Straining the Gnat: A Critique of the 1984 Federal Trade Commission Consumer Credit Regulations

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STRAINING THE GNAT: A CRITIQUE OF THE 1984 FEDERAL TRADE COMMISSION CONSUMER CREDIT REGULATIONS

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I. INTRODUCTION

On March 1, 1985, a group of consumer regulations promulgated by the Federal Trade Commission (FTC) in 1984 went into effect.[1] Those regulations (the "rule") represent the FTC's latest foray into regulating the field of consumer lending and are the fruit of a twelve-year regulatory process.[2] It is a remarkable tribute to the power of bureaucratic momentum that the FTC's rulemaking process continued in a decade of deregulatory fervor and in the face of strong criticism of the FTC's prior intrusions into consumer credit.[3] Still more remarkable is the fact that a

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1. The regulations appear at 16 C.F.R. §§ 444.1-.5 (1986); the effective date appears at 49 Fed. Reg. 7740 (1984). Parallel rules have been adopted, effective January 1, 1986, by the Federal Home Loan Bank Board, 12 C.F.R. §§ 535.1-.5 (1986), and by the Federal Reserve Board, 12 C.F.R. § 227 (1986). Because the FTC, rather than those agencies, took the lead in promulgating the regulations and because the parallel regulations were issued only because required by law, this Article discusses only the FTC rule.

2. An investigation of consumer credit practices began in 1972, the initial Notice of Rulemaking was published in 1975, and the Final Notice of Rulemaking was published in 1977. 49 Fed. Reg. 7740 (1984). The rule was adopted in 1984, accompanied by an extensive Statement of Basis and Purpose and Regulatory Analysis (FTC Statement). *See id.* at 7740-41. Further discussion of the background and evolution of the rule can be found in American Fin. Servs. Ass'n v. FTC, 767 F.2d 957 (D.C. Cir. 1985), *cert. denied*, 106 S. Ct. 1185 (1986); Butler & Kaswell, *Recent Developments: Federal Trade Commission Rulemaking in 1984*, 40 BUS. LAW. 1119 (1985); Braasch, *Recent Developments: Federal Trade Commission Credit Practices Rule*, 36 BUS. LAW. 1252 (1981).

3. *See, e.g.*, J. WHITE & R. SUMMERS, HANDBOOK OF LAW UNDER THE UNIFORM COMMERCIAL CODE 571 (2d ed. 1980) [hereinafter WHITE & SUMMERS]; Note, *Let the Holder Beware! A Problematic Analysis of the FTC Holder in Due Course Rule*, 27 CASE W. RES. L. REV. 977 (1977).

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decade of work produced a rule that is, in some key respects, almost irrelevant to the problems it is designed to alleviate.

Many of the perceived consumer credit abuses used by the FTC to justify the regulations were not widespread and indeed were already sharply restricted by state law. There was no pressing need for the FTC to second the efforts of state regulatory agencies efforts to enforce those restrictions. Moreover, many of the problems created for consumers by the proscribed practices could be avoided or ameliorated by filing bankruptcy.[4] Finally, one of the few provisions of the rule that was genuinely needed, a "plain language" description of cosigner obligations, was poorly drafted since it requires lenders to make dangerously misleading disclosures to cosigners about the scope of their liability to the creditor.[5] Although the required cosigner disclosures may have the salutary effect of discouraging thoughtless cosigning, the disclosures may also persuade cosigners that they have fewer rights than they in fact have. Paradoxically, this may discourage the cosigner from utilizing state law remedies and defenses against the creditor.

II. BACKGROUND AND STRUCTURE OF THE RULE

In 1973 the United States Court of Appeals for the District of Columbia noted in passing that rules issued by the FTC could not create an independent FTC "law of consumer protection."[6] The prescience of this dictum has not yet been disproved, since

4. For example, the effect of a confession of judgment provision, the use of which is now prohibited by the rule, could largely be avoided by the filing of a bankruptcy petition. The creditor's rights under the cognovit provision could not be exercised after the commencement of the bankruptcy because of the automatic stay of all actions against the debtor's property. 11 U.S.C. § 362 (1982 & Supp. III 1985). Any judicial lien created by a prebankruptcy cognovit judgment could be avoided as a preference if the case were filed within 90 days of the creation of the lien. *Id.* § 547. Judicial liens, including judicial liens created by a cognovit judgment, in exempt property are avoidable. *Id.* § 522(f). In addition, a waiver of exemptions is unenforceable by an unsecured creditor, *id.* § 522(e), as are many nonpurchase money security interests, *id.* § 522(f). In spite of all this, the impact of the Bankruptcy Code, which was enacted in 1978, midway through the FTC's marathon, was not viewed as a sufficient basis to void the rule. *American Fin. Servs. Ass'n*, 767 F.2d at 964 n.5.

5. *See infra* notes 146-52 and accompanying text.

6. National Petroleum Refiners Ass'n v. FTC, 482 F.2d 672, 693 (D.C. Cir. 1973), *cert. denied*, 415 U.S. 951 (1974). This decision also affirmed the FTC's right to regulate unfair trade practices by the promulgation of rules.

neither the 1984 FTC rule, nor that rule in combination with other FTC regulations,[7] is an FTC-created consumer credit code. Indeed, the rule itself is concerned exclusively with collection practices. Moreover, some of the consumer credit regulations imposed prior to the rule were required by Congress;[8] and the FTC has yet to promulgate rules concerning some consumer practices Congress allowed it to regulate a decade ago.[9] Finally, except when regulating those practices it was explicitly empowered to regulate, the FTC has hewn closely to the approaches taken by the states and has supplemented existing restrictions on consumer credit practices rather than initiating new ones.

During the last fifteen years, the Commission has fitfully pursued limited restrictions on what it deems to be "unfair" and "deceptive" consumer credit practices. The accuracy of its data has been attacked,[10] and the need for any federal regulation of the practices restricted has been questioned.[11] Such regulation has been criticized, in proper libertarian tones, as a deprivation of a debtor's right to choose the obligations he wishes to incur.[12] Despite these criticisms the Commission plodded on.

Given the controversy surrounding consumer credit regulation in general and the FTC's consumer credit regulations in particular, it is perhaps not surprising that the rule produced by

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7. *E.g.*, 16 C.F.R. §§ 700-03 (1986) (FTC's regulation of consumer warranties pursuant to the Magnuson-Moss Act); 16 C.F.R. § 429.1 (1986) (door-to-door sales regulations); 16 C.F.R. § 433 (1986) (holder in due course rule).

8. Magnuson-Moss Warranty-Federal Trade Commission Improvement Act §§ 102-04, 109, 15 U.S.C. §§ 2302-04, 2309 (1982) [hereinafter Magnuson-Moss Act].

9. Consumer service contracts, which are subject to the FTC's rule-making authority under the Magnuson-Moss Act, have never been regulated by the Commission. *See* 15 U.S.C. § 2306 (1982).

10. Butler & Kaswell, *supra* note 2, at 1119-21. Mr. Butler, who authored the article's short but superb review of the rule, noted:

> There is something oddly ambivalent, contradictory, or even quixotic about the Federal Trade Commission Credit Practices Rule . . . . The record is immense, but at the same time the record is stale and the rule may regulate an industry that hardly exists today. Similarly, the practices covered by the rule are already regulated by the states, yet this fact is used to argue that the rule is needed . . . . Once a rule was proposed and the record begun, it became inevitable that there would be a rule.

Id. at 1119.

11. Butler & Kaswell, *supra* note 2, at 1119-21; *see also* American Fin. Servs. Ass'n v. FTC, 767 F.2d 957, 991-98 (D.C. Cir.1985) (Tamm, J., dissenting).

12. *American Fin. Servs. Ass'n*, 767 F.2d at 998 (Tamm, J., dissenting) ("*'These people' are not children.*") (emphasis in original).

the Commission is so insignificant. The rule does not apply to all lenders;[13] neither does it apply to many consumer credit practices elsewhere condemned. Worst of all, the rule deals inadequately with those practices it does restrict.

The rule is dressed in the current fashion of economic analysis.[14] It makes dutiful, if sometimes dubious, observations that the benefits engendered will outweigh the costs imposed.[15] One of the Commission's central economic assertions is probably correct. In the FTC's view, it is economically legitimate to regulate the remedies provided to consumer creditors in part because there is no effective negotiation over, and thus no market in, remedies. Generally, debtors do not expect to default; therefore, they do not bargain over the effects of default or shop around for less onerous default terms.[16] Although this hypothesis seems to reflect actual consumer behavior, its significance is less clear. Cynics might note that the absence of negotiation over remedies may mean that the economic value of easy default terms is zero. Presumably, if those terms had economic value, putatively rational debtors would bargain over them. This subtle question was not addressed; the FTC merely noted the lack of negotiation, vaguely ascribed to market failure, and viewed that market failure as a sufficient basis to regulate.[17]

Whether the FTC's obescience to economic analysis was sincere or its efforts to effectuate that analysis effective is unclear.[18] Indeed, this article proposes that the purely economic approach to consumer credit protection is inherently flawed. Economic theory does not provide an adequate basis for analyzing consumer injuries that are not economically based. While it provides a comforting harbor in a deregulatory environment, it does not explain the rationale for consumer credit regulation or the method by which such regulation can be accomplished.

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13. It does not apply to lenders under the jurisdiction of the Federal Reserve or the Home Loan Bank Board. 15 U.S.C. § 57a(f) (1982). *See generally* Butler & Kaswell, *supra* note 2, at 1121.

14. *See, e.g.*, 49 Fed. Reg. 7745 (1984) ("To justify a finding of unfairness, the injury must be substantial, not outweighed by countervailing benefits to consumers or competition, and not reasonably avoidable by consumers.")

15. *See, e.g.*, *id.* at 7743-44.

16. *Id.* at 7745-49.

17. *Id.*

18. *See American Fin. Servs. Ass'n*, 767 F.2d at 994-98 (Tamm, J., dissenting).

This Article reviews the FTC rule in light of existing state and federal law. It takes the position that much of the rule is superfluous, that other portions are mishandled and that many more important consumer credit issues remain unaddressed. The scope of this review is somewhat narrow. Generally, this Article does not explore in detail the related question of whether the FTC has power to promulgate consumer credit regulations, a topic widely explored ten years ago when the FTC first ventured into significant consumer credit rulemaking with its partial abrogation of the holder in due course doctrine.[19] Nor does this Article attempt any comprehensive critique of other administrative law issues created by the Commission's actions, such as the adequacy of the record or the relationship of the record to the decision, although it should be obvious that these play a role in any discussion of the rule's legitimacy and significance.[20] This analysis is deliberately limited to implications of the rule, with respect to both current and prospective commercial law and its usefulness in ameliorating the problems its promulgator perceived. To a limited extent, however, it does discuss the suitability, as opposed to the propriety, of the FTC as a consumer credit regulator.

III. Content of the FTC Rule

A. *In General*

The FTC rule defines six consumer credit practices as "unfair" and one as "deceptive" under the Federal Trade Commis-

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19. *See* authority cited *supra* note 3.

20. *See American Fin. Servs. Ass'n*, 767 F.2d at 972-89. For a review and critique of agency decision processes, see generally M. Pertschuk, Revolt Against Regulation: The Rise and Pause of the Consumer Movement 147 (1982); Bruff, *Legislative Formality, Administrative Rationality*, 63 Tex. L. Rev. 207 (1984); Davis, *Judicial, Legislative, and Administrative Lawmaking: A Proposed Research Service for the Supreme Court*, 71 Minn. L. Rev. 1 (1986); Demuth & Ginsburg, *White House Review of Agency Rulemaking*, 99 Harv. L. Rev. 1075 (1986); Hammond, *To Be or Not to Be: FCC Regulation of Video Subscription Technologies*, 35 Cath. U.L. Rev. 737 (1986); Koch & Martin, *FTC Rulemaking Through Negotiation*, 61 N.C.L. Rev. 275 (1983); Magat & Schroeder, *Administrative Process Reform in a Discretionary Age: The Role of Social Consequences*, 1984 Duke L.J. 301; Powell, *Pressing the NCAPA Paradigm: Too Much Form for Ad Hoc Adjudicatory Rulemaking*, 61 N.C.L. Rev. 67 (1982); Robinson, *The Making of Administrative Policy: Another Look at Rulemaking and Adjudication and Administrative Procedure Reform*, 118 U. Pa. L. Rev. (1970).

sion Act.[21] The unfair practices are the use of cognovit provisions,[22] executory waivers of exemption rights,[23] "remedial" wage assignments,[24] nonpurchase money security interests in certain household goods,[25] the pyramiding of late charges,[26] and failure to inform cosigners of their liability prior to the time it arises.[27] Misrepresenting cosigner liability is a deceptive practice.[28] Each of these practices is examined separately; however, a few general definitions and provisions should first be noted.

The rule's prohibitions apply only to "lenders" and "retail installment sellers"[29] who are within the jurisdiction of the Federal Trade Commission,[30] but only when they are dealing with "consumers."[31] The terms "lender" and "retail installment seller" are limited to professional lenders and sellers.[32] Thus, the rule excludes informal extensions of credit between consumers. As under most statutory definitions of the term, a "consumer" is defined as "a natural person who seeks or acquires goods, services or money for personal, family, or household use."[33] This excludes a corporation or other business entity from the rule's protection. The rule says nothing about the treatment of consumer loans made to or through a corporation owned by a consumer.

Another definitional issue significant to only four of the six unfair trade practices is that the rule does not allow a creditor to "directly or *indirectly* take or *receive*" the proscribed obliga-

21. Federal Trade Commission Act § 5, 15 U.S.C. § 45 (1982).

22. 16 C.F.R. § 444.2(a)(1) (1986).

23. *Id.* § 444.2(a)(2).

24. *Id.* § 444.2(a)(3).

25. *Id.* § 444.2(a)(4).

26. *Id.* § 444.4.

27. *Id.* § 444.3(a)(2). Imposing as both these provisions sound, one can evade them by handing out an inaccurate FTC description of "cosigner" liability. *See infra* notes 146-52 and accompanying text.

28. *Id.* § 444.3(a)(1).

29. *See* 16 C.F.R. §§ 444.1(a), (b), (c), (f).

30. Certain financial institutions are not included within the FTC's jurisdiction. *See supra* note 13 and accompanying text.

31. 16 C.F.R. § 444.1(d) (1986).

32. A "lender" is "[a] person who engages in the business of lending money to consumers . . . ." *Id.* § 444.1(a). A "retail installment seller" is one who "sells goods or services to consumers on a deferred payment basis or pursuant to a lease-purchase arrangement . . . ." *Id.* § 444.1(b).

33. 16 C.F.R. § 444.1(d) (1986).

tions.[34] Clearly this means that the rule's limitations apply not only to the creditor who initially creates the obligation but also to subsequent creditors, that is, creditors who subsequently purchase such obligations. Some creditors in the secondary market are unaffected by the rule because it applies only to lenders and retail installment sellers subject to the FTC's jurisdiction.[35] Other creditors do not meet the rule's definition of "lender"[36] or "retail installment seller"[37] because they are solely in the business of buying consumer paper from other creditors and do not extend credit directly to consumers, which is an integral part of the relevant definitions. Those creditors that do fit within both the FTC's jurisdiction and the rule's general definitions, however, now have an obligation not to "indirectly . . . receive" certain types of consumer obligations.[38] This may create some difficulties. Affected secondary creditors should review all consumer paper offered for purchase and refuse to buy any paper that does not comply with the FTC rule. Such a procedure, however, is cumbersome and may lead to litigation with those primary lenders with whom the secondary creditor has a profitable relationship that it wishes to retain. In any event, a secondary lender might not want to risk the loss of good business by being too sticky about the contents of the primary lender's forms.

A less clumsy approach is possible. The secondary creditor could attempt compliance by using a blanket exclusion from the purchase of all prohibited terms. In other words, the secondary lender's contract with the primary lender might state:

> ABC Acceptance purchases all rights of XYZ Finance Company and all obligations of all debtors and cosigners in the assigned loans, except for prohibited obligations of any debtors and/or cosigners. Prohibited obligations are those which creditors are proscribed from taking or receiving under the provi-

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34. *Id.* § 444.2(a) (emphasis added). The description of the fifth unfair trade practice—the pyramiding of late charges—does not use this language. The rule prohibits a creditor from "directly or *indirectly* . . . *levy[ing]* or *collect[ing]*. . ." the pyramided charges. *Id.* § 444.4(a) (emphasis added). This is somewhat different from the prohibition on taking or receiving the other obligations, because it only affects the lender's ability to *enforce* a provision which allows for pyramiding.

35. *See supra* note 13 and accompanying text.

36. *See supra* note 32.

37. *See id.*

38. 16 C.F.R. § 444.2(a) (1986).

sions of 16 C.F.R. §§444.1-444.5.

While it is better practice for secondary lenders to require primary lenders to comply with the rule, the use of such a blanket form exclusion of prohibited obligations in every transaction between the primary and the secondary lender may be sufficient to protect the secondary lender against the possibility (most likely the probability) that some contracts violative of the rule will slip through. The rule prohibits the secondary lender from receiving "an *obligation*," that "constitutes or contains" a prohibited provision.[39] This rule defines an "obligation" as "[a]n agreement between a consumer and a lender or retail installment seller."[40] This rule seems to prohibit only the receipt of the obligation itself, not the receipt of the paper that *evidences* the obligation.[41] The exclusion of the prohibited remedy from the purchase agreement may be sufficient to prevent the lender from "receiving" the obligation and thus from violating the rule.[42]

B. *Prohibition of Cognovit Provisions*

Under the rule it is an unfair trade practice to "take or receive" a "cognovit or confession of judgment (for purposes other than executory process in the State of Louisiana), warrant of attorney, or other waiver of the right to notice and the opportunity to be heard in the event of suit or process thereon."[43] To the FTC (though, interestingly enough, not to the Supreme Court)[44] cognovit provisions, which waive the debtor's right to be heard prior to judgment, "fail to provide the full due process protection required by the fourteenth amendment to the

39. *Id.* (emphasis added). Exception is made for pyramided late charges, which the secondary lender need only refrain from collecting.

40. 16 C.F.R. § 444.1(e) (1986).

41. It must be noted, however, that this definition also can mean that the document received is the "agreement," a word which is not defined by the rule. The Federal Reserve's version of the rule clarifies this point, and only prohibits secondary lenders from enforcing prohibited obligations. 12 C.F.R. § 227.13 (1986).

42. Many of these interpretational issues will of course remain uncertain until the FTC further explains its rule. Recently, the Federal Reserve published staff guidelines for its version of the rule. 50 Fed. Reg. 47,036 (1985).

43. 16 C.F.R. § 444.2(a)(1) (1986).

44. *See* D.H. Overmyer Co. v. Frick Co., 405 U.S. 174 (1972); *see also* Swarb v. Lennox, 405 U.S. 191 (1972).

[C]onstitution."[45] There is certainly no question that a cognovit provision, when enforced according to its terms, fails to give the debtor much protection against either creditor overreaching or creditor error. If, as is true in typical comprehensive cognovit provisions, the creditor has the right to appoint the debtor's attorney and to have that attorney confess judgment against the debtor, there are practically no protections of any kind against the improper or erroneous entry of judgment.[46] Indeed, a debtor may not even know that he or she has been sued prior to the institution of a collection action on a judgment already rendered.

While there is obviously no reason to prevent a debtor from confessing judgment once an action has commenced and the debtor has had an opportunity to review the viability of available defenses,[47] cognovit provisions provide for confession of judgment immediately upon default. Since these provisions are granted at the time the obligation is incurred, the debtor cannot at that time evaluate defenses because default, suit, and the reasons therefor are wholly hypothetical. For all intents and purposes, a cognovit provision is, to the extent it is actually enforced in accordance with its stated terms, a surrender of all the debtor's legal rights to the discretion and mercy of the creditor. Consequently, cognovits have long been attacked, especially

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45. 49 Fed. Reg. 7749 (1984).

46. One hopes, at least, that the lawyer's ethical obligations will usually prevent the confession of judgment in cases where no basis for suit exists. *See* MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 7-102(A)(1) (1981); *see also* MODEL RULES OF PROFESSIONAL CONDUCT Rule 3.1 (1983); *cf.* FED. R. CIV. P. 11 (signature of attorney certifies that pleadings or motions are well grounded in fact and not intended for an improper purpose).

47. Caveat: This is only true if the debtor truly understands the meaning of the agreement. The central difficulty with the cognovit provisions of the rule is they do not adequately distinguish between a well-advised, voluntary admission of liability and a failure to exercise rights. The obviously rare consumer who understands the risks of a cognovit and wishes to undertake them in exchange for some countervailing benefit such as a lower interest rate is not allowed to do so. Conversely, the quite common consumer who cannot afford a lawyer and who does not understand his rights is given the derisory procedural protection of two bits of paper headed "summons" and "complaint." *See infra* notes 54-68 and accompanying text. Obviously, the FTC was in no position to solve the latter problem since it has no power to provide such debtors with lawyers. Yet the absence of a lawyer makes the protections provided so meager as to call into question the utility of banning cognovits. Moreover, the FTC could have, but did not, provide relief from the related problem of self-help repossession. *See infra* notes 59-68 and accompanying text.

when used in consumer transactions.

The problem with the FTC rule is not that consumer cognovit provisions have substantial intrinsic value, but that they were nearly extinct and nowhere enforced without severe limitations. According to the FTC's own research, many states prohibited the use of cognovit provisions, at least in consumer transactions.[48] Those that permitted them gave the debtor the right to reopen the judgment and to raise defenses.[49] Indeed, cognovits of any stripe were used in only a handful of states.[50] Of the states that accounted for most of the cognovit provisions—Pennsylvania, Ohio, Illinois, and Louisiana—consumer cognovits were prohibited in two[51] and were used in a third, Louisiana,[52] for purposes which the FTC itself found inoffensive and did not prohibit.[53] Thus, the portion of the FTC statement which discusses the cognovit prohibition is often little more than a critique of Pennsylvania law. The Pennsylvania law permitting consumer cognovits may have been foolish and may even have been wicked, but it is difficult to see why a problem concentrated in a single state should have so obsessed the FTC.

The rule, in fact, does not reach the root of the problem. In the FTC's view, the primary reason why state laws permitting the reopening of cognovit judgments gave inadequate procedural protection to the debtor was that "debtors are unlikely to succeed [in invoking those procedural protections] without incurring the cost of hiring an attorney."[54] This is undoubtedly correct. However, it does not explain why the same consumers will be markedly more successful in defending their interests without an attorney if the creditor has to give prior notice of suit to the debtor. Exercising the right to be heard at a *pro se* appearance is difficult at best. Put simply, the problem with any procedural protection which depends upon a court to effectuate that protection is that courts are extremely difficult to use without an attorney. This problem is not significantly different if the court pro-

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48. 49 Fed. Reg. 7749-53 (1984).

49. *Id.* at 7750-52.

50. *Id.*

51. Illinois and Ohio. *See* ILL. REV. STAT. ch. 110, para. 50 (1983); OHIO REV. CODE ANN. § 2323.13(e) (Anderson 1986).

52. LA. CODE CIV. PROC. ANN. art. 2631-2644 (West 1971).

53. 49 Fed. Reg. at 7753 n.66, 7755; 16 C.F.R. § 444.2(a)(1) (1986).

54. 49 Fed. Reg. at 7753.

vided protections are made available before the judgment is entered by giving prior notice and the right to be heard, or after the judgment is entered by giving the defendant the right to reopen a cognovit judgment.

The FTC, in evaluating the burden of the cognovit prohibition on creditors, discounted the argument that the lack of a cognovit would cause creditors to incur heavy costs. The reason given by the Commission was simple—even when given notice and an opportunity to be heard, most debtors just default anyway. In fact, the Commission noted, "[I]t appears that as many as 91 percent of debtors fail to appear to defend when creditors institute suit against them."[55] Perhaps someone at the FTC has a sense of the absurd. The procedural protections provided to defendants under the rules governing the entry of default judgment are not markedly different from those provided under cognovit judgment rules. Indeed, a default judgment on a liquidated claim (such as a promissory note) is entered so mechanically and perfunctorily that it is the functional equivalent of a cognovit judgment.[56] The apparent prevalence of default, even in those cases in which the defendant-debtor is given prior notice, suggests the futility of abolishing the creditor's right to obtain a judgment against the debtor without such notice. In any event, to justify the imposition of a procedural protection on the ground that it will rarely be used by those whom it is designed to protect is a senseless rationalization.[57]

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55. *Id.* at 7754.

56. *See* FED. R. CIV. P. 55, which states in pertinent part:

> (a) ENTRY. When a party against whom a judgment for affirmative relief is sought has failed to plead or otherwise defend as provided by these rules and that fact is made to appear by affidavit or otherwise, the clerk shall enter his default.
>
> (b) JUDGMENT. Judgment by default may be entered as follows:
>
> (1) *By the Clerk.* When the plaintiff's claim against a defendant is for a sum certain or for a sum which can by computation be made certain, the clerk upon request of the plaintiff and upon affidavit of the amount due shall enter judgment for that amount and costs against the defendant, if he has been defaulted for failure to appear and if he is not an infant or incompetent person.

Id.

57. The FTC apparently believes that if a debtor fails to defend after notice of an action is given, "the waiver of the right to a trial on the merits may be assumed to have been made intelligently and voluntarily." 49 Fed. Reg. at 7750. If so, the frequency of such "intelligent and voluntary" waivers, as evidenced by the number of default judgments, suggests there is little need to control cognovits because creditors do not exercise

Moreover, all of the criticisms leveled by the FTC at the use of cognovits are equally applicable to a more widespread consumer credit practice—the use of self-help repossession. Even before the rule, consumer cognovits were rare. Yet then, as now, most states permitted a creditor who had obtained a security interest under Article Nine of the Uniform Commercial Code to repossess collateral upon the debtor's default.[58] This right can be exercised without *any* notice of *any* kind and without giving the debtor any prior opportunity to be heard.[59] The right of self-help repossession has routinely been upheld against constitutional due process challenges on the ground that there is insufficient state action in the taking to create a right to due process.[60] While conventional state action analysis means that self-help does not strip the debtor of constitutionally protected rights, this can scarcely be a sufficient rationale for the FTC's failure to regulate. The FTC's mandate is to regulate unfair and deceptive practices, not to correct the Supreme Court's supposed errors of constitutional law. Apart from the direct action of the state, self-help repossession has all the purportedly obnoxious characteristics of a cognovit proceeding. Only the creditor is involved in determining whether or not the debtor is in default. Only the creditor decides whether the debtor has any right to raise a defense. Only the creditor decides whether the debtor's defenses are valid. The secured creditor is litigant, judge, jury, and appel-

their rights except in circumstances that 91% of their debtors apparently consider justified. *See id.* at 7754. Of course, there may be another sort of intelligence involved and another sort of voluntariness—an intelligent realization that there is no money to pay for a lawyer nor any local legal aid society prepared to take the case for free, coupled with a voluntary decision not to bumble through a *pro se* defense.

The FTC's rationale is weak, regardless of which analysis reflects reality. To the extent debtors default because creditors sue only those debtors who are liable, the cognovit prohibition is superfluous. To the extent debtors default because they cannot afford to hire a lawyer, the provision is irrelevant.

58. *See* U.C.C. § 9-503 (1977). All states except Louisiana have adopted the 1962 or 1972 versions of Article Nine. *See* sources cited *infra* note 69. Section 9-503, however, is unchanged in the 1972 version of Article Nine. *See* U.C.C. § 9-503 historical note, 3A U.L.A. 211, 212 (1981).

59. U.C.C. § 9-503 (1977) permits the secured party to repossess "without judicial process if this can be done without breach of the peace . . . ."

60. *E.g.*, Gibson v. Dixon, 579 F.2d 1071 (7th Cir. 1978); Brantly v. Union Bank & Trust Co., 498 F.2d 365 (5th Cir. 1974), *cert. denied*, 419 U.S. 1034 (1974); Adams v. Southern Cal. First Nat'l Bank, 492 F.2d 324 (9th Cir. 1973), *cert. denied*, 419 U.S. 1006 (1974).

late court. As was true with cognovits, the debtor retains the right subsequently to litigate the validity of the repossession,[61] but this will require just as much lawyering as reopening a cognovit judgment.

The FTC did not tackle this problem; indeed, it exempted the Louisiana form of cognovit from the rule because it operates as a security interest in property rather than as a means of obtaining a personal judgment against the debtor.[62] The distinction drawn by the FTC is between a security interest, which acts only in rem and gives the creditor rights only in specific collateral; and a true cognovit, which acts in personam and gives the creditor rights in all the debtor's nonexempt property.[63] In the context of the "abuses" cited by the rule, the logic underlying this distinction is rather evanescent. One major reason for the FTC's finding that cognovits were unfair was that cognovit proceedings deprived the debtor of property without giving the debtor any right to be heard before the deprivation occurred.[64] The FTC found that a property deprivation occurred merely by entry of the judgment.[65] Whether or not the creditor was ultimately successful in collecting the judgment was deemed to be irrelevant. The reason given was that even though the creditor who obtained a cognovit judgment could not immediately seize the debtor's assets and, indeed, was generally not able to do so prior to the time the debtor had an opportunity to be heard,[66] the creditor could immediately cloud title to the debtor's assets by subjecting them to a judicial lien.[67] While it is true that the

61. U.C.C. § 9-503 (1977) only allows self-help repossession in the event of default and only if it can be done without breach of the peace. Violations of procedural requirements entitle the debtor to actual damages. *Id.* § 9-507(1). When the collateral consists of consumer goods, the aggrieved debtor is entitled to minimum damages equal to "the credit service charge plus ten percent of the principal amount of the debt or the time price differential plus 10 percent of the cash price." *Id.* It is also well established that an improper repossession constitutes conversion. *See, e.g.*, Wells v. Central Bank, 347 So. 2d 114 (Ala. Civ. App. 1977); UIV Corp. v. Oswald, 139 Ga. App. 697, 229 S.E.2d 512 (1976).

62. 49 Fed. Reg. 7755 (1984).

63. *Id.*

64. *Id.* at 7749.

65. *Id.*

66. A cognovit provision merely gives the right to confess judgment. The judgment must subsequently be enforced, like any other judgment, through execution and levy. The process of collection will nearly always take time and give notice of the judgment to the debtor. This, in turn, gives the debtor at least some opportunity to be heard.

67. 49 Fed. Reg. at 7753-54.

imposition of a lien impinges upon valuable ownership rights such as the ability to sell the property, it is by no means so severe a deprivation of property as the physical seizure permitted by Article Nine. The debtor who has given a security interest can be deprived not only of clear title to property but also of its possession and use; this deprivation can occur prior to the time the debtor has any opportunity to be heard.[68] The FTC has thus prohibited the lesser property deprivation while preserving the greater, without making the slightest attempt to articulate a rationale for the distinction other than the peculiar in rem/in personam dichotomy.

This Article is not a plea for abolition of self-help. The author's own biases are to the contrary. It is rather an assertion of the value of consistency. Cognovits and self-help differ greatly in name but only slightly in effect. The essence of each is the unilateral resolution of a dispute by depriving the debtor of property without giving the debtor prior notice of the deprivation or the opportunity to assert any defenses before a neutral magistrate.

It may well be that the FTC was reluctant to regulate a practice that has been enshrined in the Uniform Commercial Code and by a majority of the states. This reluctance does not explain why the Commission was willing to regulate cognovits, which are also creatures of state law; nor is it consistent with the FTC's earlier decision to regulate holder in due course status in consumer transactions.[69] In any event, there is little logic in prohibiting a seldom-used practice without prohibiting another that is far more common and substantially identical in its effect upon the debtor's ability to be heard.

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68. *See supra* note 59. It is arguable that a distinction between cognovits and security interests is justifiable because consumers are more likely to understand the implications of granting the latter and thus more likely to bargain over the terms. The FTC did not even discuss this possibility. Its distinction was based on the purportedly lesser deprivation caused by enforcement of a security interest, not on any difference in the degree to which security interests represent a bargained-for exchange. *See supra* notes 62-63 and accompanying text.

69. Forty-nine states have adopted Article Nine (Secured Transactions); all fifty have adopted Article Three (Commercial Paper). *See* WHITE & SUMMERS, *supra* note 3, at 5. For a table denoting adopting jurisdictions and citations thereto, see 1 U.L.A. 1 (Supp. 1986). Article Three codifies and continues the right of a holder in due course of a negotiable instrument to take free of most defenses, including fraud. U.C.C. § 3-305 (1977).

C. *Exemption Waivers and Limitations*

The second newly defined unfair trade practice is the taking or receiving of "an executory waiver or a limitation of exemption from attachment, execution, or other process . . . unless the waiver applies solely to property subject to a security interest executed in connection with the obligations."[70] The reason for exempting property from execution is to preserve a nucleus of assets for insolvents by protecting a portion of the debtor's property from creditors.[71] Obviously, this purpose is frustrated when creditors obtain waiver of the exemption rights. This was the concern which underlay this portion of the rule.[72]

Waivers of exemption have long been a routine part of loan agreement boilerplate.[73] Indeed, the Commission found that waiver provisions were common even in states in which they were unenforceable.[74] It is difficult to argue with the prohibition on the use of unenforceable waivers and limitations, although its significance is open to question.[75] The FTC's concern was that even an unenforceable waiver has an *in terrorem* effect[76] which can very often result in the creditor succeeding in what it wants to accomplish—squeezing payment out of a debtor who does not realize that the creditor's threats to take away his pots and pans are meaningless.[77] Worse still is the possibility (not expressly contemplated by the FTC) that even a debtor represented by counsel might be misled by an unenforceable waiver because the attorney might not know the waiver is invalid.[78]

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70. 16 C.F.R. § 444.2(a)(2) (1986).

71. 49 Fed. Reg. at 7768.

72. *Id.* at 7768-69.

73. *See, e.g.*, 7B C. NICHOLS, NICHOLS CYCLOPEDIA OF LEGAL FORMS ¶ 7.2669, at 402 (1986).

74. 49 Fed. Reg. at 7769.

75. A debtor represented by competent counsel would obviously give short shrift to such a provision, and a state that took its own prohibitions seriously would take action to prevent their violation.

76. 49 Fed. Reg. at 7769.

77. Whether this practice of making such threats should be condemned, either by the states or by the FTC, is beyond the scope of this article. What is important is that the FTC rule prohibits unenforceable waivers while permitting enforceable threats. *See infra* note 84 and accompanying text.

78. It is troubling that the attorneys most likely to represent consumer debtors—small firm general practitioners—often lack understanding of either common-law or statutory debtors' rights. The FTC might have better served the interests of consumers

The rule extends to all executory waivers and limitations other than those taken in conjunction with security interests. The propriety of the FTC's regulating an area the states already regulate has been touched on above.[79] In the context of exemptions, however, this concern may be especially significant. The states traditionally have been given wide discretion in regulating exemptions. The current Bankruptcy Code continues the long-standing practice of giving states the right to decide how many assets a debtor in bankruptcy can preserve from creditors,[80] even though the federal government's power over bankruptcy is plenary and virtually exclusive.[81] During the development of the Bankruptcy Code in the 1970s, there was a vigorous attempt by many bankruptcy reformers in Congress to federalize exemption law by granting all bankrupts in all states the right to a set of federal exemptions.[82] This effort was largely unsuccessful.[83] While the FTC rule federalizes only one small aspect of exemption law, it does so in the face of a fresh assertion of state rights over the issue. Its propriety is thus doubly suspect.

It is also questionable whether the rule will avoid the *in terrorem* effect feared. The creditor is prohibited from obtaining an exemption waiver, but not from *threatening* to seize exempt property. The debtor is not likely to know that some property is exempt and that threats with regard to such property are hollow.[84] The debtor's attorney *may*, but this, of course, returns

by requiring creditors to write consumer credit contracts that would trigger inquiry by the debtor or his attorney about those rights. *See infra* notes 153-55 and accompanying text. The FTC's holder in due course rule is a superb example of this type of regulation. It requires certain consumer creditors to include on the document creating the obligation a statement that transferees take subject to the consumer's defenses. 16 C.F.R. § 433.2 (1986). This not only destroys negotiability by imposing a condition upon the obligation to pay, *see* U.C.C. §§ 3-104(1), -105 (1977), it also alerts the obligor to the limited nature of the obligee's rights.

79. *See supra* notes 48-53 and accompanying text.

80. 11 U.S.C. § 522 (1982 & Supp. II 1984 & Supp. III 1985). *See generally* 3 L. KING, COLLIER ON BANKRUPTCY ¶ 522.02, at 522-12 to -13 (15th ed. 1985).

81. *See generally* 1 J. MOORE, COLLIER ON BANKRUPTCY ¶ 0.02, at 4-6.1 (14th ed. 1976).

82. *See* sources cited *supra* note 80. The results of this effort are found in the Bankruptcy Code, 11 U.S.C. § 522(b)(1), which gives debtors the right to elect between state and federal exemptions, subject to a state's right to opt out of the federal exemption scheme and force debtors to be content with the state-prescribed exemptions.

83. A large majority of the states have opted out of the federal exemptions. 3 L. KING, *supra* note 80, ¶ 522.02, at 522-12 n.4a.

84. 49 Fed. Reg. 7770 (1984) ("The rulemaking record shows that most consumers

us to the problem of the consumer's presumed lack of access to assistance of counsel.

The exemption provision also contains at least one serious ambiguity. It permits waivers or limitations of exemptions in conjunction with the grant of a security interest. What if the security interest is avoidable? In some states, some forms of security interests in exempt property are avoidable by the debtor.[85] If, however, a waiver of exemption with regard to that property is valid under both state law and the FTC rule, the creditor could obtain the same result as it would if the avoidable security interest were valid—it would obtain the ability to seize the property from the debtor.

The last point is part of a broader objection to the exemption provision. As is true with the prohibition on cognovits, the exemption provision strains the relative gnat of waiver while swallowing whole the camel of security interest. Unless the relevant state law makes a security interest in exempt property void or voidable, debtors can be deprived of a nucleus of property if they grant a security interest to a creditor in that nucleus. Whether the debtor loses property to repossession pursuant to an Article Nine security interest or to execution and levy under a writ of *fieri facias* is of little consequence to him.[86] What is important is that the property is gone. It appears that the FTC avoided dealing with this issue in order to placate creditors.[87] That avoidance, however, largely guts the impact of the exemption waiver provision.

This does not mean that there is no reason to permit the

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are neither aware of the rights they have under exemption statutes nor of the presence or significance of waiver clauses in their contracts.") (emphasis added). If this is true, the rule is anemic, at best; at worst, the rule lacks due pessimism about creditor ingenuity and mendacity.

85. *See, e.g.*, VA. CODE ANN. § 34-28 (1984), which avoids non-purchase money security interests in some exempt property acquired pursuant to a deed of trust, mortgage, or other writing or pledge.

86. Indeed, the debtor is slightly better off in the latter circumstance. A waiver of exemption is not a waiver of the right to be heard on the merits, nor of defenses or counterclaims. Conversely, in most states, the grant of a security interest is partial waiver of those rights, because the creditor has the right of self-help repossession prior to any notice or hearing. *See supra* notes 59 & 68 and accompanying text. At least nine percent of consumer debtors, considering the FTC-determined default rate, *see* 49 Fed. Reg. at 7753, would benefit from a rule that prohibited self-help repossession but permitted exemption waivers.

87. *See* 49 Fed. Reg. at 7769 n.15.

voluntary relinquishment of exemptions, whether by the grant of a security interest or otherwise. If a creditor cannot gain access to some portion of the debtor's property, the creditor may be unwilling to lend or willing to lend only at a higher interest rate. This problem may be especially acute in states with broad exemption rights which would, if unwaivable, immunize all of the debtor's valuable assets.[88]

Thus, any limitation on the debtor's ability to grant rights to creditors in exempt property would increase the costs of granting credit to such an extent that some debtors would be deprived of access to credit or at least of access to low interest rate credit.[89] The problem is that there is no significant difference between giving creditors access to exempt property by an exemption waiver and giving them access to the same property by the grant of a security interest.[90] The exemption waiver requires, at most, a portion of one piece of paper. The security interest requires, at most, two documents: a security agreement and a financing statement.[91] The additional bit of paper does not create much of a barrier to creditors. It also does not give much benefit to debtors, although it may at least alert them more effectively to the risk of losing their property than would an exemption waiver provision buried in the fine print of a note. Put simply, if the exemption waiver is valid, debtors lose their property. If the security interest is valid, debtors not only lose their property, they may lose it without a prior opportunity to be heard—a right that is not lost with an exemption waiver.

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88. This problem could be dealt with by coordinating prohibitions on security interests with exemption waivers, i.e., by identifying an appropriate nucleus of assets and protecting that nucleus against all creditors.

89. In theory, given a perfect market, all credit extensions will cost the same, whether the costs are borne as interest or as the loss of absolute ownership of one's assets. This theory has been extensively explored in the context of commercial financing. *See generally* Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981). The utility of this thesis in evaluating specific consumer credit regulations is questionable, since much consumer credit regulation is based on the assumption that imperfect market conditions result in some consumers paying more for credit than some lenders would be satisfied to get. If the latter assumption is false, it is difficult to justify any consumer credit regulation. If it is true, one goal of such regulation should be the goal the FTC set for itself—the identification and amelioration of excessive costs caused by imperfect markets.

90. Indeed, the latter, if anything, imposes a greater burden on the debtor because it deprives the debtor of the right to be heard prior to seizure. *See* U.C.C. § 9-503 (1977).

91. U.C.C. §§ 9-203, -302 (1977).

Since both have the same allegedly bad effect on the debtor, there is no logical reason to treat them differently. If one should be banned, both should be banned; if either is beneficial, both are beneficial.

Perhaps the best justification for the exemption waiver provision is that it provides a necessary barrier for the limitation on security interests in household goods. While the scope of property exemptions often extends far beyond household goods,[92] it usually includes most or all of them. If the FTC's limitation on the grant of a security interest in household goods was not backed up with a parallel prohibition on the waiver of exemptions, the security interest provision would be rendered largely meaningless.

D. *Wage Assignments*

The third unfair trade practice is the taking or receiving of "an assignment of [unearned] wages or other earnings" that is neither revocable at will nor pursuant to a payroll deduction plan.[93] This provision has several goals. First, remedial wage assignments that permit the creditor to seize the debtor's wages upon default operate much like prejudgment garnishments since they permit the creditor to deprive the debtor of property without giving the debtor a prior opportunity to be heard by a court.[94] Second, at least in the FTC's view, employers take a dim view of wage assignments because of the burden they place on them to segregate a portion of the employee's wages and remit it to the creditor.[95] The employer's distaste for assuming this burden can lead to the employee's loss of employment, paradoxically resulting in the employee's becoming unable to pay debts.[96] Third, the enforcement of a remedial wage assignment can sud-

92. This is especially true under the FTC's very narrow definition of household goods. *See infra* note 120 and accompanying text.

93. 16 C.F.R. § 444.2(a)(3) (1986). Strictly speaking, the rule permits "a payroll deduction plan or preauthorized payment plan, commencing at the time of the transaction, in which the consumer authorizes a series of wage deductions as a method of making each payment . . . ." *Id.* § 444.2(a)(3)(ii). For simplicity, permissible wage assignments are referred to in this Article as "payroll deduction plans," while others are referred to as "remedial wage assignments."

94. 49 Fed. Reg. 7755, 7757 (1984).

95. *Id.* at 7758.

96. *Id.*

denly disrupt the debtor's ability to meet other financial obligations.[97]

As is true with the other practices regulated by the rule, wage assignments have already come under increasing state regulation.[98] In the FTC's opinion, however, this state regulation is inadequate. States are not consistent in their regulations.[99] Moreover, some of the remedies provided were seen to be inadequate.[100] In addition, there was some indication state regulations were not being adequately enforced because wage assignments were being used for purposes not permitted by applicable state law.[101]

As predictable as this assertion may be, it must be said that the significance of this prohibition is questionable. It will force some creditors to sue and garnish wages after judgment,[102] which will require notice and an opportunity to be heard prior to seizure of the debtor's property. However, as is true with the prohibition on cognovits, this protection is meaningful only to those debtors who exercise their right to be heard. If they do not, and the FTC went to some pains to assure creditors that they do not,[103] the requirement of a summons and complaint will be of comfort primarily to the lender's lawyers and to paper companies.[104]

Suppose, however, that debtors who have been sued begin to present defenses. The prohibition of remedial wage assignments would still be an inadequate response to the perceived abuses. Even if one assumes that the FTC was correct in finding that remedial wage assignments impose excessive burdens on debtors and that state regulation of the practice is inadequate, it is difficult to justify the FTC's response to the problem for the same reason the cognovit and exemption waiver provisions are

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97. *Id.* at 7758-59.

98. *Id.* at 7756-75.

99. *Id.* at 7758.

100. *Id.*

101. *Id.* at 7756 n.25.

102. Only "some" because others will have collateral they can seize without court action.

103. *See supra* note 55 and accompanying text; *see also* 49 Fed. Reg. at 7779-81.

104. It should be noted that one beneficial side effect of forcing creditors to garnish is that the amount which can be garnished is limited by the Federal Consumer Credit Protection Act to 25% of the debtor's disposable income. Federal Consumer Protection Act § 303(a), 15 U.S.C. § 1673(a) (1982).

so inadequate-the exclusion of security interests from the prohibition.

If a wage assignment "is a payroll deduction plan or preauthorized payment plan, commencing at the time of the transaction," it is not prohibited.[105] The FTC justified this exception by asserting that "the potential for the type of injury that this rule seeks to prevent is nonexistent."[106] This statement is not absurd; it is only absurdly incomplete.

The FTC's discussion of the wage assignment provision identifies three distinct "injuries." First is the risk of employer sanctions against an employee whose wages are seized by the creditor. A related risk is that the creditor might use the threat of seizing the wages, and thus triggering those sanctions, to squeeze payment from the debtor.[107] It is possible that these types of injury may not exist when the wage assignment is a payroll deduction if "the employer is aware of the plan from the outset of the transaction."[108]

Most employers are probably used to payroll deductions, are not disturbed by the extra paperwork involved, view them as an orderly method of payment, and feel no moral revulsion toward an employee who is paying debts on time rather than defaulting. Whether employer behavior in this regard is rational is an interesting question.[109] The Federal Consumer Credit Protection Act's prohibition on discharge of an employee for a single wage garnishment was based on the assumption that employers make such distinctions.[110] In this respect, the FTC rule, although aimed at the creditor rather than the employer,[111] complements the Consumer Credit Protection Act.

It is also unlikely the debtor's finances will be unexpectedly disrupted by a payroll deduction plan. The debtor knows in ad-

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105. *See* 49 Fed. Reg. at 7755, 7757.

106. *Id.* at 7759.

107. *Id.* at 7757-58.

108. *Id.* at 7759 n.78.

109. The amount of paperwork involved in processing and paying out monies under a payroll deduction plan is not significantly less than that involved in processing a remedial wage assignment. Moreover, the logic behind the creditor's use of remedial assignments is questionable since enforcement of those remedies may lead to the debtor's loss of employment, and a consequent inability to pay.

110. Federal Consumer Credit Protection Act § 304(a), 15 U.S.C. § 1674(2) (1982).

111. This is contrary to the suggestion of some credit unions, which pushed unsuccessfully for sanctions against punitive employer action. 49 Fed. Reg. at 7759.

vance the amount of the deduction and can plan accordingly. Conversely, since the remedial wage assignment only begins to operate upon default, its effect is difficult to anticipate.

The central problem is that other burdens are placed on the debtor by a wage assignment. The FTC particularly noted the loss by the debtor of the ability to contest the creditor's claim prior to seizure of wages.[112] This problem continues to exist because payroll deduction plans are permitted by the rule *even if* such plans are *not* revocable at will by the debtor.[113] An irrevocable wage assignment is a type of security interest that, among other things, permits a creditor to continue receiving payment during the pendency of a dispute with the debtor. If the debtor complains about the home or goods purchased or the terms of the loan, the creditor need do nothing because the payments will continue. The debtor is forced to initiate court action if he or she wishes to resolve the dispute. The FTC found this possibility outrageous when dealing with remedial wage assignments.[114] It is odd that it never seems to have occurred to the Commission that the same problem exists if the payment is made pursuant to wage assignments that are nonremedial, that is, payments made pursuant to a payroll deduction plan.

There is, of course, a difference between a payroll deduction plan and a remedial wage assignment. A payroll deduction begins at the commencement of the transaction,[115] whereas a remedial wage assignment takes effect only if the normal method of payment fails.[116] This distinction may be important with regard to the employer's attitude toward the assignment or the debtor's ability to manage finances, but not to the debtor's right to be heard. The real issue underlying the loss of the right to be heard prior to seizure is not whether the wage assignment is a payroll deduction operating from the beginning of the transaction or a remedial wage assignment operating only from the date the creditor says the debtor is in default. The real issue is whether the debtor can terminate the assignment when a dispute arises.

112. *Id.* at 7757-58.

113. *Id.* at 7760 n.96.

114. *Id.* at 7758 ("[M]any wage assignments result in collection by creditors even when there have [sic] been a breach of warranty, fraud, or other violation of law that may constitute a defense to payment.").

115. *Id.* at 7756, 7760.

116. *Id.* at 7755-56.

Since the FTC does not give the debtor the right to revoke the payroll deduction wage assignment, this problem is only partially addressed. The FTC's inaction with regard to payroll deductions, however, is consistent with its "hands off" treatment of security interests in general, except for the household goods provisions.

E. Household Goods Security Interests

As should be clear from prior discussion in this Article, a major weakness of the FTC rule is the Commission's disinclination to deal with the impact of security interests on the ability of consumers to effectuate their rights. While there is surely nothing wrong with using collateral to secure consumer obligations, it is not clear that secured creditors should be given the scope of rights they presently enjoy. If a right to be heard prior to seizure is fundamental, it is difficult to countenance either self-help repossession or irrevocable wage assignments.[117] If debtors are given the right to preserve a few assets from economic collapse, security interests should not be permitted to take precedence over exemptions.[118] In any event, there is little sense in having most of the prohibitions imposed by the FTC if security interests are untouched.

Only one consumer credit practice which involves the grant of a security interest is regulated by the rule. Creditors are prohibited from taking or receiving "a nonpossessory security interest in household goods other than a purchase money security interest."[119] The regulatory definition of household goods is rather narrow.[120]

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117. *See supra* notes 59 & 112-14 and accompanying text.

118. *See supra* notes 86-92 and accompanying text.

119. 16 C.F.R. § 444.2(a)(4) (1986).

120. The rule provides as follows:

> Clothing, furniture, appliances, one radio and one television, linens, china, crockery, kitchenware, and personal effects (including wedding rings) of the consumer and his or her dependents, provided that the following are not included within the scope of the term "household goods":
>
> (1) Works of art;
>
> (2) Electronic entertainment equipment (except one television and one radio);
>
> (3) Items acquired as antiques; and
>
> (4) Jewelry (except wedding rings).

These provisions are designed to end the widespread practice of taking so-called "blanket" household goods security interests (HHG). The perceived problem with the HHG is that creditors are not particularly interested in household goods as assets; they want them for leverage. Most used household goods have relatively little market value, and their repossession and resale is unlikely to satisfy the obligation they secure.[121] Household goods, however, have relatively high replacement costs and often have substantial emotional value to their owner.[122] Thus, the threat of repossession will often induce the debtor to make extraordinary efforts to pay.

As is true with many consumer law issues, use of the HHG is abusive if one values the debtor's pride above the creditor's purse; it is an appropriate collection tactic if one believes that the debtor owes the money and ought to pay. A number of states have made the former judgment.[123] The FTC has now done so as well, although in a limited and rather prudish manner.

Most jewelry and all art, antiques, and portable radio-cassette players are explicitly excluded from the Commission's prohibition on the taking of an HHG. Other consumer goods, such as boats, fishing tackle, and other sports equipment, obviously would not fall under the FTC's definition of household goods.[124] This means that the creditor still has access to many of the debtor's most treasured assets. Some of these assets will have substantial value. Thus, security interests in these assets obviously do not run afoul of the use of valued but valueless property as collateral that the Commission found to be abusive. Others, however, will be items of little economic but great sentimental value. For example, the explicit inclusion of wedding rings in the definition of "personal effects" and its exclusion from the definition of "jewelry"[125] clearly imply that the secured creditor can take a nonpurchase money security interest in an *engagement* ring. Yet, the emotional value attached to it is surely as great as that attached to a wedding ring. Examples

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Id. § 444.2(i).

121. 49 Fed. Reg. 7763 (1984).

122. *Id.*

123. *Id.* at 7761-62.

124. For example, the status of the family Bible is uncertain: it might be a personal effect; it might also be an antique.

125. *See supra* note 120 and accompanying text.

could be multiplied indefinitely. The key point is that creditors can still use the HHG, albeit in slightly more limited form, to bring severe psychological pressure on the debtor. The FTC might have attacked the "abuse" of the HHG by prohibiting nonpurchase money security interests in *all* consumer goods or all consumer goods with a fair market value below a fixed dollar amount at the time of extension of credit. The rule would also have been more effective if the taking of a security interest in exempt property had been prohibited or restricted.[126]

F. Late Charges

The fifth unfair trade practice, dealt with in a separate section of the rule, makes it unfair "for a creditor, directly or indirectly, to levy or collect any delinquency charge on a payment . . . when the only delinquency is attributable to late fee(s) or delinquency charge(s) assessed on earlier installment(s)."[127] This provision was aimed at the practice of imposing perpetually growing default charges on the debtor by applying those payments made by the debtor to late charges before current charges.[128] For example, a debtor might default on a $100 monthly payment, and the creditor would impose a $5 late charge. If the debtor paid $200 the following month, the creditor would apply $5 to the late charge, $100 to the overdue payment, and $95 to the current payment, leaving a deficiency of $5 and creating another default. The creditor would impose an additional $5 late charge on the default in the current installment, thus causing the late charges to "pyramid."[129]

This practice is already prohibited in some states, either outright or as a violation of the state's usury law.[130] Pyramiding creates two problems: it increases the effective interest rate paid by the debtor[131] and extends the time during which the debtor is

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126. *See supra* notes 86-92 and accompanying text.

127. 16 C.F.R. § 444.4 (1986).

128. 49 Fed. Reg. 7771 (1984).

129. *Id.*

130. *Id.* The Uniform Consumer Credit Code prohibits this practice in its limitation on deferral and delinquency charges. U.C.C.C. §§ 2-203, -204 (1969) (amended 1974); *see, e.g.*, S.C. CODE ANN. §§ 37-2-203, -204 (1976). *See generally* 1 Consumer Cred. Guide (CCH) ¶ 570, at 1421-50.

131. *See* 49 Fed. Reg. at 7772.

in default.[132] This latter problem can, in turn, negatively affect the debtor's credit rating and even result in suit on a loan that is only technically in default.[133]

The rule does not prohibit late charges, nor does it require creditors to apply payments to current charges ahead of late charges. It simply prohibits the creditor from imposing a further late charge if the delinquency is "attributable" to a prior late charge. As is true of much of the rule, this provision is likely to be of little significance, because it will only assist those debtors who are in default solely because of their failure to pay a late charge. Moreover, it only partially corrects the problems created by pyramiding since it addresses only the increased cost of credit caused by the charges.

Creditors who deliberately use late charges to increase effective interest rates on defaulted obligations[134] can, within the limits of usury law, compensate for the lost pyramided charges by increasing base interest rates. By doing so, they will divide the costs imposed among all their borrowers rather than among those who have defaulted and not paid late charges; they will also be forced by the Federal Consumer Credit Protection Act to disclose this cost as part of the annual percentage rate and the finance charge.[135] Creditors can also make up lost revenues by increasing initial late charges; this too would have to be disclosed,[136] but not as part of the annual percentage rate or the finance charge.[137]

On the other hand, the rule does nothing about the problem of perpetual default. It is clear that the creditor may treat the failure to pay the late charge as a further default.[138] The net result of the late charge provision is a shuffling of one small portion of the creditor's charges. The FTC apparently thought that creditors who pyramid imposed an unfair penalty in the form of

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132. The second potential problem was not dealt with by the Commission in the rule. *See id.* at 7771.

133. The significance of this latter problem is questionable, because, as the FTC Statement indicates, many creditors do not even bother to collect the charges. *Id.* at 7772.

134. It is unlikely that such creditors exist, given the apparent fact that late charges do not even compensate for collection costs, let alone increase net revenues. *Id.* n.18.

135. 15 U.S.C. §§ 1605, 1606 (1982).

136. *Id.* §§ 1637(a)(5), 1638(a)(10).

137. *See id.* §§ 1605, 1606.

138. 49 Fed. Reg. 7771 (1984).

additional late charges on those few debtors who paid all of a delinquency except the late charge. Those charges will now be imposed either upon all borrowers as part of the basic interest rate, upon all borrowers in default in the form of increased initial late charges, or will be absorbed by the creditor. In short, the late charge provision provides a modest benefit to a presumably miniscule class of debtors at an equally modest cost either to other debtors or to the creditor. Its significance renders it as unobjectionable as it is unimportant.

G. Cosigner Provisions

The rule, in two provisions that could have added significantly to consumer protection, brands two practices regarding "cosigners"[139] as either deceptive or unfair. The first, which is almost tautological and thus merits virtually no discussion, declares it a deceptive practice "to misrepresent the nature or extent of cosigner liability to any person."[140] The second requires the creditor to inform the cosigner about the nature of the cosigner's obligation.[141] These worthy sentiments, however, are significantly limited by a further provision which provides a safe harbor for the creditor. Any creditor who gives the cosigner a

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139. The term "cosigner" is somewhat misleading. It is defined by the rule as:

> A natural person who renders himself or herself liable for the obligation of another person without compensation. The term shall include any person whose signature is requested . . . as a condition for forbearance on collection of another person's obligation that is in default. The term shall not include a spouse whose signature is required on a credit obligation to perfect a security interest pursuant to state law. A person who does not receive goods, services, or money in return for a credit obligation does not receive compensation within the meaning of this definition. A person is a cosigner within the meaning of this definition whether or not he or she is designated as such on a credit obligation.

16 C.F.R. § 444.1(k) (1986). Apart from its exclusion of spouses signing security agreements and sureties who are not individuals, the definition is functionally identical to the broad definition of "surety" contained in the Restatement of Security, which states as follows:

> Suretyship is the relation which exists where one person has undertaken an obligation and another person is also under an obligation or other duty to the obligee, who is entitled to but one performance, and as between the two who are bound, one rather than the other should perform.

RESTATEMENT OF SECURITY § 82 (1941); *see also* BLACK'S LAW DICTIONARY 1293 (5th ed. 1979). For this reason, the terms "cosigner" and "surety" are used interchangeably.

140. 16 C.F.R. § 444.3(a)(1) (1986).

141. *Id.* § 444.3(a)(2).

separate document which contains only the FTC's limited description of the nature and extent of a cosigner's liability to the creditor does not violate the misrepresentation and information provisions.[142] The idea of requiring a plain language notice to cosigners is a good one. At present, many suretyship agreements are barely comprehensible to lawyers, let alone to laypersons.[143] While it is probably true that most cosigners have a general notion about the nature of their liability, others certainly do not.[144] In any event, the use of such a plain language provision is an inexpensive prophylactic against consumer confusion and creditor overreaching.

There are two problems with the FTC's approach to this issue. First, by making the use of the statement a safe harbor, the FTC apparently immunizes other misrepresentations from

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142. *Id.* § 444.3(b). The FTC requires the following description:

Notice to Cosigner

> You are being asked to guarantee this debt. Think carefully before you do. If the borrower doesn't pay the debt, you will have to. Be sure you can afford to pay if you have to, and that you want to accept this responsibility.
>
> You may have to pay up to the full amount of the debt if the borrower does not pay. You may also have to pay late fees or collection costs, which increase this amount.
>
> The creditor can collect this debt from you without first trying to collect from the borrower. The creditor can use the same collection methods against you that can be used against the borrower, such as suing you, garnishing your wages, etc. If this debt is ever in default, that fact may become part of *your* credit record.
>
> This notice is not the contract that makes you liable for the debt.

Id. § 444.3(c).

143. The following is an example of one portion of a typical suretyship contract that waives all of the surety's rights:

> No renewal or extention [sic] of the instrument, no release or surrender of any security for the instrument, nor release of any person, primarily or secondarily liable on the instrument, no delay in the enforcement of the payment of the instrument, and no delay or omission in exercising any right or power under the instrument shall affect the liability of the undersigned. The liability of the undersigned on this guaranty shall be direct and not conditional or contingent on the pursuit of any remedies against any maker, endorser, or any collateral held as security for the payment of the above instrument. The undersigned expressly waive presentment, protest, demand, notice of dishonor or default, notice of acceptance of this guaranty, and notice of any kind with respect to the above instrument or the performance of the obligations under the instrument.

1 R. ANDERSON, ANDERSON ON THE UNIFORM COMMERCIAL CODE, Legal Forms 580-81 (2d ed. 1974).

144. 49 Fed. Reg. 7774 (1984).

classification as deceptive practices. The rule seems to permit loan officers to mislead cosigners about their obligations as long as the cosigner receives this statement. This severely weakens the impact of the cosigner statement on the cosigner's decision.Second, the cosigner statement is grossly incomplete in its description of the potential liabilities of a cosigner. This is important because key provisions of the statement are written in absolute terms.[145] Such absolute statements are likely to lead the cosigner to believe they are true. They are not. The FTC's cosigners are sureties, and consequently may have viable defenses against the creditor.

The cosigner statement says that "[i]f the borrower doesn't pay the debt, you will have to."[146] Usually this is true; but not always. If the borrower doesn't pay the debt and there has been a binding change in the underlying obligation or an impairment of recourse made without a reservation of rights of the cosigner's consent, the cosigner will be discharged from any liability to the creditor.[147] If the borrower does not pay the debt, but there has been an unjustified impairment of collateral by the creditor without the consent of the cosigner, the cosigner is discharged.[148]

Another provision provides that "[t]he creditor can collect this debt from you without first trying to collect from the borrower."[149] This is also true only on some occasions. Some cosigners, such as accommodation endorsers[150] or guarantors of collection,[151] are only secondary parties who cannot be sued until action has been taken against the principal. In addition, many states permit any surety to force the creditor to pursue its remedies against the principal before suing the surety.[152]

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145. *See infra* notes 151-153 and accompanying text.

146. 16 C.F.R. § 444.3(c) (1986).

147. *See generally* RESTATEMENT OF SECURITY §§ 122, 128 & 129 (1941); U.C.C. §§ 3-606(1)(a), -606(2) (1977).

148. *See generally* RESTATEMENT OF SECURITY § 132 (1941); U.C.C. § 3-606(1)(b) (1977).

149. 16 C.F.R. § 444.3(c).

150. *See generally* U.C.C. § 3-415(2) (1977) ([any] accomodation party is liable in the capacity in which he has signed . . . ."); U.C.C. § 3-414(1) (1977) (". . . every indorser engages that *upon dishonor and any necessary notice of dishonor* . . . he will pay the instrument . . . .") (emphasis added).

151. *See generally* U.C.C. § 3-416(2) (1977); RESTATEMENT OF SECURITY § 82 comment g (1941).

152. *See generally* L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP § 42, at 178-79 (1950); Herbert, *Twisting Slowly, Slowly in the Wind: The Effect of Delay on a Surety's*

Obviously, little purpose would be served by attempting to explain to the cosigner in detail all the suretyship rights. The struggle of loan officers to explain, and consumers to comprehend, the intricacies of suretyship law would provide amusement, but little else. Thus, the problem with the FTC statement is not that it should be a treatise on impairment of recourse, impairment of collateral, and the nature of secondary liability. The problem with the FTC statement is that consumers who read it are likely to assume that no defenses exist. A cosigner examining the statement *after* the principal has gone into default may be persuaded by the statement to pay the creditor, precisely because it says that the cosigner has an unqualified obligation to do so. Cosigners may thus be discouraged from seeking legal advice. Even if they do, many lawyers' knowledge of suretyship law is limited. The attorney may have no idea of the existence or significance of the cosigner's rights. Thus, those lawyers who read the statement may come to the same erroneous conclusions as their clients.

These problems could have been avoided if the FTC followed the ingenious approach used under the Magnuson-Moss Act to warn consumers about the possibility of misleading terms in a seller's warranty.[153] Warrantors covered by the Magnuson-Moss regulations are required to disclose the possibility that the rights set out in the warranty itself may be expanded by state law,[154] and that warranty and damage limitations imposed by the seller may be unenforceable.[155] This at least alerts the buyer and the buyer's attorney that the buyer's rights may differ from those stated in the seller's document. The paradox of the FTC cosigner disclosure statement is that it arms the creditor with a statement, promulgated by the federal government, which can be used to trick cosigners into foregoing their rights.

Apart from promulgating an inadequate disclosure statement, the FTC did nothing to protect cosigners. If it had wanted to tackle a more serious surety problem, it could have regulated

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Obligations in Virginia, 18 U. RICH. L. REV. 781 (1984); Comment, *The Doctrine of* Pain v. Packard, 37 YALE L.J. 971 (1928).

153. 16 C.F.R. § 701 (1986).

154. Among the disclosures required is a statement that "[t]his warranty gives you specific legal rights, *and you may also have other rights which vary from state to state.*" *Id.* § 701.3(a)(9) (emphasis added).

155. *Id.* § 701.3(a)(7), (8).

substantive provisions of the cosigner agreement itself. In theory, sureties, especially gratuitous sureties who receive no compensation for their assurance of an obligation, are "favorites of the court" whose rights are scrupulously protected and whose obligations are narrowly construed.[156] Thus, any action by the creditor that increases the surety's risk should discharge the surety's obligation. In practice, many of the surety's rights are ephemeral at best. Most of them can be eliminated by the ritualistic invocation of a so-called "reservation of rights" by the creditor.[157] A reservation of rights does not even have to be communicated by the creditor to the surety.[158] The remainder of the surety's rights can be abrogated by the surety's "consent."[159] While there is obviously nothing intrinsically wrong with a surety bargaining away his rights, the putative "consents" are often written in legalese and usually found buried in the boilerplate of the suretyship contract.[160] It is almost certainly true that many of these "consents" do not represent bargained-for exchanges; the typical consumer cosigner probably does not know that they exist or what they mean. As with the other remedial provisions dealt with by the rule, there is no effective bargaining process regarding them.

Of course, there may be no rational reason to give sureties the rights they are supposedly given at common law,[161] and thus no reason to regulate the manner in which they are lost. The concern of this Article is not so much with the value of suretyship defenses as with the failure of the FTC to consider their significance. A sufficient cosigner warning would provide a significant protection for consumer cosigners. Preservation of suretyship defenses would provide far more. That preservation might impose a disproportionate burden on creditors; it might for that or other reasons be inappropriate. The problem is that the FTC wrestled ineptly with the lesser issue and utterly ignored the greater. That, of course, is the problem with the entire rule.

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156. *See* L. SIMPSON, *supra* note 152, § 29, at 94.
157. *See* sources cited *infra* note 147.
158. *See* WHITE & SUMMERS, *supra* note 3, at 529.
159. *See* U.C.C. § 3-606(1) (1977).
160. *See supra* note 143.
161. *See, e.g.*, WHITE & SUMMERS, *supra* note 3, at 522-23.

IV. CONCLUSION

Twelve years is a long gestation period for any law. It took approximately that amount of time to produce the Uniform Commercial Code (UCC).[162] The UCC, however, managed to codify and in some respects revolutionize vast stretches of commercial law. The FTC consumer credit rule nibbles at the edge of a few minor issues while completely ignoring far more important problems.

This raises a serious question about the competence of the Federal Trade Commission to regulate consumer credit. Even assuming that it has the power to do so and does not thereby intrude excessively into an area traditionally reserved to the states,[163] does it have the institutional wherewithal to succeed? The rule suggests that the answer to this question may be: "No." There are at least two reasons for this conclusion.

First, the supposed popular disenchantment with the work of regulatory agencies must be considered. As was noted repeatedly in this Article, much of the rule merely recapitulates reforms already widespread in the states. On the other hand, practices permitted by most states, such as the use of self-help repossession or the grant of security interests in exempt property,[164] are generally unaffected. In only slight respects, for example, the attempt at cosigner disclosures,[165] does the rule break significant new ground.

Perhaps this reflects the concern that a more radical approach would be improper or not politically feasible. Perhaps a more radical approach *is* improper when it is adopted by an unelected agency rather than by a legislature; that is a question beyond the scope of this Article. Certainly it is worth noting that this was a major basis for criticizing the holder in due course rule, and the narrow scope of the present rule may be a result of those, and related, criticisms. If those critics are correct, and the FTC's proper role in the regulation of consumer credit should be narrowly circumscribed, then it is difficult to justify spending twelve years of work eking out a rule that will

162. *Id.* at 3-4.
163. *See supra* notes 117-26 and accompanying text.
164. *See supra* notes 139-61 and accompanying text.
165. *See generally* 49 Fed. Reg. 7783-89 (1984); Braasch, *supra* note 2.

not be allowed to do much more than quibble and nitpick.

Of course, the rule's timidity may change with the makeup of the Commission. If so, the narrowness of the rule merely reflects the current political climate (which has changed at least twice during the past twelve years). The likelihood of these possibilities is somewhat undercut by the fact that, even in its earlier versions, the rule was fairly anemic.[166]

The second limitation on the FTC's ability to regulate consumer credit is its obligation to justify its rules in cost-benefit terms. Obviously, some aspects of consumer credit, such as usury laws, can readily be analyzed from an economic viewpoint. On the other hand, many of the most important consumer credit issues cannot be fit neatly into a Posnerian schema.[167]

It is very difficult to determine the cost to creditors of many types of consumer credit regulation. The effect of an interest rate cap is fairly easy to analyze. If usury laws permit lenders to charge only below-market rates, unsubsidized credit will not be extended. Sufficient information exists about the credit markets to make possible a passably accurate determination of the interest rates necessary to attract capital to the consumer credit market.

This is not true with cognovit provisions or exemption waivers. There is little systematic information on the effect of those restrictions. The FTC itself was able to gather little but anecdotal evidence about the impact of its regulations on consumer credit.[168] In addition, unlike the regulation of interest rates, which has a gross and obvious impact on the creditor's business, the regulation of remedies has subtle and diffuse effects.[169] For example, creditors are now prohibited from using cognovits, but may still use default judgments and, in most states, self-help repossession. The cognovit was important to the creditor because it shortened the time necessary to seize the debtor's assets. As noted above, default judgment is almost as good a tool as a cog-

166. 49 Fed. Reg. at 7743.

167. For an outline of Judge Posner's views on the strengths and weaknesses of the economic theory of regulation, see generally Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335 (1974).

168. This, of course, is part of the reason why there is so little bargaining over remedies in the first place. The FTC did not seem to realize that the market failure upon which it relied to support the rule also militates against economics as justification.

169. *See supra* notes 56, 59, 69 and accompanying text.

novit; self-help repossession in some ways is better. Similarly, the protection of a radio against an HHG may not be terribly significant in light of the creditor's power to seize a video cassette recorder. It is difficult to determine the extent to which the abolition of one of a related set of remedies will have an impact on lending practices. It is thus difficult to measure the "cost" of the regulation.

In addition, many of the "benefits" created by regulation are completely unquantifiable. Much of the FTC's rule, like much of consumer credit regulation in general, is aimed at noneconomic injuries. Part of the reason for restricting some creditor practices is that they are perceived to be psychologically harmful. There is, however, little market for humiliation.

There is no question about the fact that economic analysis should play a major role in any decision to regulate credit. Populist movements to scourge banks are self-defeating. But if the economic impact of the regulation is slight or diffuse and the benefits not subject to real-world market quantification, the decision to regulate or not to regulate is not an economic one. The FTC, given its current mandate, may be uniquely ill-suited to make such decisions.

After twelve years of hard straining, a few of the purported gnats have been painfully squeezed out. The FTC has reinforced existing efforts to curb some consumer credit practices; it has done little that is original. Whether the rule will be the first shot in a new round of credit regulation or merely the last echo of a moribund consumer movement remains to be seen.