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“Negative Equity” Financing Under Scrutiny

Earlier this year, the New Hampshire Supreme Court issued a ruling addressing a dispute that arose out of a trade practice which some auto dealers use in situations involving trade-in vehicles that have “negative equity.” This article will review this ruling and address this particular practice for how negative trade-in equity is handled.

By way of background, a trade-in vehicle is said to have “negative equity” if at the time the vehicle is traded-in, the customer owes an outstanding balance on the vehicle’s loan which is more than the value of the trade-in vehicle. There are several practices dealers use to address this scenario; the practice under scrutiny in the recent Supreme Court case involves the auto dealer artificially increasing the value of the trade-in vehicle by the amount of the negative equity and then inflating the purchase price of the new vehicle by the same amount. The effect is that the customer essentially refinances the amount left on the trade-in vehicle loan, but the fact that the negative equity is being financed in addition to the purchase price of the new car is masked.

Looking at the particular facts of this case, a customer bought a car in a sale in which the purchase price first had been stated in the original cash

amount in a vehicle cash purchase agreement but was then inflated by the amount of the negative equity when the retail installment contract was signed. Subsequently, the customer sought a refund of the purchase price under New Hampshire’s so-called “lemon law,” RSA 357-D. RSA 357-D states that if a dealer is unable to repair a problem covered by a new vehicle’s warranty in three tries or if the vehicle is out of service for 30 days, then at the customer’s option the customer is entitled to a refund of the car’s “full purchase price” as stated in the “purchase contract” or to a comparable replacement vehicle. The customer in this case wanted a refund, and at issue was whether the amount to be refunded was the original sales price of the vehicle set forth in the purchase agreement or the amount set forth in the retail installment contract after it was grossed-up by the amount of the negative equity. The New Hampshire New Motor Vehicle Arbitration Board, which administers RSA 357-D, ruled that the price listed in the retail installment contract (which included the negative equity gross-up) was the amount that was ordered to be refunded to the consumer by the manufacturer. A trial court sided with the Board’s interpretation. In its ruling, the Supreme Court overturned the New Motor Vehicle Arbitration Board and the trial court and ruled that the Board exceeded its authority by adopting the inflated vehicle price from the retail installment contract and instead should have used the non-inflated purchase price from the vehicle cash purchase agreement.

What is interesting is the discussion of this grossing-up practice during the case. In arguing that the grossed-up value from the retail installment contract is the correct amount to refund, the Office of the New Hampshire Attorney General argued that the practice of increasing sales prices by negative equity constitutes an “unlawful and unfair trade practice” in that it improperly documents the negative equity and represents a false cost of the new car. Notably, the New Hampshire Supreme Court does not disagree with this argument, but rather states twice that the propriety of this practice was not an issue that the Court was asked to address in this particular litigation. That statement should be sufficient to make any dealer who uses this practice pause to consider its implications and whether it is likely that such issue will be presented to the Court next time under a different statute. Sometimes a subtle hint is the only warning you get. A review of this case, with consideration of the arguments made by the Attorney General’s Office and the subtle response of the Supreme Court, then raises the question of how to best address situations involving negative equity of trade-in vehicles.

Across the country, several courts that have examined this practice have come to differing conclusions as to how it must be addressed and whether the practice is permissible. None of the courts have jurisdiction over New Hampshire, however. There is some guidance from a federal agency that is illuminating. Regulation Z is the federal regulation issued by the Board of Governors of


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the Federal Reserve System to implement the Federal Truth in Lending Act. The Official Staff Commentary to Regulation Z, setting forth the position of the Federal Reserve Staff, states in one example that in their opinion the amount of negative equity should be disclosed "as an additional amount financed," separate and distinct from the "principal loan amount or the cash price." The regulations are clear that the "cash price" is the amount at which the dealer offers to sell the motor vehicle for cash; when reflected in the required "amount financed" disclosures, the "cash price" figure should not be inflated by negative equity.

Thus, in conclusion, the advisability of grossing-up a purchase price by negative equity is debatable. Adopting a practice of disclosing the negative equity pay-out as a separate detailed amount in the itemization of the amount financed is consistent with the opinion of the federal agency overseeing Regulation Z. With the caveat that the practice advocated by this article is **not** necessarily the only legally permissible practice and, to be very clear, noting that **no** New Hampshire court has found grossing-up by negative equity to be illegal, a more prudent practice would be to list the amount of the negative equity as a separate line item which is included in the amount financed, separate and apart from the price of the new vehicle, much the same way that additional amounts due for warranties and service contracts are added as separate line items. 📌

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Safety/OBD II Inspections Statistics				
Safety Inspection Results	Oct 06	% of Total	YTD 06	% of Total
Total *	100,270	100.00%	1,066,378	100.00%
Passed	80,322	80.10%	854,100	80.10%
Corrected	15,985	15.90%	171,027	16.00%
Rejected	3,959	3.90%	41,198	3.90%
Untested	4	0.00%	53	0.00%
OBD II Inspection Results (1996 and newer)				
Total	81,009	100.00%	847,589	100.00%
Passed	67,475	83.30%	708,770	83.60%
Rejected	11,581	14.30%	119,533	14.10%
Untested	1,953	2.40%	19,286	2.30%
* Total numbers include OBD II Inspections				



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