# THE MATURING OF DEBT PROTECTION AGREEMENTS

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We have written two articles on debt protection agreements ("DPAs") in previous editions of the FORC Journal.[i] This article will provide additional comments on DPAs in the marketplace and address the maturing of this product since 2002.

## *What is a DPA?*

A DPA is a two party agreement between a lender and a debtor that will either cancel or waive the remaining debt (a debt cancellation agreement) or suspend the required debt payments for a defined period of time (a debt suspension agreement). In nearly all cases a DPA is paid for by the debtor through an additional charge for the DPA in the finance agreement. In a few cases, the cost of the DPA has been included in the finance charge. Many lenders insure their financial exposure caused by the loss of contract income with a contractual liability policy sold by a property and casualty insurer.

## *Who sells DPAs?*

DPAs are now sold by national and state chartered depository institutions and by non-depository lenders (depository institutions also include federally and state chartered credit card banks). Federally chartered depository institutions led the way in bringing DPAs to the marketplace. Credit card banks were, and continue to be, the largest segment of the federally and state chartered institutions offering DPAs. Once federally chartered depository institutions started selling DPAs, their state chartered counterparts commenced the process of securing permission from their respective regulators to sell the product. Today, both federally chartered and state chartered depository institutions sell DPAs to their customers where allowed by the lending laws of the given states.

Non-depository lenders (finance companies, dealers and merchants) are developing DPAs and selling these products where allowed by state finance laws. These are states where there has not been a statute passed that limits DPAs to depository institutions or where a state insurance department still maintains that the products are insurance products for non-depository lenders.

## *What are the lenders of DPAs selling?*

Ten years ago when the first DPA products were introduced to the marketplace, the DPAs mimicked credit insurance products. In today's marketplace, lenders are branding the products to fit within the lenders' branded programs and to fit their debtor needs. The most significant change has been the adoption of the use of an accidental death benefit and limited duration disability programs. Lenders determined that their debtors do not fear dying of natural causes, but do fear dying from accidental death. Debtors also voiced a strong desire for limited disability products that will pay their monthly debt for a

limited number of months, i.e. 6, 12, 24 months, instead of the remaining term of the debt-like credit insurance products. In addition to these two product offerings, many lenders are packaging involuntary unemployment programs and family leave programs with a limited number of payments into package programs. A few programs offer one or two payment holidays (a monthly payment can be missed for any reason), divorce protection (a debt suspension option for a limited number of months), and natural disaster protection (a limited suspension if the person resides in a declared natural disaster area).

### *Who is regulating DPAs?*

DPAs are not a per se regulated product. The extent of the regulation of DPAs is for the most part, with the notable exception of the Office of the Comptroller of the Currency ("OCC"), the granting of permission to sell the product by the proper regulatory authority. What has generally happened is that the regulatory body has issued a form of an official document which informs the institutions that are regulated by that authority that the institution can sell DPAs.[ii] The OCC issued, with an effective date of June 13, 2003, a rule 12 CFR Parts 12 and 37 that regulates national banks that sell DPAs. The rule has several parts. The first part sets out that DPAs are not insurance products but are contracts between the national bank and the debtor. The second part sets out certain disclosure requirements (notably Appendix A and B) and prohibitions to protect consumers i.e., the anti-tying provisions. The third and last section deals with the safety and soundness requirements that national banks must implement prior to selling a DPA. Many of the other federal and state regulators of depository institutions have adopted the OCC regulation for their constituents.[iii] As of this writing, most state regulatory authorities have not established a formal requirement, including a reference to the OCC rule.

The states have taken varied approaches to regulating DPAs. Many of the states that have automatic parity statutes have announced that they need not do anything for their institutions to sell DPAs. Those states with permission required statutes have either granted permission broadly or have granted permission on an institution by institution basis. In the few remaining states that have effective date statutes, the statutes have been changed or there has been no action to date. The end result is that with the exception of one state, state charted depositories have been allowed to sell DPAs and to be competitive with their federal counterparts.

The Consumer Credit Insurance Association has recently drafted a version of the OCC rule that will work on the state level, and within the last month presented this model rule to a state regulator who is required to adopt a rule to allow creditors to sell DPAs.

### *What is the most significant obstacle to selling DPAs?*

The largest obstacle to selling DPAs is the ability of a state lender to sell the DPA and charge a separate additional fee within the state's lending laws. Many of the states have statutes that enumerate what additional fees can be added to the contract and not have those fees be included within the permissible finance changes. A good number of the

states have statutes that allow the administrator of the financial code to promulgate new types of additional fees. Efforts are underway or have been completed in those states to bring about the change**.** This year several legislatures have adopted statutes that allow for the additional fees. Not only do the state loan laws have to be changed, but in many states the state motor vehicle finance law has to be changed to allow for the additional fee of a DPA to be included.

A few states continue to classify DPAs as insurance, but most states have issued letters, opinions or bulletins or passed a statute which have begrudgingly stated that the state insurance department will not take any action against depository institutions which sell DPAs.[iv]

There is one facet of this maturing process that we find very interesting. There is a split with financial institution lawyers, representing both depository institutions and regulators, on the authority of national banks operating in the various states. Some counsel for depository institutions and regulators take the position that the National Banking Act preempts state lending laws. Other counsels take the position that the state lending laws are not preempted. As a result, some national banks sell debt protection products across all state lines while others sell only in those states that explicitly allow for a DPA.

***Has there been any litigation?***

Surprisingly since 2000 there has only been one reported case regarding a debt protection product, *Automotive Funding Group, Inc. v. Garamendi*, 114 Cal APP $4^{th}$ 846 (2003). The following are paraphrased statements from this case:

- Whether or not a risk shifting arrangement is insurance necessarily turns on two factors: (1) to what extent the specific transactions or the general line of business at issue involve one or more of the evils at which the regulatory insurance statutes were aimed; and (2) whether the elements of risk shifting and risk assumption were a central and important part of the transaction or were merely incidental to other elements that gave the transaction its distinctive character.

- The tangential risk allocation provision [the waiver] should not have the effect of converting the [finance source] into insurers subject to statutory regulation.

- It was not the purpose of the insurance statutes to regulate all arrangements for assumption or distribution of risk.

- There is a fallacy in looking at only the risk element, to the exclusion of all other elements present or subordinate to it. The question turns not on whether risk is involved or assumed, but on whether risk or something else to which it is related in the particular plan is its principal object and purpose.

- California insurance laws do not create an absolute prohibition against risk shifting and risk assumption provisions on contracts for the sale of services or goods.

The automobile finance agreement's main purpose was to finance the purchase of an automobile and the debt waiver agreement was only ancillary to the main purpose of the agreement. The California Department of Insurance did not appeal this ruling.

### *What does the future hold for DPAs?*

DPAs will continue to grow in the lender marketplace. Competition and lender branding of the different programs has created a vital and vibrant marketplace. Competition is creating competitive programs and consequently lowering the pricing. Not all lenders will adopt a DPA program for their institution, but we project that a majority of the lenders will have some form of a debt protection program for their customers by the end of the decade. So far, with the exception of the OCC regulation, there are no other regulations of the product. We expect states will adopt regulations, but the state versions will continue the trend of the OCC and not regulate the structure or pricing of the product. States will continue to let the marketplace self-regulate and will do so as long as there are no significant consumer abuses.

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[i] Gramm-Leach-Bliley: What's Good for the Federal Goose is Good for the State Gander—Debt Cancellation Agreements, Vol. XII, Edition IV, December 2, 2000; Debt Cancellation contracts for Financial Lenders: An Overview—Vol. XIII, Edition I, March 24, 2001.

[ii] For example: South Dakota Department of Commerce and Regulation, June 5, 2000; California Department of Financial Institutions, Month Bulletin September, 2002; Colorado Division of Banking, Operating Memorandum, May 3, 2004; Georgia Department of Banking and Finance, Memorandum of June, 10, 2003; and Utah Department of Finance, Rule R331-25, August 6, 2003.

[iii] For example: Office of Thrift Supervision, Powers of Federal Savings Associations, March 1, 2002; National Credit Union Administration, Part 721; and Regulation Z, 12 CFR 226.4 and Utah Department of Finance, Rule R331-25, August 6, 2003.

[iv] For Example: Office of the General Counsel, New York Department of Insurance Opinion June 17, 2004; Nevada Division of Insurance Letter, July 29, 2003; Kansas Department of Insurance letter of January 5, 2004.