Much Ado About Technicalities: A Retail Installment Sale Is Not a Loan

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What's in a name? That which we call a rose
By any other name would smell as sweet

William Shakespeare, *Romeo and Juliet*

This line, delivered by Juliet, suggests that names of things don't matter so much. In this love-struck teenager's world, only lawyers worry about such technicalities.

In the sweet smelling world of consumer finance, we see two common forms of financing transactions - loans and retail installment sales (aka credit sales). As a lawyer, I am conditioned to cringe slightly whenever I see the word "loan" used to describe a retail installment sale. There are many differences between a loan and a retail installment sale. To my mind, failing to use the proper term for the transaction can lead to confusion. And that can lead to problems later, especially for financial institutions that service both purchase money loans and retail installment sales.

Now, you may be thinking: "consumers generally don't understand or care about the difference, so why should any of us?" Well, the reason is that there are a lot of clever lawyers out there who understand the subtle and not-so-subtle distinctions between a loan and a retail installment sale. Many of them represent the interests of those consumers. If servicing your retail installment sales as though they are loans is detrimental to consumers, then you could have a problem. Let's focus on one potential pitfall - the accrual of interest on a post-repossession deficiency balance.

Imagine that Friendly Finance Company has two different customers, each of whom has financed the purchase of a new motor vehicle. Customer A obtained a simple interest loan and used the proceeds to purchase the vehicle. The loan bears interest at 8.99% a year and there are no other finance charges, so the effective APR is also 8.99%. Customer B finances the purchase on a retail installment sales contract with finance charges (in the form of the time-price differential), having an effective APR of 8.99%.

Now imagine that Customer A and Customer B both default. The creditor repossess their vehicles repossessed and sells them at auction. After the sale, a deficiency balance remains on both accounts. Friendly wants to continue to accrue interest at 8.99% on both accounts. Can it do so? Probably not. This is one of those times where there may be a significant difference between a loan and a retail installment sale. To understand why, read on.

Customer A obtained a loan and agreed to repay that loan, with interest, until the loan is repaid. The repossession of the vehicle pledged as collateral for the loan does not fundamentally change the lender/borrower relationship. As long as there is a principal balance outstanding, the borrower has an obligation to repay the principal balance and interest continues to accrue at 8.99% per year until the loan is repaid in full.

Customer B purchased a vehicle on an installment basis, agreeing to pay the purchase price of that vehicle over time. The repossession of that vehicle is a big deal. The seller (or its finance company assignee) got the vehicle back. Why should Customer B continue to pay the purchase price? Because the retail installment contract (if it is properly written) specifically says so. But what about charging interest on the deficiency balance? Well, it all depends on what's in the contract. Some contracts provide for the payment of interest at a specified rate, or at a rate chosen by the seller/assignee but not to exceed the highest lawful rate. In our case, this might be higher or lower than 8.99%. If the contract does not provide for the charging of interest on a deficiency balance, a creditor may rely on some statutory authority to charge interest, but that will varies by state, and in some cases, it's likely that it cannot charge interest at any rate.

What this exercise demonstrates is that Friendly should not assume that it can continue to charge interest at 8.99% on the deficiency balances owed by both Customer A and Customer B. Treating both transactions as "loans" and servicing them accordingly may lead Friendly to charge Customer B for unauthorized interest.

If, like Friendly, your company services both loans and retail installment sales, you might ask:

- What Are My Processes? Do you charge interest on deficiency balances? If so, do you differentiate between loans and retail installment sales? If you accept retail installment contracts from different forms vendors, do you know how those forms differ on this question, and do your processes respect those differences?

- What's In My Forms? Do you know exactly what your promissory notes and retail installment contracts say about charging interest on deficiency balances?

- What's The Law? The states differ on the amount of interest that may be charged, or if it may be charged in the absence of specific agreement with the consumer. In the states where you operate, you need to understand the statutory framework for charging interest on general obligations, particularly if your forms are silent on this issue.

Pay attention to technicalities. Don't be like Juliet. Spoiler Alert: Things don't turn out well for her and Romeo.

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