

Security Interests in Insurance Proceeds and Unearned Premiums - Have the Courts Gone Too Far with Truth in Lending?

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Repository Citation

Paul David, *Security Interests in Insurance Proceeds and Unearned Premiums - Have the Courts Gone Too Far with Truth in Lending?*, 41 La. L. Rev. (1980)
Available at: <https://digitalcommons.law.lsu.edu/lalrev/vol41/iss1/10>

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COMMENTS

SECURITY INTERESTS IN INSURANCE PROCEEDS AND UNEARNED PREMIUMS—HAVE THE COURTS GONE TOO FAR WITH TRUTH IN LENDING?

The Truth in Lending Act¹ is the popular name for Subchapter One of the Federal Consumer Credit Protection Act.² Passage of the Act in 1968 was the result of several years of congressional study and debate concerning mandatory disclosure requirements in consumer credit transactions. Congress, cognizant that consumers were remarkably ignorant of the nature of their credit obligations and the costs of deferring payment, was faced with consumer credit expansion at an extremely rapid rate. Credit was experiencing a growth rate more than four and one-half times as great as that of the economy as a whole, increasing from \$5.6 billion shortly after World War II to \$95.9 billion in 1967.³

Prior to the enactment of the Truth in Lending Act, consumers were unable to make simple and direct cost comparisons among the many alternative sources of credit, such as bank financing, credit loans, or revolving credit. In most circumstances, consumers were faced with divergent methods of credit cost disclosure and, at times, fraudulent creditor practices. Many consumers were prevented from shopping for the best credit terms available and often were prompted to assume liabilities they could not afford.⁴

1. Pub. L. No. 90-321, § 102, 82 Stat. 146 (1968). See 15 U.S.C. §§ 1601-665 (1976).

2. The Federal Consumer Credit Protection Act is a multipronged statutory scheme enacted by Congress to protect consumers. Included in the scheme are the Truth in Lending Act, 15 U.S.C. §§ 1601-665 (1976), compelling creditors to disclose the true cost of credit; the Fair Credit Billing Act, 15 U.S.C. § 1666 (1976), setting forth procedures to protect debtors when a billing dispute arises; the Fair Credit Reporting Act, 15 U.S.C. § 1681 (1976), regulating credit reporting agencies; the Equal Credit Opportunity Act, 15 U.S.C. § 1691 (1976); and the Consumer Leasing Act, 15 U.S.C.A. § 1667-1667e (1977).

3. H.R. REP. NO. 1040, 90th Cong., 1st Sess. 10-11, reprinted in [1968] U.S. CODE CONG. & AD. NEWS 1962, 1966.

4. Proponents of the legislation claimed that the Act would enhance the consumer's ability to make an informed choice even if finance charges were hidden. For example, the Act requires disclosure of the actual cash selling price and any finance charges. Thus, the judgment of the consumer can be on the basis of both these factors, not merely one alone. If a merchant attempts to have a low finance charge and bury it in a high cash price, then the consumer is able to use comparative shopping on price just as much as on the finance charges. See generally H.R. REP. NO. 1040, 90th Cong.,

Truth in Lending was designed to remedy the problem.⁵ The primary purpose of the Act is to require creditors to provide consumers with meaningful and uniform disclosures of credit costs and terms.⁶ Under the Truth in Lending Act, Congress delegated authority to the Board of Governors of the Federal Reserve System to construct regulations to implement and carry out the legislative purpose of the statute. The Board of Governor's regulations, known as Regulation Z,⁷ are comprehensive and contain a full restatement of all the requirements of the Act.

Supporters of the Act originally envisioned a simple statutory scheme, allowing the consumer to make credit decisions on the basis of comparing meaningfully disclosed costs of credit.⁸ However, there is rising concern, even among the sponsors of the Act,⁹ that it is not

1st Sess. 13, *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS 1962, 1966; S. REP. NO. 392, 90th Cong. 1st Sess. 2, *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS 1962, 1966.

5. The House Committee on Banking and Currency stated:

[B]y requiring all creditors to disclose credit information in a uniform manner, and by requiring all additional mandatory charges imposed by the creditor as an incident to credit be included in the computation of the applicable percentage rate, the American consumer will be given the information he needs to compare the costs of credit and to make the best informed decision on the use of credit.

H.R. REP. NO. 1040, 90th Cong., 1st Sess. 13 n.4, *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS 1962, 1970.

6. The Act provides: "[I]t is the purpose of this subchapter to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit." 15 U.S.C. § 1601 (1976).

7. Federal Reserve Board Regulation Z, 12 C.F.R. § 226.1-226.13 (1980).

8. For example, in his Consumer Message of 1967, President Lyndon Johnson stated: "I recommend the Truth in Lending Act of 1967 to assure . . . full and accurate information to the borrower, and *simple* and *routine* calculation for the lender. The Truth in Lending Act of 1967 would strengthen the efficiency of our credit markets without restraining them." S. JOURNAL, 90th Cong., 1st Sess. 158, *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS 1962 (emphasis added). Shortly thereafter, Senator William Proxmire, Chairman of the Subcommittee on Financial Institutions, and one of the principal advocates of Truth in Lending, commenced hearings on the proposed act by stating:

I want to emphasize the essential purpose of this bill. We are considering a full disclosure bill and nothing more. The bill does not regulate credit. The bill does not tell lenders how much they can charge. The bill contains no assumption that credit is bad. The bill contains no implications that the vast majority of creditors are nothing [sic] but the most honest and productive businessmen who are making a valuable contribution to our dynamic economy. In short, the bill contains no indictment of the credit industry.

Proposed Consumer Credit Protection Act, Hearings on S.5 Before the Subcomm. on Banking and Currency, 90th Cong., 1st Sess. 12 (statement of William Proxmire).

9. In recent years, Senator Proxmire and others have supported major proposals aimed at simplification of Truth in Lending. See text at notes 78-83, *infra*.

accomplishing its goals.¹⁰ Nevertheless, because of the numerous hardships, financial and otherwise, incurred by consumers that tend to discourage consumer litigation, the Truth in Lending Act provides several incentives for consumer suits.¹¹ For example, the consumer is given access to federal court without regard to jurisdictional amount¹² and is awarded reasonable attorney's fees if successful, with the amount of fees not contingent upon the amount of the plaintiff's recovery.¹³ The Act allows recovery for actual damages or for twice the finance charge,¹⁴ with a maximum recovery of \$1,000 and a minimum of \$100.¹⁵

Since the general standard under the Truth in Lending Act is clear and meaningful disclosure, the debtor who brings an action alleging a violation benefits from a jurisprudential requirement of strict compliance with the technical terms of the Act. All ambiguities in the disclosure statement are construed against the creditor, since it is both the drafter of the disclosures and the party upon whom the Act imposes the burden of compliance.¹⁶ Further, Regulation Z adds requirements that are not mandated by the Act itself: components of the finance charge must be separately itemized;¹⁷ prepaid finance charges must be disclosed;¹⁸ and all disclosures must be made on a single document, either above the consumer's signature on the note evidencing the obligation, or on "one side of a separate statement which identifies the transaction."¹⁹

10. Many authorities believe that Regulation Z has expanded the quantity and the detail of the disclosure requirements to the point that unnecessarily complex disclosures that consumers may ignore or fail to understand are destroying the benefits of the Act. See text at notes 78-83, *infra*.

11. Further, there are a number of jurisprudential developments which provide strong economic incentives for the creditor to comply.

12. 15 U.S.C. § 1640(e) (1976).

13. 15 U.S.C. § 1640(a) (1976). It is not uncommon for attorney's fees of several thousands of dollars to be awarded to a plaintiff even though the maximum damage recovery is \$1,000. See, e.g., *Tinsman v. Moline Beneficial Fin. Co.*, 531 F.2d 817 (7th Cir. 1976) (amount loaned was \$300 while the total award which the creditor was required to pay because of attorney's fees and costs was over \$3,000).

14. 15 U.S.C. § 1640(a)(1) (1976).

15. In class actions actual damages can be recovered, but the ceiling on any award is limited to the lesser of \$500,000 or one percent of a creditor's net worth.

16. See *Sneed v. Beneficial Fin. Co.*, 410 F. Supp. 1135 (D. Hawaii 1976).

17. 12 C.F.R. § 226.8(c)(8)(i), (d)(3) (1980).

18. 12 C.F.R. § 226.8(c)(6), (d)(2) (1980).

19. 12 C.F.R. § 226.8(a) (1980). See *Lauletta v. Valley Buick, Inc.*, 421 F. Supp. 1036, 1040 (W.D. Pa. 1976), wherein the court stated: "Regulation Z unequivocally requires that necessary disclosures shall be written and made together on one document. The drafters of the legislation obviously felt that oral statements by creditors or piecemeal disclosures are not adequate to ensure the consumer's protection."

It is readily apparent that these incentives to litigate for consumers often result in disincentives to litigate for creditors. Creditors may find it more advantageous to settle a weak claim than to incur the costs of a defense that could far exceed the amount of statutory damages.²⁰ Moreover, estimates indicate that consumers are likely to win a majority of the cases that are decided on the merits.²¹ Because of a vague standard of accountability generated by inconsistent interpretations of Truth in Lending and Regulation Z, creditors often seek to insulate themselves from suits with lengthy disclosure statements jammed with every bit of information they think a court might require.²² Frequently, the inability to anticipate judicial construction of violations renders the creditor's efforts futile. The result is a frustration of the purpose of the Truth in Lending Act, as the consumer is left with a complex disclosure statement which he often ignores or fails to understand.

Security Interests Violations

To ensure clear and meaningful disclosures, the Truth in Lending Act and Regulation Z delineate specifically *what* must be disclosed. The specific disclosure requirements for security interests are set out in 15 U.S.C. § 1638(a)(10)²³ and Regulation Z § 226.8(b)(5).²⁴ Although the Truth in Lending Act does not define "security interest," it is defined in section 226.2(gg) of Regulation Z as an interest in property which secures payment or performance of an obligation.

20. See note 13, *supra*.

21. See generally Landers, *Some Reflections on Truth in Lending*, 1977 ILL. L. FORUM 669, 681.

22. Creditors often protest that they are being harassed by increasingly technical claims based on minor and harmless violations of the Act. See *Hearings on S.3008 Before the Subcomm. on Consumer Affairs*, 94th Cong., 2d Sess. 55170 (1976).

23. Actually, the Truth in Lending Act requires disclosure of security interests for closed-end credit transactions for both sales and consumer loans under 15 U.S.C. § 1638(a)(10) (1976) and 15 U.S.C. § 1639(a)(8) (1976), respectively. Under these provisions, the extender of credit is required to include on the disclosure statement a description of any security interest held or to be retained or acquired by the creditor in connection with the extension of credit, and a clear identification of the property to which the security interest relates.

24. Section 226.8(b) provides in pertinent part:

In any transaction subject this section, the following items, as applicable, shall be disclosed: . . .

(5) A description or identification of the type of any security interest held or to be retained or acquired by the creditor in connection with the extension of credit, and a clear identification of the property to which the security interest relates or, if such property is not identifiable, an explanation of the manner in which the creditor retains or may acquire a security interest in such property

12 C.F.R. § 226.8(b)(5) (1980).

The term includes, but is not limited to, security interests under the Uniform Commercial Code, vendor's liens, and liens on property arising by operation of law.

One Federal Reserve Board staff letter interpreting Regulation Z stated that "the primary purpose of § 226.8(b)(5), requiring disclosure of a security interest, is to alert the customer at the outset of the transaction that his property might be used to discharge the debt which he had incurred, should it become necessary."²⁵ In general, disclosure is required of (1) the type of security interest retained or acquired by the creditor and (2) a clear identification of the specific property subject to the security interest. Among the types of security interests required to be disclosed are chattel mortgages,²⁶ interests in after-acquired property,²⁷ and add-on credit sales. Moreover, a creditor's interest may require disclosure even though that interest is not perfected under applicable state law.²⁹

Alleged security interest disclosure violations have prompted a disproportionate amount of litigation in Truth in Lending. Because the courts have been inconsistent in identifying security interests, creditors are left with little guidance in predicting whether a particular right should be disclosed. In some instances seemingly obvious rights requiring section 226.8(b)(5) disclosure have been held not to be security interests. For example, a creditor's right to set off a consumer's deposits against his indebtedness was determined not to be a security interest in the property of depositors, and disclosure was not required.³⁰ In other situations, somewhat more

25. Staff Opinion Letter No. 1145, CONS. CRED. GUIDE (CCH) ¶ 31,520 (Jan. 11, 1977). Interpretation letters of Regulation Z are published by the Federal Reserve Board in response to inquiries from interested persons. The letters are not binding on the courts, but rather are intended as an unofficial means of helping creditors to comply with the technicalities of the regulation. The Federal Reserve Board also publishes official staff interpretations pursuant to Regulation Z section 226.1(d); good faith reliance upon these official interpretations constitutes a defense to liability.

26. *Starks v. Orleans Motors, Inc.*, 372 F. Supp. 928 (E.D. La.) *aff'd*, 500 F.2d 1182 (5th Cir. 1974).

27. 12 C.F.R. § 226.8(b)(5) (1980). See generally *Tinsman v. Moline Beneficial Fin. Co.*, 531 F.2d 815 (7th Cir. 1976). See also Staff Opinion Letter No. 829, CONS. CRED. GUIDE (CCH), ¶ 31,151 (Aug. 22, 1974).

28. *Blackmond v. Walker-Thomas Furniture Co.*, 428 F. Supp. 344 (D.C. D.C. 1977).

29. Staff Opinion Letter No. 1145, note 25, *supra*. The staff determined that if mere retention of the certificate of title of an automobile gives a creditor the right to note its interest on the title under applicable state law, a security interest is created, notwithstanding the creditor's failure to secure a chattel mortgage on the automobile.

30. *Fletcher v. Rhode Island Hosp. Trust Nat'l Bank*, 496 F.2d 927 (1st Cir.), *cert. denied*, 419 U.S. 1001 (1974). The court stated:

Plainly a banker's privilege to apply the debt arising from a deposit against a

obscure rights of creditors, such as a waiver of homestead exemption,³¹ have been determined to be valid security interests. Moreover, with certain interests, such as the right of acceleration, the circuits have been unable to agree whether disclosure is required.³² Compounding the problems involved in deciding which interests require disclosure are cases which hold that disclosures by creditors of non-existent security interests violate section 226.6(c) of Regulation Z prohibiting false or misleading disclosures.³³

One particularly troublesome interest has been the right of creditors in the proceeds and unearned premiums of property insurance policies covering the collateral for a loan. For example, when a borrower finances an automobile and secures the loan with a chattel mortgage on the vehicle, the standard practice of the lending industry is to require the borrower to name the creditor as the loss payee in the borrower's automobile insurance policy. By assignment, the creditor is usually given the unequivocal power to receive and apply any insurance proceeds or unearned premiums to the unpaid balance of the loan. The creation of this right is so common that it may be viewed as incidental to virtually all consumer loans secured by insurable property, regardless of the type of property purchased or of the ability of the borrower to pay.³⁴ Yet, very few creditors would view a loss payable clause as creating a security interest in property similar to a mortgage or lien. Nevertheless, with some dissenting opinion, the jurisprudence appears to be settled that the assignment of insurance proceeds and unearned premiums creates security interests that require disclosure.

The first case to address this issue was *Gennuso v. Commercial Bank and Trust Company*.³⁵ Extending credit to the borrower for

depositor's unrelated debt to the bank is not a security interest in the ordinary sense. A deposit of money to one's credit in a bank, although it may give rise to a set off allowing the bank to obtain more than other general creditors, "is not a transfer of property as a payment, pledge, mortgage, gift or security."

496 F.2d at 934 (citations omitted).

31. See *Elzea v. National Bank of Georgia*, 570 F.2d 1248 (5th Cir. 1978). See also *Lamar v. American Finance Systems*, 577 F.2d 953 (5th Cir. 1978) (categorized security interests to include the foregoing of any valuable right).

32. The Fifth and Tenth Circuits consistently have held that the right of acceleration is not a security interest requiring disclosure. See *Begay v. Ziems Motor Co.*, 550 F.2d 1244 (10th Cir. 1977). *Martin v. Commercial Sec. Co.*, 539 F.2d 521 (5th Cir. 1976). Other circuits have required disclosure of the right of acceleration in at least some circumstances. See, e.g., *St. Germain v. Bank of Hawaii*, 573 F.2d 572 (9th Cir. 1977).

33. *Gennuso v. Commercial Bank & Trust*, 566 F.2d 437 (3d Cir. 1977); *Engle v. Shapert Constr. Co.*, 433 F. Supp. 1383 (M.D. Pa. 1978).

34. See, e.g., *Edmondson v. Allen-Russell Ford, Inc.*, 577 F.2d 291, 294 (5th Cir. 1978).

35. 566 F.2d 437 (3d Cir. 1977).

the purchase of a new automobile, the lender was assigned an interest in the proceeds and in the unearned premiums of a property insurance policy covering the automobile. Although the only security interest disclosed on the lender's disclosure statement was that of the automobile used as collateral, the reader was referred to a separate "Note and Security Agreement" in which the loss payee interest in the insurance policy was fully described.³⁶ The borrower claimed a violation of the Act's disclosure provisions, and the Third Circuit agreed, holding that a security interest had been created in the insurance proceeds and unearned premiums and that the lender had violated Regulation Z by failing to make all necessary disclosures on one side of a single document.³⁷

While the court in *Gennuso* devotes much language to the previously established "one document" rule,³⁸ there is little discussion of the court's determination that a security interest is created under Regulation Z section 226.8(b)(5) when a creditor is assigned rights to the proceeds and unearned premiums of property insurance.³⁹ Unfortunately, the court offers no guidance as to why such assignments create security interests within the contemplation of Regulation Z. While convinced that the borrower was apprised of the creditor's rights and that the facts "admittedly [did] not involve egregious misconduct on the part of [the bank]," the court nevertheless felt constrained to hold the creditor liable for violation of the security interest disclosure requirements of Regulation Z.⁴⁰

Although *Gennuso* did not address directly the reasons for finding a security interest, the court in *Edmondson v. Allen-Russell Ford, Inc.*⁴¹ did. Confronted with a factual situation analogous to that in *Gennuso*, the *Edmondson* court similarly found that the assignment of returned or unearned premiums of a property insurance policy⁴² was a security interest under section 226.8(b)(5). In so

36. See note 19, *supra*, for the requirement that all disclosures be made on the same side of a single document.

37. 566 F.2d at 440.

38. See note 19, *supra*.

39. In one sentence, the *Gennuso* court stated that the debtor's covenants "create a security interest in an insurance policy covering the automobile." 566 F.2d at 440. The balance of the opinion treating the issue is devoted to the previously established requirement that every security interest be identified clearly under the "one document" rule. See note 19 *supra*.

40. *Id.* at 443.

41. 577 F.2d 291, 291 (5th Cir. 1978). The same day, the Fifth Circuit also decided *Shanks v. Greenbriar Dodge*, 577 F.2d 296 (5th Cir. 1978), involving similar circumstances and an identical holding.

42. This right gives the creditor the discretion, in the event of the borrower's default, to cancel the insurance policy and to apply any premium refund to the unpaid

holding, the court gave the term "security interest" an extremely broad reading; the court was convinced that the assignment conferred an interest in property designed to secure payment or performance of contractual obligations.⁴³ The right to unearned property insurance premiums was viewed to be a valuable economic right that the debtor had surrendered in favor of the creditor to the extent of the debt. According to the majority, this valuable right was "an interest in property" within Regulation Z's definition of security interest.⁴⁴ As stated by the court, "[i]f the security interest was important enough for defendant to acquire, it was important enough to disclose."⁴⁵ Citing the desirability of uniform interpretation of the Truth in Lending disclosure requirements,⁴⁶ the Fifth Circuit referred to *Gennuso* and found liability for failure to disclose a security interest.⁴⁷

However, not every case involving the assignment of proceeds and unearned premiums has reached this result. Only a week after *Edmondson* was decided, a contrary result was reached in *Rounds v. Community National Bank in Monmouth*,⁴⁸ a case involving parallel facts. Without mentioning *Gennuso* or *Edmondson*, the court in *Rounds* persuasively argued that no security interest is created. Drawing heavily upon the rationale of *Mims v. Dixie Finance Corp.*,⁴⁹ involving waiver of homestead exemption, the opinion traced several steps involved in the determination of whether a security interest has been created:

The first is that the character of a right which is claimed to create a security interest must be adjudged and determined by the application of state law. The second is that TILA [Truth in Lending Act] disclosures as to security interests must be so limited as to avoid the obscuration of required disclosures by

balance of the loan. If the borrower is not in default, the creditor may apply returned premiums toward substitute insurance on the property.

43. 577 F.2d at 294. The *Edmondson* court quoted extensively from *Elzea v. National Bank of Georgia*, 570 F.2d 1248 (5th Cir. 1978), emphasizing that attention should focus on whether a debtor has given up a valuable privilege as security for his debt.

44. 12 C.F.R. § 226.2(gg) provides in pertinent part: "'security interest' and 'security' means any interest in property which secures payment or performance of an obligation." (emphasis added).

45. 577 F.2d at 294. Actually, the *Edmondson* court was quoting a statement made by the special master who presided over the trial of this complex case.

46. This desire was expressed previously by the Fifth Circuit in *McDaniel v. Fulton Nat'l Bank of Georgia*, 571 F.2d 948, 951 (5th Cir. 1978).

47. 577 F.2d at 294-95.

48. 454 F. Supp. 883 (S.D. Ill. 1978).

49. 426 F. Supp. 627 (N.D. Ga. 1976) (waiver of homestead exemption is not a security interest within Regulation Z § 226.8(b)(5)).

the inclusion of the unnecessary and irrelevant description of other contract clauses and rights which do not create a security interest in the legal sense. The third is that the term "security interest," as employed in TILA and the Regulation [Z], must be limited by its definition to those contractual or statutory rights which create a lien upon the debtor's property.⁵⁰

The court in *Rounds*, in contrast to *Edmondson*, avoided a strict interpretation of Regulation Z and instead used a practical approach to find that not every interest or benefit in favor of a creditor is a security interest within the intent of the Truth in Lending Act. While conceding that assignments of proceeds and unearned premiums provide some benefit to the creditor, the *Rounds* court determined that such assignments amount to an even greater benefit for the debtor.⁵¹ Under the terms of the contract involved, risk of loss of the automobile was on the debtor. In the event of loss, the debtor would have been bound to discharge the obligation. However, by applying the proceeds of the insurance to the debt, the debtor's obligation would have been extinguished or reduced. In other words, the right was designed to ensure that the debtor would not be left with a significant obligation if he suffered an accidental loss of his property. Such contractual provisions could not create security interests within the intent of the Truth in Lending Act. In the words of the *Rounds* court: "If such ephemeral interests are to be deemed to be security interests within the disclosure requirements of the Act, that determination should emanate from Congressional enactment or from a determination of the Board, not from judicial decree."⁵²

Perhaps the most interesting security interest case involving a loss payable clause is *Souife v. First National Bank of Commerce*.⁵³ The plaintiff alleged that the defendant bank failed to disclose a security interest in property insurance proceeds and in unearned property insurance premiums, as well as in the proceeds of voluntary credit life insurance and in any returned premiums thereunder. The defendant bank argued that the determination of what constitutes a

50. 454 F. Supp. at 887 (citation omitted). The *Rounds* court believed that a security interest within the contemplation of Regulation Z is limited to provisions that have the effect of imposing a lien upon or a charge against the property of the debtor. Hence, the court perceived the issue of this case to be "whether the definition of 'security interest' should be *expanded* . . . to include the rights to apply unearned premiums, which the lender advanced as a part of the loan, and to apply the proceeds obtained by any insured loss to payment of the loan." *Id.* at 887-88 (emphasis added).

51. *Id.* at 888.

52. *Id.*

53. 452 F. Supp. 818 (E.D. La. 1978).

security interest involves interpreting state law⁵⁴ and that the assignment of proceeds and unearned premiums is not a security interest under the applicable Louisiana law.⁵⁵ Unfortunately, the district court skirted this important question, holding that if indeed the assignment was a security interest, it was adequately disclosed. In so doing, however, the court took a significant step away from the typically strict enforcement of Regulation Z requirements, finding that disclosure of the assignment of proceeds and of unearned premiums was even more meaningful when disclosed under the heading "Insurance" rather than under "Security Interests."⁵⁶

State Law and Opinion Letter No. 1263

Certainly, courts such as those in *Rounds* and *Souife*, which take a common sense approach to alleged Truth in Lending violations, are the exception and not the rule. All too often courts simply look to the introductory phrase in the Regulation Z definition of security interest which states that it is "any interest in property which secures payment or performance of an obligation."⁵⁷ Illustrating this point is the recent decision in *Hernandez v. O'Neal Motors, Inc.*,⁵⁸ involving the consolidation of ten security interest cases alleging failure to disclose interests in unearned or rebated premiums of property insurance policies. Citing Federal Reserve Board Staff Opinion Letter No. 1263⁵⁹ for the proposition that state law determines

54. In so arguing the defendant bank relied upon Staff Opinion Letter No. 1263, CONS. CRED. GUIDE (CCH) ¶ 31,750 (Nov. 23, 1977), which arguably determines that state law controls in determining what constitutes a security interest. See text at notes 57-89, *infra*.

55. 452 F. Supp. 820 n.4.

56. *Id.* at 821. Apparently, the defendant bank had separated its disclosure statement into paragraphs, each paragraph making a required disclosure and designated by a letter of the alphabet and by the type of disclosure made. Under the paragraph labeled "D. SECURITY INTEREST," the creditor clearly disclosed the type of security interest as a "Louisiana Chattel Mortgage." *Id.* Immediately following is a paragraph designated as "E. INSURANCE" in which unearned premiums are assigned. *Id.*

57. 12 C.F.R. § 226.2(gg) (1980).

58. 480 F. Supp. 491 (D. N.M. 1979).

59. CONS. CRED. GUIDE (CCH) ¶ 31,736 (Nov. 23, 1977). Opinion Letter No. 1263 provides, in pertinent part:

What constitutes adequate identification of the *type* of security interest acquired by the creditor depends upon how relevant *State law* would describe the security interest. Note that a more fundamental matter in these circumstances may be to determine whether a security interest exists at all and, if so, to identify the property subject to such interest. Section 226.2(gg) [of Regulation Z] defines "security interest" as "any interest in property which secures payment or performance of an obligation." Thus, if the creditor does not acquire any interest in property (including real property and tangible or intangible personal property), or

whether an interest in property is created, *Hernandez* holds that if such an interest is created under state law, a disclosure is required, since a security interest under Regulation Z is *any interest* in property. The approach is simplistic: if *any* interest is created under state law, it is a security interest for the purposes of Regulation Z.

Perhaps the solution to the security interest dilemma is not this simple. The definition of "security interest" found in Regulation Z is not as broad as courts such as *Hernandez* and *Edmondson* have indicated. The Regulation Z definition modifies the "any interest in property" language to illustrate the kinds of security interests contemplated by the Board of Governors.⁶⁰ Among the enumerated interests are mortgages, deeds of trust, mechanic's and materialmen's liens, and any lien on property arising by operation of law. The examples of contemplated security interests involve liens or privileges on the debtor's property in favor of the creditor that are superior to the rights of *third persons*.⁶¹ Indeed, if a creditor were to be asked what constitutes a security interest under Regulation Z, an almost automatic response probably would be that a security interest is any interest which gives the creditor a preference over the rights of third persons in the debtor's property. Such interests typically require special forms and registry in the public records. It becomes increasingly apparent that the same creditor would probably not even consider the need for making a security interest disclosure when

if any such interest does not secure payment of the debt, no security interest exists. For example, the contractual right to proceed under an insurance policy may not amount to an interest in property. On the other hand, assignment of returned and unearned premiums may transfer to the creditors such an interest. However, staff believes these questions would be better addressed as a matter of *State law*.

Id. (emphasis added).

60. 12 C.F.R. § 226.2(gg) (1980) defines a security interest subject to disclosure as: any interest in property which secures payment or performance of an obligation. The terms include, but are not limited to, security interests under the Uniform Commercial Code, real property mortgages, deeds of trust, and other consensual or confessed liens whether or not recorded, mechanic's, materialmen's, artisan's, and other similar liens, vendor's liens in both real and personal property, the interest of a seller in a contract for the sale of real property, any lien on property arising by operation of law, and any interest in a lease when used to secure payment or performance of an obligation.

61. Although the enumerated examples of security interests given by the drafters of Regulation Z appear directed at those interests that give the creditor a preference over the rights of third persons, the majority of security interest cases have not considered the issue. Only two cases have discussed the requirement of lien or preference. See *Rounds v. Community Nat'l Bank*, 454 F. Supp. 883, 887 (S.D. Ill. 1978); *Mims v. Dixie Fin. Corp.*, 426 F. Supp. 627, 637 (N.D. Ga. 1976). In both instances, the courts found that the question of whether a lien or privilege creating a security interest is found in a transaction is one to be determined by state law.

there is an assignment of insurance proceeds or unearned premiums.⁶²

As *Hernandez* points out, Opinion Letter No. 1263 explicitly states that state law is determinative of whether a security interest has been created.⁶³ The creditor in *Souife* seized upon this interpretation to argue that under Louisiana law, no security interest had been created.⁶⁴ Under Louisiana's unique civil law concept of security interests, an interest in property in favor of a creditor is effective against the debtor, as well as third persons, only if the interest is a mortgage, pledge, privilege, or other security device under Louisiana law.⁶⁵ Although the court never reached the issue, apparently state law should be the determining factor in these cases. However, *Hernandez* appears to dismiss both Opinion Letter No. 1263 and any serious study of state law considerations by finding that *any* substantive interest in property is a security interest requiring disclosure.⁶⁶ Although *Hernandez* declares that state law determines the substance of the interest created, the effect of this holding is to find a security interest requiring disclosure any time any interest is created that is not illegal under state law, regardless of whether the interest grants the creditor a preference over third parties or of whether state law actually defines the interest.⁶⁷ Certainly, these are not the types of security interests contemplated when the Regulation Z section 226.2(gg) illustrations of privileges and liens were adopted.⁶⁸ Just as the creditor viewed a security interest as involving specialized forms and recordation, so did the examples given in the security interest definition. Surely the drafters of Truth in Lending and Regulation Z did not intend that their

62. The court in *Edmondson v. Allen-Russell Ford, Inc.*, 557 F.2d 291, 294-95 (5th Cir. 1978), recognized the frequency with which such assignments occur and the failure of creditors to recognize these as security interests. However, the court believed quite strongly that a valuable interest in property requiring disclosure had been created, regardless of whether this interest gave the creditor a preference in the debtor's property superior to the right of third persons.

63. See note 60, *supra*.

64. 452 F. Supp. at 820 n.4.

65. See generally LA. CIV. CODE arts. 3133-3411. This is not the first time a creditor has argued that an interest that would be a security device requiring disclosure under the laws of other states would not require disclosure under Louisiana law. In *Meyers v. Clearview Dodge Sales, Inc.*, 539 F.2d 511 (1976), the creditor successfully argued that a confession of judgment clause—a security interest in most common law jurisdictions—is merely a procedural device under Louisiana law, giving the creditor no additional substantive rights. See Staff Opinion Letter No. 759, CONS. CRED. GUIDE (CCH) ¶ 31,081 (Feb. 28, 1974).

66. 480 F. Supp. at 495.

67. *Id.*

68. See text at note 60, *supra*.

somewhat limited definition of security interest should be expanded to cover the widest possible interests not invalidated by state law.

It is evident that Truth in Lending cases pose serious problems for the courts because of the enormous number of regulations, interpretations, opinion letters, and conflicting jurisprudence. The rights created by the assignment of insurance proceeds and by the assignment of unearned premiums have been combined here for the sake of convenience; but few courts have managed to draw a distinction between these entirely separate rights.⁶⁹ For example, it can be argued persuasively that many of the loss payee cases could have been avoided, since an assignment of proceeds clause should not create an interest in property until an accident or event arises which causes a payment of proceeds. Indeed, Regulation Z section 226.6(g) provides that a creditor will not be liable under the Act if the information disclosed is rendered inaccurate because a subsequent occurrence (*e.g.*, an accident for which payment will be forthcoming under the insurance policy) creates a security interest.⁷⁰ If a Truth in Lending claim is brought on an existing loan and no accident has occurred requiring that insurance proceeds be paid to the creditor, the case is premature; there is not yet any *property* in which the creditor may have a security interest. A similar argument can be made for the separate right to any return of insurance premiums. Absent an early cancellation of the insurance policy, there is no property (rebated premiums) within the contemplation of the security interest provisions of Regulation Z. Hence, it appears that despite the frequent failure of courts to recognize that only preferences superior to the rights of third persons should be classified as security interests requiring disclosures, courts could avoid considerable litigation by examining general disclosure require-

69. The Federal Reserve Board staff recognized the basic distinction in the rights and remedies of these two interests in Opinion Letter No. 1263, note 59 *supra*, when it stated:

Note that a more fundamental matter in these circumstances may be to determine whether a security interest exists at all and, if so, to identify the property subject to such interest. . . . For example, the contractual right to proceed under an insurance policy may not amount to an interest in property. On the other hand, assignment of returned and unearned premiums may transfer to the creditors such an interest.

Staff Opinion Letter No. 1263, CONS. CRED. GUIDE (CCH) ¶ 31,736 (Nov. 23, 1977).

70. 12 C.F.R. § 226.6(g) (1980) provides:

Effect of subsequent occurrence. If information disclosed in accordance with this Part is subsequently rendered inaccurate as the result of any act, occurrence, or agreement subsequent to the delivery of the required disclosures, the inaccuracy resulting therefrom does not constitute a violation of this Part.

(Footnote omitted.)

ments such as section 226.6(g) in addition to the security interest provisions.⁷¹

Truth in Lending Simplification

The Truth in Lending Act has a laudable purpose: to provide consumers with information sufficient to enable them to make informed decisions about credit. Unfortunately, enforcement of the Act is problematical, and abuse of its remedies by plaintiffs undermines its purpose.⁷² Often a consumer who has defaulted on his loan will seek legal aid to avoid impending seizure and garnishment proceedings. Rather than attempting to build a defense, the consumer is encouraged to take the offensive by bringing a Truth in Lending claim against the creditor.⁷³

Potential and actual abuse of the Act has not gone entirely unnoticed by the courts. Noting that many Truth in Lending claims are brought by plaintiffs who are not misled or misinformed by disclosure statements,⁷⁴ one court stated:

These plaintiffs have merely sought a windfall penalty from a lender by picking apart its loan form word by word in search of a technical deviation from the language of the statutes and regulations. The Truth in Lending Act was never meant to make the district courts forums for word games between lenders and borrowers in which a borrower's attorney who is adept at using legalese and arguing technicalities is awarded a prize for himself and his client.⁷⁵

Whether Truth in Lending is achieving its objectives is questionable. The Board of Governors of the Federal Reserve System,

71. 12 C.F.R. § 226.6(g), 226.8(b)(5) (1980).

72. This writer is not the first to direct criticism at the Truth in Lending Act. See Edmonds & Taylor, *Truth and Consequences*, 35 WASH. & LEE L. REV. 367 (1978) in which it is said that Truth in Lending serves mostly as "a trap for the unwary creditor." *Id.* at 391.

73. As one authority has stated, "[f]ew clients come to a lawyer's office with an inkling that they have a TIL [Truth in Lending] claim. To recognize a potential TIL claim a consumer would have to know the intricate provisions of the statute and Regulation Z and . . . that the TIL statement did not comply." Landers, *supra* note 21, at 677.

74. To bring successfully a claim for violation of the Truth in Lending Act, a plaintiff need not prove that he was misled by the disclosures. He must show only that the disclosures were such that someone could have been misled. The Act apparently views plaintiffs who have not been misled as useful in enforcing the Act.

75. Sanders v. Auto Associates, Inc., 450 F. Supp. 900, 902 (D. S.C. 1978). Cf. Wilson v. Allied Loans, Inc., 448 F. Supp. 1020, 1022 (D. S.C. 1978), where the court said: "This barratrous legislation transforms loan documents into contest puzzles in which prizes are awarded to those who can uncover the technical defects."

the body responsible for implementing Regulation Z, noted in its annual report to Congress for the year 1978 that a survey indicated that nearly two-thirds of consumers believed that Truth in Lending statements are not read and almost three-fourths agreed that the disclosure statements are too complicated.⁷⁶ Apparently, the likelihood of severe penalties for technical violations⁷⁷ has encouraged creditors to include every bit of information that might possibly require disclosure. Instead of receiving a simplified disclosure of the annual percentage rate and finance charge on his loan, the consumer often finds himself holding a two-foot-long disclosure statement crammed with information that he does not understand and about which he has no desire to learn.

In 1976 Congress realized that disclosure requirements had become so complicated that it was unreasonable to expect consumers to read or understand the disclosure.⁷⁸ Instead of encouraging competitive shopping for better credit terms, the Act has reduced competition by driving small creditors out of the market.⁷⁹ Moreover, despite the sustained efforts of creditors to achieve compliance with the Act, the Federal Deposit Insurance Corporation cited 507 banks in a six-month period in 1976 for failure to comply with the very basic disclosures of annual percentage rates and finance charges.⁸⁰

Congressional awareness of these problems with Truth in Lending has led to the introduction of at least one bill each year proposing simplification and reform of the Act.⁸¹ One of the major proponents of Truth in Lending reform is Senator William Proxmire, an original supporter of Truth in Lending when it was enacted in

76. Federal Reserve Board Recommendations to Congress, *Truth in Lending Annual Report To Congress for the Year 1978 by the Board of Governors of the Federal Reserve System*, CONS. CRED. GUIDE (CCH) 4 (January 25, 1979).

77. For example, in one consolidated case, two creditors were held liable for failure to disclose license and title fees as required by Regulation Z section 226.4(b)(4). One creditor was liable for \$577.84 plus attorney's fees for failing to disclose a \$4.00 fee while the other was obligated to pay \$2,000 plus attorney's fees for failure to itemize \$17.75 in fees. *Dalton v. Bob Neill Pontiac, Inc.*, 476 F. Supp. 789 (M.D. N.C. 1979).

78. See generally *Oversight On Consumer Protection Activities of Federal Banking Agencies: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. 145 (1976).

79. *Id.* at 162.

80. S. REP. NO. 94-1388, 94th Cong., 2d Sess. 6. As one author states, if this is the compliance rate for bankers, one can only wonder what it must be for less scrupulous merchants. Note, *Truth In Lending—A Time For Reform*, 26 CATH. U.L. REV. 575 (1977).

81. See S. 108, 96th Cong., 1st Sess. (1979); S. 1846, 95th Cong., 1st Sess. (1977); S. 3875, 94th Cong., 2d Sess. (1976).

1968.⁸² On March 31, 1980, the most recent simplification proposal⁸³ was enacted as the Truth in Lending Simplification and Reform Act⁸⁴ and will be fully effective April 1, 1982. The purpose of the reform legislation is to streamline the twelve-year-old Truth in Lending Act, limiting civil liability to those disclosures that are of central importance in clarifying a credit transaction's costs or terms, thereby eliminating litigation for purely technical violations.⁸⁵ Significantly, section 615(b) of Truth in Lending Simplification amends the security interest provisions of the Truth in Lending Act to require only disclosure of whether the transaction is secured, whether a security interest is taken in property purchased under the transaction, and whether a security interest is taken in other (non-purchased) property, identified by time or type. Requirements that the collateral be identified and that disclosure be made of any security interest affecting after-acquired property or future indebtedness are eliminated. Presumably, much of the litigation involving technical disclosures of security interests will be obviated by the reform legislation. It will be remembered that *Rounds*⁸⁶ stated that any rights of the creditor to insurance proceeds and unearned premiums serve to benefit the consumer as well as the creditor and therefore are not the kinds of interest required to be disclosed within the original intent of the Truth in Lending Act. Evidently, the new Act adopts a practical approach similar to that of *Rounds* and requires only disclosure of information central to making informed credit decisions.

Conclusion

There can be no doubt that the Truth in Lending Act and, in particular, disclosure of security interests have benefitted the con-

82. See note 8, *supra*.

83. H.R. 4986, 96th Cong., 2d Sess., 126 CONG. REC. 2271 (1980).

84. The Truth in Lending Simplification and Reform Act comprises title VI of the Depository Institutions Deregulation and Monetary Control Act of 1980. Pub. L. 96-221, 94 Stat. 132 (1980).

85. Truth in Lending Simplification and Reform Act, Pub. L. 96-221, § 615(b), amending 15 U.S.C. 1640(a) (1976). A Senate Committee Report clearly expresses the intent to eliminate liability for inconsequential violations:

This section [615(b)] is intended to restrict the scope of creditor liability for statutory penalties to only those disclosures which are of material importance in credit shopping. The committee believes this will eliminate litigation based on purely technical violations of the Act.

S. REP. NO. 96-73, 96th Cong., 1st Sess., reprinted in [1979] U.S. CODE CONG. & AD. NEWS 878, 883. The substance of the text of S. 108 was inserted into H.R. 4986, subsequently enacted as Pub. L. 96-221, 94 Stat. 132 (1980).

86. *Rounds v. Community Nat'l Bank in Monmouth*, 454 F. Supp. 883 (S.D. Ill. 1978).

sumer. The greater standardization of the terminology of credit transactions and the development of such uniform concepts as annual percentage rate and finance charge help protect consumers from questionable credit practices. However, the lack of harmony in security interest cases such as *Edmondson* and *Rounds*, the incentives to litigate provided to consumers,⁸⁷ and the resulting disincentives to creditors⁸⁸ make the Truth in Lending Act a catalyst for litigation and often force creditors into settlements disproportionate to the harm caused.⁸⁹ Moreover, the disclosure requirements of the Truth in Lending Act and Regulation Z have become so complex that disclosure statements are virtually useless to anyone but the student of semantics. The Truth in Lending Simplification and Reform Act should serve to streamline disclosure forms and to eliminate unnecessary disclosures that actually obscure critical transaction information while still promoting the achievement of Truth in Lending goals by tying claims under the Act to actual harm caused the consumer by a violation. Until the Truth in Lending Simplification and Reform Act becomes effective in 1982, it is hoped courts will use the reform legislation as a guide to the original intent of Truth in Lending and not delay for two years the elimination of civil liability for mere technical violations of the Act.

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87. See notes 11-15, *supra* and accompanying text.

88. Estimates indicate that consumers have a very good success record in the cases that are decided on the merits. See Landers, *supra* note 21.

89. Creditors often find it more advantageous to settle a weak claim than to incur the defense costs that could far exceed the amount of statutory damages. See note 13, *supra*.