

The Federal Truth in Lending Act: What You Don't Know Can Hurt You

Pamela D. Simmons, Attorney at Law

Introduction

Ten years ago, I represented the borrower in a case that stemmed from a title company's failure to secure a loan on all of the borrower's land. (The title company had listed only one of several parcels of land and the lender was unable to non-judicially foreclose on the property as a result.) The complaint had already been filed, and listed among the many causes of action was one entitled "Violation of Reg Z." One day an attorney for one of the defendants asked me: "What is this Reg Z? I've never even heard of it." So began my love affair with the Federal Truth in Lending Act.

Most attorneys know the Federal Truth in Lending Act (TILA) as the group of laws requiring certain disclosures about the cost of borrowing money. You have seen the disclosures every time you have received a new credit card. Many readers may also be aware that consumers who are borrowing against their homes have a three-day right to cancel the transaction—another feature of TILA. However, few real estate attorneys know that TILA's right to cancel can last for as long as three years after the loan is made. Moreover, under certain circumstances, TILA can govern individual lenders making a first loan secured by residential property. And even fewer practitioners know that the cost of rescission to the lender is all of the interest, fees, costs, and any other charges not directly for the benefit of the borrower. I have personally seen the loss to the lender exceed \$280,000. In this article I will discuss the history of TILA, describe rescission (its most important provision), and offer some tips on avoiding its pitfalls and attorney malpractice.

I. TILA's History and Predatory Lending

In 1968, Congress enacted TILA (15 USC §§1601–1693r). Section 105 of TILA requires the Federal Reserve Board to promulgate implementing regulations, which are collectively known as Regulation Z (12 CFR pt 226). Regulation Z provides for Official Staff Interpretations (known as the Commentary), which give guidance to the attorney, effectively putting meat on the bones that is TILA; reliance on the Commentary protects the creditor from any civil or criminal liability under TILA.

Initially, TILA was only a disclosure statute; by requiring that consumers be informed of the true cost of their borrowing, it was hoped that consumers could not only make informed decisions, but also make comparisons between similar lending products. In 1980, however, TILA was substantially changed to provide greater simplicity and new consumer protections.

In 1994, TILA was again amended to add the Homeowner's Equity Protection Act (HOEPA), which was implemented through Reg Z §32 and is known as "HOEPA" to those who work with borrowers and "Section 32" to those who work with lenders. HOEPA was an attempt to control predatory lending practices that were perceived to be a

problem in the “sub-prime” lending arena. Sub-prime loans are those made to borrowers who do not meet conventional loan criteria—*i.e.*, who have depressed credit scores, high income-to-debt ratios, unconfirmable income sources, and so forth. Sub-prime lenders charge higher interest rates and fees to borrowers because the loans are considered higher risk.

Since interest rates, over time, can vary significantly, HOEPA establishes triggers indexed to the Treasury Bill rate. If the Annual Percentage Rate (APR) of a home loan exceeds 8 percent plus the comparable T-Bill rate on a first deed of trust (10 percent on a second deed of trust), it is a HOEPA loan. Alternatively, if the costs and fees of the loan exceed eight points, it is a HOEPA loan. It was through HOEPA that federal law began to prohibit certain loan terms and lender behavior.

II. How to Find the Law

As mentioned above, the law regarding TILA is comprised of three parts:

- TILA, found at 15 USC §§1601–1693r;
- Reg Z (the implementing regulations), found at 12 CFR pt 226; and
- Official Staff Commentary, found at Supp I of Reg Z.

In many areas, Reg Z fleshes out the meaning of TILA, and the Commentary fleshes out the meaning of Reg Z. If you are doing research in this area of law, you must look to all three components. An example of the interrelationship is as follows:

Title 15 USC §1602(h) defines “consumer”:

The adjective “consumer,” used with reference to a credit transaction, characterizes the transaction as one in which the party to whom the credit is offered or extended is a natural person, and the money, property, or services which are the subject of the transaction are primarily for personal, family, or household purposes. Regulation Z §226.2(a)(11) defines “consumers”: [A] cardholder or a natural person to whom consumer credit is offered or extended. However, for purposes of rescission under §§226.15 and 226.23, the term also includes a natural person in whose principal dwelling a security interest is or will be retained or acquired, if that person’s ownership interest in the dwelling is or will be subject to the security interest.

Official Staff Commentary §226.2(a)(11) states:

1. Scope. Guarantors, endorsers, and sureties are not generally consumers for purposes of the regulation, but they may be entitled to rescind under certain circumstances and they may have certain rights if they are obligated on credit card plans.
2. Rescission Rules. For purposes of rescission under §§226.15 and 226.23, a “consumer” includes any natural person whose ownership interest in his or her principal dwelling is subject to risk of loss. Thus, if a security interest is taken in A’s ownership interest in a

house which is A's principal dwelling, A is a consumer for purposes of rescission, even if A is not liable, either primarily or secondarily, on the underlying consumer credit transaction. An ownership interest does not include, for example, leaseholds or inchoate rights, such as dower.

3. Land Trusts. Credit extended to land trusts, as described in the commentary to §226.3(a), is considered to be credit extended to a natural person for purposes of the definition of consumer.

As always, case law adds additional clarification, or sometimes more confusion.

III. What Every Real Estate Attorney Should Know About TILA

A. Who Is a Lender Under TILA?

Jim came into my office quite concerned. He had lent money to someone he knew and the balloon payment was due, but had not been paid. He showed me the loan documents, which consisted of a promissory note and short-form deed of trust, which had been recorded by the escrow company. Jim explained that the borrower was someone he was familiar with who had approached Jim for a loan on a house, and had come up with the loan amount, interest rate, and payment terms. Jim had lent \$50,000, secured by a third deed of trust, at 12-percent interest; interest-only payments were to be made monthly, with a balloon payment due at the end of a year. Jim arranged the loan through a real estate broker friend of his and the borrower was charged an additional \$4000 in "points" paid to the broker. Jim knew that the borrower was behind on his other mortgages and was borrowing the money to "catch up." The borrower had fallen behind on the loan due to illness, but he was going to list the house for sale—and it had plenty of equity. The deal had originally sounded great to Jim, but now the balloon was due and the money was not forthcoming. Jim was a plumber and had never made a loan secured by property to anyone before.

Poor Jim. The bad news was that Jim was a lender, as defined by TILA, and had failed to make the disclosures required under TILA and had used prohibited terms. The loan was therefore rescindable by the borrower. If that happened, Jim would lose not only all interest due on the note, but also the broker fee and all other closing costs. Moreover, he would be liable for statutory penalties and the borrower's reasonable attorney fees. The good news was that so few real estate attorneys know anything about this law that the issue would be missed by virtually any attorney whom the borrower might consult.

How is it possible that plumber Jim, a first time lender, ran afoul of federal law? TILA governs loans made by a lender to consumers for primarily household purposes. A lender is a lender for TILA purposes if the lender has made more than five loans secured by residential property last year or more than five loans this year. However, under HOEPA, a lender is defined as a lender who makes two HOEPA loans, in any 12-month period, secured by the borrower's residence; and if a lender uses a mortgage broker to make a

HOEPA loan, that lender is a lender for all TILA purposes on the first HOEPA loan made. 15 USC §1602(f); Reg Z §226.2 n3.

B. Assignee Liability

Inherent in the business of making loans secured by residential property is a continuing need for capital to lend. As such, many home loans are sold to raise additional capital. Liability for violating TILA runs to the lender. Once the loan is sold, the liability, as related to rescission, extends to the assignee as well. 15 USC §1641(c).

When Does a Borrower Have a Right to Rescind?

The general rule is that a borrower whose loan is secured by his or her principal dwelling has the right to rescind, unless the loan is not intended primarily for personal family purposes or the loan is a purchase money loan. 15 USC §1635(f). There are, effectively, two separate rights to rescind. The first is the three-day right to cancel, which can be exercised by the borrower during the three business days after the loan documents are signed. During this three-day period, the lender should not release loan proceeds or record the security interest. This three-day right to cancel ends at midnight on the third business day after the loan documents were signed. A business day is Monday through Saturday, with certain holidays excluded.

The second right to rescind is the extended right to cancel. The statute of limitations on this extended right is three years; however, it can be tolled for certain reasons, and more importantly, a borrower can always rescind, if the loan is rescindable, if the lender starts foreclosure proceedings.

Under TILA, the extended right to rescind is created when the borrower is not properly notified of the three-day right to cancel or the TILA disclosures are not accurate within certain statutorily defined tolerances. Additional rights to rescind are also afforded under HOEPA, more fully discussed later in this article.

1. The Right to Cancel

Borrowers must be clearly informed when the right to cancel expires and where to cancel. Additionally, each borrower must be given two copies of the form that explains the right to cancel. One is for the borrower to give to the lender if he or she wishes to cancel the loan; the other is for the borrower to keep. Thus, if the person filling out the form miscounts the days, or leaves the form blank, or fails to give each borrower two copies of the right to cancel form, the borrower effectively has never received notice of the right to cancel and the right to cancel continues until either the borrower is given a properly filled out form (with a new current three-day cancellation period) or the statute of limitations expires.

2. The TILA Disclosure Form

Further, borrowers must be given an accurate disclosure of the terms of the loan (the TILA Disclosure). If no disclosure is made or if certain terms are not accurately disclosed within certain tolerances, the borrowers have an extended right to cancel. The TILA Disclosure is a form that has four boxes at the top of the page (undoubtedly you have seen them before) that disclose the APR, Finance Charge, Amount Financed, and the Total Payments. Some of the other necessary disclosures in the body of the form include the number of payments to be made over the term of the loan and the regular payment amount.

The Total Payments amount is equal to the monthly payment multiplied by the number of payments to be made during the term of the loan. When the loan is a fully amortized fixed-rate mortgage, this calculation is easy. The same holds when it is an interest-only loan with a balloon at the end. However, when the loan is a variable-rate mortgage, the calculation is more complicated. As an example, we will use the loan Jim made, an interest-only mortgage, with a balloon:

Our borrower has borrowed \$50,000 with a fixed rate of 10-percent interest, interest-only payments payable in equal amounts over a one-year term. The first 11 monthly payments are \$416.67, with a balloon payment due on the twelfth month of \$50,416.63. Accordingly, the amount listed in the Total Payments box should be \$55,000. Since the loan principal amount is \$50,000, we can easily determine that \$5000 is interest being paid on the \$50,000 loan. However, our borrower also paid \$4000 in broker fees, which were determined to be finance charges. Thus, the total finance charges that must be disclosed are \$9000.

The APR is considered the true interest rate that will be paid by the borrower over the life of the loan. The Finance Charge is broadly defined as any charge, payable directly or indirectly by the borrower, that is imposed directly or indirectly by the lender as an incident to or a condition of the extension of credit. 15 USC §1605(a); Reg Z §226.4(a). Even for those familiar with the myriad charges incurred by borrowers for a loan secured by their home, the determination of which charges are or are not finance charges can be daunting. It is beyond the scope of this article to address those issues; however, it is important to know that many charges are included in the definition of finance charge and, for purposes of determining the APR, these fees are lumped together with the interest charges.

The Amount Financed is generally the amount of credit provided to the borrower. Essentially, it is the remainder after the Finance Charge has been subtracted from the Total Payments. So, by subtracting the Finance Charge from the Total Payments, the Amount Financed by our borrower is \$41,000. TILA allows several methods of determining the APR. For this article, I used the APR calculator program offered by the Office of the Comptroller of the Currency, located at www.occ.treas.gov/aprwin.htm. Using that system, the APR on our loan is 31.18 percent, which is considerably higher than the stated interest rate, due to the high fees charged.

3. TILA Disclosure Accuracy Tolerances

The amount disclosed as Finance Charge in the TILA Disclosure must be accurate, up to certain tolerances. The tolerance depends on what action or right the borrower is enforcing. If the borrower is seeking to rescind the loan transaction and the lender has not started foreclosure proceedings, the tolerance is one-half of one percent (.005). If the lender overstates the Finance Charge, there is no extended right to rescind. However, if the lender has started foreclosure proceedings, either judicial or nonjudicial, the tolerance is \$35. Again, if the APR is overstated, there is no extended right to cancel.

The APR must be accurate as well. The tolerance for the APR rate disclosed in the TILA Disclosure is one-eighth of one percent (.00125). TILA states that the APR is inaccurate if it exceeds or is lower than the accurate APR by .00125; however, there is some disagreement about this. See Official Staff Commentary §226.22(a)(2)–1; 15 USC §1602(z); *Ramsey v Vista Mortgage Corp. (In re Ramsey)* (BAP 9th Cir 1994) 176 BR 183; *Barber v Knox County School Employees Credit Union (In re Cox)* (Bankr CD Ill 1990) 114 BR 165.

The accuracy tolerances listed above apply to “regular” transactions. An “irregular” transaction is one that has either multiple advances, irregular payment periods, or irregular payment amounts (other than an irregular first or final payment). Reg Z §226.22(a)(2) n46; Official Staff Commentary §226.22(a)(2)–1. The tolerance for an irregular transaction is one-fourth of one percent (.0025).

4. HOEPA

As discussed earlier, HOEPA is a section of TILA enacted to protect consumers from predatory lending practices. Loans governed by HOEPA not only have additional disclosures required, HOEPA also governs certain loan terms and practices. Violation of the disclosure rules or use of a prohibited loan term gives the borrower an extended right to rescind the loan.

Most commercial lenders are no longer making HOEPA loans because, generally, HOEPA loans are no longer accepted in the resale marketplace. As a result, HOEPA loans are becoming rare, although some small “hard money” lenders are still making these loans. Additionally, unsophisticated individuals, such as our “Jim,” are also making these loans without ever realizing that they are governed by and have run afoul of HOEPA. I have encountered both very recently. My experience has been that, as interest rates drop to low levels, many retirees have looked for a safe place to make a higher rate of return (relative to, say, government bonds). Some of them have begun to lend money secured by residences, but they have no idea how regulated this area has become.

a. APR and Points and Fees Triggers. For loans in first position, made after October 1, 2002, HOEPA will be triggered if the APR exceeds by more than 8 percent the yield on Treasury securities having comparable maturities on the fifteenth day of the month immediately preceding the time the loan was made. For junior loans the spread must be more than 10 percent. 15 USC §1602(aa)(1)(A); Reg Z §226.32(a)(i).

The other trigger that activates HOEPA is the points and fees trigger. If the lender charges points and fees totaling more than 8 percent of the total loan amount, it is governed by HOEPA. 15 USC §1602(aa)(1)(B); Reg Z §226.32(a)(1)(ii). In actual practice, a determination of the exact percentage rate of the points and fees, with respect to the total loan amount, is rather complicated and beyond the scope of this article.

b. HOEPA Disclosures. Borrowers obtaining a HOEPA loan are required to receive additional disclosures. These disclosures augment and do not replace the disclosures required under TILA generally. HOEPA disclosures must be given to the borrower three business days before the consummation of the loan. The disclosures require the following statements:

You are not required to complete this agreement merely because you received these disclosures or have signed a loan application.

If you obtain this loan, the lender will have a mortgage on your home. You could lose your home and any money you have put into it, if you do not meet your obligation under the loan.

Additionally, the lender must disclose the accurate APR and monthly payment amount, if the loan is a fixed-rate loan. If the loan is a variable interest rate loan, the disclosure must also inform the borrower that the monthly payment may increase and must state the amount of the maximum potential monthly payment. The monthly payment amount must also include disclosure of any balloon payment. The disclosure also must show the total face amount of the loan and state whether optional credit insurance or debt cancellation coverage is being sold to the borrower. 15 USC §1639; Reg Z §§226.31–226.32.

c. Prohibited Contract Terms. As discussed earlier, HOEPA prohibits certain loan contract terms. Inclusion of a prohibited term constitutes a failure to deliver the proper disclosures and creates an extended right to rescind the loan. The prohibited contract terms are:

(1) Prepayment Penalties (15 USC §1639(c); Reg Z §226.32(d)(6), (7)). Allowed under the following conditions: Loan must not cause borrower to pay more than 50 percent of gross monthly income towards “monthly indebtedness payments”; income and expenses must be verified by a financial statement signed by borrower, a credit report, and payment records for any employment income; penalty must not apply when borrower refinances one of its or an affiliate’s loans; repayment penalty can only be imposed for the first five years of loan term; and, must be valid under state law.

(2) Default Interest Rate Increases (15 USC §1639(d); Reg Z §226.32(d)(4)).

(3) Balloon Payments (15 USC §1639(e); Reg Z §226.32(d)(1)). Allowed if loan has term of five years or longer.

(4) Negative Amortization (15 USC §1639(f); Reg Z §226.32(d)(2)).

(5) Prepaid Interest Payments (15 USC §1639(g); Reg Z §226.32(d)(3)). Allowed if up to two months of payments are escrowed.

(6) Due-On-Demand Clauses (Reg Z §226.32(d)(8); Official Staff Commentary §226.32(d)(8)(ii)–(iii)). Allowed if there is fraud or material misrepresentation by the consumer in connection with obtaining the loan, the consumer fails to meet its financial obligations under the terms of the loan, or there is any action or inaction by the consumer that adversely affects the lender’s security interest in the home.

IV. The Rescission Process: The Law and Reality

A. The Law

The rescission process was intended to be self-enforcing and able to be completed without the necessity of going to court. If the homeowner does not sell the home, the extended right of rescission can last up to three years after the loan consummation—and longer if the lender initiates foreclosure proceedings. 15 USC §1635(f); Reg Z §§226.15(a)(3), 226.23(a)(3). The regulations set up a three-step process to rescind a loan.

First, the borrower must notify the lender, in writing, of the cancellation of the loan. While the notice must be in writing, it can be transmitted by mail, telegram, or other means. Reg Z §§226.15(a)(2), 226.23(a)(2). It should be sent to the lender’s designated place of business. A rescission notice sent by the borrower’s attorney is also effective. Official Staff Commentary §226.2(a)(22)–2. While signing the right to cancel and sending it to the lender is effective, my practice is to draft a letter notifying the lender of the rescission and the reasons for it. I usually send the letter to the address provided on the right to cancel form, if there is such a form, as well as any other address that the borrower may have for the lender.

A note on loan servicers: Currently, rescission letters sent to loan servicers are not effective notice to the lender. Many borrowers do not understand the difference between the owner of the loan and a loan servicer. Even savvy attorneys have trouble determining who owns the loan, because assignments are no longer routinely recorded. It is important to review the loan file to determine who was the lender at the time the loan was consummated. Additionally, I always check the chain of title to see if the loan has been assigned. If so, I send a copy of the rescission letter to the new lender as well. A call to the servicer can reveal who the owner is, although they generally do not like to give that information. Additionally, a proper written request under RESPA should work, if you have the time. A new Commentary states that, when the creditor fails to provide an address for a designated agent to whom rescission notice may be sent, delivery to the entity that the borrower makes the payments to will be effective notice to the lender or the lender’s assignee. Official Staff Commentary §226.23(a)(2)–1.

Once the loan is rescinded, the security interest or lien becomes automatically void, by operation of law. 15 USC §1635(b); Reg Z §§226.15(d)(1), 226.23(d)(1). The note also is voided. The lender's interest in the property is "automatically negated, regardless of its status and whether or not it was recorded or perfected." Official Staff Commentary §§226.15(d)(1)-1, 226.23(d)(1)-1.

Within 20 days of receipt of the notice of cancellation, the lender must return to the borrower any money or property that has been given to anyone in connection with the loan. 15 USC §1635(b); Reg Z §§226.15(d)(2), 226.23(d)(2). The lender must also take steps to reflect that the security interest has terminated.

Once the lender has terminated the security interest and returned any money or property it received, the borrower is then required to tender any property or money received from the lender. 15 USC §1635(b); Reg Z §§226.15(d)(3), 226.23(d)(3); Official Staff Commentary §§226.15(d)(3)-1, 226.23(d)(3)-1. This step is the reverse of most states' rescission law. The statute does not prescribe a time period in which tender must be accomplished.

As a result of the rescission, the lender retroactively loses the right to charge interest, fees, and costs on the loan, even costs paid to outside third parties such as the title insurer. The amount, therefore, of tender is calculated by first determining what funds the borrower actually received for his or her direct benefit. (Cash out to the borrower and funds released to pay the borrower's debts are examples of uses for the borrower's direct benefit.) Once that amount is determined, it is reduced by the total payments the borrower has made on the loan. Attorney fees are available against a violating lender, as well as actual and statutory damages. 15 USC §1640(a). The remaining balance is the amount due on tender. Once tender is delivered, the rescission process is complete.

B. How Rescissions Work in Practice

TILA grants the courts power to modify certain aspects of the statutory rescission scheme. In particular, Reg Z enables the courts to modify the second and third steps of the rescission process. Reg Z §§226.15(d), 226.23(d). However, some courts have been uncomfortable with enforcing the statutes' first step as well—the voiding of the security interest. For that reason, I have never forced a lender to remove their security interest prior to tender. I generally require the lender to indicate an acceptance of the rescission within the required 20-day period. Once the rescission has been accepted, I work with the lender to determine the amount of tender. Generally, clients refinance or sell their property to fund the tender. Sometimes lenders agree to rewrite the loan at the new loan balance. Either way, the lender submits a payoff demand, equal to the tender amount, into escrow and title insurance is obtained.

A note on attorney fees: I always require the lenders to pay the reasonable attorney fees in rescission matters. Because it is the lender who is paying the attorney fees, I generally submit my own demand directly into escrow, indicating that the bill should be paid out of the lender's proceeds. Of course, the lender must agree to this in advance.

V. Conclusion

TILA is an extremely powerful tool for borrowers and should be considered every time anyone makes or obtains a loan secured by residential property. At least one court has held that it may be malpractice for an attorney not to review a borrower's rescission rights when representing them in a foreclosure proceeding. This article just scratches the surface of this area of law. Even though there are classes given to consumer law attorneys on this area of practice, it is my experience that most consumer attorneys do not have the background to understand the loan process when it comes to securing the loan against real property. To put it starkly, most of them look like deer caught in headlights when they leave such a class. Real property attorneys, however, already have the preliminary expertise. They understand the escrow process, can read and understand a HUD-1 RESPA Settlement Statement, and know and understand the relationship between a note and deed of trust. While this article will not make you an expert on TILA, it hopefully will allow you to have an informed view of the issue the next time you are consulted on a loan or lender-related issue.

© Law Office of Simmons & Purdy