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Sherzer v. Homestar Mortgage Services: The Third Circuit Takes Sides in a Circuit Split Over How a Borrower Exercises Rescission Rights Under TILA

By Marieke T. Beck Coon, Christopher H. Hart and Stephen J. Shapiro

In a recent decision, the Third Circuit took sides in a split between U.S. Circuit Courts of Appeal over what action borrowers must take to exercise their right to rescind a loan under the Truth in Lending Act (TILA). It ruled that borrowers need only send lenders valid notice within the time allowed under the statute in order to rescind a loan agreement.

TILA requires lenders to make certain disclosures of credit terms to potential borrowers. Even if borrowers receive these disclosures, they have an absolute right to rescind a loan secured by a principal dwelling for a period of three days after closing on the loan. If they get the disclosures after the loan commences, they have three days to rescind the loan after they are received. If they never receive the requisite disclosures, the right to rescind "expire[s] three years after the date of consummation of the transaction or upon the sale of the property, whichever occurs first." 15 U.S.C. § 1635(f).

In *Sherzer v. Homestar Mortgage Services*, the Third Circuit addressed what action borrowers must take in order to exercise their right to rescind before the three-year Section 1635(f) period expires. In that case, borrowers Daniel and Geraldine Sherzer sent a letter to the lender of two loans secured by mortgages on their home, along with the lender's assignee (together, the "lenders"), asserting they had not received the disclosures required under TILA and exercising the right to rescind the loans. The letter was sent about two years and nine months after closing on the loans. The lenders agreed to rescind one loan, but denied the asserted TILA violation as to the other, much larger loan. The Sherzers filed suit more than three years after their closing date, asking for a declaration of rescission among other remedies. The trial court granted judgment on the pleadings for the lenders, ruling the suit time-barred under Section 1635(f). Slip. Op. at 4-5.

On appeal, the Sherzers argued that rescission of the loan occurs when a valid notice of rescission is sent to the lender, a view adopted by the Fourth Circuit. The lenders argued that unilateral notice is not enough; rescission of the loan occurs when the parties so agree or a court enters an order of rescission. If the right to rescind is disputed, they argued, borrowers must file suit within three years of the closing date. This view has been adopted by the Ninth and Tenth Circuits. *Id.* at 6-8.

The Third Circuit sided with the borrowers and Fourth Circuit, holding that "an obligor exercises his right of rescission by sending the creditor valid written notice of rescission, and need not also file suit within the three-year period." *Id.* at 15. The court reasoned that the plain language of TILA and its implementing regulation require borrowers to send notice in order to exercise their right, but say nothing of filing suit. *Id.*

The court rejected the argument, adopted by the Ninth and Tenth Circuits, that the U.S. Supreme Court's decision in *Beach v. Ocwen Federal Bank*, 523 U.S. 410 (1998), required a contrary result. *Beach* addressed whether obligors who failed to provide notice of rescission within the Section 1635(f) three-year period may nevertheless assert rescission as an affirmative

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defense. The *Beach* court reasoned that, under the terms of Section 1635(f), the right of rescission itself is extinguished after three years, not just the right to file suit. Borrowers could not therefore raise the extinguished right as an affirmative defense. As the Third Circuit read it, *Beach* does not address *how* borrowers must exercise their right of rescission within the three years and so does not conflict with *Sherzer's* conclusion that the right is invoked by sending valid notice to the lender. Slip. Op. at 17.

The Third Circuit acknowledged that its ruling posed some risk of uncertainty and cost to lenders. Under its holding, for example, borrowers could send notice of rescission within the three-year period and raise rescission as an affirmative defense to a foreclosure proceeding 10 years later. However, the court noted that lenders have the option to clear such cloud on title by filing suit to confirm whether or not rescission was valid. *Id.* at 25. Though this poses an additional cost to lenders, such costs are usually passed on to customers. The court observed that "[m]any TILA regulations increase costs for lenders (and, in turn, consumers), and it is for Congress — not the courts — to determine whether those increases are warranted." *Id.* at 26. ◆

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