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Negative equity revisited

by Gil Van Over

One of the depositions I read in a case involving negative equity went terribly awry against the dealer to the point that the dealer's insurance company hastened to settle with the plaintiff.

The General Manager was being deposed. He proudly pointed to a separate form he had customers sign acknowledging that the customer was paying an overallowance in the purchase price which was offset by the overallowance the dealer was providing in the trade allowance. This was being done so that the contract did not reflect the true negative equity in the transaction.

The turning point came with this follow-up question from the plaintiff's attorney, "What other federal laws did you knowingly ask my client to violate?"

History

Negative equity became a phenomenon after the Truth in Lending Act was passed in 1968. At that time it was standard credit practices for the customer to put down a large down payment and have a short term loan. Negative equity did not come into play until lenders loosened underwriting criteria, permitting longer terms and no down payments, while consumers continued to trade in a short cycle.

The Truth in Lending Act is a disclosure statute. It stated that no negative numbers can appear on the contract.

When negative equity started cropping up, TILA did not provide any disclosure direction. The lenders came through by advising dealers to increase the cash price and the trade allowance by the same amount so that the net amount financed did not change.

Then in 1998, the feds updated Regulation Z, which is the federal regulation under which TILA is promulgated. One update was a methodology for properly disclosing negative equity on a Retail Installment Sales Contract. Lenders had the option of choosing a netting or a non-netting method to show disclosure.

This change went largely ignored by the lending community, who was more concerned that the financial world was coming to an end with the Y2K scare. Computer programming resources were dedicated to Y2K and lenders did not want to mess with a silly old regulation. They advised dealers to continue the practice of overallowing.

Then came the lawsuits. And dealer started losing the lawsuits. The "Lender made me do it defense" did not help because the dealer-lender agreements universally stated that the dealer agreed to abide by state and federal regulations. Even though the lenders would not cash the contracts if they did.

Present

Now, however, the third party lenders who are buying contracts from dealers recognize that they must permit the proper disclosure of negative equity on the Retail Installment Sales Contract.

I do not know of a lender today who will not accept a contract with negative equity properly disclosed. If you haven't talked to your lenders lately, you may be operating under the mistaken assumption that they won't cash contracts with negative equity properly disclosed. It is worth a phone call to help avoid a lawsuit that you can't win.

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