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SPECIAL COMPLIANCE ALERT

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NINTH CIRCUIT REQUIRES NOTICE BEFORE IMPOSING DEFAULT RATE

Has your credit union implemented a default rate pricing feature under your open-end loan plan or credit card account agreement? If so, you need to be aware of a recent decision by the U.S. Court of Appeals for the Ninth Circuit. In *McCoy v. Chase Manhattan Bank* (http://www.ca9.uscourts.gov/datastore/opinions/2009/03/16/0656278.pdf), the Ninth Circuit held that when imposing a default rate under an open-end credit plan, the creditor must provide the borrower with a notice on or before the effective date of the default rate. Although this ruling conflicts with decisions from other courts, it is binding on creditors in the Ninth Circuit, which includes Oregon, Washington, Alaska, California, Arizona, Hawaii, Idaho, Montana, and Nevada.

The dispute arose from an arrangement under which Chase provided what it called "preferred" pricing, but reserved the right to revoke the preferred pricing and impose "a non-preferred rate" if the borrower did not continue to meet the preferred pricing conditions outlined in the agreement. The non-preferred rate was not specifically identified; it could be any rate up to the maximum rate specified in a schedule. The agreement further provided that imposition of a non-preferred rate would be retroactive to the beginning of the billing cycle in which the non-preferred rate was imposed.

Interpretation of Regulation Z

Chase argued that this is the type of change covered by Official Comment No. 1 to Regulation Z, Section 226.9(c), which provides that a creditor need not give a notice of change in terms if "the specific change is set forth initially." Examples of such changes include rate increases under a properly disclosed variable rate plan, a rate increase that occurs when an employee has been under a preferential rate agreement and terminates employment, or an increase that occurs when the consumer has agreed to maintain a certain balance in a savings account for a discount rate and the account balance falls below the specified minimum. This standard is fairly straightforward. So how did Chase run into trouble?

The Ninth Circuit held that Chase's default rate provision was not specific enough to be treated as an initially disclosed change, and was therefore subject to the contemporaneous notice requirement specified in Official Comment No. 3 to Section 226.9(c)(1). This comment states that the standard 15 day advance notice of change in terms is not required for increased rates due to delinquency or default, but notice must still be provided on or before the effective date of the change. Chase's vaguely drafted pricing terms undercut its argument that the change was part of the initial disclosures.

First, there was no specific indication of what the default rate would be, only of the maximum default rate that could apply. Second, the agreement provided that the preferred rate "may" be revoked in the event

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of default. Third, Chase waited until three months after the initial default before revoking the preferred rate. Then it applied the default rate retroactively to the first day of the statement period. Based on these factors, the Court held that the increased default rate was a "discretionary" increase and not a specific change agreed to by the borrower.

Credit Union Impact - Notice Required

Many of our credit union clients have adopted a default rate pricing feature for credit cards or other consumer loans. In most cases, the agreement provides for imposition of a specific rate (such as 18%) upon occurrence of any event of default or the increase in the rate upon failing to satisfy discount rate conditions. In addition, these rate provisions often specify that the rate "will" be increased, rather than "may" be increased. These two factors are critical to avoiding a "discretionary" change treatment by the courts and could lead to a different result than the one Chase got. We believe that creditors in the Ninth Circuit should make sure their rate provisions are clear and complete and should consider sending borrowers a notice if the credit union is imposing a default rate under an open-end plan. The notice should be provided on or before the date that the default or increased rate goes into effect. This approach would avoid giving a court the opportunity to impose a result like the one that Chase suffered. This would apply to any open-end credit plan, including credit cards, home equity lines of credit, and loans under a consumer open-end plan.

If you have questions about the impact of this court decision, or the exercise of your rights under a default provision in your loan documents, please contact Brian Witt or Hal Scoggins.

Hal Scoggins

NEWS & UPCOMING EVENTS:

Deposit Account Compliance Seminars - Hal Scoggins will present deposit account compliance seminars for the Washington Credit Union League (WCUL) on May 5, 2009, in Federal Way, WA, and on May 6, 2009, in Vancouver, WA. The seminars will cover key aspects of opening, maintaining, and closing deposit accounts. For more information, please visit WCUL's website.

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