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SERVICE CONTRACTS

Lending

Is the Financing of Service Contracts An Extension of Consumer 'Credit'? – It Depends

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Introduction:

What is consumer ''credit''? As with most legal issues, the answer is that it depends. This article provides an overview of how stand-alone financing of service contracts, oftentimes broadly labeled as extended warranties, can be structured and outline some of the federal and state consumer lending and credit laws that may apply to payment plan agreements used for service contracts. As with any situation, the details control the outcome.

There is a risk of triggering federal and state consumer financing laws if the language of a service contract financing agreement is unclear or imposes conditions or fees on the purchaser that can be argued to make the obligation anything less than fully cancelable at will. Inconsistent language within the terms of such an agreement or advertising communications can lead to unintended, adverse consequences to service contract obligors and payment plan providers and unwanted regulatory scrutiny. Yet, knowing the applicable rules of the road can help make reaching the desired destination more navigable.

The Anatomy of Financing Service Contracts

The purchase of a service contract may be ''financed'' in different ways. A retailer or lender may include the cost of a service contract within another credit transaction, such as a vehicle loan in the case of a vehicle service contract or the financing of a cellular phone in the case of a cell phone service contract. The service contract may also be paid for separately. In these scenarios, a service contract can be purchased by making a lump-sum payment or in a series of payments made over a period of time. In the latter scenario, a consumer is often presented with a payment plan agreement, which al-

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lows the consumer to pay for the cost of the service contract under an installment payment program. Upon execution of the payment plan agreement, the consumer usually must make a down payment (typically 5 percent - 10 percent of the total sales price) and then will pay the balance of the sales price in monthly installments (usually over a period that is less than the full term of the service contract). The payment plan provider pays the full purchase price of the service contract to the service contract obligor or its sales agent, allowing the sale agent to receive payment of its full sales commission, subject to certain commission repayment obligations if the consumer's payment plan and service contract become canceled. In the event that the consumer fails to make a monthly payment within a certain number of days of the due date (typically ten days), the payment plan provider is authorized to cancel the consumer's service contract and the consumer has no further obligations under the payment plan agreement. Similarly, if the consumer cancels the service contract, the consumer has no further obligations under the payment plan agreement. Service contract payment plans function very similarly to insurance premium financing agreements used in the property and casualty insurance industry.[2]

Given the cancelation feature in most service contracts financings, the service contract's purchase price is not, in reality, ''financed'' as most people might use and understand that term. Purchase prices of this type, like insurance premiums, are paid prospectively; that is, they are paid in advance for coverage to be provided in the future. In other words, consumers can ''pay-as-they-go,'' canceling coverage for future periods. For this critical reason, the financing of service contracts do not likely involve the extension of credit and are not truly financed; however, industry participants are well-advised to exercise care in structuring their business models and supporting documentation. Such care first requires knowledge of the basic consumer credit related laws.

Applicability of the Truth in Lending Act

What is Credit?

The purpose of the Truth in Lending Act (TILA) and its implementing regulations, Regulation Z, is to promote the informed use of credit by consumers, requiring clear and conspicuous disclosures to consumers of all relevant costs in a credit transaction and in any advertisement that includes credit terms. Regulation Z applies to each person that offers or extends consumer credit when four specific conditions are met: (1) the credit is offered or extended to consumers; (2) the offering or extension of credit is done on a regular basis; (3) the credit is subject to a finance charge or is payable by a written agreement in more than four installments; and (4) the credit is primarily for personal, family or household purposes. As a preliminary matter, the term ''credit'' means ''the right granted by a creditor to a debtor to defer payment of debt or to incur debt and defer its payment.''[3]

What is Not Credit?

Where an obligation is cancelable at any time, also known as ''pay-as-you-go'' agreements, there is no extension of credit. A ''credit'' situation only arises when a debtor is required to make full and complete payment of an amount advanced. In these ''pay-as-you-go'' situations, payment is not deferred; rather, payment is simply made for a future period of coverage. This is a critical distinction, which is sometimes lost upon consumer advocates and regulators.

Courts have held that ''pay-as-you-go'' contracts, in which consumers pay for goods and services in advance with no further obligations after cancelation, are not extensions of ''credit'' and not subject to TILA. As a part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the authority to make rules and interpret TILA was transferred from the Federal Reserve Board to the then newly created Consumer Financial Protection Bureau (CFPB). The CFPB has not yet weighed in on this specific issue, but the CFPB's Official Interpretation for TILA excludes from the definition of ''credit'' comparable ''insurance premium plans that involve payment in installments . . . unless the consumer is contractually obligated to continue making payments.''[4]

Accordingly, where an obligation is truly cancelable at any time, there is no extension of ''credit'' under TILA. It is more likely than not that well-constructed service contract financing transactions would be excluded from the definition of ''credit'' under TILA. A ''credit'' situation only arises when a debtor is required to make full and complete payment, a condition not present in typical service contract financing situations since the payment plan obligation (and by extension the underlying service contract) is cancelable at any time.

Accordingly, where an obligation is truly cancelable at any time, there is no extension of "credit" under TILA. It is more likely than not that well-constructed service contract financing transactions would be excluded from the definition of "credit" under TILA.

That said, the details of a given financing transaction will govern the result. Drafters of such agreements must exercise caution and know how certain language, even if taken in isolation, could be interpreted in a manner that creates a ''credit'' transaction. For instance, the presence of a late payment clause could be challenged as making the obligation something less than fully cancelable at will. Ultimately, any ambiguity would likely be held against the payment plan provider by consumers or regulators.

[2] In most states, service contracts, while regulated within state insurance codes, are deemed not to be insurance products.

[3] 15 U.S.C. § 1602(f).

[4] 12 C.F.R. Part 1026, Supplement I, Official Interpretations to 12 C.F.R. pt. 1026.2(a)(14).

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Equal Credit Opportunity Act Applicability

The Equal Credit Opportunity Act (''ECOA'') applies to all ''creditors.'' The term ''creditor'' is defined as ''a person who, in the ordinary course of business, regularly participates in a credit decision, including setting the terms of the credit.''[5] The term ''credit'' is broadly defined as ''the right granted by a creditor to an applicant to defer payment of a debt, incur debt and defer its payment, or purchase property or services and defer payment therefor.''[6] The scope of the term ''credit'' is arguably broader under ECOA than other federal consumer credit related laws, like TILA, based on the last part of that definition, including the right to ''purchase property or services and defer payment therefor.''

The statute provides that its purpose is to require those engaged in the extension of credit to make credit equally available to all creditworthy customers without regard to certain protected statuses. The statute makes it unlawful for ''any creditor to discriminate against any applicant with respect to any aspect of a credit transaction (1) on the basis of race, color, religion, national origin, sex or marital status, or age (provided the applicant has the capacity to contract); (2) because all or part of the applicant's income derives from any public assistance program; or (3) because the applicant has in good faith exercised any right under the Consumer Credit Protection Act.'' The ECOA covers creditor activities before, during, and after the extension of credit and is essentially a non-discrimination law that also imposes certain affirmative consumer disclosure requirements.

As with TILA, there is room for debate surrounding ECOA's applicability to the financing of service contract transactions. A determination of the applicability of the ECOA depends on the structure and wording of the underlying transactions. Even presuming the ECOA's applicability, care should be exercised in crafting eligibility requirements. If any particular method of credit analysis is performed, care must be exercised in choosing decision criteria for approval. Further, those financing service contracts should exercise caution in determining whether to request or collect information about a consumer's race, color, religion, national origin, sex, or source of income. Lastly, ECOA issues can even arise in the context of payment collections. By way of example, micro segmentation is the practice of breaking a large target consumer group into smaller sub-groups based on lifestyle, demographic, geographic and behavioral differences. In collections, this practice can raise potential ECOA violations under a disparate impact theory of liability.

Fair Debt Collection Practices Act Applicability

The Fair Debt Collection Practices Act[7] (FDCPA) is intended to eliminate abusive debt collection practices by debt collectors. The FDCPA imposes certain obligations upon debt collectors in order to promote transparency in the debt collection process, and it also prohibits certain conduct on the part of debt collectors in order to ensure consumers are not the subject of deceptive, harassing, or abusive conduct.

The definition of ''debt'' under the FDCPA is truly broad, including: ''any obligation or alleged obligation of a consumer to pay money arising out of a transaction in which the money, property, *insurance*, or services which are the subject of the transaction are primarily for personal, family, or household purposes, whether or not such obligation has been reduced to judgment.''[8] Regardless of whether the stand-alone financing of service contracts would constitute ''credit'' under other laws, there is an argument that they could constitute a ''debt'' for purposes of the FDCPA.

Those collecting their own debts are generally excluded from the scope of the FDCPA. The FDCPA is applicable to ''debt collectors,'' which the law defines as a person or entity ''who regularly collects or attempts to collect, directly or indirectly, debts owed or due or asserted to be owed or due another.''[9] It is noteworthy, however, that the FDCPA extends to ''any creditor who, in the process of collecting his own debt, uses any name other than his own which would indicate that a third person is collecting or attempting to collect such debts.''[10] This is an important note for participants in the service contract industry, where the relationships of the various parties can be less than straight-forward, particularly to less sophisticated consumers. A typical arrangement will include a service contract administrator, a payment plan provider, and the seller of the service contract. All of these parties must be sensitive to the issues that can arise when it comes to collecting debts arising out of these relationships.

As with TILA, there is room for debate surrounding ECOA's applicability to the financing of service contract transactions.

Industry participants would be well-advised to think critically about whether any debt is created in their agreements, and to ensure that consumer interactions are handled in as transparent and simple a process as possible. As noted in the prior section on ECOA, care must be exercised before undertaking collections to ensure that various consumer protection laws are not inadvertently violated.

State Small Principal Dollar Amount Loan Laws

Ensuring compliance with applicable consumer finance federal laws is only the beginning, as each state has unique laws that might be applicable to financing service contracts. State laws likely include small loan (sometimes referred to industrial loan) acts, personal loan acts, consumer loan acts, licensing acts, installment loan acts, retail installment sales acts, revolving credit acts, truth-in-lending acts, and insurance premium financing acts. These state laws generally establish maximum rates of interest on loans and credit sales; require consumer disclosure of finance charges and other information; and prohibit deceptive and unconscionable contractual provisions.

In many states the definition of ''credit'' is similar to that under TILA; however, it is critical to consult the lat-

[5] 12 C.F.R. 1002.2(l).
[6] 12 C.F.R. 1002.2(j).
[7] 15 U.S.C. § 1692 *et seq*.
[8] 15 U.S.C. § 1692a(5) (emphasis added).
[9] 15 U.S.C. § 1692a(6).
[10] *Id*.

est codified version of each state's law to determine whether service contract financing might fit a state's definition of loan and credit sale, triggering application of one of these consumer protection laws. The lack of any interest or other finance charges does not end the inquiry, since under many states laws, credit can be extended either with or without interest or other charges.[11] Further, some states' laws define a ''creditor'' as including those sellers that simply arrange for the extension of credit from another party.[12] Aside from simple compliance diligence, care in determining the applicability of these laws is critical as some carry criminal penalties against any person found to be operating without a license or in violation of their provisions.[13]

Takeaways:

As with any situation, the details control the outcome. Where the language of a service contract financing agreement makes clear that it is cancelable at will, then there is likely no credit extended under TILA and most state lending laws. Where the language is less than clear or imposes conditions or fees that can be argued to make the obligation anything less than fully cancelable at will, then there is a risk of triggering federal and state financing laws. Inconsistent language within the terms of an agreement or advertising materials can lead to unintended consequences and regulatory scrutiny. In other words, make sure there are no strings attached to your service contract financing agreements, and make sure that experienced and knowledgeable professionals assist in creating those agreements.

[11] *See*, *e.g*., Ga. Code § 7-3-3(4) (defining a ''loan'' as ''*any advance of money* in an amount of $3,000.00 or less under a contract requiring repayment and any and all renewals or refinancing thereof or any part thereof'' (emphasis added)); *see also Southwest Concrete Prods. v. Gosh Constr. Corp*., 798 P.2d 1247, 1249 (Cal. 1990) (''A loan of money is the delivery of a sum of money to another under a contract to return at some future time an equivalent amount.'').

[12] *See*, *e.g*., N.C. Gen. Stat. § 25A-2(a).

[13] 205 ILCS 670/20(a) (noting a person operating as a Consumer Installment Loan lender without the license required by this Act shall be guilty of a Class 4 felony.).

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