Time to Update
the Credit Practices Rule

CFPB Should Modernize FTC Rule Addressing
Abusive Creditor Collection Practices

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I. Introduction and Summary

In 1984, the Federal Trade Commission issued the earth-moving Credit Practices Rule to protect consumers against abusive terms and conditions in credit contracts. While the Fair Debt Collection Practices Act – passed in 1977 – protected consumers from harassment and other abuses by third-party debt collectors, the original credit contracts often contained provisions that led to abusive collections activities by the creditors themselves (as well as their agents).

The FTC’s Credit Practices Rule protects consumers from abusive contract provisions that are designed to give the creditor an upper hand in collections and to evade legal protections for the debtor. The rule prohibits confessions of judgment, exemption waivers, irrevocable wage assignments, non-purchase security interests in household goods, pyramiding late charges, and deceptive cosigner practices.

Unfortunately, the credit industry has created a new set of practices in consumer credit relationships that are just as abusive, unfair, and harmful to consumers as those made illegal by the FTC in 1984. As the new Consumer Financial Protection Bureau prepares to take over financial consumer protection from the FTC, it should address the practices of creditors in the 21st century. The Credit Practices Rule should be updated to:

1. Require full assignee liability for all consumer loans.
2. Prohibit loans secured by check or electronic access to the consumer's bank account, when at the time of the loan, there are insufficient funds in the account to cover the check or promise to pay.
3. Prohibit multiple late fees for a single missed payment when subsequent payments are made on time.
4. Require a right to reinstate after repossession of a vehicle or manufactured home.
5. Prohibit the inclusion in consumer contracts of clauses requiring arbitration or waiving trial by jury or the right to bring a class action.
6. Prohibit creditors and debt collectors from selling or assigning a debt without giving the consumer notice of the transfer and providing the transferee with proof of the details of the debt, including proof that it is not time-barred.
7. Prohibit creditors or their agents from entering a debtor's home for any purpose allegedly authorized by contract without first obtaining a court order.
8. Prohibit a debt collector from collecting a contingent fee from child support payments, unless the payments were solely the result of the debt collector's efforts.
9. Prohibit the attachment of funds or property known to be exempt from collection.

3 At the time – the early 1980s – most states had healthy limits on the terms and conditions of credit contracts, which meant that these credit origination issues were not as much of an issue.
II. The Protections Provided by the Credit Practices Rule

The FTC used its “mandate to proscribe unfair or deceptive acts or practices”\(^4\) that operate to cause injury for consumers as the basis for the Credit Practices Rule (CPR). Declaring that consumer injury was “the focus of any inquiry regarding unfairness,” the FTC confined its definition of consumer injury to those injuries “found to be substantial, not reasonably avoidable by the consumer, and not outweighed by countervailing benefits to consumers or competition.”\(^5\)

Employing this three-part definitional and analytical rubric, the FTC based its prohibitions upon a finding that its substantial rulemaking record established “by a preponderance of the evidence that consumers suffer substantial economic or monetary injury from creditors’ use”\(^6\) of the practices proscribed by the Rule. Additionally, the record established that because of the identified practices, “consumers often suffer substantial emotional or subjective harm as well.”\(^7\)

After finding substantial harm to consumers in six areas of consumer credit, without countervailing benefits, the FTC specifically prohibited six practices in 16 C.F.R. § 444:

1. **Confessions of judgment, cognovits, and other waivers of the right to notice and opportunity to be heard in the event of suit.** (16 CFR § 444.2(a)(1).) Confessions of judgments were standard form contract clauses in which the debtor agreed in advance to a judgment in the amount of any debt unpaid. The result was that consumers were denied any opportunity to present meritorious defenses in lawsuits. The judgment typically led to wage garnishment, execution on the consumer’s household goods, and a lien on the consumer’s real property.\(^8\) Recognizing these abuses, the CPR prohibits confessions of judgments.

2. **Waiver of exemptions from execution on personal or real property, such as waiver of a homestead exemption, unless the waiver applies only to property that is the subject of a security interest granted in that credit transaction.** (16 CFR § 444.2(a)(2).) Both state and federal law provide exemptions to protect the property of judgment debtors from seizure by judgment creditors. For example, all state laws provide some level of protections for household goods, some cash, and property used as a home, as well as other protections. Prior to the CPR, creditors commonly required consumers to waive all of those exemptions, thus making consumers vulnerable to loss of their most basic property: all of their household goods, their homes, all savings.\(^9\) To address this abuse, the CPR prohibits contract clauses that waive or limit exemptions from attachment, execution, or other process on the debtor’s real or personal property.\(^10\)

3. **Most irrevocable wage assignments.** (16 CFR § 444.2(a)(3).) Wage assignments (in which the consumer agrees in the initial credit contract that her wages will be paid directly to the creditor) occur without the procedural safeguards of a hearing and an

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\(^6\) Id. at 7744.
\(^7\) Id.
\(^8\) Id.
\(^10\) 16 C.F.R. § 444.2(a)(2).
opportunity to assert defenses or counterclaims. The FTC found that wage assignments were particularly harmful because the pressure from the threat of wage assignments caused consumers to abandon legitimate defenses to prevent the creditors from contacting the employers and exercising the wage assignment. Consumers feared that the wage assignment would result in job loss.\footnote{49 Fed. Reg. 7740 (Mar. 1, 1984) at 7758.}

To address this, the CPR rule prohibits wage assignments except those that are revocable at the will of the debtor.\footnote{16 C.F.R. § 444.2(a)(3)(i).} Exceptions were permitted for payroll deduction plans and preauthorized payment plans in which the consumer authorizes a series of wage deductions as a method of making each payment,\footnote{16 C.F.R. § 444.2(a)(3)(ii).} as long as only part of the debtor’s paycheck is taken.\footnote{Kelley, FTC Informal Staff Opinion Letter (June 17, 1987).}

\textbf{4. Non-purchase money security interests in certain household goods.} (16 CFR § 444.2(a)(4).) The FTC found that both banks and small loan finance companies routinely took blanket security interests in household goods for their \textit{in terrorsam} impact, rather than to provide any economic security to the creditor:

\begin{quote}
In this proceeding, a large majority of industry witnesses confirmed that household goods have little, if any, economic value to creditors.
Their value to creditors is psychological, . . . \footnote{49 Fed. Reg. 7740, 7764 (Mar. 1, 1984).}
\end{quote}

The imminence of seizure of all of their personal property – including beds, tables and chairs, linen, kitchen plates and pots and pans, even the family bible – placed considerable pressure on consumers to make disadvantageous repayment arrangements. Not only would debtors forego the assertion of valid or meritorious defenses in their rush to complete repayment agreements acceptable to the lenders, but “such consumers are likely willing to take other steps they would not willingly take but for the security interest. Accordingly, such creditors are in a prime position to urge debtors to take steps which may worsen their financial circumstances.”\footnote{Id.}

Based on these findings, the CPR prohibited virtually all non-purchase money, non-possessory security interests in household goods.\footnote{16 C.F.R. § 444.2(a)(4).} It defines household goods to include clothing, furniture, appliances, one radio, one television, linens, china, crockery, kitchenware, and personal effects, including wedding rings.\footnote{16 C.F.R. § 444.1(i).} Just the \textit{listing} of a security interest in these protected household goods violates the rule.

\textbf{5. Pyramiding late charges by assessing more than one delinquency charge for one late payment (pyramiding late charges for a missed payment is not prohibited).} (16 CFR § 444.4.) The FTC found that creditors routinely charged late charges on timely payments because a late charge due for a previous late payment was not included. Often, the only delinquency in the account was attributable to the prior late

\begin{footnotes}
\item[12] 16 C.F.R. § 444.2(a)(3)(i).
\item[14] Kelley, FTC Informal Staff Opinion Letter (June 17, 1987).
\item[16] Id.
\item[17] 16 C.F.R. § 444.2(a)(4).
\item[18] 16 C.F.R. § 444.1(i).
\end{footnotes}
charge. Moreover, the assessment of these fees was far in excess of the amounts, if any, actually expended by creditors to collect on the account. The problem of this late charge pyramiding was compounded by the fact that consumers are usually unaware that the late charges are “pyramiding” until the final payment is made. Consumers could not avoid the practice, because it was not something that was disclosed in credit contracts.19

Addressing this abuse, the CPR prohibits late charge pyramiding by assessing more than one delinquency charge for one late payment.20 The rule does not prevent a creditor from assessing a late charge for each month that an installment remains unpaid.21 Nor does it dictate which month a late payment is applied to – the month when it was due or the month in which it was actually paid.22

6. Failure to provide cosigners with a specified warning indicating the potential obligations of a cosigner. (16 CFR § 444.3.) The FTC found that many creditors routinely required consumers to obtain cosigners for their debts. A cosigner is required to pay if the debtor defaults, but the cosigner receives no benefit for agreeing to this obligation. The cosigner agreement was a standard form contract drafted by the creditor which waived all defenses a cosigner might otherwise have. Often multiple cosigners were required (one finance company stated it required six cosigners on some loans). Cosigners were not provided any notice of their obligations and liability.23

As a result, the CPR requires a form notice to cosigners, as prescribed by the FTC, warning them of their potential obligations.24

III. Analogous Rules Adopted for Banks

The FTC rule applies to finance companies, retailers, and other creditors within the FTC’s jurisdiction, but does not apply to most banks. Nevertheless, the Office of Thrift Supervision (OTS) and the Federal Reserve Board (FRB) have adopted analogous rules for savings and loan institutions25 and for all other banks,26 respectively. Credit unions are covered by a comparable rule adopted by the National Credit Union Administration (NCUA).27

While the rules enacted by these other agencies closely track the FTC rule, there are a number of differences. The most important difference is that the FRB, OTS and NCUA rules only prohibit banks and credit unions from entering into credit agreements containing or enforcing the prohibited creditor remedies. The banking agency rules do not prohibit a bank or credit union from purchasing consumer credit agreements containing the prohibited terms as long as the financial entity does not enforce the prohibited creditor remedy.

20 16 C.F.R. § 444.4.
24 16 C.F.R. § 444.3.
25 12 C.F.R. § 535.
26 12 C.F.R. §§ 227.11/-/227.16.
27 See 12 C.F.R. § 706.
IV. The Effect of the Credit Practices Rule on the Marketplace

The credit industry revolted against the Credit Practices Rule. But, after the Rule was affirmed by the appellate court, the game was finally over. The credit industry obeyed – because it had to. And all of these offensive and damaging terms and practices were stopped. Within a few years of the passage of the CPR, consumer advocates rarely saw these problems in consumer credit contracts. And, despite the promises from the industry that if this rule were passed the “credit” sky would fall, nothing terrible happened to the credit industry or small businesses. The sky did not fall. Credit continued to be widely available, only with less abusive terms.

But over time, some in the consumer credit industry developed new terms and practices, just as dangerous, just as outrageous, just as unavoidable, that harm consumers. This second-generation of abusive credit terms needs to be addressed in an update to the Credit Practices Rule.

V. New Terms and Practices That Need to Be Addressed

As the FTC recognized in its adoption of the Credit Practices Rule 26 years ago:

In consumer credit transactions, the rights and duties of the parties are defined by standard-form contracts, over most of which there is no bargaining. The economic exigencies of extending credit to large numbers of consumers each day make standardization a necessity. The issue, however, is whether the contents of these standard form contracts are a product of market forces.

Although market forces undoubtedly influence the remedies included in standard form contracts, several factors indicate that competition will not necessarily produce optimal contracts. Consumers have limited incentives to search out better remedial provisions in credit contracts. The substantive similarities of contracts from different creditors mean that search is less likely to reveal a different alternative. Because remedies are relevant only in the event of default, and default is relatively infrequent, consumers reasonably concentrate their search on such factors as interest rates and payment terms. Searching for credit contracts is also difficult, because contracts are written in obscure technical language, do not use standardized terminology, and may not be provided before the transaction is consummated. Individual creditors have little incentive to provide better terms and explain their benefits to consumers, because a costly education effort would be required with all creditors sharing the benefits. Moreover, such a campaign might differentially attract relatively high risk borrowers.

The Commission recognized that consumers cannot avoid the remedial provisions themselves. Nor can consumers avoid the harsh consequences of the remedies in the contracts by avoiding default. When default occurs, it is most often a response to events such as unemployment or illness that are not within the borrower's control. The substantial injury that the FTC sought to prevent by passage of the Credit Practices Rule three decades ago is still being perpetuated by the creditor terms and practices that are typical of consumer contracts in 2010.

To address credit practices of the 21st century, the Credit Practices Rule should be amended to address modern creditor practices.

1. **Require full assignee liability for all consumer loans.** Consumer credit obligations are commonly sold to an assignee by the original creditor, and then often transferred further from one assignee to another. Generally, these loans would not have been made but for the promise or at least the expectation that the loan would be purchased. Yet, the buyers of many consumer credit transactions hide behind the legal fiction of “holder in due course” created by the UCC for commercial transactions to avoid liability for the illegal conduct of the originator. The holder in due course doctrine has led to enormous litigation costs, and worse – complete avoidance by large institutions of liability for creating and funding fraudulent and unfair credit schemes that are tremendously harmful to American consumers. The doctrine should simply be eliminated as it applies to consumer loans.

2. **Prohibit loans secured by check or electronic access to the consumer's bank account, when at the time of the loan, there are insufficient funds in the account to cover the check or promise to pay.** When a payday lender makes a short-term loan, it invariably demand a post-dated check (or the electronic equivalent) to hold in the event that the borrower does not repay the loan at the designated time. Some banks and credit unions also require the consumer to authorize an electronic payment as security. Using the retained check or electronic debit capability as a “collection device,” the lender gains access to the borrower’s bank account as security for the loan, and can seize the borrower’s paycheck once it becomes available. Lenders who use electronic security often structure their loans as single payment loans in order to evade the rule forbidding mandatory electronic repayment as a condition of credit.  

These practices are tantamount to the wage assignments that the FTC prohibited in the original CPR twenty-six years ago. These forms of security are clearly a collection method like those prohibited by the CPR, not a method of making payments. Just as in other kinds of wage assignments, borrowers who deliver access to their bank accounts relinquish control over their power to buy food, pay the rent, or repay the payday loan if the funds do not cover all these costs. The lender evades the legal protections against garnishing funds needed to pay for necessities, such as laws protecting Social Security, unemployment insurance, and a basic amount of wages. The lender’s access causes “disruption of the family’s finances and makes it difficult for the debtor to purchase necessities.” This consequence is precisely the sort of substantial consumer injury implicated by wage assignments that the FTC sought to eradicate in enacting the Credit Practices Rule.

32 **Id.** at 7758.
Payday lenders also routinely threaten to initiate a prosecution for passing a bad check as a way to force borrowers into refinancing the payday loan. Yet, the act of writing the check was essential to obtain the loan, and the lender obviously knew at the time the check was written that there were not sufficient funds in the account to cover the check. If there had been sufficient funds in the account to cover the check, the consumer would not have needed the loan. This behavior is analogous to the in terrorem acts of taking meaningless security interests in household goods just so the lenders could threaten to repossess the goods as a means of pushing the consumers into refinancing at high rates.

3. **Prohibit late fees for a single missed payment when all subsequent payments are made on time.** The FTC prohibited charging a late fee when a consumer failed to pay a fee for a previous late payment, but it did not prohibit the repeated charging of a late fee for a single missed payment. If one payment is missed, and all other subsequent payments are made on time, the FTC rule permits the creditor to apply the missed payment to the previous month, causing every subsequent payment to be considered late as well. This is a form of pyramidng of late fees that can lead to substantial cost for consumers, with little justification. The FTC recognized the inherent unfairness of this practice and initially proposed including it within the prohibition, but backed off in the final rule.

4. **Require a right to reinstate after repossession of a vehicle or manufactured home.** When a consumer defaults on an automobile loan, invariably the lender does not just repossess the car, but also “accelerates” the debt. Acceleration means that the entire debt for the car is now due, even though the consumer may have fallen just one or two payments behind. Even if the consumer is able to catch up on the missed payments and pay all the costs the lender incurred in repossessing the car, the consumer has no right to get the car back. The result is that the car is sold, typically for a fraction of its value. The consumer loses transportation that may be essential for work, school, or family, yet is required to pay the shortfall between the balance on the loan and the amount the car was sold for. The same pattern applies to manufactured home loans.

   Article 9 of the Uniform Commercial Code, in effect in every state and the District of Columbia, explicitly allows this unjust and harmful result. While Article 9’s rules may be appropriate for business transactions, they cause great harm to consumers as well as great economic waste.

   Requiring lenders to allow consumers to reclaim repossessed cars or manufactured homes – by paying the missed payments and repossession costs within a certain number of days – would not unduly burden or restrict commerce. About six states already provide such a right, with no appreciable diminution in car or manufactured home sales in those states.

5. **Prohibit the inclusion in consumer contracts of clauses requiring arbitration or waiving trial by jury or the right to bring a class action.** Arbitration clauses force consumers pre-dispute to give up the right to bring individual cases before a judge or jury. The typical arbitration clause also requires the consumer to give up the right to bring a class action not only in court but also in arbitration.

   Even clauses which do not require arbitration, but do waive class actions or trial by jury, deny consumers essential avenues to pursue valid legal claims. Individual actions for
smaller injuries are generally not practical, and when class-wide relief is unavailable that means the many consumer wrongs have no effective remedy. If there is no effective remedy, there is no incentive for industry to follow the law or avoid abusive actions.

Even for more significant injuries, the cost to arbitrate a matter can be in the thousands of dollars a day and repeat player bias means that the arbitration forum is tilted toward the corporation. In arbitration, arbitrators are not required to follow the law, there is little effective review, and the consumer may have to pay all arbitration costs and attorney fees if an arbitrator rules (arbitrarily or not) against the consumer.

6. **Prohibit creditors and debt collectors from selling or assigning a debt for collection without giving the consumer notice of the transfer and providing the transferee with proof of the details of the debt, including proof that it is not time-barred.** Many debt collectors and particularly debt buyers undertake their collections of consumer credit without most (or even any) of the transactional documents and business records involved.\(^3^3\) Debt collectors should be required to possess at least certain basic information about the debt: (1) the agreements involved and documentary proof of indebtedness, including the consumer’s signature signifying agreement; (2) the date that the debt was incurred and the date of the last payment to determine whether the claim is time barred; (3) the identity of the original creditor as known to the consumer; (4) several years of history of the account prior to default; (5) a full record of any disputes or of any bankruptcy filings; and (5) the chain of title if the debt has been sold. To diminish collections by imposters, no collection activity should ensue after a consumer account is sold until the consumer has been notified by the seller of the sale.

Before a collector files a complaint, the collector should possess the basic information listed above in a form admissible in the court, certify that fact in the complaint, and certify to the court or arbitrator that the collector possesses any license required by state law.

The creditor and each subsequent holder of the debt must retain and pass on to the next holder all communications from the consumer concerning the debt and information about all known disputes and parties. Debt collectors should not be permitted to launder the debt of claims and defenses simply by selling it to another collector.

7. **Prohibit creditors or their agents from entering a debtor’s home for any purpose allegedly authorized by contract without first obtaining a court order.** Most home mortgages today include terms authorizing the lender or its agent (i.e. the mortgage servicer and subcontractors) to enter the borrower’s home for repairs or to change the locks,\(^3^3\) See McCollough v. Johnson, Rodenburg & Lauinger, 645 F. Supp. 2d 917 (D. Mont. June 3, 2009); Miller v. Upton, Cohen & Slamowitz, 2009 WL 3212556 (E.D.N.Y. Oct. 5, 2009), on remand from Miller v. Wolpof & Abramson, L.L.P., 321 F.3d 292 (2d Cir. 2003); Midland Funding L.L.C. v. Brent, 644 F. Supp. 2d 961, 966 - 967 (N.D. Ohio 2009) (“Ivan Jimenez, one of Midland’s ten “specialists” in the department that supports law firms, personally signs between 200 and 400 of such affidavits per day… He finds the stack on a printer, signs them, and sends them by internal mail to the notary… (“Q: Where do your affidavits come from? A: As far as what I deal with, they just come from the printer as far as where we get them”). Mr. Jimenez has the ability to check the accuracy of the information on the affidavit via the computer system and he does, but the percentage of those that are checked for accuracy is “very few and far between.”).
board-up the windows and doors, and shut-off the utilities. The contract allows this to take place whenever the servicer deems appropriate to protect the lender's security in the property, such as when it believes the property has been abandoned. While this may seem reasonable for the lender, the homeowner is not entitled to any semblance of due process or warning, even though the consequences can be a de facto eviction. A homeowner improperly locked out by a mortgage servicer often faces a frustrating battle to gain re-entry. The local police may refuse to get involved in what they perceive to be a contract dispute and local courts may be of no use because landlord-tenant laws written to prohibit self-help evictions only apply to leases. As a result, homeowners must resort to breaking into their own home or pleading with their mortgage servicer. Self-help eviction by landlords has been largely abolished. There is no reason to allow mortgage lenders and their agents to engage in similar conduct when they could simply seek permission to enter from the courts.

8. **Prohibit a debt collector from collecting a contingent fee from child support payments, unless the payments were solely the result of the debt collector's efforts.** Private child support collection agencies contract with parents to collect support payments on a contingent fee that is based on all support that is paid to the family, whether through government support enforcement efforts, voluntary payments by the parent, or the debt collector's effort. The contingent fee is actually not earned in many cases and can significantly diminish the child support available to family and create greater financial distress for them. When the family seeks to get out of this predicament, they are likely to be told by the debt collector that their debt collection contract states the contract is not cancellable. The Fair Debt Collection Practices Act has been construed not to apply to child support. A few states have addressed this with targeted legislation. State law enforcement efforts have been faced with bankrupt defendants and dilatory tactics.

9. **Prohibit the attachment of funds or property known to be exempt.** As the FTC found in its promulgation of the original CPR, property designated as exempt is designed to protect consumers from complete destitution. Creditors have avoided the express prohibition in the CPR against seeking a waiver of exemptions, by simply ignoring the exempt status of property and attaching it. This forces consumers to hire attorneys and go to court to prove the exemptions to reclaim the benefit of their own protected property, something elderly and poor consumers generally do not have the means to do. The problem has been particularly devastating in the context of bank seizures of exempt Social Security funds to satisfy garnishment orders and to pay themselves back for high cost overdrafts and payday-like loans. All creditors should be required to recognize the exempt status of

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34 See, e.g., Fannie Mae Standard Security Instrument for Alabama, Form 3001, ¶ 9 ("Protection of Lender's Interest in the Property and Rights Under this Security Instrument. If (a) Borrower fails to perform the covenants and agreements contained in this Security Instrument . . . , or (c) Borrower has abandoned the Property, then Lender may do and pay for whatever is reasonable or appropriate to protect Lender's interest in the Property and rights under this Security Instrument, including protecting and/or assessing the value of the Property, and securing and/or repairing the Property. . . . Securing the Property includes, but is not limited to, entering the Property to make repairs, change locks, replace or board up doors and windows, drain water from pipes, eliminate building or other code violations or dangerous conditions, and have utilities turned on or off.")


property known to be exempt and should be prohibited from attaching or seizing such property.

VI. Conclusion

Creditor practices have changed tremendously in the 26 years since the FTC adopted the Credit Practices Rule. Consumer contracts have become vastly more complicated, creditors have become much more sophisticated in their collection techniques, and the number of abusive credit products on the market has exploded. The newer creditor practices listed above are just as unfair as those banned by the FTC Credit Practices Rule.

The FTC adopted the original rule out of the common sense notion that the creditor debtor relationship, which always starts from an imbalance of power, should not be abused to exploit consumers or to undermine the rights and protections of debtors. That goal is just as relevant today. The Credit Practices Rule needs urgent updating to protect consumers in the 21st century.

For more information:

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