

**Federal Trade Commission**

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April 7, 1986

Senator Kirby Holmes
Senate State Affairs, Veterans,
and Transportation Committee
Post Office Box 30036
Lansing, Michigan 48909

Dear Senator Holmes:

The Federal Trade Commission's Cleveland Regional Office is pleased to respond to your invitation to comment on Substitute House Bill 4588, which is under consideration by the Michigan Legislature. ^{1/} In these comments, we first discuss certain general competitive considerations raised by the proposed legislation concerning the sale of "pre-need" funeral goods and services. We then specifically address the issues of trust arrangements and alternatives to them, restrictions on who can be escrow agents, restrictions on interest rates, and the requirement that a specific provider be identified at the inception of the contract.

The Federal Trade Commission seeks to promote competition among members of licensed professions to the maximum extent compatible with other legitimate state and federal goals. For several years, the Commission has been investigating the effects of restrictions on the business practices of professionals, including optometrists, dentists, lawyers, physicians, funeral directors, and others. Our goal is to identify and seek removal of restrictions that impede competition, increase costs, and harm consumers without providing countervailing benefits.

The Commission has pursued this goal actively in the funeral industry. As you may be aware, the Commission's Funeral Industry Trade Practices Rule ("Funeral Rule"), 16 C.F.R. Part 453, became effective in full on April 30, 1984. The purpose of the Funeral Rule is to permit increased competition and consumer choice in the funeral industry by facilitating informed purchasing decisions by consumers. Among other things, the Funeral Rule requires providers of funeral goods and funeral services to disclose detailed information about prices and legal requirements to purchasers of funerals.

^{1/} These comments represent the views of the Cleveland Regional Office and of the Bureaus of Competition, Consumer Protection, and Economics of the Federal Trade Commission and do not necessarily represent the views of the Commission or any individual Commissioner. The Commission, however, has authorized the staff to submit these comments.

Substitute House Bill 4588 sets up an extensive regulatory scheme for the "pre-need" (or prepaid) sale of funeral goods and services. The bill requires sellers and providers of pre-need funeral goods and services to register with the Department of Licensing and Regulation ("Department"), to comply with detailed escrow requirements governing the limited permissible arrangements, to maintain extensive records with respect to all escrow arrangements, and to adhere to the limitations set forth in the bill on the amount of commission that can be charged on a sale as well as the "interest rate" that can be applied when the purchaser pays over a period of time. Also, the bill requires the designation of named providers at the time the contract is entered into, regulates cancellation of contracts, gives the purchaser a ten-day right to rescind the contract, allows the Department to promulgate rules and regulations that would govern the solicitation of pre-need sales, and sets up an enforcement mechanism.

We believe that the following comments, which discuss in general the regulatory scheme established by the bill as well as several specific restrictions, will assist you in evaluating the bill's possible effects on competition and consumers.

A. General Comments.

Pre-need sales of funeral goods and services are a rapidly growing way of marketing many of the goods and services involved in funerals. These sales appear to have significant potential for offering consumers opportunities they did not have before. For example, pre-need arrangements enable consumers to make buying decisions without the time or emotional pressures associated with at-need purchases.

Because pre-need sales are relatively new, providers are still learning which methods of marketing are most feasible and consumers are still learning which are most useful. It is especially important to allow a new form of marketing goods and services, such as pre-need sales, to develop without unnecessary or overly burdensome regulation so that consumers can reap the benefits of new, creative forms of competition. Through innovation and experimentation, these benefits can become available to consumers.

Restrictions on the business practices of licensed professionals can reduce competition by preventing the introduction and development of innovative forms of practice that may be more efficient, provide comparable quality at lower prices, and offer competitive alternatives to traditional providers. For example, in a case challenging various ethical code provisions enforced by the American Medical Association (AMA), the Commission found that AMA rules prohibiting physicians from working on a salaried basis for a hospital or other lay institution, and from entering into partnerships or similar business relationships with non-physicians, unreasonably restrained competition and thereby violated the antitrust laws.^{2/} The Commission

^{2/} American Medical Association, 94 F.T.C. 701 (1979), aff'd, 638 F.2d 443 (2d Cir. 1980), aff'd mem. by an equally divided Court, 455 U.S. 676 (1982).

concluded that the AMA's prohibitions kept physicians from adopting more economically efficient business formats and that, in particular, these restrictions precluded competition by organizations not directly and completely under the control of physicians. The Commission also found that there were no countervailing procompetitive justifications for these restrictions. 3/

We also recognize that Michigan has a legitimate interest in protecting the investment of pre-need purchasers and in preventing fraudulent or deceptive practices. Most important, because pre-need purchasers may pay a substantial sum of money for goods or services that may not be provided for many years, there is a need to ensure that there will be funds and providers to deliver these goods and services at the time they are required. 4/

However, when adopting regulatory measures in order to protect the pre-need consumer's investment or prevent abuses, the Legislature should at the same time be aware that consumer injury may occur when regulation stifles price competition and inhibits innovation. The appropriate way to achieve the optimal balance between protecting pre-need purchasers on the one hand, and facilitating competition and innovation on the other, is to strive to find the least restrictive means to protect consumers against insolvency, fraud, and deceptive practices. Balancing these considerations in this way assures that consumers will receive adequate protection while allowing the market to function in the freest possible manner. This is particularly important when dealing with a relatively new and growing form of distribution, such as pre-need funeral sales, where regulation may have a disproportionate impact on innovation.

In the remainder of this letter, we will comment on specific portions of the bill in light of these general comments.

3/ In another example, the Commission recently issued a notice of proposed rulemaking for a trade regulation rule that would preempt state laws and regulations that ban, among other things, employment or other business relationships between optometrists and non-optometrists. In its notice, the Commission stated that public restraints on forms of ophthalmic practice appear to increase prices without providing offsetting public health or safety benefits. 50 Fed. Reg. 598, 599-600 (1985).

4/ On the other hand, one of the factors that led to the promulgation of the Federal Trade Commission's Funeral Rule — the particular vulnerability that relatives or close friends of a recently deceased person may have to certain kinds of pressure because of grief and a short time to make arrangements — is not present to nearly the same extent in pre-need sales.

B. The Provisions Concerning the Disposition of Money Paid by Purchasers.

Substitute House Bill No. 4588 sets up detailed procedures for the handling and accounting for funds paid by pre-need purchasers, apparently to ensure that adequate funds will be available at the time the funeral goods and services will be needed. 5/ The linchpin of these procedures is a detailed escrow arrangement, often referred to as a "trust requirement." While the bill in its present form would ensure the availability of funds, it would do so at a significant — and, perhaps, unnecessary — cost to consumers.

The bill states that "all funds received in connection with a prepaid funeral contract shall be held in escrow." 6/ It then provides that "an additional commission of not more than 10% of the contract price" may be charged, and that the commission is not subject to the escrow requirement. 7/ Finally, it provides detailed procedures for the handling and disbursing of the funds kept in escrow. 8/ Thus, while the bill uses language similar to that used in the "100 Percent Trust" laws (laws requiring that 100 percent of the pre-need funds received be put in trust), it is really a 91 percent trust law — i.e., it requires at least 91 percent of the total funds paid to be put in trust.

This particular escrow arrangement will probably provide adequate assurance that there will be funds available to pay for the goods and services at the time the contract beneficiary dies. However, it may also unnecessarily increase the cost consumers incur in purchasing funeral goods and services on a pre-need basis. We first address the general impact of a trust requirement and then suggest an alternative way to guarantee the performance of the pre-need seller which avoids some of the anticompetitive risks posed by a trust requirement.

5/ The bill includes several provisions apparently aimed at ensuring that there will be funds and providers to deliver the goods and services at the time of need. See, for example, Sections 6 and 8 (requiring registration and reporting by contract sellers and providers), Section 9 (requiring reassignment of contracts by any provider who goes out of business), and Section 11 (requiring that a provider be designated and obligated at the inception of the contract).

6/ Section 12(1)

7/ Id.

8/ Section 12(2) - (11).

1. The Impact of a Trust Requirement.

Some states have determined that trust requirements are an appropriate regulatory mechanism for protecting the pre-need consumer's investment, and for preventing fraud and other abuses.^{9/} Nevertheless, a trust requirement — most obviously, a 100 percent trust requirement — can have unintended anticompetitive consequences that injure consumers. Thus, although a trust requirement will provide some benefits to consumers, the Legislature will want either to select carefully the level of trust to avoid competitive harm or to consider alternative arrangements that provide the same benefits but do not have the same anticompetitive potential.

While Substitute House Bill 4588 sets a trust requirement that is less than 100 percent, the potential problem that it poses is one similar to that raised by a 100 percent trust requirement. One hundred percent trusts require that all funds paid by the consumer must remain in a trust fund until death occurs. Under this requirement, the seller cannot recover its financial outlay for overhead, selling and administrative expenses, or a competitive rate of return until an uncertain, possibly distant future date. Many potential sellers may be unwilling or unable to cover the initial costs of pre-need sales (either by using their own capital or by financing these costs) for a lengthy, indefinite period of time. This requirement may therefore discourage competitors from entering the pre-need market. Fewer sellers and the resulting reduced competition in the pre-need market can cause injury to consumers by depriving them of the lowest prices for the goods and services they wish to purchase and of the full array of pre-need alternatives and pricing options that would otherwise be available.

A trust requirement that is less than 100 percent, such as one that simply specifies the amount of money that must be put in trust (for example, the wholesale cost of the goods), may still raise competitive concerns. If the amount of money required by law to be placed in trust, added to the amount the seller needs up front, exceeds the price that the market would set for the whole transaction (absent legislative intervention), then the trust requirement has the effect of raising the price consumers must pay for the goods and services. If this increase in price is not offset by an increased benefit to the consumer (i.e., a reduction in the risk of non-performance), then the trust requirement will make the pre-need goods and services unattractive to the consumer. As a result, a source of competition for at-need sellers will be

^{9/} There are myriad ways in which a trust requirement might be set up, including requiring that some percentage of the retail price for the goods and services be placed in escrow, or requiring that some percentage of the wholesale price of the goods and services be placed in escrow.

discouraged. 10/

Ideally, if a trust requirement is to be imposed, it should be set at a level that will provide protection to consumers at the level they desire while having the least competitive impact. This means the Legislature must undertake the task of determining how much money is adequate to ensure the achievement of that level of protection. This task is difficult, and it is practically impossible without extensive investigation and study. In addition, as market conditions change, the optimal trust level may well change. If the Legislature wishes to establish a fixed trust level that will continue to protect consumers but not raise prices unnecessarily even as market conditions change, it should either routinely reevaluate this level or set up an administrative mechanism to do so. Both of these alternatives are costly in time and tax dollars.

2. An Alternative Guarantee.

Rather than attempt the difficult task of determining the precise trust requirement that will adequately protect consumers with the minimum adverse impact on competition, the Legislature may wish to examine an alternative guarantee, the performance bond.

In analogous types of sales where delivery is deferred or occurs over an extended time, performance bonds have been an effective means of protecting the consumer's investment. For example, in three recent Commission cases, health spa businesses were charged with, among other things, failing to fulfill contracts with customers and retaining customers' money without offering or making refunds. 11/ The consent judgments in those cases prohibit the spa operators from accepting any payment for a spa membership in advance of providing promised services unless performance bonds have been obtained. The consent judgments specify that the bond amount must be for at least \$50,000 or enough to provide refunds to all health spa members in the event that a spa fails to open or closes before all the services are provided.

10/ A trust requirement can affect price in less obvious ways. For example, a high trust requirement — combined with a cancellation clause like that found in Section 13 of the bill — will indirectly raise costs. One option that is open to sellers who want more money at the inception of the contract is to borrow the money, using the escrow account as a form of security. The seller will include the cost of borrowing in the cost of the pre-need goods and services. If the consumer can cancel the agreement at will, the lender will feel less secure and raise the interest rate the seller pays. This additional cost will, of course, be passed along to the consumer in the form of a higher price for pre-need goods and services. Competition with at-need sellers will again be reduced.

11/ FTC v. Lady Venus Centers, Inc., No. 3-84-0158 (M.D. Tenn. Feb. 16, 1984); FTC v. Tyler-Radcliffe Co., Inc., No. 3-84-0159 (M.D. Tenn. Feb. 16, 1984); FTC v. Thor Enterprises, Inc., No. 84-2121-MA (W.D. Tenn. Feb. 16, 1984).

A performance bond can be written to ensure that the guarantor stands ready to pay for the goods and services if the seller cannot provide them, so that the consumer is protected from seller default whether it is caused by fraud or insolvency. 12/ In addition, because guarantors compete among themselves for the performance bond business, the price of these bonds and the requirements on sellers (whether they be escrow arrangements or otherwise) will be set in the most efficient manner by the market. Guarantors will be able to determine requirements individually for each seller, providing adequate protection at the lowest cost. 13/

If the Legislature elects to require performance bonds, it will no longer be necessary to restrict the money a seller can keep for its own use at the time the contract is signed (the commission). We believe that the restriction on commission is an undesirable feature of the bill, one that may potentially injure consumers. To the extent that a commission is inadequate to cover the cost of overhead, selling and administrative expenses, and the competitive rate of return that sellers believe they need at the inception of the contract, they are either discouraged from entering the market or forced to raise the price of the pre-need goods and services to compensate for this. In either case, consumers will be disadvantaged. 14/ A performance bond eliminates any need for regulating the commission and therefore benefits consumers by reducing the risk that unnecessary costs will be incurred and that competition will be weakened.

Thus, a requirement that pre-need sellers obtain performance bonds to guarantee the delivery of prepaid funeral goods and services is a viable, less costly, and procompetitive alternative that the Legislature should consider.

12/ The best performance bond for consumers is not necessarily one with 100 percent coverage of the goods and services promised in the contract. The Legislature may want to consider whether some reduction of a performance bond requirement from 100 percent will save consumers more money in fees for the bond than it will cost them in lost goods and services.

13/ One particular seller may be a better risk than a second one, for example, because of a large fixed-asset base. If the lower risk seller is charged a lower fee for a performance bond, the seller can pass that savings along to consumers. In addition, it may be reasonable to put fewer restrictions on the lower risk seller, for example, a lower escrow requirement. This can only be done if sellers are dealt with individually.

14/ On its face, Section 12 of Substitute House Bill 4588 sets a maximum "price" for the allowable commission. If, in fact, the 10 percent limit were substantially in excess of the total of the cost of overhead, selling and administrative expenses, and the competitive rate of return that the seller required at the inception of the contract to run its business most efficiently, there would be no harm because competitive forces would drive down the amount of commission actually charged. However, a 10 percent commission may not provide an adequate amount of money at the time the contract is initially signed for every legitimate method of marketing pre-need funeral goods or services. If the initial compensation (the commission) is inadequate, sellers either must finance their need for cash (and pass that additional cost along to consumers) or they simply may not enter the market (reducing competition).

C. The Limitation on Who Can Be an Escrow Agent.

Section 12(2) of Substitute House Bill 4588 lists institutions that may act as escrow agents. Various financial institutions are allowed to act as escrow agents and a non-profit corporation set up by 250 funeral homes or 250 cemeteries may also act as the escrow agent.^{15/} While the bill contemplates that there will be sellers other than funeral homes and cemeteries, it does not allow any other group of sellers to set up a similar non-profit corporation as an escrow agent.

If the Legislature elects to keep an escrow arrangement, we believe the designation of responsible financial institutions as escrow agents is meritorious. However, we are concerned that the restriction that non-profit groups functioning as escrow agents must be composed of at least 250 funeral homes or cemeteries may be more restrictive than necessary. While we cannot advise the Legislature on the number of firms that need to be included in such a non-profit organization, we would encourage the Legislature to consider whether organizations with fewer than 250 members would be financially sound enough to protect the funds it holds in escrow. We would also encourage the legislature to consider whether it might be advantageous to permit both funeral homes and cemeteries to participate jointly in a single non-profit organization.

Further, we are concerned that, under the bill, pre-need sellers who do not operate funeral homes or cemeteries (e.g., organizations that sell only funeral goods or organizations that sell both funeral goods and services but always contract with providers for delivery) are not able to form or participate in non-profit organizations that provide escrow services. If there are significant cost advantages from using a non-profit organization rather than a financial institution as an escrow agent, the failure to provide this option to alternative sellers of pre-need funerals could place these sellers at a competitive disadvantage.

D. The Limitation on the "Interest" that May Be Charged on Pre-Need Contracts Paid Over Time.

Substitute House Bill 4588 limits to 10.5 percent the "interest" that may be charged on a pre-need contract that the consumer pays in installments. Assuming the interest rate is clearly disclosed to the consumer before the contract is signed (as federal law requires, 15 U.S.C. § 1601, et seq.), we fail to see how this provision protects consumers from fraud or deception, whereas it may have a substantial anticompetitive impact.

^{15/} According to our information, there are currently approximately 2100 funeral directors licensed in the State of Michigan, but only about 285 licensed cemeteries. This number does not include cemeteries operated by municipalities or religious organizations because these types of cemeteries are not licensed under Michigan law.

If the market interest rate again rises above 10.5 percent, as it has done in the recent past, then the bill will artificially set a below market ceiling on the interest that can be charged, and sellers will find offering this service financially unattractive. This will discourage sellers from offering the service in Michigan, thus depriving consumers of the additional choice of paying on an installment basis. ^{16/} Competition with at-need sellers will be further weakened.

E. The Requirement that a Specific Provider Be Identified and Obligated Before the Consumer Pays.

Substitute House Bill 4588 requires that guaranteed price contracts for pre-need goods and services designate a specific provider, and that the seller have a contract with that provider to supply the goods and services before the consumer pays any consideration. ^{17/} This provision presumably is intended to ensure that the consumer receives the goods and services when they are required.

We are concerned that, although this provision may not materially handicap sellers in the pre-need market as this market is currently structured, the requirement may discourage innovation that could be of substantial benefit to consumers. For example, if a seller wished to offer pre-need goods and services that a purchaser could use anywhere in the State of Michigan, or even in the entire United States, this provision in Substitute House Bill 4588 would make that virtually impossible unless the seller could find a provider who could deliver service over a very large area. More mobile consumers could be deprived of the benefits of pre-need sales that are available to consumers who expect to stay in one location for the remainder of their lives. By reducing the demand of mobile consumers, this provision would reduce the competitive impact of pre-need sellers.

^{16/} This provision could have the curious effect of allowing the consumer to pay for pre-need funeral goods and services in installments only by setting up two separate transactions (i.e., by negotiating the loan from a totally separate entity that is not subject to the 10.5 percent interest rate limitation, such as a consumer finance company), but prohibiting the consumer from achieving an identical result in the more convenient form of having one seller for both the sale and the financing.

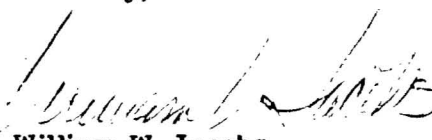
^{17/} Section 11. A guaranteed price contract is one that sets a fixed price for the goods and services and does not allow for the imposition of any additional charges.

The Legislature may wish to consider whether there is a less restrictive way to provide consumers with adequate guarantees of performance, particularly because this provision may be wholly or partially redundant when coupled with a performance bond or an adequate trust requirement. For example, it may be sufficient to identify an association or organization of providers that can furnish the goods and services in multiple locations. Furthermore, a performance bond (discussed above) could be structured to require the guarantor to pay for performance even if the person making the arrangements for the contract beneficiary was forced to locate another provider because the seller failed to perform. In this case, although consumers may be inconvenienced, they would not lose any money, making it unnecessary to identify a specific provider at the inception of the contract.

F. Conclusion.

We have focused our comments solely on those portions of substitute House Bill 4588 that appear to be of particular competitive impact. We do not necessarily endorse the remaining provisions of the bill, but rather express no opinion on them. We hope that our comments concerning the competitive and consumer protection aspects of certain types of pre-need trust agreements, restrictions on commission, escrow agents and interest, and the requirement to designate a provider will assist you in your deliberations on Substitute House Bill 4588. We appreciate having had the opportunity to present our views.

Sincerely,



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