THE WORK-UP OF A CONSUMER CREDIT FRAUD CASE

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Alabama has some of the weakest consumer protection laws in the entire country, especially in the area of consumer finance. Most states have a limit on the interest rate that can be charged on consumer loans. In Alabama, on loans over $2,000.00, there is no numerical limit. The only limit is that the interest rate cannot be "unconscionable". (Code of Alabama, (1975) §8-8-5).

Most states also have a strong deceptive trade practices act. These acts often prohibit unfair practices of finance companies. In Alabama, finance companies and insurance companies are exempt from our deceptive trade practices act. Our only regulations dealing with consumer finance are found in the mini-code. The mini-code is called "mini-code" because it started out as a very stringent set of regulations and was gradually watered down by the finance and banking lobby in the state. Thus, the result was a "mini-code". The mini-code is really a mini-regulation.

Even though the mini-code provides very little regulation on finance companies, the finance industry currently has introduced bills to amend it to make it even weaker. One of the bills (SB 95) requires a plaintiff to write the finance company prior to filing suit over a hidden finance charge. If the company returns the money, it is immune from suit. A copy of that bill is attached in the appendix.

Most finance companies target consumers who are unable to make loans from traditional lending sources. The finance companies make loans to these people at a much higher interest rate. Many times there are needless and useless charges placed on the loans. Most consumers are not aware of these charges. Apparently, finance companies justify these practices by arguing that they are willing to make loans to people that traditional banks would not make loans to. However, this extra risk is reflected in the higher interest rate. It should not be reflected in add on fees that are useless to consumers.

This paper deals with how to recognize and apply theories of liability in the consumer finance setting. It also discusses the discovery and work up of these cases.

I. **REQUIRING INSURANCE** (AKA INSURANCE PACKING)

Finance Companies have a motive to place insurance on all loans. The premium charged increases the amount financed, which increases the interest and profit to the company. Also, the finance company or its employees receive a commission from the sale of some of these products. Many times the sale of the insurance product is through one of the finance company's subsidiaries or sister corporations which add to the profit. Alabama law allows the finance companies to sell insurance through their subsidiaries if it is disclosed somewhere in the documents (usually the fine print). The following sections discuss different types of insurance that is placed on the loans.

A. **CREDIT INSURANCE**

Credit insurance takes many forms. Credit life insurance is one form of credit insurance. It is designed to pay off the loan balance in the event of the consumer's death. Many consumers have been told by finance companies that they were required to purchase credit life insurance in order to receive the loan. Credit life insurance is the most costly life insurance allowed to be sold in Alabama.

It is illegal to require credit life insurance as a condition to receiving the loan. (Code of Alabama, (1975) §5-19-20). The fine print of the loan documents signed by the consumer always states that the insurance is not required and that it is completely voluntary. Many people who deal with the finance companies do not read the documents they sign. They usually trust who they are dealing with.

The fraud theory is:

Lie: I promise you the insurance is required;

Reliance: taking out the insurance;

Damage: the cost of the premium plus the interest.

Of course, there would be a justifiable reliance issue. See the case of Hickox v. Stover, 551 So.2d 259 (Ala. 1989); Harris v. M.S. Toyota Inc., 575 So.2d 74 (Ala. 1991); Hicks v. Globe Life, 584 So.2d 458 (Ala. 1991), which are some of the most applicable cases holding justifiable reliance is for the jury.

Most of the time, there are health questions that are required to be answered before the credit life insurance policy can be issued. The finance companies realize that if the questions are answered in a fashion showing the consumer is in bad health that the insurance will not issue. Therefore, some don't ask the health questions so that the policy will issue. Later, when a claim is made, the insurance company can use the bad health of the consumer as grounds to deny the claim. The theory here is known as "clean sheeting". Clean sheeting is fraud. *See Liberty National v. Waite 551 So. 2d 1003 (Ala. 1989), See John Hancock v. Variable Life Insurance Company vs. Pierce, 537 So.2d 719 (Ala. 1987)*

Another form of credit insurance which has been required as a condition to receiving a loan is credit disability or credit accident insurance. This insurance is designed to make the payments of the consumer while he is disabled or in an accident. Many consumers have made claims on such insurance that have never been paid. The major ground used to deny claims is that the consumer was disabled at the time he took the policy out. However, many times no questions are asked regarding whether or not the consumer is disabled at the time the loan is made. The theory of fraud here is:

> **Lie:** I promise that disability insurance will pay in the event of your disabled;
>
> **Reliance:** purchasing the insurance;
>
> **Damages:** paying the premium for it, plus interest.

Alternatively, if the consumer is uneducated and cannot read and write a fraudulent failure to disclose theory may be appropriate.

Another type of credit insurance is involuntary unemployment insurance. This insurance is designed to make the payments of the consumer if he loses his job involuntarily. In the fine print of the insurance policy, there is a provision that the consumer must be employed for 12 consecutive months before taking out the insurance in order for there to be coverage (see sample policy attached in appendix). No questions are asked regarding the length of the consumer's employment at the time he takes out the insurance. However, the consumer's lack of employment is used by the insurance company as grounds to deny coverage. The fraud theory here is:

> **Lie:** I promise you the insurance will pay in the event you are unemployed;
>
> **Reliance:** taking out the insurance;
>
> **Damages:** the premium payment plus interest.

B. **PROPERTY DAMAGE INSURANCE**

Another area of insurance packing in the consumer finance industry deals with collateral protection insurance. Many finance companies require that the collateral protection insurance be sold through the finance company. Of course, it is perfectly permissible to require insurance on the collateral. However, it is illegal to require the consumer to purchase collateral protection insurance through the finance company. (Code of Alabama (1975) §5-19-20(b)). On many occasions, consumers are told they must buy the collateral protection insurance through the finance company in order to obtain the loan. Many times, the value of the collateral is inflated, which causes the premium on the insurance to be higher than the premium which the consumer would pay elsewhere. As stated above, there is a motive for the finance company to charge as high a premium as possible. The finance company receives interest on the total amount financed, commissions and many times the insurance is sold through a related corporation.

The theory of liability again is fraud:

> **Lie** - I promise you that you are required to purchase insurance through the finance company;
>
> **Reliance:** purchasing insurance through the finance company;
>
> **Damages:** difference in the cost of insurance

plus interest minus the amount the consumer could have paid elsewhere for the same insurance.

C. **NON-FILING INSURANCE**

This is a type insurance where the finance company charges a fee to the consumer in lieu of filing a UCC financing statement. The finance company charges a premium and supposedly gives the premium to an insurance company to cover it in case it has to repossess the collateral and is unable to repossess it solely because it failed to file a UCC financing statement to perfect its security interest. Theoretically, the finance company can then look to the insurance company for payment of the value of the collateral.

There is much abuse in this practice. Many times, there is no insurance at all. The finance company simply keeps the money. Other times, the money is paid to an insurance company and 100% of the premium is returned to the finance company. Other times, the non-filing insurance is charged on collateral that the debtor finances at point of purchase. This involves the finance company's purchase money security interest. Non-filing insurance on this transaction is useless because UCC financing statements are not required to perfect the security interest in such goods. Therefore, non-filing insurance is not necessary. As stated above, the motive for this is to increase the amount financed.

The theory of liability here is a scheme to defraud, or, fraudulent failure to disclose. *See* *<u>Smith v. First Family</u>, 626 So.2d 1266 (Ala. 1993)*, which allowed a scheme to defraud theory to go to the jury. The non-filing insurance costs ten to fifteen dollars per transaction; therefore, this type theory lends itself more to a class action.

D. **<u>HOUSEHOLD GOODS AS COLLATERAL</u>**

The Federal Trade Commission has enacted strict regulations regarding household goods being used as collateral in consumer loans. Generally, most household goods cannot be used as collateral. 16 *<u>C.F.R.</u>* §444.2(a)(4). Since they cannot be used as collateral, they certainly cannot be repossessed. However, many finance companies take a security interest in these goods solely to be able to charge collateral protection insurance on it.

Some finance companies take a security interest in such things as fishing poles, clock radios, blankets, televisions, and other similar items. Since it is not real collateral, it is improper to charge insurance on it. The company has no insurable interest in it. They rarely try to repossess the collateral. The fraud theory here is a scheme to defraud and a fraudulent failure to disclose that the insurance charges are not required.

Normally, the defendants will try to remove these cases, stating that since FTC rules are the basis for the claim that the claim involves a federal question. However, the *Gully v. First National Bank in Meridian, 299 U.S. 109, 57 S.Ct. 96 (1936)*; *Merrell Dow Pharmecuticals, Inc. v. Thompson, 478 U.S. 804, 106 S.Ct. 3229 (1986)* cases require remand. These cases state that removal is not allowed simply because an element of your state law claim involves federal law.

E. **FORCE PLACE INSURANCE**

This type insurance deals with collateral protection. At the time of the loan, many consumers take out their own collateral protection insurance from a separate company. However, if the consumer does not keep the collateral protection insurance, the finance company in the loan contract has the right to purchase collateral protection insurance on the collateral. It is permissible, for the finance company to buy insurance similar to the insurance that the consumer let lapse. However, many finance companies have abused this privilege by purchasing insurance that gives them more protection than the consumer originally had with his insurance. For example, there are some policies force placed that protect the finance company against the consumer's default. In other words, if the borrower doesn't make his payments to the finance company, the insurance will make the payments. The premiums are the highest allowed by law and the finance companies are allowed to charge interest on the premium.

Perhaps the area that is most abused is that the insurance premium on this type insurance is based on the total gross balance of the loan, but in the event of a total loss of the collateral, the insurance will only pay the actual cash value, or depreciated value of the collateral. Many times, the collateral is worth less than the gross balance of the loan; i.e., cars, mobile home, and things that depreciate.

While the consumer pays a higher premium based on the total amount owed plus interest, the most the insurance will ever pay is a lesser amount; i.e., the value of the collateral. This violates the Alabama Insurance Department bulletin of February 22, 1994, (AB-133).

The theory of liability is fraud. It can be couched in a failure to disclose or a scheme to defraud theory. See the appendix for a sample complaint.

II. DEALER DISCOUNTS

Many consumer financial transactions take place through dealers; i.e., sellers of goods and services such as cars, mobile homes, televisions, stereos, washing machines, etc. Most of us have seen things advertised wherein the dealers state they can handle the financing.

Most of the time, this dealer arranged financing is handled in the following manner. The finance company gives the dealer all of the necessary documents for the consumer to sign in order to consummate a loan, i.e., a retail installment contract, mortgage or UCC financing statements, truth in lending documents, etc. The dealer then sells the product and gets the consumer to sign all of the finance papers. In actuality, this is a loan from the finance company to the consumer, with the consumer making his payments back to the finance company from the very beginning. However, on paper, the dealer is shown to be the finance company.

This paper trail is created so the finance company can claim that it is purchasing the loan from the dealer and not making a direct loan to the consumer. Since the finance company is purchasing the loan, it can assert that it can purchase the loan for less than the face value of the loan (at a discount). Many times the finance company purchases the loan at a discount, which was agreed upon prior to the underlying loan ever being consummated.

Other times, the finance company will simply keep a certain amount of the amount financed in each deal. In other words, when the finance company "buys the loan", the finance company will keep for example $500.00 of the amount financed and never give it to the dealer. This is money that never leaves the hands of the finance company, yet the consumer is charged interest on it.

Practically, the act of buying the loan at a pre-approved discount or keeping part of the amount financed requires the dealer to raise his prices by $500.00 (in the example above) to make the same profit he would make if the money had not been kept by the finance company. It can be argued that the $500.00 that the finance company kept or the discount is a finance charge (Code of Alabama (1975) §5-19-1). If it is a finance charge, it should be disclosed to the buyer.

Another form of the dealer discount works as follows. The dealer will call the finance company and ask what interest rate the finance company is willing to make the loan to the particular consumer. The finance company agrees to make the loan for example at 10%. The dealer will then add 2% on top and make the loan at 12%. The dealer and finance company will split the 2%. The consumer is never told that the finance company was willing to make him the loan at 10%. This is sometimes referred to as a yield spread premium. It is a jury question whether or not the finance company and dealer are required to disclose the yield spread premium to the consumer. The theory of liability in the dealer discount area is that the company fraudulently failed to disclose to the consumer that there was a finance charge. Many times, the consumer never would have entered into the loan if he had known the true facts or if he had known that he could have gone elsewhere and gotten the financing cheaper. *See Smith v. First Family*, *supra*.

Since the *Smith* opinion, the finance lobby supported and got passed an amendment to the mini-code, §5-19-6(c), which states that there is no duty, under the mini-code, to disclose the above mentioned hidden finance charge. This amendment had retroactive application. It is questionable whether or not retroactive application will be upheld as constitutional. Also, the amendment dealt with the mini-code only. It did not affect whether or not there was a common law duty to disclose. Of course, when deciding whether or not there is a common law fraud duty to disclose, one must look to the Alabama Pattern Jury Instruction §18.08. Certainly, there is an argument there is still a duty to disclose this information.

III. **DISCOVERY TIPS**

1. Study the Insurance and Banking Department regulations.

2. Try to find ex-employees of the finance company to testify about the company's practices. This can be invaluable. We usually try to find these by asking questions in depositions.

3. Get the policy and procedures manual that employees of the company are required to follow. Many times, the information in these can be extremely damaging.

4. Get the training videotapes which train the employees. Again, the information on these videotapes can be extremely damaging.

5. Find similar occurrence information. Do this by getting the customer list of the company, contacting them, and asking them if they have had similar action perpetrated on them. Hopefully, they will agree to be witnesses for you. See the cases of *Ex*

Parte Asher, Inc., 569 So.2d 733 (Ala. 1990); Ex Parte State Farm, 452 So.2d 861 (Ala. 1984) which allow this discovery.

6. Also, if you are hooked into the Administrative Office of the Courts computer, you can find other similar lawsuits against the company. You can also use the AOC network by going to any Circuit Clerk.

7. Do a ***WESTLAW*** search to see if the company has been sued for other similar occurrences.

8. Contact The American Trial Lawyers. They have a database which may have some information regarding the companies.

9. Check the Attorney General's Consumer Division to see if there has ever been any investigation of the company.

10. Check the Better Business Bureau to see if there have ever been any complaints regarding the company.

IV. **APPENDIX**

A. Senate Bill 95

B. Sample Complaint on requiring insurance

C. Sample Complaint on force place insurance

D. Sample Discovery - credit insurance

E. Sample Finance Contract

F. Sample Policy on involuntary unemployment insurance

G. Resources