Fourth Quarter 2007

Compliance Corner

Federal Reserve Bank of Philadelphia

The Right of Rescission: Overview and Recent Legal Developments

by Kenneth J. Benton, Consumer Regulations Specialist

This article provides an overview of the right of rescission (rescission), a significant consumer protection provided under the Truth in Lending Act (TILA) and Regulation Z, TILA's implementing regulation. For covered transactions, in which a creditor extends credit to a consumer primarily for personal, family, or household purposes and takes a security interest in the consumer's primary residence (excluding purchase or construction loans), rescission provides a three-day cooling off period during which the consumer can cancel the loan without penalty. The rescission period is extended to three years if the creditor fails to provide the required rescission notice or fails to provide accurate, material disclosures. Rescission presents compliance risks for banks because a violation can be very costly. Not only does the bank have to return all finance charges and fees the customer has paid, but the bank is also liable for statutory damages, court costs, and attorney's fees.[1] In addition, rescission applies to assignees of the loan, so if a bank purchases a covered loan, it could be forced to rescind the loan if the disclosures have violations triggering rescission.

An article in the fourth quarter 2006 issue of *Compliance Corner* discussed the damages and remedies available to a consumer when a creditor violates a section of TILA or Regulation Z subject to rescission protection. This article reviews the legislative history of rescission, its compliance requirements, and recent legal developments concerning rescission claims in class actions.

continued on page CC8

[1] For more details about damages, see <www.philadelphiafed.org/src/srcinsights/srcinsights/q4_06_cc1.html>.

Compliance Corner is published quarterly and is distributed via *SRC Insights* to institutions supervised by the Federal Reserve Bank of Philadelphia. *SRC Insights* is available on the Federal Reserve Bank's website at www.philadelphiafed.org. Suggestions, comments, and requests for back issues are welcome in writing, by telephone (215-574-3769), or by e-mail (joanne.branigan@phil.frb.org). Please address all correspondence to: Joanne Branigan, Federal Reserve Bank of Philadelphia, SRC - 7th Floor, Ten Independence Mall, Philadelphia, PA 19106-1574.

Editor....................Joanne Branigan
Associate Editor..........Katrina Beck
Designer................Dianne Hallowell

FEDERAL RESERVE BANK OF PHILADELPHIA

Compliance Alert: Attachment and Setoff of a Bank Account Receiving Social Security Benefits

The federal banking agencies (the agencies) recently announced a proposed guidance for the banks they supervise titled "Garnishment of Exempt Federal Benefit Funds." The guidance addresses the recurring problem of banks garnishing accounts exempt from judgment execution under federal law, such as a deposit account funded only by social security benefits, and provides best practices for banks to follow when a creditor attempts to garnish an exempted account (see sidebox on the guidance). The agencies published the guidance because garnishment of these exempt accounts imposes severe hardship on the type of customers most likely to have them, namely, retirees receiving social security. The agencies' request for comment makes this an appropriate time to review recent court cases that highlight the circumstances under which courts have allowed banks to exercise their right of setoff against a customer account that receives social security benefits.

Generally speaking, bank accounts funded only by social security benefits are exempt from execution because of the anti-assignment provision in section 207 of the Social Security Act. This section provides:

(a) The right of any person to any future payment under this title shall not be transferable or assignable, at law or in equity, and none of the moneys paid or payable or rights existing under this title shall be subject to execution, levy, attachment, garnishment, or other legal process or to the operation of any bankruptcy or insolvency law.

(b) No other provision of law, enacted before, on, or after the date of the enactment of this section [103], may be construed to limit, supersede, or otherwise modify the provisions of this section except to the extent that it does so by express reference to this section.

(c) Nothing in this section shall be construed to prohibit withholding taxes from any benefit under this title, if such withholding is done pursuant to a request made in accordance with section 3402(p)(1) of the Internal Revenue Code of 1986 [104] by the person entitled to such benefit or such person's representative payee.

The agencies' guidance, which is designed to help implement section

207 and other federal laws protecting federal benefits from execution, is directed to the fairly common issue of a bank receiving legal process from a third-party creditor against a customer bank account that receives social security benefits. That issue is subject to a bright-line rule: if the account is funded only by social security benefits, section 207 prevents the creditor from attaching it unless another federal law specifically provides for attachment of social security benefits.[1] But recent court cases have carved out a new exception—when a bank exercises its right of setoff against a deposit account that receives social security benefits to pay a delinquent bank debt that arises *out* of that account, such as an overdraft or overdraft fees.

The Right of Setoff

Setoff is a self-help right of a creditor holding a delinquent debt to obtain payment from assets of the debtor in the creditor's possession. For example, if a bank has a customer who is in default on a car loan, and the customer also maintains a deposit account with the bank, the bank can exercise its right of setoff against the deposit account to obtain payment on the car loan debt. But in light of the broad prohibition on assignment of social security benefits in section 207 of the Social Security Act, the question arises whether banks can legally attach an account receiving social security benefits as a setoff against a debt of that customer.

In light of recent court decisions, the answer appears to be that the bank can exercise the right of setoff against an account receiving social security benefits if the debt to the bank arises out of the account. For example, in the recent case of *Wilson v. Harris Bank N.A.*, 2007 U.S. Dist. LEXIS 65345 (N.D. Ill. Sept. 4, 2007), a customer's checking account was overdrawn because of allegedly unauthorized debit card transactions. The bank also assessed overdraft fees because the transactions exceeded the balance in the account.

The customer notified the bank that transactions were unauthorized, but the bank rejected the customer's claim after conducting an investigation. When the customer's social security benefits were deposited, the bank offset the negative balance in the account against the deposit. The customer sued the bank, alleging, among other things, that the bank violated the anti-assignment provision of section 207 of the Social Security Act. However, the court rejected the customer's claim that the bank violated section 207, noting a distinction between attachment of a protected account for an *independent* debt and attachment to pay a debt *arising* from the protected account. The court upheld the right of the bank to exercise its right of setoff against the social security benefits because the debt to the bank being offset arose from that account.

Bank accounts funded only by social security benefits are exempt from execution because of the anti-assignment provision in section 207 of the Social Security Act.

The United States Court of Appeals for the Ninth Circuit reached a similar conclusion in *Lopez v. Washington Mutual Bank*, 302 F.3d 900 (9th Cir. 2002).[2] Lopez concerned a class action against Washington Mutual Bank (Wamu) alleging violations of section 207 because Wamu was using social security ben-

[1] The three primary exceptions are found in 1) section 6334(c) of The Tax Code, which allows the IRS to levy against social security benefits; 2) section 3716(a) of the Debt Collection Act of 1982, 31 U.S.C. 3716(a), which allows any federal executive, judicial, or legislative agency to collect a defaulted debt by administrative offset against social security benefits; and 3) section 459 of the Social Security Act, 42 U.S.C. 659, which allows social security benefits to be garnished to repay delinquent child support and/or alimony payments.

[2] The Ninth Circuit is the federal appeals court for appeals from federal courts and agencies in Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Washington, the U.S. Territory of Guam, and the Commonwealth of the Northern Mariana Islands.

efits deposited to checking accounts to obtain repayment of overdrafts and overdraft fees incurred in those accounts. The Ninth Circuit rejected the plaintiffs' claims, finding that

> *the plaintiffs voluntarily opened an account with the bank and executed an account holder agreement which outlined the terms and conditions of the bank's overdraft policies. They also established a direct deposit for their benefits (an agreement to which Washington Mutual was not a party). The plaintiffs remained free at all times to close their account or change their direct deposit instructions. Because they did not do so, Washington Mutual argues, each deposit to the account after an overdraft should be treated as a voluntary payment of a debt incurred. We agree.*

It is important to emphasize that the cases approving the right of setoff concerned an obligation arising from the account being offset. However, a different rule has been applied for setoffs in the context of a debt unrelated to the account receiving social security benefits. For example, in *Tom v. First American Credit Union*, 151 F.3d 1289 (10th Cir. 1998), the United States Court of Appeals for the Tenth Circuit held a credit union liable for conducting an offset against a customer account receiving social security benefits to pay delinquent loans of the account holder *unrelated* to the deposit account.[3]

The trial court in *Marengo v. First Massachusetts Bank*, 152 F. Supp. 2d 92, 93 (D. Mass. 2001) reached a similar conclusion. The plaintiffs in that case were retirees who were delinquent on their unsecured line of credit with their bank. To collect payment on the delinquent account, the bank conducted an offset against their deposit account, which only received social security benefits.

The couple sued the bank for violating the Social Security Act's anti-assignment provision. The court

[3] The Tenth Circuit has jurisdiction for appeals from federal courts and agencies in Oklahoma, Kansas, New Mexico, Colorado, Wyoming, and Utah.

Banking Agencies Propose Best Practices When Exempt Federal Benefit Funds Are Garnished

The agencies are seeking public comment on their proposed "best practices" for financial institutions to follow when a creditor garnishes a customer's account that receives benefits exempt from garnishment or other legal process under federal law. To lessen the hardships from garnishment, the agencies propose these best practices:

- Promptly notify a consumer when a financial institution receives a garnishment order and places a freeze on the consumer's account
- Provide the consumer with information about what types of federal benefit funds are exempt, including SSA and VA benefits, in order to aid the consumer in asserting federal protections
- Promptly determine, as feasible, whether an account contains only exempt federal benefit funds, such as SSA or VA benefits
- Notify the creditor, collection agent, or relevant state court that the account contains exempt funds in cases in which the financial institution is aware that the account contains exempt funds
- Act accordingly if state law or the court order permits that a freeze does not have to be imposed if the account is determined to contain only exempt federal benefit funds
- Minimize the cost to a consumer when the consumer's account containing exempt federal benefit funds is frozen, such as by refraining from imposing overdraft, NSF, or similar fees while the account is frozen or by refunding such fees when the freeze has been lifted
- Allow the consumer access to a portion of the account equivalent to the documented amount of exempt federal benefit funds as soon as the financial institution determines that none of the exceptions to the federal protections against garnishment of exempt federal benefit funds are triggered by the garnishment order
- Offer consumers segregated accounts that contain only federal benefit funds without commingling of other funds
- Lift the freeze on an account as soon as permissible under state law.

Banks are encouraged to submit comments on the proposed best practices. The rulemaking notice contains contact information for all of the agencies and is available at <a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/07-4783.pdf>.

ruled for the customers, finding that setoff was not an exception to section 207 of the Social Security Act. But the court also stated that the outcome might be different if evidence were presented that the customer had signed an agreement allowing the bank to offset the account for the customer's other indebtedness to the bank.

It should be noted that the United States Court of Appeals for the Third Circuit, which has jurisdiction for appeals from federal courts and agencies in Pennsylvania, New Jersey, and Delaware, has not yet specifically addressed the issue of whether a setoff is permissible against a social security account to cover a debt arising from that account.

However, it appears from these cases that banks are generally prohibited from allowing levy or garnishment of customer accounts funded only by social security benefits when the garnishment is from a third-party creditor or when the debt is owed to the bank but is unrelated to the account receiving the social security benefits. One example is attempting to pay a customer's delinquent credit card debt by a setoff against the deposit account for social security benefits. But some recent cases have recognized an exception when the bank is performing an offset against a protected account because of a delinquency in the account, typically an overdraft or an overdraft fee. The lesson for banks is that they should proceed cautiously in this area and review their policies and procedures to ensure that they are in compliance with state and federal law. ☐

FRS Alert: Federal and State Banking Regulators' Statement on Loss Mitigation Strategies for Servicers of Securitized Residential Mortgages

On September 5, 2007, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the National Credit Union Administration, and the Conference of State Bank Supervisors (CSBS) issued a *Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages*. The statement encourages federally-regulated and state-supervised institutions that service residential mortgages (servicers) to pursue strategies that mitigate losses while preserving homeownership to the possible and appropriate extent.

The federal agencies previously issued statements encouraging the institutions they supervise to work with delinquent mortgage borrowers to avoid foreclosure. However, the prior statements did not address the special issues that arise for servicers of securitized mortgage loans. When a bank originates a loan and holds it in its portfolio, it has complete discretion to perform a loan workout with the borrower to avoid default. But with securitization, mortgage loans are pooled together and transferred to a trust. Servicing for these securitized loans is governed by the terms of a contract document, typically referred to as a Pooling and Servicing Agreement. Such an agreement will specify the circumstances under which delinquent mortgages can be restructured and the types of restructurings that are permissible. The agencies encourage financial institutions to take the following steps when they identify a loan at risk for default:

- Proactively identify borrowers at heightened risk of delinquency or default, such as those with impending interest rate resets
- Contact borrowers to assess their ability to repay
- Assess whether there is a reasonable basis to conclude that default is "reasonably foreseeable"
- Explore, when appropriate, a loss mitigation strategy that avoids foreclosure or other actions that result in a loss of homeownership

The full statement is available at: <www.federalreserve.gov/newsevents/press/bcreg/bcreg20070904a1.pdf>. ☐

Compliance Alert:
Federal Reserve System Change of Address For Consumer Complaints

The Federal Reserve System recently restructured its procedures for responding to consumer complaints. Previously, each of the 12 regional Federal Reserve Banks received consumer complaints and either investigated and responded to them if that Reserve Bank was the regulator of the relevant financial institution or forwarded the complaint to the appropriate bank regulator. In the new system, which started on November 16, 2007, and is called Federal Reserve Consumer Help (FRCH), all consumer complaint calls to Reserve Banks or to the Board of Governors are received at a central site maintained jointly by the Federal Reserve Banks of Minneapolis and Kansas City. All consumer complaints and inquiries should be directed to the new center, whose address and toll-free number are:

Federal Reserve
Consumer Help
P.O. Box 1200
Minneapolis, MN 55480
(888) 851-1920
(8 a.m. to 6 p.m. CST)

Consumers can also file complaints online at FRCH's website: <federalreserveconsumerhelp.gov/>.

The address change will affect Regulation B and the Fair Housing Act (FHA) and will require action to be taken by all supervised institutions. For Regulation B, this change requires state member banks to update the section of their adverse action notices that identifies the agency that administers compliance with Regulation B.[1] Also, the address for the new FRCH must be reflected on the Equal Housing Lending posters that are required under the FHA to be displayed in bank-

ing offices.[2] Banks may obtain copies of the poster from the Federal Reserve Board at no charge by calling (202) 452-3245 or writing to: Board of Governors of the Federal Reserve System Publications Fulfillment, MS-127, Washington, DC 20551.

Banks may also reprint the posters themselves with the new FRCH address or print the address on stickers to be placed over the Federal Reserve Board addresses on their existing posters. For more information, please refer to the Federal Reserve Board's CA Letter 07-06, which was sent to all institutions supervised by the Federal Reserve System on October 16, 2007.

---

[1] Section 202.9(a)(2) of Regulation B requires that the adverse action notice identify "the name and address of the federal agency that administers compliance with respect to the creditor."

[2] Pursuant to the March 20, 1989, Board Order on Fair Housing Advertising and Poster Requirements, "A state member bank that engages in extending any loan for the purpose of purchasing, constructing, improving, repairing, or maintaining a dwelling…or any loan secured by a dwelling shall conspicuously display an equal housing lender poster in any public lobby and area within the bank where deposits are received or where such loans are made in a manner clearly visible to the general public entering such areas."

Compliance Alert: New Federal Reserve Consumer Publication

5 Tips for Protecting Your Checking Account

On October 24, 2007, the Board of Governors of the Federal Reserve System announced the availability of a new consumer publication titled *5 Tips for Protecting Your Checking Account*. The publication provides these helpful tips to consumers to protect their checking accounts:

1. Don't give your account number and bank routing information to anyone you don't know.
2. Review your monthly statement.
3. Notify your bank about any problems as soon as possible.
4. If you don't have enough money in your account, don't write the check or authorize the debit.
5. Know your rights under consumer protection laws.

The full publication is available on the Board's website at <www.federalreserve.gov/pubs/checkingaccount/default.htm> and in pdf format at: <www.federalreserve.gov/pubs/checkingaccount/checkacctips.pdf>. Banks may order copies of the brochure for distribution to their customers at the following address: <www.federalreserve.gov/pubs/order.htm>.

The Right of Rescission: Overview and Recent Legal Developments

...continued from page CC1

History

TILA's legislative history indicates that Congress included rescission to provide a cooling off period to borrowers who obtained credit secured by a lien against their primary residence. Congress heard a parade of horror stories from consumers about unscrupulous home improvement contractors who pressured them into financing expensive renovation projects but failed to disclose that the loan was secured by a lien on the consumer's dwelling. Consumers who subsequently defaulted on the financing lost their homes. Rescission is designed to protect consumers from making an impulsive decision by disclosing the lien and providing a three-day cooling off period after the loan closing. Recission provides consumers with the opportunity to reconsider whether to place their home at risk.[2]

Covered Transactions

Rescission applies to consumer credit transactions secured by a lien on the consumer's principal dwelling.[3] Congress did not believe loans to purchase or construct a home—which TILA and Regulation Z identify as a residential mortgage transaction—presented the risk of a consumer making a decision he would later regret, or would feel pressured into making, so it exempted those transactions from rescission. Rescission does apply to a home equity line of credit, a home improvement loan, the refinancing of an existing mortgage, or any other nonpurchase credit transaction secured by the consumer's principal dwelling.

[2] The legislative history is discussed in *Rudisell v. Fifth Third Bank*, 622 F.2d 243 (6th Cir. 1980), and *N.C. Freed Co., Inc. v. F.R.S.*, 473 F.2d 1210, 1215 (2d Cir. 1973).

[3] Regulation Z defines "consumer credit" as credit offered or extended to a consumer primarily for personal, family, or household purposes. Section 3(a) of the Official Staff Commentary for Regulation Z provides an extended discussion about the definition of "business credit" that helps illuminate the distinction between consumer and business credit. Business credit is exempt from the requirements of TILA and Regulation Z.

Compliance Requirements

The primary compliance requirements for the right of rescission are that the creditor must 1) provide two copies of the notice of rescission, to each owner of the property, and 2) provide a statement that accurately discloses, subject to a small tolerance for error, the material disclosures about the credit transaction. For open-end credit, the material disclosures are "the information that must be provided to satisfy the requirements in §226.6 with regard to the method of determining the finance charge and the balance upon which a finance charge will be imposed, the annual percentage rate, the amount or method of determining the amount of any membership or participation fee that may be imposed as part of the plan, and the payment information described in §226.5b(d)(5)(i) and (ii) that is required under §226.6(e)(2)."[4] For closed-end credit, the material disclosures are the annual percentage rate, the finance charge, the amount financed, the total payments, the payment schedule, and the disclosures and limitations referred to in §226.32 (c) and (d)."[5] The material disclosures are typically grouped together at the top of the disclosure statement in a box known as the "Fed Box."

The rescission notice must disclose the following information: 1) that the creditor retains or acquires a security interest in the consumer's principal dwelling; 2) the consumer's right to rescind the transaction; 3) the procedure for exercising that right, with a form for that purpose that designates the address of the creditor's place of business; 4) the effects of rescission;[6] and 5) the date the rescission period expires.

[4] See section 226.15(a)(3) <ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=296382c85b4875c00cfa09bb6ef1a668&rgn=div8&view=text&node=12:3.0.1.1.7.2.8.13&idno=12>.

[5] See section 226.23(a)(3). <ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=296382c85b4875c00cfa09bb6ef1a668&rgn=div8&view=text&node=12:3.0.1.1.7.3.8.7&idno=12>.

The notice must follow the language of the official rescission notice form or be substantially similar.

Rescission applies to both open-end and closed-end credit. The primary difference in the rescission rule for open-end credit, which appears in section 15 of Regulation Z, and closed-end credit, which appears in section 23, is that each disbursement in an open-end plan is not subject to rescission if it is made in accordance with a previously established credit limit for the plan. In that case, only the initial credit transaction establishing the credit plan is subject to rescission. For example, if the creditor establishes a $100,000 home equity line of credit, and the consumer initially borrows $10,000, the entire transaction can be rescinded during the rescission period for the $100,000 line of credit. But once the initial rescission period passes, each subsequent draw on the credit line, up to $100,000, is not subject to rescission. If the creditor extends additional credit above the credit limit of the initial plan, only the credit in excess of the prior credit limit is subject to the right of rescission.

The consumer's right to exercise rescission expires three days after the closing of the loan. However, if the creditor fails to deliver the notice of the right of rescission to the consumer, fails to provide all of the material disclosures, or makes computational errors in the material disclosures in excess of the tolerance for such errors, the rescission period is extended to three years from the date of consummation of the loan.

Assignee Liability

Assignee liability is an important issue in rescission. The general rule for assignee liability, set forth in section 131 of TILA, 15 U.S.C. § 1641, is that the assignee of a credit transaction covered by TILA and Regu-

lation Z is only liable for violations that are apparent on the face of the disclosure statement. However, section 131 specifically exempts rescission from this rule so a borrower could compel the assignee of a loan with violations triggering the right of rescission to rescind the loan, even though the violations are not apparent on the face of the disclosure statement. Thus, banks must be careful in purchasing loans subject to rescission.

Recent Legal Developments

The following sections outline recent developments from legal cases regarding rescission.

Rescission class actions. In the last year, two federal trial courts made headlines when they issued rulings certifying class actions of lawsuits seeking rescission of mortgages for thousands of borrowers.[7] Until these rulings, rescission class actions had been rejected in leading court cases. Because rescission of a mortgage is an expensive remedy, the prospect of rescission class actions, with hundreds or thousands of borrowers, created intense anxiety in the mortgage industry.

In the first case, *McKenna v. First Horizon Home Loan Corp.*, 429 F. Supp. 2d 291 (D. Mass. 2006), a federal trial court in Boston certified a class action of borrowers involving the right of rescission. However, the decision was later reversed by the United States

---

[6] The effects of rescission that must be described are: 1) rescission voids the security interest in the property securing the loan, and the consumer is not liable for any amount, including any finance charge; 2) within 20 days after receipt of the rescission request, the creditor will return any money or property and will terminate the security interest; 3) the consumer may retain possession of the money or property until the creditor has met its obligations.

[7] See <www4.law.cornell.edu/uscode/html/uscode15/usc_sec_15_00001641----000-.html>.

Court of Appeals for the First Circuit [*McKenna v. First Horizon Home Loan Corp.*, 475 F.3d 418 (1st Cir. 2007)].[8] Prior to this decision, only one other federal appeals court had addressed this issue, ruling that rescission class action claims cannot be maintained under TILA [*James v. Home Constr. Co. of Mobile, Inc.*, 621 F.2d 727, 731 (5th Cir. 1980)].

In seeking reversal of the class certification, First Horizon noted that its potential liability could exceed $200 million. This point resonated with the First Circuit in light of TILA's legislative history. Congress amended TILA in 1995 to establish a ceiling of $500,000 for statutory damages in class actions under section 130 of TILA, the civil liability provision, to protect creditors from catastrophic damage awards. Because rescission damages are governed by section 125 of TILA, the damage limitation in section 130 does not apply to rescission cases. However, the First Circuit noted that it was implausible for Congress to amend TILA to address creditors' concerns that a technical TILA violation could result in catastrophic damage awards, while still allowing unlimited rescission damage awards.

A few days later, the California Court of Appeal affirmed a lower court ruling that a borrower's claim for rescission could not be certified as a class action in *Laliberte v. Pacific Mercantile Bank*, 147 Cal. App. 4th 1, 53 Cal.Rptr.3d 745 (Cal. App. 4th Dist. 2007).[9] The California court was also persuaded by the legislative history of the 1995 TILA amendment limiting class-action statutory damage awards, stating: "We…find it difficult to believe that Congress would carefully balance the deterrent effect of class actions under TILA against the potential harm to businesses in the context of statutory damages, and yet allow class action rescission to proceed without any safeguard for the affected business…Here, 100 class members seeking rescission would mean [Pacific Mercantile Bank] could face the loss of over $37 million in security upon entry of an unfavorable declaratory judgment. In other words, a declaratory judgment authorizing all class members to rescind their loans could be 'catastrophic.'" Lenders were relieved that the First Circuit and California state appeal court rejected rescission class actions in well-reasoned decisions.

This rescission issue also arose in another recent case involving Chevy Chase Bank of Maryland (Chevy Chase). A Wisconsin couple filed a rescission class action against the bank because of ambiguities in the TILA disclosure statement for their option ARM loan. The disclosure statement contained the required prominent disclosure box for the APR, which was 4.047%. However, it also disclosed "note interest rate of 1.95%." Significantly, the 1.95% rate was a discounted teaser rate that only applied to the first payment. The court held that this conflicting rate information violated TILA's requirement that disclosures be made clearly and conspicuously [*Andrews v. Chevy Chase Bank, FSB*, 474 F.Supp.2d 1006, 1007 (E.D. Wis. 2007)].

The disclosure statement also identified the bank's name for the loan product (WS Cashflow 5-year Fixed). The borrowers alleged that this led them to believe that the interest rate was fixed for five years and became variable after that. However, while the payment was fixed for five years, the interest rate was not. The bank also stated in the promissory note that the rate *may* change in August 2004 when, in fact, it knew it *would* change, and provided a misleading definition of "APR" on the back of the disclosure statement. Based on these TILA violations, the trial court held that the loan could be rescinded and certified the case as a class action.[10]

This case illustrates potential pitfalls for creditors with their TILA disclosures. In particular, a bank should only

[8] The First Circuit's decision is available at <www.ca1.uscourts.gov/cgi-bin/getopn.pl?OPINION=06-8018.01A>.

[9] The case is available at <fsnews.findlaw.com/cases/ca/caapp4th/slip/2007/g036235.html>.

[10] The court's decision is available at <classactiondefense.jmbm.com/andrewsclassactiondefense_ord.pdf>.

include information in the disclosure statement that is required by TILA or Regulation Z. Section 226.17(a) of Regulation Z, for closed-end credit, specifically prohibits a creditor from including information in the disclosure statement that is not directly related to the required disclosures. TILA and Regulation Z identify the information that a creditor must disclose in a credit transaction. Creditors should fully comply with these laws, without including unnecessary information that could potentially violate TILA or Regulation Z, as happened in the Chevy Chase case.

Chevy Chase appealed the class action ruling to the United States Court of Appeals for the Seventh Circuit, which recently heard oral arguments. The Seventh Circuit's decision, which is expected in the near future, will provide further clarity on this important issue. But even if Chevy Chase wins the class action issue on appeal, it still faces liability to the original borrowers. In addition, the trial judge's decision was reported in the *Wall Street Journal*, the *Washington Post*, and other publications, creating reputational risk. These risks underscore the importance of strict adherence to the rescission compliance requirements under Regulation Z and TILA.

Spousal homestead laws do not trigger rescission rights. In 2006, a federal trial court in Illinois addressed a novel rescission argument: whether a creditor extending a loan subject to rescission to a husband, secured by property of which he is the sole owner, must provide the rescission notice to his spouse based solely on her state homestead rights in the property. Section 226.23 of Regulation Z requires that "in a credit transaction in which a security interest is or will be retained or acquired in a consumer's principal dwelling, *each consumer whose ownership interest is or will be subject to the security interest shall have the right to rescind the transaction*." The wife argued that she was entitled to the notice and to rescind because of homestead rights in the property. Some states have adopted homestead laws, under which when only one spouse owns a family home that both spouses have occupied during the marital relationship, the owning spouse cannot sell or encumber the property without the permission of the non-owning spouse. In this case, *Bills v. BNC Mortgage, Inc.*, 2006 WL 3227887 (N.D. Illinois, Nov. 2006), the court rejected this argument because it concluded that a spouse's homestead rights in a property do not legally constitute an "ownership interest." The rescission notice and right to rescind only apply to a consumer with an ownership interest in a property in which a creditor is obtaining a security interest. Therefore, the spouse had no right to rescind.

Amount consumer must repay when loan is rescinded. A number of court cases have wrestled with the issue of what amounts a consumer must return to a lender when he rescinds a loan. Section 125 of TILA specifies that when a loan is rescinded, "the consumer is not liable for any finance or other charge, and any security interest given by the obligor, including any such interest arising by operation of law, becomes void upon such a rescission." In some loans, a consumer borrows not only a principal amount but also lender's fees and finance charges. In a recent case, *Moore v. Cycon Enterprises, Inc.*, 2007 WL 475202 (W.D. Michigan, Feb. 2007), a trial court in Michigan ruled that a husband and wife who rescinded a loan were not required to repay any amounts of a loan they borrowed to cover lender's fees and finance charges because of the language in section 125 quoted above. The lender tried to argue that section 125 only applied to amounts that were finance charges under TILA. However, the court noted that section 125's plain language states "the consumer is not liable for any finance *or other charge*." The Court therefore ruled that the borrowers were not required to repay any of these fees and charges, which amounted to $25,237.85 out of the total loan for $215,500.

These cases underscore the importance of strict adherence to the rescission compliance requirements under Regulation Z and TILA. Rescission presents compliance and reputational risks for banks and therefore must be handled appropriately in order to manage the risks effectively. □

FEDERAL RESERVE BANK
OF PHILADELPHIA

Supervision, Regulation and Credit Department
Ten Independence Mall
Philadelphia, PA 19106

www.philadelphiafed.org

E-Mail Notification Service

Would you like to read *SRC Insights* and *Compliance Corner* on our website up to three weeks before they are mailed? Sign up for our e-mail notification service today at <www.philadelphiafed.org/phil_mailing_list/dsp_user_login.cfm>.