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Rescinding a Mortgage Transaction under TILA after Refinancing the Loan

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The wave of refinancing activity in the early 2000s has created an interesting and important issue relating to potential creditor liability. Among other consumer rights, consumers have the right under the Truth in Lending Act (TILA)[1] to rescind a transaction. If a loan is refinanced and the original lender's security interest is released, that lenders logically might argue that there is nothing left to rescind, so the right of rescission must have been extinguished. The Ninth Circuit Court of Appeals adopted this view of the law in *King v. California*.[2]

More recently, however, other courts have examined TILA more closely and concluded that the right to rescind does, in fact, survive the refinancing of the loan and release of the security interest. Most recently, the Sixth Circuit issued a carefully-reasoned opinion adopting this view in *Barrett v. J.P. Morgan Chase Bank, N.A.*[3]

Because this issue is of substantial importance to mortgage lenders, both as they address future compliance issues and as they attempt to evaluate potential exposure for previous conduct, this article examines the evolution of the courts' construction of TILA's right to rescind as it relates to refinancing.

TILA, REGULATION Z, AND THE RIGHT TO RESCIND

The TILA was enacted by Congress to "assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available and avoid the uninformed use of credit."[4] As implemented by Federal Reserve Board Regulation Z,[5] TILA "promote[s] the informed use of consumer credit by requiring disclosures about its terms and cost."[6]

TILA and its implementing regulation detail the disclosure requirements for lenders. They also outline the potential penalties for lenders who fail to comply with those disclosure obligations. TILA requires lenders to make material disclosures, in writing, in a form that the borrower may keep. A section of Regulation Z, 12 C.F.R. § 226.18, details the specific items that must be included in the set of disclosures that creditors are required to make. Among other things, lenders must accurately

disclose the annual percentage rate, the finance charge, the amount financed, the total payments, and the payment schedule.[7]

Although certain governmental agencies may enforce some of TILA's requirements, the act also provides private borrowers with a host of remedies they may enforce through private rights of action. One such remedy is the right of rescission. For consumer credit loans secured by the borrower's principal dwelling, TILA permits the borrower to rescind the transaction up to three days after the transaction.[8] This three-day period is automatic and does not require any misconduct on the part of the lender. TILA extends this right of rescission, however, if the lender does not comply with TILA's disclosure requirements and fails accurately to disclose material terms to the borrower. If the borrowers allege that they did not receive the requisite disclosures, the three-day right may last for up to three years. When TILA disclosures were not made, the right to rescind expires upon the earlier of (a) three years after the consummation of the transaction; (b) the sale of the property; or (c) the transfer of the borrower's interest in the property.[9] Additionally, if an agency with TILA-enforcement authority institutes a proceeding against the lender and finds a TILA violation, then a borrower whose right to rescind is based on any matter in the proceeding may have an even longer period to rescind.[10]

If a borrower successfully asserts a claim for rescission, the borrower is entitled to several types of relief. First, when borrowers lawfully exercise the right to rescind a transaction, the security interest becomes void; the lender has 20 days within which to take any and all actions necessary to reflect the termination of the security interest.[11] Second, the lender is obligated to return any money or property given as earnest money or down payment.[12] Third, a rescinding borrower is not liable for any finance or other charges and is entitled to recover all fees incurred in the transaction.[13] Obviously, in situations when rescission does not occur until months or years after closing, the amount of fees and incurred finance charges can be quite substantial. Under TILA, the rescinding borrower is obligated to return to the lender any money or property the borrower received as part of the credit transaction.[14] In most cases, the borrower will be able to refund the borrowed funds to the lender only when the rescinding borrower has alternative financing ready and available. In the case of a rescission following a refinancing, however, the lender already has been repaid and the borrower is not obligated to make any repayment as a condition to rescinding.

RESCISSION AFTER REFINANCING

This rescission regime creates an obvious question that courts have only recently begun to address thoroughly: What happens if the mortgage loan transaction sought to be rescinded has been refinanced prior to the date on which borrowers provide notice of rescission? Neither the statute nor the regulation explicitly addresses rescission following refinancing or addresses whether refinancing extinguishes the right to rescind.

On the one hand, lenders have argued that there cannot possibly be any rescission after a refinancing. The basic, three-day right of rescission exists to provide consumers with a brief period in which to reconsider their borrowing. That right is extended in the case of nondisclosures that effectively undermine borrowers' ability to evaluate the transaction during their three-day period of reflection. In either case, the point of a rescission is to undo a credit transaction, to release a security interest in property and put the borrowers in the same position they occupied before entering into the transaction. This simply is not possible if the loan has been refinanced, as the security interest has been released as part of the refinancing, prior to the lender's receipt of the notice of rescission. As the Ninth Circuit ruled in *King v. California*, a refinanced loan "cannot be rescinded, because there is nothing to rescind."[15]

On the other hand, there is much in the language and purpose of TILA and Regulation Z to suggest that the right to rescind should survive, even after refinancing. A rule allowing rescission even after refinancing arguably promotes TILA's goal of providing consumer protection and protects the deterrent function of the remedy of rescission. In addition, a borrower exercising the right to rescind is entitled not only to a release of the security interest, but also to a recovery of the downpayment and all fees or finance charges incurred. If courts construe TILA and Regulation Z as providing no right of rescission following a refinancing, then borrowers will lose this right to recover downpayments, fees and finance charges on some transactions even if the required disclosures were not made.

There thus exist plausible arguments on both sides of the issue. Barring Congressional or agency clarification, neither of which seem imminent, it is up to the courts to determine how TILA's right to rescind is to be interpreted and applied. The courts' treatment of this issue is discussed in this article, culminating in a conclusion that the current trend of

authority appears to support the view that borrowers may exercise the right to rescind even after they refinance the underlying loan.

THE COURTS' POSITION—FROM CIRCUIT SPLIT TO GROWING CONSENSUS

Federal Courts of Appeal are technically split on whether TILA permits rescission following refinancing, yet the recent trend has been to permit rescission. The Ninth Circuit determined in *King v. California* that rescission was unavailable following refinancing,[16] while the DC Circuit rejected that same contention in *Duren v. First Government Mortgage & Investors Corp.*[17] Although the Ninth Circuit's conclusion has been followed and cited by some district court decisions, the most recent district court decisions have rejected the logic and decision of the *King* court. Most recently, the Sixth Circuit held that rescission was still available after refinancing, and in the course of its decision provided the first detailed analysis by a federal appellate court of the rescission following refinancing issue.

DISAGREEMENT WITHOUT ANALYSIS: *KING* AND *DUREN*

Two decades ago, in *King v. California*, the Ninth Circuit rejected the plaintiff's TILA claims for rescission of three loans. As to one of the loans, the court based its decision on the fact that the loan had been refinanced prior to the date on which the plaintiff requested rescission.[18] The court found that the plaintiff could not rescind the first loan, as it was time barred by the three-year limitation on rescission; the third loan could not be rescinded under TILA because plaintiff could not identify any flaws pertaining to material disclosures. As to the remaining loan, which had been refinanced, the court stated that it "cannot be rescinded, because there is nothing to rescind. [The plaintiff] refinanced that loan in November 1981, and the deed of trust underlying the March 1981 loan has been superseded."[19] The court offered no additional explanation of how it reached the conclusion that refinancing automatically eliminates the borrower access to TILA's rescission remedy. In 1991, in an unpublished opinion in *Mijo v. Avco Financial Services of Hawaii*,[20] the Ninth Circuit followed *King* and reaffirmed its conclusion that refinancing cuts off the rescission remedy.

Several years later, the federal Courts of Appeal again confronted the issue of rescission after refinancing. In an unpublished opinion in 2000, the DC Circuit expressly rejected the Ninth Circuit's conclusion that refinancing automatically disqualifies borrowers from rescinding. The DC Circuit's analysis, however, was even more perfunctory than that of the Ninth Circuit in *King*. In *Duren v. First Government Mortgage & Investors Corp.*, the court addressed a number of the lender's contentions challenging the district court award in favor of the plaintiff borrower.[21] In one sentence, the court disagreed with the lender's contention that the borrower's refinancing had rendered TILA's rescission remedy unavailable, "notwithstanding the Ninth Circuit's terse suggestion to the contrary in *King* . . . ."[22] The court remanded the case with no further discussion of the rescission/refinancing issue.

DISTRICT COURTS MOVE AWAY FROM KING

With scant guidance from the circuit courts, a more fulsome analysis of this issue was left to occur in the district courts. In the late 1980s, the District Court and Bankruptcy Court for the Eastern District of Pennsylvania considered the issue on a handful of occasions. Each time the issue arose, the courts disagreed with *King* and held that rescission is permissible even after refinancing.[23]

Throughout much of the 1990s, courts were not often called on to address the impact of mortgage refinancing on the availability of TILA's right to rescind. With the onset of the refinancing boom at the start of this decade, however, the issue began arising with increasing frequency. Within the last five years, the issue has been addressed on several occasions by judges in the Northern District of Illinois, a district in which litigation under TILA and other federal consumer lending statutes is especially widespread. The judges in the Northern District of Illinois have not agreed on how to interpret TILA's right to rescind, although the trend in more recent decisions seems to be towards a rule that the right to rescind may be exercised even after a rescission. Thus, in 2002, two judges ruled that refinancing cuts off the right to rescind in *Coleman v. Equicredit Corp. of America*[24] and *Jenkins v. Mercantile Mortgage Co.*[25] Only a year later, two other judges in the same district disagreed, questioning the Ninth Circuit's reasoning in *King* and reaching contrary results in *Pulphus v. Sullivan*[26] and *Payton v. New Century Mortgage Corp.*[27]

In *Coleman* and *Jenkins*, the judges based their decisions on the notion that claims for rescission fail when there is nothing left to rescind. In *Coleman*, the court rejected the TILA claim on the basis that "there is nothing to rescind

because the mortgage they want rescinded has been released and no longer exists."[28] In *Jenkins*, the plaintiff, who had refinanced, attached a Discharge of Mortgage to her amended complaint. The court treated that Discharge of Mortgage as an admission that the mortgage no longer existed.[29] The plaintiff cited cases from other district courts, such as *In re Wright*,[30] for the proposition that a loan that has been refinanced nevertheless may be rescinded.[31] The court, however, was persuaded instead by the statement in *Coleman* and *King* that, if a loan has been paid off, there is nothing left to rescind because the mortgage no longer exists.[32] Neither the *Coleman* nor the *Jenkins* court devoted much attention to the actual, statutory language creating the right to rescind, or to the full range of relief that is to accompany a successful rescission.

Within eight months of the *Jenkins* decision, however, the issue was presented in a case before a different judge in the Northern District of Illinois. In that decision, the court expressly questioned the reasoning behind *King*, instead concluding that rescission is permissible even after refinancing. In *Pulphus*, the court pointed out that the *King* court stated its conclusion "without any analysis or citation to authority," "devot[ing] only two sentences to the issue."[33] The court then attempted to supply the type of analysis lacking in *King*, determining that the Ninth Circuit's conclusion is inconsistent with TILA and its regulations and that "there is no statutory basis for concluding that loan payment terminates a consumer's right to rescind."[34] In *Payton*, a different judge in the Northern District of Illinois similarly stated that, in the absence of guidance from the Seventh Circuit, "[g]iven the absence of statutory or regulatory language of such a requirement, and the absence of analysis by the Ninth Circuit in *King*, this court agrees with the courts which have held that refinancing does not bar a suit for rescission."[35]

More recently, other district courts asked to consider the issue have agreed with the conclusion in *Pulphus* and *Payton* that refinancing does not bar access to TILA's rescission remedy. The District of Massachusetts has twice considered the issue, noting that the First Circuit has not decided the issue, and both times has concluded that refinancing does not bar rescission.[36] It is worth noting, however, that the *McKenna* case presently is on appeal to the First Circuit; as part of that appeal, a large group of industry representatives has filed an *amicus curiae* brief arguing that the First Circuit should reverse the ruling as to rescission after refinancing.

THE SIXTH CIRCUIT REJECTS KING

The most important development in the courts' understanding of this issue occurred earlier this year. In the first federal appellate decision on the issue since the recent wave of home mortgage loan refinancing, the Sixth Circuit held in *Barrett v. JP Morgan Chase Bank* that home mortgage borrowers can rescind a loan under TILA, and recover closing costs and fees, even if the loan has been refinanced and the lender no longer holds security for the loan.[37]

In *Barrett*, the plaintiff borrowers had initially refinanced obligations on their home with loans from Bank One. They later refinanced those Bank One loans with a loan from a different lender. Within three years of closing on the Bank One loans, but after refinancing, the borrowers asked Bank One to rescind the loans because of alleged TILA violations. Bank One refused, claiming that nothing was left to rescind because the loans had been refinanced and the security interests had been removed. Bank One's refusal prompted the plaintiffs to file suit in federal court under TILA and various state law theories.[38] The district court accepted the defendant's arguments and held that the plaintiffs were not entitled to rescission because the bank no longer held a security interest. In doing so, the district court expressly followed the Ninth Circuit's 1986 holding in *King*.[39]

The Sixth Circuit reversed the decision of the district court. The Sixth Circuit refused to follow *King*, instead choosing to analyze the language and purpose of TILA and Regulation Z. Based on that analysis, the Sixth Circuit identified three separate reasons why, in its view, the right to rescind is not extinguished by refinancing.

First, neither TILA nor Regulation Z states that refinancing extinguishes a borrower's right to rescind.[40] The statute and regulation both specify particular transactions that are exempt from rescission and certain events that extinguish the right to rescind, but refinancing is not mentioned in either category. For example, Regulation Z ties the rescission right to certain events, defining the time frame for rescission as the earlier of within three years of the transaction, upon sale of the property, or upon the transfer of all of the borrower's interest in the property.[41] As the *Pulphus* court has pointed out, "[c]onspicuously absent from that list is payment of the loan."[42] The Sixth Circuit rejected the effort to read payment of the loan into that list, thereby eliminating the rescission remedy for borrowers who have refinanced.

Second, the *Barrett* court relied on the fact that TILA allows rescission of the entire transaction, not simply the

security interest, and provides for multiple forms of relief. Both the statute and the regulation refer to the right to rescind the "transaction." The section of TILA dealing with rescission is titled "Right of rescission as to certain transactions,"[43] and Regulation Z provides that consumers "shall have the right to rescind the transaction."[44] Reference to the "transaction" is significant because the entire loan transaction involves more than simply the granting of a security interest. The provisions of TILA dealing with the rescission remedy indicate that rescission involves unwinding the entire agreement to return the parties to their original positions. By its terms, TILA grants the rescinding borrower the right to void the security interest *and* the right to recover all fees incurred in the transaction.[45] If a court denied rescission after refinancing, the court would be precluding borrowers from obtaining a remedy to which they are statutorily entitled, in contravention of the plain language of TILA. The *Barrett* court concluded that permitting borrowers to rescind despite refinancing is more consistent with the plain language of TILA and Regulation Z.

Third and finally, the *Barrett* court opined that allowing rescission even after refinancing is more consistent with the consumer protection foundations of TILA, the deterrent function of the rescission remedy, and the basic purpose of rescission.[46] Congress enacted TILA to "assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit."[47] Allowing rescission even after refinancing is consistent with this purpose because it does not allow a refinancing to insulate lenders from responsibility for noncompliance.[48] Permitting rescission in this circumstance acts as a penalty for lenders who fail to comply with the disclosure provisions, theoretically deterring noncompliance and protecting consumers.[49] Additionally, the basic purpose of rescission is to return the parties to as close as possible to where they were before the transaction, as if the transaction had never happened.[50] Applying TILA's rescission remedy, which includes return of finance charges and other fees, even where the security interest no longer exists is consistent with returning the parties to their pre-transaction positions.

DEVELOPMENTS FOLLOWING BARRETT

Less than 10 days after the Sixth Circuit's decision, the California Court of Appeals cited *Barrett* and joined the growing number of courts permitting borrowers to rescind even refinanced loans.[51] In *Pacific Shore Funding v. Lozo*, the court determined that nothing in the statute or regulation supports the view that refinancing terminates the right to rescind, and stated, "we are adverse to reading into the statute an implicit basis for terminating consumers' remedies that would only benefit lenders at the expense of borrowers."[52] In doing so, the California Court of Appeals became one of the most recent court to reject *King* and perpetuate the apparent movement away from an interpretation of TILA that prohibits borrowers from rescinding if they have refinanced.

As might be expected, participants in the mortgage lending industry are seeking to reverse the apparent trend in cases such as *Barrett*, *Lozo*, and *McKenna*. The defendants in *Barrett* have filed a petition with the Sixth Circuit for *rehearing en banc*. The Court has requested a response from plaintiffs, providing some indication that it is at least considering the request. The defendants sought an immediate appeal to the First Circuit in *McKenna v. First Horizon Home Loan Corp.*,[53] a case in which the District Court for the District of Massachusetts issued a class certification order that allowed class treatment of TILA claims, even those that have been paid off or extinguished. The First Circuit granted the petition for review and a group of financial services companies has filed an *amicus curiae* brief in *McKenna*,[54] which the companies view as particularly troubling because of the potential for substantial losses via aggregation of rescission claims.

These defense efforts rely not only on their view of TILA's language and legislative history, but also on the perceived threat to the mortgage lending industry. Even without claim aggregation, rescission after refinancing is troubling to the lending industry. First, the statutory $500,000 limit on damages under TILA does not apply to rescission. Moreover, lenders faced with such uncapped liability have only 20 days to act following receipt of a rescission demand.[55] Second, the secondary market also is susceptible to losses, as TILA liability extends to assignees of loans,[56] and rescission of loans that have been paid off could effectively force assignees to return all interest and fees they have received. Lenders perceive serious danger.

CONCLUSION

In light of the increased refinancing activity seen in the early 2000s, the question of whether refinancing extinguishes the right to rescind is likely to be a recurring one. This may be particularly true if, as some critics have contended, a substantial portion of the recent refinancing

activity involved lenders and brokers seeking to refinance borrowers into exotic, non-traditional mortgages that the borrowers ultimately will not be able to afford. With only three federal appellate courts and a handful of district courts having addressed the issue, it is too early to conclude that the right to rescind necessarily will be construed as surviving loan refinancing. Although the trend definitely is towards protection of the right to rescind, careful lenders should monitor developments closely. As always, the most sure-fire way to avoid claims for rescission is to strengthen compliance efforts to ensure that all TILA-required disclosures are documented and given to the borrower.

NOTES

1. 15 U.S.C. § 1601(a).
2. King v. California, 784 F.2d 910 (9th Cir. 1986), cert. denied, 484 U.S. 802 (1987).
3. Barrett v. J.P. Morgan Chase Bank, N.A., 445 F.3d 874 (6th Cir. Apr. 18, 2006), *petition for reh'g en banc filed,* 05-5035, 05-5146 (6th Cir. May 16, 2006).
4. 15 U.S.C. § 1601(a).
5. 12 C.F.R. Part 226.
6. 12 C.F.R. § 226.1(b).
7. 12 C.F.R. § 226.23(3) n.48.
8. 15 U.S.C. § 1635(a); see also 12 C.F.R. § 226.23(3).
9. 15 U.S.C. § 1635(f); see also 12 C.F.R. § 226.23(3).
10. *Id*.
11. 15 U.S.C. § 1635(b); see also 12 C.F.R. § 226.23(d)(1)-(2).
12. 15 U.S.C. § 1635(b); see also 12 C.F.R. § 226.23(d)(2).
13. 15 U.S.C. § 1635(b); see also 12 C.F.R. § 226.23(d)(1).
14. 15 U.S.C. § 1635(b).
15. *King,* 784 F.2d at 913.
16. *Id*.
17. Duren v. First Gov. Mort. & Investors Corp., 221 F.3d 195, 2000 WL 816042, at *2 (D.C. Cir. June 7, 2000) (unpublished table opinion).
18. *King,* 784 F.2d at 913.
19. *Id*.
20. Mijo v. Avco Fin. Servs. of Hawaii, 937 F.2d 613, 1991 WL 126660, at *1 (9th Cir. July 1, 1991) (unpublished table decision) ("When the Mijos refinanced their loan prior to attempting to rescind the loan, their right of rescission under 15 U.S.C. § 1635(f) was extinguished. Simply stated, the loan cannot be rescinded because there is nothing to rescind." (citation to *King* omitted)).
21. *Duren,* 2000 WL 816042, at *2.
22. *Id*.
23. Nichols v. Mid-Penn Consumer Discount Co., No. A-88-1253, 1989 WL 46682, at *6 (E.D. Pa. Apr. 28, 1989), *judgment aff'd,* 893 F.2d 1331 (3d Cir.); In re Wright, 127 B.R. 766 (Bankr. E.D. Pa. 1991), *aff'd,* 133 B.R. 704 (E.D.Pa.); In re Steinbrecher, 110 B.R. 155, 166 (Bankr. E.D. Pa. 1990).
24. Coleman v. Equicredit Corp. of Am., No. 01 C 2130, 2002 WL 88750 (N.D. Ill. Jan. 22, 2002) (Leinenweber, J.).
25. Jenkins v. Mercantile Mort. Co., 231 F. Supp. 2d 737 (N.D. Ill. 2002) (Bucklo, J.).
26. Pulphus v. Sullivan, No. 02 C 5794, 2003 WL 1964333 (N.D. Ill. Apr. 28, 2003) (Plunkett, J.).
27. Payton v. New Century Mort. Corp., No. 03 C 333, 03 C 703, 2003 WL 22349118 (N.D. Ill. Oct. 14, 2003) (Holderman, J.).
28. *Coleman,* 2002 WL 88750, at *2.
29. *Jenkins,* 231 F. Supp. 2d at 745.
30. In re Wright, 127 B.R. 766, 770–771 (E.D. Pa. 1991).
31. *Jenkins,* 231 F. Supp. 2d at 745.
32. *Id*.
33. *Pulphus,* 2003 WL 1964333, at *17.
34. *Id*.
35. Payton, 2003 WL 22349118, at *2.
36. McKenna v. First Horizon Home Loan Corp., 429 F. Supp. 2d 291, 312–315 (D. Mass. Mar. 31, 2006) (interpreting a Massachusetts state consumer finance law by reference to TILA and cases interpreting it), petition for review granted, No. 06-8018 (1st Cir. June 28, 2006); McIntosh v. Irwin Union Bank & Trust Co., 215 F.R.D. 26, 30-31 (D. Mass. 2003) (noting that the First Circuit has not addressed this issue, on which courts are split, but concluding that rescission is possible after refinancing).
37. *Barrett,* 445 F.3d 874.
38. *Id*. at 876–877.
39. *Id*. at 877.
40. *Id*. at 878–879.
41. 12 C.F.R. § 226.23(3).
42. *Pulphus,* 2003 WL 1964333, at *17.
43. 15 U.S.C. § 1635.
44. 12 C.F.R. § 226.23(a).
45. *See* 15 U.S.C. § 1635(b); see also 12 C.F.R. § 226.23(d)(1)-(2).
46. Barrett, 445 F.3d at 879–880.
47. 15 U.S.C. § 1601(a).
48. *See* Barrett, 445 F.3d at 879.
49. *See* Elwin Griffith, "Truth in Lending-The Right of Rescission, Disclosure of the Finance Charge, and Itemization of the Amount Financed in Closed-End Transactions," 6 Geo. Mason L. Rev. 191, 232 (1998) ("The statute should not lose its impetus as an enforcement tool; any coddling of creditors removes the incentive for creditors to respond to statutory demands."); Robert Murton, "Can't Get No Satisfaction? Revising How Courts Rescind Home Equity Loans Under the Truth in Lending Act," 77 Temp. L. Rev. 457, 458 (2004).
50. Murton, *supra* n.49 at 458.
51. Pacific Shore Funding v. Lozo, 42 Cal. Rptr. 3d 283 (Cal. Ct. App. Apr. 27, 2006) review denied (July 19, 2006).
52. *Id*. at 290.
53. McKenna v. First Horizon Home Loan Corp., 429 F. Supp. 2d 291, 312–315 (D. Mass. Mar. 31, 2006) (interpreting a Massachusetts state consumer finance law by reference to TILA and cases interpreting it), appeal docketed, No. 06-8018 (1st Cir. Apr. 18, 2006).
54. Brief of Financial Services Amici Curiae in Support of Defendant-Petitioner's Rule 23(f) Petition for Review of Order Certifying Class, McKenna v. First Horizon Home Loan Corp., No 06-8018 (6th Cir. Apr. 27, 2006).
55. 15 U.S.C. § 1635(b); *see also* 12 C.F.R. § 226.23(d)(1)-(2).
56. 15 U.S.C. § 1641.

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