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GUEST COMMENTARY

LIFE AFTER *JESINOSKI*: THE NEW 'WILD WEST' OF TILA RESCISSION

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The U.S. Supreme Court recently issued its opinion in a landmark case that interpreted what it takes under the Truth in Lending Act to affect a rescission of a loan transaction. The issue was hotter than a $2 pistol and the holding leaves the industry with results which are anything but cut and dried. Indeed, the brevity of Justice Antonin Scalia's opinion belies the complexity of the new TILA rescission landscape now littered with tumbleweeds, prickly cactus, and more rocks than ever before.

This article provides a brief overview of the Court's decision in *Jesinoski, et ux. v. Countrywide Home Loans, Inc. et al.*, 135 S.Ct. 790 (2015), including the necessary implications and questions that have arisen as a result. We then take a look at the potential solutions to some big-picture issues and suggest a map for the rugged terrain. Looks like the industry will have to pony up to meet the uncertainties created by the bushwhack potential of a destroyed security interest.

WHAT THE COURT DECIDED

The right of rescission provided by the Truth in Lending Act is well-known to participants in the residential mortgage market: TILA provides that a borrower has a right to rescind a loan "until midnight of the third business day following the consummation of the transaction or the delivery of the [TILA disclosures], whichever is later." (15 U.S.C. § 1635(a)). Thus, within the first three days following consummation of a covered loan, a borrower's right of rescission is unconditional. After that, a borrower's right to rescind is conditioned upon a failure of the lender to provide the required disclosures.

As the Supreme Court noted, however, "this conditional right to rescind does not last forever" and, quoting § 1635(f), "[e]ven if a lender *never* makes the required disclosures, the 'right of rescission shall expire three years after the date of consummation of the transaction or upon the sale of the property, whichever comes first.'"

At issue in *Jesinoski* was the question of what, exactly, a borrower must do within that three-year period to exercise the right to rescind provided by TILA. The Jesinoskis argued that mere notice to its lender within the three-year period was sufficient to exercise its right of rescission. Countrywide argued that the statute required a borrower to file suit.

Despite a hefty dose of questions at oral argument that seemed to indicate the automatic rescission interpretation was balderdash, Justice Scalia decided otherwise — and was joined by a unanimous court: "The language [of TILA] leaves no doubt that rescission is effected when the borrower notifies the creditor of his intention to rescind."

The import of Justice Scalia's statement cannot be overstated. By stating that the rescission is "*effected*" upon notice, and not merely "exercised," Justice Scalia turned 40 years of TILA rescission jurisprudence into a scene which is now as clear as mud.

Courts in the past had the freedom to require proof of ability to tender loan proceeds prior to effecting the actual rescission. But there is no such freedom in the new Wild West: Any suit relating to a TILA rescission in which notice was already provided is merely a suit for a declaratory judgment on a rescission that was already had. And alas, any hope that Justice Scalia's word choice was flippant was shot full of holes when he expressly disclaimed any influence that the common law principles of rescission at law and rescission in equity might have on a question of TILA rescission.

While acknowledging that TILA did not codify the rescission at law requirement that a borrower tender the loan proceeds prior to the rescission, Scalia

refused to fill this void by bootstrapping to TILA the rescission in equity requirement that a court affirmatively decree a rescission. Worse still, the Court simply stopped there without explaining what the industry must do to avoid meeting Calamity Jane. On this point, the Court pretty much "beat the devil around the stump," as the saying goes.

Justice Scalia's brief five-page decision just may be the proverbial "wolf in sheep's clothing." Mutton punchers or not, market participants will have to cowboy-up and deal with some vexing choices. Let's take a closer look at seven of the buttes on the horizon which we can presently see (there are surely others we don't yet know about).

IS THE LIEN DEAD OR ALIVE?

Problem: The Court's unequivocal statement that "rescission is effected when the borrower notifies the creditor of his intention to rescind" creates grave uncertainty for mortgage creditors. In legal-speak, "rescind" means to abrogate or cancel unilaterally or by agreement, and to "effect" means to bring about or to make happen. Although the Court does not say as much, contextually this mandate is limited to those notices upon which the condition precedent (invalid disclosures) is satisfied.

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So, when a creditor receives a communication of a borrower's intent to rescind, his status as a secured creditor hangs upon whether the TILA notice (as the condition precedent) was inadequate at the time of transaction funding. Where the creditor cannot come to a 100 percent conclusion regarding the validity of the TILA notice, it doesn't know whether or not its security interest in the underlying property is dead or alive.

And, time is not on the creditor's side; 20 days is all there is. TILA requires that within 20 days of the rescission "the creditor shall ... take any action necessary or appropriate to reflect the termination of any security interest created under the transaction."

Solution: There's no lickity-split salve. Bank of America and other *amici* stressed this result to the Court, but without success. Post-*Jesinoski*, a creditor that has received a rescission notice that it considers invalid must either live with the risk that it is unsecured or litigate the issue by way of a declaratory judgment seeking a statement that the condition precedent to a borrower's right of rescission (deficient disclosures) has not been met.

THE QUICKSILVER FUNDING DILEMMA

Problem: Whether the lien is dead or alive is particularly problematic for participants in the residential mortgage-backed securities market if they have a business model which relies upon capital and financing from others. In TILA-speak, this refers to securitized second mortgages or home equity lines of credit — because TILA does not apply to purchase-money first mortgages. RMBS transactions typically involve representations and warranties regarding the status of the lien on the property.

Upon receipt of a TILA notice of a rescission, an originator or sponsor of an RMBS deal must make the difficult determination regarding which of the three forks in the road to take. One fork assumes that the notice is valid and initiates an expensive buy-back procedure, which would avoid R&W-related litigation. A second is to assume that the notice is invalid, not initiate a buy-back, and in turn leave itself vulnerable to the investor-wrath-risk of R&W-related liability in the event that the notice is subsequently found to be valid. And the third fork is to initiate a declaratory judgment proceeding in which the court is asked to make a determination as to whether the notice is valid, while still running the risk of R&W-related liability for losses during the period between the notice of rescission and the declaratory judgment.

Relatedly, where an originator or RMBS sponsor receives a rescission notice for a loan — which it has not yet pooled into an RMBS or sold to a party who will pool it into an RMBS — that loan then becomes a stray that is in effect unsecuritizable until the matter of rescission has been litigated, lest that party subject itself to significant liability.

Solution: The first two forks have the potential to a negative material impact on the RMBS market. With respect to the first path, initiating an expensive buy-back for all loans for which a notice of rescission has been received would dramatically increase the costs associated with sponsoring such securities. With respect to the second path, confidence in the RMBS market is just beginning to return, and any actions which may be seen as dishonest towards investors should be avoided at all costs — no matter how earnest the sponsor/originator's belief that the rescission was invalid.

The third path is a RMBS sponsor's safest bet. Even so, during the time period between a rescission notice and a declaratory judgment, a sponsor runs the risk of being in violation of the enforceable-

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lien R&W. RMBS participants could rope-in this risk by including within their R&Ws a statement that for purposes of the enforceable-lien provision, a TILA rescission will not be construed as effective until the validity of the notice of rescission has either been acknowledged by the servicer or confirmed by an appropriate court.

THE ACE IN THE HOLE?

Problem:Although the issue was evidently not enough to garner his vote, Justice Alito grasped one of the practical anomalies associated with a rescission procedure that is effected immediately upon the giving of notice: He asked if there are not scenarios where the "the rescission is rescinded."

This could be the hidden gun that the industry needs. During oral argument, Justice Alito posited the scenario where a rescission is already completed upon the borrower's giving notice, but where the borrower is thereafter unable to tender back the funds delivered. This is real quicksand which cannot be avoided and must be crossed.

What type of security interest does a creditor obtain in the property after a failure to tender? Does the rescinded mortgage go back into effect? Is the property now held in a constructive trust on behalf of the creditor? Or perhaps the creditor's secured status never returns, and they may only sue upon the note?

TILA does not answer these questions. Rescission at law and rescission in equity both require that a tender be made at least contemporaneously with the rescission. Thus, the problems associated with the post-rescission and pre-tender time period are unique to TILA rescission.

Solution: This conundrum may be best left to Congress, but the new Wild West may be littered with bones before Congress acts. TILA could be amended to include a provision which states that upon a borrower's failure to tender, a creditor's previously rescinded security interest is revived and placed in the same position of priority with respect to other secured parties that it was in prior to the rescission.

Disregarding the long-odds of a statutory clarification, there are other options for courts. Equitable mortgages, equitable liens, and constructive trusts are all common-law creations to resolve inequitable circumstances. Courts have long held that an equitable lien creates "a right of a special nature over the thing, which constitutes a charge or incumbrance upon the thing, so that the very thing itself may be proceeded against in an equitable action." It can be "either sold or sequestered under a judicial decree, and its proceeds in the one case, or its rents and profits in the other, applied upon the demand of the creditor in whose favor the lien exists." (Q*uoting Jones v. Carpenter*, 106 So. 127 (1925).)

A court could determine that an equitable lien is automatically placed upon the subject property at the time of a borrower's failure to tender, subject to the terms and conditions of the rescinded mortgage. Alternatively, a court could use its equitable powers to do just what Justice Alito suggested: Rescind the rescission and act as if nothing had ever happened to the security interest of the creditor.

BALLYHOO AND BAMBOOZLING

Problem: The rescinded rescission obstacle also raises issues regarding the relationship between a post-failure-to-tender creditor and other innocent third parties. Properties sales will occur and no one wants to get a raw deal. By requiring creditors to comply with mortgage satisfaction filing requirements prior to tender, TILA rescission is ripe for implicating third parties.

For example, where does a post-failure-to-tender creditor fall in the hierarchy of secured creditors? Does it retain its pre-rescission seniority or is it bumped down to the bottom of the list? Is the conclusion different if the other secured creditor gained its interest after the rescission? Also, what is the relationship between a post-failure-to-tender creditor and a bona fide purchaser of the subject property? If the rescission has already been "effected", can the creditor now seek to foreclose on the property under a revived mortgage agreement? And from whom may the bona fide purchaser and/or creditor seek damages?

Solution: Once again, further clarity from Congress would be the best medicine for this statutorily-created ailment. That said, courts' hands are not tied. For example, the doctrine of equitable subrogation may provide fertile ground for ensuring that a post-failure-to-tender creditor returns to its pre-rescission priority. (*See, e.g., Davis v. Johnson*, 246 S.E.2d 297 (Ga. 1978).) As for bona fide purchasers, a creditor's best bet may be to seek the proceeds of the sale from the original borrower by way of a constructive trust.

Also, creditors may be able to reduce the risk of third-party complications by acting promptly as soon as tender is not made. TILA requires that "upon the performance of the creditor's obligations under this section, the obligor shall tender the property to the creditor." Thus, as soon as the creditor has returned all earnest money, down payments, and interest, and has filed a satisfaction of mortgage, it should demand payment. When payment is not received, prudence suggests that the creditor should

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immediately file a declaratory judgment action seeking a statement that the creditor's security interest is valid, while simultaneously recording a notice *lis pendens*.

BETTER THAN A LICK AND A PROMISE?

Problem: Opportunistic borrowers may game the system. Because TILA requires that a creditor must return all earnest moneys, down payments, and interest payments made prior to the time of rescission, TILA rescission provides the potential for a significant borrower windfall. Thus, a borrower who is disinclined to above-board behavior and aware of a TILA disclosure violation (e.g., only receiving one copy of the necessary disclosures) has a strong incentive to delay giving notice to the creditor until the end of the three-year period.

Furthermore, because the borrower, once notice has been given, has done all that it needs to do to effect the rescission under *Jesinoski*, it is in the borrower's best interests to act unresponsively and uncooperatively with regards to the lender going forward. Indeed, the borrower's incentive benefit grows larger the longer the time period between consummation and ultimate rescission

Solution: The best solution to the problem of the opportunistic borrower is a prompt declaratory judgment action. The CFPB acknowledged this path in its *Jesinoski* brief by stating that "[a] court could apply the doctrine of laches to bar equitable relief if the obligor's delay sufficiently prejudiced the creditor." Courts should adhere to this recommendation. There is no justice in allowing a borrower to intentionally sit on its claims in an effort to maximize its pecuniary gain, especially where the underlying violation of the hyper-technical TILA statute has caused the borrower no harm.

WHEN IS WORRY REDUCED TO SIMPLY BARKING AT A KNOT?

Problem: If three years is not a hard and fast statute of repose for filing TILA rescission claims, then when is the issue dead and the worry no longer valid? There are several options now created for the statute of limitations. For example, the Jesinoski's brief argued that courts should look to the most analogous statute of limitations in state law, while the CFPB acknowledged that there are a number of possible sources, including § 1640's one-year period for damages under TILA or the statute of limitations applicable to the enforcement of a rescission under state law.

A comparison of just three states demonstrates the wide range of limitations periods, and manners of application, which could be found most analogous. This risk could survive for as little as two years and up to a decade. Compare California's rule stated in *Galen v. Mobil Oil Corp.*, 922 F. Supp. 318 (C.D. Cal. 1996), which held that the limitations period is four years and "begins to run from the date upon which the facts that entitle the aggrieved party to rescind occurred;" with Ohio's in *Corrigan v. Rockefeller*, 8 Ohio N.P. 281 (1900), where the limitations period is generally four years but can be two years per the doctrine of laches (slumbering on one's rights) if the plaintiff was aware of its right to rescind; and Iowa's Code § 614.1, which establishes a 10-year limitations period to an action upon written contract.

Solution: The myriad statutes of limitations that could apply, not to mention accrual dates, provide a strong policy reason for courts to adopt the one-year limitations period in § 1640 that is applicable to claims for damages under TILA. Although state law is typically "the lender of first resort" (*N. Star Steel Co. v. Thomas*, 515 U.S. 29 (1995)), where impractical courts will instead use a federal analogue. (*See, e.g., Prostar v. Massachi*, 239 F.3d 669 (5th Cir. 2001).)

As discussed above, TILA rescission creates a scenario previously unknown to the common law. Thus, state statutes of limitation for rescission at law, rescission in equity, or breach of contract are hardly analogous. More appropriate is the one-year period in § 1640, which acknowledges the fact that, at heart, TILA is a notice statute and that the violations upon which most TILA claims are premised are trivial in nature.

WILL THE FEDS DICTATE TO DODGE CITY?

Problem: While local property law process and procedures — for enforcement of liens, foreclosure, and eviction requirements — are quintessentially local jurisdictional issues, there is a danger of federal-law interference. The *Jesinoski* decision's statement that rescission is effected upon mere notice might grant a borrower in a non-judicial foreclosure state the power to force their foreclosure process into the judicial realm, especially when the foreclosure is brought within three years.

For example, if a creditor initiates foreclosure proceedings in a non-judicial foreclosure state within the first three years after consummation, the borrower can, in effect, force the proceedings into the judicial arena by proceeding to send the creditor a notice of rescission. The lender then has to go to court to avoid risking a wrongful foreclosure claim or the setting aside of the foreclosure sale. In this

way, *Jesinoski* could undermine the carefully thought out non-judicial procedures created by state legislatures by moving their foreclosure process back into the judicial pipeline.

Solution: This is another unfortunate result of *Jesinoski* for which a creditor has little recourse. In fact, the best solution to this problem might be an acknowledgment by courts of the availability of a claim for bad faith notice of rescission and strict adherence to state versions of Rule 11 for improper foreclosure defenses that premised on imposter notices of rescission.

AND THERE'S EVEN MORE... MUCH MORE

The new Wild West rules for dealing with TILA rescission notices, processing foreclosures, and accommodating shootouts at the OK Corral will take time and considerable effort to map out with clarity. It could be years before the whole kit and caboodle can be settled. While we address a number of the compressed hay piles along the path to prosperity, there are other buckin' broncos in need of breaking.

For example, might a borrower be entitled to contractually waive his right of rescission outside the three-day automatic window, based upon a clear acknowledgement that the TILA disclosures were complete before funding, and perhaps have the waiver buttressed by a small rate discount concession for the deal which reflects the higher certainty and marketability of the transaction? What extra protection comes to lenders which have borrowers reaffirm on the anniversary of each of the first three years that the TILA disclosures were accurately and completely made- an affirmation perhaps horse-traded for some monetary advantage? Is this helpful to RMBS deals?

Furthermore, can lenders in receipt of a belated rescission demand from borrowers in default-and perhaps attempting to roost one over on the lender-immediately file a DJ lawsuit with proof of accurate TILA disclosures on the face of the pleadings and asking for a TRO on the rescission effect pending outcome of the determination? Would this prevent the wipe-out of the lien after the prescribed 20 days and allow the lender to seek expedited justice by motion for judgment on the pleadings? If a rescission notice is delivered and 20 days pass, then what insurable interest does a lender have in the property? Will it allow valid lender-placed hazard insurance to remain in force and effect to protect the premises in case the defaulted borrower has no means or plans to keep the property protected?

And finally, how will the local sheriffs handle the separate eviction process where a bodacious borrower insists they have rescinded their loan, but has no plans or means to pay the debt and continues to squat upon a premises?

Challenging terrain lies ahead. Let's hope there are some Wyatt Earp wanna-be's out there who are up to the task of keeping order in the new Wild West of TILA rescission.

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