

December 9, 1996

Dear

You recently asked how service contracts should be handled for purposes of the I-CCC, in view of the informal advisory letter of February 18, 1985. Specifically, you asked whether they could be included on the standard motor vehicle installment sales contract as a charge paid to third parties, or whether they were permissible charges which might be included under the cash price.

As your question came at a time when Truth in Lending disclosure issues concerning service contracts, particularly those with "upcharges," or dealer mark-ups, have been the subject of recent litigation and amendments to the Official Staff Commentary to Regulation Z, we have taken your question as an opportunity to conduct a review of a variety of issues as they relate to service contracts.

Given that you have a wide audience of interested parties, we felt it would be useful if we not only responded to your question, but shared with you our thinking on a variety of other issues raised by service contracts. We'd be happy to talk any of these issues over with you.

Iowa Consumer Credit Code

We have re-examined the advisory letter of February 18, 1985. It is our view that a slight modification of the position taken in that letter is warranted. We feel that bona fide charges for voluntarily purchased service contracts which are made equally available on the same terms to cash and credit customers are not charges imposed in connection with a credit transaction. Consequently, under those circumstances, a charge for a service contract would not fall within the category of an "additional charge" which must be authorized by rule.

There are several criteria which must be met for a service contract charge to fall outside that category:

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a. It must be made equally available to cash and credit customers.¹

b. It must be made available on the same terms to cash and credit customers. If credit customers are charged more than cash customers for an equivalent product, the difference is a finance charge.

c. It cannot be a requirement that a credit customer purchase the service contract.²

d. And, of course, there must be bona fide consideration given in exchange for the purchase price of the service contract.³

Provided all of these criteria are met, the purchase price of a bona fide, optional service contract falls outside the I-CCC, as it is not a charge imposed "in connection" with the credit transaction.

Please note, though, that we do not feel that the purchase of a post-consummation service, such as the service contract, falls within the statutory definition of the "cash price" of the vehicle or other product to which the service contract relates. It is our position that the "cash price of accessories or services related to the sale," encompasses only items relating to the product itself. The examples given in I-CCC § 537.1301(8) -- "delivery, installation, alterations, modifications, and improvements," and certain taxes -- do not seem to encompass an agreement to offer post-consummation repairs for problems which may surface or arise in the future.

¹ In the event that the service contracts are not offered to cash customers, or if the dealer's business is so arranged that cash sales are rarely, if ever, made, the charge may constitute interest in connection to credit. Such a determination would have to be made on a case by case basis, looking at the substance of the transaction. Cf. S.C. Dept. of Consumer Affairs Adm. Interp. No. 2 110-8701, Consumer Credit Guide Para. 95,911 (Dec. 30, 1987)

² While the I-CCC, of course, relates only to the financing portion of the transaction, we also believe that cash customers also have the freedom to choose whether or not to purchase a service contract, as mandating a purchase would appear to constitute an illegal tie-in. In turn, making representations to any customer that a service contract was required would, we believe, constitute an unfair and deceptive practice in violation of Iowa Code § 714.16.

³ Cf. *West Virginia v. Scott Runyan Pontiac-Buick*, 461 S.E.2d 516 (W.Va. 1995) (auto dealer collected purchase price of extended service contract, but failed to purchase them from warranty company; assignees held liable for refunds).

Truth in Lending Disclosure

As you know, our office also has authority to enforce the disclosure requirements of the Truth in Lending Act. I-CCC §§ 537.3201, 537.6104. The question of the proper method to disclose the charge for the purchase of service contracts where there is a dealer mark-up, or "upcharge," is the subject of both considerable recent litigation, and of a 1996 amendment to the Federal Reserve Board's Official Staff Commentary to Regulation Z.

Service contracts triggered TIL litigation because they were most commonly disclosed under the category "amounts paid to third parties on your behalf" when, in fact, the charge most commonly included an "upcharge" which in fact is retained by the dealer.

In introducing the 1996 Commentary amendments, the supplementary information stated the following:

"...a sentence has been added to clarify that given the flexibility in itemizing the amount financed, creditors may reflect that they have retained a portion of the 'amount paid to others' rather than disclosing the specific amount retained." 61 Fed. Reg. 14954 (Apr. 4, 1996)(emphasis added).

As amended, the Commentary currently reads:

226.18(c)(1)(iii)-2 Charges added to amounts paid to others

A sum is sometimes added to the amount of a fee charged to a consumer for a service provided by a third party (such as for an extended warranty or a service contract) that is payable in the same amount in comparable cash and credit transactions. In the credit transaction, the amount is retained by the creditor. Given the flexibility permitted in meeting the requirements of the amount financed itemization..., the creditor in such cases may reflect that the creditor has retained a portion of the amount paid to others. For example, the creditor could add to the category 'amount paid to others' language such as '(we may be retaining a portion of this amount.)'" 61 Fed. Reg. 14956 (Apr 4, 1996).

Courts, in issuing opinions following the above commentary change, have not agreed on how service contracts with upcharges are to be disclosed.

One line of cases has held that the language "may" meant that

disclosure was optional.⁴

However, other cases have interpreted the Commentary to mean that

the creditor is required to disclose the fact that it is retaining a portion of the purchase price of the extended warranty but does not require the amount to be disclosed.⁵

It will be our policy to adopt this latter reading of TIL's disclosure requirements, for several reasons. First, as originally proposed, the official staff commentary would have explicitly left it to the creditor's discretion whether or not to disclose the existence of an upcharge.⁶ That proposal was not adopted. In view of that retreat, and in view of the supplementary explanation to the final language, we believe that the FRB staff did not intend to sanction clearly inaccurate disclosures.⁷ Second, as the courts which have adopted this position have noted, since the purpose of Truth in Lending is to provide accurate and honest disclosures, it would be inconsistent with the goal of TIL to sanction a deliberate misrepresentation. Finally, as those courts have also noted, that reading benefits both consumers, who are put on notice of the existence of the upcharge, and creditors, who do not have to disclose the actual amount of the upcharge.⁸

Discretionary Pricing

To the extent that service contracts are the subject of discretionary pricing by dealers, there are several issues that they should be aware of.

First, as was noted earlier, if credit customers pay more than cash customers for a comparable product, the difference is a finance charge for both I-CCC and TIL purposes.

⁴ E.g. *Taylor v. Quality Hyundai, Inc.* 932 F.Supp. 218 (N.D. Ill. 1996); *Gibson v. Bob Watson Chevrolet-Geo*, 1996 WL 316975 (N.D. Ill. June 10, 1996); *Abercrombie v. William Chevrolet/Geo, Inc.* 1996 WL 251435 (N.D. Ill., May 8, 1996).

⁵ *Ritter v. Durand Chevrolet, Inc.*, 932 F.Supp. 32 (D. Mass. 1996); *Alexander v. Continental Motor Werks, Inc.*, 933 F. Supp. 715 (N.D. Ill. 1996); *Bambilla v. Evanston Nissan*, 1996 WL 284954 (N.D. Ill. May 21, 1996) and *Mejia v. River Oaks Imports*, 1996 WL 284954 (N.D. Ill. May 21, 1996) (joint opinion).

⁶ See 60 Fed. Reg. at 62769 (Dec. 7, 1995).

⁷ *Accord Lindsey v. Ed Johnson Oldsmobile*, 1996 WL 411336 (N.D. Ill. 1996).

⁸ See *Ritter and Alexander, supra.*, note 5.

Second, it is our reading of Iowa Insurance Division Regulations that service contracts which are not issued by motor vehicle manufacturers, importers, or third-party administrators acting on their behalf cannot be the subject of discretionary pricing schemes. We believe that charging a different price for a like product to purchasers would constitute unfair discrimination between individuals of the same class in the terms of the contract in violation of 191 Iowa Administrative Code § 23.22(6).⁹

Third, we are aware that recent studies have found that discretionary pricing can sometimes result in discriminatory pricing, with members of protected classes under various civil rights laws paying more without any legitimate justification for the higher price.¹⁰ As I know that we all are committed to fairness in the marketplace, I am sure that there is no design to engage in discriminatory pricing. Yet it cannot hurt to be alert to the possibility that discretionary pricing could unintentionally lead to that result.

Disclaimers of Implied Warranties in Sales with Service Contracts

Finally, it may be useful to remind dealers that the Magnuson-Moss Warranty Act prohibits disclaiming implied warranties if a service contract is sold at the time of the sale of the vehicle or within 90 days thereafter,¹¹ and any disclaimer made in violation of Magnuson-Moss is ineffective.¹²

If you want to talk over these or any other issues about service contracts, please feel free to give me a call.

Sincerely,

SK
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Assistant Attorney General,
Deputy Administrator, Iowa
Consumer Credit Code

⁹ See 161 IAC § 23.5 for the manufacturer exemption.

¹⁰ See, e.g. Ian Ayres, "Fair Driving: Gender and Race Discrimination in Retail Car Negotiations," 104 Harv. L. Rev. 817 (1991).

¹¹ 15 U.S.C. § 2308.

¹² 15 U.S.C. § 2308(c).