

## DEBT CANCELLATION CONTRACTS FOR FINANCIAL LENDERS: AN OVERVIEW

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With the passage of the Gramm-Leach-Bliley Act (“GLBA”), many of the post-depression separations between banking, securities and insurance have been altered. One product which has not gained a lot of attention in the press, but which could provide a very positive contribution to a financial lender’s revenue stream, is debt cancellation agreements (“DCAs”).

### **Description.** What is debt cancellation?

- Debt cancellation agreements or DCAs are just as the name implies. Under a DCA, a creditor will cancel or discharge a debtor’s indebtedness upon the occurrence of certain events.<sup>1</sup>
- Death or Dismemberment Protection cancels the amount due on the date of death or dismemberment. Certain exclusions may be added, e.g. suicide.
- Disability or Unemployment Protection cancels payment of the amount due on the date of disability or unemployment, or after a waiting period (e.g. 30 days).
- Family Leave Protection cancels or defers the amount due during the period of an approved family leave under the Federal Family Leave Act, typically after a waiting period (e.g. 30 days).
- Loss of Collateral Protection cancels the amount due against which the lender has a security interest in the event of the loss of collateral securing the loan for certain specified events, i.e. theft, destruction, etc.
- New and innovative products are currently being developed to protect against disability, long term care and other events.

Guaranteed Auto Protection Plans (“GAP”) are among the most common forms of DCAs. Under a GAP plan, a vehicle purchaser pays an additional charge in exchange for which the creditor agrees not to hold the purchaser liable for the difference between the balance on the debt and the benefit paid under an automobile insurance policy in the event that the vehicle is totaled or stolen. Under Regulation Z, lenders may exclude the cost from the finance charge provided the requirements of 12 C.F.R. 226.4(d)(3) are satisfied. Those requirements as applied to new vehicle purchases are: (1) the purchase of the GAP Plan (the DCA) was not a condition to obtain a loan; (2) the purchase of GAP was voluntary; and (3) the purchaser acknowledges in writing that the purchase price and program details were disclosed. These same requirements apply to all forms of DCAs in order to be able to exclude the DCA fees from the calculation of finance charges.

In order to finance the DCA losses, the creditor may incur the fee as part of its administrative expenses or internal rate of return, or alternatively, impose an additional charge to the consumer when making a loan. As stated above, the inclusion of the DCA payments in the customers’ monthly payments has Regulation Z implications. The funds collected are used to create reserves to cover the creditor’s interest in the loan should the indebtedness be reduced, deferred, or canceled by the stated event.

**Benefits of DCAs.** From the creditor’s perspective, the primary purpose of a DCA is to protect the creditor from the risk of a loan loss caused by the occurrence of a stated contingency. The risks covered are ones which the creditor otherwise bears as part of the loan transaction.

The cost of a DCA program is expected to be less than traditional credit insurance charges for numerous reasons, including simpler and uniform disclosure requirements, greater ability to customize programs to specific consumer

base, and removal of third party credit insurance expense. Further, provided proper risk analysis has been done by the creditor, the DCA fees can provide additional revenue to the lender.

**Legal Authority.** The ability of the creditor to offer DCAs resides in case law, national banking legislation and regulation. Protecting the lender from the contractual events is a lawful exercise of the inherent lending powers of a national bank and is a necessary function of the business of banking.

- A. **Case Law.** The offering of DCAs by national banks was approved in federal court. In *First Nat'l. Bank v. Taylor*, 907 F.2d 775 (8<sup>th</sup> Cir. 1990), the Eighth Circuit concluded that a bank, engaged in the business of issuing DCAs, was not subject to state insurance regulation. In *Taylor*, First National Bank (“FNB”) issued DCAs to its consumers with loans of \$10,000 or less. The contracts provided that FNB would cancel the unpaid balance of the loan in the event of the borrower’s death, regardless of how the death was caused. Although the customer had to pay an additional charge for the contract, the charge did not vary with the borrower’s age or medical condition.<sup>2</sup>

The *Taylor* court noted that the Comptroller had declared the issuance of DCAs to be an incidental power of banks under the National Bank Act, and further remarked that the Comptroller’s view was to be accorded significant deference by the reviewing court.<sup>3</sup>

Having found the issuance of DCAs to be an incidental power of a bank, the *Taylor* court proceeded to address, and reject, the Insurance Commissioner’s argument that said contracts constitute the “business of insurance” under McCarran-Ferguson. In doing so, the court noted that: (1) McCarran-Ferguson was not intended to grant States any regulatory power in excess of that which they possessed prior to the U.S. Supreme Court’s decision in *United States v. South-Eastern Underwriters Ass’n*, 322 U.S. 533, 88 L. Ed. 1440, 64 S. Ct. 1162 (1944); (2) prior to *South-Eastern Underwriters*, the regulation of banks was within the exclusive domain of the federal government; and (3) DCAs differ significantly from traditional contracts of insurance.

More recently, this same conclusion was reached in *Steele v. First Deposit National Bank et al*, (Oct. 1999, AL. Ct. of App.).

- B. **Federal Regulators.** The Office of the Comptroller of Currency (“OCC”) first authorized DCAs in 1964. On March 10, 1964, the OCC issued a Private Letter Ruling stating that, “The use of debt cancellation agreements, the imposition of an additional charge, and the establishment of reserves as protection against losses arising out of such contracts is a lawful exercise of the powers of a National Bank. The exercise of such powers is necessary to and is a part of the business of banking.” This Letter Ruling was subsequently codified in 12 CFR § 7.7495, currently § 7.1013.

In addition to death, the OCC has ruled that other events may also be protected against. Pursuant to OCC Interpretative Letter 640, dated January 7, 1994, the Comptroller provides that, “pursuant to 12 U.S.C. § 24(Seventh), national banks may offer DCAs that cancel debt upon a borrower’s disability and/or unemployment, as well as a borrower’s death.” The Comptroller states that, while Interpretive Ruling 7.7495, 12 C.F.R. § 7.7495 only addresses DCAs that cancel debt upon the death of the debtor, the same rationale underlying the ruling that DCAs are incidental to a bank’s express loan-making authority would apply to DCAs involving the borrower’s disability or unemployment.

In OCC Interpretative Letter 827, dated April 3, 1998, the OCC approved the offering by banks of debt suspension contracts that would “freeze” the cardholder’s account “in the event that the cardholder becomes involuntarily unemployed, is unable to work due to disability, goes on an approved family leave, is hospitalized for more than a specified number of days, or becomes temporarily unable to continue to make payments on the account for certain other reasons;....” The Comptroller stated that, “like DCAs, a debt suspension agreement helps protect the borrower against the risk of financial hardship *in times of adversity*.... From the bank’s perspective, a debt suspension contract provides a mechanism for the bank to manage and obtain compensation for the credit risk that it undertakes in making a loan. Thus, it is a very logical outgrowth of the bank’s express lending authority.” (emphasis added). Thus, this opinion

specifically authorizes debt suspension and DCAs that protect against events other than death, disability or unemployment.

Other federal regulators have taken the same position with respect to the financial entities that they regulate. The Office of Thrift Supervision (“OTS”) regulates Federal Savings Associations. On September 15, 1993, the OTS specifically stated that Federal Savings Associations have authority to include DCAs in their consumer loan contracts.<sup>4</sup> On December 18, 1995, the OTS reaffirmed this opinion and provided that Federal Savings Associations may offer debt cancellation clauses in the loan contracts directly without utilizing an operating subsidiary.<sup>5</sup>

With respect to federal credit unions (“FCUs”), the governing body is the National Credit Union Administration (“NCUA”) and the statutory authority for the creation and powers of a FCU is found in The Federal Credit Union Act.<sup>6</sup> The Federal Credit Union Act expressly provides that FCUs may “exercise such incidental powers as shall be necessary or requisite to enable it to carry on effectively the business for which it is incorporated.”<sup>7</sup> As with the OCC, the NCUA is responsible for interpreting the extent and type of activities that may be conducted under the FCU’s incidental powers.

The NCUA, in response to an inquiry from an insurance company, issued a letter dated September 12, 1997, clarifying that it is its opinion that DCAs or GAP Waivers are not insurance products, citing the *Taylor* case.

On November 16, 2000, the NCUA Board proposed a rule regarding the expansion of the incidental powers of a Federal Credit Union.<sup>8</sup> The NCUA Board specifically noted that after considering case law and OCC interpretations that have evolved over time, the NCUA Board, like the OCC, has the discretion under the incidental powers provision to authorize activities beyond those enumerated in the FCU Act.<sup>9</sup> It is also important to note that the NCUA states that deference should be given to the NCUA as the regulator in making the determinations as to what activities fall within a FCU’s incidental powers, similar to the deference that has been granted to the OCC and upheld in numerous cases.<sup>10</sup>

The NCUA proposed 12 CFR 721.2 which sets out the standard to be followed in determining whether an activity falls within the FCU’s incidental powers. In determining whether an activity is authorized as an appropriate exercise of a FCU’s incidental powers, the Board will consider: (1) whether the activity is convenient or useful in carrying out the mission or business of credit unions consistent with the FCU Act; (2) whether the activity is the functional equivalent or logical outgrowth of activities that are part of the mission or business of credit unions; and (3) whether the activity involves risks similar in nature to those already assumed as part of the business of credit unions.<sup>11</sup> The NCUA Board further notes that it is adopting criteria that are substantially similar to those used by the OCC.<sup>12</sup> Thus, there is a bias in these rules to reach similar conclusions regarding the scope of a credit union’s incidental powers as have been reached by the OCC with respect to a bank’s incidental powers. However, the NCUA takes this one step further and specifically pre-approves certain categories as within a FCU’s incidental powers. Under 12 CFR 721.3(f), the offering of DCAs is specifically referenced as within a FCU’s incidental powers.<sup>13</sup>

- C. **Federal Legislation.** Finally, in November 1999, Congress and the President passed the Gramm-Leach-Bliley Act. GLBA provides that the prohibition on national banks and their subsidiaries against providing insurance in a State as principal does not apply to “authorized products.”<sup>14</sup> The definition of “authorized products” includes products that, as of January 1, 1999, the Comptroller of the Currency had determined in writing national banks may provide as principal, or that national banks were in fact lawfully providing such product as principal.<sup>15</sup> As clearly shown above, DCAs were among the products the OCC had determined in writing that could be lawfully provided by banks as the principal prior to 1999.

### ***Conclusion***

The need for DCAs continues to grow. In 1995, total consumer credit outstanding climbed past the \$1 trillion mark, and as of June 2000 stood at approximately \$1.465 trillion.<sup>16</sup> From June 1999 to June 2000, total consumer credit outstanding grew 8.7%.<sup>17</sup> Total Revolving Credit Outstanding from June 1999 to June 2000 grew 9.3%, while personal income only grew at 6.2%.<sup>18</sup> As the demand for loans and consumer credit increases, creditors will tighten their standards. Alternatively, creditors could implement DCA programs to alleviate some of the pressure on the

tightening standards. Even assuming that a market correction is inevitable, and its likely impact on consumer debt, the DCA marketplace can provide a cushion for banks and lenders against a downward correction via administrative fees. Accordingly, the legal grounds and the business environment provide an opportunity for federal lenders to use DCAs as a tool for enhancing their financial stability by minimizing their lending risks.

#### *Endnotes*

1. There are also debt deferment and debt suspension products, which do not cancel loan payments, but merely defer the amount due during the period of disability, unemployment or other contingency. These products are not discussed in this paper.
2. The facts of *Taylor* are important, as subsequent courts have distinguished *Taylor* on its facts. See *Norwest v. Sween*, 916 F. Supp. 1494 (D. Minn. 1996).
3. *First Nat'l. Bank v. Taylor*, 907 F.2d 775 at 777-778 (8<sup>th</sup> Cir. 1990).
4. OTS Op. Acting Chief Counsel, September 15, 1993.
5. OTS Op. Chief Counsel, December 18, 1995.
6. 12 U.S.C. § 1751 et seq.
7. 12 U.S.C. § 1757(17).
8. See 7535-01-U, regarding proposed rule 12 CFR 721 et seq.
9. *Id.*, at page 6.
10. 7535-01-U, page 5; *First Nat'l. Bank v. Taylor*, 907 F.2d 775 at 777-778 (8<sup>th</sup> Cir. 1990); *Steele v. First Deposit National Bank et al*, 732 So.2d 301, (Oct. 1999, AL. Ct. of App.).
11. 7535-01-U, pages 8-9.
12. *Id.* at page 8.
13. *Id.* at page 17.
14. Title III, Insurance, Subtitle A--State Regulation of Insurance, SEC. 302.
15. See Title III, Insurance, Subtitle A--State Regulation of Insurance, SEC. 302.
16. Source: G.19 Release - Federal Reserve Board of Governors, Total Consumer Credit Outstanding Seasonally Adjusted.
17. *Id.*
18. Source: G.19 Release - Federal Reserve Board of Governors, Total Revolving Credit Outstanding Seasonally Adjusted; U.S. Department of Commerce, Bureau of Economic Analysis - Personal Income.