AIR 59000-6/78-TR

Consumer Fraud: An Analysis of Impact and Opportunities for Intervention

Consumer Fraud Intervention Strategies

Jonathan A. Sheldon

Submitted to the Community Crime Prevention Division, National Institute of Law Enforcement and Criminal Justice, Law Enforcement Assistance Administration, Washington, DC 20531.

Prepared by the National Consumer Law Center, 11 Beacon Street, Boston, Massachusetts 02108.

Grant No. 76-NI-99-0122
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Mark E. Budnitz, Executive Director of NCLC, has primary responsibility for all of NCLC's technical and administrative efforts. Jonathan Sheldon devoted full time to production of this document. He was assisted by Richard Alpert, Geraldine Azzata, Robert Hobbs, Kenneth Reeves, George Zweibel and other members of the professional staff. Research was conducted by the following law students: Steven Brault, Lynne Girton, Mary Gourley-Hart, Scott Heekin-Canedy, Barbara Hendrie, and Bruce Silverglade. Appreciation is extended to Pat Kenah who provided typing and administrative assistance to this report.

*Sheldon, J., & Zweibel, G. *Survey of Consumer Fraud Law*. Washington, D. C.: U.S. Government Printing Office, June 1978.

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INTRODUCTION

This report analyzes seven consumer fraud intervention approaches. In particular, it evaluates the effectiveness of twenty-two illustrative strategies implementing these approaches. Organizing consumer fraud enforcement efforts into seven general approaches is intended to facilitate analysis and suggest innovative strategies utilizing these approaches.

This report will not recommend new intervention strategies; a later report will identify promising interventions to selected consumer fraud patterns. Nor will this report describe in any detail existing consumer fraud laws; an earlier NCLC report, Survey of Consumer Fraud Law, delineates state, local, and federal governments' consumer fraud concerns and the methods they use to combat these perceived problems. Separate AIR reports describe the characteristics, incidence, and impact of consumer fraud.

This report is designed to provide a basis for subsequent efforts to develop interventions for selected fraud patterns. It analyzes the strengths and weaknesses of common and little used fraud enforcement strategies. By evaluating existing strategies, the report suggests innovations worthy of future exploration - both reforms of existing interventions and the development of new strategies more effectively implementing one or more of the seven general approaches identified.

The first approach, deterrence, utilizes the threat of prison sentences, monetary penalties or other sanctions to discourage sellers from engaging in consumer fraud. Criminal or civil prosecutions deter future merchant misconduct. In sharp contrast to this prospective remedy, a second approach, compensating victims, solely orders or convinces offending sellers to return defrauded consumers to the status quo.

Both of these approaches rely on government prosecution, court adjudication, or agency mediation to effectuate the strategies. A third approach, self-enforcing remedies, allows consumers to directly redress or deter fraud with little or no government intervention.

Another approach attempts to control merchant behavior, thus preventing consumer fraud. By limiting sellers who can engage in an occupation or restricting sales methods or contract provisions, fraud becomes more difficult to perpetrate. A fifth approach improves consumers' purchase decisions so that the consumer's own marketplace vigilence prevents fraud. Decision-making is assisted by either giving the consumer more information or restricting the decision-making process.

A more indirect approach limits the amount of money at stake in a sales transaction, limiting consumer losses and merchant's incentive to defraud. This can be accomplished either by limiting the price or by delaying payment until consumers determine they have not been defrauded.

A final approach shifts the burdens of paying for and policing fraud from the consumer and government to third parties. Common third parties are creditors, insurance companies, and corporate officials.

The report's data base is divided into two major categories. The available literature provides one informational source. Specific documents utilized in the report are cited in the footnotes.

The second data source was 112 interviews with enforcement officials and consumer experts that NCLC conducted for this study. The interviewees represent a sampling of different types of perspectives, positions, and areas of the country. Twenty-six interviews were with federal enforcement officials; 35 with state prosecutors, agency members, judges and legislators; 25 with local officials; and 26 with private individuals.

<u>Federal</u>

12 FTC attorneys in Washington, D.C. and in regional offices
5 Assistant United States Attorneys or Justice Department Attorneys in fraud units
5 U.S. Postal Inspectors
1 FBI agent
3 Officials of other federal agencies

26

State

11 assistant attorneys general in consumer protection units or staff, National Association of Attorneys General
11 staff members of consumer protection boards
3 judges
4 legislators or legislative staff members
6 regulatory or licensing board staff

35

Local

14 assistant district attorneys in fraud units or staff, National District Attorneys Association
10 local consumer protection board staff
1 police officer, bunco division

25

Private

18 private attorneys, including legal service attorneys, consumer lawyers, creditor attorneys, and heads of law clinics
3 law professors
2 representatives of bar associations
2 private consumer agency members
1 television consumer reporter

26

These interviews were conducted in California, Georgia, Massachusetts, New York, and Washington, D.C. To encourage honest and insightful participation, interviewees were promised that their statements would not be attributed to them. Consequently, the report does not footnote or otherwise indicate the source of much of the information it relies upon. This detracts from the study's replicability, but this is not considered an important flaw for a report only intended to provide background and suggestions for future development of promising intervention strategies.

CONTENTS - CHAPTER I

I DETER FRAUD

Deterrence is an important government approach aimed at preventing consumer fraud. Sellers are put on notice that fraudulent conduct will be penalized, and the threat of prosecution deters merchant misconduct throughout an industry.

The effectiveness of this approach is not directly measured by the number or result of fraud prosecutions, but by sellers' response to the threat of such prosecution. A deterrence program is cost-effective if a few prosecutions prevent most sellers from engaging in consumer fraud. This approach also impinges minimally on the marketplace. Only sellers allegedly engaging in fraud are prosecuted; all others are left undisturbed.

If deterrence is successful, there will be no defrauded consumers. If there are fraud victims, a deterrence approach will not assist them, being only a prospective remedy aimed at preventing future misconduct.

Four strategies implementing this approach will be explored. Criminal prison sentences are an effective deterrent if the threat of prosecution and harsh sentencing is real enough to the merchant. Unfortunately, criminal sentences' actual deterrent effect have not been measured. "Mainstream businesses" are easier to deter than fly-by-night sellers. Deterrence is also limited because criminal prosecutions are not brought for a number of legal and institutional reasons, and, when they are brought, long prison sentences rarely result.

Injunctions and cease and desist orders attempt to deter the merchant being prosecuted from future frauds. Prosecution is eased by use of civil procedures and more liberal standards of actionable merchant misconduct. But injunctive orders are often difficult and slow to obtain, and too narrow or not complied with when eventually ordered.

Prosecutors also use injunctions to deter more generally by using them to establish standards of illegal conduct and adding costly additional requirements to injunctive orders. Difficulties with both of these approaches severely limits injunctions' utilization as a means of deterring an industry generally.

Fines, penalties and license revocations use simple standards and procedures to prosecute frauds and penalize sellers for initial violations. But significant fines and penalties are infrequently awarded and the threat of a minimal monetary award is not significant. License revocations are a harsher sanction but rarely used.

Private individuals can also bring actions that deter fraud, avoiding the need of agency action. But legislatures must provide consumers with powerful special tools to accomplish this, and even then, consumers have a minimal financial incentive to act as "private attorneys general."

A. CRIMINAL SENTENCES

Criminal prosecution is the most extreme form of deterrence. Consumer fraud offenders are criminally prosecuted and those convicted receive prison sentences that will deter others from similarly defrauding consumers.

This strategy's goal is not to compensate past victims, or, since criminal prosecution is a slow process, to stop ongoing frauds. Deterring the merchant being prosecuted from future misconduct is only a secondary aim. Criminal prosecutions are too costly, difficult, and time-consuming to be used to prevent a particular merchant from defrauding consumers.

The strategy is only cost-effective if it has a widespread and compelling deterrent effect on other merchants. If it does, it is more efficient than monitoring the conduct of each of the hundreds of thousands of businesses in the economy.

This report will not consider another goal of criminal prosecution, punishment or satisfying society's sense of justice, limiting itself to criminal sentences' effectiveness as a consumer fraud intervention strategy. Moreover another section of this report will analyze the misdemeanor sanctions authorized by numerous regulatory statutes. 1/

This section will focus on felony prosecutions against fraud schemes, alleging mail fraud, theft by deception or criminal fraud. Maximum authorized prison sentences upon conviction are as high as five or ten years. Every state's district attorney offices enforce at least one such criminal statute. United States Attorney offices enforce mail and other federal fraud statutes with the assistance of the Postal Service, the FBI, and other federal investigatory agencies.

1. Deterrence Measurement

There is no hard data on how widespread and powerfully serious criminal sanctions deter consumer fraud. Systematic attempts to measure crime deterrence in other areas have not met with great success either. Interviews with members of district attorney and United States Attorney consumer fraud units, postal inspectors and numerous other consumer fraud enforcement officials show that no one really knows how to evaluate the effect of criminal sanctions. Consumer fraud prosecution units can not measure the deterrent effect of their activities and do not even try. Officials are skeptical of easy solutions and do not predict the effect of their efforts.

Some prosecutors suggested as a measurement technique counting the consumer complaints an office receives in a fraud area to determine if the number decreases after several prosecutions. But a drop in complaints can be caused by numerous factors. A temporary flurry of publicity surrounding a new office causes a short-lived rise in consumer complaints, that then drops off as the publicity dies down. Consumers realize that an office does not offer restitution, but only criminal prosecution, and stop complaining to it. Other consumer offices are created, drawing complaints away from existing offices.

Fraud schemes are also so responsive to consumer behavior that they adjust themselves to discourage complaint volume when consumers start contacting agencies too often. For example, used car dealers have discovered that repossessing cars and seeking deficiency judgments drives consumers to neighborhood legal services office. So these dealers shift their procedure to only repossessing the car or suing on the debt owed, but not both.

Thus fraud may not be decreasing; merchants may just be shielding it better from enforcement officials. In fact, some officials claim that an increase in complaints is an indication of program success as the public becomes more aware of frauds being perpetrated and realizes that government will respond to the problem.

Another common measurement technique for fraud deterrence consists of enforcement officials' rough feelings, based on personal observations and discussions with merchants. A prosecutor with a jurisdiction of only a small community can do this better than one with a major city or several state areas within his jurisdiction.

The use of undercover investigators and test products is a promising measurement technique that is not often used as such, but primarily as an enforcement tool. Practical and evidentiary obstacles to using this technique to prosecute fraud do not apply to using it to measure fraud. A Federal Trade Commission staff study of the effects of licensing on television repair fraud successfully used the method to compare fraud's prevelence in two different states with different enforcement approaches. Pre-tested and pre-marked television sets were taken to a selection of service shops to determine what claims would be made and what work actually done. 2/

Criminal Sanctions and "Mainstream" Sellers

The lack of good measuring techniques has not prevented enforcement officials and other consumer experts from offering personal evaluations of criminal sentences' deterrent effect. Most feel that if the threat of a prison sentence is real enough, it will deter "mainstream" sellers - established businessmen with ties to the community who happen to see an opportunity to make sizeable profits by stepping over the line of legitimate business conduct.

Imprisonment is the worst thing that can happen to a white collar criminal and thus the most effective deterrent. His reputation and standing in the community are destroyed, and the actual imprisonment can be crushing. In comparison, fines are just a cost of doing business and other sanctions may not be strong enough to force a seller to forego the fraud schemes' enormous profits.

Moreover, consumer fraud activity is more responsive to deterrents than other crimes. It is not a crime of passion or impulse, but is planned and carried out over a period of months. Dire need, desperation, or stupidity rarely are motivating factors. The offender has a clear option whether to engage in the illegal conduct.

But criminal prosecution's deterrent effect is localized geographically, by type of fraud, and in time. One prosecutor claimed that 45 day prison sentences handed down to managers of 2 major car dealerships completely stopped odometer rollbacks in the area, but odometer fraud increased in surrounding areas. The real crooks apparently just moved to jurisdictions where prosecution was not a threat.

Similarly, an odometer or automobile repair conviction will have little effect on health spa and mail order operators. Those operating on the fringe of the law are attuned to the nature and effectiveness of fraud prosecutions in their area. The advice of legal counsel often assists merchants in knowing when and where to fear criminal prosecution. A six month prosecution program against auto repair fraud was successful in one metropolitan area, but a year-and-a-half later, repair fraud had picked up again. Frauds are often cyclical in nature, appearing, disappearing, only to appear again.

As corporations increase in size, criminal sentences' deterrent effect diminishes. Top corporate officers become more and more insulated from the acts of their subordinates. At the same time, subordinates claim they are only following company policy. The corporation itself cannot go to prison.

Criminal Sanctions and Hard Core Fraud

Hard core fraud schemers present a different problem. They often move rapidly from place to place, with no concern about their reputation in the community. They are willing to risk jail time if the profits are great enough. The only realistic threat for these sellers are lengthy prison sentences. Even this threat will not deter the incorrigible. Prosecutors consider some offenders psychopaths who cannot distinguish between legitimate and fraudulent business conduct.

Other fraud offenders are highly mobile and pick and choose areas with the least enforcement. Effective prosecution just increases fraud in some other jurisdiction. Some schemes move so quickly they are gone before local prosecutors discover their existence. The National Association of Attorneys General and the National District Attorneys Association have developed networks that track the whereabouts of these merchants, serving as an effective early warning system for participating offices.

Knowing these sellers are coming and arresting them at the first sign of fraud will still not deter them. They always have lots of cash with which to make bail. Bail forfeitures are just a cost of doing business since prevailing judicial attitudes favor low bail orders. Courts are only beginning to order higher bail if the defendant's likelihood to flee is documented. Once itinerant merchants jump bail, local prosecutors rarely apprehend them. One district attorney consumer fraud office has 2,000 outstanding arrest warrants.

Federal prosecutors do not have these problems; almost all federal fugitives are eventually apprehended. As many as 40% of all defendants are fugitives at some time, but 90% of all defendants are available when their trial is scheduled. Federal prosecutors have jurisdiction to arrest individuals anywhere in the United States; state and local prosecutors only retain authority within their own jurisdictions and extradition is rarely used. Merchants learn they are safe from state but not federal prosecution if they just move to the next state.

2. Prosecuting Consumer Fraud

Whether the fraud perpetrator is an established businessman or a hard core offender, the deterrent effect of criminal prosecution depends on the number of consumer fraud cases brought, the difficulty of proving fraud and convicting perpetrators, the severity of the sentences, and the publicity generated.

Uncovering Consumer Frauds

Only criminal prosecutors can initiate criminal prosecutions. Consequently, criminal sanctions' deterrent effect depends in the first instance on the decision of prosecutors to prosecute. There are varied reasons why prosecutors do not bring cases against fraud offenders.

Prosecutors never discover fraud schemes. Consumers often do not report frauds to enforcement officials. The consumer is not even aware of a really successful fraud scheme. When consumers discover frauds, they are embarrassed by their own gullibility or avarice. Others realize that reporting a crime to a criminal prosecutor will not get their money back.

Some groups of consumers are uncomfortable going to a courthouse to complain to a criminal law enforcement official. For example, complaints to one district attorney's office come from middle class, surburban areas; none originate from Black and Mexican ghettos. Branch offices away from courthouses ease this problem.

Even if consumers complain, agencies may be swamped by individual problems and fail to see patterns of frauds emerging. Complaints about the same fraud can be scattered among different agencies so that no one office discovers the extent of abuse. Too often rivalries and jurisdictional arguments among government agencies accentuate this problem. Other complaint resources, such as legal services programs and small claims courts are largely untapped. One response to these problems is the pooling and computerization of complaints received by different agencies so that patterns can be identified.

Enforcement officials also uncover frauds through their own active investigation, favoring this approach to passively reacting to consumer complaints. Some units send out test shoppers, undercover cars, actively monitor advertising, and scrutinize the marketplace. But most enforcement offices wait for consumers to complain and some even do little investigation beyond taking down the consumer's story.

One important resource, local police forces, rarely investigate consumer fraud. Bunco sections concentrate on traditional scams, not consumer problems. Police are beginning to participate in some district attorney economic crime units, but more commonly these organizations hire their own investigators. The United States Postal Service and other federal investigatory agencies commit significant manpower to consumer fraud investigations.

Deciding to Prosecute

Enforcement agencies often fail to prosecute frauds because of lack of interest or expertise. District attorney and other offices prosecute predominantly street crimes. Consumer fraud actions involve different laws, procedures and problems. Cases are time consuming and complicated, requiring accounting, marketing, or consumer behavior expertise. Company file searches are particularly onerous.

Consequently, prosecutors specializing or at least experienced in consumer fraud cases are generally the only ones willing or able to pursue them. But only 40% of the nation's population lives within jurisdictions that have special district attorney economic crime units. Many major cities have no specialized consumer fraud prosecutors. A Florida survey found only six of the state's eighty prosecutorial offices had an attorney specializing in consumer fraud, and only 156 of the state's 31,000 criminal cases involved consumer fraud. 3/

Even specialized economic crime units are moving away from consumer fraud prosecutions and are turning to even more complex and challenging cases. As a unit develops enough expertise, it begins to prosecute official corruption, securities fraud, computer theft, and other more glamorous crimes.

Prosecutors also allow merchants to buy their way out of criminal prosecution by compensating fraud victims for their losses. Offices that combine complaint mediation and prosecution usually only prosecute if complaint mediation fails. Other cases are dropped after restitution settlements.

Some offices refuse to drop prosecutions after restitution is made, seeing prosecution's purpose as deterrence, not compensation. But others accept full restitution for victims when the alternative is devoting enormous resources and time into a trial, only to find the defendant placed on probation or some other minimal sentence with little deterrent effect. Institution of a criminal action also usually will preclude civil remedies, eliminating any chance of recovery by the victims. Judges and prosecutors alike often see consumer fraud as a civil problem, not a criminal one.

Inadequate resources prevent other prosecutors from bringing consumer fraud cases that almost always are very time consuming. Ten investigators spending two years on a land fraud case is an extreme example, but it is common for two attorneys to spend months, even years, investigating and prosecuting a case. While guilty pleas resolve many cases, white collar criminals have the legal resources to push cases to lengthy and complicated trials. In 1975, 149 attorneys and about 250 investigators and paralegals in 41 economic crime offices were needed to win 226 felony trials, obtain 385 guilty pleas and prosecute a large number of misdemeanor cases. 4/

Another substantial prosecution cost is paying for witnesses who have to be brought in from around the country and kept for indeterminate periods of time during the trial. Experts, depositions, and other costs can also be significant.

Available resources to prosecute these costly and time consuming cases are severely limited. There are probably less than 300 criminal prosecutors concentrating on consumer fraud cases around the country at the federal, state and local levels. 5/ Consequently, prosecutors must decline because of limited resources cases already investigated and ready for trial. Business lobbies oppose legislation increasing resources for economic crime prosecutions.

Criminal prosecutors develop priorities for the trial of consumer fraud cases. Some offices concentrate on one type of fraud; others look for sizeable consumer losses or particularly hard core fraud. Federal offices give priority to cases with national implications or involving large companies. State and local prosecutors rarely bring cases involving out-of-state victims or sellers.

Prosecutors' reluctance to initiate consumer fraud cases does not necessarily destroy the strategy's effectiveness. The central strength of criminal sanctions is that a few actions can deter large numbers of sellers; enforcement agencies do not have to sue everyone. There is little hard knowledge about how many prosecutions are enough, but it appears that if specific types of fraud do not receive at least minimal periodic prosecution in each locality they occur, sellers will not be deterred. Some sellers are only deterred by really extensive prosecution programs.

Elements of Criminal Consumer Fraud

Criminal sentences' deterrent effect depend not only on enforcement agencies initiating lawsuits, but on them proving criminal fraud and convicting the defendant. The prosecutor must show that the merchant's actions meet the basic legal elements of criminal fraud. Most state prosecutions are brought under theft by deception or false pretenses statutes which require:

- intent to defraud
- misrepresentation knowingly or recklessly of a past or existing fact
- reliance by the victim
- surrender of property

Intent to defraud is usually the most difficult element to prove. The inner-workings of the defendant's mind is difficult to show and prosecutors instead demonstrate a scheme to defraud, often relying on a massive, expensive evidentiary display. Intent is more easily proved if the fraud pattern is shown to be widespread and longstanding than if it is seemingly an isolated instance.

The misrepresentation standard also creates problems. Unlike the standard in civil cases, the false representation must concern a past or existing fact. A promissory statement later shown to be false, such as a promise to perform a service, is insufficient to prove criminal fraud.

Several jurisdictions hold that promises made without the intention to perform are misrepresentations of present states of mind and are thus actionable. But this state of mind is often difficult to prove, the merchant claiming that that he intended to perform but got sick, his employees were negligent, or his business faced unforeseen financial difficulties.

The federal mail fraud statute provides a more liberal standard, finding false promises actionable. New York has recently patterned its fraud standard after the mail fraud act, but requires proof that 5, or in some case, 10 people have been defrauded. West Virginia also patterned its act exactly after the federal mail fraud statute, but its own courts found it unconstitutional.

The third element of criminal fraud, reliance by the victim, is usually not difficult to demonstrate, but becomes a real barrier when using undercover investigators and test products, since these sales are not made relying on the merchants' representations. Purchases are motivated by the investigation itself.

The fourth element, surrender of property, also causes few problems. Courts will still find fraud even if the merchant later refunds the money. Proof problems become more complex when at least part of a transaction is legitimate and the consumer receives something of real value for his payment.

Criminal consumer fraud statutes also have other proof requirements. The mail fraud statute applies only to schemes that use the mails, so some fraud offenders intentionally do not use the mails but only messengers. Some state statutes require a separate indictment for each victim unless there is a commonality of interest. Prosecution of a fraud scheme may result in 40 separate indictments and 40 separate trials.

Consequently, fitting a fraud scheme into the elements of criminal fraud statutes is not a simple matter. Some prosecutors claim one can "massage" almost any fraud into a prosecutable case; others feel that significant numbers of frauds are not actionable. One investigator stated he could discover a fraud in a day, but it might take 2 years to develop sufficient evidence for an indictment.

The obvious solution, to make criminal fraud easier to prove, is self-defeating. The more liberal the standard for actionable fraud, the more difficult it is to obtain severe sentences. Judges will not send to prison merchants who are only proved negligent, to have unknowingly misrepresented the public, or to have failed to comply with certain technical requirements of regulatory statutes. But judges not handing down severe prison sentences defeats the central rationale for felony prosecutions, deterring seller misconduct through the threat of harsh penalties. Quicker, easier prosecutions, resulting in fines or probation, is an important consumer fraud intervention strategy in its own right, and it will be discussed in a later section. 6/

Developing Evidence

Developing extensive evidence to meet the strict standards for felony fraud prosecutions thus can not be avoided, even though it creates substantial problems. In some states prosecutors have no subpoena power and must use the grand jury or the court to obtain information. Local prosecutors also complain about legal impediments to the exchange of evidence with other prosecutors and the reluctance of federal agencies to reveal anything.

Consumer witnesses often do not cooperate. No one likes to be sworn under oath and forced to testify how one was duped, particularly if one does not get anything out of it. Witnesses have to be brought from all over the country, and even local consumer witnesses are notorious for not showing up at the trial. When consumers do testify, it is often to oral misrepresentations contradicted both by the defendant and written contracts.

Important alternative evidentiary sources being used with increasing frequency and success are undercover shoppers and test products. They document with great precision such conduct as failure to make disclosures, performing unneeded repairs, charging for work not done, or replacing parts with other used parts. But evidentiary problems include showing reliance and defeating entrapment defenses. It is costly to rig an undercover car or other test product and then preserve it for trial and inspection by the defendant's attorney. The technique is useless if the product is not rigged with care and precision. In Philadelphia, an industry auto repair council provides the district attorney with cars with carefully controlled problems, and then tests and evaluates repair shops' claims and performance.

Important evidentiary sources not used by economic crime prosecutors are traditional police investigational techniques such as surveilance, electronic bugging, videotapes, and other undercover work. While police forces sometimes assign 4 or 5 investigators to utilize these methods on a single violent crime case, economic crime prosecutors rarely use these techniques at all. One prosecutor claimed that instead consumer fraud cases become "swearing matches with businesses".

Trial Issues

After sufficient evidence is developed to meet the elements of criminal fraud, the prosecutor has to be prepared to take the case to trial, where various additional obstacles prevent convictions. Jurisdictional and venue issues frequently arise. Information developed in civil proceedings may not be admissable in a criminal trial, and other problems of simultaneous criminal and civil proceedings develop. Rules of evidence prevent other data from being presented to the jury. For example, despite modern rules to the contrary, judges exclude from evidence business records, describing them as hearsay.

Prosecutors must educate the jury about complex business arrangements and legal standards so that the jury can reach an informed verdict. In order to shoulder his burden of proving guilt beyond a reasonable doubt, the prosecutor also needs to make a powerful factual presentation. While not strictly necessary to prove guilt, he will want to show the defendant's evil motive and the crippling impact of the fraud on his victims. Judges also play an important role in the trial. But prosecutors complain that they must work with judges who do not take consumer fraud laws seriously and narrowly interpret them.

The defense attorney's actions can be the prosecutor's greatest obstacle. Consumer fraud defendants pay for experienced counsel who will attempt to drag cases out for years, challenging the prosecutor at every step. Federal fraud cases take as long as five years.

Despite all of these impediments, most consumer fraud indictments lead to convictions. Economic crime units affiliated with the National District Attorneys Association in 1975 reported 226 successful felony prosecutions, 385 guilty pleas, and only 31 acquittals or dismissals. 7/ Other prosecutors also report that 80% to over 95% of consumer fraud trials result in convictions, and that many others result in guilty pleas.

3. Sentencing Practices

In the last analysis, criminal prosecutions' deterrent effect depends on the sentences those convicted serve. With few exceptions, judges' sentencing practices have severely limited the effectiveness of this fraud intervention strategy.

Suspended sentences, probation, and fines are the norm; serving time in prison is rare. Famous Dallas "hanging" judges hand out probation in consumer fraud cases; only a handful of judges in other cities routinely sentence white collar criminals to prison terms. Six months probation is typical, with harsher sentences being a few weekends imprisonment. Even more startling, judges rarely revoke a seller's probation upon a subsequent fraud conviction. Probations are piled on top of probations.

Individual sentences provide dramatic examples. A $25,000 a year fraud perpetrated for 18 years received a six months prison term. A $7 million fraud scheme was settled with $100,000 in restitution and no jail time. A merchant convicted a <u>third</u> time for a similar multimillion dollar swindle finally received a 16 months sentence. His partner was placed on probation. After serving 2 of the 16 months, the third time offender was back in court requesting a reduction in his sentence.

This reduction request is not atypical. White collar inmates find it quite easy to be paroled and rarely serve the full term of their sentences. A federal prosecutor has described this problem in some detail, and its effect on potential fraud offenders.

> ...sentences are often deceptive. Many with a severe appearance have no teeth. A federal sentence couched as "five years imprisonment", but subject to the provisions of 18 USC 4208(a)(2), is an indeterminate sentence with a possibility of parole at any time. The United States Parole Board, in turn, has no specific

> statutory obligation to take on the task of general deterrence. Even a straight federal prison term of five years, the maximum for many federal fraud offenses, make the offender eligible for parole in 20 months. With "good time" reductions and the occassional use of half-way house programs, the white-collar offender may return to the community before the minimum term prescribed in the sentence has elapsed. In addition, judges grant sentence reductions readily. If the assumption that many white-collar criminals are sophisticated offenders is accurate, then they have probably discerned that it is rare to serve more than three years in prison, and virtually impossible to serve that much time if they plead guilty to the charges. Moreover, the well-financed commercial criminal is often represented by counsel during the pre-indictment investigation stage of a case and therefore more capable of making this cost-risk analysis. 8/

Nationwide statistics on consumer fraud sentences are not available. Several studies of economic crime sentences probably overstate typical consumer fraud sentences which will not be as severe as those convicted for crimes against businesses or the public trust. Nevertheless they provide some indication. Specialized economic crime units affiliated with the National District Attorneys' Association obtained prison sentences in about one-third of their felony cases. 9/

> Seventy-one percent of those convicted of auto theft went to jail for an average sentence of 3 years. Sixty-four percent of those convicted of transporting stolen property went to jail for an average sentence of 4 years. Fifty percent of those convicted of stealing from the mails went to jail for an average sentence of 2.6 years. In contrast, those convicted of white-collar crimes...ran a far smaller risk of being sentenced to jail, and, if sentenced, could count on a much shorter prison term. Thirty-five percent of those convicted of income tax evasion received jail terms, the average 9.5 months. Twenty-two percent of those convicted of embezzlement received jail terms, the average 1.7 years. Sixteen and three-tenths percent of those convicted of securities fraud received jail terms, the average less than one year. 10/

Another study of Federal District Courts reached the same conclusion: "There are plain indications that white collar defendants, predominantly white, receive more lenient treatment as a general rule." 11/

Reasons for Light Sentences

Judges do not hand out lengthy prison sentences for several reasons. Prosecutors will often only indict the corporation to avoid proving the responsibility of individual officers and to generate more publicity. But corporations can not serve time in prison.

Judges also are reluctant to imprison individual fraud offenders. There is more class identification between judges and businessmen than with street criminals. White collar criminals are pillars of the community and attractive, convincing people. They easily appear contrite and always have a good excuse for their behavior. They persuasively argue that arrest and conviction have been enough punishment, that they are financially ruined and socially ostracized. Judges accept this plea from white collar criminals while rejecting it out of hand for others.

Judges also hesitate to put white collar criminals in the same institutions with street criminals. Consumer fraud defendants hire psychiatrists to testify to the damage even one day in prison with such people will cause them. A federal prosecutor agreed, it is "one thing to be punished, another to be tortured for the rest of your life."

Prisons are designed for violent, not white collar criminals, and are not suitable for the rehabilitation of businessmen. Prosecutors and judges alike favor social work or other alternatives to prison. Judges faced with overcrowded prisons prefer to use the limited space for violent criminals. White collar defendants' advanced age is another mitigating factor keeping them out of prison.

Some judges also feel that consumer fraud is not a criminal problem and should not be remedied with criminal sanctions, but with restitution, particularly if small amounts of money are at stake. Since consumer fraud cases rarely appear in court, judges do not perceive them as seriously as street crimes and are less concerned with deterrence.

This is particularly so since a courtroom trial is a difficult forum to describe the extent of a fraud scheme's impact. Normally only a few victims are introduced as witnesses, and the conviction will be based on only part of the fraud scheme. If the defendant pleads guilty, there will be even less opportunity to demonstrate the extent of the fraud. The judge will only look at the indictment and a pre-sentence report. Fraud offenders normally have unblemished previous records. A burglar committing five robberies in a year is a hardened criminal, but a merchant bilking thousands of people over a period of years is considered a first-time offender.

There is a growing trend for judges to sentence consumer fraud offenders to prison terms. Causes include increased public pressure, prosecutors demanding stiffer sentences, and judges becoming aware of the consequences of light sentences. At sentencing in some jurisdictions prosecutors and reporters pack the courtroom to demonstrate to the judge the public's concern.

Nevertheless, the strategy of using harsh prison terms for white collar criminals will always face problems. A sentencing judge looks at the defendant primarily as an individual who should be rehabilitated or punished, not as an example to deter other frauds. The judge is not responsible for a fraud deterrence program; he is responsible for the future of the person he is sentencing.

Sociologists also question the feasibility of widespread convictions and sentencing of middle class businessmen. "The effectiveness of the penal conviction in this case leads to pressure against the use of the sanction...middle class persons resent being treated like criminals no matter what legal rule they may violate." 12/

Publicity

The deterrent effect of any sentence, no matter how stiff, will depend on the dissemination of the sentence's existence to merchants considering fraud schemes. Some enforcement agencies regularly talk to business groups; others have two-minute economic crime spots on television each week. Suits against major corporations, such as Sears Roebuck, always generate substantial press attention.

Prosecutors, being either elected or political appointees, encourage favorable publicity.

But courts do nothing to publicize their actions and prosecutors can do nothing during the trial's pendency, the best time to publicize. The "Sheppard Doctrine" prohibits the dissemination by parties to a criminal action of information not publicly known. 13/

Nor has there been a study of the most effective way of disseminating to potential fraud offenders information about sanctions affecting them. But if prosecutions are rarely initiated and prison sentences are never ordered, wider dissemination of this information would be counter-productive.

B. INJUNCTIONS, CEASE AND DESIST ORDERS

Another important but very different strategy than criminal sanctions utilizing the deterrence approach is injunctive actions. An injunction or cease and desist order, as it is sometimes called, results from a government agency prosecuting a merchant in court or before an administrative hearing. The judge or presiding officer orders the fraud offender to stop specific illegal practices, with threats of further penalties for violation of the injunction.

Like criminal sanctions, injunctions deter in two ways. They deter future misconduct by the seller in question, called specific deterrence, and also misconduct by other similarly situated sellers, called general deterrence. Criminal prosecution is an inefficient strategy for specific deterrence; injunctions are easier to obtain, making specific deterrence more cost-effective.

Injunctions are not primarily suited to deter generally because initial violations result in no monetary penalty or prison sentence. Nevertheless, enforcement agencies do seek injunctions to deter generally and other times do not seem to know which type of deterrence they are seeking.

1) Specific Deterrence

Orders to cease merchant misconduct vary depending on how voluntary they are. At one extreme is a court issued injunction after a trial on the merits. More voluntary is a consent agreement where the seller and prosecutor agree on a settlement before trial, and the court approves it. The consent agreement typically does not include any admission of guilt. The merchant just agrees not to engage in specified acts. Violations of consent agreements bear the same penalties as violations of court ordered injunctions.

Assurances of voluntary compliance are less formal consent agreements, essentially a written promise not to perform certain practices. Violation of the assurance draws no penalties, although this varies in some states. The least formal action is a simple warning to the merchant not to repeat his misconduct.

Injunctions' Effects as Specific Deterrents

Since warnings, assurances, and consent agreements are faster and easier to obtain, enforcement officials much prefer them. Officials report that warnings and company assurances normally quickly terminate the offending practice. This expression of prosecutorial interest is enough to deter "mainstream" sellers. "Hard core" criminals or those seriously bent on fraud are not so easily discouraged.

Warnings and written assurances are most proper when an enforcement agency wants to change previously accepted, widespread industry practices or is responding to unintentional, technical violations of regulatory statutes. In other contexts, these informal approaches are increasingly criticized as just slaps on the wrist, having no special penalties for further violations. Many fraud offenders will just ignore them. The Federal Trade Commission, for one, rarely accepts assurances of voluntary compliance, and presses at least for consent agreements.

Even consent agreements and final orders, with their accompanying penalties for future violations, may not be sufficient to deter merchant fraud. A great deal depends on the prosecutor's skill and foresight in drafting the order. If the merchant can alter his mode of operation to skirt the order, but still successfully defraud consumers, the injunction will have no effect since only violations of the order draw penalties.

Orders are not limited to prohibiting acts the merchant previously engaged in; orders can "fence in" the seller by prohibiting related activities. Since overly broad orders are difficult to enforce, they must be very specific, while at the same time prohibiting not only past, but potentially future acts.

But prosecutors do not draft injunctive orders alone. Consent agreements, by their very nature, are compromises between the prosecutor and merchant. There are strong pressures on enforcement officials to settle, so strong that critics claim enforcement officials will agree to almost any order rather than litigate the case. If the case goes to trial, the judge, not the prosecutor, determines the final order. Judges have neither the experience nor the time to carefully draft consumer fraud injunctions.

No order will deter fly-by-night businesses. By the time the injunction is obtained, and certainly before violation of the injunction is prosecuted, the seller will have left the jurisdiction.

A county court injunction against activities occurring in that county may have no binding effect on the seller when acting outside that county. Even if it does, officials outside that jurisdiction will not know about the order and will not enforce violations, particularly if the seller changes names. California has a state-wide system of disseminating the terms of judgments and settlements to all the state's enforcement officials.

State court injunctions apply to the whole state, but have no binding effect outside the state. Only federal cease and desist orders have a national scope. States will have particular problems enjoining companies that predominantly do business in other states.

If an order is addressed to the company and not individuals, the company can cease business and reincorporate under a new name not subject to the injunction. An injunction is only effective against those to whom it is directed.

Despite these problems, injunctions allow more flexibility than criminal remedies in dealing in the same action with not only the company, but directors, officers, agents, and third parties, such as advertising or collection agencies and holders of the company's consumer paper. While evidence must be introduced concerning the activities of these other parties, this is much simpler than joining them as co-defendants in a criminal trial. In one imaginative and apparently effective action, a trade association was ordered to stop the illegal actions of its members, turning the association into a quasi-regulatory agency.

Compliance With Injunctive Orders

Compliance with injunctive orders is only guaranteed if strong sanctions are used against violators. Most deceptive trade practice statutes authorize $5,000 or $10,000 penalties per violation of injunctive orders. Courts will order these penalties based solely on a showing of a violation of the order; the legality of enjoined conduct does not have to be relitigated, even if the original order was by consent.

Violation of court orders can also lead to criminal contempt actions and the jailing of offenders. Jailing is a more powerful deterrent than even sizeable civil monetary penalties. Publicity surrounding criminal contempt actions also exceeds that for civil actions.

Criminal contempt proceedings are often expedited ahead of civil actions. A trial can be held and a jail term ordered within a month of the violation. Unlike criminal sentences for initial violations that involve lengthy trials with high standards of proof, criminal contempt actions require only clear and convincing evidence , and the elimination of both a grand jury and a jury trial speed its resolution.

Criminal contempt is not an effective remedy if a corporation, and not an individual, is the subject of an injunction. While sizeable civil penalties will then be the more effective sanction, violations may provide more profits than the penalty.

Whether civil or criminal contempt is sought, judges are likely to order stiff sentences, viewing the violation of the court's order as a challenge to the court's own integrity. Courts are less "insulted" by violations of consent orders, but even these were approved by the court.

Stiff contempt penalties only deter order violations if the threat of prosecution is real. But agencies typically devote minimal staff to compliance efforts, leaving most resources to prosecute new cases. Typically, compliance is cursorily reviewed six months after the injunction, and not again unless further complaints are received. Consequently, companies just return to their former practices a few years after the injunction. Spot checks for compliance are unusual; borderline violations are ignored; only blatant conduct is recommended for contempt or penalty action.

One legal services office even went to court to enforce an injunction won by an attorney general's office after that office refused to enforce the order. The attorney general's response was to try to stop the legal services action. But another attorney general office finds violations in over 10% of the cases it has initiated, and seeks contempt actions in half of these, settling the others voluntarily.

Responding to troublesome compliance problems, prosecutors increasingly turn to self-policing orders. Injunctions require sellers to keep for the enforcing agency's inspection records proving compliance. Orders mandate that the seller give copies of the injunction or other notices to customers, helping them to look out for themselves for fraudulent conduct. Orders can even require that the merchant create a trust to fund spot checks, blind purchases, and other monitoring by the enforcing agency.

Other injunctions are even more self-enforcing. The United States Postal Service can initiate action to stop postal deliveries to mail fraud violators, effectively ending mail order frauds. While this remedy is only rarely sought, several Postal Service offices advocate internal reforms that encourage its use. Merchants can circumvent the remedy by changing their address and the name they do business under.

The most extreme form of self-enforcing injunction prohibits the seller from doing business at all, or for a period of years. Judges rarely order such injunctions, preferring to prohibit specific illegal practices. But courts will uphold regulatory boards' license revocation actions.

(2) <u>Prosecuting the Injunctive Action</u>

Since specific deterrence stops only one seller's ongoing misconduct, intervention strategies with this goal must be inexpensive and swift. Injunctive actions meet these criteria more readily than criminal prosecutions because their civil nature allows for more flexibile and simpler procedures.

Civil discovery techniques are less cumbersome. Depositions and written interrogatories can be directed to the seller and others. Admissions can be entered into evidence. The prosecutor can inspect business records and fully explore the company's financial status.

The trial is more streamlined; the defendant has fewer constitutional rights. There is no right to a jury trial, no prohibition on double jeopardy, no right to confront adverse witnesses. Proof is by a preponderence of the evidence, not beyond a reasonable doubt. The trial's forum need not be a court, but an administrative proceeding. 14/

Generalized Standards

Civil prosecutors do not have to prove the elements of criminal fraud, but only deception, a broad, flexible and developing standard. Intent to defraud need not be shown; unintentional deception is actionable. Misrepresentations of future events and false promises can be prosecuted if the seller did not have a reasonable basis for making them.

Actual consumer reliance is not a necessary element; solely the tendency or capacity to deceive must be shown. If only the credulous and the least sophisticated can be deceived, the practice is deceptive. Actual damage does not have to be proven, so the prosecutor need not present actual victims or prove injury.

While an extremely flexible standard, deception still is based on the notion of a misleading inducement, not that the underlying transaction is a "rip off". Injunctive suits in some jurisdictions can allege one of two other civil standards of merchant misconduct, unfairness or unconscionability, that do not require seller misrepresentations to be actionable.

Unfairness is an ambiguous and evolving standard, but important considerations are:

- whether the practice offends public policy. Is it within at least the penumbra of some common law, statutory, or other established concept of unfairness.
- whether the practice is immoral, unethical, oppressive, or unscrupulous.
- whether the practice causes substantial injury to consumers. 15/

The standard for when a practice is unconscionable is similarly vague, but criteria suggested by state legislation include:

- whether unfair advantage is taken of consumers' lack of knowledge, ability, experience, or capacity, or whether consumers would reasonably misunderstand the transaction's true nature;
- whether merchants knew of consumers' inability to receive anticipated benefits or make payment in full;

- whether goods are grossly overpriced or agreements substantially one-sided;
- whether consumers are required to waive legal rights or agreements contain terms prohibited by law or unreasonably jeopardize additional money or property. 16/

Criticism of General Standards, Use of Specific Standards

Deception, unfairness, and unconscionability, while providing flexible, evolving and liberal standards of merchant misconduct, are criticized as too subjective and not specific enough. Criminal fraud is limited by the proof of intent requirement. These other civil standards make all kinds of unintentional conduct arguably actionable.

Enforcement agencies hesitate to prosecute, uncertain whether conduct violates these standards. They avoid litigation in new areas, afraid that adverse precedent will be created. For the same reasons, review of such actions within the agency is often lengthy and time-consuming. Before prosecuting, offices overinvestigate, wasting resources and time developing a "fool-proof" record. Prosecutors do not know what they have to show a judge, so they show everything.

Judges, used to specific standards, do not enforce the law creatively, and are reluctant to order strong injunctions for violation of such a vague standard. For example, a judge will rarely penalize a seller severely for failing to disclose information if there were no pre-existing specific standards about what information must be disclosed. These general standards also leave businesses and consumers uncertain as to whether particular practices are illegal.

Alternative standards for civil prosecutions are specific guidelines for prohibited and required seller behavior. Examples include requirements that specified information be affirmatively disclosed, that products be delivered within a certain number of days, and that certain transactions must be in writing. The list of possible guidelines and prescriptions is endless.

Specific standards can be tailored to particular types of fraud. The more specific the standard, the easier it is to prove a violation. Prosecutors find such straightforward suits easier to bring, readily determining whether conduct is illegal. They can ascertain how much evidence is enough and limit their investigation to that. Evidence can be limited to just defective sales contracts or disclosure forms. Prosecutors do not have to resort to detailed fishing investigations or time-consuming attempts to obtain information from the seller. Proving oral misrepresentations is rarely important, so finding credible consumer witnesses is not necessary.

Courts also are receptive to actions alleging violations of clearcut guidelines. Similarly, specific standards better notify merchants and consumers what sales practices are illegal.

But general standards also have their supporters who argue that deception, unfairness and unconscionability are powerful standards, allowing creative applications. No frauds escape prosecution as these standards develop and evolve to meet new types of fraud in new areas. Specific standards just provide guidelines to fraudulent merchants about how to develop schemes that can not be prosecuted because they fit into loopholes or fall outside a regulation's scope.

Practical Obstacles to Obtaining Injunctions

Whatever standard used, prosecutors face certain obstacles to obtaining injunctions. Problems vary with the type of merchant involved, the agency seeking the injunction, and the type of order sought. Most sellers (and courts, where approval is necessary) readily agree to voluntarily discontinue practices or sign weak consent agreements. Most enforcement agency investigations are resolved in this fashion; with the exception when companies leave the state or cease business operations, virtually none are closed or litigated.

Critics attribute this to agencies' willingness to settle for almost anything on paper, rather than close a case or litigate it. One FTC regional office, for example, has not tried a case in four years.

But when enforcement agencies go after litigious major corporations with almost unlimited legal resources, cease and desist orders are difficult to obtain. If the company decides to fight, cases drag on for years. Defense attorneys raise every conceivable issue and make every permissable appeal. Five years or more can elapse from the FTC initiating an investigation to the final order.

Enforcement agencies report a different experience dealing with small companies. Their counsel is less effective, not raising articulate defenses, and it is easy to reach quick, favorable settlements with them. The more substantial problem with small companies is finding them to prosecute. They often leave the jurisdiction or go into bankruptcy when prosecution is threatened.

But if cases against even small companies go to trial, they require significant resource committments. Suits can involve thousands of consumers, who, according to one prosecutor, all want to be "pen pals", resulting in more time spent talking and writing to consumers than litigating the case. Business records and other documentation for some cases can literally fill up rooms. A typical FTC litigation requires two attorneys working full time for 6 to 8 months.

It is remarkable that so many resources have to be expended solely to order a seller not to engage again in certain narrowly defined illegal acts. Some prosecutions seek novel or far-reaching orders, but the core problem is a general attitude by judges, prosecutors, and defendants that the company has to be proved "guilty" before an injunction can be issued. Courts do not issue orders after simply determining that the public interest would be served if a particular merchant is put on notice not to perform certain illegal acts.

This tendency to over-litigate injunctive actions has ramifications beyond those few cases that are actually litigated. The seller's major bargaining chip in consent agreement negotiations is the threat that the prosecutor will be forced to go to trial. If injunctions were awarded after simpler and easier hearings, consent agreements would be tougher on fraud offenders.

Speed in Obtaining Injunctions, Temporary Restraining Orders

Even more debilitating than the resources required to prosecute a case is the time it takes to obtain an injunction. FTC cases take years; attorney general actions are significantly faster, but still drag on for months. Meanwhile, the merchant can continue his fraudulent activity. Sellers do not have to stop their illegal behavior when sued by the FTC until all appeals are exhausted, often taking several additional years.

Consequently, critics consider injunctions to have no effect. By the time an order is in force, merchants have milked the fraud scheme for all it is worth and have moved on to a different one, keeping their illegally gotten profits.

Temporary restraining orders ("TRO's") and preliminary injunctions solve this problem by ordering the seller to temporarily cease his challenged conduct during the pendency of the case. The slowness of the trial then becomes a factor in the prosecutor's favor as the merchant is under order until the case is concluded.

TRO's are generally easy to obtain. While these orders are only available to prevent irreparable injury, courts rule that this requirement is satisfied if a merchant retains the future ability to misrepresent and if resumption of fraudulent acts is likely. Continuing violation of a deceptive trade practice law thus demonstrates irreparable injury. A merchant's promise to discontinue the challenged practice is no defense.

Nor does the prosecutor have to show a pattern of misconduct to obtain a TRO . A few consumer affadavits or defective contracts are enough, eliminating the need for an extensive investigation. Prosecutors report winning almost all of their TRO cases, particularly if they involve unlicensed activity.

TRO's can be effective against highly mobile fraud offenders by freezing bank accounts before the merchant can skip town with the money. Consumers' returned checks indicate where a merchant banks, and a prosecutor can then go to court without notice and obtain the TRO. Timing is often critical. In one case a TRO was issued just two hours before the seller was to withdraw his assets from his bank account.

Surprisingly, prosecutors rarely request TRO's. The hundreds of FTC attorneys prosecuting deceptive trade practices have only sought a handful of preliminary injunctions in the four years it has had that authority. State and local enforcement offices also infrequently seek TRO's.

3. General Deterrence

Enforcement agencies use injunctive actions not only for specific but also general deterrence. There can be no other justification for pursuing cases taking years and valuable resources which have minimal effect on the seller being prosecuted.

Use of Injunctions to Create Standards

Injunctions act as general deterrents by establishing and notifying the industry of clear standards of illegal conduct. An order against one company will warn the rest of the industry what conduct is unacceptable, interpreting such broad and vague categories as deception, unfairness, and unconscionability.

Mainstream companies, wishing to live within the scope of the law, will often abide by these new standards. But sometimes whole industries are willing to face some bad publicity and a few more injunctive actions in exchange for exhorbitant profits. For example, the FTC's attempt to stop vocational school abuses with cease and desist orders proved virtually useless. Similarly, an enforcement agency's prosecution of the largest companies in an industry has an impact on major corporations but has less on smaller companies who know they will be the last to be prosecuted.

Injunction created standards of prosecutable conduct do not deter other merchants because there are no special sanctions if companies ignore this warning. All they face is another injunction, directed against them this time, warning them not to do it again.

Recent FTC legislation responds to this weakness by authorizing sizeable civil penalties for initial violations by companies that have notice of standards set by individual adjudications. While this legislation gives litigated injunctions more of a deterrent effect, the statute significantly does not apply to almost all FTC actions, those settled by consent agreements.

Others criticize any use of individual litigations to establish binding standards. Case by case litigation is expensive and does not always provide useful precedent. Cases often turn on their own individual facts, and judges prefer not to go beyond those facts to create standards applying to other cases.

Agencies do not trust judges to interpret aggressively such vague and flexible standards as deception and unfairness. The FTC is reluctant to bring cases of first impression before federal courts, preferring first to establish the precedent through slower and less effective administrative action. Attorney general offices will often settle cases instead of allowing the court to decide the case and create bad precedent. Moreover, when cases go to trial, other industry members, consumers, and other interested parties are not able to participate in the standard setting decision.

The FTC and many attorney general offices utilize rulemaking as a more effective method of establishing and notifying the industry of specific standards. The non-adjudicatory proceeding, involving the whole industry and consumer groups, does not prove companies' past illegal acts, but concentrates on creating appropriate standards.

State rulemaking procedures are less cumbersome than injunctive litigations, dispensing with formalized, adjudicatory procedures. Written notice and an opportunity for written and sometimes oral comment is all that is required. But enabling legislation can make the rulemaking process more time-consuming; the FTC has a complicated rulemaking procedure that takes years to complete.

Injunctions as Penalties

A second way injunctions can serve as general deterrents, beside creating and notifying the industry of specific standards, is if the injunctive order includes so many affirmative requirements that the offending seller is actually penalized. Sellers do not fear injunctions that just warn them not to engage in certain specific acts again. But injunctions are more threatening if they include additional costly requirements that place the seller at a competitive disadvantage. Types of orders containing such added onerous prescriptions are only limited by the human imagination. Examples include affirmative disclosures, recordkeeping, compulsory arbitration of consumer disputes, ceasing certain non-deceptive marketing techniques, and liberal refund standards for future service sales. Added to the burden of these expanded injunctions are the costs and adverse publicity associated with litigating the case.

Even so, injunctive actions are not as severe deterrents as prison sentences and judges will not always order onerous affirmative actions, particularly if no evil intent is shown and the standard violated is vague. Consequently, injunctions' general deterrent effect must rely on their widespread prosecution.

(4) Limits on the Initiation of Injunctive Suits

Enforcement agencies do not bring injunctive actions for many of the same reasons criminal prosecutions are not brought. There are also additional factors causing government agencies' reluctance to prosecute.

Agency Discretion

Many agencies do not consider injunctions as effective specific or general deterrents and prefer restitution, rulemaking, and other strategies. Other offices only consider injunctive actions meeting certain criteria. One FTC regional office will not touch cases against companies with less than $3 million in sales, that involve individual monetary losses less than $300, or have only local implications. Other agencies seek injunctions selectively for health and safety problems.

Other offices limit cases if contractual defenses are available, proof relies on oral representations, or if the defendant is likely to leave the state or go out of business. Offices do not initiate litigations based on only a few complaints. State enforcement agencies rarely prosecute in-state companies who only defraud out-of-state consumers.

Limitations on injunctive cases prosecuted are invariably attributed to a chronic lack of resources. But that complaint is either evidence that offices are in fact understaffed or that the injunctive strategy is just not cost-effective.

The average attorney general office has about six attorneys and a similar number of investigators working full time on consumer protection. Variation by state is significant. Arkansas, Indiana, and Tennessee each report one full time attorney; Illinois, Massachusetts, New York, and Texas each report more than 20. 17/
Local consumer protection agency budgets range from

under $5,000 to over $1,000,000. More than 70% have budgets under $100,000; only 14% have budgets more than $300,000. 18/

Institutional Impediments

Prosecutors can only bring cases they know about. Consumer complaints are a major information source, but consumers do not always complain or clearly articulate the underlying fraud. Experts criticize agencies for sitting back and waiting for complaints to come in, instead of actively monitoring the marketplace.

Active investigation is the best method of discovering patterns of abuse, allowing offices to develop intervention programs. Advertising can be scrutinized, undercover shoppers and test products can be utilized. Former auto mechanics and salesmen are skillful investigators of the industry they were formerly employed with.

Jealousy and conflict between competing enforcement agencies is a surprisingly important factor in diminishing agency effectiveness. Offices seem as intent at criticizing each other as prosecuting fraud, and merchants are skillful at playing off one agency against another.

Similarly, no one office is perfectly constituted to stop consumer fraud. Legislators grant certain regulatory agencies, with special expertise dealing with particular industries, exclusive jurisdiction to prosecute frauds committed by that industry, preempting efforts by consumer fraud enforcement agencies. But these agencies are also inexperienced and often uninterested in acting as consumer fraud prosecutors.

State enforcement agencies are distant and bureaucratic. Local consumer protection offices are more accountable, accessible and tangible to the local community, and their actions generate local publicity.

State agencies have more resources, and their greater size leads to more expertise and specialization. They are less subject to local idiosyncracies and can deal with state problems in a more coherent and uniform fashion.

State agencies, on the other hand, have difficulty dealing with interstate problems. Federal agencies, while better at inter-state issues, do not effectively police local problems. Such institutional limitations to government enforcement efforts, whether they be at the federal, state, or local level, are inescapable for as broad an area as consumer fraud.

Within agencies, staff complain about excessive layers of review, delay, and continuing changes in guidelines and priorities. The upper levels of review are subject to political pressures. Many attorneys general and district attorneys are elected, so an office's public image, and not just its law enforcement effectiveness, is important. Political appointees are concerned with the views of those appointing them. Consequently, staff independence is always an issue.

Staff are often inexperienced due to the high turnover among professionals. The high turnover can also result in several different prosecutors handling the same case. None may be fully familiar with the whole case, and if just one prosecutor loses interest, the case is dropped.

Some offices downplay litigation, emphasizing complaint mediation in its stead. Violations of some laws are not enforced at all because no agency is responsible or interested in enforcing the statute.

Enforcement agencies can also just be ineffective. In one case an investigative reporter developed through informants and other investigative reporters solid evidence of a serious consumer fraud, but could not convince the attorney general to bring suit. A law professor stopped providing students to an attorney general office after discovering only one case had gone to trial in a year. Others comment that offices are afraid to lose cases and thus never bring any. A legal services office was so enraged over the inaction and incompetence of one enforcement agency it considered a malpractice suit. While such harsh criticism is not widespread, it is not isolated either.

Number of Injunctive Actions Brought

The result of all these factors is that relatively few injunctive actions are brought. A negligible number of civil prosecutions of any sort actually go to trial. One active attorney general office has not had a case go all the way to trial in 2-1/2 years. FTC regional offices average 1 or 2 administrative trials a year.

Significantly more consent agreements are signed. The FTC averages about a consent agreement per attorney per year. In 1977, attorney general consumer protection offices filed about 1200 civil suits, or an average of 24 a state or four an attorney. 19/ Few go to trial; most result in simple settlements or assurances of discontinuance, having little general deterrent value.

C. FINES, PENALTIES, AND LICENSE REVOCATIONS

An intermediate deterrent approach between criminal sentences and injunctions is to fine or, in extreme cases, revoke licenses of defrauding merchants. Sanctions are not as harsh as prison terms but,unlike injunctive actions, initial violations are penalized.

Civil monetary penalty and license revocation actions utilize favorable standards and procedures similar to civil injunctive actions. While actions for misdemeanor fines necessitate criminal procedures and standards, these are relaxed compared to felony prosecutions.

Simpler prosecutions resulting in penalties for initial violations is an effective general deterrent if two conditions are met. Prosecutions must be frequently initiated so that the threat of government action is greater than with felony prosecutions. And the actual sanction for the initial violation must be severe enough to deter.

1. Fines and Penalties

Criminal fines and civil monetary penalties vary significantly in their size. Regulatory statutes often authorize $50 or $100 fines. Even misdemeanor fraud statutes have maximum fines as low as $500. On the other hand, several federal felony statutes allow fines of $5,000 or more,but state criminal statutes rarely authorize such sizable criminal fines

Civil penalties for initial violations of deceptive trade practice statutes are higher, as much as $5,000 or $10,000 per violation. Since each instance of fraud is a separate violation, maximum penalties can be significant. But these larger penalties are infrequently awarded. Courts usually limit penalties to several thousand dollars; only rarely are penalties of $100,000 or more ordered.

No sellers find several hundred dollar penalties significant deterrents. Large companies do not even consider a $50,000 penalty anything more than a cost of doing business, and may even be able to write it off for tax purposes. Fraud schemes net more revenues than the fine, so restricting government sanctions to minimal fines insures the fraud's profitability.

Only large penalties awarded against small companies engaging in minor frauds have significant deterrent effects. Commentators suggest increasing monetary fines to a percentage of a company's sales or a multiple of its fraudulent profits. 20/

The real threat of misdemeanor and civil prosecutions is not the monetary fine. For established merchants, the attendant publicity damages sales. Even more damaging to local merchants with strong ties to a community is the stigma attached to a criminal conviction, even one resulting only in probation.

But neither publicity or probation threaten fly-by-night sellers or other non-established merchants. Probation also has less effect if corporations, not individuals, are convicted. Companies also minimize publicity's unwanted effects by settling almost all matters in their earliest stages, while not admitting guilt. Increased advertising and public relations efforts can counteract adverse publicity generated.

To the extent that monetary sanctions are not as severe deterrents as criminal sentences, failure to bring frequent actions particularly limits their effectiveness. Sellers will risk occasional $1,000 fines more than five year prison terms.

This section will not reiterate the procedural, proof, resource, organizational and other problems facing the civil prosecutor. 21/ And while misdemeanor criminal actions are simpler to bring, they meet many of the same obstacles as felony prosecutions. 22/

But, unlike other government prosecutions, monetary penalty suits should not be limited for want of resources. The actions generate more revenue than they cost. For example, one office with an $800,000 budget returned to the county $1,700,000 in fines. Legislation can also require offending sellers to pay for prosecution costs, further minimizing the strategy's cost.

Forcing the merchant to return fraud profits to the state also avoids the significant distributional costs and problems associated with ordering the seller to make restitution to individual defrauded consumers. Instead of calculating each victim's loss, locating him, and giving him the award, the court awards a fixed amount, independent of proof of loss, to the state to distribute as it sees fit. This is a deterrent strategy, and does not compensate victims.

2. License Revocation

License revocation is a far more serious deterrent than monetary penalties. Even a temporary suspension can result in hundreds of thousands of dollars of lost profits and significant adverse publicity. Permanent revocations put the seller out of business in the jurisdiction revoking the license.

This sanction does not affect unlicensed sellers, marginal operations that move to other states or change names, or sellers continuing to operate unlicensed. But for established sellers, the sanction is a very serious threat, meaning the end of the enterprise and the loss of a substantial investment.

While the deterrent may be equal in force to prison terms, license revocation procedures are civil and often just involve hearings before licensing boards. Aggressive agencies can quickly and simply revoke licenses, but court appeals inevitably drag cases out much longer.

Because of the sanction's seriousness and the likelihood of appeals, the remedy is not applied to all but the most egregious first time offenses. License revocation is more successfully used after a string of warnings and fines document the seller's wanton disregard of the law.

This in turn requires an active enforcement program continually monitoring individual sellers' compliance with the law. Licensing boards, the agencies with this responsibility, are usually unable or unwilling to perform this task, and rarely revoke licenses. Reasons for licensing board inaction are developed elsewhere in this report. 23/

D. "PRIVATE ATTORNEYS GENERAL"

"Private attorneys general" deter fraud without relying on government agency action. Legislatures give private individuals the tools to bring their own legal actions that deter merchant misconduct. Limited prosecutor resources are not utilized, and frauds that no government agency is interested in are prosecuted.

Private suits for actual damages do not deter fraud; at best, they compensate victims. Private actions only threaten fraud offenders if consumers are given special remedies. This section will discuss two such remedies - private injunctive actions that act as specific deterrents, and special damage awards that serve as general deterrents.

1. Private Injunctive Action

Individual consumers, much like enforcement agencies, can request courts to temporarily or permanently enjoin merchant fraud. Violations of these injunctions, as with agency initiated orders, insult the court's integrity and readily result in criminal or civil contempt sanctions.

Consequently, a private litigation can have same deterrent effect as a government agency action. Earlier analyses of injunctions' strengths and weaknesses as specific deterrents will not be repeated 24/, but certain factors make it more difficult for individuals than enforcement agencies to bring these actions.

An individual consumer rarely continues to deal with a defrauding seller, and thus the seller's future conduct is not of direct concern to him. But courts are reluctant to grant injunctions if there is no prospect of litigants benefiting from them. The judiciary settles disputes between two interested parties, and does not respond to general pleas for reform.

A number of statutes authorize individual injunctive actions, even if the plaintiff has no prospect of being harmed in the future, as long as he was damaged by the scheme in the past. But frequently those best equipped and most likely to bring injunctive actions are not past fraud victims, but consumer organizations or attorneys who can not ethically solicit past victims.

The required proof of actual damage also complicates cases since plaintiffs must show reliance and injury, not just a tendency to deceive. This is particularly difficult for consumers attacking just advertising practices.

Several state laws allow individual injunctive suits without a showing of damage or interest in the practice. Consumer lawyers and organizations, legal services offices, and others can go into court, demonstrate that the statutory standard has been violated, and request future violations be enjoined.

This apparently powerful strategy is limited by the lack of individual resources or motivation to pursue essentially altruistic actions. The consumer suffers no financial harm if he does not bring the action, and no gain if he does. The merchant, on the other hand, has a strong incentive to expend substantial legal resources fighting the suit.

Offers of generous attorney fees and statutory penalties to successful litigants can overcome these problems, but the more these awards penalize the seller, the stronger must be the consumer showing that the seller's misconduct was willful or gross. Judges rarely order strong penalties for unintentional, technical violations. Statutes effectively encouraging consumer litigation also are criticized as overloading courts with matters outside the judiciary's traditional expertise, and fostering frivolous suits.

2. Special Damage Awards

Private damage suits act as general deterrents if the penalties inflicted are large enough and the threat of litigation is real enough. Actual damage awards do not deter at all, but only return the consumer to the status quo.

Special damage awards, when authorized, order merchants to pay more than actual damages and thus deter. While individual special damage awards do not penalize sellers as much as government prosecutions can, there are more consumers than there are government prosecutors to initiate such actions.

Three types of special damages are awarded in private consumer fraud actions. Courts order punitive damages in addition to actual damages when the fraud is particularly offensive, and when there is a strong public interest in deterring similar misconduct.

In a recent product liability case involving the Ford Pinto, the jury awarded $3 million actual damages for bodily injuries and $125 million punitive damages, believing that only an award of this size would deter car manufacturers from designing dangerous cars. But consumer fraud actions do not have $3 million at stake, and the consumer will not be able to afford the type of investigation and legal presentation necessary to show sufficient seller culpability to support sizeable punitive damages.

Consumer fraud statutes occasionally authorize treble damages, where actual damages are trebled in calculating the final verdict. Treble damages are easier to justify than punitive, but consumers must still prove their actual damages. If provable damages are small, treble that amount will have little punitive effect.

The third special damage award is statutory damages. A minimal award is made if the plaintiff proves violation of the statutory standard, regardless of the litigant's actual injury. Statutory damages range from $25 to several hundred dollars. This small amount is insufficient to deter most fraud.

While individual statutory or treble damage awards are insufficient to deter seller abuse, if enough consumers bring these actions, the cumulative effect can be significant. But, as described elsewhere in this report, 25/ private damage actions are not economically feasible and are rarely brought, even with the prospect of special damage awards. Small claims courts encourage some private actions, but do not authorize punitive, treble, and statutory damages. Attorney fees facilitate other actions, but not enough to produce any significant deterrent effect.

The use of the class action device to aggregate special damage awards is a more promising solution. Treble the actual damages of thousands of class members can be a sizeable penalty. Awards are even more substantial if minimum damages are calculated for each class member, i.e. $100 to each of 10,000 class members, for a total award of $1 million. Statutory damages are particularly effective because the class does not have to prove class members' actual damages or reliance on the fraud.

This remedy is so powerful, leading to enormous awards for minor violations, that courts are reluctant to use it. Truth-in-Lending legislation has been amended to clarify that courts should award minimum damages to each class member, but sets a maximum penalty equalling a percentage of the seller's assets.

Businesses report fearing no government sanction as much as a class action seeking minimum damages, particularly if violation of a specific, easy to prove standard is alleged. Private attorneys have sprung up specializing in this sort of action, responding to the potential sizeable attorney fees that can be won.

While not as effective as statutory damages, class actions alleging punitive damages can also be successful. The amounts at stake allow the development of a factual record sufficient to show gross fraud affecting the public at large and justifying punitive damages. Nevertheless, use of class actions to seek any kind of damages for consumer fraud has severe legal and practical limitations, analyzed in some detail later in this report. 26/

FOOTNOTES

(Chapter I)

1. "Fines, Penalties, and License Revocation", Section IC.

2. BUREAU OF ECONOMICS, FEDERAL TRADE COMMISSION, REGULATION OF THE TELEVISION REPAIR INDUSTRY IN LOUISIANA AND CALIFORNIA (1974).

3. A. ENGLAND, CONSUMER AFFAIRS IN FLORIDA, Vol. I at 155, 156, (1973).

4. NATIONAL DISTRICT ATTORNEYS ASSOCIAITON, FIGHTING THE $40 BILLION RIP-OFF (1976).

5. Based on estimate that approximately half of the 149 attorneys in district attorney economic crime units work on consumer fraud cases, and that only small numbers of other assistant district attorneys, assistant attorneys general, Assistant United States Attorneys, and Department of Justice attorneys criminally prosecute consumer fraud.

6. "Fines, Penalties and License Revocation," Section IC.

7. NATIONAL DISTRICT ATTORNEYS ASSOCIATION, supra note 4.

8. Ogren, The Ineffectiveness of the Criminal Sanction in Fraud and Corruption Cases: Losing the Battle Against White Collar Crime, 11 AM. CRIM. L. REV. 951, 963 (1973)

9. NATIONAL DISTRICT ATTORNEYS ASSOCIATION, supra, note 4.

10. W.N. SEYMOUR, JR., WHY JUSTICE FAILS (1973) at 45-46

11. L. ORLAND AND H. TYLER, JUSTICE IN SENTENCING (1974)

12. Ball and Friedman, The Use of Criminal Sanctions in the Enforcement of Economic Legislation: A Sociological View, 17 STAN. L. REV. 197 (1965)

13. Sheppard v. Maxwell, 384 U.S. 333 (1966)

14. See for further comparison of civil and criminal prosceutions G. Bowley, Law Enforcement's Role in Consumer Protection, 14 SANTA CLARA LW. 555 (1974)

15. Sperry D. hutchinson Co. v. FTC, 403 U.S. 233 at 244-45 (1972)

16. J. SHELDON AND G. ZWEIBEL, SURVEY OF CONSUMER FRAUD LAW (1978) at 31

17. Committee on the Office of the Attorney General, National Association of Attorneys General, 1977 Questionnaire of Attorney General Offices.

18. C. Kashnig, Center for Consumer Affairs, Date of Origin, Budget, Number of Staff and Legal Authority of 161 Consumer Agencies in State and Local Government, 1976 Questionnaire.

19. Committee on the Office of Attorney General, *supra* note 17

20. W. Breit and K. Elzinga, *Antitrust Penalties and Attitudes Toward Risk: An Economic Analysis*, 86 HARV L REV 693 (1973)

21. See "Injunctions, Cease and Desist Orders", Section IB.

22. See "Criminal Sentences", Section IA

23. See "Licensing", Section IVA

24. See "Injunctions, Cease and Desist Orders", Section IB

25. "Private Damage Actions", Section IIA

26. "Class Actions", Subsection IIA(5).

CONTENTS - CHAPTER II

II COMPENSATE VICTIMS

Compensating victims is another important consumer fraud approach. The offending merchant returns the defrauded consumer to the status quo, redressing wrongs suffered. This approach does not prevent or deter fraud, but only compensates victims.

To the extent consumers can be quickly and effectively returned to the status quo, there is no need for other approaches preventing fraud. But, since no available strategy returns all defrauded consumers to the status quo, this approach must be viewed as a partial solution, compensating as many victims as possible.

There are three important strategies utilizing this approach. Injured consumers can bring private damage actions alleging fraud and asking the court to order the offending seller to pay damages. Since traditional actions are not practical to redress small frauds, states have developed a number of innovations. Special damage awards, attorney fees, small claims courts, and class actions attempt to make fraud actions easier and cheaper to bring. While successful to some extent, all of these innovations have important weaknesses.

Warranties and other liberal standards of merchant misconduct and post-sale disclosures make proof easier. These too fail to make private actions cost-effective.

Government prosecutors can request a court to order restitution to all consumers defrauded by a seller. This strategy is similar to a private class action, sharing its strengths and weaknesses. It also has advantages and disadvantages of its own.

Complaint mediation is the essentially voluntary process of government agencies mediating disputes between sellers and buyers. Many defrauded consumers do not complain, agencies refuse to mediate certain complaints, and certain merchants refuse to participate. But for a large number of consumers, complaint mediation results in at least partial compensation.

A. PRIVATE DAMAGE ACTIONS

Defrauded consumers can compensate their losses by bringing private damage actions in state courts against the offending merchants. If the consumer proves fraud, the court will order the merchant to pay the consumer the proven damages. In theory, this is a powerful consumer fraud intervention strategy. Every time an individual is ripped off, he goes to court and gets his money back. The consumer ends up with no financial loss and the merchant may even come out behind.

For the strategy to be effective, consumers must initiate suits, these actions must be cheap and quick, fraud and the amount of damages must be easily proved, and consumers must in fact get their money back. In practice, none of these things happen.

A number of innovations - special damages, attorney fees, small claims courts, class actions, warranty law, and post-sale disclosures - encourage and simplify private actions. This section will evaluate these innovative approaches after first analyzing traditional private fraud actions.

1) Traditional Fraud Actions for Actual Damages

Collecting Judgments ; Jurisdiction

To bring a damage suit successfully the consumer must properly notify the merchant of the action and must later collect the judgment from him. Serving a complaint against a local, established merchant is not difficult; properly notifying an out-of-state seller such as a mail order firm is. Courts traditionally did not have jurisdiction over such defendants, but modern courts find "long arm" jurisdiction if the defendant has the requisite minimum contracts with the consumer's state.

More troubling is the merchant who disappears. If the defendant is a corporation, service of the complaint can usually be made on the Secretary of State or some other statute-created agent. Non-corporate defendants must be served personally. If the consumer can not find the seller, he can not sue him.

Properly commencing the action does not guarantee that court-awarded damages can be collected. If the merchant is bankrupt, the consumer will be lucky to collect ten cents on the dollar. 1/ Even if the merchant has adequate assets to satisfy the judgment, the consumer may not be able to reach them. Consumers may have to enforce their judgments against out-of-state firms in a court in the state where that firm has assets.

Consumer Reluctance to Sue

Consumers only sue if they know they have been defrauded. Good fraud schemes do not let consumers know they have been taken. The consumer sees no pattern of abuse, and considers his own bad purchase experience as his own fault or the result of unintentional merchant error.

Self-improvement sellers such as health spas, dance studios, and vocational schools encourage consumers to blame their own inadequacies and not the sellers' for problems they have. A buyer may shrug off as accidental a product's shortcount, unaware that everyone else is being shortchanged. A pattern of a repair service charging more than estimates will be perceived as fraud; one isolated instance will not be.

A consumer realizing he has been taken may not know that he can remedy his injury through court action. Most lawyers are not familiar with recent, often complex consumer legislation; the public certainly is not either.

Legal ethics prohibit attorneys from approaching fraud victims and encouraging them to bring legal action. Attorneys willing to handle small consumer fraud cases must wait until the consumer realizes the fraud and contacts him.

But many individuals will not contact any attorney, being afraid of lawyers or never having used one before. Some merchants monitor closely this reluctance to hire a lawyer. Finding that certain practices are so outrageous as to make consumers seek legal assistance, they limit their fraud to acts that come just short of arousing that level of consumer anger.

Economic Restraints

Hiring an attorney is only economically feasible in consumer fraud cases where damages run into the thousands of dollars. Attorneys may accept a $250 retainer for a simple case requiring only pleadings, court costs, and one court appearance, but for most cases attorneys will require about

$500 and a sizeable percentage of any recovery.

Specialists mass-producing consumer fraud cases will not be able to decrease these prohibitive attorney costs. Each case is different, requiring investigation, preparation, depositions, and proof at trial that a complicated, unique factual situation falls into the narrow fraud standard. Consumers rarely keep sales documents and the attorney must investigate the case from scratch.

Consumers meeting strict income guidelines can turn to legal services programs, but access is limited. The Legal Services Corporation reports that over 8 million of the 29 million eligible clients do not have minimum access to a program. 2/

Legal services lawyers have enormous caseloads and give non-consumer cases priority. Apartment evictions and welfare benefit cut-offs are more pressing than suing for a refund on a consumer transaction. Some legal services programs do not take new consumer cases or litigate only those with law reform impact.

Consumers unable to retain legal counsel will find it virtually impossible in most courts to initiate their own actions. Legal complexities, proof problems, court forms and procedural requirements bar lay litigations.

Delays

As debilitating to consumer damage actions as the failure to obtain counsel is the tremendous delays litigants face in obtaining trial dates. In Chicago civil suits have one year delays in small claims court and three year waits in other courts. Other cities experience even worse problems.

Consumers and consumer lawyers are uniquely vulnerable to time delays. Major corporate litigants generally have a miniscule percentage of their assets at stake in any case and can accomodate any outcome through advance planning. Their attorneys are on retainer or have a sizeable practice. Waiting five years for an outcome is no financial strain on either the corporation or its lawyers.

On the other hand, for consumers and consumer lawyers significant time delays are almost synonymous with losing the case. While waiting for a judgment, defrauded consumers can not replace the money lost and their disposable income may be seriously affected. Consumers also move and forget about the facts of the case.

Attorneys taking cases for altruistic motives may lose interest over time, and those taking cases for profit find that the small returns do not compensate for the delay. Legal services attorney turnover is so great that cases are inherited by a whole series of attorneys, the last one often having little knowledge or interest in the case.

Proof of Fraud

If the consumer gets to trial, proof problems may be insurmountable. The goods in question age, so by the trial they are of little evidentiary value. Consumers' evidence is often limited to their version of the seller's oral representations. Often salesmen will not be available for cross-examination, having left the company and disappeared before the trial. Consumers rarely retain the documentation surrounding the transaction. The merchant's version will be buttressed by documents, often signed by the consumer.

Particularly troublesome is proving fraudulent intent, and not just negligence, misrepresentation or defective goods. The easiest way to prove intent is to demonstrate a pattern or scheme to defraud, but this places significant investigatory strains on the individual litigant. He has to go beyond his own experience and explore practices aimed at other consumers. Expert testimony's cost makes its use to demonstrate fraudulent intent prohibitive in minor actions.

Proof of Damages

Courts only order merchants to pay for recoverable consumer injuries that are proved and measured at trial. The consumer has the burden of substantiating his damage claims. If he does not, the merchant, while proved fraudulent, is not required to pay damages. Awards rarely equal actual damages.

Certain damages are not recoverable at all. Consumers usually cannot receive awards for damages indirectly caused by the merchant's fraud, such as loss of job due to a defective car. The consumer receives only the difference between the value of the product or service and the price paid for it, often far less than the indirect injury. When indirect consumer losses are awarded, normally they will exclude damages for mental suffering unless connected with physical ailments.

A number of legal innovations respond to these prohibitive obstacles to successful use of private damage actions. Special damage awards, attorneys fees, small claims courts, and class actions attempt to alleviate economic constraints. Warranty and deception standards and post-sale disclosures are designed to ease proof burdens.

2) Special Damage Awards

Punitive, treble and statutory damages provide more than provable, actual damages, increasing consumers' financial incentive to initiate litigation. An earlier section analyzed the effectiveness of these special damage awards in deterring merchant misconduct. 3/

Punitive damages, as the name suggests, are designed to punish and deter merchant misconduct, with the consumer being the lucky recipient. Consumers must prove that the "fraud, aimed at the public generally, is gross and involves high moral culpability...". 4/

Only certain frauds meet this standard, and consumers are forced to make a difficult and costly evidentiary showing to prove this gross fraud. Punitive damages are not applicable to normal consumer suits where only one deceptive transaction is alleged.

Statutes authorizing treble damages usually require consumers to show "willful" or "bad faith" behavior, nullifying the use of deception and other liberal standards in these actions. Even when statutes authorize treble damages without proof of intent, judges will not award such damages unless the violation is gross.

Treble damage awards are also tied to proof of actual damages. If actual damages are not proved, three times nothing is still nothing. Small damage awards trebled will still be insufficient to encourage private actions, but trebling damages convinces attorneys to take some larger cases.

Statutory or minimum damages are awarded without a showing of actual loss, significantly simplifying proof problems. As long as statutory damages are reasonable in comparison to consumer loss, judges will award them, without having to find gross or willful misconduct. But judges are reluctant to order statutory damages that provide substantial windfalls.

For very small purchases statutory damages authorize higher consumer awards than actual or multiple damages. For example, a $1 loss provides $3 treble damages, but could result in a $100 statutory damage award. Where consumer injury is substantially more than $100, $100 statutory damages is not significant and does not encourage consumer actions.

If statutory damage awards were increased to $1,000, high enough to hire an attorney, judges would rarely award such consumer windfalls, particularly in small cases.

Floating statutory damage awards respond to this problem by varying minimum damages depending on the size of the challenged transaction. For example, violations of the Uniform Commercial Code's repossession section result in awards equal to actual damages or 10% of the value of the good, whichever is more. Automobile cases result in sizeable recoveries; radio or kitchen appliance cases do not. Floating statutory damage schemes will still not provide sufficient incentive to initiate private litigations involving small purchases.

3) Attorney Fees

Attorney fee awards encourage lawyers to represent consumers in fraud actions. The court, after deciding the case, determines how much the merchant must pay toward the consumer's legal fees.

Normally, attorney fees are awarded only when the consumer wins on his affirmative claims. Non-frivolous losing claims and winning defenses against merchants' collection actions do not result in the consumer recovering attorney fees. Court authorized attorney fees are distinguished from the common situation where consumers, in credit contracts, agree to pay for the merchant's attorney fees in a debt collection action.

Attorney fees are useful and sometimes essential to meaningful consumer litigation. But lawyers will not take consumer cases, even if attorney fees are authorized, if there is a substantial chance of losing. Attorney fees, at best, compensate the lawyer's actual costs; taking cases that can go either way is a losing proposition as long as attorney fees go only to winning attorneys. But consumer fraud cases, turning on oral representations and vague legal standards, are rarely sure winners.

Attorney awards' effectiveness also depend on courts' generosity in computing them, since judges do not award attorneys' normal fees. Courts use a double standard. Major law firms representing plaintiffs in large anti-trust cases receive better awards than smaller firms bringing civil rights or consumer cases.

Courts usually award consumer attorneys less than 50% of their normal hourly rate, if they grant attorney fees at all. Part of the trouble is that judges hesitate to give lawyers more in fees than the consumer receives by way of judgment, even though legislation does not limit attorney fees depending on the size of the principal judgment.

The threat of sizeable attorney fee awards does push merchants to settle cases, thus lowering the cost of the action to the consumer. A merchant not settling risks a court order that he compensate both the consumer and the consumer's attorney. The consumer attorney, on the other hand, may not wish to settle if he can make more in attorney fees by litigating the case. Consequently, settlements have to include generous provision for the attorney's fee.

Legal services attorneys do not charge their clients, but use attorney fee awards exclusively as a bargaining chip to obtain a better settlement for their client. Some legal services offices do not seek attorney fees, afraid that the private bar will be angered at sizeable fees going to legal services offices and not the private bar.

4) <u>Small Claims Courts</u>

Small claims courts are designed to resolve disputes quickly and cheaply, but still within traditional legal mechanisms, i.e. through a court trial before a judge. Small claims courts provide an alternative forum for consumer claims to costly, complicated and slow traditional court actions. In addition, government agencies, unable or unwilling to assist individual complainants, often refer consumers to these courts.

<u>Small Claims Courts Described</u> 5/

Small claims courts provide an accessible, inexpensive, high turnover forum employing informal and uncomplicated procedures. Simple court forms are used; low filing fees are charged; pre-trial discovery and juries are forbidden; trials are scheduled rapidly; lawyers are not required; strict rules of evidence are not followed. Small claims courts exist in all but eight states, but six states only establish the courts in one or more designated urban areas.

Small claims courts generally hear only breach of contract and personal injury cases; many cases arising from statutorily created rights are not actionable. Usually the court has no power to order an injunction, cancellation, reformation or other equitable relief, but can only award a maximum amount of damages, varying from $150 in some states to $3,000 in others. The median is $500-750, but the legislative trend is toward increasing the amount of damages that can be awarded.

Small Claims Courts as Collection Mills

Although small claims courts were established to assist private individuals, in practice they are used overwhelmingly by businesses to sue individuals. 6/ They have been branded as creditor courts and as little more than collection agencies. Some states have barred collection agencies and other types of businesses from using these courts; New York prohibits all corporate plaintiffs.

Consequently, very few small claims court cases involve consumers bringing fraud actions against businesses; "consumer" cases are brought by businesses against consumers to collect debts. 7/ Consumer defendants can raise fraud defenses and counterclaims, but small claims judges and clerks report this is infrequent. Plaintiffs usually prevail in small claims courts and business plaintiffs prevail a much higher percentage of the time than consumer plaintiffs. 8/

Thus small claims courts can act against consumer interests, making it easier, less expensive and quicker for creditors to collect from consumers who may be withholding payment because they feel defrauded. Many small claims courts assist consumer plaintiffs; almost no courts help consumer defendants. 9/

Limits to Effectiveness of Small Claims Courts

Small claims court actions are not likely to deter fraud, but only compensate individual victims. Most defrauded consumers do not sue even when small claims courts are available. Some consumers do not know they have been defrauded; others will not take judicial action no matter how informal and inexpensive; others are discouraged by real impediments to bringing small claims court actions.

Recoveries for the small portion of victims who successfully sue are limited by both jurisdictional maximums - often in the $500-$750 range - and by the consumers' own provable damages. Treble, minimum, and other punitive damage awards are not imposed; other sanctions are not authorized.

Consequently, defrauding merchants break even or come out ahead with individual consumers who resort to small claims court. Only rarely will small claims courts be used so often as to significantly reduce a fraud scheme's profits. Thus it is exceptional that the small claims judges in one city reported that numerous speedy judgments encouraged defrauding sellers to leave town, presumably moving to an area where the pickings were better.

Nor does a consumer's small claims court action trigger more serious, punitive government actions. Small claims courts do not have a formal system for referring consumer fraud to law enforcement officials, even when a string of similar cases involve the same merchant and where the judge finds a pattern of gross abuse. Small claims courts have no legal mandate to establish such a system and judges consider it non-judicial to take it upon themselves to do so. New York and California are beginning to require better public records and monitoring of what happens in small claims courts.

Impediments to Initiating Small Claims Court Suit

Small claims courts' primary consumer fraud function thus is to force merchants to compensate individual consumers. But some types of fraud are not actionable in these courts. If the consumer's damage is greater than the court's jurisdictional limit - as low as $150 in some states - the consumer must either find another forum or sue for that limit. Vocational school and mobile home frauds, for example, can run into thousands of dollars.

On the other hand, if the loss is too small, a small claims court case is not practical. Filing fees, the burden of filling out forms, and then going to court a second time for the trial may outweigh the benefits of any possible recovery. Small claims courts do not allow attorney fees, minimum, treble, or punitive damages, class actions or any of the other devices created to make such small actions possible.

In addition, small claims courts can only deal with frauds that can be remedied by minimal monetary compensation. For example, small claims courts can not enjoin debt collection harassment or cancel or reform contracts.

Many of the same impediments to initiating regular damage suits are also present for small claims courts. The consumer must be able to find the defendant, and the defendant must have sufficient assets to satisfy the judgment.

Another important impediment is consumer ignorance of the existence of such courts. One study found case loads to relate directly to the amount of publicity the court received.

Even if consumers know about the court, they may find it difficult to appear before it. Most small claims courts are open only during regular working hours and courts do not award as damages pay lost because of court attendance. Some courts are experimenting with Saturday and evening sessions.

Many consumers also find it difficult to locate the small claims court. 10/ The court usually is not listed in the telephone book; even if the consumer finds the building, he may not locate the appropriate clerk's office within it.

Difficulties finding the court, while seemingly trivial, become significant when compounded with people's negative connotations about courts as places where people are evicted from homes, convicted of crimes, or divorced from spouses. San Jose, California is solving this problem by establishing a neighborhood small claims court in one of the city's recreational centers used by low income, Spanish speaking residents. The center is conveniently located and a popular meeting place. 11/

Drafting the Complaint

Once the consumer reaches the clerk's office, he must still draft a complaint, abstracting his dissatisfaction into a written statement of an actionable case. But court forms and legal requirements are often bewildering.

Courts often do offer special informational booklets and advisers and clerks sometimes fill out the forms and advise consumers what evidence is needed. 12/ In Harlem, three "community advocates" help consumers file claims and prepare for trial; in Manhatten, volunteer "consumer counsels" help fill out forms and advise on necessary evidence.

Recent California legislation authorizes two lawyers to serve as legal advisors to litigants, but not as court room advocates. California courts also use very simple forms and, according to a California judge, cases are never thrown out for failure to fill out forms properly, even if claims are incomprehensible.

Despite these innovative efforts, most small claims courts do not give consumers much substantive advice, and even when assistance is offered, it may not be adequate or institutionalized on a long term basis. One study found a minority of courts permitted clerks to give minimal legal advice to litigants and that many informational brochures were indaequate. Harlem's "community advocates" has been cut back as it has lost some federal funding. After an initial spurt of enthusiasm, most volunteer consumer counsels dropped out of Manhatten's program. 13/

Thus, while a consumer plaintiff is better off in a small claims court, existing courts still make the filing of an action difficult. While in theory an attorney is not needed, and in Chicago's pro se court, for example, not allowed, consumers may not be up to the task of presenting their own cases under existing procedures.

Proof of the Case

Consumer plaintiffs, after drafting their complaint, must return to court and convince the judge that the defendant merchant has so wronged him that the merchant must pay damages of a specific amount. Presumably, small claims court judges will require less rigorous proof than other types of courts, but in some ways small claims court plaintiffs are worse off.

As described earlier, common law fraud actions require such extensive proof that almost all state legislatures have developed broader and more easily proved standards of actionable merchant misconduct - deception and unfairness. However, many states do not allow the use of these more liberal standards in small claims court.

Similarly, in recognition of the difficulty of proving actual damages, most courts award minimum, punitive or treble damages in consumer fraud cases. But these damage remedies are either unavailable or infrequently used in small claims courts.

These proof problems are accentuated by the difficulty consumer plaintiffs face obtaining evidence. Often it is critical to examine documents in the merchant's possession or names of salesmen and other witnesses known only to the merchant. But small claims courts do not allow the ordinary litigation tools for pretrial investigation and fact gathering -- interrogatories and depositions. Moreover, consumers may not understand how to subpoena a merchant to force him to bring contracts or other documents with him to trial.

Even if the merchant brings the documents to the trial, this will be too late for the consumer to use them to prepare his case. Typically, contracts differ markedly from salesmen's oral representations. Consequently inexperienced and unconfident consumer plaintiffs, testifying to oral misrepresentations, are usually unprepared when suddenly confronted at trial by a conflicting document full of legal jargon.

Other proof problems abound:

> Another type of case where proof tends to be difficult is automobile or television repair, since the mechanic accused of the faulty repair is usually the only person in a position to explain what was wrong, and what was done. The plaintiff knows only that it doesn't work. As a judge in Dallas put it, "the plaintiff is in the worst position in a repair case since he is suing an expert, and he is not an expert. The plaintiff can rarely get a mechanic to come to court to testify for him in a $150 repair case. These problems of proof also exist in construction cases, in dry cleaning cases, and in malpractice claims.
>
> Some of the jurisdictions we surveyed had mustered some resources for assisting with these problems of proof. The Minneapolis court held all dry cleaning cases for a special "dry cleaning day" when an expert would come in to examine the garments and tell the referee whether the job was up to industry standards or not. Other judges would occasionally send garments to the Dry Cleaning Institute laboratory for examination.
>
> In Sacramento one small claims judge reported that if he was unsure about an automobile repair case he would ask the California Bureau of Automobile Repair to investigate the complaint. A small claims judge in Philadelphia told us about another new resource which deserves close attention. In that city the automotive repair industry has formed an Automotive Technical Assistance Panel (AUTOTAP) which provides an inspection service for consumers with automobile repair complaints.
>
> For an inspection charge of $5.00 the AUTOTAP service will check a car for work done incorrectly, work billed but not done, work charged which did not affect the problem, and gross overcharging for a repair. Claimants on auto repair cases are referred by the small claims clerk to the AUTOTAP service and all names of the garage or repair shop complained of are deleted from the complaint when AUTOTAP examines the car. Many

repair agencies have agreed to honor AUTOTAP findings and the AUTOTAP affidavit of inspection is admissable in a subsequent small claims proceeding if the complainant is unable to obtain satisfaction from the original repair shop. 14/

Adequacy of Representation

Consumers routinely oppose in court merchants possessing more experienced legal representation. Small claims courts are designed to allow consumers to appear without counsel, but merchants usually retain attorneys or other skilled advocates. 15/ In many states, corporations must be represented in court by attorneys. 16/ This imbalance in legal representation is particularly significant in consumer fraud cases involving conflicting oral statements where skilled investigational techniques, preparation of witnesses, and cross-examination are critical.

Judges respond differently to this imbalance. Some judges lean over backwards to help consumers; others show great deference to merchants' attorneys who are fellow members of the bar.

Many commentators suggest that this imbalance should not be corrected by use of more lawyers or paralegals to represent consumers. Instead, judges should take active roles at trial, in sharp contrast to their usual passive role. 17/ Interviews with judges indicate that many feel uncomfortable with and refuse to take this active role, considering it unseemly, in effect representing the consumer. 18/

Small claims courts' effectiveness is also hampered by judges' and consumers' lack of knowledge of recent, innovative consumer protection laws. In other courts, if a judge is not sufficiently abreast of legal developments, he orders both sides' lawyers to prepare legal briefs and may have his own law clerk conduct additional research.

This does not occur in small claims courts. California's recent provision of a law clerk in one of its small claims courts is a notable exception. 19/ Consumers do not present their claims based upon technical consumer laws. Judges usually decide cases based upon "rough justice","common sense", or ordinary contract law, which may be very different and less beneficial to the consumer than the state's own consumer protection laws. 20/ In some states, these consumer protection laws can not even be applied in small claims courts.

Settlements and Arbitration

These issues of proof and applicability of consumer protection laws have limited importance if the case is settled before the judge decides the case. The advisability of these settlements is open to question.

A recent study found that half the judges interviewed pushed the parties to settle the case between themselves, and one-half opposed the practice. 21/ Those opposing felt that settlements were usually unfair to consumers who typically are ignorant of their legal rights and have no informed basis for deciding what a fair settlement might consist of.

Settlements do often result in remedies the court itself has no power to order, such as specific performance or cancellation. 22/ For example, an auto repairman may agree to fix a car properly where a court could only order money damages. But if a case has been settled, there will be no official court record of the merchant's fraudulent conduct, making it that much easier for the merchant to continue the scheme.

Arbitration is more formal than settlement, but less so than a judicial hearing. In theory, it offers a neutral decision-maker who decides cases in a relaxed setting. Harlem, Manhatten and other small claims courts have established arbitration sessions for those who prefer this method to going before a judge.

While many consumers are pleased with the procedure, in practice arbitration does not operate the way its conceptual model would indicate. Arbitrators see themselves as negotiators, not decision-makers. They tend to push parties toward settlement or just "split the difference", instead of adjudicating the dispute. As long as the plaintiff shows some damage, the arbitrator will urge the defendant to pay something, even if a judge would consider the plaintiff to have failed to meet his burden of proof.

Collecting Judgments

By whatever form a dispute is resolved - settlement arbitration, or adjudication before a small claims court judge - there is a good chance the consumer will never be able to collect on his judgment or settlement. In most jurisdictions collecting a judgment is a complicated process requiring a lawyer. Since the small claims dispute was too small in the first place to justify hiring a lawyer, it will hardly pay to hire one to collect the judgment. Nor do most small claims courts assist consumers in collecting their judgments. 23/

Judgment may also be legally defective. Usually consumers sue the companies under their trade name, the name they do business under. However, in most states, unless the judgment is made out against the company in the exact form in which it is legally incorporated, the judgment is worthless. 24/ Thus a hard won judgment may prove a pyrrhic victory against a recalcitrant merchant.

Some corrective action is being taken. A bank is subsidizing a one-lawyer project that in less than six months has assisted 1,500 people collect over $15,000 in judgments. 25/ New York City's Department of Consumer Affairs will not renew licenses of businesses with outstanding small claims court judgments. Under a New York State law, consumers can sue for treble damages if a business displays a pattern of refusing to pay judgments.

5. Class Actions

Theoretically, class actions are well suited for securing wide-scale redress for consumer fraud. Class actions adjudicate numerous claims and provide widespread compensation in one action without class members' active involvement.

Accordingly, the class action device provides relief for consumers who are uninformed about their rights, deterred from filing individual suits because of an ongoing relationship with the prospective defendant, have claims too small to merit individual adjudication, or lack access to counsel. Combining numbers and resources allows class members to counteract the imbalance in financial resources between a business defendant and an individual consumer.

Nevertheless, substantive, procedural, and practical impediments limit the full utilization and effectiveness of the class action device. Class actions are rarely brought against certain types of consumer fraud and not used widely against any type.

Attorney Resources Required; Judicial Hostility

Attorneys are reluctant to file time consuming class actions. Although the time expended for each individual claim is less than an individual suit, most attorneys will not gamble on spending most of their time on a risky case only paying on a contingency fee basis. Attorney fees, if authorized, will not be awarded unless and until the class action is successful.

The substantial costs associated with initiating a class action begin with the extensive investigation and discovery required. The defendant's increased potential liability also produces a much more vigorous defense, as better counsel are employed to raise numerous procedural hurdles to the action.

Judicial hostility to class actions is another substantial obstacle. Judges are unfamiliar with class action procedure and are not interested in learning. They view class actions as gluts on their calendar, and pressure for early dismissals or unnecessarily delay rulings on procedural motions.

Courts are reluctant to preside over cases with large potential liabilities. For example, some courts refuse to permit class actions where the recovery is based upon aggregating a statutory penalty so that technical violations result in enormous awards.

Predominance Requirement

Before a class action seeking monetary relief can be brought, the court must find that questions common to the class "predominate" over questions of an individual nature. The "predominance" requirement is a serious impediment to class actions alleging common law fraud. The plaintiff must prove that false representations were made and relied upon by each class member, requiring testimony by each class member. Evidence of misrepresentation and reliance by one class member does not prove those facts for other class members.

Plaintiffs can demonstrate that representations were made to all class members by proof that the seller made the representations pursuant to pattern, practice or policy. But this is still a difficult evidentiary task because the defendant rarely puts schemes to defraud in writing or admits to them.

At least one state's supreme court has held that demonstration of a memorized or standardized sales pitch which the sales representatives were trained to deliver was sufficient to prove misrepresentation to each class member. The court also inferred reliance by each class member from the fact that each member purchased the misrepresented product. 26/

A pattern of misrepresentations can also be proved when claims are made through the media, on signs, flyers, mailings, or charts shown to all purchasers. The defendant's failure to disclose important information is more susceptible to common proof than are affirmative misrepresentations.

Class action plaintiffs can also meet the predominance requirement by turning to standards other than common law fraud to challenge merchant misconduct. Actions alleging deception need not prove reliance or materiality. Courts are also lenient in finding sufficient conduct to prove deception from only a few individual cases of misrepresentation.

Use of the unfairness standard eliminates proof of common representations if inducement is not part of the alleged unfair conduct. For example, a class action can allege that the sale of duplicative health insurance to the aged is unfair regardless of whether it was sold through the use of misrepresentations concerning the coverage of existing Medicare/Medicaid benefits. The seller should know that the aged purchasers are covered by government health benefits, and no proof is needed about reliance and individual representations.

Individual questions of misrepresentation, materiality and reliance also are irrelevant when alleging violations of specific statutory requirements that authorize statutory damages to private litigants. Frauds can be indirectly challenged by proving technical violations and seeking statutory remedies that may be higher than damage awards for the underlying fraud. The Truth-in-Lending legislation is one example.

Breach of warranty claims' susceptibility to class treatment vary. Where the product defect is one of design, mode of manufacture or otherwise applicable to a whole model, the defect becomes a common question provable on a class basis.

Sales of poor quality merchandise, such as used cars, require proof that each individual product is defective. Warranty class actions challenge this type of misconduct if a specific statutory standard governing fulfillment of warranty claims is enacted. For example, violation of a Massachusetts regulation requiring free repair of all defects appearing within the first 30 days after the sale can be easily shown by the defendant's records.

Manageability

A class action must be "manageable" for the court to allow it to proceed. But the calculation and distribution of damages to consumer class members often requires too much court time to make them manageable. Only a minority of courts use imaginative management procedures to overcome these problems.

Legislation can simplify damage calculations so that the actual damage suffered by each of thousands of class members does not have to be proved. Minimum or statutory damages fix the amount awarded each class member without any proof of damages. Courts can be authorized to calculate damages on an aggregate or class-wide basis, avoiding individual damage measurements. It may be impractical for each class member to prove his individual overcharge, but relatively simple, using the defendant's records, to determine the total overcharge.

Similar flexible methods can handle the significant damage distribution problems. Courts can conclude that damage distribution is unmanageable in a consumer case where only a few dollars are at stake for each class member and the cost of damage distribution approaches or even exceeds the class members' recovery. When distribution is attempted, many class members are unreachable, resulting in the seller keeping monies rightfully belonging to defrauded consumers.

One solution to these problems is not to distribute damages to individual class members, but in some other equitable fashion. Money can be returned to the defendant on the condition that he spend the money on some project benefiting a general class of consumers. This device, known as "fluid recovery" or "cy pres" distribution, prevents the defendant from being unjustly enriched and indirectly benefits class members. Another approach is to return unclaimed damages to the state as unclaimed property.

A court may also dismiss a consumer class action as unmanageable if the defendant raises numerous counterclaims against individual class members, which he can do as a matter of right. Counterclaims not only intimidate class members into excluding themselves from the suit, but also discourage courts from permitting the class action for fear of getting involved in numerous individual counterclaims. For example, federal courts are loathe while adjudicating a Truth-in-Lending class action to hear numerous state law debt collection counter-claims against individual class members.

The Uniform Class Action Act proposes that leave of court be obtained before the defendant pleads any individual counterclaims. This act, not yet adopted by the states, avoids the defendant's legal right to bring such claims by allowing him to assert those claims in a subsequent action.

Notice

Inflexible notice requirements are another serious impediment to consumer damage class actions. The federal rule dealing with class action procedures, Federal Rule 23, and state procedures based on Rule 23, mandate that individual notice be sent to all class members who can be identified through reasonable efforts.

Federal courts strictly interpret this requirement. Plaintiffs must pay the significant cost of this extensive notice during the litigation, 27/ and even winning plaintiffs probably can not receive reimbursement for this cost from the defendant. 28/ States with class action procedures similar to Rule 23 normally impose the same requirements.

Courts are also reluctant to allow less expensive forms of notice, insisting that first class, rather than third class or bulk mail, be used, and refusing to require defendants to send notices along with their regular communications to class members, such as in billing statements. Consequently, plaintiffs bringing large class actions must have access to significant financial resources and be willing to risk them at the notice stage.

A small number of states have modified Federal Rule 23 notice requirements, adopting more flexible procedures. Individual notice to all class members is dispensed with where the court determines it is unnecessary. Defendants bear some of the expense of notifying class members if the court finds a good likelihood that the defendant will be held liable on the merits.

The Uniform Class Action Act proposes eliminating individual notice for class members with claims of less than $100, requiring defendants to share the notice costs if counterclaims are asserted, and authorizing courts to minimize notice expenses. Similar legislation has been introduced in Congress.

Proof of Claim Filings

Another impediment to wide-scale class action recovery are requirements that class members file with the court proof of claims prior to the determination of liability. Failure to file bars individuals' recovery.

Notifications of this requirement are lengthy and legalistic,resulting in class members failing to submit the requested information because they do not comprehend the nature of the proceeding, the steps they must take, or the significance of their failure to file. Consumers easily mistake the official notice for a complaint filed against them by the class action defendant.

Class members are included in the action unless they affirmatively request exclusion, thereby protecting their interests without their need to actively participate. Filing proof of claims prior to any determination of liability defeats the advantages of requiring members to opt out of class actions.

For this reason, many courts do not require filings prior to a determination of the defendant's liability, but only before individual members can recover any money. Knowledge that the defendant has been adjudged liable and that they can recover damages encourages class members to file claims. Nevertheless, a significant portion of the class still will not file and will not secure redress.

Courts occasionally avoid these problems by dispensing with filing requirements entirely when individual damages are calculable by reference to documents in the defendant's possession. When they are not, aggregate damage calculations are infrequently used. Actual individual damages are ignored and a proportionate share of the pot is distributed to each class member whose whereabouts is known.

Harrassment

Defendants can narrow consumer redress by harassing class members so that they exclude themselves from the action. The defendant's assertion of counterclaims against individual class members is one effective means of scaring consumers into opting-out of the action.

Defendants also contact class members persuading them of the disadvantages of the action. This is particularly effective where defendants have ongoing relationships with class members, such as employer-employee or creditor-debtor. Courts prevent this abuse to some extent by issuing non-communication orders, prohibiting contact with class members regarding the class action.

Defendants also harass class members by seeking costly discovery from individuals relating to their claims. Typically, the defendant does not need this information since it is already in his possession or collateral to the issues involved in the suit. A number of courts prohibit or sharply limit the defendant's right to discover information from individual class members, at least in the early stages of the litigation.

Other Restrictive State Court Procedures

Most consumer fraud class actions are instituted in state courts since they can not meet federal courts' jurisdictional requirements. Federal court actions based on the parties' diversity of state citizenship are virtually impossible because class members' claims can not be aggregated to achieve the $10,000 jurisdictional minimum. 29/ Class members with claims of less than $10,000 can not be "piggy-backed" into the suit if one member has a $10,000 claim. 30/ Federal courts also frequently limit consumer actions by exercising their discretion to refuse to hear state law claims pendant to federal claims. Consumer fraud claims rarely involve violations of federal law.

Limiting consumer fraud class actions to state courts creates several added obstacles to successful litigation. State judges are less familiar with and more hostile to class action procedures. State court rules of joinder, discovery, and pleading practice are often less flexible than federal procedures. Federal judges are less influenced by local politics, a significant factor when a large local business is named as a defendant.

The greatest impediment is states' antiquated or restrictive class action procedures that do not permit the maintenance of consumer class actions at all. Some states' class action procedures provide flexibility and meet modern concerns. The Commissioners on Uniform State Laws designed the Uniform Class Act to make such reform universal, but in the two years since the model act's adoption only one state has enacted it.

State courts are also limited in their ability to bind non-resident class members. If members are not bound by a judgment, they can not receive its benefits. Some courts bind non-resident class members to judgments, considering that their interests are represented adequately in the litigation; others do not. Access to federal courts for consumer class actions can alleviate this and other state court restrictions.

6. Warranty Standards

Class actions, small claims courts, attorney fees, and special damages intend to overcome economic restraints and encourage private damage actions. They do not alleviate the significant evidentiary problems of proving common law fraud.

Almost all states respond to this problem by allowing private actions to be brought under "little FTC" or other statutes that limit proof to a showing of unfairness, deception, and, in a few states, unconscionability. Private actions are also sometimes authorized for merchant violations of specific standards. The effectiveness of deception, unfairness, unconscionability, and specific standards as substitutes for fraud is discussed in an earlier section. 31/

Warranty Standards Described

Defrauded consumers can also sue under breach of warranty theory. Breach of warranty is easier to prove than either fraud or deception since the consumer only alleges that the good or service has not performed as warranted. Intent is unnecessary; deception and misrepresentation are irrelevant.

Warranty standards in the sale of goods are spelled out by a model state code, the Uniform Commercial Code ("The UCC"), adopted in all states but Louisiana. Warranty standards for the sale of services are spelled out in legislation or left to varying judicial interpretations.

Sellers give express warranties in the sale of goods by affirming a fact or making a promise that becomes part of the basis of the bargain. The seller does not have to use any formal words such as "warrant" or "guarantee"; warranties can be created in writing or orally. Intention and reliance are not necessary, and good faith is not a defense.

Implied warranties of merchantability in the sale of new and used goods are created when the seller is a merchant with respect to those goods. "Merchantability" means that the goods must pass without objection in the trade and they are fit for their ordinary purpose and the affirmations of fact made on the container or label.

The seller creates an implied warranty of fitness for a particular purpose when he has reason to know of a particular purpose for which the goods are required and that the buyer was relying on the seller's skill or judgment to select the goods.

The UCC limits implied warranties in several technical ways. The most important is that implied warranties can be waived by the seller--that is, sold "as is". The UCC, except in a few states, does not limit such waivers, but only requires that they be clearly given.

After the buyer notifies the seller of a breach of warranty, the buyer can seek damages for the difference between the value of the goods accepted and the value they would have had if they were as warranted, unless special circumstances show proximate damages of a different amount. The buyer can also claim consequential damages for losses resulting from his needs which the seller had reason to know of when the contract was made, and for injury to person or property.

Practical Limitations

This liberal standard of proof suffers from several economic and practical limitations. Consumers are not aware of their warranty rights. Only 50% of first year law students are able to comprehend standard warranty language. 32/ Consumer understanding of implied warranty rights is virtually non-existent.

Consumers pressing their warranty rights find the same economic constraints as any fraud action. The only warranty claims ordinarily pressed in court involve large ticket items such as automobiles or mobile homes. 33/ The number of automobile warranty suits initiated also depend on various legal rulings. 34/

Treble damage awards do not encourage warranty actions. Accompanying standards of "knowing", "willful", or "bad faith" behavior turn a warranty case back into a common law fraud action. Even if legislation authorized special damage awards for breach of warranty alone, judges would be reluctant to order these awards.

Warranty claims can be pressed through the class action device, as described in the previous subsection. But recent legislation effectively bars class action warranty cases in federal courts. 35/

Informal arbitration mechanisms for resolution of warranty disputes provide a cheap, quick, informal, and less intimidating alternative to litigation. 36/ Federal legislation encourages the establishment of informal dispute settlement mechanisms ("ISDM's") by requiring consumers as a pre-condition to litigation to resort to IDSM's if sellers establish them. 37/

The business community, to date, has established only one IDSM. Consumers will only use IDSM's, if established, if they provide an easy, quick and fair determination, if their existence is publicized, and if consumer claims are large enough to make initiating the procedure worthwhile.

The requirement that consumers turn to IDSM's before litigation indicates another problem litigating a warranty claim. Warranty arrangements prescribe numerous initial steps before consumers can press their warranty rights in court. Warranty standards are created through contract and contain almost any term agreed upon between seller and buyer.

Consumers first complain to the seller and can receive such a "run-around" that they give up all hope at that stage. 38/ Other consumers believe they forfeit their warranty rights by failing to meet such warranty conditions as sending in registration cards, obtaining certification of required maintenance, and delivering defective goods to distant locations. Sellers use these warranty conditions to discourage consumer litigation. 39/ Federal legislation curtails these conditions for "full" but not "limited" warranties 40/.

Warranty Disclaimers

Sellers not only place onerous preconditions to collecting on a warranty but give very limited express warranties and waive all implied warranties. This is perfectly legal under the UCC that sets out standards when warranties are given, but not whether they must be given. Virtually all major appliance and automobile warranties disclaim implied warranties of merchantability and fitness. 41/ The typical consumer product warranty has the following elements:

"First, a carefully delineated express warranty is made; second, all other warranties, express or implied, are disclaimed; third, the remedy for breach of the express warranty is limited to a sole remedy of repair or replacement, at the seller's option; and fourth, the provision may additionally state that seller shall have no liability for consequential damages". 42/

Warranty Disclosure

The major government response to merchant failure to offer product warranties is to require disclosure of the limited nature of the warranty given. The federal Magnuson-Moss Act attempts to increase comparison shopping for warranties, resulting in manufacturers using increased warranty coverage as a competitive tool in marketing consumer products. 43/

The Act makes warranty considerations a significant factor in consumers' purchasing decisions by forcing suppliers to underscore any disclaimers and limitations, by increasing consumers' before-sale exposure to warranty terms, and by making warranties comprehensible. It requires specification of warranties as either "full" or "limited", insuring that the bold print conforms with the actual content of the warranty.

Nevertheless, legal commentators doubt that consumers read warranty information until after they experience operating difficulties with their purchase. 44/ At the time of sale other aspects of the purchasing decision overshadow the consumers' interest in warranty provision details. 45/

In most industries there is a tradition of standardized warranty policies within product lines, making comparison shopping for warranties futile. 46/ Businesses find that transferral of the risks of loss to consumers is most profitable and are skeptical about using warranties as a competitive tool. 47/

Consequently, most companies offer "limited" rather than "full" warranties. 48/ If the Magnuson-Moss disclosures fail to encourage "mainstream" businessmen to offer fuller warranties, they certainly will not do so for merchants bent on fraud, who will continue to sell "as is".

Minimum Warranty Standards

Government can also establish minimum warranty standards that merchants can not waive. Potent political forces constrain this substantive regulation of warranty practices, and favor allowing free enterprise and competition to determine warranty standards. 49/

Substantive regulation results in increases in the prices of goods, not giving consumers the option to buy cheap, less fully warranted goods. One commentator encapsulated this approach, "Where loss is unavoidable, shouldn't parties be free to allocate it as they see fit?" 50/

Other experts argue that consumers do not make free choices and can not bargain for different terms. They are usually unaware of warranty provisions and are presented with take it or leave it standard form contracts. 51/ Various legislative bodies see merit in this argument and curtail disclaimers of implied warranties.

The Magnuson-Moss Act prohibits disclaimers for products with written warranties, but allows limits on the duration of implied warranties. 52/ Consequently, at least for a period of time, accompanying every manufacturer's written guarantee, there is an accompanying implied warranty that the product is merchantable and fit for the ordinary use for which such goods are purchased. Merchants not offering written warranties, primarily ghetto merchants who stipulate that goods are sold "as is", are not covered by these Manguson-Moss restrictions.

Five states have also amended their UCC, nullifying disclaimers of implied warranties or attempts to modify the consumer's remedies for breach of those warranties. 53/ These state laws establish minimum implied warranties for the sale of goods, not the rendering of services.

Consumer advocates and legislators in these states feel that elimination of warranty waivers increases the quality of goods sold and remedies available to injured consumers, without causing excessive increases in the price of goods. But, surprisingly, there has been no careful, empirical study of the effect of restrictions on warranty disclaimers.

7. Post-Sale Disclosures

Post-sale disclosures serve different purposes than pre-sale disclosures. They inform consumers of their post-sale rights, describe what further performance they should expect, and document the terms of the sale.

Consequently, post-sale disclosures assist consumers in realizing they have been defrauded and in what particular way. Once consumers decide to redress the fraud, the post-sale disclosures provide important evidence documenting the consumer's claim.

Legislation does not focus on post-sale disclosures, but many statutes do include such provisions. Merchants must give consumers receipts, itemized bills, copies of their contracts and warranties, insurance policies, cancellation notices, care manuals, copies of other documents, and even replaced parts on serviced items.

Consumers rarely question before a sale what their rights or remedies may be if something goes wrong. If they are informed, they may not pay attention. Thus consumers use copies of warranty and cancellation rights by referring to them if anything goes wrong.

Contracts spell out the extent and nature of buyers' and sellers' continuing performance obligations, allowing consumers to independently verify the seller's claims and evaluate the adequacy of his performance. The buyer also has a second chance to reflect on the nature of the agreement to determine if fraud is involved.

Post-sale disclosures such as copies of contracts and receipts provide evidence of the nature of the transaction that can be used by private attorneys to piece together what happened. Consumer memories and understanding of the nature of transactions they are involved in are notoriously faulty.

One document is worth a thousand words. Consumer possession of a copy of a sales contract is particularly useful if there is a dispute as to the nature of that agreement or if the law requires certain disclosures to be made in that contract.

Impediments to Use of Post-Sale Disclosures

Consumers invariably lose sales documentation. Private attorneys rarely find clients who have saved receipts, sales agreements and other documentation surrounding the sales transaction.

Documents that consumers retain are only useful if they provide useful information. Experienced fraud offenders will take care that documentation they give a consumer is as unhelpful as possible. Written materials will not contain damaging information, and, instead, disclaim liability for all eventualities arising from the sales transaction. Hard core fraud offenders will fail even to make required disclosures.

But post-sale disclosures can be effectively utilized against fraud in certain specific contexts. Merchants will make required post-sale disclosures if they fear prosecution for violating disclosure requirements more than the consumer's use of the disclosure. Other merchants will not "break the law" by violating specific disclosure requirements, but will swindle consumers through "aggressive" or "imaginative" sales techniques. In some cases disclosures are useful sales tools and are willingly made.

Most promising are contexts where the party making disclosures is not the same as the fraud offender. For example, a defrauding car dealer may not make accurate post-sale disclosures, but the finance company it uses will. Manufacturers can include product information in the packaging that is difficult for defrauding retailers to remove.

If the consumer receives post-sale disclosures, he may retain the information, particularly if large or unique purchases are involved. Other times the consumer will discover the fraud before he loses the disclosure. Finally, even if the disclosure is lost, an innocent third party, such as the finance company or manufacturer in the above examples, will retain copies.

Little is known about the actual effect of post-sale disclosures if made by the seller and retained by the consumer. Similarly, little thought has been given to designing such disclosures to maximize their utility in alerting consumers to frauds or helping consumers prove frauds in court.

B. RESTITUTION

Restitution is a state initiated class action. The enforcement agency brings suit against the offending company seeking compensation for all those defrauded. The court, after determining that the law has been violated and calculating damages, orders a plan to distribute the restitution award to the affected consumers.

Restitution has both strengths and weaknesses when compared to private class actions. In some states, class action law is so antiquated that restitution is a far superior remedy because class actions provide no viable remedy at all. But other states that follow the federal rules allow class actions that are comparable to restitution actions.

1. Initiating Restitution Actions

Prosecutors are better equipped than private litigants to initiate widescale consumer redress actions. The enforcement agency's job is to seek out and uncover frauds, bringing them to immediate prosecution. Individual consumers, on the other hand, are not interested in or even know about class recoveries, but only want to get their own money back. They are easily "bought off" from instituting class actions, and it is unethical for attorneys to instigate class actions on their own.

Enforcement officials, receiving complaints and actively monitoring the marketplace, are also in a better position to see patterns and whole schemes developing. They can institute restitution actions where patterns of fraud are widespread and assist complaint mediation where only individual consumers are injured. It is difficult for private litigants to make this same determination.

State attorneys general and the FTC have adequate resources and expertise to litigate major restitution cases. Individual attorneys with limited retainers may find class actions too risky, time-consuming and costly.

But earlier sections of this report have enumerated reasons why prosecutors do not act on fraud problems. 54/ Restitution suits are even less frequently pursued because they are more complex and time-consuming than other remedies. Fraud offenders sign consent agreements, are fined, or are criminally prosecuted without having to make restitution, and many others are not prosecuted at all. Restitution actions rarely go to trial.

Restitution actions do avoid preliminary obstacles inherent in class actions. Restitution actions do not have to meet the complicated notice requirements that foreclose many class suits. Consumers do not have to opt in or out of the action, so there is less reason for merchants to harass consumers into giving up their claims. Seller counterclaims against consumers are not allowed, so the resulting action is simpler and less threatening to consumers. Problems of class members not residing in the same state where the action is unitiated are minimized.

2. Prosecuting the Restitútion Action

Proof problems at restitution trials are analogous to those for class actions. Predominance of consumer complaints must be shown, but this requirement is more relaxed. Usually proof of a pattern of conduct violating the statutory standard is enough, damage distribution problems being handled later.

Restitution is most appropriate when consumers never receive purchased goods or services or when those products turn out to be worthless. If buyers receive something of substantial value, difficult problems arise as to whether the deception was material to individual consumers' purchase decisions.

Restitution actions also must meet statutory standards; if restitution is not authorized, no action can be brought. Some states only allow restitution for certain itemized violations. The FTC can only seek restitution for violations of specific trade regulation rules or for dishonest or fraudulent practices. Unfair or deceptive practices not prohibited by rules do not result in restitution.

The rationale for these statutory limitations is unclear. Restitution actions do not punish or penalize sellers; they return consumers and the merchant to the status quo. Even if the seller does not have clear notice of an action's illegality, and even if the violation is unintentional, the parties still should be returned to where they would be without the merchant's misconduct.

Issues of damage proof, calculation, and distribution present the same difficult problems as they do for class actions. Since initial notice is not required for restitution actions, the parties will first attempt to locate the injured consumers after the restitution action is completed and years after the fraud is perpetrated. Many consumers can not be located; others do not reply to proof of claim requests. Actions that appear to award million of dollars in restitution result in little money actually changing hands.

If the seller is bankrupt or leaves the jurisdiction, there will be nothing to distribute. Agencies consequently avoid using their limited resources on cases involving small, mobile or other types of sellers where no actual restitution may result.

Class actions seek any damages an individual litigant can request, including consequential and other indirect damages, statutory, treble, and punitive damages. But restitution actions rarely authorize these additional damages, limiting recovery to the difference in value of what was promised and what was received.

Nevertheless, the state prosecutor may settle the case for more money than the class action plaintiff. Merchants treat government agencies with deference while vigorously defending private litigation. Sellers wish to keep amicable relations with government regulators and to avoid in-depth state investigation. Other merchants are impressed with the seeming power of the state compared to an individual litigant. Government offices can also generate more adverse publicity about a case than can class action plaintiffs.

A final distinction between private class actions and state initiated restitution suits is the motivations of the attorneys involved. The private plaintiff's attorney has an incentive to settle a case if he can get a sizeable fee for a minimum amount of work. Otherwise, he will press for as large a judgment as he can. The government prosecutor's motivations do not involve personal profit, but office priorities, resource commitments, political pressures, and other organizational factors.

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C. COMPLAINT MEDIATION

Complaint mediation is the informal process of government agencies effecting voluntary settlements between a complaining consumer and the merchant complained about. Private organizations such as better business bureaus also mediate complaints; this section concentrates on mediation performed by government agencies.

1. Background

Common Criticisms

Enforcement officials and consumer advocates malign complaint mediation, but much of the criticism is misdirected. Complaint mediation is attacked as having no deterrent effect since providing some complaining consumers with partial restitution does not penalize seller misconduct. But that is not complaint mediation's function; it attempts to quickly and cheaply compensate consumers who feel ripped off.

Complaint mediation is criticized as helping only those who complain, a small minority of those defrauded. This is both correct and misses the point. Complaint mediation results in compensation in only a minority of fraudulent transactions, but its success is certainly more substantial than the other two available compensation strategies - private damage actions and restitution. For consumers who have small claims not shared by large numbers of other buyers, particularly where small claims courts are not effective, complaint mediation is the only viable remedy.

A more relevant criticism is that complaint mediation takes government agencies' resources and attention away from enforcement activities that do have a deterrent effect or that can result in widespread restitution for all the victims of a fraud scheme. Previous sections have evaluated those efforts; 55/ this section will look at the value of complaint mediation, allowing a judgment as to which is the most important activity for an enforcement agency.

Nevertheless, litigation and complaint mediation are to a certain extent complementary. Complaints provide prosecutors with data to be utilized in an enforcement program; the threat of legal sanctions gives credibility to an agency's mediation efforts.

Another cogent critique of complaint mediation is that it hides government's inability to deal with consumer fraud and diffuses forces that could bring about effective reform. Successful complaint mediation programs give the illusion that government is adequately dealing with the consumer fraud problem.

In actuality, a small minority of all fraud transactions are partially remedied. Only the most vocal complainants are satisfied, insuring that these consumers' energies are not channeled into more effective fraud intervention approaches. Fraudulent sellers can shortchange everyone but give complainers their money back. Then no one complains and there is no pressure to take more meaningful action against the offending seller.

This section will evaluate the effectiveness of complaint mediation in terms of how often it reaches a settlement, how satisfied consumers are with the final results, and how cost-effective the strategy is. Judgments whether this level of effectiveness is in the long run counter-productive or the only successful method of compensating at least some consumers for some of their losses will be left to others.

Complaint Mediation Described

Complaint mediation is performed by all kinds of government organizations - local consumer protection, district attorney, state attorney general, and state consumer protection offices, various regulatory boards, the Federal Trade Commission, and other federal agencies. Many of those offices are primarily enforcement agencies; others are almost exclusively complaint mediation centers.

Offices with only mediation authority generally will have a number of consumer complaint handlers taking complaints over the telephone. Some offices are so informal that the telephone is the only mode of communication in the whole process, the merchant and consumer never facing each other. The complaint handler calls the seller to get his side of the story and an offer may be made over the telephone. The mediator calls the consumer back, makes the offer, and tells him to call back if he is not satisfied.

Only rarely will mediators examine merchandise or documents, or interview the parties personally. One office has even installed a three-way phone system allowing simultaneous conversations between seller, buyer and mediator.

Most agencies accept complaints in any form. Some offices are more rigid, mediators not taking any action until consumers sign a complaint form and turn over copies of relevant documents. Some offices help the consumer by filling out the form for him, others require the consumer to write his own complaint. One office reported that 90% of those who called, when requested, later mailed in written complaints; 10% of the complaints were dropped.

Some offices have formal proceedings if initial telephone contacts do not resolve the matter. Both parties appear before a hearing officer who will hold a quasi-judicial proceeding to determine the facts and recommend a settlement. Neither attendance or acceptance of the proposed settlement are compulsory on either party. A few offices utilize subpoena power to compel merchant appearance.

On the other extreme, several enforcement agencies do not have formal complaint mediation programs but will respond to individual complaints in a haphazard fashion. The agency may send letters to companies, but with no follow-up.

2. Obstacles to Initiating Complaint Mediation

Consumer Failure to Complain

Many defrauded consumers never contact complaint mediation agencies. One expert estimates that only 5 to 10% of a fraud scheme's victims complain to a government agency. Low income consumers in particular have limited knowledge and even more limited use of available community resources. 56/ Seven percent of consumers within one agency's jurisdiction had incomes below the poverty line, but only 1% of complainants were from that group. Blacks also complain less per capita than whites. 57/

Consumers fail to complain because of ignorance of available remedies, inertia, the small amount at stake, distrust of government, feelings of powerlessness, embarrassment at being duped, and failure to discover frauds. Difficulty contacting the complaint mediation agency magnifies these problems. Offices receive hundreds of phone calls a day and telephone lines are often unanswered or continuously busy. One office reported 3 to 7 day delays scheduling appointments with counselors. Personal visits are limited by difficulties in finding offices and the threatening nature of court and other government buildings.

Agency Refusal to Mediate Complaints

Many complainants find the agency refuses to handle their case. One major state office finds about 20% of the complaints outside its jurisdiction, involving out-of-state sellers or areas in other agencies' substantive expertise. 58/ This percentage is higher for local consumer protection agencies that limit their mediation to merchants within their own local jurisdiction.

The office declined another 13% of complaints because it found that the consumer protection statute was not violated, even though it did not investigate the claim beyond looking at the face of the complaint letter. The agency probably is just screening out complaints it considers unpersuasive or difficult to settle. 59/ Another 3% of the consumers failed to recontact the agency and their complaints were dropped. The office thus screened out 36% of written complaints and a higher percentage of telephone contacts.

Another office finds half the complaints it receives not within its jurisdiction. Yet another agency started with over 7,200 inquiries and ended with just over 2,300 cases for mediation.

Consequently, the consumer is at the mercy of the mediator. The mediator, based just on a telephone conversation or a letter, will decide whether the claim is meritorious, resolvable, and within the office's jurisdiction. Some offices refuse to mediate if there is no showing of wrongful intent or willful misrepresentation inducing reliance. They will turn down cases involving shoddy repair jobs, overpricing complaints, or disputes over the terms of a contract.

Complaints also bounce from agency to agency as each office prefers to move the complaint onto someone else's desk than handle it itself. This process of "referring to other agencies" can take months. Jurisdictional limitations used as justification are often self-imposed.

3. Effectiveness of Mediation Efforts

Most mediated complaints are resolved to the mediating agency's satisfaction, somewhere between 70 to 80% on the average. One office failed to settle 44% of cases accepted for mediation , or 65% of all written complaints received. Major reasons for failure to settle the 44 percent were failure to find the seller (16%), no actionable claim being found (13%), and the consumer dropping out of the process (11%). 60/ Other offices fail less than 20% of the time and regional U.S. Postal Service offices settle over 90% of complaints handled.

This does not mean that cases reach satisfactory settlements. Of cases where the merchant was successfully contacted, one office mediated 39% complete solutions, 31% partial, and 30% no solution. 61/ Complete solutions are more likely to occur if mediation is informal, just through telephone conversations. If the agency must resort to a formal hearing partial solutions become much more common. 62/

Consumers are also generally satisfied with complaint mediation efforts. 86% of complainants to one agency were satisfied with the manner their complaint was handled and 71% were satisfied with the settlement. Another study found that 88% of complainants were satisfied with the agency's efforts, and 62% had a successful resolution of their problem. 63/ But less than half the consumers whose complaints were handled by another agency would go back again. 64/

The average recovery varies with the type of problem mediated. An attorney general's office handling a large number of automobile complaints assisted in settlements averaging $425 a case. A U.S. Postal Service Office primarily handling complaints involving mail order sales found an average recovery of about $40.

The total number of complaints handled by agencies are significant, running as high as thousands a year per office. The United States Postal Service handles about 100,000 complaints a year nationally. Consequently, complaint mediation succeeds in satisfying or at least partially compensating large numbers of consumers.

Factors Affecting Mediation Success

Mediation is successful in handling complaints when disputes do not arise out of merchant fraud but honest mistakes or lack of communication. Mediation provides the necessary communication channel to resolve the matter.

Defrauding sellers also respond to mediation, to avoid publicity and the investigative agency's scrutiny. Settling a few cases is a small price to pay for the unhindered continuance of a successful fraud scheme.

The relationship between the mediator and the seller is also critical in arranging a settlement. Agencies find industry trade associations to be very effective at pressing members for repayment. The mediators themselves develop relationships with established companies in the area and resolve matters very informally based on their personal connection. This leads to quick resolutions in the consumer's favor, but also places merchants in strong positions to dispute claims. Experts, such as former auto repairmen, are effective at mediating complaints within areas of their special knowledge.

Obstacles to Successful Mediation

The major problem agencies face in mediating complaints is finding a merchant to complain to. Fly-by-night sellers are hard to contact and will rarely remain in the jurisdiction to mediate a complaint.

These merchants do not have established addresses but use post office boxes and answering services. One official favors legislation requiring answering services to disclose the whereabouts of the merchant.

Other fraud offenders refuse to talk to the mediator or show up at hearings. Offices usually do not have subpoena powers. Some that have them are afraid to use them because of the political backlash. Merchant failure to participate in the mediation forces the case to be dropped because one can not mediate with only one party.

The consumer's problem is not solved once the company agrees to mediate. Consumers have difficulty getting their complete story across. Mediators make no efforts to investigate the case, and the merchant's explanation will be more sophisticated and backed up with documents. The seller may even be represented by an attorney. If the case is just one person's word against another, mediators will rarely be successful.

The mediator's problem is accentuated when the consumer's evidence is stale. Only 14% of those complaining to one office contacted the agency within 7 days of the disputed transaction, 62% waited at least 30 days, and 36% waited more than 90 days. 65/

Another problem can be the mediators themselves. They are not attorneys, are not knowledgeable in the latest developments in consumer law, and are not well paid. Since the selection process is seldom rigorous, the quality of mediators varies significantly. One attorney interviewed found mediators pathetic, even ignoring cases of gross fraud and forgery. Mediators' actions are critical because, unless a consumer is unusually persistent, if a mediator discourages the consumer from pressing the complaint, the consumer will drop it, even giving up on other avenues of attack.

Mediators have no authority to make their settlement recommendation binding on sellers, who can just respond "take me to court". Mediators generally can not go to court on behalf of consumers, and, if they can, they will not do so for such a small claim. Complaint handlers process hundreds of cases a year; time can not be wasted litigating an individual case.

Some agencies mediate and also enforce consumer statutes, giving clout to their complaint handling functions. But prosecutors' interests and priorities often concentrate on enforcement and not complaint mediation, officials not considering themselves "bill collectors".

Merchants intending to skirt the law are keenly aware of these legal and practical limitations to mediation. One agency estimates that from 5 to 15% of its cases can only reach meaningful outcomes if there is a threat of enforcement.

Complaint mediation's biggest hidden failing is its failure to monitor merchant compliance with mediated settlements. Sellers agree to adjust complaints but never follow through on their promises. Since mediation is not binding, neither are such promises. One study found merchants never did anything on 20% of cases the agency thought were settled satisfactorily. 66/

Mediators do not actively monitor compliance, but wait for the consumer to call back and complain about the seller's failure to comply. But consumers rarely recontact the agency, being frustrated and angry with both the seller and the mediating office. Consumers perceive the office will not take any further action since mediation is only voluntary.

Cost-Effectiveness of Complaint Mediation

With all of these problems, complaint mediation still succeeds in compensating thousands of consumers millions of dollars. Mediation is faster and cheaper than court actions and remedies are more flexible. For example, a settlement to repair an item can please both the consumer and seller more than a damage award.

Mediation is particularly useful in cases where legal proof is difficult, such as where shoes do not fit correctly or curtains fade after several years. Decisions have no precedential value, so emphasis is placed on solving individual cases to the greatest benefit of those involved.

The cost of mediation to the agency can be crudely measured as about $1 for every $2 of settlements. Illinois' Attorney General Consumer Fraud Office in past years devoted much of its approximately $1 million a year budget to reaching settlements of a little less than $2 million a year. New York's Attorney General Consumer Protection Office's budget of about $4 million equalls the amount recovered in complaint mediation and restitution actions. The budget also went to other significant enforcement activities. 67/

The Los Angeles County Department of Consumer Affairs from 1975 to 1977 had expenditures of $546,514 and assisted in $676,064 worth of settlements. Expenditures went not only to mediation, but consumer education, consumer advocacy, and coordinating consumer protection activities. 68/

FOOTNOTES

(Chapter II)

1. Consumer remedies against bankrupt sellers are analyzed in "Bankruptcy", Section VIIB.

2. LEGAL SERVICES CORPORATION, ANNUAL REPORT (1977).

3. "Private Attorneys General", Section ID.

4. Sheldon v. Walker, 10 NY2d 401 (1961).

5. Information of a general nature on small claims courts was taken largely from RHUNKA and WELLER, SMALL CLAIMS COURTS: A NATIONAL EXAMINATION, (Draft 9/1/77) a project of the National Center for States Courts. (Hereinafter referred to as NCSC). See also, GOULD, STAFF STUDIES PREPARED FOR THE NATIONAL INSTITUTE FOR CONSUMER JUSTICE ON SMALL CLAIM COURTS (1972) (Hereinafter referred to as NICJ), and Yngvesson and Hennessey, Small Claims, Complex Disputes: A Review of the Small Claims Literature, LAW AND SOCIETY 219 (Winter, 1975) (hereinafter referred to as Yngvesson).

6. NCSC supra note 5, at 4-3 and 4-9.

7. Id at 4-16; Yngvesson, supra note 5, at 236.

8. NCSC, supra note 5, at 4-10.

9. Id at 6-25.

10. Id at 6-9.

11. Beresford, It Takes a Big Judge to Handle Small Claims, THE JUDGE'S JOURNAL (Fall 1977) (Hereinafter referred to as "Beresford").

12. Twelve of 15 courts surveyed in a recent national study provided some form of information sheet or pamphlet to plaintiffs and clerks in all 15 provided some advice on how to fill out forms. In 11 the clerk actually fills out the forms, and in an equal number the clerk will provide advice on what evidence is needed. (NCSC, supra note 5 at 6-14).

13. NCSC, supra note 5 at 6-14.

14. Id.

15. Note, Small Claims Courts: An Overview and Recommendation, U. MICH. J. L. REFORM 590 at 602 (Spring, 1976).

16. NCSC, supra, note 5 at 3-19.

17. Beresford, supra note 11 at 16; NCSC, supra note 5 at 3-4.

18. NCSC, supra note 5 at 3-5.

19. Id at 3-18, 9-11.

20. Id at 3-11.

21. Id at 7-27.

22. Id at 7-31.

23. Id at 8-13.

24. Id at 6-18.

25. AMERICAN BANKER (December 22, 1977) at 2.

26. Vasquez v. Superior Court, 4 Cal 3d 800, 484 P2d 964 (1971).

27. Eisen v. Carlisle and Jacquelin, 417 U.S. 156 (1974).

28. This issue is presently before the U.S. Supreme Court after an U.S. Court of Appeals held notice costs are solely the plaintiff's obligation.

29. Snyder v. Harris, 394 U.S. 332 (1969).

30. Zahn v. International Paper Co., 414 U.S. 291 (1972).

31. "Injunctions, Cease and Desist Orders", Section IB.

32. W. Whitford, Strict Products Liability and the Automobile Industry: Much Ado About Nothing, 1968 WIS L REV 83, 146 (1968) (Hereinafter Whitford, Much Ado).

33. W. Whitford, Law and the Consumer Transaction: A Case Study of the Automobile Warranty , 1968 WIS L REV 1006, at 1077 (1968) (Hereinafter Whitford, Case Study); Rothschild, The Magnuson-Moss Warranty Act: Does it Balance Warrantor and Consumer Interests?, 44 GEO WASH L REV 335 at 360 (1976).

34. BUREAU OF CONSUMER PROTECTION, FEDERAL TRADE COMMISSION, STAFF REPORT ON AUTOMOBILE WARRANTIES at 180 (1968).

35. 15 USC 2310(d).

36. Whitford, Case Study, supra note 33 at 1081.

37. 15 USC 2310.

38. Eddy, Effects of the Magnuson-Moss Act Upon Consumer Product Warranties, 55 N.C. L. REV. 835 (1977).

39. Whitford, Case Study, supra note 33 at 1029-31.

40. 15 USC 2304(b).

41. H.R. REP. NO. 1107, 93 Cong., 2nd Sess. (1974); Whitford, supra note 33 at 1115.

42. Eddy, On the "Essential" Purposes of Limited Remedies: The Metaphysics of UCC Section 2-719(2), 65 CAL L REV 28 at 58-59 (1977).

43. Rothschild, supra note 33 at 376.

44. M. Trebilcock, Manufacturers' Guarantees, 18 McGILL L. J. 1 at 17-20 (1972); Rothschild, supra, note 33 at 365; Whitford, Much Ado, supra note 32 at 153.

45. Whitford, Much Ado, supra note 32 at 153.

46. Whitford, Case Study, supra note 33 at 1013; TASK FORCE REPORT, APPLIANCE WARRANTIES AND SERVICES (1969).

47. Rothschild, supra note 33 at 229.

48. Id at 364.

49. Eddy, On the Effects of Magnuson-Moss, supra note 38; Whitford, Case Study, supra note 33 at 1081ff.

50. Eddy, On the "Essential" Purposes, supra note 42 at 30.

51. Rothschild, supra note 33; Note, Restricting Disclaimer of the Implied Warranty of Merchantability in Consumer Sales: Proposed Alternatives to the UCC, 12 W AND MARY L REV 895 (1971).

52. 15 USC 2308.

53. WASH REV CODE Ch. 62A §2-316(4)(Supp. 1974); MASS GEN LAWS ANN Ch. 106 §2-316A(Supp. 1977); ORE REV STAT 72.8010-8200 (1974); MD ANN CODE art 95B §2-316A(1971); ME REV STAT ANN title 11 §2-316(Supp. 1973).

54. "Criminal Sentences", Section IA; "Injunctions, Cease and Desist Orders", Section IB.

55. "Criminal Sentences", Section IA; "Injunctions, Cease and Desist Orders", Section IB; "Fines, Penalties and License Revocations", Section IC; "Restitution", Section IIB.

56. Levine and Preston, Community Resource Orientation, Among Low Income Groups, 1970 WIS L REV 80; D. CAPLOVITZ, THE POOR PAY MORE (1976).

57. E. Steele, Fraud, Dispute and the Consumer: Responding, to Consumer Complaints 123 U PENN L REV 1107 (1975).

58. Id.

59. Id.

60. Id.

61. Id.

62. Id.

63. The Center for the Study of Responsive Law (unpublished survey).

64. Steele, supra note 57.

65. Id.

66. Id.

67. Committee on the Office of Attorney GEneral, National Association of Attorneys General; 1977 Questionnaire of Attorney General Offices.

68. LOS ANGELES COUNTY DEPARTMENT OF CONSUMER AFFAIRS, BIENNIAL REPORT (1977).

CONTENTS - CHAPTER III

III SELF-ENFORCING REMEDIES

Self-enforcing remedies allow consumers to redress or even deter fraud with little or no government intervention. Previous approaches required the state to act as prosecutor, judge, or mediator. Self-enforcing remedies, to the extent they are self-enforcing, free consumers from reliance on government action. Three strategies implementing this approach are explored.

Consumers buying on credit can withhold payments due on fraudulent sales. This partially compensates the consumer and requires him to take no affirmative action.

Creditors utilize various techniques to discourage consumers withholding payment and other obstacles prevent utilization of the strategy. Consumers who do default on their debts are ineffective in defending debt collection actions. But if they manage to retain an attorney, defrauded consumers are in a powerful position raising fraud defenses to the creditor's collection action.

Other more or less "automatic remedies", such as rejecting non-conforming goods, cancelling contracts, and retaining unsolicited goods are available and effective in certain contexts, but often rely on government action to insure sellers comply with them.

Consumer demonstrations is the most self-enforcing remedy, using publicity to attack defrauding merchants. If the demonstration discourages business, the seller may negotiate. Legal and practical impediments prevent widespread use of this remedy.

A. WITHHOLDING PAYMENT

Withholding payment is a simple, widespread, but overlooked consumer fraud intervention strategy. Consumers not making full payment before discovering the fraud just refuse to pay the remaining amount.

The strategy is self-enforcing and requires no affirmative consumer action. The defrauded consumer does not have to rely on a government agency, or, at least initially, on an attorney. In fact, he does not have to do anything; he just takes the natural step of not paying the merchant who defrauded him.

Withholding payment minimizes the consumer loss, but fails to fully compensate fraud victims who still lose their downpayments. Nor will merchants be deterred by the threat of losing some of their profits from some consumers.

1. Frequency, Reasons For Consumers Withholding Payment

The extensive use of credit in the American economy means that withholding payment will often be available to defrauded consumers. There is over $200 billion in outstanding consumer installment credit, excluding real estate loans and informal credit purchases where full payment is due but delayed.

Fraud schemes can avoid this intervention strategy by requiring immediate full payment. But fraud offenders will have to sell on credit to low income consumers, who can not make payment in advance. Some purchases, such as automobiles, mobile homes, and future service contracts, are so large as to almost always involve credit, no matter who the buyer is.

Caplovitz, in Consumers in Trouble, A Study of Debtors in Default, 1/ his classic survey of consumer defaulters in three cities, found that 19% of debtors in default mentioned merchant misconduct as a reason for withholding payment, and 14% said merchant fraud was the primary reason. These percentages were higher for Blacks and low income defaulters.

The number of consumers defaulting because of merchant fraud varies by type of sellers. Fraud was cited as the primary reason for default in transactions involving direct sellers 24% of the time, auto dealers 23% of the time, low income retailers 14%, general retailers 7%, small loan companies 3%, and banks 1%. 2/

Other major reasons for default are consumers' inability to pay because of a sudden loss of job or other unplanned event, and confusion as to the terms of the credit arrangement. Perhaps 10% of defaulters are attempting to take advantage of honest sellers.

Between 1 and 3% of consumers default on their loans for any reason, 3/ indicating debtors pay on their loans even after being defrauded. 4/ Consumers do not realize they have been defrauded or that they can legally withhold payments they "owe" if they have been defrauded.

One legal services office has conducted a successful program encouraging low income consumers to stand up for their rights and not make payments. Radio spots publicized that consumers do not have to let "the man" take their furniture and other belongings and the office actively defended debt collection actions.

Consumers will withhold payment in situations where they are reluctant to take affirmative action to complain or sue for damages. For example, vocational school regulators, attorney general offices, and other complaint sources receive small numbers of vocational school complaints. HEW officials attempting to collect on defaulted federally insured student loans discover substantial numbers of students refusing to pay because of fraud. Students drop out of their courses in disgust and refuse to pay any more, but take no affirmative action against the school.

2. Effect of Withholding Payment

Effect of Consumers Represented By Attorneys Withholding Payment

Consumers who withhold payment and obtain legal representation are in a very strong position, even if the merchant sues to collect the debt. The consumer's defensive posture is critical. A creditor attorney succinctly described the merchant attitude if the consumer must sue affirmatively as "screw him".

Virtually every burden a consumer bears in affirmatively bringing a fraud action is suddenly shifted to the merchant when the consumer is in the defensive posture. The fraud offender, not the victim is faced with long court delays, filing fees, hiring an attorney, drawing up legal papers, proving the case, and collecting the judgment.

Consumer attorneys with a minimum of effort can make it very costly for a defrauding merchant to try to collect on a debt. A settlement with a 50% reduction in the amount owed is almost automatic if the consumer has any legitimate complaint, and he retains experienced counsel.

Collection attorneys mass produce as many as 30 cases a day, with their compensation based on a percentage of the recovery. Contested cases disrupt this procedure. During the time it takes to try a case, responding to interrogatories and counterclaims, researching legal issues and drafting documents, the collection attorney can make the same amount from each of 30 uncontested cases.

Even worse, the consumer's defenses and counterclaims can result in an insignificant judgment for the merchant or even a sizeable judgment against the merchant if the consumer's counterclaims result in treble, punative, or statutory damages.

Unrepresented Consumers Defending Collection Actions

Advantages of the defensive posture are lost because consumers withholding payment rarely retain counsel and can not effectively defend suits on their own. For example, 90% of one local court's cases are collection actions, but consumers almost never appear with counsel and rarely appear at all to contest these actions. A scrutiny of a sample of these cases showed that 80% had defects on the face of the complaint, not even considering available defences and counterclaims. But, since the collection actions were uncontested, creditors always obtained judgments.

The practical and economic impediments to hiring a lawyer are as great if the consumer is being sued as they are if he is suing 5/. The consumer hopes the attorney's fees will be less than the amount the attorney saves him. The possibility of a quick settlement aided by the defensive posture may minimize attorney fees somewhat, but only legal services attorneys will defend small collection actions.

Consumers without lawyers have significant problems defending collection actions, beginning at the very initiation of the suit. Consumers are victims of sewer service, the practice of plaintiffs misrepresenting to the court that notice of the court action has been delivered to the defendant. Without notice that suit has been brought against him, the consumer loses the case through failure to appear and contest the action. The Caplovitz study found that 29% of debtors claimed never to have been served with summonses 6/.

Consumers receiving summonses do not understand or know what to do with them. Legal notices are notorious for their unintelligible language. Drafted by and for lawyers, they do not assist consumers in understanding what is happening or what their obligations are. Some consumers are also afraid to appear unrepresented in court to answer a merchant's charges.

Consumer court attendence is discouraged by creditors bringing actions miles from the consumer's residence and from where the credit agreement was made. For example, San Francisco residents buying products on credit in San Francisco may be sued in Los Angeles. Caplovitz found only 25% of those sued in Manhattan lived in Manhattan. 7/

For all these reasons, Caplovitz found that over 90% of debtors do not appear in court and thus lose by default judgments. 8/ Many consumers do not even know they have been sued until their wages are garnished. In some states wage garnishment can be quickly stopped by filling out a simple form claiming the debtor has a bona fide defense to the original suit, but consumers generally are unaware of this right. In most states, stopping the garnishment is a lengthy process requiring a lawyer.

Similarly, an attorney, but not an unrepresented consumer, can easily vacate a judgment if the summons was never served. One unusual solution is a class action seeking to vacate all class members' default judgments alleging sewer service or similar abuse of process.

Those few consumers who do appear in court and defend themselves will not raise fraud defenses or present sufficient evidence to prove them, and judges will not actively assist them. Those consumers prepared to raise solid defenses discover they can not argue them as creditor attorneys continually seek continuances in the case.

Continuances will not bother creditor attorneys who are in court almost every day processing a large volume of cases, but they can seriously affect consumers who have to leave work just to sit in court and wait until the case is continued yet another day. Consequently, Caplovitz found that less than 3% of debtors sued succeeded in getting an outcome even "probably favorable to the defendant". 9/

An unrepresented consumer does have one significant advantage in withholding payment. Creditors, after winning judgments in court, still have to collect on them. Some consumers are so poor as to be judgment proof; others refuse to pay even after judgment is entered against them. Caplovitz found 40% of judgments were not satisfied at all. The major creditor weapon in collecting judgments is garnishing wages, but some employers refuse to participate and state laws also limit this procedure.

3. Creditor Remedies Impact on Consumers

Practices Discouraging Consumers Withholding Payment

A number of creditor practices discourage consumers from withholding payment, partially explaining why so few defrauded consumers default on loans. Consumers withholding payment are first turned over to collection agencies with threats of damage to their credit rating. In theory, a collection agency can do no more than request payment. But collection agencies have devised persuasive techniques convincing consumers to pay, including misrepresentations of the legal consequences of the consumer's default, harrassment through late night phone calls, and humiliating visits in front of employers and neighbors.

State law prohibits these techniques, but has been less than effective in stopping them. Congress has recently enacted a debt collection law to attempt to solve the problem through federal enforcement.

Creditors also discourage defaulters by including terms in the credit agreement that harshly penalize withholding payment. Debtors do not consider these terms at the time of sale because they then think they will pay their debt. Unless prevented by law, creditors will put in these agreements anything they can think of that will deter non-payment.

Attorney fee clauses in credit contracts provide that a consumer bears the creditor's attorney fees and collection costs in the event of default. Most courts will not enforce an attorney fee clause if the consumer is successful in asserting a claim or defense. Nevertheless, the amount the consumer risks by contesting the debt is considerable, with the creditor's attorney fees often being greater than the debt at stake.

Some states prohibit creditor attorney fees; others limit them to from 10 to 30% of the debt or to a "reasonable" amount. A proposed FTC Rule recommends that they be severely limited nationwide 10/.

Virtually every credit contract contains a clause giving the creditor the right to accelerate and demand immediate payment on all future installments if the consumer withholds a single payment. Debtors withholding payment while attempting to negotiate with the seller thus risk insolvency as the whole debt becomes due.

Blanket security interests allow creditors to seize virtually all of the consumer's possessions to satisfy outstanding debts, including household and personal items of small monetary but large sentimental value. Creditors take security interests in many possessions solely for the in terrorem effect. State laws exempt certain personal items from seizure, but credit agreements require consumers to waive these statutory rights.

Wage assignments automatically pay part of the consumer's wages to the creditor upon default. The very threat of this remedy deters withholding payment because employers look dimly at employees whose wages are assigned.

Self-help repossession allows creditors to seize without judicial hearing consumer purchases when the debtor is behind on his payments. A consumer withholding payments on a defective automobile is worse off than if he had paid in full if the car is repossessed. He will have made substantial payments and does not even have a defective car to show for them. State laws place only limited restrictions on self-help repossession.

Co-signer provisions hold third parties jointly liable on consumer debts. A consumer's withholding payment results in legal action against the co-signer. The very threat of contacting a co-signer may be embarrassing enough for the consumer to pay the seller.

Confession of judgment clauses 11/ authorize creditors to enter judgments against consumers who the creditors believe are in default, without giving the consumers notice or an opportunity to defend the actions. Consumers may first become aware of the judgment when a sheriff or constable attaches the consumer's home or household goods.

The few states that still permit the use of this device in consumer transactions usually permit consumers to assert claims or defenses after the judgment. This still puts the consumer at a greater procedural disadvantage than in an ordinary lawsuit and the original judgment creates the impression of finality and unassailability.

Consumer Defense Cut-Offs

Defense cut-off devices preclude consumers from raising fraud defenses in debt collection actions by insulating the financer of a consumer credit transaction from the seller's fraud liabilities. Defense cut-off devices consequently only apply to transactions where the creditor and merchant are different entities or where the merchant sells the consumer's note to a bank or other financer. In these situations, consumers lose their legal grounds to withhold payment from the creditor and are forced to bring affirmative fraud actions against the defrauding merchants. This affirmative suit puts the consumer in a more difficult posture than a defense to a collection action.

The holder-in-due-course (HDC) doctrine is the best-known defense cut off device. Holders of negotiable instruments are insulated from claims or defenses arising out of the underlying sales transaction if the holder is an innocent purchaser of paper in the proper form. Typically, promisory notes running from a consumer to the seller are sold to a bank or finance company which asserts HDC status if an aggrieved consumer withholds payment.

The HDC Doctrine only applies to "negotiable instruments". Waiver of defense clauses are inserted in non-negotiable instruments, such as sales contracts and security agreements, and provide the financer with similar insulation as the HDC doctrine. The consumer waives his right to raise claims and defenses against the seller's assignee.

Recently state courts have rigorously denied HDC status where financers fail to meet technical requirements, and a few courts find waiver of defense clauses in consumer transactions unconscionable. A majority of state legislatures also restrict in varying degrees the availability of HDC and waiver of defense clauses. 12/ Most importantly, a 1976 FTC trade regulation rule eliminates the HDC doctrine and waiver of defense clauses in almost all consumer transactions. 13/ The FTC Rule does not apply to most real estate transactions or insurance financing.

Creditors have found other means of cutting off consumer defenses. Under common law contract principles of novation, a new contract substituted for a prior contract discharges the claims and defenses associated with that prior contract. Finance companies "flip" or refinance over 70% of their existing contracts, substituting them for new ones. 14/ Nearly one-third of finance company loans consolidate existing bills, substituting a single loan for several retail installment sale contracts. 15/

It is uncertain whether the FTC's HDC rule also limits discharge of consumers' claims and defenses by flipped and consolidation loans. States do not regulate the problem.

Seller arranged loans are another way of creditors avoiding consumer defenses and claims. Instead of financers purchasing from the seller consumer promisory notes, they make direct loans to consumers to finance purchase of the seller's products. The FTC's HDC rule limits financer insulation in certain seller arranged loans.

Three-party credit cards and revolving credit contracts contain waiver of defense clauses. Other times credit card issuers simply tell complaining consumers that fraud issues must be taken up with the seller. Credit card holders' actual legal status is unclear.

The recent enactment of the Fair Credit Billing Act 16/ allows consumers to assert claims and defenses against a credit card issuer in limited situations. The consumer must first attempt to resolve the matter with the seller, the transaction must exceed $50.00 and must have occurred near the consumer's residence.

A final example of a fraud cut-off device is created by the federal government. HEW guarantees loans for students to attend certain private vocational and correspondence schools. When defrauded students withhold payment, the school collects on the loan from HEW, and HEW collects the loan from the student. The United State Government collecting on a debt convinces some students to pay without protest. Students pressing fraud defenses find HEW more interested in collecting from the student than investigating the school. 17/

B. AUTOMATIC REMEDIES

Consumers have a number of self-enforcing, more or less "automatic" remedies. While relatively little research and evaluation have been devoted to these as fraud intervention strategies, this section will outline theoretical strengths and weaknesses of several automatic remedies.

1. Retention of Unsolicited Goods

Retaining unsolicited goods is a special self-help remedy geared to one type of fraud - merchants sending and then billing consumers for unsolicited goods, even pursuing debt collection actions for non-payment. Consumers do not want to invest the effort and postage to return the item, but feel obligated to pay if they keep the good. Most states and federal law allow consumers to keep unsolicited merchandise as gifts.

No detailed study has been made of this remedy, but it appears to be successful at decreasing the number of sellers sending unsolicited goods. The remedy is effective because it is self-enforcing. The consumer does not have to hire an attorney, go to court, rely on government agency action, complain, or take any other action. He just retains the good.

If the merchant illegally presses for payment, the consumer's action is purely defensive. Defense cut offs and credit terms discouraging withholding payment do not exist. If the merchant disappears or goes bankrupt, the consumer is just as well off.

The consumer is better off than he is withholding payment. There is no consumer loss because there is never any prepayment. Consumers feel less moral obligation to pay for unrequested goods and may know the merchant's debt collection effort is illegal. Moreover, consumers do not have to prove fraud in resisting collection actions, but only demonstrate the goods were unsolicited.

The remedy's major failing is that consumers are unaware of its existence. Public education is minimal, and fraud offenders may not make mandated disclosures of consumers' right to keep goods as gifts.

Consumer agencies or others knowledgeable with the law can give simple and direct advice to consumers who contact them. Moreover, the possibility of legally keeping free goods arouses consumer interest in the remedy, stimulating awareness. The consumer windfall also causes an equal merchant loss, deterring similar merchant misconduct.

2. Rejection, Revocation of Acceptance

Rejection or revocation of acceptance applies to the sale of all goods. Delivered goods may be rejected if they do not conform to the sales agreement and the seller is so notified. After rejection, the buyer must hold the goods with reasonable care awaiting the seller's disposition of them. Acceptance of goods by the buyer precludes rejection. Mere receipt is not acceptance; acceptance occurs when the buyer, after an opportunity to inspect the goods, fails to object to them.

While goods accepted may not subsequently be "rejected", acceptance may be "revoked" when a substantial impairment of value is found. A buyer may revoke acceptance if the nonconformity was difficult to discover or if the seller assured the buyer it was free of defects. Revocation of acceptance must occur within a reasonable time after the buyer should have discovered the impairment, and before a substantial change in the condition of the goods, not caused by the defect, has occurred. Revocation only takes place when the seller is notified.

This self-enforcing remedy has several characteristics that do not make it as effective as retaining unsolicited goods. Usually some payment has been made, and the rejecting consumer must try to get his money back from the merchant. If the merchant does not cooperate, the consumer must go to court to obtain relief.

Consumers rarely return goods immediately, and this retention signifies acceptance. To revoke his acceptance, the consumer has the burden of proving a substantial defect. Courts have found for the merchant where the necessary expert investigation to prove the defect would cost more than the good itself or where cars have blown up, obliterating the defect. Courts also interpret notice requirements stringently, causing consumers to lose their rights by their slowness in acting.

When businesses refuse to honor the remedy, consumers find themselves in a bind, handing over the defective product to the seller, but not receiving money in return to buy a replacement. Keeping the product forfeits the right to reject.

There is little incentive for merchants to willingly honor rejections because courts do not add on punitive damages for intransigence, and consumers rarely initiate court actions. Rejection or revocation do not deter merchant misconduct but only return matters to the status quo when used successfully. Unlike other automatic remedies, merchants are not required to disclose to consumers the remedy's availability, thus accentuating consumers' ignorance of their legal right to reject or revoke acceptance.

3. Cooling-Off Periods, Refund Standards

A number of other remedies also allow consumers to back out of sales agreements and still receive all or most of their money back. Cooling-off periods give consumers three days to cancel contracts; trial periods allow consumers to try out products before the buyer becomes financially obligated. Refund standards allow consumers to drop out of long-term contracts and only pay a fair price for that portion of the contract they benefitted from. All of these remedies are analyzed in detail in other sections of this report. 18/ This section will only briefly compare these remedies with the other "automatic" self-enforcing remedies.

Cooling-off and trial periods and refund standards are very much like the rejection remedy because consumers must initiate action to recover downpayments from uncooperative merchants, and consumers must comply with technical cancellation requirements. Consequently, there is the danger that the consumer will not receive any of his money back while also not receiving whatever benefit the good or service still had. But unlike the rejection remedy, cooling-off and trial periods and refund standards allow consumers to cancel for any reason. The consumer does not have to prove a defect or sales misrperesentations.

Again unlike rejection, these remedies are normally accompanied by requirements that sellers disclose to consumers cancellation rights under the remedy. Nevertheless, these disclosures are criticized as difficult to read and understand, resulting in consumers being unaware of their cancellation rights.

Cooling-off periods and refund standards are designed not only to compensate consumers but to deter oppressive door-to-door sales. While the consumer is returned to the status quo, with no windfall, the seller loses money on a cancellation if he spends an excessive amount on sales commissions to make the initial sale.

4. Liquidated Damages

Another automatic remedy mandates that merchants give consumers fixed money damages or discounts if specified facts occur. This report will name this rarely authorized type of remedy "liquidated damages".

A good example is Civil Aeronautics Board requirements that air travelers with reservations bumped from their flight be placed on a later flight free. The remedy defines a specific consumer payment, the cost of the flight, if the merchant violates the standard. If the merchant complies and makes the liquidated damage award, no court action is necessary.

Unlike rejection, cooling-off periods, and refund standards, the consumer does not have to do anything to initiate the remedy. It is the seller's obligation to make the damage payment. Putting the burden to act on the offending merchant, not the consumer, is a critical component leading to effective use of self-enforcing remedies.

If the merchant fails to comply with the liquidated damage remedy, the consumer must rely on government enforcement or initiate private court action. But consumers must be aware of the remedy if they are to take actions against non-complying sellers. Legislation can require disclosure of the remedy at the point of sale. The Civil Aeronautics Board requires disclosure of the bumping remedy at airports.

The windfall implicit in the use of liquidated damages also instigates consumer awareness and use of the remedy. To the extent the remedy provides a windfall for the consumer, it also provides a deterrent for the merchant.

This brief review of several automatic remedies demonstrates that their effectiveness turns on several of their characteristics:

- consumers receiving windfalls and consequent merchant deterrence;
- consumers having to take little or no action to initiate the remedy;
- easy-to-prove standards triggering the remedy;
- placing the consumer in a defensive posture if the merchant refuses to comply with the remedy;
- and consumers being aware of the remedy.

C. CONSUMER DEMONSTRATIONS

Consumer demonstrations use publicity to attempt to damage a defrauding merchant's business enough so the merchant will "buy off" the demonstrator. Settlements are not limited to actual damages but are determined by how much the demonstration harms the merchant and how hard the consumer bargains. One picketer received $10,000 for a $500 complaint. Nor does the settlement have to be money. A consumer may have his car replaced or repaired, his sales contract canceled, or any other mutually satisfactory remedy.

Demonstrations can not only compensate defrauded consumers, but, if they generate enough publicity, deter fraud and improve other consumers' purchase decisions. Normally, neither deterrance nor education are demonstrators' principal goals; when paid off, consumers stop demonstrating.

Consumer demonstrations are a completely self-enforcing remedy, relying on no legislative, judicial, prosecutorial or agency action. Like withholding payment, the merchant, not the consumer, must resort to the courts. But, unlike debt collection actions, the law is not stacked against the consumer. The First Amendment right of free speech protects consumer action.

Demonstrations Described

Consumers usually demonstrate in front of a merchant's place of business, carrying signs or handing out leaflets. Another popular tactic is an owner painting lemons on his defective automobile. More dramatic, if rarer, is an outraged consumer destroying his car in front of the guilty auto dealership.

More common than individual protests are demonstrations organized and manned by private consumer organizations. Consumer Action of San Francisco ("CA") employs consumer picketing as part of its "complaint committee" program. Aggrieved consumers contacting CA are referred to weekly meetings of fifteen to twenty members which discuss remedies for individual complaints. Only if preliminary tactics - letters or mass visits to the merchant - are unsuccessful will CA consider picketing, finding it too time-consuming.

Demonstrations can be extensive; CA's "Rusted Chevy Project" organized 700 consumers who, for several months, have conducted informational pickets at San Francisco-area Chevrolet dealers. A more typical, demonstration will involve five to fifteen individuals picketing during peak business hours. But only a handful of consumer groups in scattered urban areas around the country consistently conduct even these more limited demonstrations.

Practical Restraints on Organizing Demonstrations

The rarity of consumer demonstrations evidences the practical difficulties of mounting an effective picket. Individual demonstrations are incredibly time consuming with no assurance of success. Even when an organization adds its resources, the total hours devoted to the project may be grossly disproportionate to the expected benefits.

A strong desire to rectify a wrong, whatever the immediate cost, is often critical to an effective picket. Few local consumer organizations are able to instill such a group commitment. Often it is not the organization membership, but the aggrieved consumer who becomes frustrated by the lack of quick resolution and requests the picket be stopped. Whatever the cause, a discontinued picket damages the organization's credibility with merchants.

Legal Restraints

The picketed merchant can seek to enjoin the demonstration as an interference with his business, a trespass on his property, or on related grounds. The court, if it rules for the seller, will prohibit or limit the demonstration. Violators of court orders face contempt of court charges.

Merchants can also seek damages against demonstrators, but injunctions are preferred because they immediately stop the picket. Damage actions take years and give no certainity of recovery. But injunctive actions, to be successful, must overcome consumers' well grounded constitutional right to freedom of speech and demonstration. This right holds even if the consumer's message is arguably misleading. 19/

Courts have enjoined certain types of picketing despite this First Amendment protection. Consumers cannot demonstrate on private property. The Supreme Court has found a shopping mall not a public place, so picketing on its premises can be enjoined. 20/ Other merchants are also so situated on private property as to make demonstrations impossible.

A number of isolated cases have also enjoined consumer demonstrations as "coercive," "malicious," or seriously damaging a merchant's business. A court enjoined one consumer who threatened to ruin the dealer's reputation and displayed on his car lemon signs and actual strings of lemons. 21/ Another court prohibited pickets stating that the merchant sold "rotten meat" in a "dirty store." 22/

Despite these cases, modern courts, influenced by trends toward more consumer rights and First Amendment protections, hesitate to prohibit consumer picketing, but will only limit its scope. Recently, one court limited picketing to groups of four who could not interfere or initiate conversations with passersby. The court prohibited use of a public address system or making "unusual noise." 23/

Even if the consumer wins in court, the need to hire an attorney to defend himself creates additional financial strains. Forcing the merchant to go to court is not the strategic victory it is when consumers withhold payment. Cases do not drag on for years; courts can immediately issue temporary restraining orders and preliminary injunctions.

Effectiveness of Consumer Demonstrations

Legal and practical obstacles stop all but the most motivated or organized consumer demonstrators. Consequently the strategy's infrequent use diminishes its deterrent effect and its ability to significantly change business practices.

But a determined group of protestors can effectively obtain redress for individual, aggrieved consumers. Consumer organizations report success in most instances, as long as the consumer does not back down too quickly. Moreover, the threat of a demonstration gives consumer grievance committees real bargaining power negotiating with merchants.

A demonstration's effectiveness varies with the type of business involved, the grievance being protested, and the picket's financial impact on the merchant. Fly-by-night operations are immune to this strategy; merchants with virtual monopolies, like some ghetto sellers, will not be significantly damaged. But small local merchants who value their reputation in the community are especially vulnerable.

Major national corporations are concerned with their image up to a point. CA's extensive picketing in the "Rusted Chevy Project" has not been effective. The damage to local dealers has not been significant enough to force General Motors to come to terms; settlement with all involved Chevrolet owners would cost GM millions of dollars. A nationwide picketing effort, involving thousands and with extensive publicity, might produce a settlement, but organizing such a demonstration is beyond the capacity of localized consumer groups with shoestring budgets.

FOOTNOTES

(Chapter III)

1. D. CAPLOVITZ, CONSUMERS IN TROUBLE, A STUDY OF DEBTORS IN DEFAULT (1974).

2. Id.

3. FEDERAL RESERVE BANK OF KANSAS CITY, MONTHLY REVIEW at 11 (February 1977).

4. CAPLOVITZ, supra note 1.

5. See "Private Damage Actions," Section IIA, for discussion of impediments to hiring a lawyer in affirmative action.

6. CAPLOVITZ, supra note 1.

7. Id.

8. Id.

9. Id.

10. Proposed Trade Regulation Rule on Credit Practices, 40 Fed. Reg. 16347 (April 11, 1975).

11. Also called cognovit notes, powers of attorney, and powers of sale.

12. NATIONAL CONSUMER LAW CENTER, CONSUMER LAW HANDBOOK, Vol. 3 at 575 (Old Series 1972).

13. Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses, 16 CFR 433 (1976).

14. R. Peterson, Commercial Bank Consumer Loan Refinancings, CREDIT RESEARCH CENTER WORKING PAPER NO. 11 (1977).

15. NATIONAL CONSUMER FINANCE ASSOCIATION, FINANCE FACTS YEARBOOK at 61 (1977).

16. 15 USC 1666 (1974).

17. BUREAU OF CONSUMER PROTECTION, FEDERAL TRADE COMMISSION, PROPRIETARY VOCATIONAL AND HOME STUDY SCHOOLS at 294 (1977).

18. "Cooling-Off, Trial Periods; Affirmation," Section VB; "Price Limitations," Section VI A.

19. Wilson-McIntosh Buick, Inc. v. Monroe, Civil Action No. 9516-71 (D.C. Sup. Ct., 1971).

20. Hudgens v. NLRB, 424 U.S. 507 (1976).

21. Schmoldt v. Oakley, 390 P2d 882 (Okla. 1964).

22. Williams v. Maloof, 223 Ga 640, 157 SE2d 479 (1967).

23. Rosenfeld Used Cars, Inc. v. CEPO, Eq No. 74658 (Ia. D. Ct., 1970).

CONTENTS - CHAPTER IV

IV CONTROL SELLERS

A fourth consumer fraud intervention approach is controlling seller behavior directly. Instead of compensating past victims or relying on a few prosecutions to deter fraud, the seller's conduct of his business is limited in certain ways, thus preventing fraud.

This approach entangles the government into sellers' day to day business, increasing costs both to the regulated and the regulator, but its prophylactic nature may be superior to other approaches. This chapter analyzes three such strategies.

Licensing restricts entry into occupations and controls licensed sellers' behavior. But existing licensing boards are often developed to reduce competition, not fraud, and industry domination and the lack of resources and enforcement authority limit their effectiveness.

Limiting various particular sales approaches and advertising practices is another strategy. These specific regulations are rarely effective against fly-by-night sellers but, if drafted carefully, influence "mainstream sellers." The more restrictive the regulation, the more effective it is and the more costly to legitimate businesses. Numerous obstacles to effective advertising monitoring makes it a questionable intervention strategy.

America and particularly foreign countries experiment with strategies controlling contract language, preventing contract terms from aiding and abetting fraud schemes. More clearly disclosing provisions has serious limitations. Substantive regulation of standard form contracts has clear advantages, but it strongly opposed by business interests.

A. LICENSING

Occupational licensing attempts to control merchant conduct, thus preventing fraud. Regulatory boards restrict entry into an occupation by selectively granting licenses to practice. Unlicensed practice is illegal. The board also prescribes standards of conduct for licensed sellers, threatening license revocation for violators.

Regulatory boards and occupations they license justify licensing as a consumer protection strategy. Legitimate, qualified sellers are admitted to an occupation; fly-by-night, incompetent, and fraudulent merchants are screened out. Specialized boards familiar with the occupation monitor licensed sellers' conduct to insure fair dealings with consumers, revoking merchant licenses for misconduct aimed at buyers.

1. Entry Restrictions

Critics claim licensing is just a device for members of an occupation to restrict entry, reduce competition, and fix prices at non-competitive levels. 1/ The industry usually has been the instigating force behind the creation of most licensing boards, successfully insulating itself from the rigors of the free market mechanism.

For example, a representative of the California Embalmers Association argued for legislation further increasing entry requirements "...to reduce the number of embalmers coming into the field because a surplus existed which was keeping compensation low". 2/ When interest groups who seek to be licensed also control the licensing board, licensing inevitably just serves anti-competitive ends. 3/

Entry standards are not used to restrict fraud offenders from the occupation, and are just used to inflate the stature of the occupation and limit competitors. California barbers must graduate from an approved barber college with 1248 hours of instruction, apprentice for 18 months, and pass an examination that emphasizes anatomy questions. 4/

No educational background or level of proficiency guarantees that the individual is honest. Strict entry standards may even encourage fraud. A high initial investment to enter an occupation increases entrants' financial incentive to turn to illegal methods if legitimate activity is not bringing a sufficient yield on this investment.

An FTC staff report 5/ empirically tested the effect of licensing's entry restrictions, comparing prices and the level of television repair fraud in three states. One state restricted entry through licensing; one state registered repairmen, but did not restrict entry; one state did not regulate television repairmen at all.

Entry restrictions in the licensed state increased the costs to enter the television repair business, reducing the number of repairmen to one-third fewer technicians per television set than states with no entry restrictions. Repair costs were 20% higher in the licensed state even though the general consumer price index was lower than in the other states sampled. 6/

Fraud was no less frequent in the licensed state than in the unregulated state, being found in half the television sets sampled in both states. In the registration state, with an active television repair fraud enforcement program, fraud fell to only 20 percent of televisions sampled. 7/

Licensing does facilitate enforcement action against fly-by-night sellers. Prosecutions do not have to allege fraud, but only unlicensed activity, a much easier standard to prove. Enforcement officials can monitor local advertising and can apprehend unlicensed advertisers at the same time consumers are first becoming aware of the scheme. Unlicensed sellers are more difficult to locate if they solicit sales only door-to-door or through the mails. By the time officials discover them, they have left town.

California prevents unlicensed sellers from enforcing contracts, limiting these merchants use of credit sales. But this law only works if a consumer decides to stop payment, goes to an attorney to defend the ensueing collection action, and the attorney knows of the law and discovers the merchant is unlicensed.

Registration Compared With Licensing

Modern commentators argue that many of licensing's consumer fraud invervention benefits can be achieved without their anti-competitive costs by adopting instead a registration and certification system. Registration does not limit entry, but only requires those wishing to practice to pay a small fee and provide minimal identifying information to a government agency.

Non-government bodies can then certify that certain members of the occupation have met standards of competence and integrity. Sellers not meeting these standards can conduct business but cannot claim certification. Only registration revocation can prevent merchants from practicing their occupation.

Compare occupation "L" that is licensed with occupation "R" that registers with the state and is certified by some other body. A consumer dealing with occupation "L" contracts with a licensed merchant meeting certain minimum qualifications. Entry restrictions raise prices and make services less available.

A consumer dealing with occupation "R" can hire anyone to perform the service, no matter how untrained or inexperienced. If the consumer wishes to pay for the best, he employs a certified seller. The consumer has a choice of differently priced and skilled sellers.

2. Post Licensing Regulation

Licensing boards do little to regulate the behaivor of sellers they license. Board regulations rarely are designed to deal with consumer fraud issues. For example, medical licensing boards do not prohibit abusive fee practices, Medicare overcharges, or unnecessary surgery. 8/ Private vocational school regulations supervise in detail class size and curricula, but not prevalent fraud abuses. 9/ Many occupational boards will proscribe fraud generally, but will not delineate or enforce specific seller abuses.

Boards rarely have the resources to enforce seller misconduct. One board complained of a backlog of 13,000 complaints; another expects two inspectors to make 4 investigations a year at each of the state's 680 funeral homes.

Florida's Construction Industry Licensing Board receives numerous consumer complaints about industry abuses. Its staff of 9 inspectors and $359,000 budget must regulate over 20,000 general contractors, not including the other half of the industry that is still unlicensed. Required background investigations of applicants for the certified contractor's license are not performed because of lack of staff and budget. 10/

Boards are usually financed by licensing fees. Occupational members, by keeping fees low, not only save themselves money, but insure the board's inadequate supervision. The board is also faced with the paradox that the more licenses it revokes or fails to grant, the less money it has to support itself. Legislators and board officials' acquiesence to these minimal board budgets is partially explained by the "licensing syndrome", the belief that licensing a seller and visiting it once or twice a year protects consumers from fraud schemes. 11/

Low board budgets and the failure to enforce consumer protection regulations are also caused by the "hand in glove" relationship of the regulators and the regulated. Boards are dominated by, and even comprised of only industry members. "Consumer representation" usually means one or two non-industry members on a board of seven or more. Only a handful of licensing boards approach 50% public representation.

FTC staff studies of the funeral and vocational school industries find regulatory boards so dominated by the industry that they act more as protectors of the industry than enforcers of consumer protection regulations.

> State regulation against unfair or deceptive funeral industry practices has been dominated by industry interests to the detriment of consumers. 12/
>
> State regulatory officials often appear to view themselves as representatives of, and apologists for, the industry they are charged with regulating...One reason for the apparent friendliness of state regulators toward the industry they oversee is that they are often part of that industry. 13/
>
> State agencies responsible for regulating vocational schools are either unable, or, in some cases, apparently unwilling to effectively control the industry. 14/

Even if boards had the interest to prosecute industry members, board remedies to enforce its regulations are limited. License revocation is frequently authorized, but its severity means it is rarely used, and then only after extensive hearings. Louisiana's Radio and Television Technicians Board is typical, having revoked only one license for fraud in eight years. 15/

Boards occasionally can seek injunctions and minimal fines. They are almost never authorized to initiate proceedings seeking criminal sentences, restitution or large civil penalties. Only a few statutes offer private rights of action for violation of licensing board regulations. These private rights of action rarely offer more than actual damages.

3. Alternative Approaches

Not all regulatory boards are industry dominated, resource-starved, and powerless to prevent consumer fraud. An example of a more successful approach is the regulation of California's television repairmen.

The California Electronic Repair Dealer Registration Law requires repairmen to register with the state, but they do not have to take an exam or meet educational requirements. Consequently the statute does not substantially increase the cost of entry into the television repair industry. The legislation also creates an advisory board, somewhat comparable to a licensing board, but a majority of the representatives are public members, not television repairmen. The board serves in an advisory capacity to the Bureau of Repair Services ("BRS"), which is also independent of the industry.

The BRS is an independent investigatory and enforcement authority and the key to the California approach. It follows up on consumer complaints by sending to the repairmen causing the complaints test television sets with carefully controlled malfunctions. The repairs are evaluated in BRS laboratories to determine if fraud is involved.

The registrations of 82 services dealers were revoked in an eight year period. 16/ This enforcement program lowered television repair fraud in California to less than half of that found in other states. 17/ The National Institute for Consumer Justice also reports a favorable evaluation of BRS when compared with other licensing approaches. 18/

The Wisconsin Motor Vehicle Department that licenses automobile dealers has a similar investigatory and enforcement arm, the Dealer Inspection Unit ("DIU"), which is also effective in preventing consumer abuses. 19/ Twelve DIU investigators enforce the agency's regulations with a variety of remedies. They are authorized to issue cease and desist orders, to initiate agency proceedings to suspend or revoke dealers' licenses, to recommend against license renewal, and to bring criminal charges through local district attorney offices.

In 1976 the DIU handled 2,100 complaints against car dealers. Investigators brought criminal action against 50 dealers, recommended against the renewal of 49 dealer licenses, and initiated agency action against 22 other dealers. 20/

Mere existence of a regulatory body does not deter consumer fraud; only continued active investigation and prosecution leads to that result. 21/ The DIU program succeeded in lowering sale prices and repair costs. 22/

Both the BRS and DIU are effective because they are specialized agencies investigating individual industries with techniques and enforcement authority tailored to that industry. This approach is a promising one, but it has drawbacks. While these two particular agencies are not dominated by merchants they regulate, there is a greater chance of this occurring when an agency only regulates one industry.

The approach is also costly. DIU and BRS are only effective because of the substantial resources available to them. It is less efficient to establish numerous specialized agencies, each with its own budget and staffs, than to concentrate enforcement authority in one office. Fraud offenders will move to industries whose regulators are least effective or have the smallest budgets. Enforcement agencies facing the most fraud do not receive assistance from other specialized agencies who closely guard their own budgets.

B. RESTRICT SALES APPROACHES, ADVERTISING

Licensing focuses government intervention on specific types of sellers. Another approach to preventing fraud is regulating specific selling methods that are so central to the conduct of fraud schemes that restricting them stops the underlying fraud. This strategy is effective only if the standards regulating sales methods are more enforceable than policing the underlying fraud, and if limiting these sales approaches do in fact eliminate fraud.

This section first analyzes regulation of two specific sales approaches, mail order and negative option sales. Discussion of analogous restrictions of layaway plans, auctions, the use of premiums, and other sales methods will be avoided as repetitious. Cooling-off periods, which attempt to control door-to-door sales, and regulation of the sale of unsolicited goods are described elsewhere in this report. 23/

This section will next analyze advertising regulation as an attempt to stop underlying frauds, not as an attempt to prevent deceptive advertising in its own right. Finally, bans on pyramid and referral sales are described as examples of the most extreme form of sales restriction.

1. Regulation of Mail Order Merchandise Sales

A Federal Trade Commission rule regulates late and non-delivery of mail order sales, requiring sellers to ship merchandise within thirty days of receiving orders or delivery dates specified in catalogs. 24/ Sellers not meeting this schedule must notify buyers of the reasons and length of the delay, giving them the option to cancel their order and receive full refunds. Buyers' silence to delays of less than 30 days signify consent; silence to delays of more than 30 days is taken as a request to cancel.

This rule is not effective in dealing with problems of non-delivery of ordered goods. Fly-by-night and other marginal operations are only in operation for a few months, making enforcement of the mail order rule impossible. Firms disappear before they can be discovered, only to set up operations in a new location under a new name.

The rule is more effective in dealing with established merchants who deliver goods late. Enforcement officials find most major sellers to be in compliance or bringing themselves in compliance with the rule, often at great expense. Large corporations spend one to two million dollars for computer tracking of mail order merchandise shipments.

The rule is effective in large part because it interprets a consumer's "silence" in some situations as an intent to have the order cancelled, taking the burden off the consumer to act. Cooling-off periods, refund standards, and most other intervention strategies require affirmative consumer action to implement the remedy.

The industry opposes this provision, pointing out that consumers are angered when they discover their order is cancelled because they failed to reply to the seller's notice. The industry believes consumers' silence signifies acquiesence.

The rule, a compromise between various interest groups, contains two limitations. It only requires shipment, not consumer receipt of goods within 30 days. Use of slow,inexpensive mail service causes substantial delays. But requiring delivery within a particular time period runs afoul of postal delays and other shipping problems.

The mail order rule's 30 day time period does not begin to run for credit card sales until the seller "effects" the consumer credit card charge by requesting payment from the sponsoring bank. The merchant can "hold" the consumer's order and credit charge as long as he wants, and the 30 day period will not begin.

2. Negative Option Plans

Negative option plans, such as record and book-of-the-month clubs, obligate consumers to purchase all offered merchandise unless they immediately and properly refuse the offer. Abuses include enrolling consumers who do not realize how the plan works, setting overly difficult cancellation requirements, and refusing to cancel memberships. In some plans, cancellation can only be made by mailing back unwanted goods at the buyer's expense. Introductory offers may fail to disclose that minimum purchases are required or that an extra charge is made for postage.

A Federal Trade Commission rule 25/ prohibits these practices, requires disclosures of negative option plan terms, and sets up easier cancellation procedures. The seller must mail a notice of the goods' impending arrival and a form permitting refusal of the selection.

FTC enforcement officials find a high rate of compliance with the disclosure provisions, based on a survey of advertisements for negative option plans. But enforcement officials have difficulty monitoring a firm's compliance with the cancellation procedures. Thorough investigations that can determine compliance are typically commenced only after receipt of a large number of complaints about a specific company.

Nevertheless, there appears to be "mainstream compliance" with the cancellation procedures. Major companies, but not always smaller ones, comply. The FTC is now suing several small violators. Stiff statutory penalties and easy proof make prosecution a real threat, but deterrence depends on the FTC's willingness to spend limited resources to enforce a regulation aimed at a relatively minor problem. An average of less than one full time attorney a year for the whole country has enforced the rule since its enactment.

The rule's scope does not include certain negative option plan abuses, including sellers refusing to cancel memberships, and abusive billing practices. Most specific regulations are limited by their failure to include within their terms all possible forms of merchant misconduct. One solution, being considered by Kentucky, is to prohibit negative option sales entirely. The FTC rejected this remedy as too costly to businesses.

3. Monitoring Advertising

Most advertising monitoring attempts to stop unfair and deceptive advertising, even if the advertising leads to legitimate sales rectifying the deception. Enforcement officials are concerned with increased consumer search costs and cluttering of the market with misinformation.

This section will examine a different, less commonly perceived function of advertising monitoring - as a strategy to stop fraud schemes in their incipiency. It is effective if limiting a merchant's advertising prevents fraud and if it is easier to control advertising than the underlying fraud. Since American advertisers spend over $25 billion annually, 26/ enforcement officials must either devote enormous resources to advertising monitoring or discover a cost-effective way to regulate a subset of advertisers.

The federal resource committment to monitoring advertising is inadequate. The primary federal advertising watchdog, the FTC, devotes only $3 million to police almost exclusively major national television advertisers. The FTC largely ignores advertising by small or local companies, rarely monitoring corporations with sales under $3 million. 27/

The FTC's enforcement of even national advertising practices is limited, issuing 41 complaints in four years. 28/ Since the most common remedy in these cases is cease and desist orders, the effort has little general deterrent effect. No other agency fills this void. State and local prosecutors with limited resources usually police the underlying fraud schemes. Existing advertising monitoring at all levels concentrates on deceptive advertising for its own sake, not as a means of stopping the underlying fraud in its incipiency.

Prosecuting Advertising Practices

Prosecuting advertising practices, whether to reduce consumer search costs or to stop fraud, is time-consuming, costly, and ineffective. FTC advertising litigations drag on for years and are quite costly. Obstructionist advertisers can force significant delays by resisting subpoenas. Lengthy factual hearings are insured by resorting to extensive expert testimony arguing the truth of their advertising claims.

To simplify these advertising actions, the FTC has introduced the advertising substantiation concept. It is unfair and deceptive for an advertiser not to have substantiation for a claim at the time it makes the claim.

When Commission staff challenge an ad, they demand the advertiser's basis for his claims at the time he made them. If the response is inadequate, a prosecution results. The advertiser is prohibited from introducing into evidence at the trial data not previously submitted in response to the FTC's substantiation request. The advertiser's only defense in the action is that the data submitted was in fact adequate substantiation for the claim.

Advertising substantiation, in theory, is a more effective approach to monitoring advertising, but a Congressional report strongly criticizes the FTC's program.

> 1. (a) The number of industry-wide ad substantiation requests has steadily declined since 1973. In 1973 four industries were asked to submit substantiating data. In 1976, one industry was asked to submit data. (b) This has resulted in the loss of a deterrent effect on which the program is dependent.
>
> * * *
>
> 4. The average length of time elapsing from the first substantiation request to the issuance of a complaint is 1 year.
> 5. Following the issuance of a complaint, final action often takes over 18 months.
> 6. In up to two-thrids of ad substantiation requests, the advertising has stopped before the substantiation material is received. 29/

Another FTC approach to regulating advertising is to promulgate rules setting out specific advertising standards for particular industries subject to widespread consumer abuse, such as vocational schools, funerals, hearing aids and used cars. Specified deceptive claims are prohibited; certain affirmative disclosures are required. The threat of large civil penalties and the specificity of the rules deter violations. Compliance with the rules should make fraud more difficult.

This strategy has two major weaknesses. The rulemaking procedure meets strong industry opposition, and is slow and costly. Advertising agencies' ingenuity circumventing specific requirements also cannot be underestimated.

Available Remedies for Deceptive Advertising

Traditional FTC remedies for illegal advertising are not effective in preventing the underlying fraud. Cease and desist orders apply only to specific advertising practices, and not to the underlying fraud. After the final order, the fraud scheme does not have to change, only the advertising that induces it. Nothing prevents continuance during the years it sometimes takes to litigate the case.

A recent FTC advertising remedy, corrective advertising, orders the company guilty of deceptive advertising to correct the false impressions of past advertising with explanatory messages in the future. Corrective advertising can have merit in minimizing misinformation in the marketplace, but it does not compensate those already taken in by the underlying fraud, and does not necessarily prevent future victims either.

Only remedies that deter future advertising violations are at all effective at stopping fraud in its incipiency. But it is difficult to convince judges to harshly penalize merchants whose only fault is inappropriate advertising.

Even more troublesome is determining what types of advertising must be stopped to prevent fraud. Advertising that on its face is non-deceptive and legal can induce consumers into fraud schemes. There is no study of what forms of advertising accompany fraud schemes. The answer may be surprising; for example, it may not be the misleading message in the advertising that is important, but the audience the advertising is geared to.

Fraudulent merchants prevented from using deceptive advertising may find other channels to continue perpetrating their scheme that are not so easily monitored and stopped, such as telephone solicitations, door-to-door sales, mass mailings, and non-deceptive advertising. It may be better to allow schemes to continue advertising deceptively in the media, making it easier for skilled investigators to discover and prosecute potential frauds. But many fraud schemes operate at highest volume if they can readily use deceptive advertising to induce sales.

4. Pyramid, Referral Sales

Pyramid and referral sales are two examples of sales techniques which have been subjected to outright bans, the most extreme regulation of a sales approach. Referral sales induce consumer purchases by making unrealistic promises of substantial discounts in return for referring the seller to the consumer's friends.

In pyramid sales schemes, sale of the product is essentially irrelevant. Each level of the pyramid sells franchises to the next level down, earning significant profits until the scheme falls under its own weight. Pyramid and referral sale abuses are so widespread and serious, with the redeeming business value so low, that many states ban them outright.

The bans are effective in preventing most companies from utilizing these schemes and simplifying enforcement against violators. All that need be shown is the sales method has been used. The bans are accompanied by stiff penalties for violations, but it is difficult to convince judges to mete them out without proof of wrongful intent.

Statutes prohibiting pyramid sales have withstood numerous challenges to their constitutionality. Nevertheless, recent United States Supreme Court First Amendment decisions leave unsettled how far states can go in preventing fraud by banning potentially non-deceptive sales methods. Legislation banning sales techniques must be carefully drafted, as non-restrictively as possible. Even then, it faces serious legal challenges.

C. CONTROLS OF CONTRACT LANGUAGE

Advertising and other sales methods induce consumers to enter fraudulent transactions; contract provisions in sales agreements prevent consumers from remedying frauds once discovered. Contract language specifies that consumers' remedies are limited, that sellers are exempt from liability, that goods and services are not warranted, that the seller's oral representations are not binding, and that consumers are penalized in various fashions for not paying the full amount due.

Some of these provisions are legally binding and effectively prevent redress of consumer wrongs. Others are not enforceable in court, but their presence in written contracts convince consumers that they are in fact binding. Consumers are easily persuaded that they are bound by written documents they sign, being unfamiliar with recent legislation and court rulings holding certain contract provisions unenforceable.

1. Improved Contract Term Disclosure

Governments use different approaches to prevent contract provisions from aiding and abetting fraud schemes. The strategy that least interferes with sellers' freedom of contract is one that assists consumers to understand the provisions they are agreeing to.

Typically consumers do not read or understand contracts they sign. Sales agreements are lengthy, filled with small print, and incomprehensible "legalese". Making sales contracts readable and understandable encourages consumers to avoid contracts that forfeit their rights to remedy frauds. Merchants compete on the basis of contract terms and consumers deal with those that offer favorable provisions.

But consumers are far more interested in the price and quality of the merchandise sold, not in provisions which come into play only if there is merchant misconduct. Moreover, sellers rarely bargain over individual provisions in standard form contracts, it being too costly for sellers to make the bargained for revisions, and determine and keep track of the legal ramifications of such alterations. Consumers are faced with a take it or leave it proposition.

If they leave it, they may fare no better with competitors, who will probably use virtually identical standard form contracts. Since non-price contract provisions are not important to consumers, if there is competition over contract terms, it is to see which seller can bury in the contract more provisions beneficial to the seller and harmful to the consumer. The merchant who most successfully does this will be able to offer goods at the lowest price, although not the lowest eventual cost to the consumer if there is a problem.

2. Substantive Regulation of Contract Terms

Government can also substantively regulate contract provisions to prevent the use of oppressive terms. Business interests argue that this regulation restricts the free market, limits individual choice, and results in higher costs.

Government action interferes with business certainty and ability to plan, resulting in decreased efficiency. It imports legislators' value judgments into sales transactions that are better left to the bargaining parties. Sellers point to the sanctity of contracts as central to the free enterprise system.

Critics of these business arguments point out that consumers rarely bargain over terms or even understand what they mean. The contract is not a real agreement because there has been no bargaining and no meeting of minds. Freedom of contract makes sense only when equal parties are bargaining at arms length, such as in a typical agreement between two businesses.

The American approach only minimally regulates contract language. The Uniform Commercial Code authorizes courts to refuse to enforce unconscionable contracts. 30/ This provision applies only to the sale of goods, and courts are reluctant to extend the unconscionability concept to other areas, such as sale of services and leases. Unconscionability itself is a vague standard and is incorrectly or unevenly applied by the courts. 31/ Nevertheless, the doctrine has been successful in striking down certain oppressive contract terms.

Judicial refusal to enforce contract provisions only affects the contract before the court. The same seller can continue to include the same terms in other contracts. Only consumers who similarly challenge the provision in court will benefit from the ruling. But most consumers take contract terms at face value. Even if they question them, court challenges are not economically feasible.

American legislatures and agencies also occasionally prohibit specific oppressive contract terms, usually declaring them unenforceable. But, unless inserting such terms in contracts is prohibited, merchants will continue to leave such terms in contracts and most consumers will continue to abide by the outlawed terms. Merchants also evade such prohibitions by using similar, but different contract provisions.

Foreign Approaches

Israel has instituted an alternative system of substantive contract regulation that encourages sellers to obtain prior approval of contracts from a special board. The board determines whether the restrictive terms are "prejudicial" to consumers or give sellers an "unfair advantage." Upon board approval, the contract is immune from further administrative agency or judicial attack for five years.

On the other hand, the board can refuse to approve the restrictive terms, declaring the contract void in whole or in part. This declaration has a retroactive effect, invalidating contracts consummated prior to the board's decision. 32/

After 5 years, only one business has applied to the board for approval of its contract. Merchants want flexibility. They want to keep open the option of quickly changing contract terms if this is necessary, and don't want to lock themselves in to the time constraints of waiting for board action, or the substantive constraints of board disapproval.

Most importantly, consumers rarely challenge contract terms, so nothing motivates merchants to take the chance of having the board disapprove the contract. 33/ Businesses are also afraid the board will not understand that certain provisions are necessary because of special business needs, even if not appropriate in most consumer contexts.

Merchant reluctance to have their contracts reviewed is easily overcome by mandating such prior inspection. But mandatory prior approval of all contracts, even if standard form, involves more regulation than a free market system can tolerate.

A more practical approach is to monitor contracts after they begin to take effect, enjoining future use of oppressive provisions. Governments not only refuse to enforce the term, but order it removed from the contract.

This task is not as hopeless as it first appears. Most consumer transactions involve standard form contracts that are uniform throughout the industry, so that review of one contract can effect its use in hundreds of thousands of individual transactions.

In 1969 Israel amended its standard form contract law to authorize the Attorney General, the Israeli Consumer Council, and any consumer organization approved by the Attorney General to apply for cancellation of a restrictive term in a standard form contract. Despite the apparent advantage of this approach, none of these groups have used this new procedure. 34/ The Israeli Attorney General gives the law low priority and the consumer movement in Israel is not developed.

There are also inherent problems with this procedure. The board has difficulty examining contract terms in the abstract, without reference to a specific transaction, its unique facts, and the relationship of the contracting parties. A clause may be unfair when applied to a $2,000, high-pressure, door-to-door sale to an illiterate, but not when applied to a $10 store sale to an attorney.

Sweden has had more success with its analogous 1971 law, An Act Prohibiting Improper Contract Terms. The Market Court, a special consumer court, or the Consumer Ombudsmen can enjoin future use of "improper" contract terms. Some of the numerous contract provisions the Act has declared void include:

- Seller has unlimited time to reject buyer's offer;
- Consumer must accept goods irrespective of their delivery delay;
- Seller decides if goods are defective and if buyer caused defect;
- Seller unilaterally sets final contract price;
- Buyer must bring legal action in a distant forum; and
- Seller has a right to claim excessive collateral. 35/

The Swedish experiment has proved effective in large part because of the aggressive activity of the Consumer Ombudsman. Most initiatives result in negotiated settlements, eliminating provisions which violate Swedish law or are enumerated in the Act Prohibiting Improper Contract Terms. The ombudsman also negotiates more imaginative and far-reaching settlements. Few cases go to the Market Court for review, so the ombudsman's actions have limited binding effect.

Required Inclusion of Contract Terms

A final method of substantively regulating consumer contracts is to require the inclusion of specific terms in the agreement, often mandating the exact language to be used. These terms not only bind the seller, but directly inform the consumer of his legal rights without forcing him to consult an attorney or law library. Specific examples of this approach will be detailed in other sections of this report. 36/

Required contract terms usually give consumers added rights to deal with merchant fraud. But this approach is also effective in counteracting sellers' oppressive contract terms. Affirmatively included terms can contradict and nullify the effect of seller provisions.

FOOTNOTES

(Chapter IV)

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2. M. SCHULMAN & J. GEESMAN, DECEPTIVE PACKAGING: A CLOSE LOOK AT THE CALIFORNIA STATE DEPARTMENT OF CONSUMER AFFAIRS (1974).

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4. Barron, supra note 3 at 652, 653.

5. BUREAU OF ECONOMICS, FEDERAL TRADE COMMISSION, REGULATION OF THE TELEVISION REPAIR INDUSTRY IN LOUISIANA AND CALIFORNIA (1974).

6. Id. at 44.

7. Id. at 45.

8. Contemporary Studies, supra note 1 at 1106.

9. BUREAU OF CONSUMER PROTECTION, FEDERAL TRADE COMMISSION, PROPRIETARY VOCATIONAL AND HOME STUDY SCHOOLS at 259-264, (1977).

10. A. ENGLAND, CONSUMER AFFAIRS IN FLORIDA, Vol. I at 71-75 (1973).

11. BUREAU OF CONSUMER PROTECTION, supra note 9 at 268.

12. PRESIDING OFFICER, FEDERAL TRADE COMMISSION, FUNERAL INDUSTRY PRACTICES at 44 (1977).

13. BUREAU OF CONSUMER PROTECTION, supra note 9 at 271, 272.

14. Id. at 264.

15. BUREAU OF ECONOMICS, supra note 5 at 46.

16. Id. at 11, 12.

17. Id. at 45.

18. STAFF STUDIES PREPARED FOR THE NATIONAL INSTITUTE FOR CONSUMER JUSTICE, State and Federal Regulatory Agencies (Orange Volume) Appendix C, at 286.

19. Hearings Before The Federal Trade Commission on Proposed Trade Regulation Rule Concerning Used Motor Vehicle Industry, (April 25, 1977)(Statement of Center for Public Representation).

20. THE CENTER FOR PUBLIC REPRESENTATION, AN INVESTIGATION OF THE RETAIL USED MOTOR VEHICLE MARKET: AN EVALUATION OF DISCLOSURE AND REGULATION at 73, 75, 77 (1978).

21. Id. at 75.

22. Id. at 91-93.

23. See "Automatic Remedies", Section IIIB and "Cooling off, Trial Periods; Affirmation", Section VB.

24. 16 CFR 435.

25. 16 CFR 425.

26. H.R. REP NO 472, 95th Cong, 1st Sess. (1977).

27. Id.

28. Id.

29. Id.

30. UCC Section 2-302.

31. S. DEUTCH, UNFAIR CONTRACTS, THE DOCTRINE OF UNCONSCIONABILITY at 177 (1977).

32. Hecht, Legislation - The Israel Law on Standard Contracts, 4 ISRAEL L. REV 586 (1968).

33. D. Kretzmer, The Standard Contracts Law In Light of Its Amendments, MISHPATIM (1971).

34. DEUTCH, supra note 31 at 248.

35. Sheldon, Consumer Protection and Standard Contracts: The Swedish Experiment in Administrative Control, 22 AM J. COMP L. 17 at 34 (1974).

36. "Withholding Payment", Section III A; "Automatic Remedies", Section III B; "Pre-Sale Disclosures", Section V A; "Cooling-Off, Trial Periods; Affirmation", Section V B.

CONTENTS - CHAPTER V

V IMPROVE CONSUMER DECISION-MAKING

Just as controlling merchant behavior can stop fraud in its incipiency, improving consumers' decision-making results in better consumer purchases, with fewer involving fraud. Consumers' own vigilance prevents fraud.

This approach has the advantage of interfering with seller decisions and practices only to the extent necessary to improve consumer purchase choices. The approach can be seen as just insuring that the free market operates properly. Of course, some frauds are so sophisticated to take in any consumer and some consumers are so unsophisticated as to be taken in no matter how much their decision-making process is assisted. This chapter will look at three strategies improving consumer decision-making.

Pre-sale disclosures require sellers to inform consumers of specified information before the purchase is made. Disclosures are designed to make consumer choices more effective, allowing buyers to avoid being defrauded. But merchants may not make ordered disclosures; if they do, it may be in a manner or in language that insures consumers will not read or understand them.

Cooling-off and trial periods and affirmation requirements restructure the purchase decision to give consumers longer to think over the sales transaction, backing out with no financial obligation if they change their mind. These techniques assist some consumers, but others do not know how to use them or are frustrated by merchant devices nullifying the remedy's benefits.

Consumer education efforts inform consumers generally of information to help them avoid or remedy fraud. Government or private consumer agencies use a variety of techniques to try to meaningfully reach the public. The effectiveness of these efforts has not been adequately measured.

A. PRE-SALE DISCLOSURES

Pre-sale disclosures prevent fraud by arming consumers with information to see through or remedy deceptive schemes. Disclosures contradict and thus decrease the impact of sellers' deceptions. The very existence of conflicting information deters deceptive claims. Forced disclosures of unfavorable aspects of a sale improve consumer decision making and discourage merchants from using hidden "catches" in their sales. Disclosures also inform consumers of remedies available to them if defrauded.

Disclosures not only prevent fraud, but also facilitate the proper working of the free market system by increasing the rationality of consumer decision making, with the accompanying improved allocation of social resources. It is often difficult to determine whether disclosure requirements are adopted primarily to prevent deception or to maximize rational consumer behavior.

Statutes and regulations mandate disclosures on labels, in contracts, on special consumer notices and even orally. Labeling requirements include unit pricing and proper disclosure of a product's identity, quantity, quality or manufacturer.

There are numerous types of disclosure requirements. Installment sales contracts and other credit agreements must reveal interest rates and other credit terms. Door-to-door sellers must provide consumers with special notice of their rights to cancel. Merchants must clearly notify buyers of the nature of offered warranties.

State attorneys general and particularly the FTC have been active in attempting to prevent fraud and deception through disclosure requirements. The FTC in recent years has adopted or proposed extensive disclosures for franchise, funeral, vocational school, used car, mobile home, hearing aid, health spa, credit, food and over-the-counter drug sales.

Opinions differ as to whether disclosures make a difference. FTC officials consider disclosure requirements to be easily enforceable, lowcost, and effective. Critics argue that disclosures are not made in timely fashion or in a meaningful way, and consumers do not read or act upon them.

But the effectiveness of affirmative disclosures does not rest solely on how well they inform the consumer. Disclosures are read by others - friends, consumer reporters, government officials - who may then educate the consumer. 1/

Disclosure requirements also facilitate prosecutions of defrauding merchants. Sellers' compliance with mandated disclosures is easier to enforce than policing for fraudulent schemes. It is a straightforward question whether certain written disclosures have been given to the buyer; more difficult to prove is whether some scheme is in fact fraudulent.

This section will consider the effectiveness of disclosures solely as a strategy to improve consumer decision-making. It will address the following issues:

- Merchant Compliance; Enforcement Efforts
- Timing of Disclosures
- Manner of Presentation
- Readability of Disclosures
- Consumer Attention to Disclosures
- Impact on Consumer Action
- Disclosure Costs

1. Merchant Compliance; Enforcement Efforts

Merchants generally provide consumers with mandated disclosures, but full compliance varies significantly with the complexity of the information to be revealed. Ninety-five percent or more of lending institutions make some efforts to comply with the Truth in Lending Act's detailed and complex disclosure requirements, but these disclosures are very often incomplete or improper. 2/ In comparison, compliance with simpler care labeling disclosures is quite high.

Another factor controlling compliance is the type of merchant involved. Large companies have adequate legal resources to meet even the most complex requirements. Their size also makes them highly visible and invariably the first targets for enforcement.

Small companies may not have the expertise to comply, may not want to draw attention to themselves by asking for advice from enforcing agencies, and may know that agencies will rarely select them for enforcement. Fly-by-night merchants, for example, can be expected to disregard at will disclosure requirements.

The seriousness of the enforcement threat also determines the compliance level. It is easier to enforce disclosure compliance than to police the underlying fraud. The prosecutor need only show that a form has not been presented to consumers or that the disclosure on its face is defective. To prosecute the underlying fraud he may have to prove the existence of oral misrepresentations, criminal intent, and argue novel fraud theories.

When authorized, private class actions seeking statutory damages for defective disclosures are the most effective weapon against merchant non-compliance. The classic example is Truth in Lending. Class actions, enforcing only technical discrepancies, and without showing any consumer injury, can win $500,000 judgments from certain non-complying companies. 3/ Creditor attorneys claim that the threat of these actions, more than any other consumer protection measure, has changed merchant practices. 4/

In stark comparison, in the early 1970's the FDA enforced the Fair Packaging and Labeling Act with only two full-time employees issuing instructional guides. No prosecutions were instituted. 5/

2. Consumer Use of Disclosures

Timing of Disclosures

Disclosures are normally made at the time a sale is consummated, not early in the transaction when the consumer is still making his purchase decision. By the time disclosures are made, the consumer is "sold," and while the contract is not signed, the buyer has already made up his mind.

Written disclosures conflicting with oral representations will be ignored; 6/ consumer reliance on the sales presentation is almost complete. 7/ For example, used car buyers receive little benefit from mandated disclosures presented at the point the sales contract is signed, after vehicle selection and negotiations are complete. 8/

Several commentators suggest that disclosures be made orally in the pre-agreement negotiations. 9/ But skilled sellers can twist and obscure oral disclosures and enforcement officials find it difficult to police oral disclosures.

Manner of Presentation

Skilled sellers easily limit disclosures' impact by distracting or otherwise making it difficult for consumers to sit down and carefully scrutinize the written notice. In one case, a salesman misrepresented the contract price and then covered up the true price with his thumb while the consumer signed the contract. 10/

While the consumer is reading the disclosures, the salesman can be giving his own "version," nullifying or garbling their true meaning. "Government regulations force us to tell you....but actually our deal is much better...."

The FTC staff is so concerned that abusive sales tactics prevalent in the private vocational school industry will succeed in nullifying the impact of mandated written disclosures that it has proposed special requirements. Disclosures must be mailed and salesmen cannot revisit the consumer afterwards to explain away or garble the disclosure information. No enrollement is binding until the consumer reads the disclosures and affirms his decision. 11/

Readability of Disclosures

The consumer notices are often unreadable. They are printed in small, difficult-to-read type, buried in some out-of-the-way corner of the contract. A good example is the cigarette health warnings on highway billboards. One has to be three feet away to read them. Legislation now specifies print type, size, and positioning or requires disclosures to be "clear and conspicuous."

Even if print is readable, consumers may not be able to understand it. Sales made to non-English speaking consumers are accompanied by English disclosures. Even more commonly, disclosure language will be highly technical or legalistic. For example, an application of a readability test to normal Truth-in-Lending disclosures, not even considering the complicated mathematics involved, finds that most passages are difficult to very difficult to read (similar to law reviews or technical journals). Some notices go off the test's scale. 12/

The UCC requires the use of the word "merchantability" in certain disclosures when most consumers do not even know what the word means. 13/ Some disclosures are not only too technical but are so lengthy and detailed as to overload the consumers normal comprehension span. 14/

This state of affairs can be remedied. Some statutes require disclosures to be in the same language as the sales transaction. The FTC's disclosure requirements mandate the exact language merchants must use. The FTC is drafting these notices to meet readability tests. 15/ New York's Plain English Law requires consumer agreements to be written in non-technical language, clearly, coherently, using words with common everyday meanings. 16/

Nevertheless, there are limits to these reforms. Government cannot draft the language for all disclosures that merchants use. Standards in New York's law may be too vague to make it enforceable. Some disclosures may be so technical that they cannot be made readable, concise and accurate all at the same time.

Consumer Attention to Disclosures

Consumers do not read their contracts or other written disclosures; 17/ shoppers do not read labels or other informational aids such as unit pricing, open dating, and nutrient labeling. 18/ This consumer aversion to disclosures is caused in part by their unreadable, incomprehensible language and format and by conscious merchant manipulations to discourage careful scrutiny.

But even the most readable disclosures go unread. Federal, state and local disclosure requirements, added to normal merchant forms, combine to bury the consumer with paper, making it difficult to read anything. Similarly, consumers cannot comprehend disclosures that provide too much information, no matter how clearly presented.

Impact on Consumer Action

Disclosures, even if read and understood by the consumer, do little good if not acted upon. Critics argue that the disclosure strategy presupposes an ideal, rational consumer able to deal with businesses on equal terms. Disclosures are less effective with real consumers. One commentator has compared the ideal consumer this legislation presupposes with real consumers. 19/

Model	Reality
(1) Knows that he should and wants to shop around for the best buys when purchasing goods and services	(1) Do not shop for good value-shop for anyone that will give credit
(2) Competent to decide what product offers the greatest value for the least money	(2) Satisfy non-material needs by their purchases. Status, escapism
	(3) Like to deal with people who speak their language, local retailer
	(4) Lack the technical knowledge to compare durable goods
	(5) Pressure to shop within community
(3) Knows the legal rights and liabilities in the event of a post-sale legal conflict with	(6) Most laymen lack more than a superficial knowledge of their rights -

the seller, is prepared to use all available tools in such a conflict	low income lack even a superficial knowledge
	(7) Motivation lacking - have been frustrated in the past and have become resigned to their situation

If disclosures are made early enough, some consumers will utilize them in making their purchase decision and in subsequent negotiations. 20/ But consumers will only act on disclosures if they receive them early enough, have viable alternative actions, and if the disclosures are more persuasive than the seller's presentation.

It may be that disclosures are no match for a seller with a well-worked out fraud scheme. There are no studies of disclosures' effectiveness specifically in preventing fraud.

3. Disclosure Costs

A major strength of affirmative disclosure as a fraud intervention strategy is that it has virtually no cost to the merchant. The major costs are printing new contracts or other forms and legal fees to insure compliance with the statute. Small merchants may find legal fees burdensome. For major companies, these one-time costs are relatively negligible and can be spread over many sales transactions.

For example, retail installment act disclosures cost merchants only a minimal amount and the cost is not passed on to consumers. 21/ Total merchant paperwork costs to comply with a used car disclosure and inspection statute is estimated at $1 a car. 22/

While the cost of compliance to the merchant is relatively low, government enforcement of merchant non-compliance is not. For example, Truth-in-Lending has sparked extensive private litigation and government monitoring activity. Still, enforcement of disclosure requirements are less expensive than other consumer fraud prosecutions that must attack the underlying fraud itself. Costs to enforce one used car disclosure requirement is estimated at about $1 a car. 23/

Disclosures are certainly less costly and less infringing on merchants than such forms of regulation as licensing or outright prohibitions of various practices. Disclosures allow sellers to do what they want as long as they inform consumers of certain information that lawmakers consider will prevent or cure fraud in the transaction.

Critics argue that disclosures do not work to prevent or cure fraud. By allowing sellers to utilize potentially deceptive practices as long as they are accompanied by full disclosures, the state is giving sellers a license to defraud.

B. COOLING-OFF, TRIAL PERIODS; AFFIRMATION

Cooling-off and trial periods and affirmation requirements improve consumer decision-making not by supplying consumers with new information, but by improving their decision-making process. The consumer is given more time, with fewer pressures to make his purchase, hopefully resulting in better decisions less likely to lead to fraud.

1. Cooling-Off, Trial Periods

Cooling-Off Periods Described

Most cooling-off periods are three days in length and apply only to sales in the home. Other cooling-off periods apply to any sale of particular products and credit agreements giving the financer an interest in the consumer's home. Sellers must cancel sales aggreements if they receive the consumer's written notice within the cooling-off period. The seller must return all monies accepted and cancel any indebtedness; the buyer must make the cancelled purchase available for return to the seller.

Cooling-off periods allow consumers to rethink their purchase, consult friends, engage in comparative shopping, and restudy the contract. Sales representations can be reevaluated away from the salesperson's pressure tactics. Goods received can be compared against sales claims.

Consumers can then cancel purchases induced by fraud or oppressive sales techniques. Cooling-off periods are particularly successful countering high-pressure sales tactics where consumers purchase products just to get sellers out of their home, and immediately discover they were tricked or regret the sales as soon as the salesperson leaves.

Cooling-Off Period Limitations

Cooling-off period effectiveness depends on merchant compliance with the remedy's requirements. Enforcement officials report reluctant compliance by the majority of businesses, but that some smaller businesses have not even heard of the requirement. Fly-by-night fraud offenders are likely to ignore the requirements. Compliance also depends on the effectiveness of government enforcement efforts.

Compliance enforcement is complicated by the difficulty of determining whether consumer cancellation notices are timely and properly mailed. Consumers rarely keep copies of records or adequately document mailings.

Consumers' ignorance of and failure to exercise their cooling-off rights is the most critical limitation to the remedy's effectiveness. Existing cancellation right disclosures are not easily readable, and often are not read and understood. Since the remedy applies only to certain special types of sales, consumers have little experience using it. Consumers believe that if they have received and used a product, they cannot return it.

Consumer intertia also defeats the remedy's purpose. Cancellation requirements may be too much of a bother, or consumers may be uncertain how to return cancelled goods. Other consumers do not rethink their purchase, talk to friends, or do any comparison shopping.

Merchants also use a "post-sell" in their sales presentations to prevent consumers from changing their minds. For example, vocational school sales representatives tell buyers signing enrollment agreements not to talk to their friends or family about the course they have enrolled in because they have not yet been admitted, and would be embarrassed if their application is turned down. In reality, everyone is accepted, and the cooling-off period has already begun to run.

Merchants also disguise the fact that the cooling-off period is beginning to run. As in the previous example, the consumer may be told he is only applying to purchase the goods or service, and will naturally think the cooling-off period only starts with the seller's acceptance of the arrangement. In fact, the period has already begun. A surprising number of consumers do not realize they have signed binding contracts, but think they have only signed indications of interest.

Another merchant strategy is to perform so much of the service before the cooling-off period expires that the consumer is embarassed to cancel. Other sellers use cooling-off periods as sales tools, overcoming consumer reluctance to buy on impulse by reminding consumers they can always change their mind and get their money back.

Even without "post-sells", the typical three day cooling-off period is often not enough time for consumers to discover they have been defrauded. Legislators respond by extending cooling-off periods for certain particularly high pressure sales to as long as ten days. But long cooling-off periods impinge on legitimate businesses' needs to know promptly whether a sale has been made.

No cooling-off period is long enough if the consumer receives defective or non-conforming goods after cancellation rights expire. Consequently commentators argue that cooling-off periods should not start to run until the consumer receives the goods, thus creating a trial period.

This reform is not practical for service contracts and forces merchants to take back "used" merchandise. But merchants most penalized are those whose sales presentations are at odds with the goods delivered. Normally consumer inertia, coupled with the cost and effort of returning merchandise, will minimize frivolous returns.

Extension of Cooling-Off Periods to In-Store Sales

Cooling-off periods generally apply only to door-to-door sales. Some high-pressure sellers now use telephone marketing approaches to avoid the rule's requirements. Commentators and enforcement officials urge that cooling-off periods be applied not only to telephone sales, but also to sales at the retailer's place of business, particularly where high pressure sales techniques or special inducements are used. 24/ Examples include sales made by dance studios and health spas.

In-store purchasers who enter with a firm objective and consistently confine their purchases to those items can still be victimized by high-pressure or deceptive tactics upon arrival. Deceptive advertising techniques may also contribute to the consumer's store selection.

Extending cooling-off periods to in-store sales places enormous practical burdens on businesses. But commentators suggest careful drafting can minimize them:

- Provisions which operate to exclude certain classes of sales from coverage, deter frivolous returns, place the onus of returning the goods upon the consumer, and minimize the merchant's burden of giving notice of the right to cancel should reduce the inconvenient effects of the extension to tolerable levels. 25/

2. Affirmation

An alternative to cooling-off periods is an affirmation requirement. Buyers must affirm previously signed contracts before the initial agreements are legally binding. For example, in one proposed affirmation requirement, after door-to-door sellers obtain buyers' signatures, companies mail consumers forms to be signed after buyers have had a chance to re-think their decisions. If the form is not returned, the buyer is not bound to the contract and has no financial obligation. Affirmation requirements are occasionally proposed, but rarely implemented.

Affirmation is a stronger remedy than cooling-off periods. Cooling-off periods place the burden of cancelling on the consumer. Purchasers wishing to cancel do not realize they can or do not cancel in time. Evidentiary problems develop when buyers claim to have sent, but sellers claim not to have received, the cancellation notice.

Affirmation shifts the effect of the buyer's failure to act. Buyer's ignorance of his rights, indecision, or inaction do not result in any obligation. The consumer is only bound if the seller obtains and can produce evidence of the affirmation. Sellers are better equipped to bear this burden.

Affirmation may also be appropriate where buyers cannot make purchase decisions without certain disclosures, and those disclosures cannot be meaningfully delivered at the time of sale. For example, commissioned door-to-door salesmen may be expected to distort or obfuscate the meaning of required disclosures. Affirmation allows buyers to receive disclosures after the salesman's visit, evaluate the information at their own leisure, and then decide whether to be bound to the contract by affirming it.

Skillful sellers can circumvent affirmation's objectives. Sales representatives can trick buyers into signing the affirmation form at the time of the original sale, or can return to the buyer's home to convince him to sign the affirmation form. To combat these tactics, sellers can be required to mail the affirmation forms to the consumer after the sale, and be prohibited from contacting the consumer between the sale and the affirmation.

Affirmation is generally rejected as too onerous on business. The prohibition on seller contact with the consumer until he affirms the agreement may be challenged on First Amendment, free speech grounds. Moreover, affirmation does not allow a cooling-off period if the buyer immediately affirms on receiving the form.

C. CONSUMER EDUCATION

Consumer education programs inform the general public of information it needs to know to act rationally in the marketplace. This is distinguished from merchants affirmatively disclosing mandated information in conjunction with actual sales transactions. Consumer education efforts are made by government or private organizations to consumers at large.

1. Consumer Education Techniques Described

Publications are the most common consumer education tools. Brochures, fliers, posters, and other materials are distributed, normally on a small scale in such public locations as supermarkets, libraries and community agencies.

Lengthier printed materials are usually sold at minimal prices. Examples include comic books describing door-to-door sales and correspondence school frauds, manuals telling consumers how to deal with shoddy products, and regularly published newsletters which spotlight questionable business practices.

The mass media is another important channel for consumer education, reaching large numbers of consumers, often without charge through radio or television public-interest messages. Less common are regular radio programs where persons with consumer problems can call in. Television stations are also beginning to hire consumer reporters who broadcast warnings about questionable business deals.

Workshops and group meetings not only inform consumers, but also mediate complaints and occasionally initiate consumer demonstrations or other specific actions against defrauding sellers. Some programs also conduct training sessions on consumer education issues for other community organizations that pass on to their members and clients the information they receive.

A promising technique not often used is inclusion of consumer education materials in school curricula. Widespread utilization would, in years to come, give at least a minimal consumer education to the whole nation.

Other approaches include distributing placemats with consumer information to neighborhood restaurants, and "dial-a-fraud" services which give the caller a message about a particular current fraudulent practice or unscrupulous merchant.

In theory, such programs are effective if they provide consumers with sufficient information to make informed marketplace decisions. Consumers on their own avoid frauds, negating the need for strategies to prevent fraud or compensate victims. Successful consumer education enables consumers to understand and employ available legal remedies and government resources.

Consumer education also creates more extensive consumer representation in the political process, affecting consumer legislation and agency rules and fraud enforcement efforts. 26/ Greater consumer awareness can even result in judges handing down stiffer sentences to consumer fraud offenders.

2. Effectiveness of Consumer Education

There is no hard evidence as to the success of consumer education programs. Existing programs do not evaluate the effects of their efforts, and the growth of consumer education programs is so recent that their influence on the marketplace is not presently measurable.

Existing programs do face various problems. Programs lack sufficient resources to reach more than limited audiences. Education efforts do not always reach the consumers who most need them. Higher income and educated consumers benefit disproportionately from education programs.

The task of conveying useful and up-to-date information on the growing number of applicable federal and state laws and regulations is becoming overwhelming. Information becomes obsolete almost as soon as it is conveyed. Consumers' ability to absorb and use all this information is even more problematical.

Fraud offenders also counteract education efforts by increasing their own advertising and "education" efforts. For example, the object of one well publicized fraud investigation increased its advertising while the investigation was pending, and managed to increase its business volume. Other unscrupulous sellers will devise new schemes as fast as the public can be educated about old ones.

FOOTNOTES

(Chapter V)

1. See "Consumer Education," Section VC, for further discussion of such educative efforts.

2. 4 U CAL DAVIS 173 at 199 (herinafter "DAVIS").

3. 15 USC 1640(a)(2)(B).

4. See "Private Attorneys General," Section ID for further discussion.

5. Note, Truth in Packaging Under the FPLA - An Untapped Source of Consumer Protection, 6 CAL JOURNAL OF LAW AND SOC PROB 180 (1970).

6. Using Simulation Techniques to Predict the Behavioral Effects of New Laws: The Case of TIL Legislation and the Consumer, 54 JOUR APPL PSYCH 297 (1970).

7. W. Whitford, The Function of Disclosure Regulation in Consumer Transactions, 1973 WIS L REV 400 (1973).

8. DAVIS, supra note 2 at 173.

9. Whitford, supra note 7 at 448.

10. DAVIS, supra note 2 at 200.

11. Proposed Trade Regulation Rule Concerning Proprietary Vocational and Home Study Schools, 40 Fed. Reg. 21048 (May 15, 1975).

12. R. FLESCH, THE ART OF READABLE WRITING.

13. Whitford, supra note 7 at 425.

14. M. Friedman, Consumer Use of Informational Aids in Supermarkets, Vol. II, no. 1 (summer 1977).

15. FTC policy for future consumer notices is that they score an 80 on the Flesch Test.

16. The Plain English Law amends NEW YORK GEN OBLIG LAW 5-701 (1977).

17. B. Cunin, Legislative Controls as a Response to Consumer Credit Problems, 8 B C IND & COMM L REV 409 (1967); R. Jordan and W. Warren, Disclosure of Finance Charges: A Rationale, 64 MICH L REV 1285 at 1320 (1966).

18. M. Friedman, *Cconsumer Responses to Unit Pricing, Open Dating, and Nutrient Labeling*, PROCEEDINGS OF THE THIRD ANNUAL CONFERENCE OF THE ASSOCIATION FOR CONSUMER RESEARCH at 361-69 (1972).

19. E. Schnapper, *Consumer Legislation and the Poor*, 76 YALE L J 745 (1967).

20. CENTER FOR PUBLIC REPRESENTATION, AN INVESTIGATION OF THE RETAIL USED MOTOR VEHICLE MARKET: AN EVALUATION OF DISCLOSURE AND REGULATION (1978).

21. Note, *A Survey of Experience Under the Massachusetts Retail Installment Sales Act*, 9 BC IND & COMM L REV 1020 (1967-68).

22. CENTER FOR PUBLIC REPRESENTATION, *supra* note 20.

23. *Id*.

24. M. Metzger & D. Wolkoff, *Fulfilling a Promise: Extending a Cooling-Off Period to Retail Sales in General*, MINN L REV 752 (1974); Sher, *The Cooling-Off Period in Door-to-Door Sales*, 15 UCLA L REV 729 (1968).

25. Metzger & Wolkoff, *supra* note 24.

26. S. Willet, *Consumer Education or Advocacy...or Both?* SOCIAL POLICY at 10-17 (Nov.-Dec. 1977).

CONTENTS - CHAPTER VI

VI MINIMIZE FRAUD LOSSES

A sixth fraud intervention approach minimizes fraud losses by restricting the amount of money at stake in a transaction. Even if the consumer is defrauded, his loss is small. Since the consumer injury is minimal, seller's profit and his consequent incentive to defraud is decreased.

One way to minimize fraud losses is to limit a product or service's price. Price regulation conflicts with fundamental notions of a free market and is not used to minimize fraud losses, but only to deal with monopolies and other special situations. Nevertheless, refund standards and contract limitations can limit the cost of future service contracts for consumers who cancel early. This type of price regulation minimally impedes sellers while offering consumers protection against fraudulent sales.

Escrow accounts do not limit a transaction's price but restrict the seller's receipt of payment until the consumer determines he has not been defrauded. A third party only makes payment to the merchant if the escrow agreement is satisfied; otherwise, the money is returned to the consumer. Effective use of escrow requires a clearcut method of determining which party should receive payment. It also restricts merchant's cash flow and increases administrative costs.

A. PRICE LIMITATIONS

Price limitations directly minimize consumers' financial losses resulting from fraudulent transactions. If consumers pay less, their losses are less and merchants' incentive to defraud decreases.

1. Future Services Contracts; Other Price Regulation

Price limitations have special applicability to future service contracts, where buyers agree to pay large sums for services to be rendered over a period of time. Typical future service contracts involve vocational school courses, health spa memberships, dance studio lessons, summer camps, and social referral services.

Consumers dropping out of these programs are obligated to pay for all or almost all of the contract price. Defrauding merchants are encouraged to use expensive high pressure sales tactics to sign up consumers, while devoting little effort to providing adequate services. If the disillusioned consumer terminates the contract, the merchant still keeps his money.

The future service nature of the transaction offers a viable intervention strategy to combat this potential for abuse. Future service contracts are unique because they can be marketed with almost equal ease as one long term sale or as a series of separate, smaller transactions. The latter marketing technique allows consumers to discover fraud early in the series of transactions, and drop out. They pay only for services they received and not for future services to be rendered.

Consumer financial loss is limited and merchants' incentive to defraud is consequently reduced. Sellers will not spend $300 on high pressure sales techniques, convincing a person to enroll in a $1,000 program, if the consumer can get out of the contract for $100 once he finds the service is not as promised.

The same approach does not apply to an indivisible sale involving a delivered good or completed service where the fraud is discovered too late to stay the transaction. Victimized consumers will not repeat the purchase, but will still lose all their money in that transaction. Limiting payment in this situation can only be accomplished by lowering the good or service's price.

But regulating prices is a much more significant infringement on business and the free market than requiring a long term contract to be split up into separate packages. Government price-setting is a complex and unusual measure, only used to regulate monopolies, such as utilities, or in industries with a long tradition of regulation, such as credit. American courts will not even void individual sales as being unconscionably overpriced. Consequently, price regulation for most goods is not a practical consumer fraud intervention strategy.

2. Refund Standards

The most important method of limiting the price of future service contracts is to impose refund standards that are fair to consumers terminating service contracts early. Refund formulas determine a buyer's obligation to the seller if the buyer only partially uses the contracted for services. The word "refund" is used because consumers commonly prepay their contracts, and thus receive some form of refund upon dropping out early. If prepayment is not made, the "refund" formula will specify how much money the consumer owes for the partial service.

Courts do not enforce penalty clauses and other arrangements that force consumers to pay inordinate amounts upon their breach of contract. But, unless legislation mandates otherwise, a seller can include whatever refund policy he wishes in the sales agreement, including arrangements that would be found unenforceable in court.

Legislatures and agencies solve this abuse by setting out specific refund standards for certain future service contracts. The most pro-consumer standard, called "pro-rata", only charges buyers for that percentage of the total cost that equals the percentage of the service used. Less liberal standards charge consumers with large initial fees and higher percentages of the total cost.

Factors Favoring Liberal Refunds

In theory, the more liberal the refund standard, the more the consumer's loss and the merchant's incentive to defraud are minimized. With a generous refund policy, it is the merchant, not the consumer who bears the loss if the program is not as promised or inadequate to meet the consumer's needs. This places responsibility for insuring that the sale is proper on the party best able to do it,the merchant, not the consumer.

The consumer is unable to determine in advance the adequacy of the service which will be rendered or the veracity of the representation which have been made as an inducement to enter into the agreement. It is the seller who can correct these problems, and generous refund standards give him the financial motivation to do so.

Defrauded consumers' early cancellations under liberal refund policies provide little profit or even create losses for the seller. Sellers are encouraged to sign only those who will be content with the services offered and remain enrolled.

Even if the refund policy does not discourage deceptive sales practices, the refund standard will minimize fraud's impact by allowing consumers to withdraw without incurring large economic losses. A continuing cooling-off period is created during which the buyer can evaluate the services offered against the sales promises made.

Businesses criticize generous refund formulas as forcing them to lose money on consumers who drop out for their own personal reasons, due to no fault of the seller. Sellers just pass these cuts on in higher prices. In effect, consumers are paying for the added insurance that, if they want to drop out, they can do so cheaply. They also benefit from the fact that the merchant's incentive to defraud is lessened.

Consumer Use Of Refund Rights

Refund formulas, to be effective intervention strategies, must be known to the consumer, allowing him to drop out if dissatisfied, and demand the appropriate refund. Defrauding merchants will often assist consumers in this regard by trying to make the refund policy sound as generous as possible as a selling tool. Consumers also often intuitively believe refund policies are "pro rata".

Nevertheless, once a consumer contracts for the service, the merchants may misrepresent the refund policy, discouraging drop outs and demands for refunds. Affirmative disclosure of refund rights can counteract this deception.

Consumers must take affirmative action to cancel their contracts. Existing refund requirements often require notice by certified mail or by other inconvenient methods, and seriously discourage consumer action.

Problems of consumers failing to take proper steps to cancel can be overcome by automatic cancellation procedures. For example, if a consumer does not attend a vocational school course for a month, his contract can be automatically cancelled. But consumers cancelled in this manner may not realize that they have a refund due, and the seller may not part with it on his own initiative.

Even when sellers demand payment, merchants may refuse or delay to make owed refunds. Insolvent and fly-by-night merchants will never reimburse consumers. Other companies only make refunds if attorneys or government agencies intervene on behalf of consumers.

3. Limits on Contract Price, Length

Another method of limiting the financial loss of consumers signing future service contracts is to limit the duration or cost of the contracts themselves. For example, lifetime, $10,000 dance studio contracts can be prohibited, setting the maximum obligation at $1,000 and one year. Buyers desiring to stay enrolled after the year must sign new contracts.

Refund standards and limits on contracts' size each have advantages as intervention strategies. A generous refund standard on a $10,000 contract allows consumers to cancel at any time and receive a sizeable refund. If cancellation is early enough, the financial obligation will be far less than $1,000.

On the other hand, a contract with a limited term, while not facilitating cancellation during that term, makes it easier to cancel between $1,000 contracts. The only way <u>not</u> to cancel is to sign a new contract.

Not signing a new contract is easier than cancelling an old one. Refund rights place the burden on the consumer to understand his cancellation and refund rights, to take action, and to provide sufficient evidence of his cancellation.

Merchants can avoid the effects of contract limitations by illegally having consumers sign several contracts at once or by using contracts not complying with the regulation's restrictions.

Existing contract limitations generally restrict contracts to 2 years and $1,000. This restriction has been effective in ending blatant dance studio sale abuses. Nevertheless, $1,000 still offers merchants a significant financial motivation to defraud consumers. Contracts will have to markedly more limited in length and cost to substantially change merchant incentives.

Smaller contracts are criticized as being inconvenient to merchants and consumers who have to continually recontract for the same services. Merchants will also experience difficulties in long term business planning.

B. ESCROW

Escrow arrangements limit the potential consumer losses by delaying payment to the merchant until it can be determined that fraud is not involved. If there is fraud, the consumer gets his money back and the merchant gets nothing. This, in theory, should decrease consumer loss and also the merchant's incentive to defraud. Nevertheless, escrow arrangements are infrequently used as consumer fraud intervention strategies, making it difficult to evaluate their effectiveness.

1. Description of Escrow

Money, a deed, or other instrument is "delivered into escrow" if a promisor (in this case, consumer) delivers it to a third party (often a bank which keeps it in an "escrow account"). The third party keeps it until a condition is performed or a certain event happens, then delivers it to a promisee (in this case, merchant).

The "escrow agreement" specifies the conditions upon which the money or instrument is delivered to the promisee. The terms of that agreement are usually arranged by the parties involved, but can be fixed by statute.

An example of a possible escrow arrangement in the consumer context is a consumer putting his mail order payment into an escrow account. The escrow agreement could specify that a bank will hold the money until the mail ordered good is delivered, at which point the payment automatically reverts to the seller. If the merchandise never arrives, the consumer gets his money back immediately. Both sides are protected if the bank, theoretically the agent of both parties, properly fulfills its function. The bank is liable if it acts improperly.

Escrow Uses

Escrow is rarely used in consumer transactions, but is often used in other contexts. Common applications include real estate closings, property tax and insurance premium payments to creditors, tax inspired installment payment arrangements, and rent withholding from landlords.

CONTINUED

2 OF 3

Escrow as a consumer fraud strategy is limited to prepayments for air charters and travel services. Civil Aeronautics Board ("CAB") regulations require passenger prepayments to air charter companies to be deposited in escrow with a bank. The air carrier receives payment only after the air charter flight has been completed. If the air carrier cancels the flight, the bank delivers the escrowed funds directly to the passengers.

This regulation was in response to extensive fraud in the charter industry when consumers were never returned their large deposits when flights were cancelled. Quebec Province has similar regulations requiring travel agencies to place in escrow prepayments for all travel services. This type of escrow arrangement, where a third party depository holds consumer prepayments until determining whether the promised good or service has been delivered, could also apply to mail order, furniture, or similar consumer transactions.

Another escrow application is rent withholding. A number of states authorize tenants to pay their rent into escrow when landlords fail to properly maintain premises. Normally, the tenant must notify the landlord of his action and a government agency must previously have found the premises unfit. The landlord receives the rent in escrow only if he corrects the defects within a specified time period.

This escrow use might also apply to long term service contracts, such as vocational school, health spa or dance studio sales. Normally, dissatisfied consumers must either drop out of these programs, losing substantial investments of time and money, or continue making payments. Putting payments in escrow until problems are corrected offers consumers a superior alternative. This escrow arrangement could be created by private agreement or by statute.

2. Effectiveness of Escrow

Effectiveness of CAB Escrow Requirements

Consumers do not have the expertise or bargaining position to create their own escrow arrangements. Even sophisticated consumer organizations reject the tactic of unilaterally placing certain payments in escrow because of the "hazy" legal questions involved, among other reasons. Existing escrow agreements between consumers and merchants are created by merchants for the benefit of merchants.

The limited evidence of the effectiveness of statute-induced escrow arrangements is more promising. The major American example is the CAB requirement that charter airline payments be placed in escrow until successful completion of the charter. 1/

Both the CAB and a Federal Trade Commission investigation of the travel service industry conclude that the regulations are effective. 2/ The FTC finds a sharp decline in complaints received. The CAB reports decreases in both fraud and defaults in the air charter industry.

Nevertheless, the CAB is publishing shortly new regulations aimed at clarifying the charter airline escrow relationship. This points out that regulations must clearly lay out the complicated duties and rights of the parties so that banks or other escrow holders will know whether to deliver prepayments to merchants or consumers.

The regulations must prevent unscrupulous merchants from meeting the escrow agreement specifications while still defrauding the consumer. For example, a fraudulent charter company might attempt to cut back on meals, leave from inconvenient airports at unusual times, lower the quality of promised accomodations. Does the bank turn over the escrow to the charter company or the passenger?

If escrow agreements are not precisely worded, merchants' superior legal resources will allow them to meet attempts to return escrow payments to consumers with a barrage of litigation. Consumers will not aggressively contest unfavorable decisions. Consequently, escrow holders will favor merchants in interpreting escrow agreements.

The CAB has also found it necessary to better explain the escrow arrangement to consumers so they will pay monies into escrow, and not to the merchant, and will demand repayment if the escrow conditions are not met. This educative task is the more difficult because escrow agreements are both rare and complex.

Effectiveness of Rent Withholding

Consumer awareness is even more critical when consumers withhold rent by putting payments in escrow, at their own option, to enforce landlord compliance with the housing code. A 1971 study, *A Practical Analysis of the Pennsylvania Rent Withholding Act* 3/ found that consumer ignorance has limited the success of these statutes:

> The tenant is normally in a low income bracket and is generally unknowledgeable as to the existence of the Act or its legal operation. His awareness, if any, comes from the local community association in his neighborhood....No matter how ideal the Act may be, if it is not brought to the attention of those who ultimately benefit from it, the results will be dismal.

Furthermore, these rent withholding escrow statutes prescribe complicated procedures allowing landlords to evict for non-payment non-complying tenants. The procedures' complexity typically necessitate the retention of legal counsel, significantly discouraging consumers from utilizing this strategy. The Pennsylvania study found escrow was used successfully only during a peak period when a neighborhood renewal project made concentrated efforts to assist residents.

Escrow Costs

Not only businessmen, but enforcement officials and legislative experts criticize escrow arrangements for consumer transactions as impractical and overly costly. Escrow accounts require additional paperwork, the hiring of third parties, and creation of separate bank accounts.

Escrow also ties up large amounts of money, unused by both consumers and merchants. Merchants who rely on continual cash flows are particularly hard hit. Critics claim that most merchants are honest and that instituting such complex, costly requirements is like "hitting a pin with a sledgehammer."

The success of the CAB's charter regulations tempers this criticism. Escrow seems appropriate where there are large prepayments, significant potential for abuse, and clear conditions when the escrow should be turned over to the merchant. Proper use can significantly reduce consumer losses and merchants' incentive to defraud.

Merchant cash flow problems can be solved by borrowing money with the escrow as collateral, requiring the creditor, not the consumer, to evaluate the merchant's reliability. Presumably higher risk merchants would be refused credit or would pay higher interest rates. This principle of shifting the policing responsibility and the potential loss from the consumer to a third party, here a creditor, will be described in more detail in the next chapter.

FOOTNOTES

(Chapter VI)

1. 14 CFR 200140.

2. Interviews conducted in November 1977 with CAB enforcement staff, Washington, D.C., and FTC staff, Boston Regional Office.

3. A Practical Analysis of the Pennsylvania Rent Withholding Act, 17 VILLANOVA L. REV. 821 (1971-72).

CONTENTS - CHAPTER VII

VII THIRD PARTY POLICES FRAUD, BEARS LOSS

The previous six approaches involved the consumer or government agency preventing fraud or compensating victims. Another approach encourages third parties, such as creditors or insurance companies, to police and bear fraud losses.

In some contexts third parties can perform these tasks better than consumers or even government enforcement agencies. But, by the same token, these third parties are also expert at avoiding this responsibility and turning it back over to consumers. There are numerous third parties that can be required to police or bear fraud losses. This chapter will explore four of these.

Limiting defense cut-offs allow consumers to raise fraud defenses against third party creditors in debt collection actions. These creditors, facing losses due to the merchant's fraud, are encouraged to screen out potentially fraudulent sellers from credit arrangements or establish recourse arrangements that pass the fraud loss back to the seller. But consumers do not often raise fraud defenses and creditors have devised other methods to insulate themselves from fraud defenses.

Bankruptcy results in the defrauding seller having insufficient assets to pay off creditors and consumers. Present procedures result in consumers receiving nothing. Proposed reforms would shift some of these bankruptcy losses to creditors who are in a better position to evaluate sellers' solvency than consumers. But even if consumers are entitled to payment from the bankrupt, they rarely know how or can press a claim before the bankruptcy court.

The ideal solution is to shift the burden of policing a corporation's fraud to shareholders, directors and officers of the corporation. But, in practice, this rarely happens. Both practical and legal factors immunize corporate officials. Even when they are found personally liable, liability insurance can further protect these officials.

Bonding shifts to surety companies consumers' fraud losses. These surety companies have a profit incentive to screen out and refuse bonds to potential fraud offenders, limiting their ability to continue in business. Unfortunately, the same profit incentive encourages bonding companies not to pay out on consumer claims. Other types of insurance schemes such as government run insurance pools and private, insured-funded insurance plans, have advantages over bonding in this regard, but have other drawbacks.

A. LIMITING DEFENSE CUT-OFFS

Creditors use a number of defense cut-off devices to insulate themselves from consumers' fraud claims arising from sale transactions they finance. These defense cut-offs prevent consumers from raising fraud defenses in creditor collection actions, forcing them to bring affirmative fraud actions against the offending merchant.

This section analyzes the effect of eliminating two such cut-off devices, the holder-in-due-course ("HDC") doctrine and waiver of defense clauses. In particular, it evaluates whether the burden of paying and policing for fraud are effectively shifted to third party creditors, and whether these creditors are better suited to bear this burden.

1. Justification for Limiting Defense Cut-Offs

Eliminating defense cut-offs does more than facilitate consumers withholding payments. Creditors subject to fraud defenses, have an incentive to screen and police merchants with whom they do business, minimizing their losses due to fraud defenses. Creditors who do not screen out fraudulent merchants are at a competitive disadvantage and will lose their market share to financers that do. More and more credit is extended only to sellers with low potentials for fraud.

Sophisticated financers are expert at evaluating merchants they do business with and develop long term relationships with such sellers. These creditors are far better equipped than consumers to screen and police for fraud.

They are also better able to bear the loss if there is fraud. Their financial and legal resources are greater. Creditors also maintain recourse arrangements with sellers giving the creditor the right to shift any losses it suffers because of the seller's fraud back to the seller. Recourse agreements, assisted by the ongoing relationship of seller and creditor, cheaply and fully compensates financers for fraud losses.

Creditors policing merchants relieves government enforcement agencies of this burden, allowing limited resources to be used elsewhere. Creditor business decisions not to finance fraudulent sellers is a less expensive process than adjudicatory procedures, and may even be a more effective remedy than those available to prosecutors.

This strategy of shifting the burden to creditors applies only to credit sales involving third party financers. Defrauding merchants can avoid its effect by selling on a cash basis or financing their own credit sales. In addition, the financer's potential liability, and consequent incentive to police the merchant, is limited to the amount of the outstanding debt. Experts have suggested that eliminating defense cutoffs would be even more effective if creditors were liable for all fraud losses and not just up to the amount of the debt.

2. Effectiveness of Limiting Defense Cut-Offs

Government officials and consumer advocates consider limiting defense cut-offs to be one of the most important and effective consumer fraud intervention strategies. There is a minimum of hard evidence either supporting or challenging this view.

Yankelovitch performed a qualitative survey of financial institutions shortly after the FTC limited the HDC doctrine and waiver of defense clauses. 2/ The survey's methodology and timing have been challenged, but the survey did find that a sizeable minority of creditors made policy changes or instituted specific actions responding to the rule.

The most common creditor action was to sever some or all credit arrangements with merchants based on sellers' solvency, record of generating consumer complaints, or unwillingness to sign indemnification agreements. Other similarly flawed studies reach similar conclusions. 3/

Financers appear to respond to restrictions on defense cut-offs by devoting more personnel and effort to screening and policing merchant conduct. 4/ But creditors find some merchants' business so profitable as to compensate for fraud losses.

Yankelovich found the other common response to the FTC's HDC Rule was the creation of recourse or indemnification agreements. 5/ These arrangements quickly pass back to the merchant losses due to the merchant's fraud. The creditor has less of an incentive to contest consumer fraud defenses if the seller immediately indemnifies the financer.

Consumers' failure to raise fraud defenses severely restricts the effectiveness of shifting the burden of policing seller fraud to thrid party creditors. If consumers do not complain, financers have no incentive to screen out defrauding merchants.

A previous section has described why consumers do not raise fraud defenses - inertia and ignorance, the economics of hiring an attorney, proof difficulties, and creditor devices discouraging fraud defenses. 6/ Existing regulations limiting defense cut-offs do little to encourage consumers to press fraud claims against creditors For example, while the FTC's HDC Rule requires disclosure of the consumer's right to raise fraud defenses against creditors, the mandated language scores "difficult" on a readability test. 7/

Creditors can circumvent limitations on the HDC doctrine and waiver of defense clauses by utilizing other, unregulated defense cut-offs devices. These include flipping and consolidation of loans, seller arranged loans, and third party credit cards. 8/ To effectively shift the burden of policing merchants from consumers to creditors these other defense cut-off devices must be equally limited.

Regulation of these other defense cut-off devices meets the same industry criticism as the FTC's HDC Rule faced, that the supply of credit will be limited and its cost raised. But several cross-sectional econometric studies have found no statistically significant relationship between state restrictions of the HDC doctrine and the supply or cost of credit. 9/ The FTC's HDC Rule caused no significant decline in the availability of credit in such industries as mobile homes, home improvements, and automobile sales. 10/

Of course, the FTC HDC Rule intends that credit will become more expensive or unavailable for potentially fraudulent sellers. As financers learn to better screen and police those sellers, the price of credit to other businesses may even decline. Even if the strategy results in a small, undifferentiated rise in the cost of credit to all consumers, this may be preferable to imposing all of fraud's costs on the victims.

B. BANKRUPTCY

For credit purchases, limiting defense cut-offs shifts from consumers to creditors losses due to a bankrupt merchant's fraud. In the opposite case, where the merchant owes the consumer, bankruptcy proceedings determine who bears the loss, the consumers or other creditors of the bankrupt.

The more common situations in which merchants owe consumers are:

merchandise deposits
mail orders
service contracts
lay-aways
merchandise credits
certificates

coupon books prepaid
warranty obligations
prepaid memberships
security deposits
damaged goods gift
prepaid tuition

goods left for repair or adjustment

In some bankruptcies hundreds of thousands of consumers are left short. 11/

Determining consumers and other creditors' relative priorities to a bankrupt's limited assets is not directly a consumer fraud, but a bankruptcy issue. Nevertheless, merchant bankruptcy and consumer fraud are so intertwined that government's treatment of bankruptcy priorities has a significant impact on consumer fraud enforcement.

Defrauding merchants often spend or divert all available assets, keeping themselves judgment proof and thus on the verge of bankruptcy, no matter how profitable the scheme. In the extreme case, the merchant induces consumer prepayment with no ability or intention to supply the promised goods. Other companies, on the verge of insolvency, resort to fraud for survival, or deceptively accelerate sales without disclosing the company's precarious financial position.

1. Determining Who Should Bear Bankruptcy Losses

Bankruptcy priorities determine who bears the brunt of a merchant's fraud. If taxes and business loans are paid first, the consumer will receive little if anything, and will bear the full burden of the fraud. If consumers are paid in full first, the remaining creditors suffer.

Law enforcement officials argue that these creditors can better bear the loss and more effectively police defrauding merchants. The Massachusetts Attorney General finds three differences between consumer and merchant creditors as justification for giving consumers priority:

> (1) Bargaining Power. The rights of creditors in bankruptcy are determined to a large extent by negotiations with the debtor prior to his insolvency. A creditor who advances money or goods with expectations of repayment will usually have much greater bargaining power with the debtor than a consumer who advances a smaller sum in exchange for future delivery of goods or services. In a typical situation, whatever small bargaining power the consumer has is not exercised because of his ignorance that these pre-bankruptcy negotiations will determine his share in the event of liquidation.
>
> (2) A Consumer's Lack of Intent to Become a Creditor. Closely related to the above is the fact that a consumer typically makes no conscious decision to become a creditor of the seller. Even if the consumer did suspect that such was the case, he does not possess and probably would not be able to acquire any of the information which would normally be considered relevant in deciding to make a loan.
>
> (3) Other Creditors are Compensated for Their Risk. While professional lenders extract either interest or other concessions for extending credit, the consumer often does not pay less for the desired items because he has contracted to pay in advance. 12/

The Wisconsin Attorney General goes even further and argues that trade creditors' priority

> encourages trade creditors to either actively or passively assist in the fraud since consumer dollars are a ready source of cash to make sure that the bankrupt's estate has enough to pay their preferred claims. Furthermore, consumer claims are usually small in individual amount but very large in aggregate. 13/

The head of New York City's Department of Consumer Affairs notes:

> Consumers are the least likely of any group to have actual or constructive knowledge of the financial situation of the vendors with whom they deal. Conversely, business creditors, are the most likely to have an understanding... because they are able to obtain this information, and are thus able to take appropriate steps to protect themselves against financial losses. 14/

If business creditors are less eager to extend credit to failing businesses, defrauding merchants will find their scheme halted earlier.

Others oppose consumer priorities, arguing, as with limiting the holder-in-due-course doctrine, that they will limit availability or terms of credit, particularly damaging small and new businesses. Many merchant-creditors, such as a newspaper delivery boys and plumbers, are in no better position to police a business' financial viability than are consumers. Consumers' priority over employees' claims for back wages are particularly questioned.

Bankruptcy priorities also determine whether tax or consumer claims are paid first. Tax claims are frequently very large and can eat up all of a bankrupt's assets. There are far more remedies available to the IRS than individual consumers, and the IRS can keep a closer watch on a business' financial stability. But should taxpayers subsidize consumers who make risky or unwise purchase decisions?

2. Existing,Proposed Bankruptcy Approaches

On balance, shifting consumer losses to the bankrupt's other creditors is an effective consumer fraud intervention strategy. Existing, bankruptcy priority schemes do not shift these losses away from consumers. But proposed reforms may not in practice be any more effective.

Federal Bankruptcy Act Priorities

The Federal Bankruptcy Act gives consumers no priority over other creditors. Secured creditors, by their special arrangement, achieve first rights to specific property. Expenses to administer the bankruptcy distribution, employee wages, taxes, and, in some circumstances, rent have next priority.

These payments often deplete the merchant's assets. If money is left to be distributed, consumers share equally with other unsecured creditors. Invariably, this means payment of only a few cents on the dollar. Giving defrauded consumers lowest priority shifts losses to, not away from, consumers.

Innovative Approaches Utilizing State Law

State law offers several theories giving consumers higher priority. One theory argues that merchants hold consumer prepayments in trust and that money held in trust is not the merchant's property. It should be returned to the consumer and not distributed in bankruptcy like other assets. 15/

Since sellers rarely intend to create trusts, consumer lawyers argue that a "constructive" trust is created when state consumer protection laws regulate the prepayment. For example, consumer payments should be held in constructive trust until applicable three day cooling-off periods expire. Constructive trusts also should be created when contracts are rescinded because of fraud or misrepresentation, as when a seller accepts prepayment intending to declare bankruptcy prior to the promised goods' delivery date.

Before allowing consumers to receive monies in trust, courts require them to "trace" their property, that is identify specifically which money or other property is theirs. But it is nearly impossible for a consumer to trace his deposit through numerous bank accounts and funds and isolate it from the merchant's other cash. 16/

Several states avoid this problem, particularly for tenants' security deposits, by requiring the merchant to set up a separate trust, segregating the consumer's deposit from his other funds, often in an escrow account. 17/ But non-compliance, while drawing criminal penalties, leaves the consumer's deposit comingled with other funds, destroying the bankruptcy preference. Separate trusts, like other escrow accounts, also restrict businesses' cash flow.

A number of very narrowly-drawn sections of the Uniform Commercial Code that governs sales of goods also give consumer priorities. Buyers may gain possession of unique goods if they can identify the exact goods they selected (not other identical goods) and if they either are unable to obtain the merchandise from other sources 18/ or the seller has become insolvent within ten days of the first deposit payment. 19/

An often mentioned proposal is for the state to create consumer liens on certain of the merchant's assets as security for consumer deposits. 20/ The lien would be satisfied before distribution of the bankrupt's remaining assets. To account for the involvement of unsophisticated consumers, the usual public filing requirement for liens would have to be eliminated. Sophisticated creditors could still defeat state-created consumers liens by encumbering all available assets in ways so they are distributed in bankruptcy to creditors, not consumers.

All of these state law theories giving consumers preference may have no effect, being preempted by the Federal Bankruptcy Act. 21/ The federal act sets up certain priorities in bankruptcy (with the consumer last). State attempts to give consumers preference may be disguised priorities conflicting with the federal act. In such cases, federal law takes precedence over state law.

Pending Federal Bankruptcy Act Amendments

Consequently, only reform of the Federal Bankruptcy Act can insure consumer priorities. Limited Bankruptcy Act amendments are pending before the U.S. Congress. 22/ The House, in February, 1978, passed a bill giving consumer claims up to $2400 priority over tax debts and claims of unsecured creditors, still leaving consumers lower in priority than secured creditors, administrative expenses and business debts arising after the commencement of bankruptcy, and employee wages. The present Senate version limits priority consumer claims to $600 and would pay them after tax claims, giving consumers precedence only over unsecured creditors.

One expert estimates that the resulting Congressional action will give 80% of consumer-creditors all or a portion of their money or property back. 23/ A Congressional report also indicates that the higher consumer priority will mean there generally will be assets available to pay the claims of consumer-creditors. 24/

3. Impediments to Shifting Bankruptcy Losses

Practical Obstacles to Consumer Participation in Bankruptcy Proceedings

Bankruptcy law reforms designed to shift consumer losses to third parties will not automatically bring about that result. To be paid, the consumer must take affirmative action and participate in bankruptcy proceedings. In this regard, limiting the holder-in-due-course doctrine is a more effective strategy because it does not require the consumer to act but only eliminates a creditor remedy, making it easier for defrauded consumers to withhold payment.

A consumer with a right to payment in bankruptcy may not invoke that right for several reasons. 25/ Consumers often do not realize their status as potential creditors in bankruptcy. In several reported cases, lawyers have even incorrectly advised consumers they are not creditors.

The bankruptcy court is unlikely to notify consumers of their rights. The court only notifies creditors listed by the bankrupt, and merchants typically do not consider consumers as creditors and do not record them as such. Even if the court does inform the consumer, typical notices are so legalistic as to be unintelligible.

A consumer is not much better off if he is aware of his right to participate. Bankruptcy proceedings for large companies, in particular, will often occur thousands of miles from a consumer's residence. Hiring a lawyer is usually not economically justified; hiring a lawyer out-of-state is even more impractical.

But a consumer unrepresented by an attorney must find and file on his own complicated forms unique to bankruptcy proceedings, an impossible task without legal training. Only 2% of the consumer creditors of one corporation participated in bankruptcy even though they were all notified of their right to do so.

Even if a consumer files the correct forms, his participation without experienced counsel will be limited. He will only be able to wait and hope no one challenges his claim, hope he needs no evidence from the bankrupt to prove his claim, hope the trustee in bankruptcy appointed by business creditors will look after consumer interests. Then, and only then, sometime years in the future, the consumer may receive part of his claim.

A large group of consumer-creditors filing a class action in bankruptcy court may avoid many of these practical difficulties. 26/ But bankruptcy court rules are silent as to the permissability of class actions, raising numerous legal issues of first impression.

Similarly, state attorneys general have attempted to intervene on behalf of consumers in bankruptcy court, but without much success, except in extraordinary cases. 27/ Bankruptcy rules are also silent about the permissability of this intervention and the National Association of Attorneys General failed to convince Congress to specifically authorize it. 28/ Even if attorneys general have such authority, they will not use it routinely, but only in exceptional cases of consumer abuse.

A third approach to overcoming these practical obstacles proposes to simplify court forms, remove affirmative filing requirements, and require retailers to list indebtedness to consumers. The court, without affirmative consumer action, could distribute the bankrupt's assets properly. 29/

Avoiding Consumer Priorities

Creditors concerned with the security of their loans will attempt to circumvent legislatively created consumer preferences in bankruptcy. Creditors will seek secured creditor status and use their bargaining power and legal expertise to impose on merchant-debtors other arrangements defeating consumer priorities.

If the creditor and merchant have a special relationship, the merchant may turn over a substantial portion of his assets to the creditor just before bankruptcy, depleting the estate for consumers. The consumer's only remedy is to convince the trustee in bankruptcy to attack the transaction as a fraudulent conveyance or a preferential payment, thus returning the assets to the bankrupt. 30/ These attacks require high standards of proof.

C. HOLDING CORPORATE OFFICIALS LIABLE

The ideal intervention strategy shifts the burden of paying for and policing a corporation's fraud from the consumer to corporate officers, directors, and shareholders ("corporate officials"). Defrauded consumers sue these officials, forcing them to bear the losses associated with their fraudulent or negligent management.

1. Practical Limitations to Collecting From Corporate Officials

This strategy of holding corporate officials liable is only effective in very limited circumstances. Corporate officials will only personally compensate consumers for the corporation's fraud if the corporation is bankrupt; other times the corporation itself will defend and pay off the claim, if necessary. Only the impractical strategy of corporation shareholders suing corporate managers to recoup fraud losses will result in corporate officials finding themselves with out-of-pocket losses when the corporation is not bankrupt.

Corporate officials will only pay for a bankrupt corporation's fraud debts if consumers initiate private damage actions or prosecutors bring restitution suits. The substantial obstacles to bringing both these types of actions have been discussed in earlier sections. 31/ These suits are the more difficult because the officials' liability must be shown, not just the corporation's. The strategy is also limited to the unlikely situation where officials of bankrupt, defrauding corporations remain in the jurisdiction and possess sufficient assets in their name to satisfy a judgment.

These limitations to collecting judgments from corporate officials not only reduce the payments officials make, but also reduce officials' incentive to police and prevent fraud within their corporation. The lure of large fraud profits overcomes officials' fear that a consumer or government agency may sue them if the corporation goes bankrupt.

2. Corporate Officials' Immunity

The doctrine of corporate immunity legally forecloses actions against individual corporate officers, directors and shareholders. Corporate officials are only liable in certain narrowly defined circumstances. Consumers can sue corporate employees for fraud losses caused directly by that employee. Consumers or prosecutors can also argue that the corporation is a mere sham or shell, and that the owners should be personally liable. In addition, officials are personally liable to the extent, and in contexts, that state law prescribes.

Otherwise, only the corporation, and not officers, directors or shareholders are liable for the debts of the corporation. The policy behind this legal ruling is the state interest in encouraging shareholders to invest and individuals to serve as corporate directors and officers. Most existing legislation finds this interest to outweigh another legitimate state interest, encouraging officers, active directors, and majority stockholders to supervise corporate activity closely to prevent consumer fraud.

When corporate officials are liable for corporate fraud, they devise further ways to immunize themselves so that they bear no loss and, consequently, have no incentive to police corporate fraud. Foremost among these devices is the corporation's purchase of liability insurance protecting officials from any potential liability. The burden of loss is shifted to an insurance company which will not be in the same position to police the corporation's fraud.

These insurance arrangements defeat the purpose of state laws limiting corporate officers' immunity from liability in fraud situations. Nevertheless, most states' insurance laws allow purchase of insurance for directors and officers for "any liability". Other states' and proposed legislation prohibit the sale of this insurance where there is a strong state interest that corporate officials personally bear the liability. 32/

D. BONDING, INSURANCE

Bonding and insurance strategies introduce new third parties to the sales context who bear the loss, and, in certain circumstances, prevent fraud. Bonding is the most important example, but government run, business funded insurance, and consumer funded private insurance are other possible approaches.

1. Bonding

Bonding laws require all merchants conducting a certain type of business to purchase a bond from a private surety company to cover certain specified eventualities. When the terms of the bond are satisfied, the surety company pays the party to be protected by the bond.

Bonds are often used to reimburse consumers if the merchant goes bankrupt or fails to satisfy a judgment. Bonds can also reimburse consumers for merchant non-performance or other clear-cut cases of merchant misconduct with easy to calculate damages. Surety companies refuse to write bonds where consumer recovery is more problematical and where the companies have to spend substantial resources resolving difficult disputes.

Surety companies bear losses due to bonded merchants' fraud, and, consequently, have an incentive to prevent fraud losses in one of several ways. They can refuse to bond sellers with high fraud potentials. Surety companies which successfully screen sellers can charge lower rates to their other customers, increasing their market shares.

Surety companies can also charge questionable merchants higher rates, putting these merchants at a competitive disadvantage with legitimate sellers. But this added cost is insignificant compared to the competitive advantage sellers who utilize fraudulent marketing techniques enjoy. Finally, a surety company can protect itself by policing the companies it insures to prevent them from engaging in conduct resulting in payment on the bond.

Bonding Limitations

The major problem with bonding is that consumers find it difficult to collect on the bond. If consumers never collect, surety companies will not screen or police for fraud. Surety companies have a financial incentive not to pay on bonds. They are not competing to satisfy consumers, but to offer merchants low rates. Consequently, the fewer bonds they pay out, the more business they will attract.

High risk sellers, unable to purchase bonds from major surety companies, turn to companies specializing in the residual market. These surety companies have unusually high losses and only stay in business by being tough on paying claims.

There are other reasons why surety companies do not pay claims. Conduct can be outside the scope of the bond. Bonds exclude payment if the bond is acquired through fraud, not unlikely behavior for a merchant defrauding consumers. If the bond is limited and claims are potentially higher than the bond, surety companies may wait and let a court distribute the bond.

Businesses represented by attorneys report difficulty collecting on bonds. It is not surprising that individual consumers have an even harder time. They may not know the seller is bonded, for what conduct he is bonded, or how to contact the surety company. Court action is not economical and consumers are quickly discouraged by the surety company's stalling techniques and evasions. These enormous delays are particularly debilitating to consumers.

Present bonding legislation does not provide consumers with penalties for surety companies' delay or improper refusal to pay. State insurance department regulation is the major force encouraging surety companies to make payment. Usually only a pattern of complaints about a surety company's failure to pay on clear cut claims will prompt insurance regulators to act. Regulators are criticized as captives of the industry, but they have broad powers and effective informal mechanisms to persuade insurance companies to treat consumers fairly.

An alternative to insurance department regulation is for state attorney general or other government agencies to sue on bonds on behalf of consumers. Even where this is authorized, state offices will not be able to act on all claims.

A bonding strategy has other disadvantages. It creates added costs for all bonded businesses. While bonds are cheap, they will become more expensive if consumers collect on them more often. Bonded merchants must pay for the surety company's losses, overhead and marketing expenses, and profit margin.

Bonding also enables surety companies to exclude from the market companies they find questionable. This is desirable if fraud characteristics are used to make this decision; it is not if race, geographic location, length of time in business, or size is used.

2. Seller Contributions to Insurance Fund

An alternative to bonding is for government to institute an insurance fund paid for by members of an industry to reimburse defrauded consumers. Canada requires travel agencies to contribute a varying percentage of their sales, depending upon their size, to a fund to protect travelers from insolvent travel agencies. Several states create similar funds to protect consumers from bankrupt money order and insurance companies.

A more ambitious alternative, proposed by the Massachusetts Consumers Council, but never enacted, authorizes state consumer claims offices located conveniently throughout the state to automatically pay consumer claims for less than $100 without determining fault. Companies doing business in Massachusetts would contribute to the fund. Informal hearings would determine fault for claims over $100 and claims over $1,000 would be referred to attorneys for private action.

These funds do not result in added policing or screening of fraud offenders. All sellers pay the same amount, regardless of fraud potential and no seller is excluded. The Massachusetts proposal would involve policing to the extent that officials could investigate sellers causing large numbers of claims. The Massachusetts system also can assess companies with bad claims records with larger contributions. But businesses will object to a system that penalizes merchants for consumer claims, while giving them no right to dispute the claims' validity.

Consumers find it easier to collect from a government fund that does not have a profit motive than from a surety company. The fund is subject to political pressures to distribute money fairly and without delay. The fund can even distribute money to consumers who do not request payment. For example, the fund can use a bankrupt seller's records to determine which consumers are owed money, and then automatically mail them checks. Unlike a restitution action, there is no need of legal proof of fraud or damages.

If a no-fault concept is used in making payments from the insurance fund, frauds which are not clear-cut can still be remedied. Since no one has a profit incentive to dispute the claim, the fund can award reasonable payments based upon quick, informal judgments.

The no-fault concept is criticized as encouraging unjustified claims and consumer abuse of the system. But experts predict this will be a minor problem, easily kept within tolerable limits. Computer printouts can document chronic complainers. Claims officers have discretion to reject unjustified claims. Deductibles can discourage frivolous claims.

A major drawback of government run insurance funds is that costly state bureaucracies are created that only redistribute money from sellers to fraud victims. Consumers' own vigilance is lessened, and little attempt is made to police or prevent fraud, or to pass on losses to offending merchants.

3. Consumer Financed Insurance

An alternative insurance scheme calls for consumer premiums to support a private company that insures consumer fraud losses. Normal competition among companies for insureds' business will result in fair claim settling procedures.

The insurance company, after reimbursing the consumer, brings a damage action against the offending seller. The insurance company will hire attorneys and other personnel specializing in collecting from offending merchants, and will develop cost-effective procedures to recover payment. A large enough insurance company may even have an incentive to police the marketplace for fraud to lower its losses, seeking special damage awards on behalf of insureds.

Consumers must pay a substantial premium for this service to subsidize the costs of pressing claims, losses due to unreimbursed claims, and the company's profit margin, administrative expenses, and acquisition costs. Low income individuals, in particular, will not purchase such insurance. Insuring consumers against fraud also lowers consumer vigilance in the marketplace.

FOOTNOTES

(Chapter VII)

1. A more detailed discussion of defense cut-off devices is found in "Withholding Payment", Section III A.

2. YANKELOVICH, SKELLY & WHITE INC., A QUALITATIVE EVALUATION OF THE HOLDER-IN-DUE COURSE RULE ON LENDING INSTITUTIONS (1976).

3. Note, A Case Study of the Impact of Consumer Legislation, 78 YALE L.J. 618 (1969).

4. Testimony for Hearings on Proposed Amendment to FTC Holder-In-Due Course Rule, TR 2722 (April, 1976).

5. YANKELOVICH, SKELLY & WHITE INC., *supra* note 2.

6. "Withholding Payment", Section III A.

7. R. FLESCH, THE ART OF READABLE WRITING.

8. Described in more detail in "Withholding Payment", Section III A.

9. E. Nagata & D. Greer, An Econometric Analysis of the Other Consumer Goods Credit Markets" NCCF TECHN STUDIES at 273, 278, 313, 326 (1973); R. Peterson & J. Frew, Creditor Remedy Restrictions and Interstate Differences in Personal Loan Rates and Availability: A Supplementary Analysis, CREDIT RESEARCH CENTER WORKING PAPER No. 14 p. 18 (1977); G. Benston, The Costs to Consumer Finance Companies of Extending Consumer Credit, II CCF TECHN. STUDIES 38-39, 44-48, 50-51, 56-57, 59, 63, 64, 65, 98-99, 106, 111, 119, 125, 136, 138-139 (1973).

But see D. Greer, Creditors' Remedies and Contract Provisions, V. CCF. TECHN. STUDIES 145-7 (1972).

10. FED. RES. BULL A 47 (Oct. 1976); FED. RES. BULL A43 (March and Sept. 1977).

11. Hearings Before the Subcommittee on Civil and Constitutional Rights of the Committee on the Judiciary, House of Representatives, on H.R. 31 and H.R. 32 (Bankruptcy Act Revision) 94th Congress, 2nd Sess., Serial No. 27, Part 3, 1723 (1976) (Statement of Representative Millicent Fenwick) (Hereinafter House Bankruptcy Hearings).

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