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Third Circuit Holds Notice of Rescission Sufficient to Rescind Loan Under Truth in Lending Act

On February 5, in *Sherzer v. Homestar Mortgage Services, Inc.*, No. 11-4254, 2013 U.S. App. Lexis 2486 (3d Cir. Feb. 5, 2013), the U.S. Court of Appeals for the Third Circuit rendered a precedent-setting decision finding that the borrowers' rescission action, which they filed more than three years after the closing on their loan, was timely. In that case, the court held that a borrower's sending of a notice of rescission to the lender within the three-year statute-of-limitations period is all that is required to exercise the right to rescind under the Truth in Lending Act ("TILA").

Congress enacted TILA to promote the "informed use of credit" by requiring "meaningful disclosures of credit terms." 15 U.S.C. 1601(a). Under TILA, if a lender fails to provide the requisite disclosures of a loan secured by the borrower's principal dwelling, the borrower has a right for three years after the transaction to rescind the loan agreement. 15 U.S.C. 1635(f). The question before the Third Circuit in *Sherzer* was what action a borrower "must take to exercise the right of rescission" within that three-year period. 2013 U.S. App. Lexis 2486, at *3.

The facts of *Sherzer* were as follows. On August 26, 2004, the borrowers obtained two loans from Homestar Mortgage Services ("Homestar"). *Id.* The loans were secured by mortgages on their primary residence. *Id.* Subsequently, the loans were assigned to HSBC Bank ("HSBC"). *Id.* Three months before the three-year anniversary of the loan closing, borrowers' counsel sent a letter to Homestar and HSBC (collectively, the "Lenders") in which the borrowers alleged that Homestar failed to provide the required TILA disclosures and, therefore, they were rescinding their loans. *Id.* Because HSBC agreed to rescind only one of the two loans, the borrowers instituted an action for rescission of the other loan. *Id.* The lawsuit was filed on November 30, 2007, shortly after the expiration of the three-year period. *Id.* at *4.

The district court dismissed the lawsuit on the ground that the action was time-barred because the borrowers did not file suit within three years of the loan closing. *Id.* The borrowers appealed, asserting that they timely exercised their rescission rights under TILA because they provided written notice of rescission to the Lenders before the three years expired. *Id.*

The Consumer Financial Protection Bureau (the "CFPB") filed an amicus



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brief in favor of the borrowers' interpretation that notification to the lender within the prescribed time limit is sufficient to satisfy TILA's rescission requirements. *Id.* at *5. Under that interpretation, "rescission of the loan agreement occurs when a valid notice of rescission is sent, not when a court enters an order enforcing the [borrower's] rights." *Id.* at *6. Thereafter, the parties may determine the validity of the notice and enforce their respective obligations in a "subsequent legal action." *Id.* The American Bankers Association, Consumer Bankers Association and Consumer Mortgage Coalition filed an amicus brief in support of the contrary position that a borrower's "unilateral notice of rescission does not automatically rescind a loan" and that a lawsuit must be brought within three years to invoke the right to rescind. *Id.* at *7-8. Under that view, "rescission occurs when the parties" are in agreement that the loan should be rescinded or "when a court enters an order of rescission." *Id.* at *8.

The Third Circuit agreed with the borrowers' position and reversed the district court's dismissal of the borrowers' action as time-barred, finding that the borrowers exercised their rescission rights by written notice within the three-year period. *Id.* at *37. The court noted that TILA and its implementing regulation (Regulation Z) plainly state that the right of rescission is exercised by written notification to the lender. Specifically, the court observed: "Section 1635(a) provides that 'the [borrower] shall have the right to rescind the transaction...by notifying the [lender], in accordance with regulations of the Bureau, of his intention to do so.'" *Id.* at *9-10 (quoting 15 U.S.C. 1635(a)). "Regulation Z, in turn, specifies that the [borrower] must notify his lender 'by mail, telegram, or other means of written communication.'" *Id.* at *10 (quoting 12 C.F.R. §§ 1026.15(a)(2), 1026.23(a)(2)).

The court further concluded that TILA and its regulations are devoid of a requirement that borrowers commence an action within that three-year period. *Id.* at *9-11. The court explained that, if Congress intended to circumscribe a borrower's right to bring suit, it would have included phrases such as "causes of action or the commencement of a civil action" in Section 1635(f), which "establishes the three-year limitation," but it did not. *Id.* at *12-13. The court further explained that the absence of such references "suggests that rescission may be accomplished without a formal court filing." *Id.* at *13.

The court added that Section 1635(b) of TILA, which frees the borrower from "liability for payment" and voids "the security interest" when a written notice of rescission to the lender is sent, supports the borrowers' position that "rescission occurs automatically" when that right is exercised. *Id.* at *11.

In support of their position, the Lenders argued that the Supreme Court had already decided this issue in *Beach v. Ocwen Federal Bank*, 523 U.S. 410 (1998), in which it was held that TILA prohibited the borrowers' assertion of their right to rescind as an affirmative defense after the prescribed three-year period. *See Sherzer*, 2013 U.S. App. Lexis 2486, at *20-21. The Third Circuit disagreed and stated that the facts and question presented in *Beach* and in *Sherzer* were different. *See id.* at *21-23.

According to the court, *Beach* involved *when* the right of rescission is extinguished under TILA, not *how* that right is exercised. See *id.* at *22-23. In addition, unlike the borrowers in *Sherzer*, the borrowers in *Beach* did not take any action until after the three-year deadline to invoke their rescission rights. *Id.* at *21-22.

The Lenders' amici also argued that rescission by notice would cause great uncertainty regarding title because "under the notice-only interpretation, the lender's security interest would become instantly void by law" regardless of whether a lender had actually violated the statute. See *id.* at *29. The court clarified that, under its holding, rescission occurs only when a borrower "with a valid TILA claim provides the lender with written notice." *Id.* at *30. The court acknowledged that its ruling may have costly implications for lenders because "[o]nce alerted to the cloud on its title," a lender would have to "sue to confirm that the obligor's rescission was invalid or do nothing and assume the risk that a court might later rule that the rescission was valid." *Id.* at *35. The court concluded, however, that the possibility that its ruling may have a costly impact on lenders is not a basis "to disregard the text of the statute." *Id.* at *36.

The court also noted that its decision does not mean that a borrower who has rescinded a loan by notice has an indefinite period of time to institute a lawsuit to enforce the rescission (i.e., to compel a lender to return the down payment and to cancel its security interest). *Id.* at *32. The court stated that "statutes of limitation will constrain [the borrower's] ability to file suit," although it did not specify which statute of limitations would apply. *Id.* at *32-33. Notwithstanding, the court left open the possibility that a borrower may raise rescission as a defense to a foreclosure action that a lender brings years after it receives a timely rescission notice. *Id.* at *33-34 (internal citations omitted). According to the court, however, such an instance would be rare "because it would exist only as to those loans for which" a notice was sent to the lender within the three-year period. See *id.* at *35. In addition, as previously mentioned, the lender may avoid such circumstances by bringing an action for a declaration as to the validity of the claimed rescission, upon receipt of a rescission notice. *Id.*

The Third Circuit's decision is at odds with other circuit courts, though in agreement with the Fourth Circuit. The First, Ninth and Tenth Circuits have sided with the lenders and have held that borrowers must file a lawsuit within three years from the consummation of the loan, regardless of whether a notice of rescission is delivered to the lender by the borrower within that three-year period, in order to timely invoke the right to rescind.

In light of this decision, lenders should be mindful of the import of receiving a notice of rescission within the three-year time period after the closing on a loan. Under the court's decision, even if suit is not brought within that time frame, a later suit, grounded on a valid and timely notice, will expose the lender to the possibility of having to rescind the loan beyond that three-year mark after the closing of the loan.

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