

# STATE OF COLORADO

## DEPARTMENT OF LAW

Uniform Consumer-Credit Code  
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### ADMINISTRATIVE INTERPRETATION NO. 3.508-8401

THE LOAN FINANCE CHARGE IS OBTAINED FROM A REVOLVING LOAN ACCOUNT RESULTING FROM THE PURCHASE OF GOODS OR SERVICES AND IS SUBJECT TO THE CONDITIONS SET FORTH BY SECTION 5-3-508(3)(b) IF THE CREDIT IS EXTENDED AT THE POINT OF SALE, INVOLVES DIRECT RATHER THAN INDIRECT ACCESS TO CREDIT, AND INVOLVES THREE PARTY AGREEMENTS BETWEEN LENDER, BORROWER AND MERCHANT.

The administrator hereby rescinds Administrative Interpretation No. 3.508-8102, adopted December 2, 1981, and promulgates the following interpretation of 5-3-508(3). Administrative Interpretation No. 3.508-8102 was issued in response to several inquiries as to the meaning and application of section 22 of H.B. 1585 (1981 Colo. Sess. Laws, p. 391). The limitations on finance charges on revolving loans are set forth in C.R.S. 1973, 5-3-508(3), as amended:

(3) (a) Except as provided in paragraph (b) of this subsection (3), the loan finance charge for a loan pursuant to a revolving loan account, calculated according to the actuarial method, may not exceed twenty-one percent per year on the unpaid balance of the principal.

(b) The finance charge obtained from a revolving loan account resulting from the purchase of goods or services may not exceed eighteen percent per year on the unpaid balance of principal, calculated according to the actuarial method, unless the lender provides the debtor the privilege of paying all charges for the purchase of such goods or services, without loan finance charge, within twenty-five days after the date of the statement first reflecting such charges. The lender may condition the exercise of this privilege upon the debtor's payment of the full balance due as shown on the statement within said twenty-five days.

The previous interpretation concluded that there were limitations on the language in section 5-3-508(3)(b) mandating a free period on revolving loan account plans which carry a loan finance charge

over 18 percent. I make no change in this conclusion and incorporate relevant portions of the previous interpretation.

This interpretation focuses on the nature of the limitations contained in 5-3-508(3)(b) and its application to debit cards with credit features and other supplemental credit devices. A variety of revolving loan account plans are currently used. Proponents of these plans have inquired as to the requirement of a 25-day free period if the creditor charges more than 18 percent. The central issue in all of these inquiries is the meaning of the phrase "resulting from the purchase of goods or services." Insofar as people ultimately purchase goods and services with the money they borrow, one could argue that subsection (3)(b) encompasses virtually all credit on a revolving loan account. My opinion is that (3)(b) applies only to credit transactions in which credit is extended at the point of sale, involves direct rather than indirect access to credit, and involves three-party agreements between lender, borrower, and merchant.

#### BACKGROUND

An abbreviated background on current revolving loan accounts is useful to the analysis.<sup>1/</sup> Variants and combinations of each type are currently used or potentially can be used.

##### A. Credit cards

The credit card demonstrates the traditional revolving loan account with three parties: lender, merchant, and borrower. The agreement between lender and borrower sets forth the terms of the loan including credit limit, periodic rates, repayment scheme, security, etc. Merchants who accept the card enter into a separate agreement with the lender providing for guarantee of payment to the merchant by the lender's promise to purchase the obligation minus a merchant's discount.

##### B. Debit cards/checks

Debit cards can be either "true" debit cards which provide on-line access to a debit account or purely check substitutes which produce another paper item drawn on the payor bank. Debit cards are customarily viewed as a substitute for "checks." The card accesses the customer's demand deposits or other withdraw-

able items. No credit is extended in this transaction, just as with a check. The transaction is a cash item to the merchant. The check is an order to the bank to transfer funds to the merchant. If the funds are not sufficient, the merchant bears the risk of loss.

One can, however, attach "overdraft" protection to the check or the debit card. In this instance, if the demand account has insufficient funds the creditor may or shall advance funds equal to or greater than the amount of the deficiency. The "credit" can be either a true credit relationship with the customer whereby a finance charge is exacted and repayment is made in installments or the overdraft protection may be simply a convenience to the customer who immediately must repay the institution. A finance charge is not earned from the date of the transaction but only from the date the credit advance is made. Note that the merchant will likely view the transaction differently: the debit card will be treated as a credit card, with a separate agreement between merchant and its depository institution.

#### C. Line of credit accessed by drafts.

Lines of credit accessed by drafts are often simply two-party transactions by which the borrower can receive cash from the lender under a prearranged credit agreement. However, in some instances the line is accessed by drafts which will be accepted generally by merchants essentially because the draft appears to be a "check." Unlike a check, the draft is not tied to any demand or other deposit item. The draft accesses a line of credit prearranged with the borrower in an agreement setting forth the terms. No separate agreement is made between lender and merchant.

#### D. Variations.

One can devise any number of variants of these arrangements. For instance, while a merchant discount is common, it is not necessary. Each participating bank can negotiate with each merchant concerning the amount of the discount, if any. The credit card system will often dictate certain fees paid by the merchant side to the issuer-side of the transaction. Institutions can participate on either or both the issuer or merchant side of the system.

Debit cards can be and are fashioned with or without credit features. Regardless of the overdraft protection, a merchant

discount may or may not exist. The lender may or may not provide access to a demand deposit through both checks and debit cards, with an overdraft feature attached to either or both of these instruments. The debit card with overdraft features may also function as a check guarantee card. The lender can provide access to a line of credit through both credit cards and drafts not tied to a demand account. Under any of these schemes one generally can obtain cash advances from the creditor. There is very nearly no limit on the ability of the market to create revolving loan account forms. The U.C.C.C. imposes few restrictions on the ability of lenders to structure these transactions.

### ISSUES

Issue No. 1: Are there any limitations on the language in section 5-3-508(3)(b) mandating a 25 day free period on revolving loan accounts which carry the maximum loan finance charge rate of 21 percent?

In my opinion, the answer is "yes."

First, note that section 5-3-508(3)(a) sets forth the general rule:

(3) (a) Except as provided in paragraph (b) of this subsection (3), the loan finance charge for a loan pursuant to a revolving loan account, calculated according to the actuarial method, may not exceed twenty-one percent per year on the unpaid balance of the principal.

Other than the reference to paragraph (b), there are no conditions in paragraph (a) on the maximum rate of 21 percent. There is no language describing or limiting the manner in which the borrower uses his revolving loan account, i.e., for cash advances, for direct or indirect purchases of goods and services.

Subsection (b) provides the exception to the general rule:

(b) The finance charge obtained from a revolving loan account resulting from the purchase of goods or services may not exceed eighteen percent per year on the unpaid balance of principal, calculated according to the actuarial method, unless the lender provides the debtor the privilege of paying all charges for the purchase of such

goods or services, without loan finance charge, within twenty-five days after the date of the statement first reflecting such charges....

This paragraph narrows the general rule by carving out certain revolving loan accounts -- those in which the loan results from the purchase of goods and services. For these particular accounts, the maximum rate is 18 percent unless the creditor provides a 25-day free period, in which case the creditor may charge 21 percent.

If subsection (3)(b) is read broadly to cover all revolving loan account plans on the theory that all such loans are used, ultimately, to purchase goods and services, then the exception would swallow the rule and the phrase "revolving loan account resulting from the purchase of goods and services" would be rendered superfluous.<sup>2/</sup> According to standard rules of statutory construction, a statute must be read so as to give effect to every word, clause and sentence.<sup>3/</sup> Thus, in order to give effect to the language in (3)(b) singling out and describing certain revolving loan accounts, it must be assumed that the legislature intended to place some limitations on the scope of section 5-3-508(3)(b).

Issue No. 2: What are the limitations on the scope of 5-3-508(3)(b)?

Obviously, (3)(b) cannot apply to the cash advance used to purchase goods or services. Just as obviously, those limitations on rates must apply to some form of the transactions outlined in the background above. The legislative history of section 22 of H.B. 1585 is sparse. The section was added on second reading in the senate. Senator Hatcher, in proposing the amendment in section 22, continually referred to "credit cards" (tapes of senate floor debate on 2d reading, May 4, 1981 at 15:52:00). No clear distinction was made in the legislative process between the various types of revolving loans outlined above; however, some such distinction was intended.<sup>4/</sup> The 1981 legislature probably was not presented with the dazzling array of current revolving loan instruments. Debit cards and equity-secured lines of credit accessed through drafts are of recent origin. Most references in the senate debate were to the evolution in the credit card from a convenience to a true source of credit (comments of Senators Phelps and Baca-Barragan, tapes of second reading, *id.*). While not dispositive, these references in the legislative history urge a conclusion that only the traditional credit card transaction was to be included in the 5-3-508(3)(b) exception to the 21 percent ceiling.

In addition to legislative history, another principle of statutory construction is that "A just and reasonable result is

intended," C.R.S. 1973, 2-4-201(1)(c); and that one consider "the consequences of a particular construction," C.R.S. 1973, 2-4-203(1)(e). The previous interpretation, by including debit cards with credit features within the 25-day free period requirement, caused peculiar operational difficulties on lending institutions. Debit items can be paid in any order convenient to the payor bank. Debits to the asset account may arise from any number of factors: purchases made with checks, purchases made with debit cards, cash advances, electronic funds transfers, service fees, etc. Lenders are faced with a bewildering task of trying to ascertain whether a particular debit card item caused the credit extension.

An additional problem is faced in ascertaining the amount of the credit to which the 25-day free period applies. Some institutions advance sums in \$50 or \$100 increments sufficient to cover the asset deficiency. What portion of these increments is covered? Furthermore, the previous interpretation required an issuer-bank to ascertain if a merchant discount were received by a separate institution. While one customarily finds the discount in the "card" setting, the issuer institution is faced with some uncertainty. These difficulties were presented in the instance of a supplemental credit device considered by lenders as equivalent to a check overdraft plan.

Lenders have instead contended that this interpretation should adopt the "sale-nonsale" distinction of reg. 2, 12 C.F.R. 226.8, made for purposes of the supplemental disclosures on open-end credit transactions. Official Staff Commentary, paragraph 226.8, Comment 3, includes within "nonsale credit": cash advances, overdraft checking, and the use of a "supplemental credit device" in the form of a check or draft or the use of the overdraft feature of a debit card, even if such use is in connection with a purchase of goods or services. While not dispositive of the state law question, <sup>5/</sup> the distinction in reg. 2 and Official Staff Commentary lends further support to this interpretation.

While one might simply conclude that "credit cards" are the only item included within (3)(b), one must identify the factors distinguishing the credit card situation from the other forms of revolving loans. First, in the instance of the credit card, credit is extended at the point of sale and because of the sale. In the debit card transaction, credit is extended only at the point of presentment of the debit item and the posting of all credits and debits. This access to credit customarily is viewed as indirect rather than direct as in the instance of credit cards. Just as with checks, the lender extends the credit only when the asset account contains insufficient funds. The extension is most directly due to the agreement to cover debit items which draw on insufficient funds rather than the nature of the debit item. Thus, any such credit extension results from the insufficiency of customer assets and lender agreement to cover

insufficiencies. Note that the line of credit accessed by drafts 6/ used for a purchase results in an extension of credit at the point of sale, regardless of how the creditor determines the computational period for purposes of earning the finance charge.

Second, both the credit card and debit card are three party agreements, while ordinary overdraft checking and line of credit drafts are two-party schemes. While the merchant credit card agreement actually might be with an institution separate from the issuer-bank, both institutions participate in the same program. The merchant's agreement and the borrower's agreement are made with different sides of the same program.7/

A few examples will illustrate the results obtained by application of these three factors (time, directness, and three-party agreements):

#### Example 1

Purchaser (P1) uses a debit card to purchase goods from merchant (M1). M1 accepts the card as a payment mechanism and uses the card to make a paper draft which P1 signs. M1 sends the paper to its depository institution which forwards it to P1's bank (B1), the payor bank. A few days after the sale, B1 posts the item to P1's account and, since there are insufficient funds in P1's account, advances \$X sufficient to pay the item to M1.

#### Example 2

P2 uses a debit card to purchase goods from M2. However, this time M2 uses an electronic terminal to access P2's account at B2, the payor bank. The sale price is subtracted from P2's account and added to M2's account (or the obligation is otherwise paid to M2). Since P2's account has insufficient funds to pay the item to M2, B2 advances \$X sufficient to pay the item. B2 previously has programmed its electronic data transfer system for approved overdraft credit in the amount of \$ Y ( $X \leq Y$ ). M2 is instantaneously informed of the payment of the item to M2 and no paper draft is created.

Both examples 1 and 2 are excluded from (3)(b). Neither involves a direct extension of credit. Credit is extended only indirectly due to the lender agreement to honor an insufficient funds debit item. Example 1 further illustrates a time delay in the extension of credit so that credit is not extended at the point of sale. Ordinary check overdraft protection, even with use of a check guarantee card, is excluded from (3)(b). Lines of credit accessed by drafts which customarily are accepted by merchants and which are not part of a three-party arrangement between lender, borrower, and merchant are excluded from (3)(b).

My conclusion is that 5-3-508(3)(b) applies only to those purchase transactions in which credit (1) is extended at the point of sale; (2) involves direct rather than indirect access to credit;<sup>8/</sup> and (3) involves a three-party rather than two-party arrangement. Clearly this test includes traditional credit card arrangements used in a purchase transaction. Debit cards and check overdraft plans are excluded. Line of credit drafts which are purely two party arrangements, even if customarily accepted by merchants, are excluded from (3)(b). Note that this interpretation does not remove any difficulties imposed on the creditor in ascertaining whether the credit transaction is a purchase from a merchant or a cash advance. The interpretation does remove some operational difficulties previously imposed on some supplemental credit devices.

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1/ The term "revolving loan account" is defined in section 5-3-108 as:

an arrangement between a lender and a debtor pursuant to which (1) the lender may permit the debtor to obtain loans from time to time, (2) the unpaid balances of principal and the loan finance and other appropriate charges are debited to an account, (3) a loan finance charge if made is not precomputed but is computed on the outstanding unpaid balances of the debtor's account from time to time, and (4) the debtor has the privilege of paying the balances in instalments.

It should be noted that, under the code, a revolving loan account used for the purchase of goods and services is distinguished from a revolving sales or charge account. The latter account is defined in sales section 5-2-108. The amendments to section 5-3-508 do not affect sections 5-2-108 or 5-2-207.

2/ Moreover, it may be impossible for the creditor to know how the borrower has used the proceeds of his loan if he has obtained a cash advance.

3/ C. Sands, 2A Sutherland Statutory Construction sec. 46.06 (4th ed. 1973).

4/ See analysis of issue number one, above.

5/ The reg. Z distinction serves a fairly minor supplemental disclosure purpose not connected with the applicable state rate limitation. Furthermore, the specific examples of "non-sale credit" are not in the regulation but in the staff commentary,

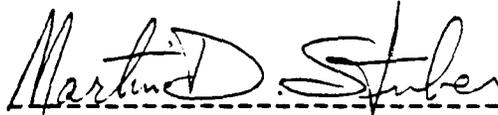
which is interpretive and illustrative only.

6/ See discussion, supra, p. 3.

7/ I am informed that for accounting and operational purposes a single institution often separates the issuer and merchant sides of its card programs.

8/ The additional distinction between timing and directness or causation of the credit extension may become increasingly important with EFTs and on-line debit cards.

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This is an official interpretation of the Colorado Uniform Consumer Credit Code pursuant to C.R.S. 1973, 5-6-104(4), as amended.