclosures for non-FDIC-insured institutions. 12 U.S.C. §§5481(12) and (14). By statute, the CFPB has limited authority over banks and credit unions with $10 billion or less in assets. 12 U.S.C. §5516. The purpose of this restriction was to reduce the regulatory burden on smaller institutions. One result is that the "regulation by institution" approach lingers in banking, rather than the "regulation by product" approach that provides more comprehensive oversight.

1. Checking Accounts

The slow demise of paper checks continues, and its end may be nigh. Check use is dwarfed by debit cards, credit cards, and cash. Scott Schuh & Joanna Stavins, *The 2013 Survey of Consumer Payment Choice: Summary Results*, Federal Reserve Bank of Boston (2015), https://www.bostonfed.org/economic/rdr/2015/rdr1504.pdf.

Number and share of consumer payments in a typical month, by type of payment instrument



Id. at 15. The trends in the graph do not make checking accounts obsolete; indeed the transformation from paper to electronic payments may create new consumer protection issues as the law lags behind the market. Professor Ronald Mann astutely observes that the move from paper to electronic systems is also a crucial policy shift from heavily regulated, government-subsidized systems to less regulated, private systems. Ronald Mann, *Payment Systems and Other Financial Transactions* 7 (5th ed. 2011). The law relating to liability for checks is well developed compared to newer payment technologies and also permits study of accounts themselves.

A checking account reflects an agreement by a bank to hold money and dispose of it as the consumer directs. State and federal laws override these contracts if their provisions are contrary to law. Articles 3 and 4 of the Uniform Commercial Code (U.C.C.) are the key state laws, with several federal statutes addressing specific issues.

Money arrives in bank accounts in a variety of ways. Money inbound to the customer's account may be a cash deposit, a fund transfer from another person's account at the same bank, or the deposit of a check drawn on a geographically distant bank. These deposits carry different levels of risk for a bank, but consumers tend to want to access the money regardless. To create consistency and bring a consumer-friendly approach to this issue, Congress passed the Expedited Funds Availability Act, 12 U.S.C. §§4001-4010. Its Regulation CC establishes a framework of deadlines by which a depository bank must release money to a customer. The rules vary by the perceived riskiness of the deposit and by the method by which the consumer wants to access the funds.

The law obligates banks to pay properly presented items. But a bank's liability for failure to do so runs to its customer, not the payee. The consumer is left holding an unpaid check and needing to track down the person who wrote the check to secure alternate payment.

Banks may dishonor a check if the account balance is smaller than the check presented. U.C.C. §4-401(a). Alternatively, the bank may pay the check and charge the consumer a fee, called an insufficient fund or non-sufficient funds (NSF) fee. The rules for ATM withdrawals or debits are different. A consumer must have opted in to overdraft protection to be charged a fee for allowing such a transaction to process. Several banks have faced lawsuits for failing to disclose adequately the costs associated with overdraft protection programs. The CFPB may attempt to improve the disclosures related to overdraft protection, although the industry has suggested that consumers simply want the charges paid, even at a cost. Note that if a bank has agreed to pay the overdraft, then the bank must pay according to its contract with the customer. To limit liability, most banks have some bounds on what overdraft protection does cover.

A major controversy has erupted about whether banks should be obligated to process transactions in the order that reduces any overdraft charges. A bank may have its program set up to deduct items by descending order of amount. By paying the largest debit first, each subsequent smaller transaction could create a separate overdraft item, and consequential fee to a consumer. Banks can pay items in "any order." U.C.C. §4-403(b), and a CFPB report found a wide variety of practices, including some banks that processed certain types of transactions first, such as bill payments, and some banks that processed transactions of all kinds together from smallest to largest. CFPB, *Study of Overdraft Programs* (June 2013), http://files.consumerfinance.gov/f/201306_cfpb_whitepaper_overdraft-practices.pdf. The lack of standardized processing means that consumers will not be able to anticipate whether a particular transaction will create an overdraft. The only sure way to avoid trouble is to have all the money currently available for all types of deductions.

Banks have good reason to worry about check fraud. Its costs amount to about $1 billion per year. The law generally puts the loss on the party that engaged in negligence, if there was one.

Marx v. Whitney Nat'l Bank

713 So. 2d 1142 (La. 1998)

MARCUS, Justice.

David Marx filed suit against the Whitney National Bank (hereinafter "Whitney") asserting that Whitney was obligated to restore to his checking account a total of $10,000 for five checks drawn on his account by a person whose signature was unauthorized.…Whitney declined to restore the funds paid out on the forged checks to the plaintiffs' account. It answered asserting that the failure of David Marx to exercise reasonable care in the handling of the account precluded relief.

The facts underlying this matter are undisputed by the parties.…David Marx maintained a checking account at Whitney for which he received monthly statements. His January 1995 statement contained evidence of five forged checks totaling $2,373.00. He did not review his January 1995 statement. Nor did he review his statements for the months of February, March, and April of 1995. Had he reviewed the January through April 1995 statements, he would have discovered seventeen forged checks totaling almost $13,000.00. On April 24, 1995, two children of David Marx, Stanley Marx and Maxine Marx Goodman, were added as joint owners to the same account. Five additional checks were forged on the account in March, April, and May 1995 which first appeared on the May 1995 statement. Stanley Marx noticed these forged instruments when he reviewed the bank statement dated May 16, 1995 and the enclosed cancelled checks. At the behest of Stanley Marx, David Marx reported the forgeries to Whitney and executed an "Affidavit of Forgery, Alteration, Loss or Theft of Instrument and Subrogation and Hold Harmless Agreement" in which he identified his grandson, Joel Goodman, as both the maker and payee of the forged instruments. Plaintiffs asked Whitney to credit back to their account the funds paid out on the last five forgeries discovered and reported upon receipt of the May 1995 statement. The parties stipulated that Joel Goodman had access to David Marx's checkbook whenever he visited his grandfather, that he was the party who had forged all of the checks in question, and that David Marx was negligent for failing to review his January, February, March, and April 1995 statements.

The trial judge granted plaintiffs' motion for summary judgment, rendering judgment in plaintiffs' favor for $10,000, plus legal interest from date of judicial demand, and all costs of the proceedings. The court of appeal affirmed. We granted certiorari to review the correctness of that decision.

The sole issue for our review is whether the stipulated negligence of David Marx precludes recovery against Whitney by all joint owners on the account for the five forged checks honored by Whitney which were discovered and reported upon receipt of the May 1995 statement.

The law applicable to this case is found in Chapters Three and Four of the Louisiana Commercial Laws. Pursuant to Louisiana's Commercial Laws as well as the established jurisprudence prior to their adoption, the relationship between a bank and its depositor is a debtor-creditor relationship that is contractual in nature. Fidelity Nat'l. Bank of Baton Rouge v. Vuci, 68 So. 2d 781 (1953). The initial deposit of funds gives rise to the contract between bank and depositor; the subsequent creation of rights of others to an interest in an account involves an amendment of the original contract.

During the course of the contract with its depositor, a bank has the right to use the funds on deposit and, in consideration thereof, it covenants to pay funds out of the depositor's account only on the depositor's orders. First Nat'l. Bank v. Pine Belt Producers Co-op, 363 So. 2d at 1204. La. R.S. 10:3-401 specifically provides that a person is not liable on an instrument unless the person signed the instrument. La. R.S. 10:3-403 further provides that an unauthorized signature is ineffective except as the signature of the unauthorized signer in favor of a person who in good faith pays the instrument or takes it for value. Accordingly, the general rule is that a bank is liable when it pays based upon a forged signature. Colonial Bank v. Marina Seafood Market, Inc., 425 So. 2d 722 (La. 1983). A charge against a customer's account based on a forged instrument is not an authorized charge under the contract between the parties because the order to pay was not given by the customer. For that reason, a banking customer can insist that the drawee bank recredit to his account any funds paid out on a forged instrument. James V. Vergai & Virginia V. Shue, Checks, Payments, and Electronic Banking 458 (Practicing Law Institute 1986); Fidelity Nat'l. Bank of Baton Rouge v. Vuci, 68 So. 2d 781 (1953).

Notwithstanding the general rule that imposes the risk of loss for payment of a forged instrument on the drawee bank, the law provides that under certain circumstances a bank's customer may be *precluded* from asserting rights against the bank in connection with a forged check. Pursuant to La. R.S. 10:3-406 and 10:4-406, a customer is precluded from having funds paid out on a forged instrument restored to his account if his failure to exercise reasonable care in handling the account, either *before or after* the forgery, substantially contributed to the loss. [ED. NOTE—emphasis added] In this case, Whitney asserted both statutory defenses in response to plaintiffs' motion for summary judgment.

…

La. R.S. 10:3-406 precludes a bank's customer from asserting a claim when the customer's conduct *before* a forgery substantially contributes to the making of the forgery. The burden of proving that the customer's handling of the account precludes recovery is on the bank. In this case, the bank asserted that David Marx substantially contributed to the forgeries and was precluded from making a claim against the bank by La. R.S. 10:3-406(a) because his grandson had access to his checkbook each time he visited the residence. No further facts were stipulated by the parties concerning where or how the checkbook was kept, the manner in which the grandson obtained blank checks of his grandfather, the frequency of his visits, or whether the grandfather had reason to be suspicious that his checks might be taken and his name forged on them. The mere fact that one family member has access to checks at the residence of another family member, without more, does not establish a failure to exercise ordinary care substantially contributing to the making of a forged signature so as to preclude recovery on a forged instrument. Accordingly, Whitney did not carry its burden of proof that plaintiffs were precluded from recovery pursuant La. R.S. 10:3-406.

Whitney also defended against plaintiffs' motion for summary judgment by asserting that David Marx failed to discover and report the initial forgeries upon receipt of the January 1995 statement, thereby precluding recovery for any subsequent forgeries on the account by the same wrongdoer. La. R.S. 10:4-406 provides in pertinent part:

> (c) If a bank sends or makes available a statement of account or items pursuant to Subsection (a), *the customer must exercise reasonable promptness in examining the statement or the items to determine whether any payment was not authorized* because of an alteration of an item or because a purported signature by or on behalf of the customer was not authorized. If, based on the statement or items provided, the customer should reasonably have discovered the unauthorized payment, the *customer must promptly notify the bank* of the relevant facts.
>
> (d) *If* the bank proves that *the customer failed, with respect to an item, to comply with the duties imposed on the customer by Subsection (c), the customer is precluded from asserting against the bank:*
>
> > (1) the customer's unauthorized signature or any alteration on the item, if the bank also proves that it suffered a loss by reason of the failure; and
> >
> > (2) *the customer's unauthorized signature* or alteration *by the same wrongdoer on any other item paid* in good faith by the bank *if the payment was made before the bank received notice* from the customer of the unauthorized signature or alteration and *after the customer had been afforded a reasonable period of time, not exceeding thirty days, in which to examine the item or statement of account and notify the bank.* [Emphasis added].

The rule stated in Subsection (d)(2) imposes on the customer the risk of loss on all subsequent forgeries by the *same wrongdoer* after the customer had a reasonable time to detect an initial forgery if the bank has honored subsequent forgeries prior to notice. Even before the adoption of the Uniform Commercial Code, case law throughout the country reflected the view that the suppression of forgery required a cooperative approach. Rules developed which shifted the risk of loss on certain forgeries to a customer who failed to give notice to the bank of forgeries and alterations. Out of the duty imposed on the customer to review his statement grew the rule that successive forgeries result from the failure of the customer to discover and report the initial forgeries which he could have detected had he acted in accord with the duty imposed by law upon him.…

In this case, plaintiffs have stipulated that David Marx did not review the January 1995 bank statement for his account and that if he had done so the unauthorized signature of his grandson on several checks would have been detected. Since he did not do so, plaintiffs are precluded from asserting against the bank *all subsequent forgeries* by the *same* unauthorized signatory. That being the case, plaintiffs are not in a position to recover against Whitney for the five forged checks that were discovered in the May 1995 statement which were forged by the same wrongdoer.

Plaintiffs argue that the "same wrongdoer" rule results in absurd consequences because a very minor undetected forgery would preclude a later claim with respect to a potentially large forged instrument drawn by the same wrongdoer. However, in our view plaintiffs' protest illustrates precisely the risk that La. R.S. 10:4-406 allocates to the customer, who is in the best position to discover and report small forgeries before the wrongdoer is emboldened and attempts a larger misdeed.

Plaintiffs further suggest that the prior conduct of David Marx should have no effect on the claims of Stanley Marx and Maxine Marx Goodman, who were not added to the account as owners until April 24, 1995 and who noticed and promptly reported the five checks sued upon after examination of the first statement sent to them. We do not agree.

Plaintiffs concede that if new owners had not been added to the account in April 1995, the failure of David Marx to examine and report the initial forgeries after receipt of the January 1995 statement would serve as an absolute bar to *his* recovery on the subsequent forgeries disclosed in the May 1995 statement. If plaintiffs' argument were accepted and the prior conduct of an account owner was deemed irrelevant to claims of new owners on the same account, a bank customer could subvert the operation of the "same wrongdoer" preclusion rule set forth in La. R.S. 10:4-406 simply by adding another person to the account, thereby defeating the system for allocation of risk adopted by our legislature. Indeed, in this case, plaintiffs' argument would allow David Marx to avoid operation of the preclusion rule and recover on the five checks at issue. Official Code Comment 7 to U.C.C. §4-406, which has been adopted in Louisiana, provides:

> Section 4-406 evidence[s] a public policy in favor of imposing on customers the duty of prompt examination of their bank statements and the notification of banks of forgeries and alterations and in favor of reasonable time limitations on the responsibility of banks for payment of forged or altered items.

We do not believe that the public policy embodied in La. R.S. 10:4-406 is furthered by allowing a customer to cleanse an account in which forgeries have occurred and avoid operation of the "same wrongdoer" preclusion rule by the simple device of adding another party to the same account. Moreover, the contract with respect to the account in question was confected between Whitney and David Marx when David Marx first deposited funds into the account. The addition of new owners to the account constituted an amendment to the account contract, which left in place all defenses already acquired by the bank. Whitney's defense to recrediting the account for funds paid out pursuant to checks forged by the same wrongdoer vested no later than thirty days after David Marx received the January 1995 statement containing instruments forged by Joel Goodman. La. R.S. 10:4-406. The addition of new owners to the account in April 1995 could not defeat defenses which had already attached in favor of the bank. Whitney carried its burden of proof to defeat plaintiffs' motion for summary judgment on the basis of the preclusion defense afforded pursuant to La. R.S. 10:4-406. The court of appeal erred in affirming the trial judge's grant of summary judgment in favor of plaintiffs. We must reverse.

DECREE

For the reasons assigned, the judgment of the court of appeal is reversed. Plaintiffs' motion for summary judgment is denied. The case is remanded to the district court for further proceedings.

Wrongdoing is not only the province of third parties, who fall neatly into categories of awful relative or thief. As the case below illustrates, checks are not the iron-clad evidence of proper payment that we might assume. Technology has sped up the checking process but also created new confusion.

In re Burrier

399 B.R. 258 (Bankr. D. Colo. 2008)

BROOKS, Judge.

…

OVERVIEW

This appears to be an ordinary case where Debtors claimed they made certain mortgage payments, but the creditor disagrees and maintains the payments were not made and it has no record of the payments being made. It is an extraordinary case, however, in that the evidence strongly suggests that the payments were indeed made by Debtors, but the creditor—here, Wells Fargo—has no record of the payments and has not credited the debtors' payments to their mortgage account. The payments have, evidently, been lost in a black hole of the creditor's organization or through accounting mismanagement.

This case illustrates three things. First, it reflects a significant and problematic imbalance between a creditor, the mortgage holder, and debtors, homeowners who are timely making their mortgage payments, and who are not knowledgeable about banking procedures and check processing.

Second, this case illustrates a major lender mortgage company whose operations and collections practices are seemingly disconnected from its own technologies. Or, put another way, this is a major lender/mortgage loan servicer where the left hand does not know what the right hand is doing—the collection department does not know what the check processing and accounting departments are doing.

Third, this dispute might portend a widespread abuse of collection practices or creditor overreaching—demanding of debtors what it, the creditor itself, is unable to provide: accurate and reliable record keeping and billing practices.

BACKGROUND

On June 18, 2004, the Debtors executed a Deed of Trust and Note with NBank, N.A. which provided the Debtors with a loan for $183,126.00.

The Note and Deed of Trust were subsequently negotiated to Wells Fargo Bank, N.A.

On February 21, 2007, Debtors filed for relief under Chapter 13 of the United States Bankruptcy Code at which time they also filed a Chapter 13 Plan. The Plan provided that Debtors…would pay regular post-petition mortgage payments directly to Wells Fargo. The Plan was confirmed on August 21, 2007 by Order of this Court.…

On February 26, 2008, Wells Fargo filed a Motion for Relief from Automatic Stay (“Motion”) based upon the Debtors’ alleged failure to make certain of their post-petition, post-confirmation monthly mortgage payments (June, July, October, and December 2007). On March 20, 2008, Debtors filed a Response to Wells Fargo’s Motion. In Debtors’ Response, they denied that they failed to make payments and asserted that “at least three of the payments referenced in Paragraph 7 of the Motion have been made.”

On April 11, 2008, the Debtors and Wells Fargo agreed to the terms of a Stipulation For Resolution of Motion for Relief From Automatic Stay and Motion For Acceptance of Stipulated Terms (“Stipulation”). On April 14, 2008, the Court issued an Order approving the Stipulation.

The Stipulation…*provided that, with regard to the four postpetition payments Wells Fargo said had not been made, if Debtors could show that the payments had, indeed, been made, then the Debtors’ account would be credited with the payments.* The Stipulation specifically provided, in pertinent part, that:

> Creditor has been provided with alleged proof of certain payments by the Debtors. At this time, insufficient information has been provided to Creditor to research the alleged payments. In the event that Debtors provide “*sufficient information*” (as defined below) to Creditor to determine pursuant to the Colorado Uniform Commercial Code and other applicable law that all of the alleged payments contemplated by this stipulation were negotiated, cleared, and were paid by the Debtors’ banking institution and, therefore, the payments should be credited to the loan secured by the Deed of Trust then: (a) Creditor will amend the stipulation to reflect that these payments have been credited to Debtors’ account; and (b) Creditor will reimburse Debtors’ counsel $400.00. *Under this Stipulation, the term “sufficient information” describes only valid, accurate, and true copies of the front side and back side of all negotiable instruments (e.g. personal banking checks) executed by the Debtors that indicate clearly and unequivocally that such negotiable instruments were negotiated by the Debtors’ banking institution.*

In other words, per the Stipulation, if the Debtors could produce true copies of their personal banking checks which demonstrated the “missing” payments had, indeed, been paid, then Wells Fargo would appropriately credit the Debtors’ mortgage debt.

On August 21, 2008, Wells Fargo filed a Verified Motion For Court to Enforce Terms of Stipulation and for Relief from the Automatic Stay (“Verified Motion”). Wells Fargo, by its Verified Motion asserts that Debtors have failed to comply with the terms of the Stipulation and requests an order of relief from stay. Debtors have filed a Response opposing the Verified Motion asserting that they were unable to comply with the terms of the Stipulation (i.e., produce "…true copies of all negotiable instruments (e.g. personal banking checks)") due to the fact that the mortgage payments were not processed by Wells Fargo in a manner in which cancelled checks were made available. Thus, Debtors maintain they were unable to comply due to impossibility of performance.

The Court held an evidentiary hearing on this matter on October 28, 2008. The Debtor, Ms. Burrier, testified that she asked her bank multiple times for proof that the payments were actually made to Wells Fargo, but was unable to obtain documentation—copies of their checks—because, according to her testimony, the checks were processed electronically and not negotiated in the more conventional manner—through the Federal Reserve System.

Ms. Burrier testified that she went to her bank, Academy Bank, on several occasions, seeking to obtain proof that the checks cleared and payments were debited from her account, but that such documentation—cancelled checks—was unavailable. Debtors did not present during their case a corroborating witness representative from Academy Bank. Nevertheless, the parties stipulated to the admission of Debtors' Exhibits A-D, which were copies of the Debtors' bank account statements for June, July, October, and December of 2007 (the months during which Wells Fargo claims payments were not made to it by the Debtors). Exhibits A-D reflected the following:

- Exhibit A reflected that a check numbered 4230 in the amount of $1,470.00 was processed electronically by "WFHM" on June 15, 2007.
- Exhibit B reflected that a check numbered 4238 in the amount of $1,470.00 was processed electronically by "WFHM" on July 16, 2007.
- Exhibit C reflected that a check numbered 4245 in the amount of $1,600.00 was processed electronically by "WFHM" on October 16, 2007.
- Exhibit D reflected that a check numbered 4182 in the amount of $1,600.00 was processed electronically by "WFHM" on December 17, 2007.

In addition, during the testimony of Ms. Burrier, Debtors' Exhibits E, F, G, and H were offered and admitted, without objection, during her testimony. Exhibits E-H reflected the following:

- Exhibit E is a check carbon for check number 4230 reflecting that the sum of $1,470.00 was paid to Wells Fargo.
- Exhibit F is a check carbon for check number 4238 in the amount of $1,470.00 payable to Wells Fargo.
- Exhibit G is a check carbon for check number 4245 in the amount of $1,600.00 payable to Wells Fargo.
- Exhibit H is a check carbon for check number 4182 in the amount of $1,600.00 payable to Wells Fargo.

Debtors maintain that they tried multiple times to comply with the Stipulation by obtaining copies of their check payments, front and back side, as required. However, Debtors assert that due to the method by which the payments were negotiated, Debtors were unable to obtain the documentation required by the Stipulation, specifically, cancelled checks.

Instead, the Debtors provided documentation to Wells Fargo of the alleged missed payments in the form of the Debtors' Academy Bank statements and carbon copies of checks. The Debtors' bank statements, which were not objected to by Wells Fargo and thus were admitted by this Court, indicate that payments in the identified amounts were debited from Debtors' bank account and sent to "WFHM." The Debtors' bank statements and carbons of the respective checks are persuasive evidence that payments were made by Debtors to Wells Fargo for the mortgage payments in question.…

CONCLUSIONS OF LAW

...

To this Court's surprise and consternation, neither party addressed the Check Clearing for the 21st Century Act. This is especially troubling since Wells Fargo was one of the proponents of this cost saving Act and modernization of banking. According to the Federal Reserve website regarding the Check Clearing for the 21st Century Act:

> The Check Clearing for the 21st Century Act (Check 21) was signed into law on October 28, 2003, and became effective on October 28, 2004. Check 21 is designed to foster innovation in the payments system and to enhance its efficiency by reducing some of the legal impediments to check truncation. The law facilitates check truncation by creating a new negotiable instrument called a substitute check, which permits banks to truncate original checks, to process check information electronically, and to deliver substitute checks to banks that want to continue receiving paper checks. A substitute check is the legal equivalent of the original check and includes all the information contained on the original check. The law does not require banks to accept checks in electronic form nor does it require banks to use the new authority granted by the act to create substitute checks.

For the uninitiated, such as was this Court before conducting its research in this matter, "check truncation" means:

> The conversion of data on a check into an electronic image after a check enters the processing system. *Check truncation eliminates the need to return canceled checks to customers.*

Moreover, the term "truncate" as defined by 12 U.S.C. §5002(18) means:

> to remove an original paper check from the check collection or return process and send to a recipient, in lieu of such original paper check, a substitute check, or, by agreement information relating to the original check (including data taken from the MICR line of the original check or an electronic image of the original check), whether with or without subsequent delivery of the original paper check.

Based upon this Court's own research, it appears that the "*sufficient information*" as required by Wells Fargo in the subject Stipulation may no longer be valid—and may no longer even be available—in today's marketplace. That is, Wells Fargo's demanded proof of payment, which was "*only valid, accurate, and true copies of the front side and back side of all negotiable instruments (e.g. personal banking checks) executed by the Debtors that indicate clearly and unequivocally that such negotiable instruments were negotiated by the Debtors' banking institution*," may no longer be required or available in the banking industry.

Key to this case and interpretation of the issues before the Court is "*what is the generally applicable industry standard*" with respect to electronically processed checks. The burden on this issue is on Wells Fargo as the party attempting to enforce the Stipulation. In particular, 12 U.S.C. §5002(18), which provides for "truncation," permits a bank to remove and destroy an original paper check and process it by transferring information, among other ways, "by agreement" evidently between banking institutions. *This Court has heard no testimony with respect to the practices and procedures of Wells Fargo with respect to the Check Clearing for the 21st Century Act and Wells Fargo's electronic check processing procedures.…*

The Debtors argue that "impossibility of performance" precludes the enforcement of the Stipulation. Specifically, Debtors argue that the terms of the Stipulation required them to provide documents that were *not available* to them—and possibly do not exist—due to the method by which Wells Fargo processed the payments. The most reasonable inference the Court can draw from the evidence is that the payments were processed electronically—that is, the checks were processed and cleared via the Check Clearing for the 21st Century Act processes. As a result, the mortgage payment checks sent by the Debtors to Wells Fargo were not returned to their bank, Academy Bank, and therefore the Debtors could not provide canceled checks to satisfy the "sufficient information" mandate of the Stipulation.

The Court concludes that the defense of "impossibility of performance" is subject to a very high standard, but that it *was* reached here. A party asserting an affirmative defense has the burden of proving the affirmative defense. In Colorado, an affirmative defense must be established by the party who asserts it. In order to establish the defense of impossibility of performance, it is necessary to demonstrate changed circumstances, which have made the "promise vitally different from what reasonably should have been within the contemplation of both parties when they entered into the contract." In this case, when the Stipulation was entered into, the evidence demonstrates that, *at least the Debtors,* did not have knowledge that the canceled checks—specifically "*valid, accurate, and true copies of the front side and back side of all negotiable instruments (e.g. personal banking checks) executed by the Debtors that indicate clearly and unequivocally that such negotiable instruments were negotiated by the Debtors' banking institution*"—as demanded in the agreement were unavailable. Generally, if the occurrence is reasonably foreseeable, the courts typically take the position that the promissor has assumed the risk of impossibility or frustration. However, no evidence was presented demonstrating that the Debtors could have reasonably foreseen the risk here.…If anything, Wells Fargo, being in the banking industry and more knowledgeable about and facile with the technology and the compliance features of the Check Clearing for the 21st Century Act, could have foreseen this risk. Nevertheless, Wells Fargo did not present to this Court any expert who could testify as to how electronic transfers occur.

Ms. Burrier's testimony regarding her reasonable efforts to obtain the cancelled checks is persuasive. The stipulated Debtors' Exhibits A-D show that certain payments were made to "WFHM." The Debtors' account was shown on the bank statements to have been debited in favor of "WFHM" for each of the months Debtors allegedly failed to make the respective mortgage payments. Moreover, the unrefuted evidence as contained in Debtors' Exhibits E-H, reflects that the corresponding checks were written by the Debtors for each of the respective months. The Court would have been greatly aided if material evidence, preferably expert testimony, explaining the process and mechanics of "paperless" electronic mortgage payments of the sort here performed, was provided. Wells Fargo provided no such evidence. Wells Fargo did not carry its burden of going forward, refuting Debtors' evidence of payment, or otherwise demonstrating lack of payments by the Debtors.…

It is evident from the testimony that neither party fully anticipated the difficulty of tracing checks in an electronic age. In this electronic age, the requirement that "sufficient information" constitutes *only* "valid, accurate, and true copies of the front side and back side of all negotiable instruments (e.g. personal banking checks) executed by the Debtors that indicate clearly and unequivocally that such negotiable instruments were negotiated by the Debtors' banking institution" may be obsolete. If Wells Fargo requires such precision, such precision will be required of it in enforcing stipulations. Wells Fargo did not meet its burden in this case and relief will be denied accordingly.…

The Court was correct in identifying the Check 21 Act as rendering it impossible for consumers to obtain the actual, deposited checks. Banks may legally destroy paper checks. Substitute checks, however, bear language that reads, "This is a legal copy of your check. You can use it the same way you would use the original check." The Debtors produced no substitute checks, and unfortunately for all parties, nothing about the Check 21 Act eliminates good ol' fraud. After losing its motion, Wells Fargo brushed up on its knowledge of check records and asked the Court to revisit the situation. The Court did so, beginning by giving more detail on Debtors' testimony in the first hearing.

> Debtor, Denon Arae Burrier, testified that she wrote checks for the post-petition months of June, July, October and December, 2007, and that these payments cleared her checking account with Academy Bank.
>
> When asked whether she altered or changed the July, 2007 check carbon copy that Debtor contended evidenced payment to Wells Fargo, Debtor replied:
>
> Absolutely not. Well, I wrote 'cleared' on it when it cleared the bank. And then, I wrote July of '07 when I was sending them over to Keven [counsel].

In support of her testimony, Debtor submitted evidence to the Court of bank statements showing debits from Debtors' Academy Bank account in the amount of the alleged mortgage payments for the months of June, July, October and December 2007.

> Debtor further testified that it was impossible to produce "sufficient information," as set forth under the terms of the Stipulation, to evidence payment to Wells Fargo because the alleged checks were "processed electronically."
>
> Debtor was adamant in her testimony that Wells Fargo debited her checking account for the alleged amounts in dispute. In regards to the alleged October, 2007 payment, Debtor's counsel asked Debtor on direct: "So the bank took the

money out of your account and gave it to Wells Fargo Home Mortgage?" Debtor replied, "Absolutely."

Debtor's counsel specifically asked Debtor whether she forged any of the carbon copies of the alleged checks. Debtor's counsel asked:

> So, in order to forge these, you would have had to write the check somewhere else, have the payment somewhere else come out of the bank or come up with a whole new set of carbon checks that had exactly the same check numbers and use those. Did you do that?

Debtor replied:

> No, I don't have time to do that. I have two small children.

In re Burrier, 403 B.R. 714, 717 (Bankr. D. Colo. 2009). The Court then summarized the new evidence and explained it was…ahem, adjusting…its prior ruling:

> Debtor, Denon Arae Burrier, appeared at the hearing. Debtor, Brandon Michael Burrier, failed to appear. Ms. Burrier indicated that both she and Mr. Burrier were invoking their Fifth Amendment right to not self-incriminate. Accordingly, Ms. Burrier did not sit for cross-examination or offer any evidence at the hearing.
>
> Katherine Lynn Works testified as the custodian of records from Academy Bank with regard to the subpoenaed bank records submitted with Wells Fargo's Supplement to Motion.
>
> Ms. Works testified that the subpoenaed bank records from Academy Bank were the true and correct bank records pertaining to the Debtors' checking account with Academy Bank. Specifically, with regard to the alleged payments made for the post-petition months of June, July, October and December, 2007, Ms. Works testified that:
>
> With respect to the alleged post-petition payment[s] allegedly payable to WFHM, referenced by Debtors [by] check number at the prior hearing, Academy Bank's records reflect that no such check number[s] were presented or negotiated on the account.

Ms. Works further testified that it would be impossible for a payment to appear on an Academy Bank statement and then disappear from a later version of the same month's statement. She testified that based upon her personal knowledge, the only way a payment could appear differently on one version of a statement versus another would be if a customer were to retrieve a statement upon request from a branch, and then alter the statement themselves.

> As further evidence that the bank statements previously submitted to the Court were altered, Ms. Works testified that one of the entries on the previously submitted June statement occurred on a Saturday, and no checks are presented for payment on any Saturday because the Federal Reserve is not open.

Id. at 719-720. The Court wrapped up the mess with a bow on top for the Debtors.

The Debtors misled the Court and Wells Fargo by submitting fraudulent evidence to the Court. The Debtors' fraudulent evidence was the product of careful, deliberate, specific and repeated acts. The Debtors intended to and did mislead the Court. Further, the Debtors made a calculated and an effective effort to mislead the Court; clearly, it was no accident.

The Debtors fraudulent testimony and evidence resulted in a misplaced and incorrect criticism of Wells Fargo's procedures and record keeping in the Court's prior opinion. The Court's prior criticism towards Wells Fargo was a mistake. It was a mistake based upon incorrect factual conclusions, as a result of what appears to be, and for which there is no other plausible explanation, than Debtors fabricated and altered evidence submitted in support of their position at the prior hearing. It is evident that the Debtor, Ms. Denon Arae Burrier, provided false testimony to the Court on October 28, 2008.

The testimony from Academy Bank was effective in overcoming and overwhelming the evidence submitted by the Debtors at the prior hearing. Moreover, the testimony from Academy Bank revealed the intrinsic fraud which led to a prior judgment founded on perjured testimony and altered evidence. In sum, the testimony of Academy Bank proved that the Debtors prior testimony was nothing more than a fabricated story —a lie. No payment was ever presented for payment or negotiated to Wells Fargo in June, July, October, or December, 2007.

Additionally, the testimony of Academy Bank proved that Debtors manipulated and lied to the Court and Wells Fargo during the course of this matter, beginning with the September 3, 2008 hearing and continuing for the duration of this matter. They specifically advised the Court and counsel that they could not obtain proof from Academy Bank that the alleged payments were paid to Wells Fargo because the payments were "electronically processed" and no copies were available. Ms. Works testified that Academy Bank would have a specific record of any payment processed through Academy Bank and that such evidence is routinely provided to customers at no charge or for a nominal $2.00 fee. Contrary to Debtor's testimony, the only impediment to obtaining proof of payment was the fact that the payments were never made.

As the prior judgment in this matter was premised upon false and misleading evidence supplied to the Court by the Debtors, it is

ORDERED as follows:

1. Wells Fargo Bank, N.A.'s Motion for Relief from Order Entered December 22, 2008 Entitled: Memorandum Opinion and Order Denying Wells Fargo Bank N.A.'s Motion for Court to Enforce Terms of Stipulation and For Relief from the Automatic Stay is GRANTED and the prior order is VACATED.

…

4. The United States Trustee shall advise the Court on or before April 10, 2009**,** as to its intentions with regard to this case and any necessary referrals to the United States Attorney upon due investigation.
5. Wells Fargo may seek sanctions for attorneys' fees and costs against the Debtors by separate motion filed on or before April 17, 2009.

Id. at 720-721.

Despite technology, all payment systems are vulnerable to fraud to at least some degree. The relevant consumer protection issue is how the risk of fraud is allocated. As the sections, *infra*, on electronic transfers and stored value cards illustrate, consumer's vulnerability varies by payment method.

2. Account Disclosures

In some ways, consumer protection related to bank accounts is theoretically similar to the investor protection bent of the Securities and Exchange Commission. The Truth in Savings Act regulates the disclosure of fees and costs, which can significantly erode the financial benefits of saving. Despite the "savings" in its name, the law and its corresponding Regulation DD, apply to both checking and savings accounts for consumers. 12 C.F.R. §1030.2(a). Required disclosures include descriptions of minimum balance requirements, applicable interest rates, and fees. These disclosures are supplemented by those required by the Gramm-Leach-Bliley Act related to privacy, those required by the Expedited Funds Availability Act related to withdrawals, and those required by the Electronic Funds Transfer Act related to electronic transactions. The result is cumulative, creating checking account disclosures that routinely exceed 100 pages. Pew Trust, *Hidden Risks: The Case for Safe Checking* (Apr. 2011) http://www.pewtrusts.org/en/research-and-analysis/reports/2011/04/27/hidden-risks. As with credit cards and mortgages, disclosures may be made more salient by using strong graphic design, but at bottom, innovations in banking have made the disclosures longer. Multiple methods of withdrawal and deposit give consumers flexibility but also produce additional terms, fees, and scenarios to disclose.

Keeping on top of disclosures is not an easy job, and the potential liability is large. These allegations against Bank of America are illustrative. In 2010, Plaintiffs Harold C. Rose and Kimberly Lane, filed a Class Action Complaint against Bank of America, N.A. alleging:

> On or about April 30, 2009 Defendants made available the following announcement to Plaintiffs Rose and Lane on their written account statements regarding their checking accounts with Defendant Bank of America:
>
>> Important Information: Please see the enclosed brochure for information about upcoming pricing changes to some deposit accounts. In addition, we've included information on how to help prevent or minimize deposit fees as well as details on improvements we've made to serve you better. If you would like more information, visit bankofamerica.com/pricingchanges.
>
> However, this announcement to Plaintiffs did not clearly and conspicuously (a) disclose which categories of fees (and their amounts) applicable to Plaintiffs' particular account services were changing; (b) direct Plaintiffs' attention to the particular changes for their accounts; and (c) inform Plaintiffs of the precise date when changes to fees on their accounts would occur. Defendants did not notify Plaintiff Rose in advance in writing that Defendants intended to charge Plaintiff Rose on a precise date on his personal deposit account a "check enclosure fee" of three dollars ($3.00) per each account statement period for returning cancelled checks to Plaintiff. Defendants did not notify Plaintiff Lane in advance in writing clearly and conspicuously that Defendants intended to charge Plaintiff Lane on a

> precise date on her personal deposit an increase from $5.95 to $8.95 per month for her monthly service charge. This announcement was also deficient in that it did not clearly differentiate the proposed specific changes in fees to Plaintiffs' account from the fee changes to the accounts of other Class members.

Class Action Complaint for Violations of the California Unfair Competition Law, *Rose v. Bank of America, N.A.*, 2010 WL 1056112 (Cal. Superior Ct. 2010) (No. BC433460). The Plaintiffs' claim under the California unfair competition law (UCL), Cal. Civ. Code §§17200 et seq., was based on the fact that the disclosures did not satisfy the Truth in Savings Act.

> Defendants' acts and practices in announcing pricing changes to the personal deposit accounts of Plaintiffs and other Class members as alleged herein constitute "unfair" business acts and practices in violation of the UCL because of the gravity of harm to Plaintiffs and the Class outweighs the utility of Defendants' practices and/or offends public policy, is immoral, unscrupulous, unethical and offensive, and causes substantial injury to Plaintiffs and the Class in that money was deducted from their personal deposit accounts by Defendants. Moreover, Defendants' wrongful conduct as described herein threatens an incipient violation of the The Truth In Savings Act and Regulation DD, or violates the policy or spirit of such laws because it effects are comparable to or the same as a violation of said laws.…Defendants' business acts and practices have caused injury to the Plaintiffs and members of the Class in that Defendants have improperly deducted since on or about June 10, 2009 money for increased service fees from their personal deposit accounts maintained at Defendant Bank of America, including but not limited to three dollars ($3.00) for check enclosures for Plaintiff Rose and from $5.95 to $8.95 for monthly service charges for Plaintiff Lane.

Id. The plaintiffs relied on state law because Congress stripped the Truth in Savings Act of a private right of action. The Ninth Circuit ruled that disobeying a federal law could create liability under a state law giving consumers the right to sue. The Supreme Court denied *certiorari* without comment. The Truth in Savings Act continues to create liability risk, much to the consternation of bankers.

3. Account Access

Consumers have no legal right to a bank account, only to be free from unlawful discrimination under ECOA when they seek an account. An estimated 25 million American adults are unbanked. Shawn Donnan & Demetri Sevastopulo, *U.S. Tries to Boost Access to 25m "Unbanked,"* FINANCIAL TIMES Nov. 30, 2015. These consumers incur hundreds of dollars each year from using alternative financial services, such as check cashers. Consumers may be denied an account based on a bank account reporting agency. As of 2016, the two largest are ChexSystems and Early Warning Services. These function similarly to the credit reporting agencies in terms of most banks being most users and furnishers of information. Designed to help banks avoid fraudulent customers, bank reporting agencies now are routinely used to guide decisions on whether consumers should be given requested accounts. If the report shows overdrafts, a consumer may be given an account with higher fees or more limited features. Jessica Silver-Greenberg, *Over a Million are Denied Bank Accounts for Past Errors*, N.Y. TIMES, July 30, 2013. Consumer advocates assert that the agencies have evolved into a substantial barrier to mainstream banking access, and need regulation beyond the Fair Credit Reporting Act.

B. Electronic Funds Transfer Act

The Electronic Funds Transfer Act (EFTA) is not as hip as it may sound. It was enacted in 1978 and signed into law by President Jimmy Carter. Its importance has grown in subsequent decades, however, as more and more transactions fall under the definition of an "electronic fund transfer." 15 U.S.C. §1693a(7). While there is uncertainty about whether things discussed *infra* such as prepaid calls or certain mobile payment services fall under the statute as currently drafted, it is clear that the EFTA applies to ATM (automated teller machine) transactions, debit card usage, and ACH transactions.

1. Debit Cards

Despite what my grandmother says, an ATM card and a debit card are the same thing. They are a card-based method for immediate access of bank funds. Hereinafter, this Assignment refers to debit cards. At the time a bank account is established, a consumer will nearly always receive a debit card or authorize the sending of such a card. One major use of the debit card is to facilitate routine transactions with the bank. Note that ATM stands for automated teller machine, and bank branches increasingly are holding facilities for ATMs, more than employee workplaces. Getting consumers to use debit cards to make deposits, withdrawals, balance inquiries, and the like reduces costs for banks. But some aspects of electronic access are costly.

Consumers have lamented ATM fees for years, but the law is clear. The fee itself—(even if $3.50 to withdraw $20 seems unconscionable to most consumers) is permissible, provided that the bank discloses the fee as required by the EFTA. In *Clemmer v. Key Bank Nat'l Ass'n*, 539 F.3d 349 (6th Cir. 2008), the court held that a consumer who pushes "yes" to acknowledge an on-screen notice that a fee "may be charged" has received sufficient notice of the subsequent charge. Interestingly, in *Clemmer*, the consumer got no traction from the fact that Key Bank did not, in fact, charge an ATM fee to certain consumers, including members of the military, non-customers conducting international transactions and non-customers using the ATM in the Cleveland Clinic (the plaintiff in *Clemmer* lived in Ohio). The consumer essentially argued that the bank should determine at the time of the transaction if a fee would actually be charged, and then either display no fee notice or state that the fee "will be charged." This type of real-time notice is precisely what consumers receive when they attempt to withdraw funds without overdraft protection and so is clearly technologically possible. The EFTA renders it legally unnecessary. The easiest EFTA disclosure cases to win, and therefore the ones that enforcement attorneys like to bring, are those where there is a complete omission of fees. The FDIC fined a bank and an affiliate for practices related to loading remaining financial aid money, less tuition, onto debit cards. Students were not informed of fees, such as those related to ATM withdrawals and the availability of no-cost ATMs in certain locations. *See* Kim Janssen, *Feds Fine Payment Card Firm Over College Students' Financial Aid*, CHI. TRIB. Dec. 24, 2015.

Debit cards also are used to pay for goods or services. The processing fees for merchants are lower when a consumer uses a debit card than a credit card, especially if the consumer enters a PIN. These transactions are cleared and settled immediately. Non-PIN debit transactions are authorized immediately at the point of sale, with a hold being placed on funds in the consumers' account, but the merchant gets paid (along with credit card transactions) a few days later. PIN or no-PIN, the EFTA requires that consumer be offered a written receipt for a debit transaction. 15 U.S.C. §1693d.

Fraud from debit card transactions is many multiples less than fraud from credit cards but the chip technology recently added to credit cards may bring the two products more in line. From the other direction, as no-PIN debit card transactions become more popular, their rate of fraud will be more similar to credit cards because they are processed in a similar way. The law, however, continues to differ on a consumer's liability for unauthorized use of a debit card versus a credit card. The EFTA allocates loss between the consumer's bank and the consumer for unauthorized use. 15 U.S.C. §1693g. Regulation E interprets the loss rules to apply to any "series of related unauthorized transfers." 12 C.F.R. §1005.6(b). In a parallel to rule for paper checks explained *supra* in *Marx v. Whitney*, consumers must review bank statements and report unauthorized transactions within 60 days. If the consumer fails to do so, any later transactions that could have been halted if the consumer had reported the unauthorized use fall on the consumer. This can include the entire amount of a consumer's account. Initially, the consumer's loss is limited to $50, even if the consumer wrote their PIN on their debit card with a Sharpie marker (true story from my dad's days as a banker). After two business days from when the consumer learns of the theft or risk of unauthorized use, the consumer's liability may increase to a total of $500 (including the prior $50) if the bank is not alerted. Some states have laws that are even more friendly to consumers, either by extending the deadline to report a lost or stolen card or by lowering the liability amount. *See, e.g.*, Mass. Gen. L. ch. 167B, §18 (limiting liability to $50 in all instances).

2. ACH and Bill Pay Systems

An Automatic Clearing House (ACH) payment is a direct debit from or direct credit to a bank account from another account. ACH payments result from a computerized system that relies entirely on electronic messages for communication. Unlike paper checks, ACHs are not governed by the U.C.C. and are not negotiable instruments under state law. While ACHs are squarely covered by the EFTA, another important source of rules are private agreements. NACHA is a non-profit association of clearinghouses that are themselves composed of banks that process ACH transactions. NACHA's Operating Rules are an important source of rules. From a consumer perspective, the most unfavorable aspects of the ACH rules relate to the finality of payment. After the settlement date, a payment cannot generally be retracted. To challenge a debit entry, the NACHA rules require a consumer to act within 15 calendar days of the statement being sent and must complete an affidavit in a specific form. Even after all that, NACHA says only vaguely that a recredit to the consumer's account should be "promptly" performed. There is also no law or policy that permits a consumer to withhold payment because of dissatisfaction with the purchase. This is a major reason that most retail purchases remain on credit cards, while ACH is used for routine bill pay such as utilities.

Businesses receive ACH payments for bills and initiate ACH payments for salaries, employee reimbursement, and the like. Consumer-initiated ACH payments took off in 2001 when NACHA changed its system to facilitate such transactions via the web. Estimates put the number of consumer ACH payments at more than $3 billion per year. A notable aspect of ACH is that consumers use it for both small routine transactions and large irregular ones. Its ubiquity is similar to credit cards; consumer use of ACH payments is probably more responsible for the decline in checking use than credit cards, which were in wide use for decades before 2001.

ACH systems also can be used to convert a paper check to an electronic image. This can happen either at the point-of-sale (in which case the consumer gets back the check after its image is captured) or in a companies' back offices. Many consumers learned the hard way that checks processed via conversion are processed on the next business day. This process makes it much harder for a consumer to exercise the right to stop payment on a check because the check may clear electronically as a conversion before the consumer can notify the bank of the desire to stop payment.

C. Other Payment Transactions

Banking is more than the process of payment as it usually includes a way to safeguard and store money, as well as transfer it. Payments are the core of banking in terms of numbers of transactions, however, and there are widely used payment methods that exist outside or at the margins of banking basics: checks and cards. Yet each of these systems present the identical legal issues for consumer protection. (No, not whether that dear lady in Nigeria really needs £1 million pounds in funds today from you, kind sir or madam.) The pervasive legal question is how much money can a consumer lose if something goes wrong from things like fraud, billing error, or mistake. For a good overview of consumer protection across payments, *see* Gail Hillebrand, *Before the Grand Rethinking: Five Things to Do Today with Payments Law and Ten Principles to Guide New Payments Products and New Payments Law*, 83 CHI.-KENT L. REV. 769 (2008).

1. Money Orders and Remittances

A money order is a check for a specified amount. The consumer pays cash to the issuing institution, which in the United States often is the U.S. Postal Service. The consumer fills in the name of the payee. Money orders are used as check substitutes by those without checking accounts or are used to pay those who refuse to accept cash or credit cards, usually out of concerns about security and processing fees, respectively. A few dozen countries, including Canada and Mexico, accept U.S. money orders, making these a useful cross-border payment method.

Remittances is an umbrella term used that describes consumers' payments to people living overseas. Immigrants frequently send money to family in their countries of origin. The World Bank reported that remittances from the United States exceeded $53 billion in 2014. Remittances can be made to and from commercial banks, wire services, and specialized remittance providers. A fee is charged for each transfer, creating a major industry. Bill Gates has noted that if the transaction costs on remittances worldwide were cut from where they are today at around 10 percent to an average of 5 percent, it would unlock $15 billion a year in poor countries. Bill Gates, *Innovation with Impact: Financing 21st Century Development* 12 (Nov. 2011), http://www.gatesfoundation.org/What-We-Do/Global-Policy/G20-Report.

Federal law now regulates remittances that originate in the United States. 15 U.S.C. §1693o-1. The statute creates baseline protections for remittance senders and requires disclosures of fees. It also creates an error resolution procedure that mimics the Electronic Funds Transfer Act.

2. Stored Value or Prepaid Cards

"Stored value card" is the term that has been coined to describe all of the other useful cards that do not meet the definition of debit or credit cards. (Okay, maybe "value" does not cover your expired rewards card you still have for that sandwich shop that went out of business last year.) Examples of stored value cards are gift cards, health care spending cards, and payroll cards. In fact, the term "prepaid card" is rapidly replacing stored value card as the generic term for these products. These cards may be physical and stored in your wallet, or digital and stored on your phone or accessed online via a code. Stored value cards may or may not be reloadable, and they may work at only a single location, called "closed-loop," or at multiple locations processed via a network such as Mastercard, called "open-loop."

Most stored value cards do not themselves "store" value; instead, they contain coding that permits a contemporaneous authorization of value stored elsewhere, such as in an account held by a prepaid issuer. Technology and consumer preference is evolving to permit transactions that are limited to the merchant and the consumer—without an intermediary. The Starbucks card is perhaps the only widely used system of this type as of 2016, and of course, it is closed-loop, useful only for paying at Starbucks. That said, Ronald Mann reports that Starbucks now loads $4 billion a year on its cards. Ronald Mann, *Payment Systems* 80 (6th ed. 2016). That is a lot of "cash" and caffeine.

The law governing stored value cards is as disparate as the items falling in the definition. The outcome is a number of lawsuits alleging unfair and deceptive practices with decidedly mixed results for consumers. The excerpt below illustrates that broad reach of stored value cards into all areas of law and life.

> The Plaintiff, Robert Reagan, was jailed overnight in the Rockdale, Georgia, County Jail on a charge that later was dropped. When booked, he turned over $764.00 in cash to his jailers. When released the next day, he was given in lieu of his cash a pre-paid debt card worth $764.00 issued by Central National Bank through Stored Value Cards. He had no option to get cash or a check instead. Simultaneously, he received from the jailers a packet of documents that included the Agreement, which was printed in illegible five-point type. The jailers did not tell Reagan that the Agreement was in the packet. And, Reagan did not know that the Agreement was in the packet. This Agreement, which Reagan had no opportunity to read and did not sign, included an arbitration clause. After Reagan brought in state court this punitive class action challenging fees attendant to using the card, Stored Value Card and Central National Bank removed the case to federal district court and filed a motion to compel arbitration.

Reagan v. Stored Value Cards, Inc., 608 Fed. Appx. 895 (11th Cir. 2015). The mandatory arbitration clauses in stored value card agreements are generally enforceable; the result is that most disputes end in a non-public resolution by a private arbiter. The fees that Mr. Reagan challenged were substantial compared with the transactional costs of cash. Getting "cash back" at a point-of-sale in a store costs nearly $1, and even *automated* customer service cost 50 cents. Regardless of whether the released person used the card, a weekly account fee of $3.50 was charged beginning about two days after the person left jail. In the very tiny print, the person learned that there was an option to get a check for the balance on the card—for $9.95.

The move to prepaid cards was animated by businesses' desire to reduce costs for processing checks and credit cards, and to speed up transactions at check out. The preparation and issuance of a paper check for payroll will be several dollars, equal to about an hour of minimum wage pay. With a payroll card, the business pays only a few cents. The government jumped into this system for disbursing benefits such as food stamps and disability benefits. The consumer protections for prepaid cards, however, are much less consistent than their benefits to businesses. Several kinds of fees may be imposed, including charges to check the balance on a card, reach a customer service representative, or obtain a routine or additional account statement.

The CFPB is poised to issue rules that would expressly bring prepaid products within the ambit of the EFTA as prepaid accounts. Its applicability under current law is debatable. The definition of "electronic fund transfer" incorporates broad definitions of "account" and "financial institution," *see* 12 C.F.R. §1005.2(b) and (i), but the explicit addition of "payroll cards" to Regulation E, creates an argument that the exclusion of other stored value cards was intentional. The CFPB's proposed rules would give consumers protection from unauthorized transactions or lost cards by applying the EFTA's provisions on limited liability and error resolution. It would also establish additional origination disclosures and periodic statements. To check whether these rules have been adopted—and to learn some valuable research skills along the way—visit www.ecfr.gov and "Browse" to Title 12, Chapter X, Part 1005.

The type of stored value card with the longest-standing regulatory regime is gift cards. Federal law provides that gift cards must not expire for at least five years from the date of activation and generally limit inactivity fees to certain circumstances, such as if there has been no transaction for at least 12 months. 12 C.F.R. §1025(d) and (e). State laws supplement these protections. In several states, there cannot be any expiration date or any fees associated with a gift card. *See, e.g.*, Fla. Stat. Ann. §501.95 (West). In other states, the emphasis is on additional disclosures. *See, e.g.*, N.Y. Gen. Bus. Law §396-i (McKinney). While more information has its appeal, the size of a gift card makes effective disclosure difficult—a point made in the prior assignment about disclosure on mobile devices.

3. Mobile Payments

Mobile payments refer to using some aspect of a cellular phone to pay. The range of methods is tremendous. In the southern half of the globe, mobile payment often refers literally to paying someone by transferring purchased cell phone minutes to them. In the United States, mobile payments most commonly involve a third-party, non-cellular carrier, although the cell phone companies also have direct carrier billing programs. The latter are used widely to make small charitable contributions via SMS (short messaging service) in partnership between non-profits and wireless carriers. Stephanie Strom, *A Deluge of Donations Via Text Message*, N.Y. TIMES (Jan. 15, 2010) at http://www.nytimes.com/2010/01/19/us/19charity.html?_r=0. Wireless payment programs generally provide many fewer consumer protections for unauthorized transactions or disputed charges than traditional payments when federal law applies. The California Public Utilities Commission requires that consumers be given the right to withhold payments for disputed charges. Most carriers cap payments at a small amount, limiting the utility of direct payments that appear on a cellular bill.

Applications downloaded onto smart phones are the payment trend that is waiting to take off in the United States. But that sentence could have been written in any of the last ten years, and it is not clear when mobile will truly become widespread. Part of the lag is that smart phone penetration is estimated at about 60 percent; that means many consumers do not have the ability to use mobile payment applications. These apps rely on smart phone technologies such a QRC (quick response codes) or NFC (near-field communication). Even among smart phone users, there is no dominant payment app, despite fierce competition. Given the rapid changes in this area, a useful exercise to update this paragraph is to whip out your smart phone and search for "payment" and see what is popular. (This also gives you an excuse for using your phone in class. Not a good excuse, but better than "I was texting my mom.")

While ApplePay and GoogleWallet garnered brand-name publicity at launch, neither is widely used as of 2016. Similarly big retailers such as Target and Walgreens have implemented point-of-sale terminals that accommodate mobile payment technology, but if you've waited in line recently at these stores, you may have observed that nearly all transactions are still on plastic cards. As a hint that mobile pay remains in the netherworld (a.k.a. Silicon Valley), the buzzword used to describe mobile pay is "ecosystem." This is a sure sign that regulators are far from grappling with the consumer protection issues in mobile pay. Law may need to wait for a bigger market before it can sensibly regulate (although note that some lawmakers seem to think that "sensible regulation" is an oxymoron). On the other hand, law waited to regulate subprime mortgages on the mistaken belief that these mortgages were uncommon and anyone paying attention in 2008 knows how that worked out for the world economy.

Mobile payment applications are tools for transferring currency. They are not innovations in the nature of money itself, although they are moves away from the idea of currency as something physical toward a digital phenomenon. The next advance is to digital currency. A little book with amazingly big ideas about the past and future of money is Bill Maurer, *How Would You Like to Pay? How Technology is Changing the Future of Money* (Duke 2015).

Problem Set 19

19.1. Stephanie French is a bit of a spendthrift, between indulging her 13 cats in kitty daycare and her shoe-shopping problem. Although she makes $60,000 as a nanny, she waits anxiously for her paycheck on the first day of the month. On Wednesday March 1, at 8:37 A.M., as soon as she dropped the older kids at school, Stephanie wheeled the babies in the stroller to the nearest bank branch. She presented her nanny paycheck of $4,025 for deposit and asked for $700 in cash. The teller, Enrique, said that Stephanie could only have $100 and cheerfully described her options of 100 $1 bills, 20 $5 bills, 10 $10 bills, etc. Stephanie interrupted and demanded "at least $500—that's the minimum that I need to pay the cat sitter." Enrique refused, repeating his offer of $100, but asked if Stephanie had any pictures of her cats. Can Enrique, on behalf of the bank, limit Stephanie's withdrawal to $100? If you are her cat sitter wanting payment, do you have a work around for this situation? *See* 12 C.F.R. §229.12.

19.2. Jonah Rome has a checking account and a savings account at Slumber Bank. He remembers receiving a notification from his bank asking him if he would like the bank to help him "rest easy at night" by having the bank cover overdrafts on his account. The notice from Slumber revealed that the cost of such overdraft protection would be $35 per instance; it also posed the question "What is your reputation worth?" in asking consumers to consider carefully the decision to toss the notice and fail to have overdraft protection. Jonah, however, felt confident that he would always have ample money and tossed the opt-in notice. Since then, he has tried to avoid overdrawing his account, which has become harder since his company quit paying a bonus. Jonah now lives paycheck to paycheck, and the end of the month is tight. On a date last Saturday, Jonah was mortified to have his debit card declined at the restaurant. Luckily, he had enough cash in his wallet to pay the bill, and he satisfied himself that the only damage was to his ego. However, when he got his bank statement the next week, the balance was lower than he expected. A review of the statement revealed that the bank had honored his automatic bill payment of $10 to the United Way charity, even when Jonah had only $5 in his account. The bank had then charged him a $35 fee for overdraft protection. Jonah likes to be generous, but he is fuming that his $10 charitable donation turned into a $45 cost to him. Did the bank violate Regulation E? *See* 12 C.F.R. §§1005.2 and 1005.17.

19.3. Deciding (mistakenly) that the third year of law school is a snooze, Laura recently took a part-time job as a nanny. The family has a stack of prepaid cards from HardCard of $100 each, and every Friday, Laura receives a card as her pay for eight hours of nanny work. She has let the cards accumulate but with the last spring break of her life coming up, Laura went to the mall to load up on suits and sundresses. Unfortunately, the cards were declined…every last one of them. The merchant explained that HardCard had been having "technical difficulties" for the last week and that Laura would have to pay a different way. Without enough cash or remaining credit on her credit card, Laura had to leave the store empty-handed, except for her stash of HardCards. When she called the number on the back of the card (not even toll-free), the customer service representative repeatedly assured Laura that the cards had value but that there was an "access delay." Enraged, Laura has had to break her vow to never re-enter the school law library to find out whether she has any legal claims against HardCard. Assume the first source that she scans is this assignment; additionally, *see* 12 C.F.R. §1005.20(b)(2) and (f)(2). What laws might give her a claim against HardCard? Also, does Laura have any claim against the family?

19.4. Robin Gray loves to pay. Specifically, she loves to pay with apps loaded onto her phone. When she woke up in a haze at 11:00 A.M. on Friday morning, she realized that she had left her phone in a bar the prior evening. Efforts to locate the phone on Friday afternoon failed, and Robin's phone has now been missing 18 hours. On Saturday morning, Robin starts trying to contact the mobile payment applications. First problem: she cannot remember all the payment applications loaded on the phone, but she does know that some of them are linked to her primary checking account. Second problem: she cannot locate a phone number for her favorite mobile pay app. Robin has $800 on deposit with application. She has emailed customer service but received an auto response that it is outside business hours and her message will be read Monday through Friday, 9:00 A.M. to 4:00 P.M. What should she do? Is her $800 safe if someone hacks her phone? (Her passcode was 1234.)

Assignment 20. Online Transactions

Consumers can go online to conduct nearly all possible transactions with businesses. From the birth of the World Wide Web, businesses have recognized the sales potential of a platform that is available nearly anytime and anywhere at a consumer's convenience. Generally, consumer protection law is the same whether the transaction is in person or via the Internet. Contract law, including warranty law, applies, as do prohibitions against deceptive advertising or unfair sales practices. Similarly, lending online is regulated by TILA, ECOA, and similar laws.

Online transactions present challenges of information for consumers and therefore require more trust. Disclosures may be hard to display digitally, especially on smaller devices such as mobile phones and tablets. Consumers cannot literally eyeball whether an Internet discount reseller of goods actually has a reasonable quantity for sale, or is merely displaying a picture of the good to drive traffic to its site. This is a digital bait and switch, with the basic problems not unlike the in-person transaction discussed in Assignment 5. Consumers may be easier to fool with a fancy website than in the non-virtual world where they can assess whether a retail business is in a well-run shopping center. Similarly, consumers may find a video sales pitch on a site to be charming, but in real life would find a salesperson to have shifty eyes. As with mail order, consumers take a leap of faith when they input payment and personal information into a web form and hope to receive a timely delivery of quality goods.

Businesses also face risks of identity fraud from consumers who buy online. The odds of getting away with the crime favor the con artist who types a verification code off a stolen credit card into a website over one who shows up in a retail store with a card and must show a stolen or fake photo identification. The ease of online transactions is attractive, but the risk of being scammed is higher for both consumers and businesses.

A. Contracting Online

As with most things in life, transacting online goes best if one uses common sense. Just as a consumer can read context clues at a mall (bare shelves; uninformed staff), online users can use shortcuts or proxies for legitimacy (a domain name suffix other than .com, .gov, or .org; no privacy verification; poor or outdated site design). The actual purchase online versus at a brick-and-mortar is the same at its most basic level. Courts have recognized that commerce is still commerce, applying contract law to digital transactions. "While new commerce on the Internet has exposed courts to many new situations, it has not fundamentally changed the principles of contract." *Register.com, Inc. v. Verio, Inc.*, 356 F.3d 393, 403 (2d Cir. 2004). The Uniform Commercial Code (U.C.C.) and common law of contracts govern online transactions.

When an online transaction requires a written contract, an electronic contract and an electronic signature satisfy the statute of frauds. The fact that a consumer did not put pen to paper to agree to a transaction does not invalidate the contract. Any "electronic sound, symbol, or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record" counts as a signature. Electronic Signatures in Global and National Commerce Act, 15 U.S.C. §7001 (2000).

Non-virtual transactions usually involve dealing with salespeople and clerks, and conversations can happen about what types of risk the consumer is taking when purchasing a product. Any particularly pertinent information can be vocalized to the consumer at the moment of purchase and things like the terms of a return policy can be disclosed via a "cashwrap" receipt (so-called because it is literally wrapped around a customer's change).

This communication is not as simple online. To communicate the terms and conditions of the transaction online early online retailers took the idea of an End User License Agreement (EULA) from software transactions—where no physical good was being purchased, only a program—and created Terms of Service or Terms of Use. There are two main types of EULAs: clickwraps and browsewraps. Sometimes consumers are confronted with a hybrid agreement. In a clickwrap/browsewrap hybrid, the consumer must still click a box to indicate agreement with the terms, but the consumer is not visually confronted with the text of the agreement, only with a link.

The following case involves a consumer who had filed suit against the social networking platform Facebook. In deciding a motion to transfer venue, the court examines a forum-selection clause contained in Facebook's Terms of Use and discusses the differences between clickwraps, browsewraps, and hybrids.

Fteja v. Facebook, Inc.

841 F. Supp. 2d 829 (S.D.N.Y. 2012)

HOLWELL, District Judge.

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[Plaintiff Mustafa] Fteja, a resident of Staten Island, New York, "was an active user of facebook.com." Fteja "ha[d] been adhering to Facebook['s] terms of service" and "help[ing] build the Facebook community by adding content and signing up new members.…" But on September 24, 2010, Facebook allegedly disabled Fteja's account on September 24, 2010 "without warning" and "without reason."

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DISCUSSION

The Court first considers "whether the action could have been brought in the transferee forum," here the Atl. Recording Corp. v. Project Playlist, Inc., 603 F. Supp. 2d 690, 695 (S.D.N.Y. 2009). That requires the Court to determine whether the Northern District of California would be a proper venue for this action and whether it would have jurisdiction over this action and over Facebook. See Unlimited Care, Inc. v. Visiting Nurse Ass'n of E. Mass., Inc., 42 F. Supp. 2d 327, 333 (S.D.N.Y. 1999) ("A court electing to transfer an action, may only transfer such action to a district where it might have been brought initially, (i.e., a district where defendant is subject to personal jurisdiction and venue would be proper).").

The Northern District of California would be a proper venue for this action. Venue is proper, inter alia, in "a judicial district in which a substantial part of the events or omissions giving rise to the claim occurred.…" 28 U.S.C. §1391(a)(2). The Northern District of California would be such a district in this action because the nub of Fteja's claim is that Facebook wrongfully disabled his account and the employees responsible for disabling accounts work at Facebook's headquarters in Palo Alto, California which is in the Northern District of California.

The Northern District of California would have subject matter jurisdiction over this action on the basis of the parties' diversity of citizenship. And that court would have personal jurisdiction over Facebook because the presence of Facebook's headquarters in Palo Alto suggests that Facebook has had "continuous and systematic general business contacts" with California. Metro. Life Ins. Co. v. Robertson-Ceco Corp., 84 F.3d 560, 568 (2d Cir. 1996).

The next question, then, is whether Facebook has made a "clear and convincing showing that transfer is proper," Hershman v. Unumprovident Corp., 658 F. Supp. 2d 598, 600 (S.D.N.Y. 2007), that is, that transfer will advance "the convenience of parties and witnesses" as well as "the interest of justice." N.Y. Marine & Gen. Ins. Co. v. Lafarge N. Am., Inc., 599 F.3d 102,112 (2d Cir. 2010).

On that score, the parties devote substantial attention to the forum selection clause contained in the terms and conditions that govern Facebook users' accounts, known as the Terms of Use at the time that Fteja signed up for an account. That clause provides as follows:

> You will resolve any claim, cause of action or dispute ("claim") you have with us arising out of or relating to this Statement or Facebook exclusively in a state or federal court located in Santa Clara County. The laws of the State of California will govern this Statement, as well as any claim that might arise between you and us, without regard to conflict of law provisions. You agree to submit to the personal jurisdiction of the courts located in Santa Clara County, California for the purpose of litigating all such claims.

As an initial matter, Fteja argues that "[t]here is no proof that [he] agreed to a forum selection clause" and that he does "not remember agreeing to [the] forum selection clause or agreeing to any Facebook agreement." Impossible, says Facebook: "a putative Facebook user cannot become an actual Facebook user unless and until they have clicked through the registration page where they acknowledge they have read and agreed to Facebook's terms of use.…"

As a matter of logic, Facebook appears to be correct. Declarations filed by Facebook employees, screenshots submitted by Fatouros, and Facebook's current website of which the Court takes judicial notice suggest that the Facebook sign-up process works as follows. A putative user is asked to fill out several fields containing personal and contact information. See http://www.facebook.com. The putative user is then asked to click a button that reads "Sign Up." After clicking this initial "Sign Up" button, the user proceeds to a page entitled "Security Check" that requires a user to reenter a series of letters and numbers displayed on the page. Below the box where the putative user enters that letter-number combination, the page displays a second "Sign Up" button similar to the button the putative user clicked on the initial page. The following sentence appears immediately below that button: "By clicking Sign Up, you are indicating that you have read and agree to the Terms of Service." The phrase "Terms of Service" is underlined, an indication that the phrase is a hyperlink, a phrase that is "usually highlighted or underlined" and "sends users who click on it directly to a new location—usually an internet address or a program of some sort." United States v. Hair, 178 F. App'x. 879, 882 n.3 (11th Cir. 2006).

In order to have obtained a Facebook account, Fteja must have clicked the second "Sign Up" button. Accordingly, if the phrase that appears below that button is given effect, when Fteja clicked "Sign Up," he "indicat[ed] that [he] ha[d] read and agree[d] to the Terms of Policy."

However, "[w]hile new commerce on the Internet has exposed courts to many new situations, it has not fundamentally changed the principles of contract." Register.com, Inc. v. Verio, Inc., 356 F.3d 393, 403 (2d Cir. 2004). And one such principle is that "[m]utual manifestation of assent, whether by written or spoken word or by conduct, is the touchstone of contract." Specht v. Netscape Commc'ns Corp., 306 F.3d 17, 29 (2d Cir. 2002). Hence the threshold requirement that the forum selection "clause was reasonably communicated to the party resisting enforcement." Phillips v. Audio Active, Ltd., 494 F.3d 373, 383 (2 Cir. 2007).

In that regard, the Second Circuit has held that "a consumer's clicking on a…button does not communicate assent to contractual terms if the offer did not make clear to the consumer that clicking on the…button would signify assent to those terms." Specht, 306 F.3d at 29-30. In *Specht*, the Second Circuit declined to enforce an arbitration clause to which a user purportedly agreed when he clicked on a button to download software. The terms and conditions were not visible anywhere on the screen containing the download button. Rather, "[t]he sole reference to" the terms and conditions "was located in text that would have become visible to plaintiffs only if they had scrolled down to the next screen where there was the following sentence: 'Please review and agree to the terms of the *Netscape SmartDownload software licensing agreement before downloading and using the software*.'" Id. The just italicized language appeared underlined and if a user "clicked on the underlined invitation to review and agree to the terms, a hypertext link would have taken the user to a separate webpage entitled 'License & Support Agreements.'" Id. at 23-24. That page included the arbitration clause. See id. at 24. "[I]n circumstances such as these, where consumers are urged to download free software at the immediate click of a button," the Court of Appeals held that "a reference to the existence of license terms on a submerged screen is not sufficient to place consumers on inquiry or constructive notice of those terms." Id. at 32.

Specht does not squarely control this case because the second Sign-Up page's reference to the Terms of Use appeared immediately below the "Sign-Up" button. Yet this case does have something in common with *Specht*: the fact that the terms and conditions were not displayed on the page where the user purportedly assented to the terms. Instead, those terms were visible only by clicking on a hyperlink. The Terms of Use therefore appear to be a kind of so-called "browsewrap" agreement, "where website terms and conditions of use are posted on the website typically as a hyperlink at the bottom of the screen." Hines v. Overstock.com, Inc., 668 F. Supp. 2d 362, 366 (E.D.N.Y. 2009). Cf. Pollstar v. Gigmania Ltd., 170 F. Supp. 2d 974, 981 (E.D. Cal. 2000) ("[A] browse wrap license is part of the web site and the user assents to the contract when the user visits the web site.").

Several courts have enforced browsewrap agreements. See, e.g., Ticketmaster L.L.C. v. RMG Technologies, Inc., 507 F. Supp. 2d 1096, 1107 (C.D. Cal. 2007) (plaintiff was "highly likely to succeed in showing that Defendant received notice of the Terms of Use and assented to them by actually using the website" where site displayed a warning that "Use of this website is subject to express Terms of Use" and "[t]he underlined phrase 'Terms of Use' is a hyperlink to the full Terms of Use").

However, several of these cases appear to have turned on the user's constructive knowledge of the hyperlinked terms. Indeed, "[m]ost courts which have considered the issue…have held that in order to state a plausible claim for relief based upon a browsewrap agreement, the website user must have had actual or constructive knowledge of the site's terms and conditions, and have manifested assent to them." Cvent, Inc. v. Eventbrite, Inc., 739 F. Supp. 2d 927, 937-38 (E.D. Va. 2010). And at least one court has declined to enforce terms and conditions that "only appear[ed] on [a] website via a link buried at the bottom of the first page" where users "are not required to click on that link, nor are they required to read or assent to the Terms of Use in order to use the website or access any of its content." Id.

Moreover, the cases in which courts have enforced browsewrap agreements have involved users who are businesses rather than, as in *Sprecht* and in this case, consumers. Cf. Mark Lemley, *Terms of Use*, 91 MINN. L. REV. 459, 472 (2006) ("An examination of the cases that have considered browsewraps in the last five years demonstrates that the courts have been willing to enforce terms of use against corporations, but have not been willing to do so against individuals."). Indeed, one prominent commentator has hypothesized that "[c]ourts may be willing to overlook the utter absence of assent only when there are reasons to believe that the [allegedly assenting party] is aware of the [other party's] terms." Id. at 477. And based on the reasonable supposition that such "awareness may be more likely with corporations than individuals, perhaps because corporations are repeat players," that commentator has argued "that if courts enforce browsewraps at all, enforcement should be limited to the context in which it has so far occurred—against sophisticated commercial entities who are repeat players." Id. at 464, 477.

On the other hand, it is not clear that these countervailing considerations apply to Facebook's Terms of Use. First, Fteja's allegation that he complied with the Terms of Use suggests that he had constructive knowledge of the Terms of Use, though it is not clear from the complaint when he acquired that knowledge and he denies that he read the terms before signing up for his Facebook account.

Second, the Terms of Use were not exactly a true browsewrap license "in which the user does not see the contract at all but in which the license terms provide that using a Web site constitutes agreement to a contract whether the user knows it or not." Lemley, *Terms of Use*, 91 MINN. L. REV. at 460. Indeed, in a pure-form browsewrap agreement, "the website will contain a notice that—by merely using the services of, obtaining information from, or initiating applications within the website—the user is agreeing to and is bound by the site's terms of service." United States v. Drew, 259 F.R.D. 449, 462 n.22 (C.D. Cal. 2009). In other words, a browsewrap agreement usually involves a disclaimer that by visiting the website—something that the user has already done—the user agrees to the Terms of Use not listed on the site itself but available only by clicking a hyperlink. Here, by contrast, the second Sign-Up page indicated that additional action beyond merely visiting that page, namely, clicking "Sign-Up," would manifest agreement to the Terms of Use.

In that sense, Facebook's Terms of Use have something in common with so-called "clickwrap" licenses, "in which an online user clicks 'I agree' to standard form terms.…" Lemley, *Terms of Use*, 91 MINN. L. REV. 459; Cf. Drew, 259 F.R.D. at 462 n. 22 ("Clickwrap agreements require a user to affirmatively click a box on the website acknowledging awareness of and agreement to the terms of service before he or she is allowed to proceed with further utilization of the website."). A clickwrap agreement "presents the potential licensee (i.e., the end-user) with a message on his or her computer screen, requiring that the user manifest his or her assent to the terms of the license agreement by clicking on an icon." Register.com, Inc. v. Verio, Inc., 356 F.3d 393, 403, 429 (2d Cir. 2004).

"Because the user has 'signed' the contract by clicking 'I agree,'" even commentators who have called for limits on browsewrap agreements find "nothing inherently troubling about enforcing clickwrap licenses." Lemley, *Terms of Use*, 91 MINN. L. REV. at 466. And the courts appear to share that view, for "[c]lickwrap agreements "have been routinely upheld by circuit and district courts." Drew, 259 F.R.D. at 462 n. 22. Indeed, numerous courts, including a number of courts in this Circuit, have enforced forum selection clauses in clickwrap agreements. See, e.g., Segal v. Amazon.com, Inc., 763 F. Supp. 2d 1367 (S.D. Fla. 2011).

Yet Facebook's Terms of Use are not a pure-form clickwrap agreement, either. While the Terms of Use require the user to click on "Sign Up" to assent, they do not contain any mechanism that forces the user to actually examine the terms before assenting. By contrast, in assenting to a clickwrap agreement, "users typically click an 'I agree' box after being presented with a list of terms and conditions of use…" Hines, 668 F. Supp. 2d at 366. That aspect of a clickwrap agreement ensures that "potential licensees are presented with the proposed license terms and forced to expressly and unambiguously manifest either assent or rejection prior to being given access to the product." Register.com, 356 F.3d at 429.

Courts have not overlooked this feature. For example, the Second Circuit in *Specht* found a "signal difference" between the software for which the defendant supplied only hyperlinked terms and other software for which users "were automatically shown a scrollable text of that program's license agreement and were not permitted to complete the installation until they had clicked on a 'Yes' button to indicate that they accepted all the license terms." Specht, 306 F.3d at 22-23. In addition, another court has interpreted the clickwrap case law for the proposition that, "[a]s a rule, a clickwrap is valid where the terms of the agreement appear on the same screen with the button the user must click to accept the terms and proceed with the installation of the product." Grosvenor v. Qwest Commc'ns Int'l, Inc., No. 09-cv-2848, 2010 U.S. Dist. LEXIS 109884, 2010 WL 3906253, at *2 (D. Colo. Sept. 30, 2010) (declining to enforce arbitration clause in clickwrap agreement where terms did not appear on the same page as the "Yes" box).

Thus Facebook's Terms of Use are somewhat like a browsewrap agreement in that the terms are only visible via a hyperlink, but also somewhat like a clickwrap agreement in that the user must do something else—click "Sign Up"—to assent to the hyperlinked terms. Yet, unlike some clickwrap agreements, the user can click to assent whether or not the user has been presented with the terms.

What result follows? Have terms been reasonably communicated where a consumer must take further action not only, as in a clickwrap agreement, to assent to the terms but also, as in a browsewrap agreement, to view them? Is it enough that Facebook warns its users that they will accept terms if they click a button while providing the opportunity to view the terms by first clicking on a hyperlink?

In answering that question, it is tempting to infer from the power with which the social network has revolutionized how we interact that Facebook has done the same to the law of contract that has been so critical to managing that interaction in a free society. But not even Facebook is so powerful.…[T]he Court of Appeals has used a rather simple analogy. "The situation might be compared to one in which" Facebook "maintains a roadside fruit stand displaying bins of apples." Register.com, 356 F.3d at 401. For purposes of this case, suppose that above the bins of apples are signs that say, "By picking up this apple, you consent to the terms of sales by this fruit stand. For those terms, turn over this sign."

In those circumstances, courts have not hesitated in applying the terms against the purchaser. Indeed, in *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 587 (1991), the Supreme Court upheld a forum selection clause in fine print on the back of a cruise ticket even though the clause became binding at the time of purchase, and the purchasers only received the ticket some time later. See id.

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There is no reason why that outcome should be different because Facebook's Terms of Use appear on another screen rather than another sheet of paper. What is the difference between a hyperlink and a sign on a bin of apples saying "Turn Over for Terms" or a cruise ticket saying "SUBJECT TO CONDITIONS OF CONTRACT ON LAST PAGES IMPORTANT! PLEASE READ CONTRACT-ON LAST PAGES 1, 2, 3"? Shute, 499 U.S. at 587. The mechanics of the internet surely remain unfamiliar, even obtuse to many people. But it is not too much to expect that an internet user whose social networking was so prolific that losing Facebook access allegedly caused him mental anguish would understand that the hyperlinked phrase "Terms of Use" is really a sign that says "Click Here for Terms of Use." So understood, at least for those to whom the internet is in an indispensable part of daily life, clicking the hyperlinked phrase is the twenty-first century equivalent of turning over the cruise ticket. In both cases, the consumer is prompted to examine terms of sale that are located somewhere else. Whether or not the consumer bothers to look is irrelevant. "Failure to read a contract before agreeing to its terms does not relieve a party of its obligations under the contract." See Centrifugal Force, Inc. v. Softnet Commc'n, Inc., No. 08 Civ. 5463, 2011 U.S. Dist. LEXIS 20536, 2011 WL 744732, at *7 (S.D.N.Y. Mar. 1, 2011) (enforcing clickwrap agreement in breach of contract action). Here, Fteja was informed of the consequences of his assenting click and he was shown, immediately below, where to click to understand those consequences. That was enough.

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[T]he Court concludes that Fteja assented to the Terms of Use and therefore to the forum selection clause therein. If that is so, Fteja agreed to litigate all disputes regarding his Facebook account "exclusively in a state or federal court located in Santa Clara County," California. The federal court for that county is the Northern District of California.…Facebook's motion to transfer is granted.

Although courts apply traditional principles of contract law and evaluate whether the consumer manifested assent to the agreement, businesses should be careful when designing their terms of service/EULAs. State and international law varies on what must be included and what will be held enforceable.

The procedural posture of the *Facebook* case illustrates another problem with online transactions: determining the "place" of the transaction. While choice of law clauses can resolve the law of the contract, the harder issues emerge when businesses try to escape the application of criminal or regulatory laws by arguing that the transaction occurs in "their" headquarters. Most courts have held that the substantive law that applies is that of the consumer's location. *See* Erin O'Hara, *Choice of Law in Internet Transactions: The Uneasy Case for Online Consumer Protection*, 153 U. PA. L. REV. 1883 (2015). The effect of this for online commerce—and lawyers working in it—is that there are a lot of 50-state surveys of laws and efforts to create operations that comply with the law of all states.

B. Shopping Online

The FTC's advice for online shopping highlights the similarities of issues with traditional consumer commerce: know who you are dealing with, know what you are buying, and know the terms. The challenge is that with online transactions it can be hard to determine some of these things. Also, there are added costs of shipping, confusion about applicable taxes, and a variety of refund policies.

A few examples of consumer protection issues from online shopping illustrate how the lack of human interaction and information problems can create trouble. Travel discounter Priceline faced a class action lawsuit alleging that it did not adequately inform consumers that, in addition to the price that the consumer "named" and that was accepted, the hotels they stayed in may charge them a "resort fee." According to the plaintiffs, Priceline knew about the hotels' mandatory fees charged and did not disclose this information to consumers to create a misperception of a lower price. Maya Rajamani, *Priceline Can't Escape Resort Fee Suit, Class Says*, Law360.com, (Oct. 26, 2015), http://www.law360.com/articles/718782.

Websites also may get in trouble with policies designed to create "sticky" customers. Some websites offered post-transaction rebates or shipping discounts that required a consumer to agree to a monthly subscription charge. The site used the consumer's previously entered payment information to process these subscription charges. Because the consumer did not enter payment information, they believed this "rebate" or "discount" was free. Under the Restore Online Shoppers' Confidence Act, this practice requires full disclosure of the subscription and forbids reuse of the consumer's payment information from a prior one-off transaction. 15 U.S.C. §8401.

Other websites may border on misleading consumers by nature of their rapid growth. Etsy began as an online marketplace to purchase one-of-a-kind, handmade goods from artists and craftsmen. As it grew, it offered a wider range of goods for sale, including those mass-produced. Etsy modified its terms of use for sellers and its disclosures to consumers, but confusion may continue as its initial reputation endures after changes in business practice. Liz Stinson, *Why Etsy's Future Depends on Redefining "Handmade,"* WIRED.COM (Apr. 19, 2014), http://tinyurl.com/gsz7e7b.

The biggest controversy has come from the biggest business. Amazon.com began as an online bookstore and expanded into an online megastore offering nearly anything a person could want to purchase. The business offers goods not only from its own warehouses, but also through third-party sellers. A consumer may go to Amazon.com, find a product that is offered by "Amazon" and place an order. The product arrives but with a defect. When the customer contacts Amazon support, the company reveals that the order was fulfilled by a third-party vendor via Amazon's online sales platform, and that any problems are the responsibility of this third-party vendor. In essence, the consumer believed that they picked an item off the shelf in Amazon's store and paid Amazon at the register upon checkout, but that the "store" has no liability because it is only a conduit. This is the modern equivalent of the historic debate about whether to make traditional merchants liable for warranty issues created by manufacturers.

Given the breadth of shopping options at Amazon.com, the retailer has run into several consumer problems. For example, Amazon.com allegedly has engaged in price discrimination based on a consumer's physical location, gathered from the digital nature of the transaction. *See* Anita Ramasastry, Web sites change prices based on customers' habits, CNN.com (June 24, 2005), http://www.cnn.com/2005/LAW/06/24/ramasastry.website.prices. As another example, consumers felt wronged when Amazon removed previously purchased e-book titles from consumer's digital libraries without notice. Consumers who paid an annual fee to be "Prime" members who receive additional benefits such as free 2-day shipping have alleged that Amazon engaged in unfair and deceptive practices by encouraging its third-party sellers to raise product prices to cover the costs of shipping. *See Ekin v. Amazon Servs., LLC*, 84 F. Supp. 3d 1172 (W.D. Wash. 2014); Amy Martinez, *Merchants file suit against Amazon.com,* The Seattle Times, (March 15, 2013), http://www.seattletimes.com/business/small-online-merchants-file-suit-against-amazoncom.

Sometimes the controversy arises not from the online nature of the transaction but from what is being sold. Software presents a classification problem for the law. Is software a good, or is it a license? The Uniform Computer

Information Transactions Act (UCITA) was intended to increase uniformity in the law that applies to purchase of software by amending the U.C.C. with regard to software transactions. But ultimately it was only adopted by two states, Virginia and Maryland. Adding further insult to UCITA's creators, some states actually adopted laws to prevent the provisions of UCITA from taking effect in their state. Dorte Toft, *Opponents Blast Proposed U.S. Software Law*, CNN.COM, July 12, 1999, http://www.cnn.com/TECH/computing/9907/12/ucita.idg. A major objection to UCITA was its provision that permitted designating, as a matter of state law, that software was a license and not a sale of goods. An anti-consumer effect of this designation was that under a license consumers could be restricted from reselling the software. The ownership of goods, in contrast, carries with it the right to resell.

Reselling is extremely common online. The right to resell a copyrighted product you legally purchased is called the "first sale" doctrine. *See* 17 U.S.C. §109 (limiting a copyright owner's exclusive right to distribute copies of the copyrighted work to give a purchaser the ability to resell). If the purchase of software is a license, it falls outside the doctrine. Online businesses that profit from individuals reselling or auctioning off previously purchased items are major beneficiaries of the first sale doctrine.

The most successful early auction site, eBay, revolutionized how consumers think about online commerce. Its model actually revived an old art—haggling (fixed prices were an invention of the 19th century and the rise of advertising). eBay allows consumers to either bid on an item, or choose the price the consumer thinks is valid for a certain item, and compete with others who may find a higher or lower price more appropriate. This kind of marketplace was wildly successful at first but is dwindling. Some of this may be due to the pervasive online presence of traditional retailers; others think that consumers discovered the allure of bidding led to regret, not unlike that associated with gambling. Another issue was that eBay created unusual policies to attract consumers. Sellers have had issues with dishonest buyers but eBay enforces a "buyer is always right" policy. Jennifer Abel, *Judge Rules Class Action Suit Against eBay and PayPal May Proceed*, CONSUMER AFFAIRS, (August 14, 2014), http://tinyurl.com/nvx59km. Also, eBay has come under fire for trading in counterfeit merchandise. Like many online merchants, eBay's refrain has been that it is a platform, and that there is no contract other than that between the buyer and the seller. One can question that claim given that eBay charges a fee for each listing based on percentage of the sale. The controversy illustrates the way in which online transactions manifest problems with trust and verification that may exceed in-person deals.

C. Marketing Online

Marketing is an area of online commerce that is governed by federal law. Businesses use the speed and pervasiveness of email to market to consumers a fraction of traditional costs. Such "spam" advertising messages are a nuisance. Like the flyers stuck under our windshield wipers or the junk mail that comes via

USPS, these emails seldom get read, but given their low cost, they need produce only a few responses to make spamming an effective direct marketing tool. Just like they did not like having their dinner interrupted by telephone solicitors and so enacted the do-not-call registry, Congress did not like spam email and did something about it, despite business's ferocious opposition. In 2003, the Controlling the Assault of Non-Solicited Pornography and Marketing (CAN-SPAM) Act created firm guidelines to businesses on what they can and cannot do when sending generalized commercial messages (as opposed to messages directly resulting from a transaction or a business relationship). 15 U.S.C. §§7701 et al. The business must properly identify itself and offer an opt-out process to allow the consumer prevent further emails. The CAN-SPAM Act is not limited to bulk emails but applies to any commercial message sent by a business. The Federal Trade Commission enforces the CAN-SPAM Act, with violations treated like an unfair or deceptive act or practice. 15 U.S.C. §7706.

Online transactions also ushered in the idea of online reviews. While these were initially prompted by the online seller as a way of easing consumers' concerns about the seller's reliability, the review business is now an area of separate commerce. Sites such as Yelp.com or Angie's List allow reviews of in-person transactions and focus primarily on services, rather than goods. Reviews are a major market innovation that protects consumers. Reviews give consumers more information and are often available right on the commerce site itself so that consumers actually see and use the feedback. Though these reviews should create trust between businesses and consumers, the anonymity of the Internet means that there are few repercussions for someone who posts a snarky or untrue review. In fact, writing false reviews can actually be a career. Websites such as Fiverr.com will pay (unsurprisingly, usually "five" bucks) for users to post reviews on websites about certain products or services. Studies have shown that up to 30 percent of online reviews for certain products, and 10-20 percent of reviews for hotels and restaurants, are fake. Rihannon Lucy Cosslett, *Many Internet Reviews are Bogus—Are You Honestly Surprised?*, THE GUARDIAN.COM, (November 2, 2015), http://www.tinyurl.com/ogez9dr.

Businesses also respond to online reviews in a transparent way at review web sites. By posting a reply that addresses or disputes a consumer's concerns, the online review process creates more information about customer service than a traditional refund that quietly appeases an unhappy consumer. Some businesses have taken their frustrations with negative reviews into their own hands—or at least, their own contracts. Companies ranging from medical providers to cell phone accessory peddlers have included "gag clauses" in their contracts that prohibit consumers from posting negative reviews. Some contracts even ban consumers from threatening to post a negative review or impose penalties on consumers who write a review that a business finds troublesome. In 2015 Congress considered a bill, the Consumer Review Freedom Act, which would ban these gag clauses in consumer contracts. If enacted, it would void any provision that imposed a penalty or fee against an individual for a review or restricted the ability of an individual to engage in "a written, verbal, or pictorial review, performance assessment of, or other similar analysis of, the products, services or conduct of a person." S. 2044, 114th Cong. §2 (2015).

Marketing oneself online is also common. From traditional sites like Match.com and eHarmony.com to the “swipe right” culture of Tinder and Grindr, people looking to get married or simply get lucky are extremely active online. Online dating services take the personal touch out of matchmaking and insert algorithms or rapid human evaluation. This adds another layer of mistrust to those that are inherent in dating. The anonymity of the Internet permits scammers to flourish. “Catfishing” is the act of pretending to be another person (or being yourself, but using false pictures and information to make yourself into someone you aren’t) to get another person interested. Some use this power simply to get a first date but others may continue the deception to defraud victims of money.

Sometimes the alleged scam is from the dating website itself. Many sites offer free registration that lets you post your profile on the site. If you want to interact with another member, however, you must pay a membership fee. Some sites have been accused of using fake profiles with attractive photographs or “bots”—computer programs—to induce nonpaying members to pay the membership fee in order to interact with the non-existent person. These sites are subject not just to traditional contract rules and consumer protection statutes, but to specific laws in place for dating services. *See* Cal. Civ. Code §1694.2(b) (requiring that every dating service feature “on its face” a clause informing the consumer of the right to cancel their membership for a refund within three days).

D. Digital Applications

With the advent of mobile phone and tablets came the rise of the application. These “apps” are programs that perform digital functions without an Internet browser interface. The law governing “apps” is undeveloped, as the law governing online transactions was a few decades ago. Generally, it appears—as with browser-based transactions—that basic contract law will govern, perhaps with specific statutory overlays for consumer protection.

Some apps make the same types of overstatements and false claims made elsewhere in marketing. The FTC sued an app developer for false advertising when the app claimed to be “scientifically proven” to improve a user’s eyesight. Federal Trade Commission, *Charges Marketers of ‘Vision Improvement’ App Deceptive Claims*, September 17, 2015, https://tinyrul.com/ng68l9m. The suit repeats a lesson from this book’s first case, *Carbolic Smoke Ball*; the more things change with marketing (from newspaper to TV to apps), the more they stay the same (consumers fall prey to quackery). Other apps have gotten into legal trouble for failing to mention certain things they do, such as hijack your phone to mine cryptocurrency. Federal Trade Commission, *App Developer Settles FTC and New Jersey Charges It Hijacked Consumers’ Phones to Mine Cryptocurrency*, June 29, 2015, https://tinyurl.com/pfxw6vh.

An emergent consumer protection problem involves “free” app games. A consumer can download the game at no cost or obligation but then will see offers to make “in-app” purchases. These may allow the consumer to unlock hidden features or advance beyond a certain level in the game. While these purchases can be reasonable or inane, the issue is one of disclosure. Can such a game be fairly called "free?" And how does the game obtain consent to purchase, particularly in a virtual world where the business can claim a certain lack of knowledge of its users.

In re Apple In-App Purchase Litig.

855 F. Supp. 2d 1030 (N.D. Cal. 2012)

DAVILA, District Judge.

Presently before the court is Defendant Apple Inc.'s ("Apple") motion to dismiss Plaintiffs' Consolidated Class Action Complaint ("Complaint") pursuant to Rule 12(b)(6).

Apple, a Delaware corporation with its headquarters and principal place of business in California, is a leading seller of software applications ("apps") that users can download onto their mobile computing devices. Plaintiffs bring the instant class action on behalf of themselves and other similarly situated parents or guardians who (a) downloaded or permitted their minor children to download a supposedly free app from Apple and (b) then incurred charges for game-related purchases made by their minor children, without the parents' and guardians' knowledge or permission.

FACTUAL AND PROCEDURAL BACKGROUND

On April 11, 2011, Plaintiff Garen Meguerian filed a complaint, individually and on behalf of others similarly situated, alleging that Plaintiffs' minor children were able to purchase "game currencies" without their parents' knowledge or authorization while playing game applications ("apps"), provided by Apple and advertised as free. An "app" is a software application that a customer can download from Apple's App Store onto a mobile computing device. "Game currencies" are virtual objects, such as supplies, that are used in connection with gameplay in certain apps.…In the Complaint, Plaintiffs allege that minors were able to make in-app purchases of game currency without Plaintiffs' knowledge or permission. The Complaint asserts claims for declaratory judgment, violation of the California Consumers Legal Remedies Act ("CLRA"), Cal. Civ. Code §1750 et seq., violation of California's Unfair Competition Law ("UCL"), Cal. Bus. Prof. Code §17200 et seq., breach of the implied covenant of good faith and fair dealing, and restitution/unjust enrichment/money had and received.

The sale of an app or any game currency is a transaction completed directly between Apple and the consumer. Apple requires users to authenticate their accounts by entering a password prior to purchasing and/or downloading an app or buying game currency. Until early 2011, however, once the password was entered once, Apple permitted users to buy game currency for up to fifteen minutes without re-entering the password. Plaintiffs claim that they were unaware that purchases could be made without re-entering the password. Plaintiffs downloaded and allowed their children to play free or nominal gaming apps, unaware that their children could, for fifteen minutes, purchase game currency without entering a password. Plaintiffs' minor children were able to charge their parents' accounts in amounts ranging from $99.99 to $338.72 at a time.

On August 8, 2011, Defendants filed this instant motion to dismiss Plaintiffs' Complaint.…

DISCUSSION

A. Declaratory Judgment

Plaintiffs seek declaratory judgment pursuant to 28 U.S.C. §2201 et seq., seeking a determination that…the sales contracts between Apple and the minor children of class members, relating to the purchase of in-app game currency, are voidable at the option of the respective class members on behalf of their minor children.… Plaintiffs allege that each in-app purchase constitutes a separate and voidable contract between Apple and Plaintiffs' minor children, which may be disaffirmed by a parent or guardian on behalf of the minors. Plaintiffs allege that a contract between Apple and minor existed each time that (1) Apple offered to sell game currency to a minor playing an app, (2) the minor accepted Apple's offer, and (3) the transaction was supported by consideration, or payment made by the Plaintiffs.[1]

Apple argues that this issue should be dismissed as a matter of law because the relevant contractual relationship governing the in-app purchases is between Apple and Plaintiffs and is based on the original Terms & Conditions signed by Plaintiffs, thus making the individual purchases not voidable. Apple contends that the Terms & Conditions governs the parties' relationships, including all subsequent purchases made using the iTunes account.

However, Plaintiffs contend that the Terms & Conditions are not the contracts at issue. Furthermore, Plaintiffs argue that the Terms & Conditions are subject to interpretation and that the court cannot dismiss the declaratory relief claim because Plaintiffs should be permitted to introduce extrinsic evidence regarding the meaning of the term "unauthorized use" in their contracts.[3] Apple claims that this term is not relevant to Plaintiffs' claim or to Apple's motion to dismiss.…

At this point, the court must construe the Complaint in the light most favorable to Plaintiffs, resolving any apparent ambiguity in their favor.…Using this standard as a guide, Defendant's request to dismiss Plaintiffs' First Cause of Action must be denied.

B. Consumer Legal Remedies Act (CLRA) and Unfair Competition Law (UCL) Claims

...

Plaintiffs allege that Apple violated the CLRA by actively marketing and promoting certain gaming apps as free or costing a nominal fee with the intent to induce minors to purchase in-app game currency.[6] Plaintiffs contend that Apple breached its duty to disclose material facts about the game currency embedded in these gaming apps and the ability to purchase such game currency for a fifteen-minute period without re-entering a password. Apple contends that Plaintiffs' CLRA claims fail to meet Rule 9(b)'s heightened pleading standard.

The CLRA proscribes "unfair methods of competition and unfair or deceptive acts or practices." Cal. Civ. Code §1770(a); In re Actimmune Marketing Litig., 2009 U.S. Dist. LEXIS 103408, 2009 WL 3740648, at 16 (N.D. Cal. Nov. 6, 2009). Conduct that is "likely to mislead a reasonable consumer" violates the CLRA. Keegan v. American Honda Motor Co., Inc., 838 F. Supp. 2d 929 (C.D. Cal. Jan. 6, 2012). CLRA claims sounding in fraud must establish reliance and causation. Buckland v. Threshold Enters., Ltd., 155 Cal. App. 4th 798, 809 (2007).

Omissions are actionable under the CLRA only when the omission is contrary to a representation actually made by the defendant or where a duty to disclose exists. Keegan, 2012 U.S. Dist. LEXIS 3007, 2012 WL 75443, at 6. Under California law, a duty to disclose arises in four circumstances: "(1) when the defendant is in a fiduciary relationship with the plaintiff; (2) when the defendant had exclusive knowledge of material facts not known to the plaintiff; (3) when the defendant actively conceals a material fact from plaintiff; or (4) when the defendant makes partial representations but also suppresses some material facts." Id. (quoting Smith v. Ford Motor Co., 749 F. Supp. 2d 980, 987 (N.D. Cal. 2010)). In the instant case, Plaintiffs allege that Apple had a duty to disclose because it concealed and/or omitted facts in the advertising, marketing, and promotion of its apps. For a non-disclosed fact to be material, a plaintiff must show that if the omitted information had been available, the plaintiff would have been aware of it and behaved differently. Id.

Contrary to Apple's argument, Plaintiffs have alleged with specificity which misrepresentations they were exposed to, their reliance on those misrepresentations, and the resulting harm. Plaintiffs pled specific facts that Apple "actively advertis[ed], market[ed] and promot[ed] its bait Apps as 'free' or nominal.…" The Complaint explicitly states that at least one Plaintiff downloaded a game app and gave it to her son "[b]ecause it said it was 'free" and another Plaintiff gave her iPhone to her daughter so that she could "play the 'free' game." Plaintiffs further assert that they were not informed by Apple that once an iTunes account holder entered a password, he or she could make purchases for up to fifteen minutes without re-entering the password. Plaintiffs contend that, "[h]ad any Plaintiff or other member of the Class known what their children were purchasing and for how much, they would not have permitted the sales transaction from being consummated." Finally, the Complaint alleges that as a result of the fraud, Plaintiffs were charged large sums of money after game currency was purchased without their knowledge.

Drawing all inferences in Plaintiffs' favor, the court denies Apple's motion to dismiss Plaintiffs' Second Cause of Action.

iii. Unfair Competition Law

...

The UCL, California Business & Professions Code §17200 et seq., prohibits acts of "unfair competition," defined as: (1) unlawful business acts or practices;[7] (2) unfair business acts or practices; (3) fraudulent business acts or practices; and (4) unfair, deceptive or misleading advertising. Each of the three prongs of the UCL ("unfair," "unlawful," and "fraudulent") constitutes an independent basis for liability and fraud is not an essential element of a claim for unfair or unlawful business practices. Actimmune, 2009 U.S. Dist. LEXIS 103408, 2009 WL 3740648, at 7.

Plaintiffs allege that Apple engaged in unlawful, unfair, fraudulent and/or deceptive business acts and practices in violation of the UCL by advertising, marketing, and promoting apps as free or at a nominal cost with the intent to lure minors to purchase game currency. Furthermore, Plaintiffs allege that the Class has suffered substantial actual economic harm. As discussed supra, for claims based on fraudulent conduct, where Rule 9(b)'s heightened pleading standard applies, the court finds that Plaintiffs have sufficiently pled specific facts to support their claims.

Under the "unlawful" prong, Plaintiffs have sufficiently alleged that Apple violated the CLRA. This violation is independently actionable under the UCL.

Under the test for "unfair" business practices, "[a]n act or practice is unfair if the consumer injury is substantial, is not outweighed by any countervailing benefit to consumers or to competition, and is not an injury the consumers themselves could reasonably have avoided." Tietsworth v. Sears, 2009 U.S. Dist. LEXIS 98532, 2009 WL 3320486, at 7. Plaintiffs have shown that they suffered substantial harm by incurring charges that they did not explicitly authorize, ranging from $99 to $338.72 at a time. Plaintiffs contend that no benefit existed and Apple does not claim that there was any benefit to consumers or competition. Plaintiffs also contend that they could not have avoided this harm because they had no way of knowing that for a fifteen-minute window, purchases could be made without re-entering a password.

Under the "fraudulent" prong, Plaintiffs must allege with specificity that Defendant's alleged misrepresentations: (1) were relied upon by the named plaintiffs; (2) were material; (3) influenced the named plaintiffs' decision to purchase the product; and (4) were likely to deceive members of the public. Tietsworth, 2009 U.S. Dist. LEXIS 98532, 2009 WL 3320486, at 8. Following other California courts and federal courts applying California law, the sufficiency of a plaintiff's UCL fraud claim may be analyzed together with the CLRA claim. Kowalsky v. Hewlett-Packard Co., 2011 U.S. Dist. LEXIS 89379, 2011 WL 3501715 (N.D. Cal. Aug. 10, 2011). As discussed in the analysis of Plaintiffs' Second Cause of Action, Plaintiffs have pled specific facts to support their claim.

Accordingly, drawing all inferences in Plaintiffs' favor, the court denies Apple's motion to dismiss Plaintiffs' Third Cause of Action.

C. Breach of Duty of Good Faith and Fair Dealing

Plaintiffs allege that Apple breached its contractual duty of good faith and fair dealing with Plaintiffs and class. Apple argues that Plaintiffs' claim fails as a matter of law because under California law the implied covenant cannot be used to negate an express contractual provision. Apple further argues that Plaintiffs have not alleged any express provision of their contract that relates to their claim, and an implied covenant claim untethered to an express provision fails as a matter of law.

It has long been recognized in California that every contract contains an implied covenant of good faith and fair dealing that neither party will injure the right of the other party to receive the benefits of the agreement. Wolf v. Walt Disney Pictures & Tel., 162 Cal. App. 4th 1107 (2008). The covenant protects the express covenants or promises of the contract. CarmaDevelopers (Cal.), Inc. v. Marathon Development California, Inc., 826 P.2d 710 (1992). As such, the implied covenant will only be recognized to further the contract's purpose; it will not be read into a contract to prohibit a party from doing that which is expressly permitted by the agreement itself. Id. at 374. However, "breach of a specific provision of the contract is not a necessary prerequisite [for breach of implied covenant of good faith and fair dealing]." Id. at 373.

To establish a claim for breach of the implied covenant of good faith and fair dealing, Plaintiffs must show that Apple lacked subjective good faith in the validity of its act or the act was intended to and did frustrate the common purpose of the agreement. Id. at 372. The Terms & Conditions signed by Plaintiffs expressly provide that Plaintiffs are responsible for activity occurring on or through their accounts and Apple may charge them for any such activity. Thus, the implied covenant cannot negate Apple's ability to charge Plaintiffs.

Plaintiffs have failed to show how Apple's act breached the duty of good faith and fair dealing. Accordingly, the claim for breach of the implied covenant is dismissed with leave to amend.

...

For the reasons stated, the court GRANTS in part and DENIES in part Defendant's motion to dismiss.

Vulnerable consumer populations, such as the elderly or children, can be especially prone to misunderstanding (or being misled by) online transactions. In 2014, the Federal Trade Commission alleged that Amazon.com unlawfully charged millions of dollars to customers without obtaining "the account holders' express informed consent" for in-app purchases made because children using devices could make purchases without an adult's affirmative consent. *See FTC v. Amazon.com, Inc.*, 71 F. Supp. 3d 1158, 1160 (W.D. Wash. 2014). A contrary argument might be that the parents consented to their children using their devices, and in so doing, consented to their full use of all applications that the parents decided to download. Another point is that while the age of majority for legal contracts is 18 years, does anybody question a "tween" (between child and teenager) who walks into a convenience store and buys a pack of gum for $0.99? How is this legally distinct from an in-app purchase of another game level? If it is not, why should stores—that can visually assess age—be off the hook, while online companies face lawsuits?

Problem Set 20

20.1. Grandpa calls you up—he knows you've been studying something to do with credit, and he was just denied for a credit card he wanted to open. He has always been extremely careful with his money and has had impeccable credit. Modern technology eludes him, however, and he has several times gotten a virus on his computer. Last month, Grandpa bought anti-virus software from someone who called him from "Window." He reports to you that he felt good about this solution because "Window" is the same name that pops up every time he turns on his computer and so "they should know what they are doing with this Internet stuff." The "Window" representative on the phone helped him install and activate the anti-virus software on his computer. You ask Grandpa what all this cost, and he says, "That's the thing. You do actually get something free in these new days. It's not like old times when everything cost money." You have a bad feeling about this, and start running through the identity theft steps that you learned in consumer law. With his permission, you check his credit report and see nine new credit cards have been opened and maxed out. What could have happened? What recourse does Grandpa have?

20.2. Jess has been shopping online for years and is extremely happy with her "Bestest" service from Pole.com, where she is treated like a preferred customer with special deals emailed directly to her, free shipping, and streaming video. Her sister, Tina, still likes to go to the mall and stroll through shopping districts, and even still pays for cable. Jess and Tina have been trying to find the best price for a birthday gift for their father: a state-of-the-art speaker set for his old school record player.

Pole.com has been showing Jess some great prices, so she chooses a speaker set and has it shipped free to her dad. When she is at Tina's house the next day, Jess hops on Tina's computer to show her the great deal that she got on the speakers from Pole. Tina's never used the site before, and Jess does not bother to log in to her account. She just does a quick search for the speakers on Pole's homepage. She finds the speakers immediately as the top-listed item based on her search but she sees the price is cheaper than she has seen before. At that point, Jess logs into her account to check what she paid and sure enough, she was charged $12 more than the display price. She searches for the speaker listing again, but now the price is back to Jess' purchase price. Angry that Tina's computer showed such a great deal when Jess is a loyal customer, Jess contacts a class action lawyer. I want to sue, she says. “Bestest” simply is not the best. What would be the basis for a lawsuit?

20.3. You are outside counsel to an online payday lender, the OC Moneymen, which is a California corporation. They’ve been getting a lot of flack lately from consumers who used their services and then been angry when they realized how much debt had mounted. One of their prior customers has started posting angry rants on Eyes, a social media site. The posts are admittedly funny, featuring video of the consumer showing how many pennies it would take to pay even 1 percent of the debt. The posts have gone viral and OC Moneymen are unhappy. Can they change their contract in the future to avoid these problems? If not, how might they challenge or work around any prohibition? Cal. Civ. Code §1670.8.

1. More specifically, the court stated:

> I just think that this case turns on the burden of proof and the bank didn't know who was fooling around with this card, Union Station, Amtrak after investigating it couldn't figure out who was involved in the unauthorized use of this card. Looking at the statements for October and November, there's really nothing that quite jumps out that makes it plain that it must have been Mr. Cheevers who was running up these charges and then selling the tickets on the street to get some money.

2. Section 1666 provides in pertinent part:

> (a)…If a creditor, within sixty days after having transmitted to an obligor a statement of the obligor's account in connection with an extension of consumer credit, receives at the address disclosed under section 1637(b)(10) of this title a written notice…from the obligor in which the obligor—
>
> …
>
> (2) indicates the obligor's belief that the statement contains a billing error and the amount of such billing error, and
>
> (3)…the creditor shall, unless the obligor has, after giving such written notice…, agreed that the statement was correct—
>
> (A) not later than thirty days after the receipt of the notice, send a written acknowledgement thereof to the obligor…, and
>
> (B) not later than two complete billing cycles of the creditor…after the receipt of the notice and prior to taking any action to collect the amount…either—
>
> (i) make appropriate corrections in the account of the obligor…; or
>
> (ii) send a written explanation or clarification to the obligor, after having conducted an investigation…

3. Section 1643(a) provides:

> (1) A cardholder shall be liable for the unauthorized use of a credit card only if—
>
> (A) the card is an accepted credit card;
>
> (B) the liability is not in excess of $50;
>
> (C) the card issuer gives adequate notice to the cardholder of the potential liability;
>
> (D) the card issuer has provided the cardholder with a description of a means by which the card issuer may be notified of loss or theft of the card, which description may be provided on the face or reverse side of the statement required by section 1637(b) of this title or on a separate notice accompanying such statement;
>
> (E) the unauthorized use occurs before the card issuer has been notified that an unauthorized use of the credit card has occurred or may occur as the result of loss, theft, or otherwise; and
>
> (F) the card issuer has provided a method whereby the user of such card can be identified as the person authorized to use it.
>
> (2) For purposes of this section, a card issuer has been notified when such steps as may be reasonably required in the ordinary course of business to provide the card issuer with the pertinent information have been taken, whether or not any particular officer, employee, or agent of the card issuer does, in fact receive such information.

1. For this reason, we disagree with the court in Ioffe v. Skokie Motor Sales, 414 F.3d 708 (7th Cir. 2005) ("[A]n Odometer Act claim that is brought by a private party and is based on a violation of §580.5(c) requires proof that the vehicle's transferor intended to defraud a transferee with respect to mileage."). We believe the Seventh Circuit failed to apply the statute's plain language, which unambiguously requires that a transferor of a motor vehicle disclose the actual mileage to the transferee *on the title.*

2. At this point in the opinion, the California court refers the reader to an earlier footnote, which states as follows:

> In 1977, the Federal Reserve Board issued a decision interpreting Regulation Z (12 C.F.R. Part 226), which implemented the federal Truth in Lending Act. The Board ruled that a dealer participation need not be identified or disclosed in Truth in Lending disclosures as a separate component of the finance charge. At the same time, the Board withdrew a proposal that would have required separate disclosure of the existence, but not the amount, of a dealer participation. The Board concluded that disclosure of the total finance charge and widespread advertisement of credit terms afforded consumers "the most important information with which to comparison shop for credit." Also, the Board believed the addition of another disclosure requirement would result in more complex disclosure statements and could lead to confusion or misunderstanding by consumers. 42 Fed. Reg. 19124-19125 (Apr. 12, 1977).

Kunert, 1 Cal. Rptr. 3d at 599 n. 10.

1. One caveat is that loans made under the Health Education Assistance Loan program are subject to TILA. These loans are for medical school.

2. An ISR plan applies only to FFEL loans.

1. Apple argues that there is no legal basis for inferring a contract where the alleged offer is made to one party but accepted by another party, and where the consideration is paid by the original offeree, rather than the party who accepted the alleged offer. Plaintiffs contend that their complaint alleges sufficient facts to establish the existence of a contract and that, pursuant to Cal. Civ. Code §1605, consideration for a contract can be conferred upon the promisor by any person, not only the offeree.

3. The Terms & Conditions, which Plaintiffs accepted and agreed to when they opened iTunes accounts, state, "[y]ou are solely responsible for maintaining the confidentiality and security of your Account and for all activities that occur on or through your Account.… Apple shall not be responsible for any losses arising out of the unauthorized use of your account."

6. Plaintiffs allege that Apple violated three provisions of the CLRA: (1) representing that goods have uses or characteristics they do not have, Cal. Civ. Code §1770(a)(5); (2) representing that goods are of a particular standard or quality when they are of another, Cal. Civ. Code §1770(a)(7); and (3) representing that a transaction confers or involves rights, remedies, or obligations which it does not have or involve, or which are prohibited by law, Cal. Civ. Code §1770(a)(14).

7. Under the "unlawful" prong, the UCL makes violations of other laws actionable under the UCL. In re Actimmune Marketing Litig., 2009 U.S. Dist. LEXIS 103408, 2009 WL 3740648, at 15 (N.D. Cal. Nov. 6, 2009). Under this prong, "it is not necessary that plaintiffs allege violation of the predicate laws with particularity; they must at a minimum, however, identify the statutory or regulatory provisions that defendants allegedly violated." Id.