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Driver-License Restoration

Truth in Lending Act and Foreclosure

Medicaid and Regulating Cultural Competence

Helping Youths Create Their Own Jobs

Juvenile Behavioral Health Court

Challenging Voter Restriction Laws

Family Court and Representing Undocumented Domestic Violence Survivors

Lawyers and Community Organizers Collaborating to Save Homes

EMPLOYMENT

ONE MODEL FOR BREAKING DOWN BARRIERS

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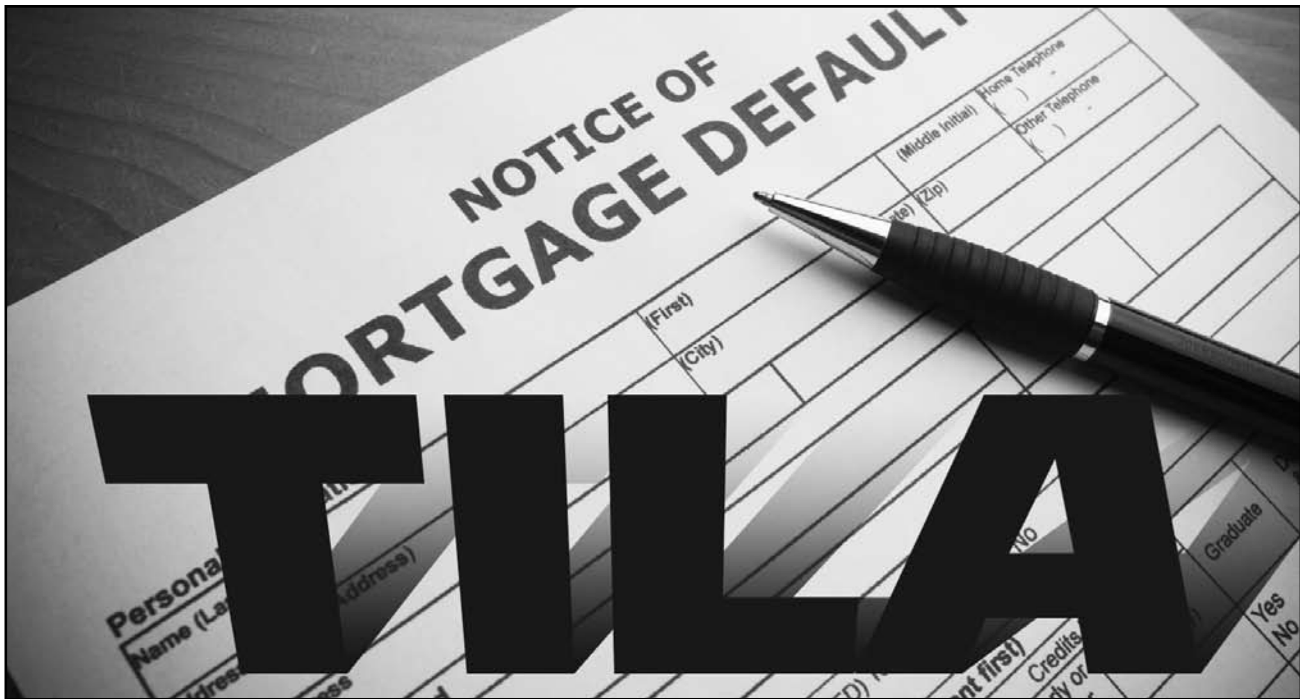

FORECLOSURE DEFENSE

Understanding TILA Basics Is Essential

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When she made the referral, the housing counselor simply said, "The loan is the worst I have ever seen."

The loan had all the toxic features: teaser interest rate and then a shock adjustment; prepayment penalty; important parts of the actual mortgage note simply left blank; disclosures for three totally different loan products all given and signed at closing; and a bizarre payment schedule. The loan was amortized over forty years even though it was a thirty-year loan, meaning that the homeowner would never come close to paying down the principal. The homeowner would have to pay a $130,000 balloon at the end of thirty years.

About four months after the housing counselor's phone call to our nonprofit law firm, a settlement was reached with the creditor. The homeowner had been a week away from losing his house, but now he had a sustainable loan. His monthly payment amount was reduced by nearly half, and all outstanding fees and late payments were waived (approximately $35,000). His credit report was fixed. The lender deleted all of the loan-related negative information sent to the credit-reporting agency as if the homeowner never missed a payment. He also received a new fixed interest rate of 4.5 percent.

How was that possible? The Truth in Lending Act, otherwise known as TILA.

The case described above demonstrates the power of TILA. Foreclosure issues are seeping into every area, and it is an attorney's obligation to know all of the tools available to help clients faced with a foreclosure. Attorneys can no longer afford to ignore TILA just because working with it often requires math. I believe that you are com-

mitting malpractice if you are advising homeowners facing foreclosure and do not understand TILA.

The Big Disclaimer

I intend this article to be a primer on TILA, to give an overview of key TILA concepts—in other words, the legal version of Cliffs Notes. Before you file a lawsuit, you should consult the National Consumer Law Center's *Truth in Lending*.[1] You should also affiliate, formally or informally, with an attorney who has handled TILA cases. The law and regulations in this area are often tricky and always changing. To get a good result for your client, you have to demonstrate early and often that you know your stuff.

What Is TILA and Why Is It Important?

At its core TILA is a disclosure statute. It was enacted to give consumers information about the cost of obtaining credit compared to paying cash.[2] It also created a uniform definition and method of calculating an interest rate, and this allows consumers to compare loan offers from competing lenders.[3] Before TILA, there was no standard definition of an interest rate. Since a home is the biggest purchase that most people will ever make, TILA also has special provisions related to mortgage loan transactions.[4]

TILA also has implementing regulations, collectively referred to as "Regulation Z," and staff commentary.[5] Sometimes federal regulations are merely redundant, and staff commentary can be dismissed as "advisory." TILA is different. Though not without limits, TILA's implementing regulations are binding, and staff commentary (supplied by the Federal Reserve Bank) is given great deference unless the regulations and commentary directly contradict TILA's language.[6] Regulation Z and the official staff commentary prescribe how TILA applies to modern lending practices and actually do clarify certain provisions of the Act.

Why is TILA important to attorneys who represent or advise people facing foreclosure? First, TILA provides the powerful remedy of rescission.[7] In essence rescission is the act of pressing the rewind button for the homeowner, putting the parties back in or as close as possible to the position that they were in when the loan was originated.

Homeowners may rescind a loan for up to three years from the date of consummation unless they have sold or transferred all of their interest in the property.[8] This remedy, however, is available only for a loan that was a refinance, not for loans that were used to purchase or acquire the home.[9]

Upon rescission, a consumer is not liable for any finance or other charge under the mortgage loan. Any security interest given by the consumer is void.[10]

Second, TILA, for purposes of rescinding a mortgage loan, is a strict-liability statute. As aptly stated by the Third Circuit Court of Appeals,

> TILA … is to be liberally construed in favor of borrowers.

[1] Elizabeth Renuart & Kathleen Keest, National Consumer Law Center, Truth in Lending § 6.7.3.1 (2007).

[2] 15 U.S.C. § 1601(a)–b) (2008) (purpose of the Truth in Lending Act (TILA) and findings in support of TILA).

[3] *Id.* § 1601(b).

[4] *Id.* §§ 1606(e), 1635, 1638(b).

[5] 12 C.F.R. §§ 226 *et seq.* (2008) (Regulation Z).

[6] *Ford Motor Credit Company v. Milhollin*, 444 U.S. 555 (1980).

[7] 12 C.F.R. § 226.23 (2008) (Regulation Z).

[8] 15 U.S.C. §§ 1635(a), 1635(f) (2008).

[9] *Id.* § 1635; 12 C.F.R. § 226.2 (2008) (Regulation Z). Note that limited exceptions to this remedy may apply.

[10] 15 U.S.C. § 1635(b) (2008); 12 C.F.R. § 226.23(d) (2008) (Regulation Z). In other words, the lender should file the requisite paperwork with the proper government entity to release the lender's lien on the property.

> TILA achieves its remedial goals by a system of strict liability in favor of the consumers when mandated disclosures have not been made. A creditor who fails to comply with TILA in any respect is liable to the consumer under the statute regardless of the nature of the violation or the creditor's intent.[11]

Common-law contract elements or defenses, such as causation, reliance, and unclean hands, do not apply. The documents speak for themselves and generally prove that the lender did comply with the law or that the lender did not. The strict liability associated with TILA enables an attorney to analyze and litigate such cases efficiently.

Third, the remedy of rescission may be made against any assignee of the loan.[12] In a world of securitization (pooling, chopping-up, and reselling mortgage loans via Wall Street) and bankrupt lenders, the duty of any assignee to honor a rescission request is critical. There is no holder in due course or bona fide purchaser defense. TILA provides a claim that can get real relief, not just an empty judgment.

The ABCs of Talking TILA

For those of you not fluent in TILA language, here are a few terms that you need to know:

Material Disclosures. The five material disclosures are the annual percentage rate, including applicable variable-rate disclosures; the finance charge; the amount financed; the total of payments; and the payment schedule.[13] This information is found on a single document, the federal truth-in-lending disclosure statement.

The Federal Truth-in-Lending Disclosure Statement. In order to determine most TILA violations, you have to refer to the federal truth-in-lending disclosure statement.[14] Usually the document has that title or something similar printed in bold and all capital letters across the top of the page. The document has a box each for the annual percentage rate, the finance charge, the amount financed, and the total of all the payments a borrower will make over the life of the loan. Below the four boxes is a schedule of payments—a list of the number of monthly payments and the amount.

HUD-1. The short name of the "U.S. Department of Housing and Urban Development Settlement Statement" is HUD-1. This document is usually two to three pages, and it looks a little like a Microsoft Excel spreadsheet. Required by the Real Estate Settlement Procedures Act, the HUD-1 is critical for TILA purposes when analyzing whether the finance charges associated with a loan were properly disclosed.[15] The HUD-1 contains that information and itemizes all charges related to the loan. Every itemized charge or settlement service fee on the HUD-1 is either a "finance charge" or an "amount financed" for TILA purposes. The two terms are mutually exclusive; a charge cannot be both or none of the above.

Amount Financed. As a rule, the amount financed is the amount that the consumer would have paid if the consumer paid cash as well as any cash that the consumer used to pay off credit cards or as "cash back" after closing.

Finance Charge. What it costs to get the credit is the finance charge.[16] It includes any charge paid directly or indirectly by the consumer or imposed directly or indirectly by the creditor. It also includes charges paid to third parties, unless those

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[11] *Smith v. Fidelity Consumer Discount Company*, 898 F.2d 896, 898 (3d Cir. 1988) (citations and quotations omitted).

[12] 15 U.S.C. § 1641(c) (2008).

[13] *Id.* § 1602(u) (2008); 12 C.F.R. § 226.23(a)(3) (2008) (Regulation Z).

[14] 12 C.F.R. § 226 (2008) (Regulation Z, app. H-2; model form).

[15] 12 U.S.C. § 2609 (2008); 24 C.F.R. § 3500.8(a)–(b) (2008) (Regulation X).

[16] 15 U.S.C. § 1605(a)–(e) (2008); 12 C.F.R. § 226.4 (2008) (Regulation Z).

charges are explicitly excluded by statute or regulation. Common examples of finance charges are interest, origination fees, discount points, and mortgage broker fees. Some noteworthy exclusions are bona fide and reasonable charges paid for title insurance, title search, document preparation, notary fees, and appraisals.[17]

Tender Amount. In order for the parties to be put back in or as close as possible to the positions that they were in before the origination of the loan, the lingering issue of the homeowner's potential obligation to "tender" to the lender any benefit that the homeowner received must be resolved. In short, the court may call upon the homeowner to tender to the lender the amount of money that the homeowner received as a result of the loan, minus closing costs and the total amount of any payments that the homeowner made. The tender obligation is often part of a court-ordered "conditioned rescission." Although there is little statutory support for such a concept, many courts find that forcing a lender to release the security interest without payment from the homeowner would be unfair.[18] The conditioned rescission is viewed by the court as a matter of equity. However, equity is a two-way street, and consumer attorneys need to prepare to argue that immediately tendering the full amount, if at all, is not just.[19]

Four Steps for a Basic TILA Analysis

If you want to rescind the mortgage loan, follow four basic steps. First, note the condition of the documents and preserve the chain of custody for the documents. Did the homeowner deliver documents still in the plastic folder given to the homeowner at closing? Were they in a paper bag? Were the mortgage loan documents mixed up with credit card bills, collection notices, and scribbled notes about rude customer service representatives?

The documents' condition is relevant when assessing the credibility of any claim premised upon the lender's failure to provide a specific written disclosure. The attorney must prove a negative. For example, if the homeowner delivers the documents in pristine condition, then a claim that the homeowner did not receive two copies of the three-day right to cancel is more credible than that of a homeowner whose documents are stained with coffee and stored in a plastic Kmart bag.

Preserving, copying, and marking the documents must also be done. Fraud in the subprime lending industry often results in different versions of the same document. The HUD-1 disclosure statement may reflect that the homeowner received $10,000 in cash back, while the disclosure statement later produced by the bank may reflect that the consumer received $15,000. Where did the extra $5,000 go?

The homeowner's attorney must track all of the mortgage documents so that they can later be compared and analyzed. The attorney needs to know when the client received the document and from whom. For example, I recently had a case where the homeowner, title company, and lender all had different versions of the HUD-1 settlement statement. I had each set of documents photocopied and placed in a designated and dated folder that was set aside, and then I created a set of working documents. Because of this system, I knew when and from whom I received each version of the HUD-1 settlement statement.

The second step is to determine if the TILA right to rescind is even applicable. Specifically, the homeowner's mortgage loan needs to

[17]See 12 C.F.R. § 226.4(c)(7) (2008) (Regulation Z).

[18]See, e.g., *Clay v. Johnson*, 77 F. Supp. 2d 879 (N.D. Ill. 1999).

[19]Equitably modifying the substantive tender obligation is not a procedure authorized or allowed by TILA or Regulation Z. Some courts, however, continue to do so under general theories of equity or by citing statutorily overturned case law. For more details related to these arguments, see Renuart & Keest, *supra* note 1.

(a) be a "consumer transaction";[20]

(b) have a lender that is considered a "creditor";[21]

(c) secure the homeowner's principal dwelling;[22]

(d) be consummated within the past three years;[23] and

(e) be given to a consumer who already owned the home or dwelling before this transaction (e.g., a refinancing, with some very limited exceptions).[24]

The third step is to identify whether the notice to the three-day right to cancel was properly given to the homeowner. Two copies of the notice of the right to cancel must be given to each consumer—two for each person signing the loan document or a husband and wife, whether or not both are signatories to the loan.[25] The notice must have the date that the rescission right expires and the address where the notice of the right to cancel needs to have been sent.[26] The dates must also be calculated correctly. The three days must not include Sundays or holidays or "minor" holidays such as Veterans Day, Labor Day, and Columbus Day.[27]

The fourth step is to review the TILA disclosure statement to determine if the material disclosures have also been made. Although a lender can fail in many ways to disclose material information properly, the disclosed finance charge is often the most likely to be inaccurate.

The finance charge on the TILA disclosure statement itself reflects the interest payments to be received over the life of the loan. This is technically the finance charge, but you want to identify the finance charge without the interest that accrues over the life of the loan. So, unless you have a fancy mortgage calculator, the easiest way to determine the finance charge, as disclosed by the lender, is simple subtraction.

Identify the principal amount of the loan as stated on the HUD-1. Then, from the principal amount of the loan, subtract the amount listed on the TILA disclosure statement as the "amount financed." The difference between the principal balance and the amount financed is the finance charge disclosed by the lender. For example, if the principal balance of the mortgage loan is $100,000 and the amount financed is $98,500, then the finance charge is $1,500 as disclosed by the lender.

The next step is to review the HUD-1 settlement statement and evaluate each settlement and closing charge listed on the statement. Regulation Z and the Official Staff Commentary help you figure out how each charge should be categorized.[28]

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[20]12 C.F.R. §§ 226.2(a)(11)–(12) (2008) (Regulation Z). This does not have to be a "mortgage"; it includes any loan—secured by the borrower's principal dwelling—such as a closed-end mortgage, home equity line of credit, contract for deed, manufactured home loan, or an equitable mortgage resulting from a sale/leaseback arrangement (see *Stella v. Anderson*, 2007 WL 1080309 (D. Minn. April 9, 2007)).

[21]A person is a "creditor" within the meaning of TILA if (a) the person is to whom the debt is payable on the face of the note; (b) the credit extended by the person is a consumer credit, meaning payable under a written agreement in four or more monthly installments, or for which a finance charge is imposed; and (c) the person regularly extends credit, meaning the person did more than five consumer credit transactions within the preceding twelve months or, for HOEPA (Home Ownership and Equity Protection) loans, the person did two within the preceding twelve months or just one using a mortgage broker (see 12 C.F.R. § 226.2(a)(17) n.3 (2008) (Regulation Z)).

[22]*Id.* § 226.15(a) (2008) (Regulation Z).

[23]*Id.* § 226.23(a)(3) (2008) (Regulation Z).

[24]15 U.S.C. § 1635(e)(1) (2008); 12 C.F.R. § 226.23(f)(1) (2008) (Regulation Z); *id.* § 226.2(a)(24) (Official Staff Commentary).

[25]12 C.F.R. § 226.23(b)(1) (2008) (Regulation Z).

[26]*Id*. § 226.23(b)(1)(i)–(v).

[27]*Id*. § 226.2(a)(6).

[28]*Id*. § 226.4.

The charges most likely to be miscategorized are the "real estate–related fees."[29] Regulation Z sets forth certain real estate–related fees that are associated with getting a mortgage loan and are normally excluded from the finance charge, unless they are "bona fide and reasonable." During the real estate boom, greedy mortgage brokers and title closing companies routinely overcharged for title insurance, credit report fees, appraisals, the cost of preparing loan-related documents, and the like. Automated computer programs could not distinguish between what was or was not a reasonable charge, and so the computer program wrongly categorized inflated fees as part of the amount financed. Since they were not bona fide and reasonable, however, these charges should have been categorized as finance charges.

On a sheet of paper or spreadsheet, list all the settlement and closing charges that are "finance charges" in one column and the other charges in the "amount financed" column. Add your finance charges and see if there is an error in the disclosed finance charge beyond acceptable tolerance limits.

As a rule, a finance charge error must exceed one-half of 1 percent of the total loan amount or 1 percent in some refinancing situations.[30] If the homeowner is in foreclosure, however, the tolerance level is just $35.[31] In the illustration described above, a homeowner in foreclosure is allowed to rescind the mortgage loan if the finance charges add up to $1,535 or more.

So You Found an Error and Have a Right to Rescind, What's Next?

Before any attorney rescinds a mortgage loan, the attorney should have a very direct conversation with the homeowner about the rescission process and likely outcome. TILA is not a good statute to obtain a massive amount of damages. So if the goal is to recover $1 million, then TILA is probably not appropriate. If a homeowner does not have any income and is likely not to have any income in the near future, then TILA is probably not appropriate in this circumstance either.

The best goal for a TILA case is a loan modification and the recovery of attorney fees and costs. This does not always happen, but it is the most likely outcome. The attorney and homeowner should work together, before rescinding a mortgage loan, to identify an appropriate and sustainable modification.

The rescission process begins when the homeowner or attorney notifies the lender in writing, that the homeowner or attorney is rescinding the mortgage loan.[32] The rescission notice is effective when mailed, but there may be a dispute about when it was sent or mailed. The rescission notice should be sent by certified U.S. mail with a signed receipt. If possible, I always supply detailed information related to why the extended right to rescind applies to my client. This establishes credibility, and there is also little point in hiding that information from the lender.

Although who should or should not receive the rescission letter is unclear, I send it to every known entity that has ever owned or serviced the loan or represented the owner or servicer of the loan. I send a rescission letter to the original lender (both to the address on the original notice of the right to cancel and to the registered agent), the attorney who commenced or threatened to commence the foreclosure action, the servicer, and the current mortgage loan owner, if known. This is the safest practice.[33]

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[29] *Id.* § 226.4(c)(7).

[30] 15 U.S.C. § 1635(f)(2) (2008).

[31] *Id.* § 1635(i)(1)–(2) (tolerance level of just $35 understatement of finance charge when foreclosure process has been initiated).

[32] 12 C.F.R. §§ 226.15(a)(2), 226.23(a)(2) (2008) (Regulation Z).

[33] See *Miguel v. Country Funding Corporation,* 309 F.3d 1161 (9th Cir. 2002) (sending rescission to the servicer is not valid).

A lender or owner of the mortgage loan has twenty days to respond to a rescission letter. Within the twenty days, you may or may not hear from the lender or owner of your mortgage loan. Whether a resolution to the matter is possible soon becomes clear if there is a response to the rescission letter. If not, you should file a lawsuit. The lawsuit against the lender and servicer should also contain other applicable and appropriate claims, such as breach of contract, breach of good faith and fair dealing, common-law contract and torts, and fraud.

As the litigation proceeds and, one hopes, before the lawsuit is even filed, the attorney and homeowner need to prepare for an order by the court to "tender." Under a strict reading of TILA, the homeowner need not "tender" until the creditor complies with its obligations to release the security interest in the home; this means that the debt ultimately becomes unsecured and could theoretically be discharged through bankruptcy proceedings. Courts, however, condition the release of the security interest on some type of tender by the homeowner. To the lender the homeowner has to give back the principal balance, minus settlement charges and payments made to the lender since origination.

The court's decision, however, is equitable in nature. An attorney should have the information and factual record developed to make a strong case against a tender obligation before the release of the security interest, or to enable the homeowner to tender in installments at a low-interest rate or no-interest rate.

Preventing foreclosure does not necessarily require new laws. Existing laws provide powerful remedies to help homeowners stop foreclosure and have leverage in negotiating sustainable mortgage modifications. TILA is one such law. Being aware of potential TILA violations and knowing what to do once a violation has been identified may not save the U.S. economy, but it just might save your client's home. And that's a start.

COMMENTS?

We invite you to fill out the comment form at http://tinyurl.com/MayJuneSurvey. Thank you.

—The Editors

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