

Client Alert

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Third Circuit Holds that Notice Alone is Sufficient to Exercise a Consumer's Right of Rescission under TILA

On February 5, 2013, the Third Circuit weighed-in on the developing Circuit Court split regarding whether notice alone is sufficient to exercise a valid right to rescind under the Truth in Lending Act.¹ The Third Circuit's decision and the Circuit Court split, along with the CFPB's focus on this issue, create uncertainties for lenders concerning the potential invalidity of liens upon merely receiving a borrower's notice of rescission. The Third Circuit's decision also suggests that after receipt of a borrower's notice of rescission, if a lender does not consent to the rescission, then the lender may need to consider filing suit to resolve the potential lien validity issues because there may be no clear deadline by which the borrower must initiate rescission litigation.

In its opinion in *Sherzer v. Homestar Mortgage Services et. al.*,² the Third Circuit aligned with the Fourth Circuit, holding that "an obligor exercises the right to rescission by sending the creditor valid written notice of rescission, and need not also file suit within three years of consummation of the loan transaction."³ In so doing, the Third Circuit adopted the position advocated by the Consumer Financial Protection Bureau ("CFPB") in an amicus brief. In June 2012, the Tenth Circuit in *Rosenfield v. HSBC Bank, USA, N.A.*⁴ had rejected a similar argument advocated by the CFPB and instead followed the Ninth Circuit, concluding that "notice by itself is not sufficient to exercise (or preserve) a consumer's right of rescission under TILA. The commencement of a lawsuit within the three-year TILA repose period [is] required."⁵ The Eighth Circuit is currently considering this issue in *Sobieniak v. BAC Home Loans Servicing*, in which oral argument was held on October 16, 2012.⁶

Summary of the TILA Right of Rescission

TILA requires lenders to provide disclosure of credit terms and affords consumers who do not receive the requisite disclosures regarding a loan secured by their principal dwelling a right to rescind the loan agreement.⁷ A consumer has an absolute right to rescind the loan for three business days after closing on the loan.⁸ If a lender does not make the required disclosures under TILA before the loan commences, the three-day right to rescind does not begin to run and the consumer has a right to rescind that lasts until

¹ TILA is codified at 15 U.S.C. § 1601 *et seq.*

² Case No. 11-4254, 2013 U.S. App. LEXIS 2486, at *17 (3d. Cir. Feb. 5, 2013).

³ *Id.* (quoting *Gilbert v. Residential Funding LLC*, 678 F.3d 271, 277-78 (4th Cir. 2012)).

⁴ 681 F.3d 1172 (10th Cir. 2012).

⁵ *Id.* at 1188; see also *McOmie-Gray v. Bank of Am.*, 667 F.3d 1325, 1328 (9th Cir. 2012) ("Under the case law of this court and the Supreme Court, rescission suits must be brought within three years from the consummation of the loan, regardless whether notice of rescission is delivered within that three-year period).

⁶ Case No. 12-1053.

⁷ 15 U.S.C. at §1635.

⁸ *Id.* at 1635(a).

three days after the consumer receives the disclosures provided,⁹ however, that “[a]n obligor’s right of rescission shall expire three years after the date of consummation of the transaction or upon the sale of the property, whichever occurs first, notwithstanding the fact that the information and forms required under this section or any other disclosures required under this part have not been delivered to the obligor.”¹⁰ The U.S. Supreme Court has held that this three-year period is a statute of repose that completely extinguishes the borrower’s right to rescind the home loan transaction after three years.¹¹

Case Background

Less than three-years after the Sherzers closed on two loans secured by their principal dwelling, their counsel wrote a letter to the Lenders,¹² asserting that borrowers did not receive the required TILA disclosures, advising that these failures were material violations under TILA and informing lenders that borrowers were asserting their right to rescind the loan agreements under 15 U.S.C. § 1635.¹³ When HSBC denied that rescission was appropriate as to the larger of the two loans, the borrowers filed suit against the Lenders seeking a declaration of rescission, remedies of rescission, and damages.¹⁴ By the time the borrowers filed suit more than three years had passed since the loan transaction closed.

The issue presented to the Third Circuit was “does an obligor exercise his right to rescind a loan subject to TILA by so notifying the creditor in writing, or must the obligor file suit before the three-year period expires?”¹⁵

The borrowers and their *amicus*, CFPB, argued that § 1635 “establishes a private, non-judicial mechanism for consumers to rescind mortgage loans by providing notice to the lenders.”¹⁶ They argued that “rescission of the loan agreement occurs when a valid notice of rescission is sent, not when a court enters an order enforcing the obligor’s rights,”¹⁷ and that any subsequent legal action simply determines whether a valid rescission had occurred and the respective obligations of the parties.¹⁸ This view is consistent with the Fourth Circuit’s holding in *Gilbert*.¹⁹

The lenders and their *amici*,²⁰ argued that “a consumer’s unilateral notice of rescission does not

⁹ *Id.* at 1635(a).

¹⁰ *Id.* at 1635(f).

¹¹ *Beach v. Ocwen Federal Bank*, 523 U.S. 410, 417-19 (1998) (holding that the right of rescission under TILA is extinguished after three years; therefore, obligors that have not exercised their right of rescission within the three-years period cannot later assert it as an affirmative defense).

¹² Homestar Mortgage Services originated the loans and later assigned both loans to HSBC Bank. They are referred to together as the “Lenders.”

¹³ *Sherzer*, 2013 U.S. App. LEXIS 2486 at *3.

¹⁴ *Id.* at *3-4.

¹⁵ *Id.* at *5.

¹⁶ *Id.* at *5 (quoting CFPB brief at p. 11).

¹⁷ *Id.* at *6.

¹⁸ *Id.* at *6.

¹⁹ *Id.* at *6 (citing *Gilbert v. Residential Funding*, 678 F.3d at 277-78). In the Fourth Circuit rescission is not automatic. An obligor timely exercises his right of rescission by sending notice of his intent to rescind within the three-year period; however, under *Gilbert*, “[t]he loan agreement is not technically rescinded until a court enters an order granting a rescission.” See 678 F.3d at 277. The borrowers’ view is also consistent with the Eleventh Circuit’s description of the TILA rescission process in *Williams v. Homestake Mortgage Co.*, 968 F.2d 1137, 1139-40 (11th Cir. 1992) (explaining that “Congress provided the consumer with the right to rescind a credit transaction under § 1635(a) solely by notifying the creditor within set time limits of his intent to rescind.”)

²⁰ The American Bankers Association, Consumer Bankers Association, and Consumer Mortgage Coalition.

automatically rescind a loan agreement.”²¹ They argued that unless the parties agree to rescission, the obligor must file suit to exercise the right of rescission within three years of the closing date or it will be forever time-barred.²² The Ninth and Tenth Circuits have adopted this rule.²³

The Third Circuit’s Decision

The Third Circuit held that timely rescission of a loan agreement requires only that the obligor send a valid notice of rescission. The Court relied on § 1635 and its implementing regulation – Regulation Z. The Court concluded that neither § 1635 nor Regulation Z requires an obligor to file suit in order to exercise the right to rescind a transaction; instead, each state only that the obligor must provide written notification to the lender.²⁴ The Third Circuit held that under the plain language of the statute and Regulation Z, the obligor exercises the right to rescind when he provides valid notice to the lender.

The Third Circuit then examined the impact of the Supreme Court’s decision in *Beach*. Unlike the Ninth and Tenth Circuits which found *Beach* dispositive and concluded that notice alone is not sufficient to exercise the right of rescission where the lender does not consent,²⁵ the Third Circuit Court distinguished *Beach*. The Third Circuit concluded that *Beach* addressed only “whether obligors who failed to provide notice of rescission within the three-year period may nevertheless assert rescission as an affirmative defense in a foreclosure proceeding,”²⁶ and that *Beach* did not address “how an obligor must exercise his right of rescission within that three-year period.”²⁷ Under the Third Circuit’s holding, the obligor need only provide a “valid written notice of rescission before the three years expire.”²⁸ If a borrower timely exercises the right to rescind, a suit to enforce that right can be filed after expiration of the three-year period.

Implications

Notwithstanding the holding in *Beach*, both the Third Circuit in *Sherzer* and the Fourth Circuit in *Gilbert* have taken the position that “the § 1635(f) bar does not preclude consumers from filing suit after the three-year period has passed, as long as they send written notice of rescission within that three year period.”²⁹

Moreover, in *Sherzer* the Third Circuit expands the Fourth Circuit’s decision in *Gilbert*. Under the Fourth Circuit’s ruling, to complete the rescission and void the contract either the creditor must consent or the

²¹ *Sherzer*, 2013 U.S. App. LEXIS 2486 at *7.

²² *Id.* at *8.

²³ *Id.* at *8 (citing *Rosenfield*, 681 F.3d at 1188; *McOmie-Gray*, 667 F.3d at 1326).

²⁴ *Id.* at *9-10 (citing 15 U.S.C. § 1635(a), which states “the obligor shall have the right to rescind the transaction . . . by notifying the creditor in accordance with the regulations of the Bureau, of his intention to do so;” 12 C.F.R. §§ 1026.15(a)(2), 1026.23(a)(2), requiring the obligor to notify the lender “by mail, telegram, or other means of written communication.”)

²⁵ See *McOmie-Gray*, 667 F.3d at 1328 (“Were we writing on a blank slate, we might consider whether notification within three years of the transaction could extend the time limit imposed by § 1635(f). But under the case law of this court and the Supreme Court, rescission suits must be brought within three years from the consummation of the loan, regardless whether notice of rescission is delivered within that three-year period.”); *Rosenfield*, 681 F.3d at 1188 (“We disagree [with the Fourth Circuit in *Gilbert*] that the filing of a suit to *rescind* is not required in order to exercise the right [of rescission]. We simply cannot square the Fourth Circuit’s view with the Supreme Court’s strong pronouncement in *Beach* that the TILA rescission right is extinguished if it is not exercised within the three-year statutory period . . . and the Court’s vision of repose and its salutary purposes under TILA.” (citing *Beach*, 523 U.S. at 416-17) (emphasis in original)).

²⁶ *Id.* at *21 (citing *Beach*, 523 U.S. at 411-13).

²⁷ *Id.* at *23.

²⁸ *Id.* at *37.

²⁹ *Id.* at *20, n. 5

borrower must file a lawsuit so that the court may enforce the right to rescind.³⁰ The Third Circuit, however, concluded that under the statutory language of §§1635(a) and (b) and Regulation Z, rescission occurs at the time the obligor exercises his right to rescission and held that “the contract is voided at the time valid notice is sent, pursuant to 15 U.S.C. § 1635(b).”³¹

The Lenders and their *amici* argued that under a notice-only interpretation, a lender’s security interest would become instantly void by law even where the obligor sends an invalid notice of rescission.³² Importantly, the Third Circuit rejected the notion that a borrower could void the security interest securing the loan simply by claiming a TILA violation and limited its holding stating “[r]escission of the loan agreement occurs when an obligor with a *valid* TILA claim provides the lender with written notice.”³³ Thus, a rescission notice may be invalid if the obligor in fact received all of the material disclosures or if the notice was fraudulent because, for example, the obligor does not intend to or cannot repay the loan.³⁴ However, the Third Circuit’s ruling appears to shift the burden to lenders to file suit if they believe that the obligor’s notice of rescission is invalid in order to resolve the uncertainty of whether the security interest is void.³⁵

Conclusion

The recent split of Circuit Court authority over what is required for an obligor to exercise the right of rescission has introduced a degree of uncertainty into TILA rescission litigation that had not previously existed after the Supreme Court’s decision in *Beach*. Moreover, while both the Third and Fourth Circuits conclude that notice alone is sufficient to timely exercise the right of rescission, neither circuit identifies what statute of limitations period applies to a suit to enforce rescission rights when an obligor has sent a written notice of rescission to the lender within the three-year deadline.³⁶ The Third Circuit also leaves open the possibility, as recognized in *Beach*, that regardless of the applicable statute of limitations, an obligor may be able to use the notice of rescission as a defense in the form of recoupment to a foreclosure proceeding. Given this uncertainty, the practical implication for lenders that receive a notice of rescission may be an increasing need to file suit to confirm whether the obligor’s notice rescission was valid. As the Court in *Sherzer* recognizes, this may result in increased litigation costs for lenders and thus loans may become more costly for borrowers.³⁷

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³⁰ *Gilbert*, 678 F.3d at 277.

³¹ *Sherzer*, 2013 U.S. App. LEXIS 2486 at *20, n.5.

³² *Id.* at *30.

³³ *Id.* at *29-30 (emphasis in original).

³⁴ *Id.* at *31.

³⁵ *Id.* at *30.

³⁶ *Id.* at *32 (explaining that “an obligor who has sent a written notice of rescission to his lender but received no response will not be able to wait indefinitely before filing a lawsuit to enforce the rescission . . . because statutes of limitation will constrain his ability to file suit.”) and n. 8 (“Because the Sherzers filed suit six months after sending the notice of rescission, we do not reach the question of what statute of limitations would apply in this context.”)

³⁷ *Id.* at 35-36.

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