



# GAP ... Do it Right!

by Patricia Covington

**T**he Truth-in-Lending Act (TILA) is all about doing it right. That is, a creditor has to prepare accurate disclosures and provide them to consumers exactly as required by TILA and its implementing rule, Regulation Z. This is incredibly important to avoid regulatory rebuke, but especially to avoid being sued and losing.

What does this have to do with GAP and doing it right? Well, if a creditor sells GAP, it ought to read carefully; these products are subject to specific TILA disclosure requirements. The TILA disclosure requirements are critical for it to be excluded from the “finance charge.” A creditor says, “Yeah, I know about these requirements; this is old news.” Well, it’s not new, but lots of folks are still getting it wrong. In addition, there are a lot of other issues regarding GAP that must be considered. TILA should not be overlooked; the requirements are simple but very specific.

Mistakes that occur in the arena of GAP can be incredibly expensive because they can easily result in class-action claims. When creditors sell GAP, after a while there tends to be a fair number of these deals on the books. GAP is a product that is generally sold and administered pretty much the same way every time. That’s a perfect “tee-up” for a class action claim.

Most creditors (which includes dealers and sales finance companies) know that GAP, an acronym for guaranteed automobile protection, is a debt cancellation product. Some additional details: there are two types of GAP products, two-party and three-party. Two-party GAP is an agreement between the creditor and buyer where the seller agrees not to pursue the buyer for monies owed when the vehicle that was the subject of the transaction is totaled (after, of course, the creditor receives the insurance check). In other words, the seller waives collection of any deficiency after it receives the insurance check. Most of the time the insurance check isn’t big enough to pay off the entire balance owed on the installment contract. That is the value that this product provides.

Then there is three-party GAP. It works much the same as two-party GAP, however rather than being an agreement

between the creditor and buyer, it is provided by a third party—hence the designation three-party GAP. The creditor would still sell the product, but just another party’s product, much like an extended warranty or insurance product. That brings up insurance.

Though creditors may consider the TILA implications of GAP, many forget about other issues. That brings up insurance. GAP is considered insurance in many states. This is usually the case with three-party GAP, and sometimes with two-party. When a state doesn’t consider two-party to be insurance it’s because the state understands that it is simply an agreement between the seller and buyer to waive monies owed. Now, if GAP is considered insurance in a state, there are several implications, like special disclosures to be provided; being properly licensed to sell it; limiting charges for it, etc. So, it’s pretty important to know what type of GAP is being sold and whether or not it is insurance.

Another detail about GAP that is largely disregarded is what happens when the buyer pays off his installment contract early. It’s not always, “Hooray, we got paid, and since the debt has been paid our risk of providing coverage is gone. No, not quite. Rather, the correct reaction is asking the following question, “Do I have any responsibility regarding the GAP because the installment contract has been prepaid?” This reaction is a bit more boring, but nevertheless, it is the best one. Remember the discussion about insurance? Well, here’s yet another implication. If GAP is insurance, there is a very good likelihood that state insurance law will require a creditor to rebate—that is refund—any unearned amounts. What? Unearned amounts, what is that? Think pre-computed installment sales. The concept is similar.

The GAP product provides value over the whole term of the installment contract. Never mind that the benefit payable would decrease over time as the contract is paid down. If the installment contract is paid off early, let’s say two years into a four-year term, there is some value that is left on the table (the remaining two years). Some laws and regulators take the position that like finance charges, the charge for the GAP

product is earned over the life of the installment contract—that is, slowly but surely as time passes. So, if the contract is paid off early, then the charge for the GAP is only partially earned. This results in unearned amounts.

Prepayment may not mean gravy on the deal. Rather, it may mean refunding unearned amounts. But who refunds? Well, it depends. State law will dictate who has to pay out of pocket. It could be the dealer, the sales finance company or the insurance company, depending on the type of GAP. While it's not usually the dealer, the dealer and/or sales finance company may still have other obligations. A creditor may be required to notify the consumer that there may be refund entitlement. Bottom line, this issue deserves some attention because many states have requirements along these lines. By the way, just because GAP isn't insurance doesn't mean a creditor is off the hook. Some states may require rebating of a non-insurance GAP product.

What else could there be? Well, a state may not allow a creditor to sell GAP. It could be a flat out prohibition, or more likely that a creditor cannot charge for the product. Then there is the question about whether and how these charges for GAP can be financed. In addition to being dependent upon state law, this answer will depend upon the type of GAP product involved. For example, a state may allow the GAP charge to be financed; but it would have to be a finance charge. That's not fun. That means it has to be included when calculating the APR. Most creditors won't like that.

Back to TILA: the following case, *In re Matthews (Matthews v. Johnson)*, provides a more positive perspective on what TILA and Regulation Z require. That's because the dealer in this case successfully defeated the plaintiff's challenge that the GAP was not disclosed properly.

Holly Matthews bought a 2005 Chevrolet from Johnny Johnson, a motor vehicle dealer. Matthews entered into a retail installment contract and security agreement with Johnson. Johnson assigned the contract to Centrix Funds, LLC. Matthews sued Johnson and Centrix, claiming violations of the federal Truth in Lending Act. Matthews alleged that a \$399 processing fee and a \$330 premium for GAP were not properly disclosed because they were not included in the finance charge. Matthews also alleged that the proper party did not make the GAP insurance disclosures. Finally, Matthews alleged that because the \$399 processing fee and the \$330 GAP insurance premium were excluded from the finance charge, more than the tolerance allowed under TILA

misstated the disclosed APR. Matthews dismissed Centrix from the lawsuit after Centrix filed for bankruptcy, and Johnson was left as the only defendant. Johnson then moved for summary judgment.

The U.S. Bankruptcy Court for Middle District of Alabama found that the processing fee was not a charge incident to the extension of credit because it was charged on all sales, cash or credit. Therefore, the court ruled that Johnson did not violate TILA by failing to group the fee with the finance charges. The court went on to find that Johnson advised Matthews in writing that debt cancellation coverage was not required (the first disclosure requirement, which must be done in writing). The court also found that Johnson had advised Matthews of the cost of the premium (the second requirement, and if the term of the coverage is less than the term of the contract, the term of the coverage must be disclosed). The court determined that Matthews had signed a request for coverage after she was advised that coverage was not required and after she was advised of the cost of coverage (the final requirement is that the consumer sign or initial an affirmative written request after receiving the prior two disclosures). Consequently, the court concluded that the GAP insurance premium was properly excluded from the finance charge disclosure. Because the court determined that both the \$399 processing fee and the \$330 GAP premium were properly excluded from the "finance charge," the court rejected Matthews' claim that Johnson misstated the APR. Accordingly, the court granted Johnson's motion for summary judgment.

GAP—it's a good thing when it's disclosed properly and a creditor knows all its responsibilities relating to it. It can be a source of future headaches and the loss of big dollars, if it's not done right. Consequently, if a creditor "does" GAP, it must do it right.

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