Post-Sherzer Residential Mortgage Financing In The 3rd Circuit: More Expensive, Less Secure?

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On February 5, 2013, the Third Circuit ruled that a lawsuit seeking rescission filed more than three years after loan consummation is timely so long as the borrower has sent a written notice of rescission to the lender within the three-year period. The ruling exacerbates a circuit split that may soon reach the Supreme Court. Moreover, its effect on the residential mortgage industry in Pennsylvania, Delaware, New Jersey, and the Virgin Islands ("Affected Territory") may be profound.

The Truth in Lending Act ("TILA") requires lenders to make certain disclosures to borrowers before a loan commences. If a lender fails to comply with this mandate, the borrower has the right to rescind the loan up to three years after closing on the loan or upon the sale of the property, whichever occurs first. 15 U.S.C. § 1635(f). Courts are split concerning *how* this right must be exercised. In *Sherzer v. Homestar Mortgage Services*, 707 F.3d 255 (3d Cir. 2013), the Third Circuit held that, to timely rescind and thereby automatically void a loan agreement and the accompanying security instruments, a borrower need only send a "valid" notice of rescission to the lender within three years of closing. Whether a borrower ever brings a lawsuit (either before or after the three year period) to test the effectiveness of that rescission is now largely irrelevant.

The Sherzers closed the loans on their home in August 2004. In May 2007 – less than three years after closing – the Sherzers wrote to their lender claiming that they had not been provided with the requisite TILA disclosures, and that they were exercising their right to rescind the loans. The lender disputed one of the Sherzers' claims, arguing that it had complied with its TILA obligations. The Sherzers failed to file suit (seeking a judicial declaration of rescission) until November 2007, more than three years after closing. The lender argued that the borrowers' suit was barred by TILA's three-year statute of repose.

In holding that a simple letter was sufficient to rescind, and automatically void, a mortgage loan (without the necessity of a judicial declaration), the Third Circuit applied what it viewed as a plain reading of TILA and its implementing regulations. TILA provides that the borrower "shall have the right to rescind the transaction . . . *by notifying the creditor, in accordance with regulations of the [Consumer Financial Protection Bureau], of his intention to do so.*" 15 U.S.C. § 1635(a). The pertinent Federal Regulation specifies that the borrower must notify the lender by some "means of written communication." Because the Sherzers had provided written notice to their lender of their intent to rescind the loan, the Third Circuit held that the loan was timely rescinded, and voided, without more. In doing so, the court backed the reasoning, in part, of two other Circuit Courts of Appeals. See *Gilbert v. Residential Funding LLC*,

678 F.3d 271, 277-78 (4th Cir. 2012); *Williams v. Homestake Mortgage Co.*, 968 F.2d 1137, 1139-40 (11th Cir. 1992).

Sherzer should give pause to all (i) lenders making residential mortgage loans on properties in the Affected Territory and (ii) purchasers of mortgages secured by properties located within the Affected Territory. It seemingly encourages borrowers to rescind loan transactions when they may have no legitimate cause to do so. It is, in practical effect, a "litigation pass" for these borrowers. According to *Sherzer*, a mere notice letter permits a borrower to void the loan and the lender's security interest simply by validly *claiming* a TILA violation has occurred, regardless of whether the borrower ever files suit to judicially determine such violation.

The onus is now entirely on the lender who, the court observed, "may choose" to file suit if any uncertainty exists as to whether a borrower's notice of rescission was invalid. Meaning, so long as the borrower has provided written notice of rescission within the three-year window, it now becomes the lender's responsibility, *in every instance*, to bring suit for judicial determination of whether the loan disclosure paperwork was properly given three years before. The Court recognized this potential problem: "[P]ermitting obligors to rescind by written notice could potentially impose additional costs on banks, as it costs little for an obligor to send a letter to the lender while, on the other hand, the lender would incur some cost to sue to determine title." While the Court did observe that borrowers would be required to tender back the loan proceeds to the lender (but, only after the lender has first performed its statutory obligations), there was no analysis or discussion of the practical likelihood of the Sherzers', or other borrowers', ability, under similar circumstances, to be able to tender back the loan proceeds that they received at closing.

Sherzer conflicts with the holdings of the Ninth and Tenth Circuits. Unlike *Sherzer*, these courts have held that borrowers who fail to receive TILA disclosures and wish to exercise their rescission rights must send written notice to their lender within three years of the closing date, *and* bring suit to enforce their rights within the same three-year period following the closing of their loan. See *Rosenfield v. HSBC Bank, USA*, 681 F.3d 1172, 1188 (10th Cir. 2012); *McOmie-Gray v. Bank of America Home Loans*, 667 F.3d 1325, 1328 (9th Cir. 2012). The Eighth Circuit is also poised to address the issue, having heard argument in October 2012. See *Sobieniak v. BAC Home Loans Servicing, L.P.*, No. 12-1053. A decision from that court will continue to perpetuate the existing split.

The method by which a borrower is required to timely rescind a mortgage loan is of critical importance, as best demonstrated by the fact that the CFPB, the American Bankers Association, the Consumer Bankers Association, and the Consumer Mortgage Coalition have all filed "friend of the court" briefs in federal courts around the country on behalf of borrowers and lenders, respectively. Because of the conflicting court decisions and the issue's national importance, the Supreme Court may choose to resolve the issue in the near future. Until that time, "let the lender (and mortgage purchaser) beware" concerning residential mortgage financing in the Affected Territory.

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