Loyola Consumer Law Review

Volume 7 | Issue 1 Article 4

1994

Automobile Leasing - Problems and Solutions

David A. Edelman
Founding Partner, Edelman & Combs, Chicago, IL.

LEAD ARTICLE

Automobile leasing

Problems and solutions

The legal protection of consumers who lease automobiles has improved recently. But the new rules don't adequately address key problems.

By Daniel A. Edelman

The number of consumers who lease automobiles in the United States has grown dramatically over the last decade. While leasing offers some advantages to consumers, it also contains many pitfalls for the unwary. One of the greatest potential dangers of leasing a car are the charges that accrue when the lease is terminated before its scheduled expiration date. This article outlines the extent of the consumer protection problem in Part I. Part II describes current regulation of automobile leasing. Part III enumerates the special problems arising from early lease termination. Part IV focuses on the harmful effects of non-disclosure of lease terms. Part V advocates legislative changes to solve auto leasing abuses.

Automobile leasing is a significant consumer protection problem

Automobile leases present a serious consumer protection problem. More than 25 percent of new cars "sold" in the United States at the present time are actually sold to a leasing company, which in turn leases them to the user.[1] In the case of some luxury car lines, including Mercedes and Jaguar, more than 50 percent are leased.[2]

Presently, the single largest consumer protection problem in automobile leases is the size and incomprehensibility of early termination charges.[3] Although the rate of early termination has declined in recent years, a few years ago 50 to 80 percent of leases terminated early.[4] Early termination may occur because the lessee defaults, because the car is wrecked or stolen, or because the lessee wants to trade the leased car in for a new car. Whatever the reason, early termination often imposes severe penalties on the lessee.

A 1989 report of an investigation by the Attorney General of New York found that many standard form leases issued by major leasing companies imposed unconscionable penalties upon early termination and failed to disclose material information concerning early termination.[5] Industry studies confirm that "[b]etter than 80 percent" of automobile lessees do not fully understand their contractual obligations.[6] Industry representatives also acknowledge widespread consumer dissatisfaction with the charges that lessees incur upon the early termination of automobile leases.[7]

In addition, the problem has become more serious because automobile leasing is no longer the exclusive province of the wealthy and professionals.[8] On the contrary,

Daniel A. Edelman is a founding partner of Edelman & Combs, a Chicago law firm specializing in consumer protection litigation. He has published and spoken extensively on consumer law issues. Mr. Edelman received his J.D. from the University of Chicago Law School in 1976.

the lower monthly payments for leases are touted as a means for persons who could not otherwise afford a new car to acquire one.[9] Lessors compare the lease arrangement to "renting an apartment when you can't afford a home."[10] Working people may not understand that while the lease payments are "seductively low," a consumer who tires of the car, or gets tired of paying for expensive repairs,[11] and turns it in early, "can trigger penalties so hefty that you would have done better to come up with a down payment to buy."[12]

Even completed leases present a problem. If the lessee turns the car in at the end of the lease, she is generally not responsible for any difference between the car's value and the leasing company's original projection.[13] Some leases, however, contain inadequate or unrealistic statements of the condition in which the car must be returned. If this is so, the consumer may receive a substantial bill for "wear and tear" or "excess mileage."

In addition, most "excess mileage" formulas are inappropriate, requiring the lessee to pay a fixed sum for each extra mile the car is driven. This is unfair because once a car is driven a certain number of miles, its value does not further diminish according to used car blue and red books. Nonetheless, many leasing provisions require the lessee to pay for the alleged devaluation of the car.

Comparing the advantages of buying and leasing is virtually impossible, which creates another major consumer protection problem. While the consumer can compare monthly payments, this comparison is meaningless because the lessee does not ultimately acquire title to the car. In addition, the information necessary to compare a lease and an installment purchase—the "capitalized cost" (equivalent of price) and the "rate of lease charge" (equivalent of rate of interest or finance charge)—is normally not disclosed by the car dealer or leasing company. Present federal law does not require disclosure of these items per se. Because the law requires the early termination liability disclosure to be comprehensible to a layperson, the dealer or leasing company may find it necessary as a practical matter to disclose this information if it is used in computing early termination liability.[14]

Because the capitalized cost is not disclosed, car dealers may try to use a capitalized cost equal to or exceeding 100 percent of the sticker price. Most people that buy cars do not pay anything near 100 percent of the sticker price. However, a surprising number of lessees do, with-

Common lease phrases

This box contains definitions of some common accounting terms used in leases.

•*Residual value,* or *lease–end value*, is the car's estimated worth at the scheduled end of the lease. The figure may be accurate, may be the product of wishful thinking by the leasing company, or may be affected by a subsidy and be totally fictitious.

•*Capitalized cost* is the equivalent of price in a sale transaction. It equals the residual value plus the car's expected depreciation during the lease's term. It may also include sales tax payable by the leasing company upon the car dealer's transfer of title to it, as well as extended warranties.

•*Lease charge*, the equivalent of interest or finance charges on a loan, represents compensation for paying in installments rather than all at once. Some recent leases provide that the lessee will pay the entire charge up front in one lump sum, and consequently do not have a lease charge.

The lease charge can be expressed as a decimal or as a percentage, which the lessor almost never discloses to the lessee voluntarily. The decimal or percentage is applied to the entire capitalized cost, not just to the depreciation that takes place during the term of the lease.

If a lease that includes a lease charge is ended early, the lessor ordinarily must provide a credit for the unearned portion. This is because where an obligation payable over time is accelerated, failure to give a credit for the "unearned interest" or its equivalent (*i.e.,* the portion of the payments representing the time value of money) imposes a penalty for early termination.

•*Monthly payments.* If the lease calls for monthly payments, they consist of a depreciation component and a lease charge component. If the leasing of a vehicle is taxed, the taxes are included as well.

•*Capitalized cost reduction* is either the equivalent of a down payment or trade–in, or a reduction given by the manufacturer.

out realizing it. The New York Attorney General's report found this a significant problem:

> The initial value of the car being leased (the cost of acquisition to the lessor) is traditionally not disclosed to lessees. Many lessors artificially inflate this value so that they can increase the amount of depreciation, the major component of the lessee's monthly payments. The higher the initial value, the greater the depreciation and the greater the monthly payment and, consequently, at early termination, the lessee will be responsible for a greater amount of depreciation.
>
> For example, some lessors reportedly assign an amount equal to 110 percent of the "Manufacturer's Suggested Retail Price" (MSRP) for the initial value of the cars leased. Even using MSRP for the initial value would constitute an exaggeration, in most instances, because cars are usually purchased for substantially less than the MSRP.[15]

Because car dealers often make much more money leasing a car than selling it, the nondisclosure of the capitalized cost gives rise to a species of "bait and switch" tactic. A consumer may visit a car dealership and negotiate a sale price with payments of $X per month. The car dealer then suggests that if the consumer leases rather than buys, she can decrease the monthly payments by some substantial amount. The consumer perceives this as a good deal and signs on the dotted line, but this is not necessarily true. Because the consumer "buys" half a car or less under a lease, a dealer can use a capitalized cost equal to 100 percent or more of the sticker price and still make the monthly payments come out lower than in the installment purchase. The uninitiated consumer might think the dealer has based the lease on the just–negotiated sales price, but she has not.[16]

Most leases present another consumer protection problem by including what is known as a "hell or high water" clause. These clauses require the lessee to continue making monthly payments "come hell or high water;" in essence, even if the leased car is completely inoperable. Since 1976, a Federal Trade Commission (FTC) regulation[17] has effectively eliminated this type of clause in transactions where a consumer signs an installment contract that is assigned to a financial institution, or where a car dealer arranges a loan, by abolishing the "holder in due course rule" in these transactions.[18] However, this regulation probably does not apply to leases.

Finally, some dealers fail to account for the consumer's trade–in vehicle. It has been alleged that dealers sometimes induce consumers to surrender their vehicles for little or no consideration.

Legal regulation of automobile leasing

While lessees are not entirely without legal protection, the current regulatory scheme often proves insufficient.

Federal regulation. Automobile leasing is regulated by the Federal Consumer Leasing Act or Truth in Leasing Act,[19] enacted in 1976 as chapter 5 of the Truth in Lending Act. The stated purposes of the Truth in Leasing Act are "to assure a meaningful disclosure of the terms of leases of personal property for personal, family, or household purposes so as to enable the lessee to compare more readily the various lease terms available to him, limit balloon payments in consumer leasing, enable comparison of lease terms with credit terms where appropriate, and to assure meaningful and accurate disclosures of lease terms in advertisements."[20]

Early termination formulas often contain unfair provisions despite regulation.

The Truth in Leasing Act and Federal Reserve Board Regulation M[21] require extensive disclosures in consumer lease transactions and regulate certain substantive terms of such transactions. The Truth in Leasing Act and Regulation M apply to any "consumer lease," defined as a "contract in the form of a lease or bailment for the use of personal property by a natural person for a period of time exceeding four months, and for a total contractual obligation not exceeding $25,000, primarily for personal, family, or household purposes, whether or not the lessee has the option to purchase or otherwise become the owner of the property at the expiration of the lease...." Leases for "agricultural, business, or commercial purposes" are excluded.[22]

The Truth in Leasing Act provides for substantive regulation of charges for early termination, delinquency and default:

> Penalties or other charges for delinquency, default, or early termination may be specified in the lease but only at an amount which is reasonable in light of the anticipated or actual harm caused by the delinquency, default, or early termination, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy.[23]

In addition, the Truth in Leasing Act and Regulation M require a lessor to provide a lessee with extensive disclosures analogous to those required in the case of credit transactions by the Truth in Lending Act, prior to the consummation of a lease.[24] The disclosures must be made "clearly, conspicuously, [and] in meaningful sequence," either on a separate written statement or in the contract above the place for the lessee's signature.[25] Also, they must be "reasonably understandable"[26] and must be "made together on a single page (which may include both sides) and above the place for the lessee's signature."[27] Conversely, required disclosures may not be in fine print on the back of the page.

Moreover, sufficiency of disclosure is viewed from the standpoint of an average consumer.[28] Whether a disclosure is reasonably understandable to a layperson is ordinarily a question of fact.[29] The usual means of proof are the testimony of the consumer, surveys, focus groups, and experts in linguistics and communications.[30]

Regulation M requires a lessor to disclose:

(1) "The amount or method of determining the amount of any penalty or other charge for delinquency, default, or late payments."[31]

(2) "A statement of the conditions under which the lessee or lessor may terminate the lease prior to the end of the lease term and the amount or method of determining the amount of any penalty or other charge for early termination."[32]

(3) "A statement identifying any express warranties or guarantees available to the lessee made by the lessor or manufacturer with respect to the leased property."[33]

(4) "The total amount paid or payable by the lessee during the lease term for official fees, registration, certificate of title, license fees, or taxes."[34]

(5) "[A] statement of reasonable standards for wear and use...."[35]

(6) When and for how much the consumer can exercise a purchase option.[36]

Finally, the Truth in Leasing Act provides that any lessor who violates any requirement imposed under its disclosure and regulation of charges sections and the implementing regulations is liable as provided in the Truth in Lending Act. However, the statute of limitations runs from the end of the lease, rather than from the consummation of a credit transaction.

State regulation. At the state level, automobile leases are generally subject to state "unfair or deceptive acts or practices" statutes, such as the Illinois Consumer Fraud Act.[37] The Federal Trade Commission has held that it is an unfair and deceptive practice to systematically impose penalties—*i.e.*, amounts which do not constitute a legitimate liquidation of damages—through form contracts.[38]

Additionally, termination charges in leases are subject to examination under state common law, which will enforce reasonable provisions for liquidated damages but not penalties.[39] Also, Article 2A of the Uniform Commercial Code, a new article dealing with leasing transactions, also regulates termination charges in leases.

The problems with typical early termination formulas in leases

Early termination formulas often contain inherently unfair provisions despite regulation. Some older automobile leases required the lessee to make all the remaining payments even though the lease was terminated and the car returned early. This type of provision is almost certainly invalid under the Truth in Leasing Act provision requiring that termination and default charges be reasonable.[40] These provisions are also likely invalid under state common law refusing to enforce penalties as opposed to liquidated damages.[41] Analytically, such a provision is the same as one that would require a borrower to pay all of the interest on a loan even though the loan is repaid halfway through the term.[42] In addition, such a formula would also be invalid under Article 2A of the U.C.C.[43]

More recent leases usually provide that upon early termination the lessee will receive some sort of credit for the unearned "lease charge." This credit may be computed according to the "actuarial" or "economic accrual" method, also known as the "constant yield" method. However, some leases still use one of the formulas that financial institutions have devised to arbitrarily allocate artificial amounts of interest to the beginning of an installment obligation, such as the "Rule of 78s," also known as the "sum–of–the–digits method."

Generally, the Rule of 78s unduly favors the lessor and penalizes the consumer because it "front–loads" the interest, allocating a disproportionate amount to the earlier months of the obligation.[44] In the absence of specific statutory or regulatory authorization to use it in connection with a transaction, it should not be appropriate to use the Rule of 78s to compute interest or other compensation for the time value of money.[45] For example, in *Kedziora v. Citicorp National Services, Inc.*,[46] the court held that a complaint alleging use of the Rule of 78s to rebate unearned lease charge stated a cause of action under the Truth in Leasing Act and Regulation M.

The early termination charges may still be unfair even if the lease uses the actuarial method. As explained previously,[47] under a closed end lease, the lessee is not responsible at the scheduled termination of the lease for any shortfall between the residual value of the car and the actual value of the car. On early termination, however, the lessee is often required to pay any shortfall between the residual value and the actual price the car brings at a wholesale auto auction ("realized value"). Thus, if the residual value is an overly optimistic estimate or a subsidized number, a very large penalty is built into the lease. Even if it is accurate, the capitalized cost is a retail figure, while an auto auction price is a low wholesale figure. Therefore, the lessee is required to pay the difference between the wholesale and retail values of the car upon early termination.[48]

Finally, use of the residual value is inappropriate in such a formula without adjustment to account for the fact that the car is being returned earlier than projected. Rather, the appropriate figure is that sum which, if presently invested, will produce the residual value at the time the car was scheduled to be returned to the leasing company.[49] The 1989 New York Attorney General's report elaborates:

> Many lessors credit the lessee with the difference between the "realized value" (*i.e.*, the amount the lessor actually receives for the car when the lessor sells it at the time of early termination) and the "residual value" (*i.e.*, the amount pre–designated in the lease as the value of the car at the end of the lease term). The residual value is what the lessor may claim at the *end* of the lease—not at the earlier time of termination. The right to the residual value at the time of early termination (before it is due), is worth less than the full amount of the residual value. Therefore, the credit to the lessee should be the difference between the residual value and the *present* worth of obtaining the residual value.
>
> For example, assume a $15,000 car with a residual value after four years of $6,000 and a realized value, following early termination after two years, of $9,000. The credit to the lessor is not $3,000 ($9,000 — $6,000) because, at a given annual interest rate of 10 percent, the present value of eventually collecting $6,000 after two years is only $4,916 (or stated differently, $4,916 earning 10 percent annual interest, compounded monthly, will yield $6,000 at the end of two years). The proper credit to the lessee, therefore, is $9,000 — $4,916 or $4,084.[50]

An additional problem results when some leases both use the realized value of the vehicle upon early termination to determine the lessee's liability and assess excess mileage charges against the lessee. This is unfair because any greater–than–normal usage of the vehicle will be reflected in a lower–than–normal realized value. In effect, the depreciating impact of the extra miles is counted twice.

An auto manufacturer that wants to move cars will often do so by subsidizing leases in one of two ways. The fair way is to reduce the price charged to the dealer, who in turn reduces the capitalized cost. The unfair way is for the manufacturer to guarantee the leasing company that the car will have an unrealistically high residual value when the lease ends, *e.g.*, 80 percent of capitalized cost at the end of a two–year lease. The effect of the residual value guarantee is that if the lessee terminates early under a lease that holds the lessee responsible for the difference between the residual value and the realized value on early termination, he must refund the subsidy. Of course, the lessee has not been told that the subsidy exists or that he has to refund the subsidy on early termination.

Disclosure issues

Even if the termination formula is fair, it may still be utterly incomprehensible to a non–accountant. Until 1993, leasing companies tended to describe their termination provisions using technical language, such as the "rules for journal entries for Lessors as to the 'direct financing leases' set forth in Statement of Financial Accounting Standards No. 13 (FASB 13) issued by the Financial Accounting Standards Board."[51] However, in *Lundquist v. Security Pacific Automotive Financial Services Corp.*[52], the Second U.S. Circuit Court of Appeals held that a lease using this language was incomprehensible to a layperson and therefore failed to comply with Regulation M. Also, other courts have held that leases that fail to disclose all components used in the early termination calculation,[53] and leases that require the lessee to perform computations to derive numbers which were known to the leasing company when the lease was drawn up, violate Regulation M.[54]

In contrast, the court in *Kedziora*, and a companion case against General Motors Acceptance Corporation,[55] held that a reference to the Rule of 78s was sufficient, even though one suspects that most consumers would find these terms as obscure as "FASB 13." However, the court relied erroneously on a now–rescinded Federal Reserve Board interpretation under the Truth in Lending Act that required a creditor to refrain from explaining the Rule of 78s to avoid "informational overload."[56] Ultimately, this conflict between decisions will have to be resolved on the appellate level.

Actually, preparing a lease which explains the actuarial method in plain English is quite simple. All that is necessary is disclosure of the capitalized cost and rate of lease charge, and a statement that each monthly payment will be applied first to the lease charge at X percent and then to reduce the capitalized cost, just like mortgage payments are applied first to interest and then to principal. Furthermore, once the capitalized cost and rate of lease charge are determined, the lessor can simply hand an amortization schedule to the lessee. However, the only leases in which the author has seen any such disclosures are in a form used by some credit unions, and leases issued in the state of Maryland, which require that the lessor give the lessee a partial amortization schedule.

The Federal Reserve Board is currently considering revisions to Regulation M. The leasing companies responded to the *Lundquist* decision by asking the Board to overrule it and authorize such "disclosures" as the "rules for journal entries for Lessors as to the 'direct financing leases' set forth in Statement of Financial Accounting Standards No. 13 issued by the Financial Accounting Standards Board." On the other hand, certain consumer groups, including the National Consumer Law Center in Boston, have asked the Board to require disclosure of the capitalized cost and rate of lease charge if they are elements of an early termination formula.

Allowing the type of meaningless "disclosure" condemned in *Lundquist* would be contrary to the intended purpose of the Truth in Leasing Act. The Senate Report that accompanied the Truth in Leasing Act explained:

> Testimony in the Subcommittee hearings indicated that a large number of auto leases were terminated prior to their scheduled expiration. Sometimes this was on account of the customer's default, but more often the early termination was at the customer's request in order to enter into a new lease for different goods. Whether the early termination is voluntary or involuntary from the customer's point of view, the bill requires full disclosure of any charges incident to such termination. It also requires disclosures of any charges for delinquency or default.[57]

Another major disclosure problem concerns warranties. Many leases do not clearly apprise the lessee of what warranty rights he has, if any. They either state that there "may be" a warranty or inform the lessee that he has whatever rights the leasing company has under the manufacturer's warranty that are assignable by the leasing company to the lessee.

In *Highsmith v. Chrysler Credit Corp.*,[58] the Seventh U.S. Circuit Court of Appeals held that a disclosure that there "may be" a warranty fails to comply with the Regulation M requirement of "[a] statement identifying any express warranties or guarantees available to the lessee made by the lessor or manufacturer with respect to the leased property."[59] In the author's view, "disclosures" requiring the lessee to make a legal judgment as to the assignability of warranty rights are no better.[60] In particular, many manufacturer's warranties distinguish between consumer and commercial purchasers of vehicles; for example, they disclaim implied warranties to commercial purchasers but not consumer purchasers. The leasing company is a commercial purchaser: it acquires title to the vehicle for the purpose of using it in its leasing business. In this situation, the consumer purchaser may not have any implied warranty rights.

Another disclosure problem is that car dealers and leasing companies are reluctant to disclose the capitalized cost and rate of lease charge. At the present time, the Truth in Leasing Act and Regulation M do not directly require disclosure of the capitalized cost and rate of lease charge per se. However, in *Maryland National Bank v. Goodman*,[61] the court indicated in an opinion on a motion to dismiss that if the capitalized cost exceeds 100 percent of the sticker price, it may be an unfair or deceptive business practice not to disclose the fact. In addition, the Illinois Appellate Court has held that it is an unfair and deceptive practice to sell a car at a price above the advertised selling price by failing to disclose the advertised price.[62] Therefore, if it is unfair and deceptive to sell a car to a consumer above the advertised price, it should also be unfair and deceptive to charge a consumer with an amount of lease depreciation which assumes the car is worth more than MSRP (which is itself substantially in excess of the normal selling price), without disclosure of that fact to the consumer at the time the lease is signed. In both cases, the same material information about the value of the car is being withheld from the consumer.

Finally, lease advertising presents a substantial problem. An examination of the auto section of a major newspaper reveals numerous advertisements which tout a monthly payment for a car, without prominent disclosure of whether it is a lease or installment purchase. This can mislead consumers about the difference in cost between buying and leasing.

Need for legislation

While recent decisions have improved the legal protection for automobile lessees, the numerous abuses in the leasing area make legislative action desirable to insure uniform protection for the 25 percent of the population that leases cars. A few states have addressed some of the abuses discussed in this article. One previous example is Maryland, which requires that the lessee be provided with a table of early termination values at various points during the lease term.

In addition, a number of reforms are made in a recent New York statute,[63] which contains provisions remedying many of the common abuses. Among its principal features are the following:

(1) Protection against unreasonable wear–and–tear charges at end of lease through an arbitration mechanism.

(2) Disclosure and substantive regulation of early termination charges. The lessor must disclose an "initial early termination charge," consisting of initial lease value plus any additional early termination liability that would be incurred by termination. There is also a reasonableness restriction similar to federal law, but more specific, in that it requires actuarial computation of the lease charge.

(3) Protection against confiscation of trade–ins. The transaction is cancelable until the lease terms are finalized by the leasing company. If the consumer does not like the terms, she is entitled to get her car back.

Under this law, a lessor cannot provide that early termination will always be treated as a default. The lessee is in effect given a right to terminate early, and there is no default unless he fails to pay the termination liability upon demand.

Furthermore, the New York law requires that an advance copy of the lease must be available at the dealership, enabling the consumer to take it to his accountant for deciphering. The law also applies the Truth in Leasing disclosure requirements to leases in excess of $25,000. This corrects the fact that the jurisdictional limit in the federal statute has not been increased since 1976, when the price of most passenger cars was less than $25,000. In addition, the statute makes the lessor subject to defenses, so that the lessee of a lemon automobile can refuse payment. However, the single most serious shortfall in the New York statute is that it does not require disclosure of the capitalized cost per se, or the equivalent of an annual percentage rate.

The author urges other states to enact statutes similar to the New York law, with the added requirements that the capitalized cost and rate of lease charge be disclosed, and that advertising disclose that a transaction is a lease in type equal in size to that used for the monthly payments. Such legislation, with effective provision for both private and governmental enforcement, would go a long way to assure fair treatment for automobile lessees and allow prospective lessees to determine if leasing is really right for them.

E N D N O T E S

[1]David Woodruff, *Leasing Fever*, BUS. WK., Feb. 7, 1994, at 92; Krystal Miller, *Car Firms Flag Down Shoppers With Array of New Lease Deals*, WALL ST. J., Oct. 26, 1993, at B1, B9; *Savings Persuade Drivers to Lease*, NEW HAVEN REG., August 9, 1993, at 17; Martha Hindes, *Leasing Lures Customers to Showrooms; Cash Poor Drivers Try This Option*, CHI. SUN TIMES, Sept. 15, 1993, at 3A.

[2]Approximately 50-55% of Mercedes production is leased rather than sold. *Mercedes to Tout Price and Value for Its New C Class,* ATLANTA J., Nov. 5, 1993, § S, at 4. Approximately 60-70% of Jaguar production is leased rather than sold. Jim Henry, *Euro Luxury at Low Cost, Lease Deals Help Protect Share*, AUTOMOTIVE NEWS, July 27, 1992, at 4.

[3]BUREAU OF CONSUMER FRAUDS & PROTECTION, NEW YORK STATE DEP'T OF LAW, "EARLY TERMINATION" CLAUSES IN LONG TERM AUTOMOBILE LEASES 2 (1989).

[4]Jeannie H. Cross, UPI, June 19, 1989, *available in* Lexis, Nexis Library, UPI File (80%); Brigid McMenamin, *The True Costs of Leasing*, FORBES, Feb. 1, 1993, at 98 (about 50%). The percentage has declined in recent years because the average term of automobile leases has declined. Two year leases are now popular, whereas previously lease terms of three to five years were more common.

[5]BUREAU OF CONSUMER FRAUDS & PROTECTION, NEW YORK STATE DEP'T OF LAW, *supra* note 3, at 2.

[6]Roger Rowand, *Repeat Business*, AUTOMOTIVE NEWS, April 29, 1991, at 22i.

[7]Paul A. Eisenstein, *The Dangers and the Allure of Car Leasing*, U.S. BANKER, August 1990, at 44.

[8]Carole Gould, *To Buy—or Lease—Your Next Car*, N.Y.TIMES, July 23, 1989, §3, at 3, col. 3.

[9]Adam Bryant, *Leasing Is Main Weapon In Battle For Top-Selling Car,* N.Y. TIMES, Dec. 9, 1992, at D18.

[10]Jim Mateja, *Two Routes to New Car: Look Beyond Cost to Weigh Pros and Cons Outlined in Small Print*, CHI. TRIB., July 7, 1991, Transportation section, at 1.

[11]Maintenance is the consumer's responsibility under almost all leases. The comprehensive portion of the warranty is normally shorter than the lease; any longer period on the engine and drive train may be shorter than the lease.

[12]Francesca Lunzer Kritz, *When lease is more*, U.S. NEWS & WORLD REP., July 29, 1991, at 56.

[13]Under what is technically known as a "closed end" lease, the lessee is not liable for the difference between the projected value of the car at the end of the lease and what the leasing company can actually get for it. Under another type of lease, known as "open end," the lessee bears the risk of such a shortfall in value. Virtually all non-fleet auto leases nowadays are "closed end." In part, this is because the Consumer Leasing Act of 1976 imposed substantial restrictions on the ability of a leasing company to impose termination liability on a consumer lessee under an open-end lease.

[14]Lundquist v. Security Pac. Automotive Fin. Serv. Corp., 993 F.2d 11 (2d Cir. 1993), *cert. denied*, — U.S.— , 114 S.Ct. 419 (1993).

[15]BUREAU OF CONSUMER FRAUDS & PROTECTION, NEW YORK STATE DEP'T OF LAW, *supra* note 3, at 7–8.

[16]*Car Leasing Rip-Offs Targeted: State Investigates Practices Used To Confuse Naive Consumers*, MIAMI HERALD, Oct. 30, 1993, § B, at 1.

[17]16 C.F.R. § 433 (1994).

[18]Abolishing the "holder in due course rule" allows the consumer to raise ordinary defenses (such as breach of contract) and stop paying the note. Although the regulation technically applies only to the dealer, a financial institution which knowingly participates in efforts to circumvent the regulation may be engaging in an unfair or deceptive trade practice or mail fraud. *See* Heastie v. Community Bank of Greater Peoria, 727 F. Supp. 1133, 1140 (N.D.Ill. 1990); Brown v. LaSalle Northwest Nat'l Bank, 820 F. Supp. 1078 (N.D.Ill. 1993).

[19]15 U.S.C. § 1667 (1994).

[20]15 U.S.C. § 1601(b) (1994).

[21]12 C.F.R. § 213 (1994 & Supp. I 1994) ("Regulation M" and staff commentary).

[22]15 U.S.C. § 1667(1) (1994).

[23]15 U.S.C. § 1667b(b) (1994).

[24]15 U.S.C. § 1667a (1994).

[25]12 C.F.R. § 213.4(a) (1994).

[26]12 C.F.R. § 213.4(a)(1) (1994 & Supp. I 1994) (comment 1).

[27]12 C.F.R § 213.4(a)(2) (1994 & Supp. I 1994).

[28]Edmondson v. Allen-Russell Ford, Inc., 577 F.2d 291, 296 (5th Cir. 1978) ("an audience composed of ordinary laypersons engaged in consumer credit transactions"); *In re* Cook, 76 B.R. 661, 664 (Bankr. C.D.Ill. 1987) ("Truth-in-Lending disclosures being for the benefit of the borrower should be construed through his eyes and not those of the lender"); *In re* Hatfield, 117 B.R. 387, 391 (Bankr. C.D.Ill. 1990) ("the eyes of the common consumer").

[29]Barber v. Kimbrell's, Inc., 577 F.2d 216, 221 (4th Cir. 1978) ("the adequacy or inadequacy of defendants' disclosure...depending as it does on the perceptions of a 'reasonable' consumer, presents a factual issue about which there is oftentimes a dispute. The questions are similar to that of materiality in federal securities litigation, the resolution of which depends upon the perceptions of a 'reasonable' investor, where summary judgment is normally inappropriate").

[30]*E.g.*, American Home Prods. Corp. v. Johnson & Johnson, 577 F.2d 160, 167-69 (2d Cir. 1978); American Home Prods. Corp. v. FTC, 695 F.2d 681, 688-91 (3d Cir. 1983).

[31]12 C.F.R. § 213.4(g)(10) (1994).

[32]12 C.F.R. § 213.4(g)(12) (1994).

[33]12 C.F.R. § 213.4(g)(7) (1994).

[34]12 C.F.R. § 213.4(g)(4) (1994).

[35]12 C.F.R. § 213.4(g)(8) (1994).

[36]12 C.F.R. § 213.4(g)(11) (1994).

[37]815 ILCS 505/1 (1994).

38AMREP Corp., 102 FTC 1362, 1668-69 (1983), *aff'd*, 768 F.2d 1171, 1179 (10th Cir. 1984); Horizon Corp., 97 FTC 464, 848-52 (1981); Capital Builders, Inc., 92 FTC 291 (1978) (consent order).

39*E.g.*, Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1289-90 (7th Cir. 1985) ("a liquidation of damages must be a reasonable estimate at the time of contracting of the likely damages from breach, and the need for estimation at that time must be shown by reference to the likely difficulty of measuring the actual damages from a breach of contract after the breach occurs"); *See also*, Hickox v. Bell, 552 N.E.2d 1133, 1140 (5th Dist. 1990). In this case, the court found that whether a contract provision is a reasonable liquidated damages provision or an unenforceable penalty requires a consideration of whether the settlement of damages that could potentially result from the contract breach was the purpose of a clause, as opposed to it being a penalty to induce compliance or a device to raise revenue. In its determination the court also considered whether "the amount so fixed is a reasonable forecast of just compensation for the harm that is caused by the breach," and whether "the harm that is caused by the breach is one that is incapable or very difficult of accurate estimation."

40*See generally*, Shepherd v. Volvo Fin. N. Am., Inc., 1-93-CV-971 (N.D. Ga. Jan. 14, 1994) (lease required all remaining payments to be made; difference between that and actuarial calculation was $8 million for 3,000 lessees who terminated early; case was settled); U. B. Vehicle Leasing, Inc. v. Bender, No. 9248 (Mass. App. Div. May 20, 1994); *In re* Dailey, 167 B.R. 932 (Bankr. D. Mont. 1994).

41*See* Adams v. D & D Leasing Co., 381 S.E.2d 94 (Ga. Ct. App. 1989) ("to the extent that a liquidated damages provision in a lease of personalty provides for the acceleration of the remaining rental payments without a reduction to present value, it cannot be said to constitute a reasonable pre–estimate of the probable loss," and constitutes an unenforceable penalty); Taylor v. Commercial Credit Equip. Corp., 316 S.E.2d 788, 789–90 (Ga. Ct. App. 1984) ("The lease provision at issue in the case before us authorizes the lessor to accelerate eight years' worth of rental payments totaling over $78,000 without reduction to present value. Such a recovery bears no reasonable relationship to probable actual damages suffered as a result of the default and is manifestly oppressive, particularly in the event of a default early in the term of the lease"); Moore v. Ford Motor Credit Co., 778 S.W.2d 657 (Ky. Ct. App. 1989) ("we hold that the failure of the default provision [in a motor vehicle lease] to discount the accelerated rent to its present value constitutes an unlawful penalty"); United Leasing & Fin. Servs., Inc. v. R. F. Optical, Inc., 309 N.W.2d 23, 27 (Wis. Ct. App. 1981) (failure to reduce future rents to present value results in penalty rather than liquidated damages; "[d]iscounting has been recognized as the second operative element of a fair liquidated damages clause"); Northwest Collectors, Inc. v. Enders, 446 P.2d 200, 205-06 (Wash. 1968) (clause in lease providing for payment of all rentals upon default, without reduction to present value, constituted unenforceable penalty); Newco Leasing, Inc. v. Hull, 213 Cal. Rptr. 202 (Cal. App. Dept. 1985) (future rentals must be discounted to present value); Heller Fin., Inc. v. Burry, 633 F. Supp. 706 (N.D. Ill. 1986).

42*See e.g.*, Ford Motor Credit Co. v. Milhollin, 444 U.S. 555, 561 (1980) (contrasting accelerating a loan with accelerating a loan without giving a credit for unearned interest; the former was held not to be a "penalty," while the latter was); *In re* Jungkirth, 74 B.R. 322 (Bankr. E.D.Pa. 1987) (failure to provide a rebate of unearned "interest" or equivalent charges constitutes the imposition of a penalty); General Elec. Credit Corp. v. McManus, 381 A.2d 1071 (Conn. C.P. 1977) ("to permit the plaintiff to recover this unearned and yet–to–be–due interest would be unconscionable and would be a windfall to the creditor"); Block v. Ford Motor Credit Co., 286 A.2d 228, 234 (D.C. 1972) ("retention of unearned interest beyond the time of the payment of the debt would permit the recovery of disproportionate damages, i.e., a penalty, and would therefore be unconscionable"); Puritan Fin. Corp. v. Vest, 504 N.E.2d 913 (Ill. App. Ct. 1987) ("To allow a lender to reap a double benefit by charging a defaulted borrower for interest on money he no longer has and charging interest on that same principal to another borrower is clearly an unjust enrichment"); Ecenrode v. Household Fin. Corp., 422 F. Supp. 1327, 1332 (D. Del. 1976) ("If a creditor is permitted to retain unearned finance charges in the event of default and acceleration, that would represent the assessment of an additional penalty charge"); *In re* United Am. Fin. Corp., 55 B.R. 117 (Bankr. E.D.Tenn. 1985); Genn v. CIT Corp., 392 A.2d 1135, 1138-39 (Md. App. 1978) (recovery of unearned interest is a "penalty" and "unconscionable"; general rule is that it cannot be recovered).

43Under Article 2A, the basic measure of damages for the lessee's breach is "the *present value* as of the date of default of the difference between the total rent for the remaining lease term of the original lease agreement and the market rent at the time and place for tender computed for the same lease term" (§2A-528) (emphasis added). Any contractual provision for determining the lessee's liability upon early termination or default must pass muster under the liquidated damages/penalty test, viewed against the measure of damages set forth in § 2A-528. Section 2A-504(1) provides that "[d]amages payable by either party for default...may be liquidated in the lease agreement but only at an amount or by a formula that is reasonable in light of the then anticipated harm caused by the default or other act or omission." The commentary to this section notes that "A liquidated damages formula that is common in leasing practice provides that the sum of lease payments past due, accelerated future lease payments, and the lessor's estimated residual interest, less the net proceeds of disposition...of the leased goods is the lessor's damages"—*i.e.*, the formula involved in this case—and states that the section is intended to impose a reasonableness requirement on it.

44Kedziora v. Citicorp Nat'l Servs. Inc., 780 F. Supp. 516, 524-6 (N.D. Ill. 1990); *In re* Willis, 6 B.R. 555, 562 (Bankr. N.D. Ill. 1980); Scott v. Liberty Fin. Co., 380 F. Supp. 475 (D. Neb. 1974); *In re* Jungkurth, 74 B.R. 323, 334 (Bankr. E.D.Pa. 1987), *aff'd*, 87 B.R. 333 (E.D.Pa. 1988); Buerger, ***Uniform Consumer Credit Code***, 28 PERSONAL FIN. L.Q. 101, 105 (1974).

45*In re* Jungkirth, 74 B.R. at 334 ("We cannot justify the use of the Rule of 78s in a context where the legislature has not expressly authorized its use, as it is incontrovertible that the Rule is an inaccurate measure of the actual rebate to the detriment of borrowers"). For example, the IRS generally does not permit use of the "Rule of 78s" to compute interest deductions for tax purposes. Prabel v. CIR, 91 T.C. 1101 (1988), *aff'd*, 882 F.2d 820 (3d Cir. 1989).

[46]Kedziora, 780 F. Supp. at 524-6.

[47]*See supra* n. 13 and accompanying text.

[48]Notwithstanding the inherent disadvantage to the lessee of selling the car in order to determine the credit to be given the lessee, the court in *Kedziora* rejected the contention that this was per se unreasonable. The alternative would be to give a credit based entirely on the residual value, adjusted for time.

[49]Kedziora, 780 F. Supp. at 524–6.

[50]BUREAU OF CONSUMER FRAUDS & PROTECTION, NEW YORK STATE DEP'T OF LAW, *supra* note 3, at 8–9.

[51]FASB 13 is about 200 pages long and filled with accounting jargon.

[52]Lundquist v. Security Pac. Automotive Fin. Serv. Corp., 993 F.2d 11 (2d Cir. 1993), *cert. denied*, — U.S. —, 114 S. Ct. 419 (1993).

[53]*See* Highsmith v. Chrysler Credit Corp., 18 F.3d 434 (7th Cir. 1994) (failure to disclose that rebate of unearned lease charge is given is violation); Anderson v. Ford Motor Credit Corp., 593 A.2d 678 (Md. 1991) (key term was only on lessor's copy of lease).

[54]Johnson v. Steven Sims Subaru and Subaru Leasing, No. 92 C 6355, 1993 U.S. Dist. LEXIS 11694 (N.D. Ill., Aug. 20, 1993) (Magistrate Judge's report).

[55]Wesley v. General Motors Acceptance Corp., No. 91 C 3368, 1994 WL 48719 (N.D. Ill. Feb. 15, 1994).

[56]The interpretation never applied to leases, where the Federal Reserve Board has always required that all disclosures be "reasonably understandable," and in any event has now been rescinded. Following its rescission, Illinois enacted a statute requiring explanation of the Rule of 78s where it is used in installment contracts and loans. 205 ILCS 670/16(m) (1994).

[57]S. REP. NO. 590, 94th Cong., 2d Sess. (1976), *reprinted in* 1976 U.S.C.C.A.N. 431, 435.

[58]Highsmith, 18 F.3d at 434.

[59]12 C.F.R. § 213.4(g)(7) (1994).

[60]Most lawyers with which the author has discussed the issue have no idea of the answer to the assignability question. Moreover, there is a substantial ambiguity in any such formulation.

[61]Maryland Nat'l Bank v. Goodman, No. 91 M1 157394 (Ill. Cir. Ct. of Cook County Jan. 4, 1994).

[62]Affrunti v. Village Ford Sales, Inc., 597 N.E.2d 1242, 1244 (Ill. App. Ct. 1992) ("the defendant ought to have informed the plaintiff of the advertised sale price").

[63]N.Y. PERSONAL PROPERTY LAW §§ 330-353 (McKinney 1994) (effective date is Jun. 30, 1995)

ANNOUNCEMENTS

Calif. insurance limits

A recent California court ruling upholding strict limits on insurance rates drew both criticism from insurance industry groups and praise from consumer groups. The decision requires California auto and home insurers to refund $1 billion to customers who were overcharged. In addition, it allows the state to set rate controls.

Insurance groups worry about the effects of the ruling on the nation's biggest state and predict other states will be affected as well. "This will likely cause other state regulators to determine whether they can also be successful in trying to get rebates or cap profits," observed Steve Goldstein, a spokesman for the Insurance Information Institute, a research group representing 250 companies.

"It's outstanding," said Kathleen F. O'Reilly, president and general counsel of a consumer rights group, the National Insurance Consumer Organization. "It has wide implications for other states that have been sitting on the sidelines waiting to see if they could do anything like this."

J. Robert Hunter, insurance commissioner in Texas and co-author of the California initiative, predicts many states will adopt similar laws. "Now there's precedent," Hunter said.

Who's listening?

The Illinois Bar Association warns attorneys that cellular phone conversations are easily intercepted and may pose a risk to attorney–client confidentiality. In addition, lawyers should warn clients of the risks and get their consent before discussing privileged legal matters over cellular phones.

Although listening in on cellular calls is a federal crime, attorney and longtime cellular phone user F. Lee Bailey warns, "Number one: You just have to remember that no one has the right to listen in on an attorney–client privileged conversation. And number two: They probably do."