

IN PRACTICE

REAL ESTATE

Truth-In-Lending Act Protects Lenders as Well as Borrowers

The right to rescind requires the ability to repay

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The effects of last year's economic debacle weave through many industries. Yet, despite widespread cutbacks and pencil sharpening, some legal fields actually flourish during periods of national economic instability. For example, attorneys specializing in bankruptcy or foreclosure work have seen our nation's recent financial struggles spark an increase in their workloads. Indeed, there has been the birth of an entirely new cottage industry resulting from the foreclosure crisis we now find ourselves in.

In typical entrepreneurial fashion, legions of attorneys responded to the recent surge in foreclosures by providing assistance to embattled debtors who have failed to fulfill obligations under their respective mortgage contracts. In the midst of this assistance, as attorneys representing borrowers searched

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for arguments which may potentially be more successful than the usual suspect foreclosure defenses of the past, a new legal niche has emerged, one which focuses on the rescission option provided in the Truth In Lending Act. 15 U.S.C. Section 1601 (2009), et seq. While rescission under the Truth In Lending Act does not always lead to a complete "victory" for borrowers, it has certainly lead to headaches for lenders, due to its overly technical requirements and strict enforcement.

The Truth in Lending Act, commonly referred to as "TILA," is a complex, federal statute meant to provide consumers with clear and accurate information regarding their loans in an effort to ensure that borrowers are fully aware of all costs and fees associated with the transactions into which they are entering. TILA, however, is now more frequently used as a loophole of sorts, which provides highly technical "letter of the law" rescission defenses to struggling mortgagors seeking relief from contractual obligations under their loan agreements. Some of the material disclosures required include: amount financed, payment schedule, finance charge, amount borrowed (in a refi-

nance), explanation of variable interest rates, mortgage balloon payments and annual percentage rate. If any of these numbers are misreported, miscalculated or improperly disclosed, the borrower may be permitted to rescind the mortgage. In fact, once a lender attempts to foreclose a mortgaged property, special expanded rescission rules apply. The language of the statute provides that rescission is appropriate if certain mortgage fees (specifically, the finance charge) are understated by as little as 35 dollars. 15 U.S.C. 1635 (i); 12 C.F.R. 226.23(a)(3).

Specifically, TILA grants the right of rescission, under certain circumstances, to borrowers involved in refinancing or borrowing money for home improvement loans. Rescission is not available for borrowers who have a purchase money mortgage. Initially, Section 1635(a) allows for rescission for any reason within three days of the consummation of the transaction. However, Regulation Z, 12 C.F.R. Section 226.23(a)(3) (2009) further states that "[i]f the required notice or material disclosures are not delivered, the right to rescind shall expire 3 years after consummation, upon transfer of all of the

consumer's interest in the property, or upon sale of the property, whichever occurs first." Recently, the language in Section 226.23 allowing borrowers to rescind where proper "notice or material disclosures" have not been made, has become an escape hatch for borrowers who are unable or unwilling to fulfill contractual obligations under their loan agreement. Rescission, it seems for many, has become a much more attractive alternative than foreclosure or continued payment.

Rescission Under TILA

As word began to spread that foreclosures were being successfully thwarted through TILA's strictly interpreted notice and disclosure requirements, the TILA-rescission-request brushfire was lit. Rescission under TILA essentially allows borrowers to avoid their obligations under the loan contract if they agree to return the loan monies, after the lender releases its security interest on the mortgaged property and returns any fees paid by the borrower.

Once the rescission request is made, the literal language of TILA requires the lender to discharge the mortgage before any money is returned to the lender. This requirement, forcing lenders to give up their security interests before the loan proceeds have been returned, caused concern among lenders because it leaves lenders without the money they loaned and without a practical way to obtain it. Consequently, with foreclosures on the rise, attorneys representing borrowers began to invoke the language of Section 1635(b), and arguments requesting rescission based on these TILA sections appeared in rapidly increasing numbers across numerous jurisdictions.

So, was this the loophole that struggling borrowers were looking for? Do the majority of courts honestly believe that even the most minute and technical requirements of TILA require a lender to discharge its lien without a practical or meaningful way to recover the money loaned to a borrower? As is often the case, many courts have responded with an equitable solution. Despite the language Section 1635(b), lenders can

breathe a little more easily because the case law that has developed, does, in fact, provide an equalizer for lenders facing a rescission request. Quite simply, in order to rescind, a borrower must be able to repay the loan.

Equitable Modifications to Rescission

In 1981, 12 C.F.R. Section 226.23(d) was added to the Truth in Lending Act, which permitted a court to modify procedures for rescission. Specifically, section 226.23(d) states that the rescission procedures described previously in the act "may be modified by court order." As a result, decisions across the country have held that the statute need not be interpreted as always requiring the creditor to discharge its security interest prior to the borrower's tender of proceeds. *Yamamoto v. Bank of New York*, 329 F.3d 1167 (9th Cir. 2003). Instead, many courts have read 15 U.S.C. 1635(b) and 12 C.F.R. Section 226.23(d) to mean that they have the power to review the facts surrounding a proposed rescission, in order to determine whether an inequitable result can be avoided.

Accordingly, many jurisdictions examining this issue have now held that courts have the discretion to condition rescission on tender by the borrower of the mortgaged property or the loan principal. For example, in *Apaydin v. Citibank Federal Savings Bank*, 201 B.R. 716, 722 (E.D.P.A. 1996); after the plaintiffs/borrowers refinanced their home mortgage, they had difficulty paying their mortgage and the lender initiated a foreclosure proceeding. The borrowers contested the proceeding, but judgment was entered against them. Thereafter, the borrowers discovered potential TILA violations and wrote to the lender to express their desire to cancel the mortgage loan and rescind the transaction. The plaintiffs filed for bankruptcy and filed a complaint alleging, among other things, TILA violations. Plaintiffs then filed a summary judgment motion on the TILA violations and for an order voiding the mortgage on their house.

The court found that although the lender clearly violated TILA, the

violations did not automatically void the mortgage. "Rather, to prevent a debtor from receiving a windfall, the voiding of the mortgage may be conditioned on the debtor tendering back to the creditor the consideration underlying the transaction." The Court explained that

[T]he purpose of rescission as a remedy is to undo a transaction and place the parties in the same position they would occupy had the transaction not occurred. As most courts have found, this goal must at times be accomplished by appropriately conditioning the avoidance of the creditor's security interest on the return of its property.

Moreover, the court distinguished the facts in *Apaydin* from the facts in the "distinct minority" of opinions in which courts have declined conditioning rescission of a lending transaction on the return of property by the debtor. Many of those cases involved a relatively minute sum of money. Conversely, the amount at issue in *Apaydin* was \$450,000. Thus, the "Court [could] not accept the proposition that the strict enforcement of TILA justifies rendering a debt in excess of \$450,000 unpaid and completely unsecured [A]utomatically relegating [the lender's] claim to unsecured status would be an utterly disproportionate and completely inequitable penalty."

Although lenders may face new challenges in the foreclosure arena presented by the increased level of rescission requests, it seems as though the majority of courts still honor the true definition of rescission, which ensures that both parties will be returned to their original status as if the transaction had never occurred. While the surge of rescission requests is far from the ideal for lenders who wish to have the original obligations of loan agreements honored, the restrictions placed on the right of rescission by the statute and cases mentioned above may make rescission a more difficult option to pursue than it originally seemed. ■