

Rulings on Auto-Loan Markups Contradictory

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A U.S. District judge in Nashville ruled in March that allowing automobile dealers to mark up the interest rate on car loans generated at the time of sale is inherently discriminatory against minorities and should be banned as a violation of the Equal Credit Opportunity Act.

This decision, though technically limited to Primus Automotive Financial Services, will have a ripple effect throughout the automobile credit market.

By ruling in favor of the plaintiffs in this class action, the court has accepted the theory that allowing automobile dealers to exercise discretion in marking up the rate on loans generated at the dealership is inherently discriminatory. What makes this ruling incongruous, however, is the fact that on no fewer than six previous occasions, federal courts have approved settlement agreements in identical cases against other lenders which expressly permit the continuation of a discretionary markup policy -- the very policy which has now been held to be illegal.

Now more than ever, legislative action is needed to restore predictability and coherence to the automobile finance market and cure yet another abuse of class-action lawsuits.

The ECOA prohibits racial discrimination in lending and allows private parties that are an "aggrieved applicant" for credit to sue in federal court to redress discriminatory practices. Since 1998 nearly a dozen class actions have been filed in the Nashville federal court against lenders involved in automobile financing.

These class actions have had a somewhat checkered history. Although one of the trial courts initially certified a nationwide class of plaintiffs, the U.S. Court of Appeals reversed that certification. The Court of Appeals held that so long as the plaintiffs were seeking money damages or other monetary relief, a class action was inappropriate, because the trial court would have to examine the financing transaction of every class member to determine whether and by how much each borrower had been damaged.

This ruling did not end the litigation. Instead, the plaintiffs' lawyers dropped their demand for money damages and amended their claims to seek only declaratory and injunctive relief. New classes of plaintiffs were certified by the trial courts, and this time the certifications passed the Court of Appeals scrutiny.

Although the plaintiffs' lawyers initially focused on "captive lenders," such as Nissan Motor Acceptance Corp., GMAC, and others, they eventually branched out to banks with portfolios of dealer-generated auto loans. One of those banks, AmSouth, obtained summary judgment in its favor by proving that the named plaintiff's loan had been marked up by less than that dealer's average markup, and that in the month she bought her car, every other customer whose loan had been purchased by AmSouth was white and received an interest rate markup greater than the plaintiff's.

AmSouth's victory demonstrated the fallacy in the plaintiffs' theory that discretionary interest rate



markups by dealers at the time of sale are inherently discriminatory. In response, the plaintiffs' innovative statistics expert retooled his analysis to focus on dealer markup as a dollar amount, rather than as an interest rate. Armed with these new opinions, the class actions against captive lenders and banks continued to progress toward trial.

As cases neared trial, however, settlements were reached. These settlements, which required and obtained court approval, contained certain common features, foremost among them that the practice of discretionary dealer markup was allowed to continue, albeit with a cap on the markup.

The first defendant to settle, Nissan Motor Acceptance Corp., was permitted dealer markups of not more than 3 percentage points above the "buy rate," the interest rate determined by an analysis of objective credit-risk criteria. In another case, the plaintiffs' lawyers agreed that American Honda Finance Corp. could cap the dealer markup at 2.25 points above the buy rate. All the other approved settlements, including the GMAC one, capped the dealer markup at 2.5 points.

In these settlements, the defendants agreed to pay to the plaintiffs' lawyers more than \$32.4 million.

Although the six agreements contain features such as agreed upon disclosure language, "Diversity-Loan Initiatives," and consumer education, the conclusion is inescapable. By paying the plaintiff's trial lawyers over \$32 million, the defendants have been allowed to continue the very practice at the core of the complaint.

It is also ironic that the district judge who approved GMAC's settlement is the same one who tried the Primus case and declared all discretionary dealer markups to be inherently discriminatory and a violation of the ECOA.

Unfortunately, while the Diversity-Loan Initiatives in the settlements were expressly blessed as not violating the ECOA, none of them contain a provision stating that the markup cap creates a safe harbor for the lender.

Therefore, the dealer-generated loan market is faced with an incongruous state of affairs. On no fewer than six occasions courts have implicitly blessed discretionary markups, capped at an amount somewhere between 2.25 and 3 points above the buy rate. However, a court has also determined that the practice of discretionary markup in and of itself is unlawful.

Because of these apparent, contradictory outcomes in similar cases, Congress should amend the ECOA to provide that lenders who purchase dealer-generated loan paper operate in a safe harbor from ECOA liability based upon a disparate impact analysis, so long as the markup does not exceed a stated statutory cap.

This legislation should also clarify that individual customers may still bring lawsuits to remedy actual discrimination they may have suffered from dealer markup irrespective of whether the dealer and lender complied with the cap. What would be removed from the current mix is the possibility of an amorphous "disparate impact" claim for ECOA class actions.

A common-sense change in the law will give dealers and lenders bright lines within which to structure car transactions, and consumers will still have access to the courts to redress injury they may suffer due to unlawful discrimination.

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