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Borrower May Be Excused From Returning Loan Proceeds Under TILA

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08-13-2007

Many homeowners borrow money as a second mortgage so as to purchase their house, pay for home improvements, or pay off unrelated personal debt. In this highly regulated industry, such homeowners can rescind the mortgage loan even after closing and receiving the loan proceeds.

In *Johnson v. Chase Manhattan Bank*, the U.S. District Court for the Eastern District of Pennsylvania recently implied that a borrower may be allowed to rescind a mortgage loan without even being obligated to return the loan proceeds back to the mortgage lender.

BORROWERS DEFRAUDED

The plaintiffs, a married couple, were approached by two men on behalf of an organization called the Philadelphia Home Improvement Outreach Program (PHI). These men told the plaintiffs that PHI would assist them in arranging financing to pay for improvements to their house and to oversee the completion of these home improvements. Without the plaintiffs' knowledge, these men contacted a mortgage broker from Bryn Mawr Mortgage to arrange for financing. Sometime thereafter, a loan application was submitted to Chase Manhattan Bank upon the plaintiffs' behalf.

The plaintiffs subsequently agreed to a loan from Chase, approximately half of which was to pay off two existing mortgages on their home and other existing debt, another portion of which was to be distributed to them in the form of cash, and the remainder of which was to be used for the home improvements.

At the loan closing, the plaintiffs were advised that Chase would escrow the loan proceeds intended for the home improvements and would disburse the funds upon authorization of the plaintiffs to PHI's subcontractors.

Despite the representations made to the plaintiffs prior to the closing, the nonmortgage debt was not paid off, and they did not receive the cash disbursement. Instead, these loan proceeds were directly distributed to these men at closing. Although PHI retained the services subcontractors to complete the home improvements, much of the work was not completed and what was completed was shoddy and consisted of substandard materials. As a result, the plaintiffs notified Chase that they were rescinding the loan.

When Chase refused to honor the plaintiffs' rescission request, the plaintiffs filed a complaint against Chase for, among other things, violations of the Truth in Lending Act (TILA). In response, Chase filed a motion attempting to dismiss the complaint due to the plaintiffs' alleged failure to assert a viable cause of action under TILA.

TILA

In the case of any consumer credit transaction, TILA gives borrowers a temporary right to rescind a mortgage loan where the mortgaged property is being used as their principal dwelling. Under TILA, borrowers can rescind the transaction until midnight of the third business day following the consummation of the transaction or the delivery of statutorily mandated information and rescission forms, whichever is later.

The creditor must provide the borrower with notice of this right of rescission by giving two copies of the notice to each borrower who has that right and the notice must clearly and conspicuously disclose the retention or acquisition of a security interest in the borrower's principal dwelling, the borrower's right to rescind the transaction, how to exercise the right to rescind, with a form for that purpose, designating the address of the creditor's place of business, the effects of rescission, and the date the rescission period expires.

If a creditor fails to deliver the notice or any of the required material disclosures, the borrower may rescind the transaction at any time up to three years following the consummation of the transaction.

The board of governors of the Federal Reserve System, which is responsible for developing model disclosure forms, has published a model notice of right to cancel form. A creditor using this model form is deemed to be in compliance with the disclosure provision of TILA.

TRIAL COURT DECISION

In *Johnson*, there was no dispute that the form used by Chase Manhattan Bank conformed to the model form promulgated under TILA. Rather, the plaintiffs pointed out that Chase failed to properly complete the paperwork given to the wife. Unlike the husband's notice, the line in the notice providing for the date by which the wife had to exercise her right to rescind the transaction was left blank. As such, the wife contended that the three-year, not the three-day, period to rescind the loan applied.

Relying upon the 1st U.S. Circuit Court of Appeals' recent decision in *Palmer v. Champion Mortgage*, Chase argued that its duty was only to provide an objectively reasonable notice of the deadline and that the wife's notice was sufficient to meet that standard because it twice provided information that would

make the deadline clear to the average consumer.

In *Palmer*, the creditor mailed the notice to the borrower after the closing had already taken place. Although the notice identified the deadline for rescission, the borrower did not receive it until after the recession deadline had passed.

The notice contained language explaining that the rescission deadline would not pass until three days after the latest of the three triggering events, one of which was the date the borrower received the notice of her right to cancel, and a parenthetical note after listing the rescission deadline setting out an alternative manner for determining the deadline if the three triggering events did not occur at the same time.

The borrower attempted to rescind the transaction 17 months later. She argued that because the original recession deadline had passed before she received the notice, the notice was "confusing" and such defective notice extended her right to rescind to the statutory three-year period.

The 1st Circuit in *Palmer* used the standard of an "average consumer, looking at the notice objectively" to determine that the notice was not confusing and that the extended rescission right under TILA was not triggered. The court stressed that the "twice-repeated alternative deadlines would have made it crystal clear to the average consumer that the . . . deadline would not necessarily be the applicable one."

The trial court in *Johnson* did not believe that the factual circumstances in *Palmer* were analogous but instead were fatally distinguishable. Unlike *Palmer*, the trial court noted that the notice in *Johnson* did not comply with TILA's statutory scheme in that the notice did not contain the requisite date to rescind the transaction.

Moreover, the trial court in *Johnson* concluded that the 1st Circuit in *Palmer* did not address whether an alleged TILA violation could be excused, but rather whether the notice was defective because it was confusing even though there was compliance with TILA.

The trial court next tackled Chase Manhattan Bank's assertion that the TILA claim should be dismissed because the plaintiffs did not return the principal of the mortgage loan prior to pursuing its rescission.

After reviewing the statutory language, the trial court held that borrowers are not required to tender the loan proceeds before invoking their right to rescind unless and until a court decides otherwise and modifies the statutory scheme. According to the trial court, "[c]ontrary to Chase Manhattan Bank's assertion, this modification is a matter of the court's equitable discretion and does not operate automatically. Indeed, in each of the cases Chase Manhattan Bank cites, the court recognizes that it is using its authorized discretion to depart from the ordinary order as described in the statute."

The trial court emphasized that even if it were to interpret Chase's motion for dismissal as a request for conditional rescission, it would have been premature at that early stage of litigation since there was no record of the plaintiffs' inability to return the proceeds of the loan or any of the other circumstances it would be obliged to consider if making a decision on equitable grounds.

LESSONS LEARNED

The trial court's ruling in *Johnson* should send shivers down the spines of mortgage lenders throughout the commonwealth. The trial court has not foreclosed the possibility that Chase Manhattan Bank could be held financially responsible for the fraudulent activity allegedly committed by unrelated third parties. In *Johnson*, the trial court will be presumably forced to determine liability based upon Chase's alleged failure to properly monitor the disbursements of loan proceeds earmarked for the nonmortgage debt and the home improvements.

At the very least, *Johnson* should clearly encourage mortgage lenders to review and tighten their business practices with respect to home equity lines of credit.

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