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Consumer Fraud

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Abstract

The North Carolina Cooperative Extension Service has worked closely with the North Carolina Attorney General's Office in educating the public about consumer fraud. This article focuses on four different consumer scams that are under investigation by the North Carolina Attorney General's Office: subprime consumer lending practices, pyramid schemes, travel scams, and home repair scams.

Introduction

Many years of networking between North Carolina Cooperative Extension and the North Carolina Attorney General's Office have resulted in a number of cooperative ventures, including the NC Partnership for Consumer Education, special training for Family and Consumer Education agents, the Family and Consumer Education Sting conducted by the North Carolina Extension Homemakers, and special updates for Command Financial Specialists in the U.S. Marine Corps whom Extension helps train. Extension's role in each of these joint efforts is to design and deliver educational programs to help consumers identify and avoid consumer fraud.

In an effort to inform readers of *The Forum for Family and Consumer Issues* about the different types of consumer fraud addressed by attorney generals' offices across the country, the Editorial Board invited the North Carolina Attorney General's Office to submit articles describing current scams and fraudulent practices of special concern in North Carolina. Four attorneys accepted the invitation, and each submitted a short article: a discussion on predatory lending practices to low-income consumers, an educational bulletin on pyramid schemes, a consumer alert on travel scams, and a news release on home repair scams. Similar information is usually available from the Web pages or news release lists from the attorney general's office in each state.

If persons in North Carolina have questions or want to report suspicious activities, they should call the Consumer Protection Section at (919) 716-6000 or visit the Department of Justice Web site at http://www.jus.state.nc.us/. Persons in other states should call their state's attorney general's office or contact the National Fraud Information Center at (800) 876-7060 or at http://www.fraud.org.

Subprime or "Predatory" Consumer Lending in North Carolina

by Phil Lehman, Assistant Attorney General, NC Department of Justice
For the average borrower, the credit marketplace is highly competitive. Mortgage loan rates are published weekly in most newspapers, making comparison shopping easy. There are a variety of credit card options available, including cards with no annual fees, cards with interest rates pegged to the prime rate, and different kinds of bonus programs. Car financing is available from dealers, banks, and credit unions, with manufacturers often subsidizing below-market rates.

It is a different story for consumers with low or irregular incomes, with blemished credit records, or with limited education or financial sophistication. Many of these consumers believe they are excluded from the credit mainstream and turn to more marginal or "subprime" sources for their credit. Credit is readily available in the subprime market but borrowers pay more, a lot more. The most common types of subprime creditors include check cashing services who make short-term payday loans at rates of 15% per month; finance companies who make $1,000 loans at 30% per annum; and mortgage lenders who may charge points and origination fees in excess of 10% of the loan amount, and then finance those fees at high rates. In addition to paying more, the subprime borrower may be subject to predatory practices, such as flipping, packing, and equity stripping.

Check cashing services

The business of check cashing was first regulated in North Carolina in 1997. By law, check cashers now have to be licensed by the Commissioner of Banks and are subject to restrictions on rates and business practices. The maximum amount that a check casher can charge for a government check is 3% of the face amount of the check; for a payroll check, the maximum rate is 5%; and for a personal check, 10%. There are now 176 check cashing companies licensed to do business in North Carolina with a total of 862 office locations.

One of the more controversial aspects of the new check cashing act is its limited authorization of cashing postdated or deferred deposit checks. Under this procedure, a consumer who has no funds in his checking account can cash a check with an agreement that the check will not be deposited until a later date, usually on the consumer's payday. The law allows the check casher to retain up to 15% of the amount of the check, with a maximum check amount of $300. For example, a consumer who cashes a $100 check on the 15th of the month would receive $85 and a promise that his check would be held for 2 weeks. Although described as a type of check cashing, this transaction is really a short term loan with an annual percentage rate of approximately 460%.

In advocating for the payday lending provision in the law, the check cashing industry contended that there was an unmet demand for short-term cash advances for consumers who did not have credit cards. Many consumers exist from payday to payday, without significant savings, and may experience temporary financial emergencies, such as a car repair. Most banks and finance companies will not make loans of $100 or $200, so check cashing services are a convenient, albeit costly, means to get a quick infusion of cash when the consumer has to pay a bill when his bank account is empty.

The danger of using check cashing services as a source of credit is that it can become a very expensive habit. Before the law was enacted, there were some check cashers around military bases who would typically charge $25 to cash a $100 check, and then allow the consumer to "roll over" or renew the check for another $25 fee after two weeks. It was not uncommon for the consumer to pay out more in renewal fees than he received in the cash advance. Consumers would also go to another check cashing branch location to borrow funds to pay off the first check casher.

The new law is intended to restrict this debt treadmill scenario by prohibiting cashing a new check to pay off outstanding checks. The law also requires a signed loan agreement with disclosure of the effective interest rate. The deferred deposit provision of the law expires in 2001 unless the General Assembly renews the authorization. In the meantime, the Commissioner of Banks is supposed to examine check cashing operations and report on complaints, abuses, or patterns of excessive use of these loans.

Finance companies

Finance companies typically lend in the range of $500 to $5,000 and serve a predominantly blue collar clientele. Since the 1970s these lenders have been governed by the N.C. Consumer Finance Act, which allows them to charge higher interest rates in return for licensing and strict regulation by the Banking Commissioner.

The rates on consumer finance loans depend on the category of lender and the size of the loan. Smaller (typically locally owned) lenders can charge 36% on the first $600. The 36% rate then blends with a 15% rate on amounts up to $3,000. Bigger lenders (usually national chain operations) can charge 30% on the first $1,000 and then 18% on additional amounts up to $7,500. The loans are usually repayable in monthly installments over two to five years.

The most common abuses in consumer finance lending are referred to as "packing" and "flipping." Packing is the practice of adding unwanted extras to the loan contract, usually in the form of credit insurance. Finance companies can sell four forms of credit insurance: life, accident and health, property, and unemployment. These policies can pay off the loan balance but offer no other benefit to the borrower. The premiums are very high, are prepaid and then financed at rates up to 36%, and are almost always a bad investment for the borrower. Credit insurance offers generous commissions, so there is a strong incentive for the loan officer to sell or "pack" the loan with as many forms of insurance as possible.

Flipping is the repeated refinancing of the consumer's loan. When the consumer has paid down the loan slightly, the finance company may offer additional cash and encourage the consumer to refinance. The new loan offers another opportunity to sell more credit insurance as well as to raise the loan amount and to extend the borrower's obligation. The effect on the borrower, of course, is to remain in debt and never reach the final payment on the loan.

Mortgage brokers

Most consumers who contact a reputable mortgage broker to arrange a loan would expect their broker to find a home loan at the lowest possible rate. In the subprime market with more unsophisticated consumers, there are mortgage brokers and lenders who do just the opposite. That is, the broker will attempt to sell the borrower on a loan with the most fees and highest rate possible so that the broker and lender will get more compensation. As a real life example, a broker recently arranged a $48,000 home loan for a borrower in Fayetteville which included a $4352 origination fee, $1089 in points, a $175 "underwriting" fee, a $200 "processing" fee and a $175 "document prep" fee, in addition to standard closing costs. After paying monthly payments of over $400 for 15 years, this elderly consumer would owe a balloon payment of $43,000. The borrower was unaware of the balloon payment provision until well after the loan closed.

Many brokers and lenders promote "bill consolidation" home equity loans. Their advertisements purport to show that the consumer's monthly payments will be decreased when he consolidates credit card, automobile, and retail debt into one mortgage loan. The problem is that the borrower is trading short-term debt, usually payable over two to four years into long-term debt payable over 15 to 30 years. And the consumer's house is on the line if he defaults on making payments. For many consumers, home equity is their primary, and possibly only, pool of savings or investment. Aggressive lenders will seek to lend up to, and sometimes over, the value of the home, and then encourage the borrower to refinance (with additional fees and costs) as soon as any equity is available.

The rates and terms for first mortgage home loans are almost completely unregulated in North Carolina. The theory is that the market will control rates, and it does, for the majority of consumers. However, in the subprime market where competition is not effective, there are few regulatory mechanisms to protect against predatory lending practices. Under current state law, mortgage brokers and lenders must register with the Banking Commissioner but there are numerous exemptions from the registration requirement, and the Commissioner has limited oversight authority. Unlike car salesmen and beauticians, individual mortgage brokers do not have to be licensed or meet any minimum professional requirements, although consumers rely on their expertise to handle home loan transactions in excess of $100,000.

These are the main sources of subprime credit, but there are other specialized categories as well. Motor vehicle dealers can arrange credit through out-of-state lenders who specialize in financing consumers with credit problems. Typically, these consumers will pay a higher price for a car in addition to paying the maximum interest rate of 29% for a used car credit sale. Secured credit cards with minimal credit lines are available at high rates and fees. Car title pawning, where the borrower "pawns" his car title to secure a loan at pawnbroker rates of 20% to 25% per month, exists in a number of Southern states but has not been legitimized in North Carolina.

Educational Bulletin: Pyramid Schemes

by Kristina Lanning, Assistant Attorney General, NC Department of Justice
Pyramid schemes are experiencing a resurgence in the United States. They currently rank in the top five categories of consumer fraud. The North Carolina Attorney General joined forces with the Federal Trade Commission and 26 other states recently in a law enforcement sweep to attack this problem. The sweep is focusing on pyramid schemes that use the Internet. Law enforcement officials first surfed the 'Net on March 10 and 11, 1999, to identify possible targets. Companies operating as pyramid schemes will be issued a warning. If the illegal activity continues, law enforcement agencies will sue.

Scams disguised as legitimate businesses
Pyramid schemes are essentially confidence games. Some organizers go to great lengths to cloak the scheme with all the trappings of corporate America to look like a legitimate business. Company headquarters may be in a high-rent office building, the officers may dress in classic business suits, and the company may even offer quality products. In other cases, the facades are not as painstakingly developed, such as those where the companies' addresses turn out to be drop boxes and the products are worthless coupons or miracle devices like laundry balls or fuel magnets.

All pyramid schemes promise great wealth, often for little effort. A frequently used slogan is, "All you have to do is get two and help them get two." In theory, a participant will recruit people who in turn recruit others and all become part of the original participant's "downline." Participants' earnings are based on all of the sales in their downlines. The people who join early usually do make money. Although these participants are typically insiders, their success is touted in testimonials and further enhances the ability of the scheme to attract new recruits.

Ultimately all pyramid schemes fail, and the vast majority of participants lose money. If the doubling plan promoted by the organizers actually worked as they claimed, within just 28 levels there would be more participants in the program than the entire population of the U.S. In reality, after the first few levels in the downline have been developed, the attrition rate becomes very high. Large numbers of participants drop out or become inactive because they cannot recruit new participants.

The primary influx of money into a pyramid scheme occurs when new recruits signing up simultaneously purchase products. Even though the products may be bona fide, they are greatly overpriced. Therefore, it is rare for any products to be sold to members of the consuming public who are not participants in the scheme.

Pyramid scheme organizers are greedy, and they often employ additional methods to further generate revenue. One common technique is to go back to the participants who remain with the company held by the promise of great wealth. The organizers convince these "true believers" that things will really take off if they attend company sponsored motivational seminars -- for a large fee. New sales materials, video tapes, and Web sites are also sold under the guise of necessary tools for success. Participants are encouraged to show continued loyalty to the company through subsequent purchases. In the most sophisticated of pyramid schemes, participants are even sold shares of stock.

At some point, either a law enforcement agency will step in or the pyramid will collapse when it is no longer able to recruit new participants. Unfortunately, all too often the organizers or the insiders who made money will leave the old scheme only to start a new one. They will go straight back to the true believers and seek out unsuspecting recruits under a new company identity. The organizers claim everything is different. They have a new product or new management, or the previous legal misunderstandings have been resolved.

Pyramid warning signs

The bottom line for consumer awareness is: No matter what a company looks like, if the focus is on recruiting, it is probably a pyramid scheme. Other warning signs include:

- Participants "pay to play." They are told the more they buy, the more they earn.

- "Opportunity meetings" emphasize potential earnings with little attention on the products.

- Pyramid scheme promoters often make comparisons to legitimate corporations and the government, pointing out that the person at the top makes the most money. What they fail to state is that legitimate organizations do not seek an unlimited number of employees, only sell products to employees, or pay employees for recruiting new employees.

North Carolina law

Operation, promotion, and participationin a pyramid scheme are against the law in North Carolina under N.C.G.S. § 14-291.2. The statute makes illegal any plan in which a participant (a) pays money (b) for the chance to receive money (c) upon the introduction of new participants into the program. The statute specifically states that it does not matter if the participant receives goods or services for the payment of the money.

Even when a multi-level plan does not violate the pyramid law, the marketing of the plan may violate North Carolina's Unfair and Deceptive Trade Practices Act, N.C. General Statute § 75-1.1 et seq. A marketing program may violate the Act if the following statements are made:

- Claiming that a certain amount of money can be earned without substantiating that the amount specified has been made by a substantial number of people over a period of time.

- Saying that the Attorney General's Office, Better Business Bureau, Chamber of Commerce, or any other organization endorses or has approved the marketing plan. Neither the Attorney General, the Better Business Bureau, nor the Chamber of Commerce ever endorse or approve specific plans.

The attorney general has the responsibility and authority to assure compliance with the above laws. (District attorneys may also bring criminal charges. As of December 1, 1997, the organizers of pyramid schemes are subject to felony charges.) Individuals may file written complaints with the Consumer Protection Section, P.O. Box 629, Raleigh, NC 27602.

Recent cases

The North Carolina Attorney General's office is sending a message that North Carolina is hostile territory for pyramid schemes. In the past two and one-half years, Club Atlanta Travel, Destiny Telecomm, TeleCard Network, International Heritage, Aspire 2000!, People's Choice Network, and Bankers International Trust have either been sued or have entered into agreements requiring dramatic changes in their operations. All are now out of business.

Consumer Alert: Travel Scams

by Harriet Worley, Assistant Attorney General, NC Department of Justice

PACK YOUR BAGS! YOU ARE CONFIRMED TO TAKE A THREE-DAY, TWO-NIGHT TRIP TO FLORIDA AND THE BAHAMAS. You have probably received more than one solicitation that begins with these words. North Carolina and several other states have recently taken actions against a number of companies based in Florida that have sent out hundreds of thousands of these solicitations. We have succeeded in getting restitution for many consumers who paid for the trips but were never able to take the trips.
During its ongoing investigation of this industry, the Attorney General's Office has found that many consumers have been misled about the details of the solicitation and the trip. When they first receive these solicitations, many consumers are convinced that they have won a trip because the solicitation does not indicate that there is a cost associated with the vacation. Consumers are also led to believe that they must respond immediately or lose this opportunity.

Only after calling the toll-free number, listening to a lengthy script read to them by a telemarketer, and then being asked for their credit card information do consumers realize that the trip is not free. In other instances, consumers have signed up to win a free trip while attending a trade show or exhibition and then receive a call telling them they have "won" a trip. Again, only after listening to the sales pitch are consumers told they must pay for the "free" trip.

Consumers are usually told that the trip is one low price -- a great savings over what they would pay on their own. However, the trip is not a bargain, and consumers later find that, in addition to the price they are quoted on the telephone, they must also pay "port fees" which are represented to be fees the company pays directly to the government. The fees represented as "port fees" are usually much greater than what the company actually has to pay to the government, so the travel company is using the additional fees to offset their cost for providing the vacation.

Additionally, consumers are not told that the purpose of the trip is to solicit them to purchase a time share. In most instances, consumers are required to sit through a lengthy, high-pressure time share sales presentation. The presentations are represented to be only 90 minutes, but many consumers report sitting through several hours of presentation without feeling they could leave.

Consumers also complain about the quality of the trips. The sales pitch entices consumers with promises of "world-class" or four-star and five-star accommodations, but those who have taken the trips sometimes report that the accommodations are not as represented. Consumers tell of ferry boat rides to the Bahamas instead of rides the luxury cruise ship that was advertised. Consumers also complain about staying at hotels miles from the beaches when they were shown pictures of beachfront hotels.

If consumers receive a solicitation that promises exciting vacations at low costs or if they are told they have won a trip, the Attorney General's Office warns consumers to be cautious, and to ask questions about the "deal." Before giving out credit card information, consumers should find out the total cost of the trip, what is included in that cost, the name of the hotel where they will be staying, and any information about cancellation rights. Consumers should not be pressured into making a hasty decision while on the telephone with the telemarketer. A legitimate business won't force a customer to make a decision right away. If a consumer is told he or she has won a prize, North Carolina statutes require that the business provide that prize to the winner within 10 days at no expense to the winner. Consumers should never pay to redeem a "free prize."

News Release: Home Repair Fraud Indictments

by David N. Kirkman, Assistant Attorney General , NC Department of Justice
On September 24, 1997, North Carolina Attorney General Mike Easley announced 64 felony indictments against 26 individuals for allegedly operating a major home repair scam in North Carolina and Virginia. The scam targeted elderly home owners. Many of the home owners lost $100,000 and more to this network through a series of expensive, unnecessary repairs. The 64 indictments were obtained by Easley's State Bureau of Investigation and were prosecuted by the office of the Wake County District Attorney, Colon Willoughby. When the 64 indictments were announced, Easley stated that many more would follow.

Since September, 1997, the State Bureau of Investigation, District Attorneys in Durham, Franklin, Johnston, Pitt, Robeson, Vance, Wake, Wayne, and Wilson Counties, together with numerous local law enforcement agencies within those counties, have brought an additional 328 indictments against more than 60 individuals. To date, those state charges have resulted in more than 250 guilty pleas or guilty verdicts, according to State Bureau of Investigation figures. Many cases are still pending in the courts. In addition, 15 individuals have been charged and convicted in Federal Court on charges related to the scam.

In late 1995, Easley organized a multi-agency task force when his Consumer Protection Section discovered the existence and size of the home repair scam network. Within two months, representatives of three dozen federal, state, and local law enforcement agencies comprised the task force. Easley's task force studied the structure and techniques of the scam network and compiled intelligence on its members. Its list of suspects and participants grew from 18 names to well over 100 names within six months.

In the fall of 1996, North Carolina-based DEA and IRS representatives on the task force brought federal drug possession and tax reporting charges against the reputed ring leaders, Robert H. House, Sr. and Robert H. House, Jr. of Rocky Mount, North Carolina. On August 24, 1997, the two received sentences of 15 1/2 years and 11 years respectively. Four of their co-defendants received federal sentences ranging from one to eight years.

Also in late 1996, members of the task force in the FBI's Richmond, Virginia, office brought federal fraud charges against Anthony F. Mazza, Jr. of Raleigh, North Carolina, reputed to be the No. 2 man in the organization, as well as six others. After pleading guilty in the U.S. District Court for the Eastern District of Virginia, Mazza received an 11-year sentence, and his co-defendants received federal sentences ranging from two to eight years.

The organization's typical repair scam began with repairmen knocking on an elderly person's door and offering to clean gutters or powerwash the home. They would then report to the home owner, falsely, that the roof was rotted or the chimney was separating from the house. After securing large sums of money for performing supposed repairs, they would ask to inspect other portions of the premises where the elderly home owner was unable to go, such as attics or crawl spaces. After making such inspections, they would conjure up other problems, such as bug infestations, sagging attic beams, rotting floors, etc. In addition, the scammers often would seek and maintain the affections of their victims by regularly taking them to the store, to lunch or on errands, by bringing them flowers, birthday presents, and other gifts, and by holding lengthy and regular conversations with them concerning their families.

In the course of two years, the scammers obtained $267,000 from a blind, 92-year-old Raleigh man for unnecessary and fraudulent repairs. Five other victims who lost more than $100,000 each resided in the Raleigh area, and several other $100,000+ victims resided in communities across North Carolina. The scam ring was featured on ABC Television's "Prime Time Live" in March 1997.

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