

Household Credit Services, Inc. v. Pfenning

Answering Questions, But Raising More

About Regulation Z

By Albert Alexander*

I. Answering Questions about Regulation Z

The Truth in Lending Act and Regulation Z

In 1968, Congress enacted the Truth in Lending Act (“TILA”)¹ “to assure a meaningful disclosure of credit terms ... to protect the consumer against inaccurate and unfair credit billing and credit card practices.”² The Federal Reserve Board (“Board”) was given broad regulatory power to further this purpose.³ The Board issued Regulation Z to implement the Truth in Lending Act.⁴ Section 226.4 of Regulation Z was promulgated to interpret what Congress intended to include as a finance charge.⁵

TILA defines the term “finance charge” in terms of what charges it includes and the relation between the charge and the extension of credit. A finance charge “in connection” with a credit transaction “shall be determined as the sum of all charges, payable ... by the person to whom the credit is extended, and imposed ... by the creditor as an incident to the extension of credit.”⁶ The Act mentions several types of charges but there is no specific command that credit card over-limit fees be included in the finance charge.⁷

Regulation Z takes a similar approach to the term “finance charge.”⁸ The Board defines finance charge as “includ[ing] any charge payable ... by the consumer and imposed ... by the creditor as an incident to or a condition of the extension of credit.”⁹ The examples provided track those in Section 1605.¹⁰ Of interest are those charges excluded from the finance charge.¹¹ Specifically, Regulation Z exempts charges “for exceeding a credit limit.”¹²

A Summary

Pfenning obtained a credit card initially issued by petitioner Household Credit Services, Inc. (Household), but which petitioner MBNA American Bank, N.A. (“MBNA”), now holds an interest.¹³ “Although the terms of respondent’s credit card agreement set respondent’s credit limit at \$2,000, respondent was able to make charges exceed-

ing that limit, subject to a \$29 ‘over-limit fee’ for each month in which her balance exceeded \$2,000.”¹⁴

Among the many provisions of TILA is one that controls the disclosures that creditors must make to consumers.¹⁵ Under the Act, the creditor is required to send the consumer a statement at the end of each billing cycle when there is a balance.¹⁶ The statement must include the amount of any finance charge incurred during the billing cycle.¹⁷

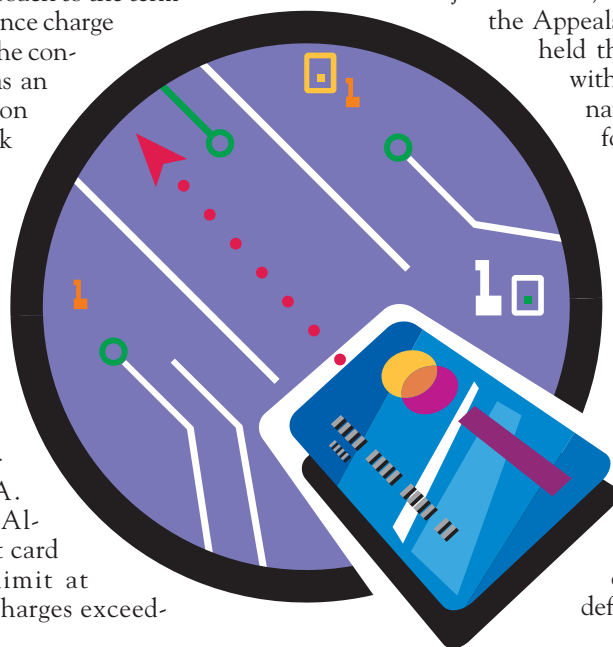
Respondent’s complaint alleged that petitioners violated TILA by “failing to classify the over-limit fees as ‘finance charges’ and thereby ‘misrepresented the true cost of credit’ to respondent.”¹⁸ The over-limit charges were explicitly exempted from being classified as a “finance charge” by the Board.¹⁹

Regulation Z’s exemption of over-limit fees raised the issue of whether Regulation Z is a reasonable interpretation of the TILA. Although the Federal Reserve Board is authorized to promulgate regulations interpreting TILA, the provisions of Regulation Z are not necessarily controlling on a court. The Court evaluates the regulation’s adequacy under a test enunciated in *Chevron U.S.A. Inc. v. Natural Res.*

*Defense Council, Inc.*²⁰ Using the *Chevron* test, the Appeals Court for the Sixth Circuit held that Regulation Z conflicted²¹ with the statutory definition of “finance charge” and that, therefore, the statute controlled.²² The Supreme Court disagreed and reversed, holding that Regulation Z was a reasonable interpretation of the TILA.²³

The Court of Appeals

Shortly into its discussion, the court of appeals noted that TILA is a consumer protection statute and should be construed liberally in the consumer’s favor.²⁴ The court disagreed with the defendant’s position that defer-



ence was owed to Regulation Z.²⁵ The court noted, “that TILA, as a remedial statute, must be given a liberal interpretation in favor of consumers.”²⁶ The court analyzed the plain language of TILA and found that the “fee was imposed incident to the extension of credit” and that the “[d]efendants were obligated to disclose the fee as a finance charge.”²⁷ Ultimately, the court did not discover any ambiguity in the statute and held that the “over-limit fee ... falls squarely within the statutory definition of a finance charge.”²⁸

The court’s holding was based on its specific characterization of the events.²⁹ According to the court, its holding applies when “the borrower has reached her credit limit, requests more credit, and the lender agrees to that extension of extra credit, but assesses a fee as a result.”³⁰

The Supreme Court

Reversing the court of appeals, the Supreme Court focused much more on the authority that Congress had delegated to the Board than on TILA’s remedial status.³¹ The Court pointed out that Congress has designated the Board “as the primary source for interpretation and application of the truth-in-lending law.”³² The Court also noted that Congress had gone so far as to create a good-faith defense for creditors complying with the Board’s regulations.³³

The Court then invalidated the characterization on which the court of appeals rested its holding.³⁴ The Court further explained that even if the characterization were correct, they disagreed with the conclusion that was drawn.³⁵ In the opinion of the Court, “the over-limit fee would be imposed ... as a result of the fact that her charges exceeded her \$2,000 limit at the time respondent’s monthly charges were officially calculated.”³⁶ Since these fees are “imposed only when a consumer exceeds his credit limit, it is perfectly reasonable to characterize an over-limit fee ... as a penalty for violating the credit agreement.”³⁷

The Court’s holding did not specifically include instances when the creditor authorized the over-limit transaction. The Court disagreed *a priori* on this characterization, adopted by the court of appeals, because “a creditor’s ‘authorization’ of a particular point-of-sale transaction does not represent a final determination that a particular transaction is within a consumer’s credit limit because the authorization system is not suited to identify instantaneously and accurately over-limit transactions.”³⁸

II. Raising Questions About Regulation Z

Form over Function

The Supreme Court held that over-limit fees are not finance charges under TILA; therefore, Regulation Z was a reasonable interpretation of the statute.³⁹ The Court left unanswered, however, whether a creditor that imposes a low credit limit and allows the creditor to continue charging above that limit after over-limit fees have been assessed would have to classify those fees as finance charges. A strict interpretation of the holding in *Pfennig* would suggest that any fee imposed for violating the agreement would be a penalty and not a finance charge.⁴⁰ This could result in allowing form to dictate over function and the Board would seem to agree.⁴¹

The Board conceded in its amicus filing to the ap-

peals court that there might be instances such as the one just mentioned.⁴² In those instances, the Board “acknowledges that the over-limit fee actually becomes an anticipated cost of the credit extension and is therefore a finance charge.”⁴³ The Supreme Court declined to comment on this position, which could result in this issue being raised again. This is because the appeals court tucked in a second reason for reversing summary judgment in note 2 of its opinion.⁴⁴ The court specifically pointed out that in the instant case the plaintiff argued and the defendants failed to challenge that they “routinely permit their credit-card customers to exceed their agreement upon credit limits, and then impose over-limit fees for doing so.”⁴⁵

The Supreme Court may be forced to decide whether to narrow its position in such a situation and include these penalties as finance charges. Also, the Board, with such strong precedent behind them, could change its position⁴⁶ and argue that all over-limit penalties, regardless of form, do not function as a finance charge.

The Dismissed Holding

The court of appeals based its holding on a very narrow scenario. Specifically, the holding only applies where

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“the borrower reaches her credit limit, requests more credit, and the lender agrees to that extension of extra credit, but assesses a fee as a result.”⁴⁷ The Supreme Court disagreed with the manner in which the court of appeals characterized the facts.⁴⁸ The Supreme Court did not comment on whether its opinion would have been different, if their characterization were correct. The Court did explain, however, that it disagreed with the appeals court rule because “the authorization system is not suited to identify instantaneously and accurately over-limit transactions.”⁴⁹

The Supreme Court is quite right that not everyone uses electronic means for registering credit transactions. Therefore, instantaneously identifying over-limit transactions is not possible. Although it is this way currently, the occurrence of the carbon-copy credit transaction is becoming few and far between. One day the courts will have to decide this issue because it will be possible to easily identify instantaneously and accurately over-limit transactions.

Authorized Extensions of Credit

The Supreme Court also noted that the respondent argued a new position that was not considered by the Court because the theory was not advanced early enough in the proceedings.⁵⁰ The respondent attempted to argue that Regulation Z does not apply because it does not cover over-limit fees imposed for authorized extensions of credit.⁵¹ This position is substantially similar to the narrow interpretation of the appeals court that the Supreme Court dismissed.

The positions are different in that the appeals court position seemed to assume that in all instances, approval could be determined by the actual extension of the

credit.⁵² The plaintiff's position in the Supreme Court is that in her case, the extension of credit was authorized.⁵³ This case-by-case presentation avoids the issue of whether the lender in all cases would have to be able to determine whether the charge would exceed the limit.

Under this "new" position, a plaintiff could argue that if the lender knew the charge would result in an over-limit extension, then the extension was authorized, and the fee was a finance charge for that extension. The outcome under this characterization is similar to charges for over drawing a bank account being considered as finance charges, if the withdrawal is previously agreed upon in writing.⁵⁴ At the very least, the Court could be forced to decide whether it is arbitrary and capricious that in some instances overdraft fees for a bank account can be considered a "finance charge," while there are no instances when a credit card over-limit fee will be considered a "finance charge."⁵⁵

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1. Pub. L. No. 90-321, 82 Stat. 146 (1968).
2. 15 U.S.C.A. § 1601(a) (2004).
3. 15 U.S.C.A. § 1604(a) (2004).
4. 12 C.F.R. § 226 (2004).
5. 12 C.F.R. § 226.4 (2004).
6. 15 U.S.C.A. § 1605(a) (2004).
7. See 15 U.S.C.A. §§ 1637, 1605 (2004). The only occurrence of over-limit fees in the TILA describes them as being "in connection with" the extension of credit and not "incident to" the extension of credit as is required for the charge to be labeled a finance charge.
8. 12 C.F.R. § 226.4 (2004).
9. 12 C.F.R. § 226.4(a) (2004).
10. 12 C.F.R. § 226.4(b)(1)-(10) (2004).
11. 12 C.F.R. § 226.4(c)(1)-(8) (2004).
12. 12 C.F.R. § 226.4(c)(2) (2004).
13. Household Credit Serv., Inc. v. Pfennig, 124 S. Ct. 1741 (2004).
14. *Id.*
15. 15 U.S.C.A. § 1637(a) (2004). "Before opening any account under an open end consumer credit plan, the creditor shall disclose to the person to whom credit is to be extended each of the following."
16. 15 U.S.C.A. § 1637(b) (2004). "The creditor of any account under an open end consumer credit plan shall transmit to the obligor, for each billing cycle at the end of which there is an outstanding balance in that account or with respect to which a finance charge is imposed, a statement setting forth each of the following items to the extent applicable."
17. 15 U.S.C.A. § 1637(b)(4) (2004). "The amount of any finance charge added to the account during the period, itemized to show the amounts, if any, due to the application of percentage rates and the amount, if any, imposed as a minimum or fixed charge."
18. Household Credit Serv., Inc. v. Pfennig, No. 02-857, slip op. at 3 (U.S. April 21, 2004). The Court noted that this case began as a Class Action Complaint in the United States District Court for the Southern District of Ohio.
19. 12 C.F.R. § 226.4(c)(2) (2004).
20. Chevron U.S.A. Inc. v. Natural Res. Defense Council, Inc.,



467 U.S. 837, 842-44 (1984). The Court poses a two-pronged inquiry. Initially, the Court asks if "Congress has directly spoken to the precise question at issue," in which case Congress' intent must control. However, if Congress

has "explicitly left a gap," the regulation will control unless it is "arbitrary, capricious, or manifestly contrary to the statute."

21. Pfennig v. Household Credit Serv., Inc., 295 F.3d 522, at 534 (6th Cir. 2002).

22. *Id.* at 531. The Appeals Court did not specifically utilize Chevron deference in making their decision. They used an amalgamation of cases and principles that are roughly the same. See Pfennig at 528-31. "It is rudimentary that 'the starting point for interpreting a statute is the language of the statute itself.'" "Where a statute and an agency regulation regarding the same matters conflict, the court must defer to the statute."

23. Household Credit Serv., Inc. v. Pfennig, No. 02-857, slip op. at 11 (U.S. April 21, 2004).

24. Pfennig v. Household Credit Serv., Inc., 295 F.3d 522, at 526 (6th Cir. 2002).

25. *Id.* at 529. See *supra* n.15. The court did not hold that regulations are not entitled to deference, but that the conflicting language between the regulation and statute dictated that deference would not be given.

26. *Id.* at 528.

27. *Id.* at 529.

28. *Id.* at 530.

29. *Id.* at 531 n.5.

30. *Id.* at 531.

31. See Household Credit Serv., Inc. v. Pfennig, No. 02-857, slip op. at 3-4 (U.S. April 21, 2004).

32. Household Credit Serv., Inc. v. Pfennig, No. 02-857, slip op. at 5 (U.S. April 21, 2004) (citing Ford Motor Credit Co. v. Milhollin, 444 U.S. 555, 566 (1980)).

33. *Id.*; See 88 Stat. 1518, codified at 15 U.S.C. § 1640(f).

34. Household Credit Serv., Inc. v. Pfennig, No. 02-857, slip op. at 6-7 (U.S. April 21, 2004).

35. *Id.* at 7.

36. *Id.*

37. *Id.*

38. Household Credit Serv., Inc. v. Pfennig, No. 02-857, slip op. at 11 (U.S. April 21, 2004).

39. *Id.*

40. Household Credit Serv., Inc. v. Pfennig, No. 02-857, slip op. at 7, 10 (U.S. April 21, 2004). The Court's position is that the penalty is not related to a charge but to the account being over-limit at the time the monthly charges are calculated. This holding does not differentiate between being over-limit because the consumer made a charge during that month and being over-limit because the prior month's over-limit balance had not been paid down. Further, the court stated that the Board's rule excluded "from the term 'finance charge' all penalties imposed for exceeding the credit limit."

41. Pfennig v. Household Credit Serv., Inc., 295 F.3d 522, at 529 (6th Cir. 2002). Pfennig at 529 n.2. The Board's amicus filing to the Appeals Court conceded an exception to the rule, but the Supreme Court characterized the rule as applying to "all penalties."

42. Pfennig at 529 n.2.

43. *Id.* See also Owen B. Asplundh, *Bounce Protection: Payday Lending in Sheep's Clothing?*, 8 N.C. BANKING INST. 349, 362 (2004) (In the banking context, banks exploit the exemption provided in 12 C.F.R. § 226.4(c)(3) by not having their “customers sign any contractual agreements in relation to” the overdraft protection service); Elwin Griffith, *The Truth and Nothing But the Truth: Confronting the Challenge in the Truth and Lending Act and Regulation Z*, 40 Hous. L. Rev. 345, 416 (2003) (This article predates the current case but argued accurately that “[o]ne gets the impression that the regulation gives a creditor too many opportunities to exclude items from the finance charge if the creditor follows a certain format”).

44. Pfennig v. Household Credit Serv., Inc., 295 F.3d 522, at 529 (6th Cir. 2002).

45. *Id.*

46. *Id.* at n.2.

47. *Id.* at 531.

48. Household Credit Serv. Inc. v. Pfennig, No. 02-857, slip op. at 6–7 (U.S. April 21, 2004).

49. *Id.* at 11.

50. *Id.* at 6 n.3.

51. *Id.*

52. See Pfennig, 295 F.3d at 530. The Court of Appeals characterization gives the impression that the creditors knew in all instances that the plaintiff was exceeding her credit limit when they extended credit. The argument is not qualified to apply the knowledge specifically to the plaintiff, but appears to assume that creditors know at all times whether the credit they extend exceeds the borrower's limit.

53. See *Id.* at n. 52. The difference between the arguments is that even if the defendants could not know at all times that the credit they were extending went over the borrowers limit, it is possible in their case specifically to know that the credit exceeded the plaintiff's limit.

54. 12 C.F.R. § 226.4(c)(3) (2004).

55. See 12 C.F.R. § 226.4(c)(2)–(3) (2004). If previously agreed upon in writing, overdraft charges are considered “finance charges” but charges for “exceeding a credit limit” have no such qualification.