

New California Law Impedes Creditors' Ability to Offer Voluntary Protection Products to Military Servicemembers

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California recently enacted Senate Bill 1311, the Military and Veteran Consumer Protection Act of 2022, with the stated intent of strengthening the state's military consumer protection laws by enhancing protections for servicemembers and their families. The MVCPA contains various financial protections. Perhaps the most significant of these is the addition of Section 408.1(c) to the Military and Veterans Code, which provides that a security interest in a motor vehicle is void and cannot be perfected if the security interest would cause a loan procured by a covered member in the course of purchasing the motor vehicle to be exempt from the Military Lending Act and the loan also funds the purchase of a credit insurance product or credit-related ancillary product.

Industry members, including motor vehicle dealers, sales finance companies, lenders, and product providers, vehemently opposed passage of Section 408.1(c) on grounds that it would prevent servicemembers from availing themselves of mainstream consumer products—credit-related voluntary protection products. Nevertheless, the MVCPA is set to take effect January 1, 2023. As the January effective date quickly approaches, the MVCPA leaves many questions unanswered. Most importantly, will creditors be able to offer credit-related VPPs when making secured vehicle purchase loans (or credit sales) to covered servicemembers? What credit-related VPPs are covered? And how far does the new section reach?

Let's start with reach. Section 408.1(c) expressly applies to a vehicle purchase "loan procured by a covered member." Applicable California law does not define the term "loan," but the legislative intent seems to be that the limitation will apply equally to all types of credit transactions, including loans and retail installment sales. A broad interpretation of the term "loan" seems consistent with Section 408.1(c)'s express application to "covered members," as that term is defined under the MLA. While use of the term "covered member" is narrower than the MLA's use of the term "covered borrower," which would include the servicemember's spouse, in some cases a child, parent, or parent-in-law, or an unmarried person in the legal custody of the servicemember, reference to the MLA's definition would seem to apply to any covered member anywhere in the country. Such an interpretation would, of course, be subject to constitutional limits constricting the MVCPA's extraterritorial application, but the language is unduly broad and raises questions regarding the reach of the statute.

Because Section 408.1(c) does not define the term "credit-related ancillary product," the MVCPA also raises questions about what VPPs are covered. The MVCPA refers to a subsection of VPPs (those that are "credit-related"). Therefore, it seems reasonable to interpret Section 408.1(c) as concerning only those VPPs that relate to the credit transaction, which very likely would include products like GAP and debt cancellation and likely would exclude products like service contracts or other vehicle protection, which have nothing to do with the credit transaction. However, there may be products in the middle. For example, what about a GPS device, which may offer theft recovery and other valuable telematics services to consumers but also may be used by creditors to locate vehicles for collection purposes? Absent a statutory definition of the term "credit-related ancillary product," it is difficult to know where to draw the line.

Finally, the biggest question of all—will creditors be able to offer credit-related VPPs when making secured vehicle purchase loans (or credit sales) to covered servicemembers? Because many creditors require security for vehicle financing, the practical effect is that the new law will largely preclude California servicemembers from being able to finance credit insurance and credit-related ancillary products. Opponents expressed concern about this outcome during the legislative process. The Assembly responded that servicemembers would still be able to purchase GAP waivers as long as the purchase does not effectively remove protections provided to them under the MLA. For example, the Assembly noted that a servicemember may complete a second transaction at the dealership or purchase a GAP waiver through an external source, such as the servicemember's insurance provider.

Sound familiar? The Department of Defense played this same game in 2017 when it published interpretive guidance intended to clarify whether auto finance purchase-money credit transactions were eligible for an exclusion from coverage under the MLA for "[a]ny credit transaction that is expressly intended to finance the purchase of a motor vehicle when the credit is secured by the vehicle being purchased." Unfortunately, the "clarification" only caused further confusion.

The interpretive rule stated that if a transaction also financed "credit-related costs," it would be disqualified from the exclusion. Much like in California, the term "credit-related costs" was not defined; however, examples were provided—namely, GAP and credit insurance. This interpretation thrust dealers into a catch-22 situation, as the MLA separately prohibits (subject to a limited carveout for banks, savings associations, and credit unions) creditors from securing credit transactions with covered borrowers with a motor vehicle title. As a result, dealers were effectively prohibited from offering credit-related ancillary products to covered borrowers because the products could not be financed (since no finance source will make a loan or buy a retail installment sale contract that is not secured by the vehicle being purchased).

Ultimately, the DOD withdrew the guidance as, after significant efforts by industry trade groups, it became aware of, and found merit in, the concern that creditors were unable to technically comply with the MLA—"if the purchase included products not expressly related to the purchase of the vehicle ... [the MLA] would prohibit creditors from taking a security interest in the vehicle in those circumstances and creditors may not extend

credit if they could not take a security interest in the vehicle being purchased."

Despite the lessons learned by the DOD, California is now poised to put dealers right back into the same catch-22. Previously, some dealers and finance sources chose to completely stop selling and financing GAP and other types of credit insurance products or to offer and sell GAP waiver and credit products only to non-covered borrowers. However, these were never perfect solutions and risked allegations of UDAAP and discrimination in states that have laws prohibiting creditors from discriminating against servicemembers. Though the Assembly has suggested that these products could be sold to servicemembers separately from the vehicle financing transaction, there are legal questions under state law about whether a creditor even has the authority to sell GAP or other credit-related products in a second transaction apart from the credit transaction. For example, is such a transaction effectuated through a modification, or should it be treated as its own credit sale?

At the end of the day, this new law risks harming the servicemembers it was intended to protect. While many regulators view VPPs as having limited value to consumers, there are many instances in which consumers benefit from these products. In the meantime, creditors wanting to offer these products to military servicemembers in California and retain their security for vehicle purchase transactions will need to proceed with caution.



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