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# Notes

## Acceleration Clause Disclosure: A Truth in Lending Policy Analysis

Acceleration clauses in consumer credit contracts are provisions "by which the time for payment of the debt is hastened or advanced because of the breach of some condition of the contract by the debtor."<sup>1</sup> Under the Uniform Commercial Code the creditor may accelerate payment upon the debtor's default<sup>2</sup> of some contract provision or when the debtor feels "insecure."<sup>3</sup> Such clauses are also used in transactions where the creditor takes a security interest in goods in the debtor's possession.<sup>4</sup> Acceleration after default is essential as a remedial action for the creditor; otherwise he would have to sue for each installment of the contract as it becomes due after the initial default.<sup>5</sup>

Acceleration is significant because it is very widely used.<sup>6</sup> A survey prepared for the National Commission on Consumer Finance (NCCF), indicates that 80 to 85% of the surveyed banks use the acceleration clause in a majority of their consumer credit contracts.<sup>7</sup> The survey also reveals that finance companies use of the acceleration clause exceeds even the usage by banks; 90% of all the finance companies responding in the survey use the acceleration clause in a majority of their credit contracts<sup>8</sup> and also invoke the clause in a large percentage of their legal proceedings.<sup>9</sup> The NCCF study concludes that "acceleration is highly valued by a clear majority of lenders of every kind and that they use it quite extensively."<sup>10</sup>

The major problem with the acceleration clause is that it can "result in an unexpected burden to the borrower."<sup>11</sup> Although debtors know they ultimately must pay, they often do not realize that delay beyond the grace

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<sup>1</sup>BLACK'S LAW DICTIONARY 26 (rev. 4th ed., 1968).

<sup>2</sup>U.C.C. § 9-503 (1972).

<sup>3</sup>U.C.C. § 1-208 (1972).

<sup>4</sup>U.C.C. § 9-503 (1972).

<sup>5</sup>5 National Commission on Consumer Finance, Technical Studies at 20 [hereinafter cited as NCCF Studies].

<sup>6</sup>See generally 5 NCCF Studies, *supra* note 5, at 29-41. Acceleration is also important because it quite often is the first of many remedies that the creditor invokes. Subsequent or concurrent collection sanctions and credit or remedies include: required payments of creditors' attorney fees by defaulting debtor; confessions of judgment (cognovit notes), repossession, deficiency judgments, garnishment, wage assignments, and levy on personal property.

<sup>7</sup>*Id.* at 37.

<sup>8</sup>*Id.* at 39.

<sup>9</sup>With respect to auto indirect credit, for instance, 75% of the time the acceleration clause is used to collect in formal legal action; and with respect to personal loans it is 71%. *Id.* at 33.

<sup>10</sup>*Id.* at 41.

<sup>11</sup>Clausen v. Beneficial Fin. Co., 423 F. Supp. 985, 988 (N.D. Cal. 1976).

period for a particular payment can result in an enforceable demand for payment of all remaining installments. Obviously a consumer who cannot meet a single installment will be unable to bear the burden of paying the entire balance immediately. Disclosure on the contract itself may come too late, as few consumers read the contract after signing it and even fewer read, or even obtain, the contract before signing.

Although nearly all consumer installment contracts contain an acceleration clause,<sup>12</sup> until recently creditors did not include this clause on the disclosure statement required by the Truth in Lending Act (TIL Act).<sup>13</sup> In 1968, Congress enacted the TIL Act expressly 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."<sup>14</sup> The Act does not regulate the substantive terms of credit extension, rather it is an informational disclosure law. Both the Act and Regulation Z,<sup>15</sup> promulgated by the Federal Reserve Board (FRB) to implement the Act, require disclosure of only specific credit terms. The TIL Act requires disclosure of the "default, delinquency, or similar charges payable in the event of late payment."<sup>16</sup> Regulation Z provides that the creditor must disclose "the amount, or method of computing the amount, of any default, delinquency, or similar charges payable in the event of late payments."<sup>17</sup>

Recent litigation has centered on the issue of whether the acceleration clause is one of those required disclosures within the language of Regulation Z and the Act. The great weight of authority is that, when unearned interest is not rebated to the consumer upon acceleration,<sup>18</sup> this interest amounts to a "charge," and the acceleration clause must be disclosed.<sup>19</sup> However, the district courts are split as to whether there must be disclosure of the acceleration clause even when the creditor is required by state law to rebate the total unearned portion of the finance charge.<sup>20</sup> The FRB issued an Official Inter-

<sup>12</sup>See generally 5 NCCF Studies, *supra* note 5, at 29-33.

<sup>13</sup>15 U.S.C. §§ 1601-1666j (1970).

<sup>14</sup>15 U.S.C. § 1601 (1970).

<sup>15</sup>12 C.F.R. §§ 226.1-226.13 (1977).

<sup>16</sup>15 U.S.C. § 1638(a)(9) (1970).

<sup>17</sup>12 C.F.R. § 226.8(b)(4) (1977).

<sup>18</sup>*Garza v. Chicago Health Clubs, Inc.*, 347 F. Supp. 955 (N.D. Ill. 1972); *McDaniel v. Fulton Nat'l Banks*, 395 F. Supp. 422 (N.D. Ga. 1974); *Barret v. Vernie Jones Ford, Inc.*, 395 F. Supp. 904 (N.D. Ga. 1975).

<sup>19</sup>Hewson, *Acceleration Clauses in Georgia: Consumer Installment Contracts and the Federal Truth in Lending Act*, 27 MERCER L. REV. 969, 976 (1976).

<sup>20</sup>This split in authority was cleared up, to some degree, by the Third Circuit Court of Appeals in *Johnson v. McCranchan Sturman Ford*, 527 F.2d 257 (3d Cir. 1975), which held that the phrase "default, delinquency, and similar charges" does not mandate disclosure if all the unearned portion of the finance charge is rebated upon acceleration. See generally Note, *The Acceleration Clause: A Truth in Lending Anomaly?* 28 BAYLOR L. REV. 593 (1976). Some courts accepted a broad interpretation of the word "charge," concluding that whether or not the unearned portion of the finance charge was rebated, the acceleration clause does result in an often unexpected burden on the borrower. This revised timing of loan repayment, *i.e.*, immediate payment of all principal when an installment is late, constitutes an "obligation, claim or burden" as charge is

pretation<sup>21</sup> in March of 1977 stating that the right of acceleration is not a charge, at least when interest is rebated, because it is conditional rather than automatic.<sup>22</sup> FRB Official Interpretations are given conclusive effect by Congress<sup>23</sup> and therefore are given the same deference as Regulation Z by the courts, so that it is unlikely that acceleration clause disclosure will be required within the context of the TIL Act in the future. In addition, there are currently several reform and/or simplification bills in Congress which could resolve the disclosure issue differently,<sup>24</sup> and the Senate Committee on Banking, Housing, and Urban Affairs<sup>25</sup> will shortly produce its own version of a TIL reform act; in their present form, however, the proposed bills<sup>26</sup> do not require disclosure of the acceleration clause.

It has been suggested<sup>27</sup> that the explanation for consumer-oriented law should be found in microeconomic rather than socio-political theory. This note will focus on the various policies behind the TIL Act, identify the microeconomic goals of those policies, and examine whether disclosure of the acceleration clause should be required in order to further the policies and associated economic goals of the TIL Act.

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defined in BLACK'S LAW DICTIONARY. This broad interpretation, it was reasoned, is in line with the liberal construction that has been traditionally given to the TIL Act in order to effectuate the policy of informed use of credit. *Woods v. Beneficial Fin. Co.*, 395 F. Supp. 9 (D. Ore. 1975); *Meyers v. Clearview Dodge Sales, Inc.*, 384 F. Supp. 722 (E.D. La. 1974); *Garza v. Chicago Health Clubs, Inc.*, 347 F. Supp. 955 (N.D. Ill. 1972); *Burley v. Bastrap Loan Co., Inc.*, 407 F. Supp. 733 (W.D. La. 1976). *Clausen v. Beneficial Fin. Co.*, 423 F. Supp. 985 (N.D. Cal. 1976). Other courts have narrowly construed the phrasing of the regulation. Their reasoning is that TIL's purpose is to provide a system of remedies that reflects commercial reality. Since this is a series of disclosure requirements imposed on creditors, Congress meant to ascribe to these terms their meaning in the credit industry. In the commercial context, default charges refer to specific pecuniary sums that are assessed against the borrower solely because of his failure to make timely payment. Since the unearned finance charge is rebated upon acceleration, there is no additional sum or charge paid by the borrower. The fact that immediate payment is burdensome, does not necessarily make the right of acceleration a default charge; rather it is accurately viewed as a future right or remedy, and not a default charge. *Barnet v. Vernie Jones Ford, Inc.*, 395 F. Supp. 904 (N.D. Ga. 1975); *McDaniel v. Fulton Nat'l Banks*, 395 F. Supp. 422 (N.D. Ga. 1974).

<sup>21</sup>12 C.F.R. § 226.101.

<sup>22</sup>The explanation for the FRB position is vague and unsatisfactory. See Federal Reserve Board Official Staff Interpretations No. FC-0054, 5 Cons. Cred. Guide (CCH) § 31,552 (Mar. 21, 1977).

<sup>23</sup>15 U.S.C. § 1640(f) (Supp. IV 1974).

<sup>24</sup>S. 1312, 95th Cong., 1st Sess. (1977); S. 1501, 95th Cong., 1st Sess. (1977).

<sup>25</sup>S. 1312 and S. 1501, *supra* note 24, were each referred to the Committee on Banking, Housing and Urban Affairs.

<sup>26</sup>S. 1312, *supra* note 24, p. 7, lines 13-20, would re-word the TIL Act to accord with the FRB Official Interpretation, *supra* note 22. S. 1501 *supra* note 24, p. 9, lines 16-23, would strike the entire default charge disclosure requirement, *supra* note 16.

<sup>27</sup>Warren, *Consumer Credit Law: Rates, Costs and Benefits*, 27 STANFORD L. REV. 951, 951 (1975); Schwartz, *Optimality and the Cutoff of Defenses Against Financers of Consumer Sales*, 15 B.C. INDUS. AND COM. L. REV. 499, 500 (1974) [hereinafter cited as Schwartz].

## THE POLICY IN THE TRUTH IN LENDING ACT

The purported objective of the TIL Act and Regulation Z is

to assure that every customer who has need for consumer credit is given meaningful information with respect to the cost of that credit . . . [O]ther relevant credit information must also be disclosed so that the customer may readily compare the various credit terms available to him from different sources and avoid the uninformed use of credit.<sup>28</sup>

Congress was not precise in stating the goals of the Act.<sup>29</sup> In fact, it has been noted that:

It is common when discussing proposed or enacted legislation first to identify the purpose of the legislation and then to take the measure of the legislation in light of those purposes. We have reserved this pattern because it is much easier to state what TIL requires than to identify its objectives. This task is made even more difficult by the fact that the hearings held in connection with the TIL act served as a forum for airing a wide variety of consumer grievances, many of which had nothing to do with the Act as finally enacted and which TIL does not purport to resolve . . . . Moreover, the hearings became so clouded by the lenders' insistence that APR disclosure was not feasible and/or was inaccurate . . . that the more basic question of the objectives of the legislation was not really addressed.<sup>30</sup>

Nevertheless, there appear to be three primary policies behind the TIL Act. The first policy of the Act is to disclose the costs of credit and other specific terms of the transaction so as to create a basis for comparative shopping by the consumer among the various extenders of credit.<sup>31</sup> The economic goal of encouraging comparative shopping through disclosure is to promote competition within the consumer credit industry;<sup>32</sup> with creditors competing for borrowing customers, a stable equilibrium price for credit is established. The second policy of the TIL Act is to disclose the relevant costs and terms essential for informed investment decisions such as whether to use cash, take funds from savings, use credit, or defer purchase of the good or service.<sup>33</sup> In economic terms, the use of the disclosure information enables the consumer to assert informed preferences, resulting in both optimal resource allocation and maximum individual economic welfare. Finally, the third policy of the

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<sup>28</sup>12 CFR § 226.1(2) (1977.)

<sup>29</sup>Landers, *Determining the Finance Charge Under The Truth in Lending Act*, 1977 AM. B. FOUNDATION RESEARCH J. 1, 53 [hereinafter cited as Landers]. Professor Jonathan M. Landers had studied the TIL Act as a Visiting Scholar at the American Bar Foundation during 1975 and 1976. The policies discerned in this note derive primarily from his articles published as a product of his study.

<sup>30</sup>Landers and Chandler, *The Truth in Lending Act and Variable-Rate Mortgages and Balloon Notes*, 1976 AM. B. FOUNDATION RESEARCH J. 35, 63-64.

<sup>31</sup>Landers, *supra* note 29, at 49, 53, 86, 91; Landers & Chandler, *supra* note 30, at 60, 63.

<sup>32</sup>Consumer Credit In The United States, Report of the National Commission on Consumer Finance at 172 (1972) [hereinafter cited as NCCF Report].

<sup>33</sup>Landers, *supra* note 29, at 55; NCCF Report, *supra* note 32, at 172; Landers, *The Scope of Coverage of the Truth in Lending Act*, 1976 AM. B. FOUNDATION RESEARCH J. 565, 589.

TIL Act is the general policy of increasing consumer awareness. The economic goal of this policy, a broad concept that runs as a thread through all consumer-oriented legislation, is to educate the consumer with respect to the credit transaction by providing the most relevant information in a concise statement, thereby reducing the disparity in party sophistication and eliminating the chance for abusive creditor practices.

In examining the utility of acceleration clause disclosure within the TIL policy context, it should be noted that characteristically, the legislative response to the imperfections<sup>34</sup> and inequalities<sup>35</sup> in the consumer credit market has been in the form of regulating the market in various ways, including: increasing access to the market by eliminating market entry barriers; making information available to the consumer; regulating terms and conditions of the agreement; and statutorily limiting remedies.<sup>36</sup> Required disclosure of the acceleration clause fits comfortably within this regulatory framework and would further the policies and economic goals of the TIL Act.<sup>37</sup>

#### PROMOTING COMPARATIVE SHOPPING

The first goal of the disclosure requirements of the TIL Act is to promote comparative shopping by consumers among creditors in the pursuit of increased competition among credit extenders. The major emphasis of TIL has been on the disclosure of information relating to the cost of credit,<sup>38</sup> such as annual percentage rate and total finance charges. When each component comprising the cost of the credit to the consumer is required to be either included in the finance charge or separately itemized and disclosed as excluded from the finance charge,<sup>39</sup> the consumer has a set of data with which he can compare the cost of using credit from the various extenders. The consumer must also be provided with various credit terms and conditions of the credit transaction,<sup>40</sup> such as "[a] description of any penalty charge that may be imposed by the creditor or his assignee for prepayment of the principal of the obligation (such as a real estate mortgage) with an explanation of the method of computation of such penalty and the conditions under which it may be imposed..."<sup>41</sup> The creditor is also required to identify "the type of any security

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<sup>34</sup>Market imperfections are any restrictions which tend to inhibit the free interaction of potential borrowers and suppliers of credit. NCCF Report, *supra* note 32, at 113. Inequalities include the greater economic resources, experience and acuity the creditor possesses.

<sup>35</sup>Alderman, *Imprisonment For Debt: Default Judgments, the Contempt Power and the Effectiveness of Notice Provisions in the State of New York*, 24 SYRACUSE L. REV. 1217, 1218 (1974).

<sup>36</sup>*Id.* at 1218-1219.

<sup>37</sup>See generally NCCF Report, *supra* note 32, at 109-114.

<sup>38</sup>12 C.F.R. § 226.1 (1977); Landers, *supra* note 29, at 60.

<sup>39</sup>12 C.F.R. § 226.4 (1977).

<sup>40</sup>12 C.F.R. §§ 226.7, 226.8 (1977).

<sup>41</sup>12 C.F.R. § 226.8(b)(6) (1977).

interest held or to be retained or acquired by the creditor in connection with the extension of credit."<sup>42</sup> The disclosure of these and other terms and conditions, coupled with the finance charge disclosures, enables the consumer to compare creditors and make an intelligent credit decision. The issue is whether the acceleration clause disclosure will further enable the consumer to make an intelligent credit decision and encourage comparative shopping among creditors.

The acceleration clause was among the credit remedies and contract provisions studied by the National Commission on Consumer Finance.<sup>43</sup> Although the study found that "acceleration is very widely used and very favorable opinions are held by banks about its utility,"<sup>44</sup> it was concluded that "acceleration does not appear to be absolutely indispensable in every instance of formal legal recovery."<sup>45</sup> Although 80% of the commercial banks surveyed included the acceleration clause within the credit contract,<sup>46</sup> it was used to collect in formal legal action only 2 out of 5 times.<sup>47</sup> Also, of this 80%, 36%<sup>48</sup> rarely use the acceleration clause to collect,<sup>49</sup> while only 26%<sup>50</sup> of those who include acceleration clauses use the clause to collect in a majority of their formal legal actions.<sup>51</sup> It thus appears that, whereas the use of acceleration in the contract is extensive, the actual invoking of the clause, when the debtor is in default and the creditor resorts to legal action, is much more infrequent. In fact one sixth of those commercial banks who invoked the clause less than 40% of the time found the clause unnecessary and nearly half found acceleration only moderately useful.<sup>52</sup> In a transaction between a creditor and a debtor with a high credit rating, the low risk of default indicates little need for the presence of the acceleration clause. A creditor would likely be willing to modify the credit contract due to this risk, and thereby gain a borrowing customer.

It can be reasoned not only that acceleration disclosure could be useful to the debtor in distinguishing those creditors who include the clause from those who do not, but also that consumer awareness of the presence of acceleration and creditor flexibility may form grounds for bargaining for the elimination or modification of the acceleration term. Thus, particularly risk-averse

<sup>42</sup>12 C.F.R. § 226.8(b)(5) (1977).

<sup>43</sup>See generally 5 NCCF Studies, *supra* note 5.

<sup>44</sup>*Id.* at 37.

<sup>45</sup>*Id.* at 41.

<sup>46</sup>*Id.* at 31.

<sup>47</sup>*Id.*

<sup>48</sup>*Id.*

<sup>49</sup>36% used the clause to collect between 0% and 19% of the time in formal legal actions. *Id.* at 31.

<sup>50</sup>*Id.* at 31.

<sup>51</sup>26% used the clause to collect between 80% and 100% of the time in formal legal actions. *Id.* at 31. For analogous statistics on finance companies, see text accompanying notes 8-10 *supra*

<sup>52</sup>5 NCCF Studies, *supra* note 5, at 31.

consumers may shop for a creditor who does not include the clause in the contract, while other more assertive consumers may seek modification of the acceleration clause—for example, a grace period longer than that employed by the creditor.

Many consumers may be indifferent about acceleration clauses since few debtors plan on defaulting when shopping for credit. However, even if only a few consumers begin to base their credit shopping decisions on the acceleration clause factor, extenders of credit may be encouraged to compete for their use of credit. As Senator Douglas pointed out in the TIL congressional hearings, "it is the undecided minority that influences the sellers. So you need only have, in my judgment, about 10 percent cost conscious and they will get the firms competing for that 10 percent."<sup>53</sup> Creditors are more likely to give the consumer a better package of terms if at least some consumers are aware of the risk acceleration poses and use this knowledge when dealing with credit extenders. Acceleration clause disclosure would not offend the policy of encouraging comparative shopping, but rather would further this goal by increasing the debtor's awareness of this creditor remedy, thus providing a significant basis for distinguishing creditors.

#### *ENCOURAGING INFORMED INVESTMENT DECISIONS*

The second policy of the TIL Act is to promote informed investment decision-making by consumers. Through required disclosure statements of credit costs and the most relevant terms of the credit agreement, consumers can properly evaluate the credit option in deciding whether to use credit, savings, or cash for their purchase, or whether to defer purchase of the good or service. The consumer is thereby enabled to assert an informed purchase preference in the market place, which is essential to the pursuit of optimal resource allocation and maximum individual welfare, the microeconomic goals of the second TIL policy. To illustrate the significance of information disclosure to these economic goals, it is necessary to examine the economic theory upon which our modified market economy is based before proceeding to analyze the acceleration clause in the context of informed investment decision-making by consumers.

The basic criterion for judging the performance of our economic system is the efficiency with which business satisfies consumer demand. The enormous gap between consumer demand for goods and services and the relatively limited ability of society to produce them gives rise to the basic premise of our modified market economy; society is forced to establish a priority system to guide production activity. In a capitalistic economy, business firms, by virtue of the profit motive, are induced to choose among the alternative uses of

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<sup>53</sup>*Consumer Credit Protection Bill; Hearings on H.R. 11601 Before the Subcomm. on Consumer Affairs of the House Comm. on Banking and Currency, 90th Cong., 1st Sess. 173.*



economic resources such that the most preferred resources are purchased first. When demand is great enough to provide an adequate profit, resources are used to meet that demand. Firms producing a product or providing a service for which demand is insufficient become unprofitable, and the price mechanism deprives them of the capital needed to obtain resources in demand elsewhere. Thus changes in consumer preference initiate price movements which signal producers to alter the composition of their output. As a consequence the profit motive, in a competitive price system, functions to provide our economy with optimal resource allocation according to the expressed preferences of the consumer.<sup>54</sup>

Consumer purchase decisions are not formal and abstract; when a consumer enters the marketplace and considers the purchase of specific items, he asks himself, either consciously or unconsciously, whether the price he must pay is "worth it," or in economic terms, whether the expected utility or benefit to be derived from the purchase is great enough to justify the consumption in lieu of saving or purchasing elsewhere. In an investment decision involving the purchase of credit, the value of the use of money must be considered and the expected benefit or utility must be discounted by the various risks faced by the consumer. The consumer is able to discount his expected utility only after he accurately estimates the risks involved.

But several factors prevent this model of marketplace behavior from operating to provide consumers with their expected utility from the purchase or investment. The most important obstacle is the lack of perfect information about prices, conditions and terms of the transaction. When the decision-maker has less than perfect information upon which to base his choice of alternatives, the principles of decision theory<sup>55</sup> call for him to bring whatever information he does have to bear upon the decision problem. Although fully aware that the information he has may be erroneous or incomplete, the rational decision-maker has no real choice but to attempt to overcome the information gap by using the best available information and knowledge to make the decision.

A simple model categorizing the degrees of knowledge<sup>56</sup> is useful for illustrating the significant impact on decision-making that acceleration clause disclosure represents. There are two types of knowledge: perfect knowledge, characterized by the ability to accurately predict the outcome from a particular event or occurrence, and imperfect knowledge, characterized by a lack of such ability. Imperfect knowledge may be further divided into three degrees. "Risk" is the class of events wherein all possible outcomes are known, with each outcome having determinable objective probabilities. One

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<sup>54</sup>For an in-depth discussion of these basic principles of economic theory, see A. THOMPSON, *ECONOMICS OF THE FIRM* (1973).

<sup>55</sup>See *id.* at 36-70.

<sup>56</sup>*Id.* at 39 & n.1.

such event is the toss of a coin; only two outcomes are possible, and the probabilities of each can be determined statistically by use of a frequency distribution. The second degree of imperfect knowledge is "uncertainty." This is a class of events wherein all possible outcomes are known, but the probabilities of each are unknown. When one possesses only uncertain knowledge he assigns subjective probabilities, that is, his individual estimate of the probabilities, to the various outcomes. Finally, the third degree of imperfect knowledge is "ignorance." Within this class of events, the possible outcomes are unknown as are, a fortiori, the probabilities of those outcomes. Within the context of this model, acceleration clause disclosure takes the consumer out of "ignorance," where he is totally unaware of the possible outcomes of late payment, and gives him "uncertain" information, where he is made aware of the possible outcome, the creditor's option to exercise his right of acceleration, when the event of late payment occurs. Acceleration disclosure thereby enables the consumer to at least subjectively evaluate the probability of this possible outcome.<sup>57</sup>

Economic models assume that the consumer acts rationally, that he is able to deal on equal terms with the business community, and that he seeks to maximize his utility.<sup>58</sup> It is assumed that the consumer, when estimating the satisfaction that he will obtain from a product or service, will consider the risks involved and thereby discount his expected utility. For the most part, however, consumers are unaware of the risks of acceleration, and economic activity without awareness of legal liabilities is inconsistent with efficient functioning of a modified market, the ability of which to provide desired products and services at lowest cost is dependent on the asserted informed choices of consumers.<sup>59</sup> If consumers are unaware of the risk that the acceleration clause represents, the cost of credit will inaccurately reflect the true price of its use. As discussed earlier, price movements signal producers to alter the composition of their output; it is therefore logical to conclude that, upon being informed of the risks, the consumer would demand less credit and resource allocation would be optimized as a result.

An algebraic cost of credit equation that is relevant to the pursuit of optimal resource allocation<sup>60</sup> can be appropriately applied to acceleration clause disclosure. The employment of this method of analysis reveals that, disclosure of acceleration will appreciably promote informed investment decision-making.

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<sup>57</sup>"Uncertainty and subjective risk characterize the environment in which most decisions are made." Therefore, the process of reaching decisions when the knowledge level is below objective risk is most relevant. *Id.* at 41.

<sup>58</sup>*Id.* at 93-97.

<sup>59</sup>See text accompanying note 55 *supra*.

<sup>60</sup>See generally Schwartz, *supra* note 27. See also Schwartz, *Cure and Revocation For Quality Defects: The Utility of Bargains*, 16 B. C. INDUS. AND COM. L. REV. 543 (1975). The cost of credit analysis incorporates an estimation of the probabilities of outcomes inquiry introduced earlier. See text accompanying notes 55-57 *supra*.

For each credit transaction, let  $C$  represent the cost to the consumer of the losses he will incur if he is unable to keep up with his installment payments.<sup>61</sup> Let  $p$  represent the probability that cost  $C$  will be incurred, that is, that the borrower will in fact be late in payment.<sup>62</sup> The product,  $pC$ , equals the risk,  $R$ , which a borrower undertakes in the credit transaction. The value of this risk,  $R$ , represents the amount by which the actual credit cost to the consumer exceeds his perceived cost of that credit.<sup>63</sup> When a consumer misvalues the cost,  $C$ , that he could incur because he is unaware of the consequences of late payment, he will have erred also in his estimate of  $p$ , the subjective probabilities. The result is that the value of  $R$  may be totally misleading. As discussed earlier, it is necessary that consumers have the ability to value the risks when asserting a preference; if they cannot value the risks created by late payment, the cost of credit will be distorted because the stated price will inaccurately reflect the relevant costs. Specifically, when the consumer misvalues  $R$ , the risk of acceleration when using credit, credit at a particular price appears to be a better buy than if the consumer had correct information as to the risk. Since demand is a function of the consumer's estimate of true cost,<sup>64</sup> when risk is underestimated, the entire demand schedule<sup>65</sup> is overstated.<sup>66</sup> A riskier credit than consumers originally perceived represents a different product,<sup>67</sup> and the greater demand for credit results in a higher price.<sup>68</sup>

Moreover, under these circumstances, producers are using more capital to finance credit purchases than they would if their true costs were perceived. The higher equilibrium price has signaled creditors to supply an inordinate amount of a vital resource, capital, for the consumer credit industry.<sup>69</sup> This capital could be better used in many other areas of the economy, but because of the overstated price, capital is attracted to the credit industry and does not flow to those other areas for more efficient use. Thus, optimal resource

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<sup>61</sup>These losses are uncertain, as the creditor has numerous legal remedies, but these remedies pose potential borrower liabilities that represent a large burden should payments be made late.

<sup>62</sup>The consumer may be late in payment because of mismanagement of money, illness, unexpected unemployment, or by a miscalculated choice when he is unaware of the consequences of non-payment.

<sup>63</sup>See generally Schwartz, *supra* note 27.

<sup>64</sup>Quantity demanded is the demand for goods or services at a certain price; demand is a series of relationships. See note 65 *infra*.

<sup>65</sup>Demand is represented by a demand schedule, a curve representing the amounts of a product or service that consumers are willing and able to buy at a set of given prices.

<sup>66</sup>The demand curve is further north-east than if consumers had correct information.

<sup>67</sup>Therefore, if consumers were using accurate risk information, the demand curve would be further south-west.

<sup>68</sup>Quantity demanded and price have an inverse relationship. However, we are not concerned with movements along the demand schedules; rather, we are comparing two demand schedules that represent informed demand and uninformed demand.

<sup>69</sup>Because of the higher price, the extenders of credit are supplied with more money to compete for capital for use in the consumer credit market.

allocation, the microeconomic goal of credit information disclosure for the investment decision, would be furthered by disclosure of the acceleration right.

The economic model also indicates that acceleration disclosure would operate to optimize individual welfare. Assuming again that the consumer seeks to obtain the maximum satisfaction from his money income, his problem is to select, from among all of the various possible commodities, that particular combination of commodities which he perceives to be most satisfactory from his economic standpoint. When the consumer misperceives the costs,  $C$ , of the purchase of credit, and as a result, the risk  $R$  is inaccurate, the use of credit appears to be a more desirable commodity than it is in actuality; as a result, the consumer uses more credit than he would if accurately informed of the acceleration risk, because he has not discounted his expected utility by the value of the acceleration risk. This means that the consumer's particular combination of commodities, or shopping basket, including an overuse of credit, will not give him the maximum utility for his money because he has substituted the use of credit in his basket for some other good or service. When informed, the consumer would use less credit, substitute in his basket a service or product with a marginal utility greater than credit, and thereby increase his overall welfare.

In addition to capital being optimally allocated, and individual welfare being optimized, a wealth transfer from informed consumers to uninformed consumers could be eliminated by acceleration clause disclosure. Since most consumers are uninformed with respect to acceleration the demand is overstated and the price is artificially high. Consumers informed of the risk the acceleration provision poses have to pay a higher market price than the use of credit is worth. If all consumers were uninformed, the demand would be further overstated, and the price still higher. In this connection, there are three relevant demand schedules, and their respective prices for credit:  $D_1$  and  $P_1$ , where all consumers are uninformed;  $D_2$  and  $P_2$ , where most consumers are uninformed; and  $D_3$  and  $P_3$ , where all consumers are informed of the acceleration risk.  $P_1$  is greater than  $P_2$  and the difference between  $P_1$ , where all consumers are uninformed, and  $P_2$ , where most consumers are uninformed, represents the amount of wealth transferred from the informed consumers to the uninformed. The uninformed consumers pay a smaller price because the informed consumers exercise restraint in their use of credit, thereby keeping the price lower, at  $P_2$ . If the informed consumers did not exercise this restraint, the uninformed would be paying the higher price. Therefore, there is a wealth transfer that could be eliminated by the disclosure of the acceleration clause; the informed consumers would no longer be forced to pay the higher price caused by the overuse of credit on the part of uninformed consumers. With all consumers informed with respect to disclosure, the market price of credit would fall to  $P_3$  due to the decreased demand.

The decrease in price to the consumer which would result from disclosure must be greater than the increase in price due to the increased administrative cost incurred by the creditor and passed on to the consumer; otherwise no net gain for the consumer would result. The creditor must change his disclosure statement to include the right of acceleration, and this increased overhead cost could create a new supply schedule which would include a higher price. The creditor must only add two or three lines to his disclosure statement, however, and this cost is minimal when compared to his total servicing and overhead costs. Moreover, the new reform and simplification bills pending in Congress are evidence that other changes in disclosure requirements are imminent. Since the new law will require changes in the disclosure statement, an additional change with respect to acceleration disclosure would not add any appreciable costs.

Economic theory thus indicates that disclosure of acceleration clause information will promote optimal resource allocation, maximize individual welfare and eliminate a current wealth transfer among consumers, and is therefore consistent with the second policy of TIL of promoting informed investment decisions. Whether these consequences will actually result from disclosure is a function of the accuracy of economic assumptions concerning consumer behavior. The issue is whether consumers *do* seek to maximize their utility and, more specifically, whether consumers, when making purchase decisions, will care enough about the acceleration clause to appreciate the risk it entails. Since no evidence is available on the effect of acceleration clause disclosure, a determination of whether consumers will evaluate this risk cannot be empirically verified. It may be argued that consumers do not consider the possibility of default, and that therefore they will ignore the risk that the creditor's acceleration right presents. However, this line of reasoning assumes that consumers cannot sensibly judge their own interests; even if this assumption is true, it is entirely inconsistent with the accepted assumptions concerning human behavior which are embodied in our legal and economic systems, and therefore should not be accepted unless it is empirically verified.<sup>70</sup> Buyers should not be kept ignorant of the true cost of consumer credit on the belief that they will act imprudently when informed.

### INCREASING CONSUMER AWARENESS

The third policy of the TIL Act is the broad concern for consumer education that overlaps the first and second policies of encouraging comparative shopping and promoting informed investment decisions. The need

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<sup>70</sup>See generally Schwartz, *supra* note 27, at 508. "It is inconsistent to say that a statute that is designed to facilitate shopping ought to be construed on the assumption that shopping does not take place. . ." Landers, *supra* note 29, at 92. This reasoning appears to logically extend to the situation presented.

for increased consumer awareness appears to be a theme that underlies all consumer protection legislation. The reasons for this need in credit transactions lies in the history of abusive practices by creditors<sup>71</sup> and in the outright neglect of consumer problems by many state legislatures.<sup>72</sup>

The phenomenal growth of installment credit has been an aid to deceptive and fraudulent marketing.<sup>73</sup> When consumer transactions depended on cash, sellers had less opportunity for fraud. In an installment credit transaction, whether the consumer can afford the purchase is less relevant for some creditors because, once the contract is made, the seller can pursue his legal right to collect.<sup>74</sup> Deception is not the only source of dysfunction in the consumer credit industry; the failure of the law to change with the industry is another major problem.<sup>75</sup> Laws regulating consumer credit in most states are borrowed from commercial law.<sup>76</sup> Commercial law is based upon the assumption that parties have equal sophistication, *i.e.*, that they both fully understand all the rights and liabilities of the various contract provisions. However, the consumer has little experience with or understanding of contractual relationships. Further, the consumer credit transaction uses an adhesion contract prepared by the financier; in most cases the consumer neither receives nor reads the contract before signing. The thrust of much consumer legislation is to inform in an effort to reduce the inequality between creditor and consumer.

The disclosure of the acceleration clause is particularly important because the acceleration right can be easily abused. In the event of non-payment after the grace period has run, the creditor has the legal right to take self-protective action.<sup>77</sup> Creditors may provide in their contracts that a debt may

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<sup>71</sup>Boyd, *The Revised Uniform Consumer Credit Code As a Replacement For Piecemeal Consumer Legislation: The Arizona Context*, 18 ARIZ. L. REV. 1, 1 (1976) [hereinafter cited as Boyd]; D. CAPLOVITZ, *CONSUMERS IN TROUBLE*, 37-46 (1974). See also Alderman, *supra* note 35; Note, *Due Process Denied: Consumer Default Judgments in New York City*, 10 COLUM. J. L. AND SOC. PROB. 370 (1974).

<sup>72</sup>See Boyd, *supra* note 71; NCCF Report, *supra* note 32, at 3.

<sup>73</sup>Consumer credit has expanded in use tremendously, from 10% of disposable income and \$21.5 billion in 1950 to 18% of disposable income and \$184.3 billion in 1975; \$151.5 billion of the 1975 figure represented installment credit. STATISTICAL ABSTRACT OF THE UNITED STATES 475 (1975). One of the most disturbing aspects of consumer borrowing is the growing length of some loans. Since 1975, the average length for personal loans has risen about five months to nearly forty-one months. New and used cars, mobile homes, appliances and furniture all are being financed by longer term loans. At the same time, borrowers are generally having to pay down less on their purchases. A Federal Reserve Board economist also voiced concern that "the trend toward longer maturities and lower down payments makes the typical loan riskier. It makes the loan much more vulnerable if the economy should begin to turn sour." The fear is that if another recession should develop, loan delinquencies could be a major economic problem as many consumers are deeply in debt. Malambre, *Borrowing Boom*, Wall St. J., June 28, 1977, at 1, col. 8.

<sup>74</sup>See generally D. CAPLOVITZ, *CONSUMERS IN TROUBLE* (1974).

<sup>75</sup>*Id.* at 2.

<sup>76</sup>*Id.* at ix & 2.

<sup>77</sup>U.C.C. § 9-501 (1972).

be accelerated if the creditor feels "insecure";<sup>78</sup> the only limit on this ability to accelerate is that the creditor must act in good faith.<sup>79</sup> However, this is not a significant limitation as good faith only requires that the creditor act honestly in fact.<sup>80</sup> Moreover, the burden of proving bad faith is on the debtor.<sup>81</sup> This allows a creditor great freedom and power.<sup>82</sup> By "hair-trigger" acceleration, the creditor is able to force debtors into default or refinancing of the debt.<sup>83</sup>

Acceleration clause disclosure would also alert consumers that they might need credit insurance. The risk of incapacity to meet installment obligations is reduced by credit life insurance, credit accident and health insurance, and property and liability insurance. Credit accident and health insurance, for instance, is designed to maintain the consumer's installment payments if he becomes sick or disabled during the payment period.<sup>84</sup> By opting for credit insurance in a large loan or credit purchase transaction, the consumer can reduce the risk of having payments accelerated during periods of illness, disability or death.

In most default cases the consumer simply misjudges his ability to manage credit obligations.<sup>85</sup> Acceleration disclosure, as suggested, alerts the consumer to the significant risk of using credit. By increasing the awareness of the risks involved, disclosure also discourages the consumer from committing himself to an overextended credit position. This is desirable both for the consumer's welfare and for stabilization of the economy.<sup>86</sup> The knowledge that the entire balance may be demanded if one installment is late also provides an additional incentive to meet the single payment for consumers who

<sup>78</sup>U.C.C. § 1-208 (1972); NCCF Report, *supra* note 32, at 24.

<sup>79</sup>U.C.C. § 1-208 (1972); Boyd, *supra* note 71, at 28; NCCF Report, *supra* note 32, at 24.

<sup>80</sup>U.C.C. § 1-201(19), 1-203 & Comment (1972); Boyd, *supra* note 71, at 28 & n.236.

<sup>81</sup>U.C.C. § 1-208 (1972); Boyd, *supra* note 71, at 28.

<sup>82</sup>NCCF Report, *supra* note 32, at 25; Boyd, *supra* note 71, at 28.

<sup>83</sup>The Uniform Consumer Credit Code (UCCC) does eliminate much of the danger of this practice. Under the UCCC, the "insecurity" basis for acceleration is allowed to the extent that the prospect of payment, performance, or realization of collateral is significantly impaired, and the creditor has the burden of proving that the impairment is substantial. U.C.C.C. § 5.109(2) & Comment Z; Boyd, *supra* note 71, at 29. However, to the extent that the UCCC has not been adopted, and to the extent that it is not effective in eliminating the potential for creditor abuse of acceleration clauses, the possibility of such abuse still exists. Informing the consumer on the disclosure statement is an aid to the over-all scheme of eliminating the harshness of acceleration by making the consumer aware of the acceleration right and how it is triggered.

<sup>84</sup>Landers, *supra* note 29, at 113. Consumer credit insurance is highly criticized as being over-priced, forced on consumers as a condition of the credit transaction, misrepresented, frequently the subject of fraudulent and deceptive practices or sold in excessive amounts or without provision for rebate in event of prepayment or refinancing. *Id.* at 114. However, credit insurance, if properly controlled by insurance statutes or regulations, could be a very useful and beneficial risk reducer, which could eliminate the harshness of acceleration in many instances.

<sup>85</sup>NCCF Report, *supra* note 32, at 193. This statement does not conflict with subsequent discussion, see text accompanying notes 86-90 *infra*. Mismanagement here includes those situations where the consumer fails to allow enough slack to absorb short-term fluctuations in income.

<sup>86</sup>See NCCF Report, *supra* note 36, at 174.

were not aware of the consequences of non-payment. The TIL Act seeks to increase the general awareness of consumers, and the goal is that disclosure information will cause consumers to act more prudently when using credit. Disclosure of the acceleration clause furthers this goal by making this information more prominent and understandable. If standardized language were used for acceleration clause provisions,<sup>87</sup> the consumer's reading of the same clause in each disclosure statement for each transaction would reinforce its prominence on the statement and would increase consumers' general awareness of the acceleration risk.

A primary argument against disclosure is the sheer complexity of the TIL statement.<sup>88</sup> Originally intended to be a simple statute for the disclosure of finance charges and interest rates, the TIL Act has resulted in statements that frequently comprise a full page or more of small print. This detailed statement hardly seems beneficial to consumers, and any simplification that cuts down on disclosures without impairing the basic operation of the statute would be desirable.<sup>89</sup> Indeed, this seems to be the trust of the current simplification bills in Congress.<sup>90</sup> It is likely that increasing the items of disclosure leads confused consumers to ignore the statement entirely since they feel incapable of comparing all the disclosed information, so that disclosure of a few key items may be more helpful than disclosure of all the relevant data.

The FRB, in a statement before the Consumer Affairs Subcommittee of the Senate Committee on Banking, Finance and Urban Affairs, has recommended improvement in the delivery of information to consumers by emphasizing the most significant disclosures and clearing up ambiguities.<sup>91</sup> This proposal would reduce required disclosures to basic finance charge and cost information.<sup>92</sup> In addition, the FRB recommends that certain important terms be disclosed—those which are less directly related to cost, and more related to the consumer's rights on default or prepayment,<sup>93</sup> *i.e.*, that a summary statement with respect to late payment charges, security interests and prepayment penalties be made along with a reference to the actual contract for details.<sup>94</sup> The FRB finally recommends a general reference to the contract for provisions dealing with the consequences of default.<sup>95</sup>

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<sup>87</sup>This is not to suggest standardizing the instances that trigger the creditor's right to acceleration, which is the subject of state statutes.

<sup>88</sup>See generally Landers, *supra* note 29, at 92-93.

<sup>89</sup>*Id.*

<sup>90</sup>See notes 24-26 *supra* & text accompanying.

<sup>91</sup>Statement by Philip C. Jackson, Jr., Governor, Board of Governors of the Federal Reserve System, before the Consumer Affairs Subcommittee of the Committee on Banking, Finance and Urban Affairs, United States Senate, July 11, 1977, at 2.

<sup>92</sup>*Id.*

<sup>93</sup>*Id.*

<sup>94</sup>*Id.*

<sup>95</sup>*Id.* at 3.



Complete disclosure of these terms in detail is legalistic and of little value to consumers in that form. However, a summary of terms is insufficiently informative. The FRB recommendation is an intermediate position that will simplify the disclosure statement without sacrificing pertinent information.<sup>96</sup> By a general reference to the acceleration right plus a cross-reference to the contract for further details, the consumer is put on notice of default consequences and can review the terms of the contract for a full explanation.<sup>97</sup>

#### CONCLUSION

Disclosure of the creditor's right of acceleration accompanied by a cross-reference to the credit contract for detailed explanation of default consequences should be required by the Truth In Lending Act. Economic analysis indicates that this disclosure would be useful in furthering the policies of the Act. Consumers informed of the risk acceleration represents will seek creditors that do not include the clause in the credit contract, and informed consumers will discount the expected utility of credit by the risk represented by the inclusion of the acceleration clause in the credit contract, thereby allowing the market to approach the optimum with respect to the allocation of capital. By making informed investment decisions, a wealth transfer from debtors informed of the acceleration risk to those uninformed will be eliminated. Further, individual welfare will be maximized by an informed purchase of credit. Finally, the presence of the acceleration clause by reference to the contract, signals to the debtor that he should read that document and become familiar with this common yet complex consumer transaction.

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<sup>96</sup>The FRB proposal is to give brief explanations in everyday language of the recommended limited number of disclosure terms. *Id.* at 5.

<sup>97</sup>The following is an example of the proposed disclosed acceleration clause, cross-referencing the debtor to the credit contract. On the FRB proposed simplified disclosure statement this clause would be on the bottom of the page just above the debtor's signature which indicates he has received and read the disclosure statement:

You should read your contract for other information including our right to declare the full balance due in the event of nonpayment or other default, and prepayment rebates and penalties.

Statement by Philip C. Jackson, Jr., *supra* note 85, Appendix C.