

# NOTES

## ACCELERATION AND PREPAYMENT DISCLOSURES UNDER TRUTH IN LENDING: NEMESIS OF THE RULE OF 78'S?

### I. INTRODUCTION

The amount of credit extended in the United States increased tenfold in the quarter century after 1939.<sup>1</sup> As industry more rapidly transformed natural resources into consumer goods, more stable jobs were created, and lenders and sellers more willingly extended unsecured credit to consumers.<sup>2</sup> Although state legislatures expressed their concern with unfair credit practices by enacting usury statutes,<sup>3</sup>

- 
1. The following tables illustrate the growth of consumer credit in the United States:  
*Total Outstanding Consumer Installment Credit*  
(Excluding Real Estate Mortgage Credit)

End of World War I	Less than \$1,000,000,000
End of 1929 (44% is automobile paper)	3,151,000,000
End of 1956 (46% is automobile paper)	31,720,000,000
End of 1963 (41% is automobile paper)	53,745,000,000

*Total Outstanding Consumer Credit*  
(Excluding Real Estate Mortgage Credit)

End of 1939	\$ 7,222,000,000
End of 1956	42,334,000,000
End of 1963	69,890,000,000

B. CURRAN, TRENDS IN CONSUMER CREDIT LEGISLATION 1 n.2 (1965).

2. *Id.* at 1-3. See also I FEDERAL RESERVE SYSTEM BOARD OF GOVERNORS, CONSUMER INSTALLMENT CREDIT 22-24 (1957), cited in CURRAN, *supra* note 1, at 1; Grattan, *Buying on Time: Where Do You Stop?*, HARPER'S MAGAZINE, April 1956, at 73; Warren, *Regulation of Finance Charges in Retail Instalment Sales*, 68 YALE L.J. 839 (1959).

3. Usury has been defined as:

- A loan of money or its equivalent or the forbearance of a debt owed.
- An agreement between the parties that the principal shall be payable absolutely.
- Exaction of a greater amount of interest or profit than is allowed by law.
- Intention to violate or evade the law at the inception of the transaction.

H. SIGMAN, USURY LAWS AND MODERN BUSINESS TRANSACTIONS 16 (1976). Most states have enacted usury laws, and, as of 1975, all but four of fifty-three jurisdictions had

common law time sales remained unregulated.<sup>4</sup> A seller could charge one

---

established maximum rates on realty loans. T. WALL & C. ZWISLER, *SURVEY OF STATE USURY LAWS* ii (1975). For a discussion of the application of usury laws to consumer transactions, see note 4 *infra*.

One state judge expressed the judicial sensitivity to usurious transactions as follows:

Usury has long been recognized as a social and economic evil affecting not only the parties to the transaction but society in general. Being widely regarded thus and condemned by law as well, it is frequently hidden by legalistic devices and cloaked in dissimulation.

*Busk v. Hoard*, 65 Wash. 2d 126, 127, 396 P.2d 171, 171 (1964).

4. The common law's refusal to subject time sales to the usury statutes is one of the more curious developments in legal history. In the earliest case on point, plaintiff claimed a land sale was at a usurious rate of interest. The court held: "The agreement was founded partly upon what was considered the present price of the estate, and partly upon what was considered its price if paid for at a future day." *Beete v. Bidgood*, 108 Eng. Rep. 792, 794 (K.B. 1827). American courts adopted this rule in *Hogg v. Ruffner*, 66 U.S. (1 Black) 115 (1861). Courts approved the time-price doctrine because most purchasers under time-sale contracts were substantial landowners who did not need the protection from usury. See generally 1975 Wis. L. Rev. 246. The following exemplifies judicial refusal to subject time-sales to usury regulation:

The reason [that an installment sale cannot be usurious] is that the statute against usury is striking at and forbidding the exaction or receipt of more than a specified legal rate for the *hire of money* and not of anything else; and a purchaser is not like the needy borrower, a victim of a rapacious lender, since he can refrain from the purchase if he does not choose to pay the price asked by the seller.

*General Motors Acceptance Corp. v. Weinrich*, 218 Mo. App. 68, 78, 262 S.W. 425, 428 (1924) (emphasis in original).

Unfortunately, courts extended the time-price doctrine beyond its original context of land sales and applied it to consumer credit contracts and to purchasers who needed protection from usury. This application of the doctrine allowed the pre-usury regulation problems of debtors to reappear and harass purchasers under consumer time-sale contracts. See B. CURRAN, *supra* note 1, at 2. Consequently, courts developed a number of exceptions to the doctrine. See Warren, *supra* note 2, at 843-51. One early critic attacked the time-price doctrine's exemption from usury regulation in the following terms:

Interest is compensation for the use of money lent. Whatever thing of benefit comes to the lender as compensation for the use of money is interest, no matter what name it may be given or what expedients may be adopted to conceal the fact that the benefit received is, in essence, compensation for the use of the money. No matter how remote a collateral transaction may seem to be, no matter how shrewdly it is made to appear that a payment to the lender is for something else, if the facts, taken together and read in the light of human experience, justify a natural inference that the lender received the benefit because the borrower had the use of his money and as compensation for the use, the benefit is interest.

F. HUBACHEK, *ANNOTATIONS ON SMALL LOAN LAWS* 146-47 (1938).

Even in the face of strong criticism, the time-price doctrine is still in effect in many jurisdictions, at least when the consumer executes a promissory note for the purchase price. See, e.g., *Mandelino v. Fribourg*, 23 N.Y.2d 145, 242 N.E.2d 823, 295 N.Y.S.2d 654 (1968); *Kidd v. J. Walter Bros.*, 212 Va. 197, 183 S.E.2d 140 (1971). The doctrine also applied if the purchaser was offered a choice of two prices at the time of purchase. *McNish v. General Credit Corp.*, 164 Neb. 526, 537, 83 N.W.2d 1, 9-10 (1957), *overruled on other grounds*, *Abel v. Conover*, 170 Neb. 926, 936-37, 104 N.W.2d 684, 692 (1960). *But see Ferguson v. Tanner Dev. Co.*, 541 S.W.2d 483 (Tex. Civ. App. 1976). Many state

price for cash sales and a higher price for time sales at common law<sup>5</sup> because the difference in the two prices, the time-price differential, theoretically resulted from bargaining and risk allocation between two essentially equal parties.<sup>6</sup>

The increased popularity of the installment contract undermined the validity of the time sale's exemption from usury regulation, and some states during the early 1940s began to regulate the amount of the time-price differential.<sup>7</sup> Most consumer credit regulation however, assumes that consumer behavior is intelligently based on available credit information<sup>8</sup> and therefore simply requires full disclosure of all credit terms.<sup>9</sup>

---

statutes treat the time-piece doctrine inconsistently. In Texas, for example, the usury statute exempts the time-price differential from the interest figure. TEX. STAT. ANN. tit. 15, § 5069-1.01(a) (Vernon). On the other hand, Texas installment contract disclosure legislation requires disclosure of the time-price differential. TEX. STAT. ANN. tit. 15, § 5069-6.02(g) (Vernon).

5. See note 4 *supra*.

6. B. CURRAN, *supra* note 1, at 2.

7. The expansion of the automobile industry in the 1920s sparked the growth of consumer credit in the United States, and Indiana responded by passing the first retail installment sales act in 1935, which imposed limits on the amount of the time-price differential. B. CURRAN, *supra* note 1, at 2. However, "retail installment sales contracts remained virtually unregulated in most states until the 1950s." *Id.* By 1950, only ten states had enacted retail installment legislation. *Id.*

Experts soon realized that lenders must be allowed to charge higher rates before they would make the smaller, riskier consumer loans. The Russell Sage Foundation drafted the UNIFORM SMALL LOAN LAW (1916) prior to the adoption of state small loan laws to protect consumers needing small loans from unscrupulous lenders. See generally I BOARD OF GOVERNORS, *supra* note 2, at 22-24; F. HUBACHEK, *supra* note 4.

8. See 54 TEX. L. REV. 652, 653 n.6 (1976). This is the fundamental assumption of the Truth in Lending Act (TILA), 15 U.S.C. §§ 1601-66 (1970 & Supp. V 1975). The Congressional intent to require full disclosure of credit terms is illustrated by the House report on TILA:

Title I, the truth in lending and credit advertising title, neither regulates the credit industry, nor does it impose ceilings on credit charges. It provides for full disclosure of credit charges, rather than regulation of the terms and conditions under which credit may be extended. It is the view of your committee that such full disclosure would aid the consumer in deciding for himself the reasonableness of the credit charges imposed and further permit the consumer to "comparison shop" for credit. It is your committee's view that full disclosure of the terms and conditions of credit charges will encourage a wiser and more judicious use of consumer credit.

H.R. REP. NO. 1040, 90th Cong., 2d Sess. 2, reprinted in [1968] U.S. CODE CONG. & AD. NEWS 1962, 1963.

After examining empirical evidence of consumer behavior, researchers have criticized the effectiveness of full disclosure regulation. See F. JUSTER, ANTICIPATIONS AND PURCHASES: AN ANALYSIS OF CONSUMER BEHAVIOR (1964); Jordan & Warren, *Disclosure of Finance Charges: A Rationale*, 64 MICH. L. REV. 1285, 1320-22 (1966); Kripke, *Consumer Credit Regulation: A Creditor-Oriented Viewpoint*, 68 COLUM. L. REV. 445 (1968) [hereinafter cited as *Consumer Credit*]; Kripke, *Gesture and Reality in Consumer Credit Reform*, 44 N.Y.U.L. REV. 1 (1969) [hereinafter cited as *Gesture and Reality*]; Note,

Thus, the Truth in Lending Act's (TILA)<sup>10</sup> stated purpose is to enhance economic stabilization and competition among financial institutions by requiring the meaningful disclosure of credit terms to consumers.<sup>11</sup>

The most important TILA disclosure is the finance charge,<sup>12</sup> or the actual monetary credit cost, expressed as an annual percentage rate.<sup>13</sup> In

---

*Consumer Legislation and the Poor*, 76 YALE L.J. 745 (1967). Professor Kripke argued that disclosure legislation has no impact on the behavior of impoverished consumers and that upper and middle income consumers had already driven high cost creditors out of the market before the enactment of TILA. See *Gesture and Reality*, *supra*, at 3-9. But see Whitford, *The Functions of Disclosure Regulation in Consumer Transactions*, 1973 WIS. L. REV. 400.

9. See *Haynes v. Logan Furniture Mart, Inc.*, 503 F.2d 1161, 1163 (7th Cir. 1974); 54 TEX. L. REV. 652, 653 (1976).

10. 15 U.S.C. §§ 1601-66 (1970 & Supp V 1975), *as amended* by State Taxation of Depositories Act, Pub. L. No. 94-222, § 3, 90 Stat. 197 (1976) & Consumer Leasing Act of 1976, Pub. L. No. 94-240, 90 Stat. 257.

11. The Congressional purpose is stated as follows:

The Congress finds that economic stabilization would be enhanced and the competition among the various financial institutions and other firms engaged in the extension of consumer credit would be strengthened by the informed use of credit. The informed use of credit results from an awareness of the cost thereof by consumers. It is the purpose of this subchapter to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit.

15 U.S.C. § 1601 (1970). TILA was finally enacted in 1968 after seven years of resistance from the consumer credit industry. Pub. L. No. 90-321, 82 Stat. 146 (1968).

12. The finance charge "shall be determined as the sum of all charges, payable directly or indirectly by the person to whom credit is extended, and imposed directly or indirectly by the creditor as an incident to the extension of credit." 15 U.S.C. § 1605 (1970). The finance charge includes the following charges:

- (1) Interest, time price differential, and any amount payable under a discount or other system of additional charges.
- (2) Service, transaction, activity, or carrying charge.
- (3) Loan fee, points, finder's fee, or similar charge.
- (4) Fee for an appraisal, investigation, or credit report.
- (5) Charges or premiums for [some] credit life, accident, health, or loss of income insurance . . . .
- (6) Charges or premiums for [some] property insurance.
- (7) Premium or other charge for any other guarantee or insurance protecting the creditor against the customer's default . . . .
- (8) Any charge imposed by a creditor upon another creditor for purchasing or accepting an obligation of a customer if the customer is required to pay any part of that charge in cash, as an addition to the obligation, or as a deduction from the proceeds of the obligation.

See 12 C.F.R. § 226.4(a) (1977).

13. The finance charge expressed as an annual percentage rate must be "calculated according to the actuarial method." 15 U.S.C. § 1606(a)(1)(A) (1970). For a discussion of this method, see notes 35-36 *infra* and accompanying text. The statute allows the disclosed annual percentage rate to vary by 1/4% from the actuarial rate. 15 U.S.C. § 1606(c) (1970).

a precomputed<sup>14</sup> installment contract the finance charge includes the total interest to be earned over the life of the loan.<sup>15</sup> When the lender accelerates,<sup>16</sup> or the borrower prepays the contract, a portion of the finance charge will be unearned and must be rebated to the borrower.<sup>17</sup> The Rule of 78's is a widely used method of computing rebates of unearned finance charges due after premature termination by acceleration<sup>18</sup> and voluntary prepayment<sup>19</sup> of precomputed installment contracts.<sup>20</sup> Rule of 78's re-

---

The finance charge, expressed as an annual percentage rate, includes many items that creditors argued were not interest and, therefore, should not be expressed as percentages. *See, e.g.*, R. JOHNSON, *METHODS OF STATING CONSUMER FINANCE CHARGES* 90-96 (1961). This argument assumes that only interest, and not other credit costs, can be meaningfully expressed in percentage terms, but Congress under TILA clearly requires the entire finance charge be expressed in percentage terms. *See* note 12, *supra* for discussion of composition of finance charge.

14. For a discussion of precomputation, *see* note 29 *infra* and accompanying text.

15. *See* note 12, *supra*.

16. An acceleration provision in an installment contract provides that upon the purchaser's failure to make timely payment, the entire amount is immediately due and payable. W. ESTRICH, *THE LAW OF INSTALLMENT SALES* 21 (1926). The acceleration provision may be either mandatory or optional with the creditor. *Id.* *See also* notes 88-91 *infra* and accompanying text.

17. *See* B. CURRAN, *supra* note 1, at 167-69. Pennsylvania's motor vehicle statute is typical of those requiring a refund of unearned finance charges:

Whenever all the time balance is liquidated prior to maturity by prepayment, refinancing or termination by surrender or repossession and re-sale of the motor vehicle, the holder of the installment sale contract shall rebate to the buyer immediately the unearned portion of the finance charge. Rebate may be made in cash or credited to the amount due on the obligation of the buyer.

PA. STAT. ANN. tit. 69, § 622(B) (Purdon 1965).

18. *See* notes 88-92 *infra* and accompanying text.

19. *See* note 20 *infra* and accompanying text. Creditors also use the Rule of 78's to calculate rebates when contracts or loans are consolidated and refinanced. Hunt, *The Rule of 78: Hidden Penalty for Prepayment in Consumer Credit Transactions*, 55 B.U. L. REV. 331, 332 (1975). By refinancing, the outstanding balance is extended over a longer period of time, resulting in greater interest and finance charges. *See* UNIFORM CONSUMER CREDIT CODE § 2.504 [hereinafter cited as U.C.C.C.]; Hunt, *supra* at 332. By consolidation, two or more loans are added together and new finance charges are computed. *See* U.C.C.C. § 2.505; Hunt, *supra* at 332. Professor Hunt also cites *In re Lowell*, Nos. BK-70-1137/38 (S.D. Me. Nov. 20, 1972), in which the court used data indicating that 80% of all small loan transactions involve refinancing or consolidation and that 50% involve four or more consolidations. Hunt, *supra* at 333. If this data is correct, then the Rule of 78's is applied in perhaps the majority of consumer credit transactions, providing a tremendous source of income to creditors. The analysis of prepayment and acceleration rebates in this Note also can be applied to rebates after refinancing and consolidation.

20. Professor Hunt noted that as of 1975, 47 states permitted creditors to compute rebates of unearned finance charges by the Rule of 78's after voluntary prepayment. Hunt, *supra* note 19, at 332. *See also* B. CURRAN, *supra* note 1, at 288-92 (Chart 16); Neifeld, *The Rule of 78's—The Sum of the Digits Method for Computing Refunds*, 13 PERSONAL FINANCE L.Q. Rep. 8 (1958).

bates are invariably smaller than actuarially determined rebates,<sup>21</sup> and consumers claim that the use of the Rule of 78's violates TILA and its implementing<sup>22</sup> Regulation Z.<sup>23</sup>

This Note discusses the Rule of 78's disclosure problems under three subsections<sup>24</sup> of Regulation Z that require disclosure of any penalties resulting from the premature termination of an installment contract. It argues that the Rule of 78's rebate differential,<sup>25</sup> the difference between the Rule of 78's rebate and the actuarial rebate, constitutes a penalty which should be disclosed under TILA and Regulation Z.

## II. PRECOMPUTATION AND THE RULE OF 78'S

In order to understand the disclosure problems caused by premature termination of a precomputed installment contract, one must understand how an installment contract at simple interest is computed.<sup>26</sup> Assume XYZ Company agrees to lend A \$1,000.00 at 12% simple interest. A would receive \$1,000.00 in exchange for a note with a face amount of \$1,000.00 that obligated A to pay \$250.00 in principal each quarter plus accrued interest. A's repayment schedule would be:

Quarter	Repayment at 12% Simple Interest			
	Beginning Principal Balance	Payments	Earned Interest	Ending Principal Balance
1	1,000.00	280.00	30.00	750.00
2	750.00	272.50	22.50	500.00
3	500.00	265.00	15.00	250.00
4	250.00	257.50	7.50	0.00

21. See note 41 *infra*.

22. Congress delegated the following powers to the Federal Reserve Board:

The Board shall prescribe regulations to carry out the purposes of this subchapter. These regulations may contain such classifications, differentiations, or other provisions . . . as in the judgment of the Board are necessary or proper to effectuate the purposes of this subchapter, to prevent circumvention or evasion thereof, or to facilitate compliance therewith.

15 U.S.C. § 1604 (1970). Federal Reserve Board Reg. Z, 12 C.F.R. §§ 226.1-.15 (1977), therefore has the force of law.

23. 12 C.F.R. §§ 226.1-.15 (1977).

24. 12 C.F.R. § 226.8(b)(4), (6), (7) (1977). See notes 55-57 *infra* and accompanying text.

25. See notes 37-52 *infra* and accompanying text.

26. Simple interest is interest computed on the amount of the principal only. D. KIESO & J. WEYGANDT, INTERMEDIATE ACCOUNTING 216 (1974) [hereinafter cited as ACCOUNTING]. It is "the return on (or growth of) the principal for one time period or for each period in a succession of periods at a given rate per period applied to the principal at the beginning of the series." *Id.* at 216-17.

As the principal balance declines, the accrued interest declines proportionately, causing the inconvenience of unequal payments.

The use of compound rather than simple interest allows the borrower to repay in equal installments. Therefore, A's payments would equal \$269.02 per quarter:<sup>27</sup>

Repayment at 12% Compound Interest				
Quarter	Beginning Principal Balance	Payments	Earned Interest	Ending Principal Balance
1	1,000.00	269.02	30.00	760.98
2	760.98	269.02	22.82	514.78
3	514.78	269.02	15.44	261.20
4	261.20	269.02	7.82	0.00

By making equal payments under the compound interest schedule, A pays less during the first two but more during the last two quarters than he would pay under the simple interest schedule. The first quarter compounded interest payment of \$269.02 is \$10.98 less than the first quarter simple interest payment of \$280.00. This difference represents interest earned by XYZ that was not paid by A at the end of the first quarter. Since A's payment is not large enough to cover both the \$250.00 principal payment and the \$30.00 earned interest payment, the \$10.98 interest must be added to the ending principal balance. By increasing the principal in this manner, XYZ can earn interest on interest—*or* compound interest.<sup>28</sup>

27. The loan transaction described in the example is in the form of an annuity. An annuity transaction is characterized by a lump sum cash receipt at the beginning of the term followed by cash prepayments equal in amount and spaced evenly over time. In the example, the face amount of the loan, \$1,000.00, represents the annuity's lump sum cash receipt. Assuming the lender and borrower agree to write the loan at a 12% annual rate of interest, payable quarterly in equal payments, the lender must use the following equation to determine the amount of each quarterly payment:

$$A = \frac{1 - \frac{1}{(1+i)^n}}{i}$$

In the example,  $i = .03$  and  $n = 4$ ;  $i$  represents the interest rate per repayment period (12% annual rate divided by the four repayment periods), and  $n$  represents the number of repayment periods. By solving for  $A$ , the lender calculates the present value of receiving \$1.00 at the end of each of four quarters, discounted at 12%;  $A$  represents the present value per dollar of repayment amount. Because  $A$  multiplied by the repayment amount equals the total present value of the annuity, and the total present value of the annuity must equal the lump sum receipt (which, in this case, equals \$1,000.00), the lender can divide the lump sum cash receipt by  $A$  to arrive at his equal repayment amounts, ( $\$1,000.00/A = \$269.02$ ). See ACCOUNTING, *supra* note 26, at 226.

28. Compound interest is

computed on principal *and* on any interest earned that has not been paid. It is the return on (or growth of) the principal for two or more time periods, assuming that

If A approached XYZ Company for a loan, the repayment terms would probably not resemble either of the examples described above. Instead, XYZ would precompute<sup>29</sup> the loan contract, that is, calculate at the beginning of the contract the total earned compounded interest assuming that payments will be made as due. This total interest figure, representing the precomputed finance charge, is added to the principal to arrive at the face amount of the loan.<sup>30</sup> The face amount is divided by the number of payments to determine the amount of the equal periodic payments.<sup>31</sup> In the example, A would receive \$1,000.00 in return for a note with a face amount of \$1,076.08 that obligated A to make equal quarterly payments of \$269.02. A's repayment schedule would be:

Repayment of Precomputed Loan Contract at 12%

Quarter	Beginning Balance Due	Payments	Ending Balance Due
1	1,076.08	269.02	807.06
2	807.06	269.02	538.04
3	538.04	269.02	269.02
4	269.02	269.02	0.00

The only significant difference between a compound interest loan and a precomputed loan contract is that the compound interest method requires allocation between principal and interest with every payment whereas the allocation is unnecessary in a precomputed loan contract that runs to maturity. If a precomputed contract is prematurely terminated,<sup>32</sup> however, the shortened earning period causes a portion of the interest in the precomputed finance charge to be unearned. Many state statutes require lenders to rebate the unearned portion of the precomputed finance

---

the growth (the interest) in each time period is added to the principal at the end of the period and earns a return in all subsequent periods. Compounding calculates interest not only on the principal but also on the interest earned to date on that principal.

ACCOUNTING, *supra* note 26, at 217 (emphasis in original).

29. Although the consumer credit industry did not seriously advocate precomputation until the 1950s, one author claimed that "we have been precomputing scheduled charges ever since we started using flat payment schedules," in the 1930s. Redfield, *Precomputation—Plain and Fancy*, 12 PERSONAL FINANCE L.Q. REP. 4, 5 (1957) [hereinafter cited as *Plain and Fancy*]. See generally Harper, *A Draftsman Looks at Precomputation*, 12 PERSONAL FINANCE L.Q. REP. 11 (1957); Kline, *Precomputation from Standpoint of a Personal Holding Company, Advertising and Customer Relations*, 14 PERSONAL FINANCE L.Q. REP. 65 (1960); Redfield, *Why Precomputation?*, 14 PERSONAL FINANCE L.Q. REP. 57 (1960) [hereinafter cited as *Precomputation*]; Wetzel, *Earned Income Under Precomputation*, 12 PERSONAL FINANCE L.Q. REP. 7 (1957).

30. See *Plain and Fancy*, *supra* note 29, at 4.

31. *Id.*

32. The premature termination may be by acceleration, prepayment, consolidation, or



charge,<sup>33</sup> and courts in states that have no statutory rebate requirement hold that the creditor's claim for the entire precomputed contract balance violates the usury statutes.<sup>34</sup>

This rebate may be computed according to the actuarial method or the Rule of 78's. The actuarial method, involving a complicated translation of the precomputed contract into the non-precomputed terms of a loan contract at compound interest,<sup>35</sup> provides the only exact method of computing the unearned interest included in the finance charge.<sup>36</sup> As a result, the exact amount of interest earned on the loan can be calculated, and the difference between the earned and precomputed interest is rebated to the debtor.

The Rule of 78's, or the sum-of-the-digits method, is a simplified method of computing unearned finance charge rebates.<sup>37</sup> The Rule uses a fraction by which the total precomputed finance charge is multiplied to allocate properly between earned and unearned interest.<sup>38</sup> The denominator of the fraction is determined by adding the digits representing

---

refinancing. Consolidation and refinancing are defined in note 19 *supra*. Acceleration is defined in note 16 *supra*.

33. See note 17 *supra*.

34. Courts have been particularly sensitive to violations of the usury statutes which often result from a creditor's claim for the entire amount of the precomputed finance charge upon premature contract termination. See, e.g., *Lawrimore v. Sun Fin. Co.*, 131 Ga. App. 96, 205 S.E.2d 110 (en banc), *aff'd*, 232 Ga. 637, 208 S.E.2d 454 (1974); *Lewis v. Termplan, Inc.*, Bolton, 124 Ga. App. 507, 184 S.E.2d 473 (1971). State courts have occasionally held that the creditor's mere demand for the entire contract balance including precomputed finance charges is usurious, notwithstanding his intent to refund the unearned portion of the finance charge. See, e.g., *Moore v. Sabine Nat'l Bank*, 527 S.W.2d 209 (Tex. Civ. App. 1975), *noted at* 54 TEX. L. REV. 652 (1976).

35. One of the disadvantages of the actuarial method for early proponents of the Rule of 78's was the substantial mathematical calculations required for this translation. *Plain and Fancy*, *supra* note 29, at 4; *Precomputation*, *supra* note 29, at 58. The argument has lost its force, however, with the introduction of computers to the credit industry. See note 141 *infra* and accompanying text.

36. See FINANCIAL PUBLISHING COMPANY, FINANCIAL RATE TRANSLATOR 3 (1969); R. JOHNSON, *supra* note 13, at 105-19; Hunt, *supra* note 19, at 332. In 1839 the Supreme Court expressly sanctioned the use of the actuarial method, or U.S. Rule, as the proper method:

The correct rule in general is, that the creditor shall calculate interest whenever a payment is made. To this interest the payment is first to be applied; and if it exceed the interest due, the balance is to be applied to diminish the principal. If the payment falls short of the interest, the balance of interest is not to be added to the principal so as to produce interest.

*Story v. Livingston*, 38 U.S. (13 Pet.) 359, 371 (1839).

37. For a thorough explanation of the Rule of 78's, see Hunt, *supra* note 19.

38. *Id.* at 333-60.

the numbers of the payment periods.<sup>39</sup> Thus, in a 12-month contract, the denominator is the sum of the digits 1 through 12, or 78, and in a four-quarter contract the denominator is the sum of the digits 1 through 4, or 10. The numerator of the fraction is determined by adding the digits representing the payment periods which are vitiated by prepayment.<sup>40</sup> Thus in a 12 month loan, the amount of the unpaid principal balance during the first month is approximately 12/78ths of the sum of the monthly principal balances for the year. Similarly, the unpaid principal balance for the first quarter of a four quarter loan is 4/10ths of the sum of the quarterly principal balances for the year. This ratio also approximates the percent of earned interest on the loan at the end of each period. Thus, if the contract is prepaid in full at the end of the second quarter of a four quarter contract, the numerator is 4 plus 3, or 7. Because 7/10ths of the precomputed interest is earned, or \$53.26, the rebate would be \$22.82.<sup>41</sup> Although A pays \$53.26 in finance charges under the Rule of 78's, he would pay \$52.82 under the actuarial method, a difference of \$.43.<sup>42</sup> Proponents of the Rule of 78's concluded from such examples that the Rule closely approximates the actuarial rebate.<sup>43</sup>

39. *Id.* at 334.  
 40. *Id.* at 334-35.

41. Neifield, *supra* note 20, at 8. The following tables illustrate the operation of the Rule of 78's in the preceding example:

Table 1  
 Rebates of Unearned Finance Charges by Rule of 78's

Prepayment During	Allocation by Rule of 78's	Rule of 78's Rebate
1st Quarter	$4/10 \times \$76.08 = 30.43$	$76.08 - 30.43 = \$ 45.65$
2nd Quarter	$7/10 \times 76.08 = 53.26$	$76.08 - 53.26 = 22.82$
3rd Quarter	$9/10 \times 76.08 = 68.48$	$76.08 - 68.48 = 7.60$
4th Quarter	$10/10 \times 76.08 = 76.08$	$76.08 - 76.08 = 0.00$

Table 2  
 Rebates of Unearned Finance Charges by Actuarial Method

Prepayment During	Actuarial Interest Allocation	Actuarial Rebate
1st Quarter	30.00	$76.08 - 30.00 = \$46.08$
2nd Quarter	52.82	$76.08 - 52.82 = 23.26$
3rd Quarter	68.26	$76.08 - 68.26 = 7.82$
4th Quarter	76.08	$76.08 - 76.08 = 0.00$

Note that the allocations by the Rule of 78's are larger than those by the actuarial method. Thus, the rebate of unearned finance charges is always smaller when computed by the Rule of 78's.

42. See note 41 *supra*.

43. See, e.g., *Bone v. Hibernia Bank*, 493 F.2d 135 (9th Cir. 1974); *Consumer Credit*, *supra* note 8, at 455; Comment, *Rule of 78's and the Required Disclosures Under Regulation Z*, 23 KAN. L. REV. 709, 713 (1975).

Statutes in most states authorize creditors to determine the finance charge rebates under the Rule of 78's.<sup>44</sup> Although aware that the rebate computed by the Rule of 78's was consistently lower than that computed actuarially, creditors and commentators considered the resulting higher yields insignificant.<sup>45</sup> Proponents claimed that the use of precomputation and the Rule of 78's led to improved customer relations, better operating procedures, and improved income.<sup>46</sup>

Subsequent scrutiny of the Rule of 78's revealed its potential for severe inaccuracy in calculating rebates of unearned interest charges when compared with the actuarial method.<sup>47</sup> Although the actuarially determined rebate in our example was only \$.43 higher than that calculated by the Rule of 78's,<sup>48</sup> the Rule of 78's rebate differential increases dramatically as the length of the loan contract<sup>49</sup> and rate of annual interest increase.<sup>50</sup> Additionally, graduated interest rates, allowed by many state statutes, significantly increase the rebate differential.<sup>51</sup> Thus, the rebate computed by the Rule of 78's on a twelve-year, \$10,000.00 loan at twelve percent interest prepaid in the fifty-second month is \$555.91 less than the actuarially determined rebate.<sup>52</sup> Surely the TILA policy of disclosure of credit costs mandates greater judicial sensitivity to

44. See note 20 *supra*.

45. See, e.g., *Consumer Credit*, *supra* note 8, at 455; *Plain and Fancy*, *supra* note 29, at 6.

46. E.g., *Precomputation*, *supra* note 29, at 57.

47. *Scott v. Liberty Fin. Co.*, 380 F. Supp. 475, 479 (D. Neb. 1974). See also notes 49-52 *infra* and accompanying text.

48. See note 42 *supra* and accompanying text.

49. Maximum Error in Rule of 78 as a Percentage of Actuarial Refund

Terms of Indebtedness in Months	12%	24%	36%
24	7.25%	13.55%	19.16%
36	10.69	19.52	26.97
60	17.02	29.67	39.36
84	22.67	37.90	48.60
120	30.07	47.57	58.86
144	34.39	52.68	63.45

Hunt, *supra* note 19, at 344-45.

50. See note 49 *supra*.

51. Hunt, *supra* note 19, at 340, 349. Professor Hunt noted that some of the discrepancy between the actuarial rebate and the Rule of 78's rebate in a state with graduated interest rates is due not to the Rule of 78's, but to the peculiar qualities of graduated interest rates themselves. He stated that

[a]lthough authorization to precompute and use of the Rule of 78 in a graduated rate transaction favors the creditor, authority to precompute and use the actuarial method to determine refunds of unearned finance charges would also be advantageous to the creditor, although to a lesser extent.

52. See 42 Fed. Reg. 45,305 (1977) (to be codified in 24 C.F.R. §§ 201.501, .540, .585,

a procedure which can increase the cost of consumer credit so dramatically.

### III. REBATE DISCLOSURE REQUIREMENTS UNDER THE TRUTH IN LENDING ACT

The primary purpose of the TILA is to require meaningful disclosure of credit terms to enable consumers to compare effectively the offers of their potential lenders.<sup>53</sup> One term particularly relevant to a concerned borrower is the amount of the rebate he will receive after acceleration or prepayment of the loan. As noted above,<sup>54</sup> the Rule of 78's is often used to compute this rebate when the loan is prematurely terminated. Consumers have contended that three subsections of Regulation Z, section 226.8(b), require disclosure of acceleration and prepayment terms, including the Rule of 78's rebate differential. Subsection 226.8(b)(4)<sup>55</sup> requires the lender to disclose the amount, or method of computing the amount, of charges in the event of late payments. Under subsection 226.8(b)(6),<sup>56</sup> the lender must disclose the prepayment penalty charge and describe the method of computing the penalty. Finally, subsection 226.8(b)(7)<sup>57</sup> requires the lender to identify the method of computing unearned finance charges, in the case of precomputation, and the amount or method of computing any deductions from the rebate of the unearned finance charge to the consumer.

---

.680). Because of the degree of error in the Rule of 78's, HUD has prohibited its use to compute rebates on home improvement and mobile home loans. The only acceptable method for this purpose is the actuarial method. *Id.* See also notes 145-48 *infra* and accompanying text.

53. See the Congressional declaration of purpose at note 11 *supra*.

54. See notes 18-20 *supra* and accompanying text.

55. 12 C.F.R. § 226.8(b)(4) (1977) requires disclosure of "[t]he amount, or method of computing the amount, of any default, delinquency, or similar charges payable in the event of late payments."

56. 12 C.F.R. § 226.8(b)(6) (1977) requires:

A description of any penalty charge that may be imposed by the creditor or his assignee for prepayment of the principal of the obligation (such as a real estate mortgage) with an explanation of the method of computation of such penalty and the conditions under which it may be imposed.

57. 12 C.F.R. § 226.8(b)(7) (1977) requires:

Identification of the method of computing any unearned portion of the finance charge in the event of prepayment in full of an obligation which includes precomputed finance charges and a statement of the amount or method of computation of any charge that may be deducted from the amount of any rebate of such unearned finance charge that will be credited to an obligation or refunded to the customer. If the credit contract does not provide for any rebate of unearned finance charges upon prepayment in full, this fact shall be disclosed.

A. *Prepayment Disclosures Under Subsections 226.8(b)(6) and 226.8(b)(7)*

Plaintiffs have challenged the lender's failure to disclose the use of the Rule of 78's on several theories. In *Bone v. Hibernia Bank (Bone I)*,<sup>58</sup> the creditor merely disclosed that a prepayment rebate would be determined by the Rule of 78's. The court held that, under subsection 226.8(b)(7), mere reference by name to the Rule of 78's is insufficient identification of the method of computing the unearned portion of the finance charge.<sup>59</sup> Other courts, relying on the express congressional purpose of the TILA, have similarly held that mere reference by name to the Rule of 78's is not a "meaningful disclosure" under subsection 226.8(b)(7).<sup>60</sup> Plaintiffs have also successfully argued that unearned finance charges not rebated to the borrower because of the inaccuracy of the Rule of 78's represent a prepayment penalty under subsection 226.8(b)(6).<sup>61</sup> In *Kenney v. Landis Financial Group, Inc.*,<sup>62</sup> the court held that mere reference by name to the Rule of 78's is not a sufficient description or explanation of the method of computing the prepayment penalty charge as required by subsection 226.8(b)(6). Other cases focused on the effect of the difference between the Rule of 78's rebate and the actuarial rebate: when added to the earned portion of the finance charge, the unearned finance charge increases the actual annual percentage rate beyond the disclosed percentage rate.<sup>63</sup>

---

58. 5 CONS. CRED. GUIDE (CCH) ¶ 99,025 (N.D. Cal. 1972), *rev'd*, 493 F.2d 135 (9th Cir. 1974).

59. *Id.*

60. *See, e.g.*, *Johnson v. Associates Fin. Inc.*, 369 F. Supp. 1121 (S.D. Ill. 1974); *Richardson v. Time Premium Co.*, 5 CONS. CRED. GUIDE (CCH) ¶ 99,272 (S.D. Fla. 1971).

61. *See, e.g.*, *Evans v. Household Fin. Corp.*, 5 CONS. CRED. GUIDE (CCH) ¶ 98,678 (S.D. Iowa, 1974); *Kenney v. Landis Financial Group, Inc.*, 349 F. Supp. 939 (N.D. Iowa 1972), *rev'd in part on rehearing*, 376 F. Supp. 852 (N.D. Iowa 1974). *Cf. Scott v. Liberty Fin. Co.*, 380 F. Supp. 475 (D. Neb. 1974) (Rule of 78's rebate differential is a prepayment penalty under subsection 226.8(b)(7) but not under subsection 226.8(b)(6)).

62. 349 F. Supp. 939 (N.D. Iowa 1972), *rev'd in part on rehearing*, 376 F. Supp. 852 (N.D. Iowa 1974).

63. This argument is based on 15 U.S.C. § 1606(c) (1970) and 12 C.F.R. § 226.5(b)(1) (1977), which require the annual percentage rate to be rounded to the nearest quarter of one percent. The validity of the argument depends, however, on inclusion of the Rule of 78's rebate differential in the finance charge from which the annual percentage rate is calculated. A majority of district courts find the argument unpersuasive. *See, e.g.*, *Hamilton v. G.A.C. Fin. Corp.*, 5 CONS. CRED. GUIDE (CCH) ¶ 98,804 (N.D. Ga. 1974). The usual reason for rejecting it is that 12 C.F.R. § 226.6(g) (1977) vitiates the effect of inaccuracies caused by occurrences subsequent to delivery of the required disclosures.

The Federal Reserve Board (FRB) responded to these decisions in 1974 by issuing an official interpretation of subsections 226.8(b)(6) and 226.8(b)(7).<sup>64</sup> The FRB stated that subsection 226.8(b)(6) applies only to non-precomputed contracts, and not to rebate disclosure actions.<sup>65</sup> Under this interpretation, consumers can no longer argue, as in *Kenney*, that a lender's use of the Rule of 78's without explaining its method of computation imposes a prepayment penalty requiring disclosure under subsection 226.8(b)(6). Secondly, the FRB stated that subsection 226.8(b)(7) only requires the identification of the *rebate method* used on precomputed contracts even though the statute refers specifically to the *method of calculating unearned finance charges*, and that this "requirement of rebate 'identification' is satisfied simply by reference by name to the 'Rule of 78's' or other method, as applicable."<sup>66</sup> The FRB reasoned that a proper explanation of the Rule of 78's involves complex mathematical

---

*See, e.g.,* Burrell v. City Dodge, Inc., 4 CONS. CRED. GUIDE (CCH) ¶ 98,764 (N.D. Ga. 1974). The Rule of 78's rebate differential defies inclusion in the finance charge because the differential amount is not determined until the contract is prepaid. The subsequent occurrence argument therefore disposes of the finance charge issue. The other subsection 226.8(b)(7) and 226.8(b)(4) arguments, discussed in notes 58-115 *infra* and accompanying text, are unaffected by the subsequent occurrence argument. Practically all of the disclosures required by 12 C.F.R. § 226.8 (1977) involve occurrences subsequent to disclosure.

64. 12 C.F.R. § 226.818 (1977) provides in pertinent part:

(b) Section 226.8(b)(6) relates only to charges assessed in connection with obligations which do not involve precomputed finance charges included in the obligation. It applies to transactions in which the finance charge is computed from time to time by application of a rate to the unpaid principal balance. Prepayment penalties which require disclosure under this section (which principally arise in connection with prepayment of real estate mortgages) occur when the obligor in such a transaction is required to pay separately an additional amount for paying all or part of the obligation before maturity. On the other hand, § 226.8(b)(7) is designed to encompass the disclosures necessary with regard to the prepayment of an obligation involving precomputed finance charges which are included in the face amount of the obligation. Therefore, although in a precomputed obligation the finance charge rebate to a customer may be less when calculated according to the "Rule of 78's," "sum of the digits," or other method than if calculated by the actuarial method, such difference does not constitute a penalty charge for prepayment that must be described pursuant to § 226.8(b)(6).

(c) Section 226.8(b)(7) requires "identification" of the rebate method used on precomputed contracts. Many State statutes provide for rebates of unearned finance charges under methods known as the "Rule of 78's" or "sum of the digits" or other methods. In view of the fact that such statutory provisions involve complex mathematical descriptions which generally cannot be condensed into simple accurate statements, and which if repeated at length on disclosure forms could detract from other important disclosures, the requirement of rebate "identification" is satisfied simply by reference by name to the "Rule of 78's" or other method, as applicable.

65. *Id.*

66. *Id.*

descriptions which, "if repeated at length on disclosure forms, could detract from other important disclosures."<sup>67</sup>

The Ninth Circuit responded to the FRB's new interpretation by reversing *Bone I* in *Bone v. Hibernia Bank (Bone II)*.<sup>68</sup> The court believed that the Rule of 78's is accurate and closely approximates the actuarial method.<sup>69</sup> Secondly, it noted that the identification requirement in subsection 226.8(b)(7) is less stringent than the description and explanation requirements in subsection 226.8(b)(6), and is satisfied simply by referring by name to the Rule of 78's.<sup>70</sup> Thirdly, the court deferred to the agency's expertise and gave presumptive effect to the new interpretation.<sup>71</sup> Finally, the court rejected the consumer's argument that the rebate differential caused by the operation of the Rule of 78's creates an unacceptable variation in the annual percentage rate.<sup>72</sup>

Other courts, however, rejected the FRB's new interpretation.<sup>73</sup> In *Scott v. Liberty Finance Co.*,<sup>74</sup> the debtor prepaid his precomputed note and received a rebate determined by the Rule of 78's, which was identified by name only in the disclosure statement. The district court reasoned that because both subsections 226.8(b)(6) and 226.8(b)(7) require disclosure of prepayment penalties, they should be construed together.<sup>75</sup> Subsection 226.8(b)(7) requires two disclosures: (1) identification of the method used to determine unearned finance charges and, (2) a statement of the amount or method of computing any charge which the creditor will deduct from the unearned finance charge rebate.<sup>76</sup> The identification disclosure is only a preliminary step which has no independent value to the consumer in comparing credit terms.<sup>77</sup> A meaningful

---

67. *Id.*

68. 493 F.2d 135 (9th Cir. 1974).

69. *Id.* at 137.

70. *Id.* at 138.

71. *Id.* at 139-40.

72. *Id.* at 140-41. The court stated that "[o]therwise, subsequent events such as late payment charges, Christmas deferrals or prepayment of the obligation, would each require a recomputation of the annual percentage rate. This result would be entirely unwieldy and impractical." *Id.* at 141. *See also* note 63 *supra*.

73. *See* *Scott v. Liberty Fin. Co.*, 380 F. Supp. 475 (D. Neb. 1975).

74. *Id.*

75. *Id.* at 477. Actually, nothing in the official interpretation, 12 C.F.R. § 226.818, precludes this parallel construction. Restricting subsection 226.8(b)(6) to non-precomputed contracts does not logically preclude the finding of similar disclosure policies underlying subsections 226.8(b)(6) and 226.8(b)(7).

76. 380 F. Supp. at 477-78.

77. *Id.* at 477.

comparison of competing credit terms can only be made after the lender discloses the amount that will be deducted from the unearned finance charge rebate.<sup>78</sup>

The *Scott* court refused to accept the Rule of 78's as a method of computing unearned finance charges,<sup>79</sup> and held that these charges may be calculated only by using the actuarial method, or a close approximation thereof.<sup>80</sup> The court, relying on subsection 226.5(b)(1),<sup>81</sup> which requires that the disclosed annual percentage rate be within one quarter percent of the actual finance charge expressed as an annual percentage rate, concluded that the Rule of 78's does not closely approximate the actuarial method;<sup>82</sup> rather, the Rule results in rebate errors that vary between 1.3% and 27.6% of the correct actuarial rebate.<sup>83</sup> Although the creditor may have adequately disclosed the annual percentage rate of the finance charge, the rebate differential caused by the Rule of 78's was larger than the allowable percentage rate variation from the actual finance charge under subsection 226.5(b)(1).<sup>84</sup>

The *Scott* court also found a violation of the second required disclosure under subsection 226.8(b)(7). The court rejected the FRB's official interpretation which required that the creditor only disclose the rebate method by name,<sup>85</sup> and held that subsection 226.8(b)(7) mandated dis-

78. *Id.*

79. The court stated:

It is readily apparent that the rule of 78's does not, in fact, compute unearned finance charge and that if, upon prepayment of the obligation, the amount of the rebate of unearned finance charge is based upon the rule of 78's, the rebate will be less than the unearned finance charge. In other words, the rebate of unearned finance charge based on the rule of 78's imposes a prepayment penalty on the consumer.

*Id.* at 478.

80. After concluding that the Rule of 78's does not compute unearned finance charges, the court indicated that it might accept the Rule of 78's if it, in fact, closely approximated the actuarial method. *Id.* The *Scott* decision differs from *Bone II*, therefore, only in its conception of the degree of inaccuracy involved in use of the Rule of 78's.

81. 12 C.F.R. § 226.5(b)(1) is the Regulation Z counterpart of 15 U.S.C. § 1606(c) (1970). See also note 63 *supra*.

82. 380 F. Supp. at 478.

83. The court *sua sponte* drew up its own tables to demonstrate the inaccuracies of the Rule of 78's. *Id.* at 480-81. These tables are similar to those at notes 41 & 49 *supra*. In the transaction before the *Scott* court, prepayment in the first month caused a Rule of 78's rebate 1.3% smaller than the actuarial rebate, while prepayment in the twenty-third month caused a Rule of 78's rebate 27.6% smaller than the actuarial rebate. 380 F. Supp. at 481.

84. 380 F. Supp. at 479.

85. See note 64 *supra*.



closure of the method of computing unearned finance charges.<sup>86</sup> *Scott* refused to equate rebate with unearned finance charge, and held that the Rule of 78's rebate differential is a prepayment penalty which the creditor had not disclosed in violation of the second requirement of subsection 226.8(b)(7).<sup>87</sup>

Therefore, two views remain concerning the rebate disclosure requirement of subsection 226.8(b)(7) for voluntary prepayments. On the one hand, *Bone II* and the FRB require only that the creditor refer to the Rule of 78's by name. The *Scott* court, on the other hand, requires the creditor to disclose the rebate differential if the Rule of 78's does not closely approximate the actuarial method.

#### B. *Acceleration Disclosure Under Subsections 226.8(b)(4) and 226.8(b)(7)*

The disclosure problems caused by a creditor's acceleration of a contract are closely related to those caused by prepayment. Most consumer contracts contain a clause granting the creditor a right of acceleration, that is, to declare the entire unpaid amount of the loan due and payable immediately, upon the customer's default or delinquency.<sup>88</sup> Some accelerating creditors demand the principal plus accrued interest, while others demand the entire unpaid balance of the note.<sup>89</sup> If, despite the acceleration, the debtor waits until the maturity date to pay the balance of the contract, no unearned finance charges result from the acceleration.<sup>90</sup> If the debtor pays an accelerated contract prior to its maturity, however, some of the precomputed finance charges are unearned.<sup>91</sup> Many state statutes permit creditors to use the Rule of 78's to compute the rebates on loans prematurely paid after acceleration.<sup>92</sup> In

---

86. 380 F. Supp. at 477.

87. *Id.* at 479.

88. *Martin v. Commercial Sec. Co.*, 539 F.2d 521, 524 (5th Cir. 1976).

89. *Compare* *Martin v. Commercial Sec. Co.*, 539 F.2d 521 (5th Cir. 1976), *with* *Johnson v. McCrackin-Sturman Ford, Inc.*, 527 F.2d 257 (3d Cir. 1975), *and* *Thompson v. Twin City Fin. Corp.*, 409 F. Supp. 924 (W.D. La. 1976).

90. If the debtor falls behind in his payment schedule, actual accrued interest may exceed that which was precomputed.

91. *See, e.g.*, *Perry v. Liberty Consumer Discount Co.*, 433 F. Supp. 1352 (E.D. Pa. 1977); *Burley v. Bastrop Loan Co.*, 407 F. Supp. 773 (W.D. La. 1976).

92. The Pennsylvania Banking Code is typical:

*Rebate of unearned charges*—In the event of payment or refinancing of the balance of a loan prior to maturity the institution shall pay or credit a refund of the unearned portion of the charge made pursuant to subsection (a) of this section in an amount which shall be at least the amount computed, for the unexpired period to the date of scheduled maturity, by the accounting method

these states, the Rule of 78's presents acceleration disclosure problems similar to those caused by applying the Rule to voluntary prepayments.

Courts and the FRB have taken five positions concerning the disclosures required of an accelerating creditor. In *Garza v. Chicago Health Clubs, Inc.*,<sup>93</sup> an important early case, the court interpreted subsection 226.8(b)(4), which requires the disclosure of "default, delinquency, or similar charges."<sup>94</sup> Although the contract provided for acceleration, the creditor had not disclosed this right in the disclosure statement. The district court rejected plaintiff's argument that payment pursuant to acceleration is essentially prepayment and thereby subject to disclosure under subsections 226.8(b)(6) and 226.8(b)(7).<sup>95</sup> Nevertheless, the court agreed with plaintiff's second argument and held that the creditor's right to accelerate is a subsection 226.8(b)(4) "charge."<sup>96</sup> The Rule of 78's rebate differential was not an issue in *Garza* because the court considered only disclosure of the creditor's right to accelerate under subsection 226.8(b)(4). Although several federal courts agree with *Garza*,<sup>97</sup> a greater number have not been persuaded by its reasoning.<sup>98</sup> Thus the Fifth

---

known as 'the sum of the digits' or 'the rule of 78' except that no such refund shall be required in an amount less than one dollar (\$1) or in any amount until the institution has received a minimum charge of five dollars (\$5) for the loan.

PA. STAT. ANN. tit. 7, § 309(g) (Purdon 1967).

93. 347 F. Supp. 955 (N.D. Ill. 1972).

94. See note 55 *supra*.

95. 347 F. Supp. at 959. The court dealt with both subsections 226.8(b)(6) and 226.8(b)(7), because the FRB had not yet issued its official interpretation, 12 C.F.R. § 226.818, which confines subsection 226.8(b)(6) to non-precomputed contracts.

96. 347 F. Supp. at 959. The Ninth Circuit, in *LaGrone v. Johnson*, 534 F.2d 1360 (9th Cir. 1976), apparently adopted a *Garza* approach to acceleration clauses. The *Garza* acceleration clause called for automatic acceleration of the entire note upon default by the customer. Courts have reached the *Garza* result in other fact situations. In *Pugh v. American Tractor Trailer Training, Inc.*, 5 CONS. CRED. GUIDE (CCH) ¶ 98,827 (D. Conn. 1974), the court required disclosure of an optional acceleration clause. See generally Rumsey, *Truth-in-Lending: Congress Reacts to the Creditors' Dilemma*, 24 EMORY L.J. 379 (1975).

97. See *Rivera v. Dick McFeely Pontiac, Inc.*, 431 F. Supp. 506 (N.D. Ill. 1977) (optional acceleration term imposes a "charge" in absence of acceleration rebate provisions); *Burley v. Bastrop Loan Co.*, 407 F. Supp. 773 (W.D. La. 1976) (acceleration is a "charge"); *Woods v. Beneficial Fin. Co.*, 395 F. Supp. 9 (D. Ore. 1975) ("meaningful disclosure" requires acceleration to be disclosed); *Pollock v. Avco Fin. Servs., Inc.*, 5 CONS. CRED. GUIDE (CCH) ¶ 98,766 (N.D. Ga. 1974) (Recommendations of Special Master) (acceleration is a "charge"); *Pugh v. American Tractor Trailer Training, Inc.*, 5 CONS. CRED. GUIDE (CCH) ¶ 98,827 (D. Conn. 1974) (acceleration may effectively increase cost of credit extended); *Hall v. Sheraton Galleries*, 5 CONS. CRED. GUIDE (CCH) ¶ 98,737 (N.D. Ga. 1974) (acceleration is a "charge," and its disclosure is essential to "meaningful disclosure").

98. See *Martin v. Commercial Sec. Co.*, 539 F.2d 521 (5th Cir. 1976) (acceleration of

Circuit, in *Martin v. Commercial Securities Co.*,<sup>99</sup> held that a creditor's right to accelerate and demand the entire face amount of the note, including unearned finance charges, is not a subsection 226.8(b)(4) "charge" requiring disclosure.<sup>100</sup>

Although the *Martin* and *Garza* courts reach opposite results, they agree that acceleration and prepayment do not represent analogous TILA disclosure problems. The cases are also similar in their analytical focus on the right of acceleration, rather than on the potential impact of this right on the cost of credit to the customer.<sup>101</sup>

The FRB and the courts in *Johnson v. McCrackin-Sturman Ford, Inc.*<sup>102</sup> and *Burley v. Bastrop Loan Co.*<sup>103</sup> take intermediate positions regarding disclosure of costs of acceleration. They recognize that acceleration and prepayment may similarly affect credit costs and attempt to adjust the TILA disclosure requirements to the credit cost variations caused by acceleration. The FRB stated in Staff Opinion Letter No. 851,<sup>104</sup> that the accelerating creditor imposed no subsection 226.8(b)(4) "charge" so long as he rebated unearned finance charges using the

---

entire balance, including unearned finance charges, need not be disclosed.); *Grant v. Imperial Motors*, 539 F.2d 506 (5th Cir. 1976) (accord with *Martin*); *Johnson v. McCrackin-Sturman Ford, Inc.*, 527 F.2d 257 (3d Cir. 1975) (acceleration need not be disclosed if creditor required by state law to refund unearned finance charges); *Ecenrode v. Household Fin. Corp.*, 422 F. Supp. 1327 (D. Del. 1976) (acceleration is not a "charge" as long as creditor computes acceleration rebate by same method as voluntary prepayment rebates under 12 C.F.R. § 226.8(b)(7) (1977)); *St. Germain v. Bank of Hawaii*, 413 F. Supp. 587 (D. Hawaii 1976) (acceleration is an optional "subsequent occurrence" and need not be disclosed); *Morris v. First Nat'l Bank*, 5 CONS. CRED. GUIDE (CCH) ¶ 98,568 (N.D. Ga. 1975) (acceleration is not a "charge," and annual percentage rate variation provision not violated because acceleration is a "subsequent occurrence").

99. 539 F.2d 521 (5th Cir. 1976). *But see* *Rivera v. Dick McFeely Pontiac, Inc.*, 431 F. Supp. 506 (N.D. Ill. 1977); *cf.* *Ecenrode v. Household Fin. Corp.*, 422 F. Supp. 1327 (D. Del. 1976) (failure to disclose acceleration term when unearned finance charges are not to be rebated states a claim upon which relief may be granted).

100. The Tenth Circuit followed *Martin* in *Begay v. Ziems Motor Co.*, 550 F.2d 1244 (10th Cir. 1977).

101. Although the issue of whether the acceleration clause should itself be disclosed is an important one, the focus of this Note is on the narrower issue of whether the Rule of 78's rebate differential produced by premature payment after acceleration should be disclosed under TILA. For the most recent discussions of the former issue, see Comment, *Acceleration Clause Disclosure Under the Truth in Lending Act*, 77 COLUM. L. REV. 649 (1977), and Note, *Truth in Lending—Failure to Disclose a Right of Acceleration Held Not a Violation*, 55 N.C.L. REV. 344 (1977).

102. 527 F.2d 257 (3d Cir. 1975).

103. 407 F. Supp. 773 (W.D. La. 1976).

104. 4 CONS. CRED. GUIDE (CCH) ¶ 31,173 (Oct. 22, 1974), which reads in pertinent part:

method disclosed under the first part of subsection 226.8(b)(7) for voluntary prepayment. The FRB subsequently issued Official Staff Interpretation No. FC-0054,<sup>105</sup> limiting the effect of Letter No. 851 to situations in which premature *payment* was made pursuant to acceleration. The FRB reasoned that such payment is "essentially the same" as a voluntary prepayment under subsection 226.8(b)(6).<sup>106</sup> Since the Rule of 78's rebate differential is undisclosed under subsection 226.8(b)(7) for voluntary prepayment, it is similarly undisclosed under subsection 226.8(b)(4) for prepayment after acceleration.<sup>107</sup>

---

For the purposes of Truth in Lending disclosures, this staff views an acceleration of payments as essentially a prepayment of the contract obligation. As such, the disclosure provisions of § 226.8(b)(7) of the Regulation, which require the creditor to identify the method of rebating any unearned portion of the finance charge or to disclose that no rebate would be made, apply. If the creditor rebates under one method for acceleration and another for voluntary prepayment, both methods would need to be identified under § 226.8(b)(7). Failure to disclose the method of rebate or nonrebate would be a violation of the Truth in Lending Act.

If, under the acceleration provision, a rebate is made by the creditor in accordance with the disclosure of the rebate provisions of § 226.8(b)(7), we believe that there is no *additional* "charge" for late payments made by the customer and therefore no need to disclose under the provisions of § 226.8(b)(4). On the other hand, if upon acceleration of the unpaid remainder of the total of payments, the creditor does not rebate unearned finance charges in accordance with the rebate provisions disclosed in § 226.8(b)(7), any amounts retained beyond those which would have been rebated under the disclosed rebate provisions represent a "charge" which should be disclosed under § 226.8(b)(4).

*Id.*

105. 5 CONS. CRED. GUIDE (CCH) ¶ 31,552 (Mar. 21, 1977).

You ask whether a creditor's *right* of acceleration upon default by the obligor must be disclosed as a default, delinquency, or late payment charge within the context of § 226.8(b)(4). It is the staff's opinion that the phrase "default, delinquency, or similar charges in the event of late payments," [sic] found in § 128(a)(9) and § 129(a)(7) of the Truth in Lending Act and § 226.8(b)(4) of Regulation Z, refers to specific sums assessed against a borrower solely because of failure to make payments when due. It is staff's opinion that the mere right to accelerate contained in a contractual provision which sets out the creditor's right to accelerate the entire obligation upon a certain event (generally the obligor's failure to make a payment when due) is not a *charge* payable in the event of late payment. Therefore, it need not be disclosed under § 226.8(b)(4).

You refer to a prior Public Information Letter, No. 851, which discusses the right of acceleration. Staff believes that letter addresses a different issue than the one posed in your letter. Staff understands that letter to say that early *payment* of the balance of a precomputed finance charge obligation by a customer upon acceleration by the creditor is essentially the same as a prepayment of the obligation. Therefore, if the creditor does not rebate unearned finance charges in accordance with the rebate provisions disclosed under § 226.8(b)(7) when the customer pays the balance of the obligation upon acceleration, any amounts retained beyond those which would have been rebated under the disclosed rebate provisions do represent the type of charge that must be disclosed under § 226.8(b)(4).

*Id.*

106. *Id.*

107. *Id.*

The Third Circuit, in *Johnson v. McCrackin-Sturman Ford Inc.*, adopted a position similar to the FRB and held that the accelerating creditor did not impose any subsection 226.8(b)(4) "charges" on the debtor as long as state law required him to refund the unearned finance charges.<sup>108</sup> The *Johnson* court noted, however, that it would have found a subsection 226.8(b)(4) "charge" if the borrower had been required to pay any amounts in addition to the unpaid principal.<sup>109</sup> If the Third Circuit had scrutinized Pennsylvania law more closely, it would have discovered that a state statute authorized use of the Rule of 78's to compute unearned finance charge rebates.<sup>110</sup> It is logical to conclude that the Third Circuit would have found a subsection 226.8(b)(4) "charge" in the amount of the rebate differential if it had understood the inaccuracy of the Rule of 78's.

Finally, the district court in *Burley v. Bastrop Loan Co.* held that an accelerating creditor imposed a subsection 226.8(b)(4) "charge" on the customer in the amount of the Rule of 78's rebate differential, even though a state law authorized use of the Rule of 78's for computing unearned finance charge rebates.<sup>111</sup> The *Burley* court, relying heavily on *Scott's* analysis of the Rule of 78's,<sup>112</sup> held that under certain circumstances acceleration and prepayment present similar TILA disclosure problems,<sup>113</sup> and that the Rule of 78's rebate differential is an added credit cost which must be disclosed under subsections 226.8(b)(4) and

---

108. 527 F.2d 257, 266 (3d Cir. 1975).

109. The court stated:

[A]ll the borrower need pay upon acceleration is the unpaid portion of the principal obligation . . . . If McCrackin-Sturman had exercised its right to accelerate payment, it would have been required under Pennsylvania law to rebate immediately to plaintiffs the entire unearned portion of the finance charge. Plaintiffs would have been obligated to pay only the unpaid principal.

*Id.* at 265 (footnotes omitted).

110. The applicable Pennsylvania statute provides:

The unearned finance charge to be rebated to the buyer shall represent at least as great a proportion of the total finance charge as the sum of the periodical time balances after the date of prepayment bears to the sum of all the periodical time balances under the schedule of payments in the original agreement: Provided, however, the holder shall not be required to rebate any portion of such unearned finance charge which results in a net minimum finance charge on the contract less than ten dollars (\$10.00); And provided further, the holder shall not be required to rebate any unearned finance charge when the amount due, computed as herein set forth, is less than one dollar (\$1.00).

PA. STAT. ANN. tit. 69, § 622(C) (Purdon 1965).

111. 407 F. Supp. 773, 781 (W.D. La. 1976).

112. See notes 74-87 *supra* and accompanying text.

113. The view that acceleration and prepayment raise related TILA issues is not shared by all courts. In *Martin v. Commercial Sec. Co.*, 539 F.2d 521 (5th Cir. 1976), the Fifth

(7).<sup>114</sup> Although the Fifth Circuit's opinion in *Martin* has effectively overruled *Burley*,<sup>115</sup> the case merits discussion as a viable and persuasive alternative.

#### IV. ANALYSIS

Although there are legal and conceptual differences between acceleration and prepayment, premature payment of a loan pursuant to acceleration imposes an added credit cost on the borrower similar to that of prepayment if the creditor computes the rebate according to the Rule of 78's.<sup>116</sup> The several intermediate acceleration positions noted above<sup>117</sup> recognize that acceleration may result in an added *cost* of credit to the customer. The FRB and the *Johnson* and *Burley* courts disagree, however, over how to treat the Rule of 78's rebate differential.<sup>118</sup> The FRB approach to acceleration, consistent with its treatment of prepayment, does not require disclosure of the rebate differential.<sup>119</sup> The *Burley* court, on the other hand, followed the *Scott* analysis for disclosure of the prepayment rebate differential and requires subsection 226.8(b)(4) disclosure of this rebate differential.<sup>120</sup> The *Johnson* court recognized the

---

Circuit rejected both FRB Opinion Letter No. 851 and Interpretation FC-0054 because of their similar treatment of voluntary prepayment under subsection 226.8(b)(7) and prepayment pursuant to acceleration under subsection 226.8(b)(4). The court stated:

[W]e . . . can not accept the [FRB] staff's interpretation of . . . 226.8(b)(4) and 226.8(b)(7). With deference, we find its one-sentence conclusion that an acceleration of payments is essentially a prepayment of the contract obligation to be an analytical construction of regulatory intent which has not been expressed in language that "all who run may read." In the installment credit context prepayment and acceleration appear to be conceptually antithetical. The former is the unilateral act of the debtor; the latter the unilateral act of the creditor in the typical installment contract.

*Id.* at 529 (footnote omitted). *But see* *Chapman v. Rhode Island Hosp. Trust Nat'l Bank*, 46 U.S.L.W. 2399 (D.R.I. Feb. 7, 1978); *Begay v. Ziems Motor Co.*, 550 F.2d 1244, 1249 (10th Cir. 1977) (Holloway, J., dissenting).

114. 407 F. Supp. at 781.

115. By holding that the acceleration term need not be disclosed despite the creditor's claim for unearned finance charges, the Fifth Circuit has a fortiori foreclosed the argument that the Rule of 78's rebate differential should be disclosed. *Martin* is arguably inconsistent with the clearly expressed congressional intent to require full disclosure of credit costs to consumers. *See* notes 8 & 11 *supra* and accompanying text.

116. Similar problems arise in refinancing and loan consolidation because creditors use the Rule of 78's to compute unearned finance charge rebates in these situations as well. *See* note 19 *supra*.

117. *See* notes 102-14 *supra* and accompanying text.

118. *Id.*

119. *See* notes 64-67, 104-07 *supra* and accompanying text.

120. *See* notes 111-15 *supra* and accompanying text.

need to disclose additional credit costs, but failed to appreciate that the Rule resulted in added cost.<sup>121</sup>

The Rule of 78's rebate differential is also the critical point of disagreement among courts considering subsection 226.8(b)(7) voluntary prepayment disclosure problems.<sup>122</sup> The FRB and *Johnson* on the one hand and *Burley* and *Scott* on the other disagree as to whether the Rule of 78's is an acceptable subsection 226.8(b)(7) method of computing unearned finance charges. Consideration of this question requires a closer analysis of the district court's reasoning in *Scott*.

*Scott*'s fundamental premise is that, for TILA disclosure purposes, unearned finance charges may only be computed actuarially.<sup>123</sup> Although the *Scott* court indicated it would accept a close approximation of the actuarial method, it held that the Rule of 78's was not such a close approximation in the case before it.<sup>124</sup> The Rule of 78's rebate differential, therefore, was a prepayment charge that had to be disclosed under subsection 226.8(b)(7).<sup>125</sup>

One commentator argues that *Scott* fundamentally misinterprets subsection 226.8(b)(7) by misinterpreting the critical word "rebate" in the second part of subsection 226.8(b)(7).<sup>126</sup> The word "rebate" qualifies the words "unearned finance charge" such that the "rebate of . . . unearned finance charge" is the amount to be refunded as computed by the Rule of 78's.<sup>127</sup> Subsection 226.8(b)(7)'s disclosure requirement of the amount of any charge deducted from the unearned finance charge is triggered only if the creditor withholds an amount *in addition* to the rebate as computed by the Rule of 78's.<sup>128</sup>

This argument is attractive for several reasons. First, it is unclear why the FRB would require "identification of the method of computing any

---

121. See notes 108-10 *supra* and accompanying text.

122. See notes 58-87 *supra* and accompanying text.

123. See notes 79-80 *supra* and accompanying text.

124. See notes 80-83 *supra* and accompanying text.

125. See note 87 *supra* and accompanying text.

126. Comment, *supra* note 43, at 727.

127. *Id.*

128. This amount would be similar to an acquisition charge, which is either a fixed amount or percentage charge by the creditor upon debtor's premature payment. The purpose of such charges is to compensate the creditor for increased overhead caused by prepayment. Acquisition charges are clearly within the purview of subsection 226.8(b)(7), and the question this Note raises is whether the Rule of 78's rebate differential is sufficiently similar to an acquisition charge to merit disclosure under subsection 226.8(b)(7).

unearned portion of the finance charge" if the actuarial method is the only one acceptable for subsection 226.8(b)(7) disclosure purposes. Furthermore, subsection 226.8(b)(7)'s identification requirement<sup>129</sup> implies that there is more than one method of computing the unearned finance charge. Additionally, subsection 226.8(b)(7) requires "a statement of the amount or method of computation of any charge that may be deducted from the amount of any rebate of such unearned finance charge."<sup>130</sup> This appears to be a response to a common practice by which creditors retain a fixed amount or percentage in addition to the unearned finance charge (however computed) upon premature contract termination.<sup>131</sup> Finally, despite *Scott's* contrary assertions,<sup>132</sup> the FRB seems to have contemplated nondisclosure when it promulgated subsection 226.8(b)(7) and its official interpretation.<sup>133</sup>

The *Scott* interpretation of subsection 226.8(b)(7) can, however, be defended on a number of grounds. First, TILA requires the cost of credit to be expressed as an annual percentage rate computed by the actuarial method.<sup>134</sup> Congress adopted the more exact actuarial method despite creditor preference for the add-on, discount, and other simplified but inaccurate methods of determining credit rates.<sup>135</sup> There is no reason why subsection 226.8(b)(7) should be the only section of TILA or Regulation Z to adopt a method of computing unearned finance charges other than the actuarial method.

Secondly, TILA's policy of informing the consumer of his credit costs arguably applies to any difference in cost caused by a creditor's use of a particular method of determining rebates upon premature contract termination.<sup>136</sup> TILA's definition of finance charge includes many costs not usually considered part of the finance charge.<sup>137</sup> Although the Rule of 78's rebate differential is not part of the finance charge,<sup>138</sup> it is clearly an indirect cost to consumers and a source of income to creditors, which should be disclosed in some manner.<sup>139</sup>

---

129. See note 57 *supra*.

130. *Id.*

131. See note 128 *supra*.

132. 380 F. Supp. 475, 479 (D. Neb. 1974).

133. See notes 57, 64-67 *supra* and accompanying text.

134. See notes 12-13 *supra*.

135. See R. JOHNSON, *supra* note 13, at 103-18.

136. See note 11 *supra* and accompanying text.

137. See notes 12-13 *supra* and accompanying text.

138. See notes 12 & 63 *supra*.

139. While the focus of this Note is on whether the Rule of 78's rebate differential



Thirdly, the creditor's argument that the Rule of 78's rebate differential is compensation for otherwise lost income and increased overhead caused by the premature contract termination should be rejected. The lost income from premature contract termination is accounted for in establishing interest rates and other forms of credit regulation.<sup>140</sup> The "increased overhead" argument is similarly without foundation because most finance companies and banks now use computers to calculate interest.<sup>141</sup> The simplicity of the Rule of 78's may have kept overhead low when contracts were first precomputed by hand in the 1930s,<sup>142</sup> but that argument is presently without merit.

Finally, the degree of error in the Rule of 78's militates against its acceptance as a method of computing unearned finance charges for purposes of subsection 226.8(b)(7) and, by derivation, subsection 226.8(b)(4).<sup>143</sup> One study concluded that the Rule of 78's "simply breaks down"<sup>144</sup> in some situations. This breakdown should propel state legislatures to consider whether more careful regulation of the Rule of 78's rebate differential is necessary.

The Department of Housing and Urban Development recently responded to the inaccuracy in the Rule of 78's by prohibiting its use on property improvement and mobile home loans.<sup>145</sup> HUD now requires that the rebates on these loans be computed by the actuarial method, despite its recognition that many state laws permit creditors to use the Rule of 78's.<sup>146</sup> HUD rejected the Rule because it is inaccurate and results in higher costs to consumers.<sup>147</sup> In addition, HUD noted that any loss of

---

should be disclosed under subsection 226.8(b)(7) as an added credit cost, other problems arise concerning the method of disclosure. Obviously, it is not clear at the time of contract formation whether the contract will run to maturity. Thus, the creditor could not possibly disclose the exact amount of the Rule of 78's rebate differential. A possible solution to this problem is to require the creditor to disclose, for contracts above a certain dollar amount, that the Rule of 78's rebate upon prepayment, acceleration, refinancing, or consolidation will be smaller than the actuarial rebate. Certain maximum percentage variations might also be relevant to the customer seeking to compare credit terms.

140. See note 148 *infra* and accompanying text.

141. See R. KOCHENBURGER & C. TURCIO, COMPUTERS IN MODERN SOCIETY 182 (1974); D. SPENCER, COMPUTERS IN SOCIETY 107-08 (1974).

142. See note 46 *supra* and accompanying text.

143. See notes 47-52 *supra* and accompanying text.

144. FINANCIAL PUBLISHING CO., COST OF PERSONAL BORROWING IN THE UNITED STATES 61 (1976).

145. 42 Fed. Reg. 45,305 (1977) (to be codified in 24 C.F.R. §§ 201.501, .540, .585, .680).

146. *Id.*

147. *Id.*

creditor income caused by prepayment is a factor considered in establishing the initial interest charge for loans.<sup>148</sup>

#### V. CONCLUSION

HUD's substantive prohibition of the Rule of 78's raises the issue of whether the FRB should permit its use without at least requiring creditors to disclose its vagaries and inaccuracies. The TILA is not a substantive regulation; it is *disclosure* legislation, and no TILA plaintiffs have attempted to prohibit the use of the Rule of 78's. The question, rather, is whether the potentially large Rule of 78's rebate differential should be exempt from disclosure, and therefore remain a substantial source of undisclosed, indirect income to creditors.

Moreover, creditors themselves indicate the similarities of voluntary prepayment and prepayment pursuant to acceleration by using the Rule of 78's to compute both kinds of rebates. Courts and the FRB should therefore require disclosure of this differential in both situations. Finally, state legislatures should prohibit the use of the Rule of 78's and, if necessary, increase interest rates to compensate creditors for otherwise lost income. This approach is consistent with the sound policy of preventing undisclosed and indirect credit charges to consumers.

*Timothy Ramsey*

---

148. *Id.*