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January 9, 1987

ATTORNEY GENERAL OPINION NO. 87- 3

Judith K. Stringer
Consumer Credit Commissioner
217 S.E. 4th Street, 4th Floor
Topeka, Kansas 66603-3501

Re: Consumer Credit Code--Insurance; Insurance in General; Consumer Credit Insurance; Property and Liability Insurance

Synopsis: A creditor may not contract for or receive a separate charge for insurance unless the credit insurance provides a benefit which covers a loss to property related to the credit transaction. Household goods cannot be related to the transaction unless a purchase money credit arrangement is involved. Nor may the creditor be named as a loss payee of a policy which covers all of a consumer's household goods, even though that creditor has a security interest in some of the property covered under the policy. The amount of insurance is limited to the lesser of either the amount of debt or the value of the property insured. If a separate charge is received for credit insurance, before the insurance may be written, the consumer must give an informed, affirmative, written request for the policy. In addition, a creditor may not sell credit insurance to a consumer if he has knowledge that an existing policy gives full coverage of the property related to the transaction, and the credit insurance would therefore be pro-rated. Cited herein: K.S.A. 16a-1-101, 16a-1-102; 16a-2-501; 16a-3-301; 16a-3-302; 16a-4-104; 16a-4-105; 16a-4-106; 16a-4-109; 16a-4-112; 16a-4-202; 16a-4-301;

16a-4-302; 50-626(b)(3); K.A.R. 40-5-8; 40-5-103; 15 U.S.C. §§45, 1605(b); 12 C.F.R. §§227.1; §227.13; §226.4; §226.18; 16 C.F.R. §444.2(a)(4).

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Dear Ms. Stringer:

As Commissioner of the Consumer Credit Commission, you have requested our opinion concerning several aspects of the Consumer Credit Code. Specifically, you inquire into matters involving the sale of insurance against loss to property related to a credit transaction. We address your questions in the order in which they were asked.

(1) In a consumer credit transaction, may creditors insure household goods in which they do not have a security interest?

As you correctly point out, the Federal Trade Commission has determined that a non-possessory security interest in household goods, other than a purchase money security interest (PMSI), is an unfair credit practice within the meaning of Section 5 of the Federal Trade Commission Act, 15 U.S.C. §45. See, 16 C.F.R. §444.1(a)(4). A regulation with nearly identical language appears in 12 C.F.R. §227.13(d), making a security interest in household goods, other than a PMSI, a prohibited act for state member banks. A state member bank is defined as a bank which is chartered by a State and is a member of the Federal Reserve System. 12 C.F.R. §227.1(c). Thus, the general rule is applicable to banks as defined above, to lenders, and to retail installment sellers. (The regulation speaks of non-possessory security interests only. It would appear that a security interest in household goods would be valid if perfected by possession. This distinction might create uncertainty in other jurisdictions. For discussion of possessory security interests in household goods, see 49 Federal Register 7767 (March 1, 1984). However, Kansas laws make the distinction largely irrelevant, as will be discussed below.) Household goods are defined narrowly to include "clothing, furniture, appliances, one radio and one television, linens, china, crockery, kitchen ware, and personal effects (including wedding rings) of the consumer and his or her dependents. . . ." 16 C.F.R. §444 (1)(i). This narrow definition allows the pledging of items which have significant economic value. 49 Federal Register 7767, note 98.

16 C.F.R. §444.1(a)(4), limiting security interests in household goods, was promulgated in recognition that such security interests are used by creditors because of their psychological or punitive effect on debtors' defaulting on loans. 49 Federal Register 7763 (March 1, 1984). Based on our understanding of the Kansas Consumer Credit Code and the federal regulation, it is our opinion that a creditor may not contract for insurance against loss to household goods [as defined at 16 C.F.R. §444(1)(i)] unless the creditor's interest in those goods is the result of a purchase money transaction.

Kansas has adopted the 1974 version of the Uniform Consumer Credit Code (U3C), K.S.A. 16a-1-101 et seq. The U3C contains provisions which are supplemented by the above-mentioned federal rule. While conflicts between the federal and state rules in this area are not common, we feel that it is necessary to note that the Federal Trade Commission Act, and regulations promulgated pursuant thereto, do not prohibit state regulation. The FTCA regulates unfair and deceptive acts or practices in or affecting interstate commerce.

Section 4.301 of the U3C, K.S.A. 16a-4-301, prohibits a creditor from contracting for credit insurance unless "the insurance covers a substantial risk of loss or damage to property related to the credit transaction." K.S.A. 16a-4-301(1)(a). Emphasis should be given the phrase, "property related to the credit transaction." If certain property is not related to the credit transaction, then the statute prohibits a creditor from contracting for insurance on that property. Unless the consumer credit transaction involves a PMSI, the Federal Rules state that property which is categorized as household goods may not be property "related to the credit transaction". (A non-possessory security interest in household goods may not be taken except in the form of a PMSI). State law would therefore prohibit a creditor from contracting for insurance on that property.

1986 Senate Bill No. 454 would have amended K.S.A. 16a-4-301(1) to read: "A creditor may not contract for or receive a separate charge for insurance against loss of or damage to property unless: (a) the insurance covers a substantial risk of loss of or damage to property all or part of which is related to the credit transaction. . . ." (Proposed amended language underscored). Our office was requested to issue an opinion regarding the proposed amendment. In Attorney General Opinion No. 86-42, we noted

that the proposed amendment would conflict with other code provisions. In particular, we expressed concern that, if a creditor could contract for or receive a separate charge for insurance covering property which is not related to the credit transaction, then the consumer might be purchasing insurance which does not confer a benefit of value to him; such practice is in conflict with K.S.A. 16a-2-501. To illustrate, assume that the consumer-debtor is the loss payee on insurance purchased pursuant to a credit transaction. If the insurance covers property which is not related to the transaction; i.e. previously owned goods, and the debtor already has insurance on those goods, such as homeowner's insurance, then the added insurance might be of no value to the consumer. (Part 6 of this opinion discusses the matter further).

Without the proposed additional language, the code does not permit a creditor to contract or receive a separate charge for insurance unless the insurance covers a substantial risk of loss of, or damage to, property related to the credit transaction. Two purposes for this prohibition come to light. First, a debtor should not be led to believe that other property, such as household goods as defined by the federal rules, are subject to the creditor's rights of possession upon default. Secondly, the debtor must receive a benefit which is of value to him when purchasing insurance in a consumer credit transaction. Unless household goods are subject to a PMSI, they cannot be property related to the credit transaction. In addition, the consumer might not receive a benefit which is of value to him if he purchases insurance to cover the non-related goods. It is therefore our opinion that a creditor may not contract or receive a separate charge for insurance to cover household goods in which the creditor does not have a PMSI. In any event, the proposed bill died in the House Committee on Insurance, June 6, 1986. Senate and House Actions Report, Final Report, June 6, 1986, at page 40.

Our opinion to this point is confined to the question you have presented, and should not be read as allowing a security interest in property other than household goods, as dealt with by the F.T.C Rule. Subsection (1) of K.S.A. 16a-3-301, also places some precise limitations on security interests when a consumer transaction is involved. When the federal rule regarding household goods, 16 C.F.R. §444(2)(a)(4), and K.S.A. 16a-3-301(1) are read together, the following rules apply in a consumer credit sale.

(a) A PMSI is valid in all goods.

(b) If services are performed on goods, then a security interest may attach to the goods on which the services were performed if:

(1) the goods are maintained, repaired, or improved as a result of the service,

(2) the debt secured is $300 or more, and

(3) the goods are

(A) not household goods, or

(B) are household goods which are subject to a security interest which is perfected by possession.

(c) If goods are sold and installed, annexed to or improve personal property, then a security interest in the personal property is valid if

(1) the personal property is maintained, repaired, or improved as a result of the improvement, installation, or annexation,

(2) the debt secured is $300 or more, and

(3) the personal property is

(A) not a household good, or

(B) is a household good which is subject to a security interest which is perfected by possession.

(d) If goods are serviced or purchased and affixed to land which is maintained, repaired, or improved by the service or purchase, a security interest may attach to the land when the debt secured is $1000 or more.

(e) If the consumer credit sale involves a valid cross-collateral arrangement, a creditor may take a security interest in goods previously purchased but which are still subject to a previous debt, in order to secure the debt arising from the latter purchase in transactions which involve interstate commerce, but only to the extent that the prior purchase does not involve household goods.

In applying the FTCA, security interests which arise out of a consumer credit sale which do not fit into one of the above categories are void. (There is a possible situation in which the U3C would allow a security interest which the FTCA would not, involving subsection (f) above. For our present purposes, it is not necessary to discuss this situation.) If property does fit into one of the above-listed categories, then it is property which is related to the transaction, and a creditor may contract for insurance on that property.

(2) May the amount of insurance contracted for in relation to a consumer credit transaction be in an amount greater than the value of the personal property in which the creditor has a security interest? May the amount of insurance contracted for in relation to a consumer credit transaction be greater than the amount of the loan or greater than the amount necessary to cover a substantial risk of loss or of damage to property related to the credit transaction?

Limitations on the amount of consumer credit insurance and benefits are provided in K.S.A. 16a-4-202. The statute provides that (with limited exceptions):

> "(a) in the case of consumer credit insurance providing life coverage, the amount of insurance may not initially exceed the debt and, if the debt is payable in installments, may not at any time exceed the greater of the scheduled or actual amount of the debt; or
>
> "(b) in the case of any other consumer credit insurance, the total amount of periodic benefits payable may not exceed the total of scheduled unpaid installments of the debt, and the amount of any periodic benefit may not exceed the original amount of debt divided by the number of periodic installments in which it is payable." K.S.A. 16a-4-202(1).

In short, the statute requires that the coverage not initially exceed the debt, and that coverage decline with the installment schedule. See generally Fonseca, Handling Consumer Credit Cases, Vol. 1, §12:9 (3d ed. 1986).

These provisions focus on the amount of the debt, not on the value of property which is the subject of a security

interest. However, a further limitation appears in K.S.A. 16a-4-301(1)(6), which states that the amount of insurance must be reasonable in relation to the value of the property insured. The practical effect of these limitations become clearer when they are applied to the three possible situations which may arise, each assuming the security interest is valid in light of other consumer oriented statutes. First, the value of the property might equal the initial amount of the debt. In that case, the amount of insurance coverage may coincide with the value of the property. The second situation is where the value of the property exceeds the amount of the debt. In that case, the creditor is oversecured. For example, if the debtor makes a down payment on a household good, the creditor may have a PMSI in the item, the value of which is greater than the actual debt. If the item is not a household good, then the interest need not be a PMSI. In either case, the amount of insurance is limited to the amount of debt. In the event of property loss, the creditor will be fully compensated. The third situation occurs when the creditor is undersecured, where the value of property subject to the security interest is less than the debt. In this case, if the amount of insurance is equal to the amount of debt, the insurance proceeds would exceed the value of the property and a surplus would result. Public policy forbids this result, as a creditor could benefit to a greater extent than the security agreement provides by receiving a surplus, or the debtor would benefit to the extent that he received the surplus. In short, the debtor may have unknowingly contracted for insurance which was not needed or desired. This last situation is covered by the limitation which requires reasonableness in relation to the value of the property insured.

In summary, the U3C limits the amount of insurance in two ways: by amount of debt, and by value of property. It is our opinion that the amount of insurance is limited to the lesser of these two.

(3) May a creditor contract for insurance and be named loss payee on a policy which insures all items of household contents and personal property even though they have a security interest in only a few of the items insured?

This question is very closely related to the first question, in which we opined that a creditor may not insure household goods in relation to a consumer credit transaction unless the creditor has a purchase money security interest in the item(s). Our opinion was premised in part on K.S.A.

16a-4-301(1)(a), which requires that the insurance cover a substantial risk of loss to property related to the transaction. The insurance contract must relate to the goods which are subject to the credit transaction. Based on our previous analysis, it is our opinion that a creditor may not be named loss payee on an insurance policy for which he contracts unless the creditor has a security interest in all the household and personal property items insured.

In addition to K.S.A. 16a-4-301(1)(a), we find support for our conclusion both in the U3C and in the common law. First, K.S.A. 16a-4-302 involves creditors' single interest insurance against loss or damage to property. The statute provides that the risk of loss "is on the consumer only to the extent of any deficiency in the effective coverage of the insurance, even though the insurance covers only the interest of the creditor." K.S.A. 16a-4-302. The 1973 Kansas Comment states that this section prohibits a creditor from receiving a separate charge from the debtor for insurance which covers a creditor's interest in the property unless the debtor also receives the benefit of the insurance. Professor Fonseca explains the practical effect of the section:

> "If a creditor obtains a separate charge for insurance covering property worth more than $300, and the property is destroyed by accident so that the insured pays the proceeds to the creditor, the creditor must first apply the proceeds to the debt, <u>turn over any surplus to the debtor</u>, and proceed against the debtor only if there is a deficiency, even though the insurance covers only the interest of the creditor." (Emphasis added). J. Fonseca, <u>Handling Consumer Credit Case</u>, Vol. 1, §12:11, at 500, (3d ed. 1986).

Both K.S.A. 16a-4-301(1)(a) and 16a-4-302 speak in terms of a creditor contracting for or receiving a separate charge for insurance. While we do not suggest that this language is ambiguous, we do acknowledge that the general purpose of the act is to regulate transactions between creditors and consumers. An argument might be made that a creditor could therefore contract with an insurer, as opposed to a consumer, for insurance on the consumer's personal property, naming the creditor as loss payee on the policy. <u>C.F.</u>, K.S.A. 16a-4-102(b). In short, a scheme could be cleverly devised

whereby the consumer did not become a party to the insurance contract, but indirectly pays for the creditor's protection through higher prices. In such a circumstance, the common law provides authority to prohibit the creditor from devising such a scheme, as the creditor would not have an insurable interest in the property. An insurable interest exists when a person "would profit or gain some advantage by [the property's] continued existence and suffer some loss or disadvantage by its destruction [independent of the insurance benefit]." Price v. Trinity Universal Insurance Co., 8 Kan.App.2d 223, 224 (1983). While the insurable-interest doctrine was not intended to, and indeed would not, be a means of regulating retail prices, its application discourages an attempt by the creditor to obtain the insurance and pass the cost to the consumer, thereby accomplishing indirectly what the statute forbids.

In summary, it is our opinion that a creditor may not be named as loss payee on an insurance policy which insures all items of household contents and personal property belonging to the consumer, when the creditor has a security interest in only some of the items insured, regardless of whether the insurance contract is in connection with or collateral to the actual consumer transaction, and regardless of whether the charge for the insurance is paid by the consumer directly or indirectly.

In addition, you inquire as to whether the policy should specifically name those items insured or the items in which a creditor has a security interest. This area is not specifically dealt with by the code. However, under authority of K.S.A. 16a-4-112, the Commissioner of Insurance has promulgated K.A.R. 40-5-103. Subsection (c) of the rule regulates evidence of coverage. Part (2)(B) states in part that, in addition to other requirements,

> "all policies of insurance issued in connection with a credit transaction or loan shall set forth the kind or kinds of insurance included, the coverages, and all the terms, exceptions, limitations, restrictions, and conditions of the contract or contracts of insurance. Certificates shall contain all provisions of the master policy applicable to the debtor."

We have previously stated that the items insured must coincide with the security interest, so listing the property both as

covered property and as collateral on a debt would result in a redundancy. We believe that K.A.R. 40-5-103(c)(2)(B) requires the listing of insured items in the policy.

(4) What disclosures must be given to the consumer before the insurance is written?

An historical analysis of credit insurance indicates a pattern of abuse by creditors and insurance companies. Fonseca, §12:1 at 484. As we noted in Attorney General Opinion No. 86-42, the FTCA and accompanying regulation Z, as well as the U3C, were established to prevent abusive credit insurance tactics by insuring that consumers have a real choice in the decision to purchase credit insurance. The problem is well summarized by John M. Sheffey:

> "It would be naive to assume that most or even many customers make a conscious decision concerning the desirability and price of insurance, and on the basis of their conclusions, inform the creditor to include or exclude the insurance from the transaction. This possibility is even more remote when the consumers must make their decisions quickly and in the presence of lenders." John M. Scheffey, 8 Fl. St. Univ. L. Rev., 463, 490 (1980).

More generally, Sheffey notes that consumers are likely to have made a decision concerning the purchase itself, and it is unlikely that they will forego the credit merely because the terms of the credit insurance are not favorable. <u>See</u> Sheffey, at 489.

Both the Federal Rule and the U3C have, in some areas, prescribed disclosure statement forms, for example, those relating to door-to-door sales. Both authorities have failed to do so regarding consumer credit insurance, however. The disclosures which are required by both bodies of law are summarized below. We do not intimate that a form disclosure is required, however, it is desirable. What is necessary is that the following information be related to the consumer in such a fashion so as to insure a meaningful choice in the purchase of credit insurance.

(a) If the premiums for credit life, accident, health, or loss-of-income insurance are not included in the finance

charge, and a separate charge is made, the following must be disclosed:

(i) whether the insurance is required by the creditor; and

(ii) the amount of the initial premium, and if the term of the premium is less than the term of the transaction, the term of the insurance; 12 C.F.R. §226.18(n), 12 C.F.R. §226.4(d)(1).

(b) If the premiums for insurance against loss or damage to property are not included in the finance charge, and a separate charge is made, the disclosure must indicate

(i) the consumer may choose the insurer, or substitute an existing policy owned by the consumer, and

(ii) if the coverage is obtained from or through the creditor, the amount of the premium, and if the term of the premium is less than the term of the insurance, then the term of the insurance; 12 C.F.R. §226.18(n), 12 C.F.R. §226.4(d)(1), K.A.R. 40-5-103.

If the premium for insurance is included in the finance charge, the amount of the charge for insurance need not be disclosed, however this does not exempt the creditor from restrictions under any other law, (such as a law pertaining to usury); 1983 Kansas Comment to K.S.A. 16a-4-104.

(c) If vendor's single interest insurance is included in the insurance policy, it must be disclosed that the premium for the coverage has been charged to the mortgagee; K.A.R. 40-5-8.

(d) If more than one insurance plan is offered by the creditor, then the consumer must be informed of all available plans. K.A.R. 40-5-103(a).

In addition, if the creditor agrees to provide insurance, an individual policy or certificate of insurance, or copy thereof, must be delivered to the consumer within 30 days after the term of the insurance commences. K.S.A. 16a-4-105.

While this list is not exhaustive, it covers those requirements relating to disclosures regarding insurance. For other disclosure requirements in consumer contracts, see generally, Regulation Z, 12 C.F.R. 226 and Part 226 Supplement I.

(5) What authorization must be given by the consumer to the lender before insurance is written and what options does the consumer have to deny the purchase of insurance?

Regulation Z, 12 C.F.R. §226.4(d)(iii), states that premiums for credit insurance may be excluded from the finance charge if, among other requirements, the "consumer signs or initials an affirmative written request for the insurance after receiving" the required disclosure. See also, 15 U.S.C. §1605(b). The Board of Governors of the Federal Reserve System has issued two relevant Official Staff Interpretations regarding this rule. In FC-0043, the Board noted that, where the purchase of insurance is strictly voluntary and such is conspicuously disclosed in writing, the intent of the regulation is best served by a separate disclosure statement of the various types of insurance. A separately signed affirmative written authorization for each type of insurance is not required. What is contemplated is that the "signature authorizing insurance coverage be separate from that on the contract document evidencing the credit transaction." 42 Fed.Reg. 9384-85. In FC-0119, the Board noted that no statement is required, such as "'I desire credit life insurance' or 'by signing below, I indicate my desire for credit life insurance'." 42 Fed.Reg. 55881.

No magical words are necessary. What is important is that the consumer must make an informed decision regarding the insurance. If the consumer elects to purchase the insurance, he must do so in a manner which indicates that the choice was informed. This is accomplished by the consumer signing an affirmative request for credit insurance.

The applicable laws do not prohibit a creditor from requiring insurance against loss of or damage to property in order to protect his interest. What is prohibited is an unscrupulous creditor's requiring insurance for a separate charge, whereby the creditor will receive a benefit over and above the benefit received from the credit transaction itself. This is avoided by requiring that the consumer be given certain options when the cost of insurance is separate from the finance charge and by other laws, such as those relating to usury, which protect the debtor. 15 U.S.C. §1605, K.S.A. 16a-4-104.

The option given the consumer when the charge for insurance is separate from the finance charge is to procure insurance from another source, or instead, to offer a policy already in existence. K.S.A. 16a-4-109. If the cost of insurance is

included in the finance charge, we find no authority which allows the consumer to refuse the purchase of the insurance.

(6) May a creditor sell insurance to a consumer knowing that the consumer has full coverage on the property and any loss will be pro-rated by the two companies?

The uniform code and the federal Truth-in-Lending act were responses to abuses by creditors which surfaced when the post-World War II years experienced a boom in the insurance and credit industries. Fonseca, §12 at 484. While the federal act deals with issues of disclosure, the U3C deals with other issues, one of which is unconscionability. Section 4.106 of the code, K.S.A. 16a-4-106, lists factors which are to be considered when determining conscionability. Subsection (a) includes the potential benefits to the consumer. This factor is a reflection of the general requirement that the insurance must cover a substantial risk of loss to property related to the credit transaction. 16a-4-301(1)(a).

If the consumer has insurance already in existence which would cover a loss to property related to the credit transaction, the additional credit insurance might not provide a benefit. (See Part 1 of this opinion). A clause in the credit insurance contract stating that coverage will be pro-rated in the event of other insurance coverage would deny the consumer a material benefit from the credit insurance. If this is done knowingly, the practice may be unconscionable.

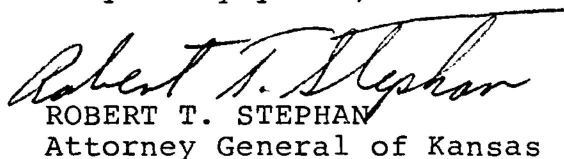
In addition, we believe that the consumer's option of providing insurance through an existing policy, as stated in K.S.A. 16a-4-109, becomes relevant. This section is in substance the equivalent of Regulation Z, 12 C.F.R. §226.4(d)(2)(i). Footnote 6 of the federal regulation states that a creditor may, for reasonable cause, reserve the right to refuse acceptance of the policy offered by the consumer. If the consumer offers existing insurance to cover the loss of property, and the creditor does not accept the policy, to sell credit insurance which will not benefit the consumer would be deceptive. That being the case, the refusal itself may be a deceptive act under the Kansas Consumer Protection Act, K.S.A. 50-626(b)(3), if the creditor knows of the existence of the pro-rata liability clause.

In summary a creditor must give the consumer the option of providing an existing insurance policy. That policy may be refused for reasonable cause. If the refusal is made with the

knowledge that the additional credit insurance contains a pro-rata liability clause, then the practice is deceptive.

In conclusion, it is our opinion that a creditor may not contract for or receive a separate charge for insurance unless the credit insurance provides a benefit which covers a loss to property related to the credit transaction. Household goods cannot be related to the transaction unless a purchase money credit arrangement is involved. The amount of insurance which a creditor may contract for is limited to the lesser of the amount of the debt or the value of the property. If a separate charge is received for credit insurance, a consumer must give an informed, affirmative, written request for insurance before the policy may be written. In addition, a creditor may not sell insurance to a consumer knowing that consumer will not receive a material benefit of the policy because an existing policy covers the property, and the benefits of the credit insurance will be pro-rated.

Very truly yours,



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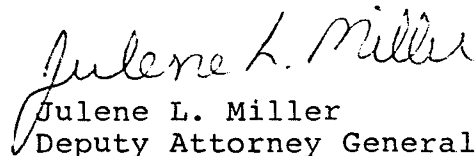

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