



Requiring Buyers to Buy Service Contracts? Read This.

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I frequently speak at industry conferences. When my presentation is over, there are always a few folks from the audience who have questions or who just want to talk about the legal side of the car business.

When there are questions, it sometimes seems that there's something of a "flavor of the month" thing going on – I'll get several questions that are either identical or have small variations on a central theme.

At this year's National Independent Auto Dealers Association conference in Orlando, that theme seemed to be service contracts in general and, in particular, whether a dealer may require a credit buyer to buy one. Like most legal questions, the answer to this one is easy, except when it isn't.

The easy part of the question is whether the practice of requiring a service contract in connection with the credit sale of a vehicle violates the federal Truth in Lending Act and Regulation Z. The answer to that question is a simple "no" because, as you might guess, the federal disclosure requirements tend to deal with disclosure rather than the substance of the transaction. It isn't far from the truth to say, "The feds don't care what you do, as long as you disclose it correctly."

But the fact that federal disclosure laws don't prohibit the practice doesn't mean that the practice is not affected by them. In this case, the key to the application of federal law is the word "require." When a dealer requires a service contract in financing transactions, but not in similar cash transactions, the charge for the service contract must be treated as a finance charge, added to other finance charges and included in the APR calculation. That's pretty basic.

A little more esoteric is just how the charge must appear in the federal disclosure part of the retail installment contract. It should be shown as a "prepaid finance charge." That means that most generic retail installment contracts cannot be used because they do not incorporate a prepaid finance charge disclosure.

And then there's state law. In states that have definitions of "finance charge" that mirror or operate like the federal disclosure laws, several problems arise. First, there may be a state law that simply prohibits requiring the purchase of a service contract. Then there's the disclosure issue, which, in a lot of states, will require the same sort of analysis required at the federal level.

Are we done? Nope.

Most states impose a rate cap for finance charges. In such states, the cost of the service contract, when added to other finance charges in the deal, may produce a rate so high that it exceeds the state's maximum permitted rate.

Finally, there is the issue of how finance charges must be computed at the state level. Some states require that finance charges be computed only by applying a rate to a declining balance. An up-front charge such as the fee for a service contract won't meet that test.

One conference attendee kept arguing that requiring a service contract couldn't create the difficulties I described to him. Finally, he said, "My DMS provider says that by simply including the cost of the service contract in the Itemization of Amount Financed, I'm disclosing everything correctly!" In response, I asked, "But have you told the DMS provider that you are *requiring* the buyer to purchase the service contract, or does the DMS provider believe that the purchase is voluntary? Go ask the DMS provider that question." The dealer left to wander over to the DMS provider's booth in the exhibit hall, and I didn't hear from him again.

From several recent AG actions, I can tell you that this one is a front-burner problem. If you're requiring buyers to buy service contracts, pull down the shades, flip the sign on the door from "OPEN" to "CLOSED," lock the doors, and go visit your lawyer.

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