Filling Empty Heads About Negative Equity

By James S. Ganther, Esq.

Last month in this space, we discussed the two underlying causes of dealer lawsuits: bad hearts and empty heads. The former afflicts dealers who take shortcuts, favor profits over ethics, and revenue over the risk of incarceration. There is no helping such dealers.

But those who fall short because of ignorance — empty heads — can be helped. And ignorance of the law is not to be equated with basic stupidity. Legions of very intelligent people violate the law every day because much of the law is not intuitive. Commitment to the Golden Rule will keep you on the right side of the law most of the time, but it won't guide you on how to disclose negative equity.

This article will. If there's an empty spot inside your head the shape of treating negative equity under Regulation Z, prepare to get it filled. Just read on.

Negative equity is the term du jour for a trade vehicle bearing more debt than it is worth. Also known as being "upside-down," it is becoming increasingly common. Thus, handling it wrong is also becoming increasingly common.

A recent case from California illustrates the perils of improperly disclosing negative equity. But *Thompson v. 10,000 RV Sales Inc.* is not just a cautionary tale; in the wrong hands it can operate as a virtual "how-to-sue" manual. For more on this case, see Rob Cohen's article in the November-December 2005 issue, titled "The Truth About Trade Allowances." The case lays bare the F&I office as a target-rich environment for plaintiffs' lawyers, so it would behoove a sober dealer to get his store in order before the local bar reads the decision. And please take no comfort from the fact it was an RV dealer that got hit for damages and a nasty injunction — the same laws that tripped up this dealer apply equally to car dealers.

The story begins when Reta (her real name, not a typo) Thompson arrives at 10,000 RV Sales to purchase a used Safari motor coach. The cash price for the Safari was $69,398. She tendered a 2000 Shasta motor coach as a trade vehicle. The Shasta was worth $30,000; Thompson owed $46,000 on the vehicle, creating $16,000 of negative equity for the dealer to handle.

To accommodate the negative equity, the dealer "valued" the trade at $54,000, magically erasing the negative equity and creating an apparent equity of $8,000 in the Shasta. That $24,000 over-valuation was then added to the original cash price for a new cash price of $93,398.

On line 1G (previous loan balance) of the installment sale contract, the dealer wrote "N/A." The dealer never explained to Thompson why it structured the deal that way, and the court noted that she never consented to it. (To be fair, she apparently never objected, either.)

Some months after the transaction, Thompson began to experience mechanical problems with the Safari, which she sought to have corrected under the terms of the vehicle service contract she bought in connection with the motor home purchase. And here — figuratively, at least — the wheels come off. Thompson's claim under the VSC was denied because the dealer sold her a *new*-vehicle VSC, and the Safari motor home she purchased was a *used* vehicle. To compound the error, the dealer refused to refund the purchase price of the incorrect VSC it had sold her. It even refused to sell her a used-vehicle VSC (though why she would want to buy anything from the dealer at this point defies analysis).

Reta Thompson eventually sued 10,000 RV Sales, alleging violations of California's Automobile Sales Finance Act, Unfair Competition Law and Consumer Legal Remedies Act. Note that she did not directly allege any violations of the Truth in Lending Act or its implementing regulation, Regulation Z. In fact, she could not — the statute of limitations for violations of Regulation Z is one year, and that time limit had passed.

But Regulation Z still took center stage in the court's analysis of the dealer's misdeeds. This is because state courts look to the FTC's interpretation of this regulation to guide their application of state deceptive trade practice statutes; some states specifically incorporate Regulation Z by reference. Thus, while Regulation Z has a statute of limitations for actions based on its violation, its precedential value never goes stale.

The court determined the following facts: First, the overstatement of the cash price to accommodate the negative equity increased Thompson's sales tax by $1,800. Second, her interest expense increased by $2,157.60. And third, the California registration fees she had to pay increased proportionately to the increase in reported cash price. Thus, she suffered actual economic damages.

The court then held that the dealer violated the California Automobile Sales Finance Act (ASFA), which required any cash down payment be first applied to any outstanding loan balance. The court also held that the dealer had a "pattern and practice" of rolling negative equity into vehicles' cash price, which constituted a violation of the California Consumer Legal Remedies Act (CLRA). And violations of the ASFA and CLRA are *per se* violations of the California Unfair Competition Law.

On, then, to the issue of damages. The court ruled that Reta Thompson was entitled to rescission of her contract and restitution. What that means in English is that the dealer was required to take back the vehicle and return Thompson's money and trade vehicle. But wait — the dealer had long since disposed of the trade vehicle. According to Hal Rosner, attorney for the plaintiff, the dealer had to cut a check for the value it had assigned to the trade vehicle in the paperwork: *the amount overstated by $24,000*.

And there's more. Because the court had found a "pattern and practice" of overstating the cash price to hide negative equity, it also assessed punitive damages. And because Reta Thomson was 73 years old, the court applied the senior citizen bonus penalty as well. Finally, to prevent the practice of rolling negative equity into the cash price in the future, the court entered an injunction prohibiting the dealer from doing so.

Lest one think that the 10,000 RV case is an isolated anomaly, Hal Rosner *alone* has approximately 12 class actions currently based on improperly reported negative equity pending in California courts. "My job is simple," Rosner says. "I shoot large fish in very small barrels."

And in late 2005, he addressed the National Consumer Law Center conference on the topic, instructing over 100 plaintiffs' lawyers from around the country on how to sue dealers for errors involving negative equity. Far from being rare, such suits can be expected to become more common in the coming year.

The obvious conclusion to be drawn from the 10,000 RV case is simple: Do not violate Regulation Z, or the state laws that look to it for guidance. This means never, ever rolling negative equity into the cash price of a vehicle. There are spaces on installment sale contracts for "previous loan or lease balance." Use them. Period.

The underlying purpose of the Truth in Lending Act and, therefore, Regulation Z, is to allow consumers to make "apples to apples" comparisons when they shop for credit. Playing fast and loose with negative equity and trade values defeats this purpose. What the 10,000 RV case makes clear is that violating Regulation Z is *not* a matter of "no harm, no foul." It is a statute of strict construction, and violating it will not be considered a mere "technicality." There is absolutely no doubt that such violations of Regulation Z are, and will continue to be, a deceptive trade practice.

State deceptive trade practice laws are powerful tools in the hands of a skilled attorney, and improper reporting of negative equity falls squarely within them. Consider a real-life example: A dealer's television ads blare "We'll pay off your current car loan no matter how much you owe!" That same dealer handles the negative equity in the same manner as 10,000 RV Sales. Thus, the consumer was told that the dealer, not the consumer, paid off the previous car loan balance, and there is nothing in the paperwork to suggest otherwise. And thus is a class-action lawsuit born, one the dealer is likely to lose.

Some dealers claim they add negative equity to the cash price only because lenders instruct them to do so. If true, it describes a situation where the lenders are forcing dealers to make the lenders' portfolios look better while at the same time leaving the dealers holding the bag of legal liability. If this describes your situation, find another lender. No loan approval is worth the ultimate chargeback: becoming a class-action defendant.

One could easily conclude that 10,000 RV Sales got what it deserved. After all, it not only misreported Reta Thompson's negative equity, but it also created $8,000 of "phantom equity" by over-valuing her trade vehicle by more than the amount of her actual negative equity. On top of that, it sold her a useless service contract and refused to either reimburse her for its cost or stand behind the repairs it did not cover. If any dealer had it coming, this was it.

But countless dealers from sea to shining sea are rolling negative equity into the cash price even as we speak, without any of the other bad facts that litter the 10,000 RV case. And these dealers aren't trying to do anything wrong because they never knew it *was* wrong. The requirements of Regulation Z, after all, are not intuitive. While we can all be expected to know that it is wrong to steal, what person on the street can recite the FTC Official Staff Commentary on Regulation Z?

So, what's a dealer to do? Fill the empty heads. Ensure that all F&I personnel understand the basic requirements of Regulation Z (and the other laws that govern their job duties). You could start by circulating this article. And those that follow. Next month: the hidden pitfalls of GAP.