

TIPPING THE SCALES: BALANCING THE WEIGHT OF EQUITY WITH LOAN RESCISSIONS IN BANKRUPTCY

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Corey Scott Hadley*

I. INTRODUCTION

Prior to the passage of the Truth-in-Lending Act (TILA) in 1968,¹ consumers were vulnerable to many deceptive practices employed by creditors when participating in loan transactions. Following the passage of TILA, it was the hope of Congress that consumers would now have the tools necessary to fend off predatory or deceptive credit terms buried within the fine print of a loan agreement.² Justice Burger described this shift in policy as a “transition in congressional policy from a philosophy of ‘Let the buyer beware’ to one of ‘Let the seller disclose.’ By erecting a barrier between the seller and the prospective purchaser in the form of hard facts, Congress expressly sought ‘to . . . avoid the uninformed use of credit.’”³ Unfortunately, Congress could not have foreseen the explosion in litigation and the multiple judicial interpretations that ensued in future decades.⁴ Consequently, a series of legislative enactments over the last forty years have sought to simplify and clarify disclosure rules for both the consumer and the creditor.⁵

One of the options afforded to consumers facing a suspect loan agreement is the right to rescission.⁶ When lenders, creditors, and other parties in the credit transaction “fail to provide the consumer with proper disclosures about the loan or

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1. 15 U.S.C. §§ 1601-1693r (1968).

2. Elwin Griffith, *Truth In Lending—The Right of Rescission, Disclosure of the Finance Charge, and Itemization of the Amount Financed in Closed-End Transactions*, 6 GEO. MASON L. REV. 191, 191 (1998) (citing H.R. REP. NO. 90-140, at 9 (1967), *reprinted in* 1968 U.S.C.C.A.N. 1962, 1965). Griffith noted:

In many instances today, consumers do not know the costs of credit. Charges are often stated in confusing or misleading terms. They are complicated by ‘add-ons’ and discounts and unfamiliar gimmicks. The consumer should not have to be an actuary or a mathematician to understand the rate of interest that is being charged.

Id.

3. *Mourning v. Family Publ’ns Serv., Inc.*, 411 U.S. 356, 377 (1973).

4. See RALPH J. ROHNER & FRED H. MILLER, *TRUTH IN LENDING* 14 (Robert A. Cook, Alvin C. Harrell & Elizabeth Huber eds., 2000) (discussing “[t]he resulting flood of litigation produced an apparently unending, and inconsistent, stream of judicial interpretations and reinterpretations of [Truth in Lending] requirements”).

5. See, e.g., Truth in Lending Simplification and Reform Act of 1980, Pub. L. No. 96-221 94 Stat. 168 (1980), and Truth in Lending Simplification and Reform Act, Pub. L. 97-320, 96 Stat. 1538 (1982) (current versions codified at 15 U.S.C. §§ 1602-1608 (2009)).

6. BLACK’S LAW DICTIONARY defines “rescission” as “the unilateral unmaking of a contract for a legally sufficient reason, such as the other party’s material breach” BLACK’S LAW DICTIONARY 1420-21 (9th ed. 2009).

their rights,”⁷ consumers may seek rescission as a possible remedy under TILA.⁸ Often, a consumer attempts to exercise their rescission rights in the face of an impending foreclosure due to a default on their loan. Moreover, a natural consequence of the impending foreclosure will often be the filing of Chapter 13 bankruptcy by the consumer. It is in the Chapter 13 setting that loan rescission produces diverging views among the various courts.

Once a debtor has exercised his or her right to rescission, TILA outlines a specific “sequence of procedures to be followed.”⁹ The sequence of these procedures¹⁰ becomes disrupted in the Chapter 13 setting and has elicited varied analyses among the courts. Under TILA, the “security interest arising from the transaction becomes void and the consumer is no longer liable for any amount owed” following the exercise of rescission.¹¹ Next, the creditor is to return any money or property in connection with the credit transaction within twenty days and must take the necessary measures “to reflect the termination of the security agreement.”¹² Finally, after the creditor has fulfilled these obligations, the consumer must tender back the amount they borrowed.¹³ The final phase of the statute states: “The procedures prescribed by this subsection shall apply except when otherwise ordered by a court.”¹⁴ This phrase, added by the Truth in Lending

7. Robert R. Murken, *Can't Get No Satisfaction? Revising How Courts Rescind Home Equity Loans Under the Truth In Lending Act*, 77 TEMP. L. REV. 457, 457 (2004).

8. It is important to note that the right of rescission does not protect all consumer credit transactions. See Regulation Z, 12 C.F.R. § 226.1 (2009) (stating in relevant part that “[t]he regulation prohibits certain acts or practices in connection with credit secured by a consumer’s principal dwelling”). Therefore, in order to exercise the right of rescission, a couple of elements must be fulfilled. First, there must be a credit transaction involving a consumer. Second, there must be a security interest in the consumer’s principal dwelling.

9. *Wells Fargo Bank, N.A. v. Jaaskelainen (Wells Fargo)*, 407 B.R. 449, 459 (D. Mass. 2009).

10. TILA requires:

When an obligor exercises his right to rescind under subsection (a) of this section, he is not liable for any finance or other charge, and any security interest given by the obligor, including any such interest arising by operation of law, becomes void upon such a rescission. Within 20 days after receipt of a notice of rescission, the creditor shall return to the obligor any money or property given as earnest money, downpayment, or otherwise, and shall take any action necessary or appropriate to reflect the termination of any security interest created under the transaction. If the creditor has delivered any property to the obligor, the obligor may retain possession of it. Upon the performance of the creditor’s obligations under this section, the obligor shall tender the property to the creditor, except that if return of the property in kind would be impracticable or inequitable, the obligor shall tender its reasonable value. Tender shall be made at the location of the property or at the residence of the obligor, at the option of the obligor. If the creditor does not take possession of the property within 20 days after tender by the obligor, ownership of the property vests in the obligor without obligation on his part to pay for it. The procedures prescribed by this subsection shall apply except when otherwise ordered by a court.

15 U.S.C. § 1635(b) (2009).

11. *Id.*

12. *Id.*

13. *Id.*

14. *Id.*

Simplification and Reform Act,¹⁵ has allowed a majority of courts to reorganize the sequence of procedures to be applied when conditioning rescission to consumers in a Chapter 13 setting.

To understand the effects of bankruptcy, it is useful to compare similar actions in a non-bankruptcy context. “In a non-bankruptcy setting, the rights and duties of the parties upon TIL[A] rescission are clear and absolute. Each party must make the other as whole as he would have been had the contract never been entered into.”¹⁶ The problem that arises in the bankruptcy setting is that the debtor has arguably been relieved of his “obligation to pay the creditor upon rescission.”¹⁷ The minority of circuit courts reason that once a consumer has rescinded a transaction in the bankruptcy context the “creditor is left with an unsecured debt . . . [which] may be discharged . . . and to require a chapter 13 Debtor to tender the full amount of the loan on a creditor’s now unsecured claim would unfairly discriminate among unsecured claims”¹⁸ The majority of courts, however, rely on the statutory language of TILA, which provides “that the procedures . . . shall apply except when otherwise ordered by a court.”¹⁹ The majority view relies on this language as a justification for “hav[ing] the equitable power to condition rescission on tender by the borrower.”²⁰ The equitable power to condition rescission on tender by the borrower allows the courts to stave off rescission until the consumer has paid back the creditor the amount they had borrowed.

Surprisingly, the “First Circuit has not spoken”²¹ as to whether courts have the equitable power to condition rescission on tender by the borrower. This Comment will first focus briefly on the historical framework of rescission and how rescission under TILA is markedly different from common law rescission. Next, this Comment will examine the splits among the circuits and explore the competing rationales to determine which circuits may serve as guideposts for the First Circuit. This Comment will then focus on the potential approaches to rescission in the bankruptcy setting. Finally, this Comment will consider several recent cases that may be illustrative of the direction in which the First Circuit is heading. *In re Jaaskelainen*,²² a case argued in the Eastern Division of Massachusetts, is particularly indicative of the trend that the First Circuit might be following and illustrates the divergent judicial interpretations throughout the circuits.

II. THE HISTORICAL FRAMEWORK OF RESCISSION: TILA STANDARDS VS. COMMON LAW

One of the most influential changes that has stemmed from TILA is the

15. Pub.L. No. 96-221, § 612(a)(4), 94 Stat. 168, 175 (1980) (codified as amended at 15 U.S.C. § 1635(b) (2009)).

16. *Jaaskelainen v. Wells Fargo Bank, N.A.* (*In re Jaaskelainen*), 391 B.R. 627, 645 (Bankr. D. Mass. 2008), *vacated in part by* Wells Fargo Bank, N.A. v. *Jaaskelainen* (*Wells Fargo*), 407 B.R. 449 (D. Mass. 2009).

17. *Id.*

18. *Id.* at 646.

19. 15 U.S.C. § 1635(b) (2009).

20. *Wells Fargo*, 407 B.R. at 460.

21. *Id.*

22. 391 B.R. 627 (Bankr. D. Mass. 2008).

rearranging of the sequence of rescission and tender that had existed under common law rescission. At common law, “the [consumer] must first tender the property that he has received under the agreement before the contract may be considered void.”²³ After the consumer had met his obligations, “the contract becomes void and the [consumer] may then bring an action in replevin²⁴ or assumpsit²⁵ to insure that the [creditor] will restore him to the position that he was in prior to entering into the agreement, i.e., return earnest money or monthly payments and void all security interests.”²⁶ The sequence of events under section 1635(b) of TILA was a pro-consumer departure from the common law standard. Section 1635(b) requires that the creditor first void all security interests related to the transaction and then return all money and property also associated with that transaction.²⁷ Once the creditor has performed his obligations, the consumer must then tender back the amount they had borrowed.²⁸ In essence, the TILA standard has rearranged the roles of the principal players.

Section 1635(b) contains language that has produced varied judicial interpretations beyond the reordering of the rescission process. The pertinent section states: “If the creditor does not take possession of the property within 20 days after tender by the obligor, ownership of the property vests in the obligor without obligation on his part to pay for it.”²⁹ This provision, which has the potential to produce a “debtor windfall”³⁰ in the event of creditor nonperformance, has met with considerable resistance from the courts. Much of this resistance garnered its reasoning from principles of equity rather than statutory authorization. The final sentence of section 1635(b), which states, “[t]he procedures prescribed by this subsection shall apply except when otherwise ordered by a court,”³¹ has arguably codified the justification for the court’s prior reliance upon notions of equitable power. Consequently, many courts have struggled with the application of this phrase, rather than whether it grants a court powers beyond that intended by Congress. Although the justification for modifying the TILA rescission framework may now exist in the majority of circuits, the manner in which the modifications are exacted is anything but uniform. Ironically, many courts have come almost full-circle back to the common law rescission scheme and now “require the consumer to tender loan proceeds up front as a prerequisite to obtaining rescission under TILA.”³² Some courts have “rescission conditioned on repayment [by the consumer] in installments, and [some] refus[e] to condition rescission on

23. *Williams v. Homestake Mortg. Co.*, 968 F.2d 1137, 1140 (11th Cir. 1992) (citing 17A AM. JUR. 2D *Contracts* § 590, at 600-01 (1991)).

24. Replevin is an “action for the repossession of personal property wrongfully taken or detained by the defendant, whereby the plaintiff gives security for and holds the property until the court decides who owns it.” BLACK’S LAW DICTIONARY 1413 (9th ed. 2009).

25. Generally, assumpsit is an “action based on the defendant’s breach of an implied promise to pay a debt to the plaintiff.” BLACK’S LAW DICTIONARY 142 (9th ed. 2009).

26. *Williams*, 968 F.2d at 1140.

27. 15 U.S.C. § 1635(b) (2009).

28. *Id.*

29. *Id.*

30. *Sosa v. Fite*, 498 F.2d 114, 119 (5th Cir. 1974).

31. 15 U.S.C. § 1635(b) (2009).

32. Murken, *supra* note 7, at 468.

repayment.”³³ As a result of these varied approaches throughout the circuits, the outcomes are often disjointed and incongruous from one circuit to another.

This Comment will focus on circuit court splits between those courts that require tender by the consumer prior to rescission and those that do not condition rescission on tender by the consumer. Although the language of section 1635(b) of TILA is clear and unambiguous, the manner in which it is applied would lead one to believe otherwise. The majority of courts have relied upon traditional notions of equity to depart from what appears to be the plain language of the statute in order to avoid unduly harsh and inequitable results to creditors. How various courts interpret the sequence of rescission and the ensuing effect on the security interest is crucial to that security interest’s treatment in the bankruptcy process.

III. COMPETING RATIONALES AMONG THE CIRCUIT COURTS

A. The Majority View: Conditioning Rescission on Tender by the Borrower

Currently, “the majority of circuits to consider the issue agree that courts have the equitable power to condition rescission on tender by the borrower.”³⁴ The common thread that runs through these decisions is the ability of the courts to freely exercise their powers of equitable discretion. Moreover, these courts extract this notion of equitable discretion not only from the language of TILA, but also from “congressional intent.”³⁵ Ironically, the same statute that was created to better inform consumers of their credit rights through disclosure has often shielded creditors from inequitable results that may ensue from a literal reading of the statute.³⁶ Although a comprehensive comparative analysis of the various approaches of all the circuit courts is outside the scope of this Comment, a sampling of the most frequently cited cases in this field will paint a sufficient portrait of the current legal landscape.

33. *Id.* at 467.

34. *Wells Fargo*, 407 B.R. at 460.

35. *Id.*; *see, e.g.*, S. REP. NO. 96-368, at 29 (1980), *reprinted in* 1980 U.S.C.C.A.N. 236, 264-65, which states:

Upon application by the consumer or the creditor, a court is authorized to modify this section’s procedures where appropriate. For example, a court might use this discretion in a situation where a consumer in bankruptcy or wage earner proceedings is prohibited from returning the property. The committee expects that the courts, *at any time during the rescission process, may impose equitable conditions to insure that the consumer meets his obligations* after the creditor has performed his obligations as required under the Act.

Id.

36. *See, e.g.*, *Ramirez v. Household Fin. Corp (In re Ramirez)*, 329 B.R. 727, 740 (D. Kan. 2005) (noting that “in the context of bankruptcy, where the borrower seeks to compromise or discharge the debt on the rescinded loan, judicial modification of the rescission process is well justified”). The court went on to state that:

Had Congress intended otherwise, there would be no reason to mention bankruptcy, as a creditor’s secured interest in a debtor’s homestead would be void upon rescission, relegating the debtor’s remaining obligations to an unsecured, often dischargeable status. The net effect, then, would be that a debtor receives the entire benefit of the credit transaction, often substantial sums of money or what amounts to a free house, while the creditor receives nothing, which would be contrary to the purpose of rescission.

Id. at 742.

Rudisell v. Fifth Third Bank,³⁷ a frequently cited Sixth Circuit case, presented a classic scenario for the proposition that courts must have the equitable power to condition rescission upon tender by the borrower. In *Rudisell*, the debtors engaged in a credit transaction with Fifth Third Bank in order to finance the installation of aluminum siding on their home.³⁸ Upon the discovery of disclosure violations found within the contract, the debtors rescinded the loan and “argue[d] that they should be allowed to rescind, receive back all monies paid to [the creditor], and keep the aluminum siding without paying for it.”³⁹ Succinct in its brevity, the court simply held that “[s]ince rescission is an equitable remedy, the court may condition the return of monies to the debtor upon the return of the property to the creditor.”⁴⁰ Because the loan had been consumed by the installation of the aluminum siding, the debtors were ordered to “tender the reasonable value of the property they received since they cannot give back what they actually received”⁴¹

The factual scenario in *Rudisell* is a classic example of a situation that often leads the debtor to consider filing for bankruptcy. When a homeowner has financed a large sum of money for home improvements, with their home as the security interest, and they later find a disclosure violation in their loan agreement, what are their options in jurisdictions that condition the rescission of the loan on their ability to give back that which they have already consumed? For many debtors, they seek refuge in a Chapter 13 bankruptcy setting. Unfortunately for the debtors, the bankruptcy setting is not a clear path to debt relief in this situation. As discussed below, the majority of courts are resistant to relegating this form of debt to unsecured status, dischargeable in the bankruptcy setting.

For example, in *Yamamoto v. Bank of New York*,⁴² the Ninth Circuit held that “a court may impose conditions on rescission that assure that the borrower meets her obligations once the creditor has performed its obligations.”⁴³ In *Yamamoto*, the debtors were refinancing an existing mortgage when they defaulted on the loan and subsequently alleged disclosure violations in the loan agreement. The *Yamamoto* court focused not only on whether they had the equitable power to modify the sequence of rescission under TILA, but also on whether rescission is automatic upon a debtor’s notice. The court held “[n]either the statute nor the regulation establishes that a borrower’s mere assertion of the right of rescission has the automatic effect of voiding the contract.”⁴⁴ In essence, the court has the equitable power to determine whether rescission has occurred in addition to altering the sequence of rescission events. The *Yamamoto* court pointed out that although courts do not have the discretion to alter “substantive provisions,”⁴⁵ they do have the discretion to alter “procedural provisions.”⁴⁶

37. 622 F.2d 243 (6th Cir. 1980).

38. *Id.* at 245.

39. *Id.* at 254.

40. *Id.*

41. *Id.*

42. 329 F.3d 1167 (9th Cir. 2003).

43. *Id.* at 1173.

44. *Id.* at 1172 (quoting *Large v. Conesco Fin. Servicing Corp.*, 292 F.3d 49, 54-55 (1st Cir. 2002)).

45. *Id.* at 1171.

46. *Id.*

Consequently, in *American Mortgage Network, Inc. v. Shelton*,⁴⁷ the Fourth Circuit addressed the procedural requirements associated with the right of rescission under section 1635(b). The debtors refinanced an existing mortgage on their primary residence in order to purchase an additional home, but because of some discrepancies within the loan documents, they decided to cancel the transaction within the proper timeframe as allowed by TILA.⁴⁸ Upon advice from counsel, the debtors offered to sell their new home to the creditor in lieu of a cash payment in order to tender back the principal amount of their loan.⁴⁹ The creditor declined this offer and “refused to release its security interest without any provision for repayment of the loan proceeds.”⁵⁰ The debtors countered that the creditor’s failure to release its security interest within the twenty days as required by TILA resulted in the “forfeit[ure] [of] the loan proceeds.”⁵¹ The court held that the debtors had “misconstrued the procedural mechanics of § 1635(b) . . . [because] it was not the intent of Congress to reduce the mortgage company to an unsecured creditor”⁵² Relying on traditional notions of equity and earlier decisions,⁵³ the court “adopt[ed] the majority view of reviewing courts that unilateral notification of cancellation does not automatically void the loan contract.”⁵⁴

The Eleventh Circuit addressed the issue of equitable conditioning in *Williams v. Homestake Mortgage Co.*,⁵⁵ and held that “a court may impose conditions that run with the voiding of a creditor’s security interest upon terms that would be equitable and just to the parties in view of all the surrounding circumstances.”⁵⁶ In *Williams*, the borrowers entered into a loan transaction primarily to consolidate existing mortgages and to finance the remodeling of a bathroom.⁵⁷ Upon later inspection of the loan documents, the borrowers discovered several TILA disclosure violations and sought rescission of the transaction.⁵⁸ The creditor “conceded that rescission was an appropriate remedy [but] . . . sought modification of the normal statutory rescission provisions, arguing that . . . the voiding of its security interest in Williams’ home should be conditioned upon the return of [the money] that Williams owe[d] in unpaid principal.”⁵⁹ In *Williams*, the court echoed the reasoning of the majority view by maintaining that the “addition of the last sentence of 1635(b)⁶⁰ . . . was a reflection of an equitable goal.”⁶¹ The reasoning

47. 486 F.3d 815 (4th Cir. 2007).

48. *Id.* at 817-18.

49. *Id.* at 818.

50. *Id.*

51. *Id.*

52. *Id.* at 820-21.

53. *See, e.g.*, *Powers v. Sims & Levin*, 542 F.2d 1216, 1222 (4th Cir. 1976) (explaining that “when rescission is attempted under circumstances which would deprive the lender of its legal due, the attempted rescission will not be judicially enforced unless it is so conditioned that the lender will be assured of receiving its legal due”).

54. *Shelton*, 486 F.3d at 821.

55. 968 F.2d 1137 (11th Cir. 1992).

56. *Id.* at 1142.

57. *Id.* at 1138.

58. *Id.*

59. *Id.*

60. 15 U.S.C. § 1635(b) (2009) (stating in relevant part that “[t]he procedures prescribed by this subsection shall apply except when otherwise ordered by a court”).

that had existed throughout the majority of circuits prior to the enactment of the Truth in Lending Simplification and Reform Act⁶² was simply codified via the additional language in section 1635(b). The court held that judicial modification of the rescission procedures was appropriate and consistent with Congressional intent.

The *Rudisell*, *Yamamoto*, *Shelton*, and *Williams* decisions are just a sampling of the pervasive view surrounding rescission procedures in the various circuits. Principles of equity, limited to the procedural reshuffling of rescission sequencing, are the common threads that run through these holdings. Where statutory authority is silent, bankruptcy courts rely on their equitable powers to apply the law. Where equity is implied from the language of a statute, the courts may yield a double-edged sword: one edge from Congress's express authority, and the other from the court's ability to equitably interpret the statute. Although express congressional authority and case law justify the majority approach, this Comment will highlight the possible inequities that arise within this equitable framework.

B. The Minority View: Tender Should Not be Required as a Condition for Rescission

In *Sosa v. Fite*,⁶³ the Fifth Circuit held that following rescission, a creditor who failed to complete their obligations, as outlined in TILA, could forfeit their right to the debtor's tender of the principal amount of the loan.⁶⁴ The circumstances in *Sosa* presented several scenarios that are not typical of most rescission actions. The borrower entered into a loan transaction with a creditor and a contractor that secured her home in return for financing for aluminum siding for that home.⁶⁵ The borrower consistently made payments on the loan until the poor work of the contractor led her to make no further payments on the loan.⁶⁶ Shortly thereafter, the creditor foreclosed on the home and the borrower rescinded the loan based on several serious disclosure violations within the loan documents.⁶⁷ Included within her notice of rescission, the borrower made an "express offer to return the aluminum siding, an overture which elicited no response whatsoever from the creditors."⁶⁸ Following the offer to tender back the aluminum siding, the creditors made no effort to terminate the security interest in the borrower's home.⁶⁹ The creditor's failure to abide by the statutory scheme as dictated by section 1635(b) was, in the eyes of the court, fatal to the creditor's ability to obtain conditional rescission.⁷⁰

61. *Williams*, 968 F.2d at 1140.

62. Truth in Lending Simplification and Reform Act, Pub.L. No. 96-221, § 612(a)(4), 94 Stat. 168, 175 (1980) (codified as amended at 15 U.S.C. § 1635(b) (1988)).

63. 498 F.2d 114 (5th Cir. 1974).

64. *Id.* at 120.

65. *Id.* at 116.

66. *Id.* as 116-17.

67. *Id.* at 117.

68. *Id.* at 118.

69. *Sosa*, 498 F.2d at 118.

70. *Id.* at 118-19. The court noted:

The significance of *Sosa*'s proffered return and the creditors' failure to comply with clear statutory directives is that *Sosa* did in fact attempt to make a tender, even though under a literal reading of the statute the creditors were unentitled to any tender at all by virtue of

Sosa is distinct from most rescission transactions for several key reasons. First, upon rescission, the borrower made an attempt to tender back the property purchased by the loan. Second, the creditors made no attempt to release the security interest in the debtor's home as mandated by section 1635(b). Finally, the reasoning employed by the court was prior to the passage of the Truth in Lending Simplification and Reform Act. Although the court did not have the modern codified language of section 1635(b) to rely upon in relation to conditional rescission, it could easily have employed the long-standing notion of equity upon which the majority of courts have relied. The minority view has the potential to create a debtor windfall in circumstances where the creditor has failed to properly disclose the terms of the loan agreement. Contract law attempts to deter debtor windfalls and prefers to return parties to their positions prior to entering the contract. The *Sosa* court argued that the facts presented were precisely one of the situations in which a debtor windfall would be justifiable.⁷¹

The Fifth Circuit again addressed the issue of conditional rescission in *Gerasta v. Hibernia National Bank*,⁷² and shortly thereafter in *Harris v. Tower Loan of Mississippi, Inc.*⁷³ In both cases, the court "refused to permit judicial modification where Congress had provided for none."⁷⁴ In *Gerasta*, the court stressed that "the [creditor's] duties are in no way conditional upon the [consumer's] tender of the loan proceeds."⁷⁵ In *Harris*, the court echoed the reasoning in *Gerasta* when it stated "we do not permit a creditor to refuse to perform unless or until the obligor tenders payment."⁷⁶

Although the minority approach relies upon a strict adherence to the statutory language and sequencing of TILA, it may be viewed as doing so at the expense of fairness and equity. In order for rescission to exist as an effective remedy for the misinformed borrower, the exercise of rescission occasionally places harsh penalties at the feet of creditors. "While the goal should always be to 'restor[e] the parties to the status quo ante,' rescission must also maintain its vitality as an enforcement tool."⁷⁷ Section 1635(b) provides that a creditor may be subject to

their failure to perform their express obligation of expurgating records of references to the invalidated security interest.

Id.

71. *Id.* at 119. The court explained that:

Congress' intended operation of the statute, as evidenced by the 1635(b) creditor-forfeiture provision, therefore clearly calls for a debtor windfall if the creditor does not set about to rectify his earlier nondisclosures in the manner envisaged by the statute. In fact, the Act flatly provides that if his creditor continues in his untoward ways, the debtor incurs no obligation to pay for property which he is at the same time entitled to keep. That this result was intended is clear beyond peradventure, for one of the measure's principal sponsors in the House stated: "[I]f the seller does not come back to pick up [his property] after a 10-day period [following the notice of rescission], the buyer can keep this item and he does not even have to pay for it"

Id. (quoting 114 CONG. REC. 14398 (1968) (remarks of Congresswoman Sullivan)).

72. 575 F.2d 580 (5th Cir. 1978).

73. 609 F.2d 120 (5th Cir. 1980).

74. *Williams*, 968 F.2d at 1140.

75. *Gerasta*, 575 F.2d at 585.

76. *Harris*, 609 F.2d at 123.

77. *Williams*, 968 F.2d at 1142 (internal citations omitted) (quoting *Harris*, 609 F.2d at 123).

harsh penalties for non-compliance, but these penalties are rarely exercised because of the potential for drastic consequences to creditors for minor errors or omissions. This Comment puts forth the proposition that, in some instances, harsh penalties are warranted because of the nature of the violations and the conduct of the creditor. In order for TILA to promote unfettered disclosure between debtors and creditors, these harsh penalties must occasionally be available to consumers.

IV. APPROACHES TO RESCISSION IN THE CHAPTER 13 BANKRUPTCY SETTING

A. An Exercise in Equity

The underlying reasons for a Chapter 13 filing are numerous—ranging from drastic changes in the debtors' economic condition to litigation strategies in order to automatically stay⁷⁸ an impending foreclosure. Because foreclosure may be a bankruptcy-inducing event, debtors must be aware of the differing approaches that exist within the courts because these procedures dictate the treatment of their estate. Because of the nuances and complexities that arise between various bankruptcy chapters, this Section will focus primarily on the various approaches to rescission in the Chapter 13 setting. However, the overarching analysis is applicable within the different bankruptcy chapters.

The procedural complexities and sequence of events that dictate the path of a transaction that is attempting to be rescinded are not clear-cut. To illustrate, assume that a creditor holds a \$100,000 refinancing loan secured by an interest in the principal residence of Jane. Because of material disclosures found within the refinancing contract, Jane exercises her right to rescission within the applicable time frame. Under section 1635(b) of TILA, the following sequence of events occurs: the creditor voids the security interest in the home; the creditor must then return any finance charges, payments, or down payments made by Jane within twenty days of the rescission notice; and finally, once the creditor has performed his obligations, Jane must tender back the principal of the loan. If Jane files for Chapter 13 bankruptcy at some point during this process, several complexities may arise: What is the nature of the security interest in her home in the bankruptcy setting? Is the previously secured interest now relegated to an unsecured status, dischargeable in the bankruptcy setting? Is the rescission automatic or conditional? The answers to these questions vary depending on the court.

B. Rescission: Automatic or Conditional?

The majority views of bankruptcy courts mirror the majority views of non-bankruptcy courts in the exercise of conditional rescission.⁷⁹ The equitable nature of rescission has been at the heart of the majority reasoning in the bankruptcy arena.⁸⁰ One of the primary concerns in the bankruptcy context is the relegation of

78. 11 U.S.C. § 362 (1979).

79. *See, e.g., Lynch v. GMAC*, 170 B.R. 26, 30 (Bankr. D.N.H. 1994) (stating “[t]his Court can see no reason why the circuit courts and the district court[s], in exercising their equitable powers, can condition the right of rescission, but the bankruptcy court cannot”).

80. *See Wells Fargo*, 407 B.R. at 461.

a creditor's secured interest to an unsecured interest.⁸¹ Whether a security interest is demoted to an unsecured status hinges largely upon the timing of rescission, which in turn is determined by whether the rescission was automatic or conditional.⁸² Divergent views arise within the bankruptcy courts as to whether the notice of rescission, when exercised by the debtor, automatically voids the security interest.⁸³

The majority of courts, "including the First Circuit, have concluded that rescission does not flow automatically from the borrower's mailing of a notice of rescission."⁸⁴ Although this reasoning may appear to depart from the statutory language of TILA, courts have interpreted section 1635(b) to require that "the security interest becomes void when the [borrower] exercises a right to rescind that is available in the particular case, either because the creditor acknowledges that the right of rescission is available, or because the appropriate decision maker has so determined."⁸⁵ Courts have justified this interpretation based on notions of equity, largely in favor of creditors, and the belief that to allow borrowers to simply allege rescission is an "untenable proposition."⁸⁶

In contrast, bankruptcy courts holding that rescission flows automatically from the notice of rescission from the borrower rely simply on the literal reading of section 1635(b).⁸⁷ In a bankruptcy setting, this view argues that "there is a legitimate, legal impediment to the debtor's reciprocal performance. It would be palpably unfair to deny the relief to which a consumer is entitled under TIL[A] because that consumer has also availed himself of bankruptcy relief."⁸⁸ This consumer-friendly approach addresses some of the problems and inequities that existed prior to TILA under traditional rules of contract law.⁸⁹

81. *See id.*

82. *See id.* at 458-59.

83. *See, e.g., id.* at 459 (holding "[n]either [TILA] or [Regulation Z] establishes 'that a borrower's mere assertion of the right of rescission has the automatic effect of voiding the contract'" (quoting *Large*, 292 F.3d at 54)); *Thompson v. Irwin Home Equity Corp.*, 300 F.3d 88, 90 (1st Cir. 2002) ("[R]eject[ing] the argument that a demand for rescission under TILA is somehow self-executing and results in the automatic voiding of the loan agreement"); and *Yamamoto v. Bank of New York*, 329 F.3d 1167, 1172 (9th Cir. 2003) (holding that the mere "communicat[ion] by a notice of rescission [constitutes rescission] makes no sense, when . . . the lender contests the ground upon which the borrower rescinds"); but see *In re Jaaskelainen*, 391 B.R. at 645 (holding "[u]pon the valid exercise of the right of rescission, the security interest becomes void").

84. *Wells Fargo*, 407 B.R. at 458-59.

85. *Large*, 292 F.3d at 54-55.

86. *Id.* at 55.

87. *In re Jaaskelainen*, 391 B.R. at 645.

88. *Id.* at 645-46.

89. *See* T. Nelson Mann, *Truth-In-Lending: Judicial Modification of the Right of Rescission*, 1974 DUKE L.J. 1227, 1231 (1974). The author provides a valuable hypothetical that illustrates pre-TILA problems that may arise in the bankruptcy or insolvency setting:

Assume, for example, that a consumer purchased storm windows costing \$2,000 and that he paid for them by check. Shortly thereafter, he discovered that the contract was voidable, rescinded the agreement by returning the windows to the seller, and demanded restoration of his payment. If the seller accepted the storm windows but refused to return the money paid, the consumer could bring an action at law to recover his property, but he would be at a serious disadvantage. He not only would have lost the use of the storm windows and his money, but he would also bear the risk that by the time he obtains an

Because of the inequities and possible abuses that could arise in situations of automatic rescission, the majority of circuits still rely on their equitable power to exercise conditional rescission in the bankruptcy setting. Ironically, TILA, enacted to protect and better inform consumers in credit transactions, rarely exercises its rescission powers to an extent that allows consumers to enjoy a windfall in the bankruptcy or non-bankruptcy setting although the statute clearly provides that this windfall does indeed exist.

C. The Home: Secured or Unsecured?

The determination of whether rescission is automatic or conditional has significant consequences in evaluating the status of the security interest. If the borrower's notice of rescission is found to automatically void the creditor's security interest, that security interest may be relegated to an unsecured status in the bankruptcy setting.⁹⁰ One consequence of the security interest becoming unsecured is that the borrower may be able to have that unsecured debt discharged in bankruptcy.⁹¹ In essence, the unsecured loan may be treated like other consumer debt, such as credit card debt. The principal dwelling of a borrower is one of the most common security interests that exists in the consumer-lending arena and is the most relevant interest when examining rescission under section 1635(b) of TILA. Furthermore, a debtor whose principal residence is secured by a second mortgage or a refinancing agreement, wholly unsupported by equity, may have that loan "stripped off" and avoided through a Chapter 13 bankruptcy.⁹² In order to understand the importance of the nature of the debtor's security interest, it is meaningful to understand the role of equity as it relates to that security interest.

A fundamental principle of bankruptcy law is that the bankruptcy court is a court of equity.⁹³ Because the term "equity" has various meanings within bankruptcy jurisprudence,⁹⁴ it is beyond the scope of this Comment to explore the intricacies of each definition. There are several key sections within the bankruptcy code that apply principles of equity to situations involving creditor misconduct. Under section 510 of Title 11 of the United States Code,⁹⁵ a creditor's claims may

enforceable judgment the seller may no longer be solvent. Furthermore, the burden of bringing suit would fall entirely on the consumer, who must assume litigation expenses if he is to recover any of the consideration that he has paid.

Id.

90. *In re Jaaskelainen*, 391 B.R. at 646.

91. *Id.*

92. 11 U.S.C. § 522(f) (2009).

93. *Young v. United States*, 535 U.S. 43, 50 (2002); *Young v. Higbee Co.*, 324 U.S. 204, 214 (1945); *Pepper v. Litton*, 308 U.S. 295, 304 (1939); *Bardes v. Hawarden Bank*, 178 U.S. 524, 535 (1900).

94. The term "equity" has various meanings depending on the context in which it is used. Equity has historically been linked to issues of "jurisdiction, procedures, court powers, justice, an ownership interest, or type of right." Adam J. Levitin, *Toward A Federal Common Law Of Bankruptcy: Judicial Lawmaking In A Statutory Regime*, 80 AM. BANKR. L.J. 1, 6 (2006).

95. 11 U.S.C. § 510 (2009). Section 510 states in relevant part:

(a) A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.

be equitably subordinated to other creditors' claims because of misconduct on the part of the offending creditor. Equitable subordination allows a bankruptcy court to procedurally reorganize the priority of the offending creditor's claim in respect to other creditors.⁹⁶ Thus, the nature of the debtor's security interest becomes vital to the reorganization of the estate and in determining which creditors will get paid first. If a creditor's security interest goes from secured to unsecured status, the creditor's collateral is at risk of discharge if the debtor files for bankruptcy. The creditor's collateral is especially at-risk if there are multiple creditors and limited assets.

Consequently, for creditors to maximize the recovery of assets in bankruptcy, they must maintain their priority as a secured creditor or face the risk of limited recovery. Absent a TILA violation, creditors enjoy considerable protection of their security interest in the debtor's home under the bankruptcy code.⁹⁷ If a creditor's interest is demoted to an unsecured status, the risk of discharge is increased even further and the creditor may see no recovery. The relegation of a creditor's formerly secured interest to one that is unsecured is a frightening scenario for creditors in the bankruptcy setting. This unsecured debt leaves open the possibility of a creditor leaving the bankruptcy table empty-handed. The threat of an unsecured interest in bankruptcy is a powerful motivator for creditors to fight tooth-and-nail to maintain their security interest in a debtor's home.

D. In re Jaaskelainen: An Illustration of the Future?

A recent case from the United States Bankruptcy Court, District of Massachusetts Eastern Division, illustrates some of the competing rationales lurking within the First Circuit. In *In re Jaaskelainen*,⁹⁸ the debtor-borrowers were

(b) For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—

- (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
- (2) order that any lien securing such a subordinated claim be transferred to the estate.

Id.

96. *Id.*

97. *See, e.g.*, 11 U.S.C. § 1322(b) (2009). Section 1322(b) states in relevant part:

The plan may . . . modify the rights of holders of secured claims, other than a claim secured by only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims.

Id.

98. 391 B.R. 627 (2008).

facing an imminent foreclosure of their home in Massachusetts.⁹⁹ In order to avoid foreclosure, the debtors entered into a refinancing agreement with a creditor.¹⁰⁰ The refinancing mortgage and note was secured by the debtor's home.¹⁰¹ Less than a year after the refinancing, the debtors defaulted on their loan payments and consulted an attorney to "get a financial overview of their predicament."¹⁰² Upon inspection of the closing documents, the attorney discovered that the debtors had not received the correct number of Notices of Right to Cancel (the NOR) as mandated by TILA and Regulation Z.¹⁰³ On behalf of the debtors, the attorney sent the creditors written notification of a request for rescission of the refinancing.¹⁰⁴ Approximately one week after requesting rescission, the debtors filed for Chapter 13 bankruptcy and listed the refinancing debt as unsecured non-priority debt on their Schedule F.¹⁰⁵ The creditors subsequently "filed a proof of claim asserting a claim . . . secured by real property."¹⁰⁶ The debtors then filed an objection to the creditor's claim and soon thereafter the creditors commenced an adversary proceeding.¹⁰⁷

The creditors argued that the mere assertion of rescission is not tantamount to an automatic rescission, but rather rescission should be conditioned upon tender of the principal.¹⁰⁸ The creditors "assert[ed] that rescission of the loan without requiring tender would be entirely inequitable and constitute a severe penalty to [creditors] and an undeserved windfall for the [d]ebtors."¹⁰⁹

The debtors argued that they did not receive the required number of NOR's pursuant to TILA, which "gave rise to an extended rescission period, during which they validly exercised their right."¹¹⁰ Furthermore, the debtors argued "that they ha[d] no obligation to tender funds back to the [creditors] in light of their bankruptcy filing . . . and it [was] well established in [their] district that tender is not a condition of rescission in Chapter 13."¹¹¹ Relying upon *In re Myers*¹¹² and *In re Whitley*,¹¹³ the debtors argued that, in Massachusetts, conditional rescission is inappropriate in the bankruptcy setting.¹¹⁴ Addressing the issue of equity, Judge Hillman stated in *Myers* that "[t]he equities . . . lie in the debtor's favor. Upholding

99. *Id.* at 631.

100. *Id.*

101. *Id.*

102. *Id.* at 633-34.

103. *Id.* at 635.

104. *In re Jaaskelainen*, 391 B.R. at 635.

105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.* at 639.

109. *In re Jaaskelainen*, 391 B.R. at 636.

110. *Id.* at 636.

111. *Id.* at 637. See *Myers v. Fed. Home Loan Mortg., Co. (In re Myers)*, 175 B.R. 122, 129 (Bankr. D. Mass. 1994) (holding that "rescission by a[] [debtor] is not conditioned by tender or payment in the context of a bankruptcy case") and *Whitley v. Rhodes Fin. Servs., Inc. (In re Whitley)*, 177 B.R. 142, 153 (Bankr. D. Mass. 1995) (holding that the debtor was not required to tender in order for rescission to be valid).

112. 175 B.R. 122 (Bankr. D. Mass. 1994).

113. 177 B.R. 142 (Bankr. D. Mass. 1995).

114. *In re Jaaskelainen*, 391 B.R. at 637.

the creditor's plea . . . would allow the creditor to escape the consequences of a serious TIL[A] violation, while at the same time negating the fresh start given the debtors upon discharge."¹¹⁵ Judge Hillman went on to state that "[j]udicial preconditioning of cancellation of the creditor's lien on the [debtor's] tender is inappropriate in bankruptcy cases."¹¹⁶ The court in *In re Whitley* also held that there should not be a bright-line rule that conditions rescission upon the tender by the borrower. Applying principles of equity, Judge Feeney stated:

[C]ourts in their effort to insure a just result should not forget that the TILA was passed primarily to aid the unsophisticated consumer and that it was intended to balance scales thought to be weighted in favor of lenders and . . . to be liberally construed in favor of borrowers.¹¹⁷

In *In re Jaaskelainen*, Judge Hillman, applying his earlier reasoning from *In re Myers*, found the position of the debtor more persuasive than that of the creditor. Judge Hillman stated that "rescission by an obligor is not conditioned by tender or payment in the context of a bankruptcy case."¹¹⁸ Additionally, the court expounded on its rationale for treating rescission in the bankruptcy context different than outside of bankruptcy by stating:

Essentially, when a borrower rescinds a transaction and the security interest is terminated as a matter of law, the creditor is left with an unsecured debt. Outside a bankruptcy proceeding, this characterization is of little consequence because unsecured debts must otherwise be paid in full, failing which, a creditor may take steps to reacquire a security interest. In a bankruptcy proceeding, however, unsecured debts are paid pro rata and may be discharged without payment. Requiring a Chapter 13 Debtor to tender the full amount of the loan on a creditor's now unsecured claim would unfairly discriminate among unsecured claims in violation of 11 U.S.C. § 1322(a)(3).¹¹⁹

Based on notions of equity, section 1635(b) of TILA has in the majority of cases applied a court's power to condition rescission in favor of creditors. In the bankruptcy context, rescission becomes more complex because the courts must balance the technical considerations of bankruptcy against the Truth-in-Lending guidelines. Rescission is a tool that is capable of producing inequitable results in an area of law, namely bankruptcy, which is charged with upholding traditional notions of equity. It is inevitable that harsh or inequitable outcomes will result from adversarial proceedings involving a debtor and creditor. "Although the policy of avoiding harsh Truth-in-Lending sanctions has great weight in cases where both damages and rescission of the debt are imposed by the Act, we find it inapplicable when the harshness results from events, [i.e., bankruptcy] independent of the Truth-

115. *In re Myers*, 175 B.R. at 129 (quoting *In re Piercy*, 18 B.R. 1004, 1007-08 (Bankr. W.D. Ky. 1982)).

116. *In re Myers*, 175 B.R. at 128 (quoting *Celona v. Equitable Nat'l Bank*, 98 B.R. 705, 707 (E.D. Pa. 1989)).

117. *In re Whitley*, 177 B.R. at 152-53 (internal quotation marks omitted).

118. *In re Jaaskelainen*, 391 B.R. at 645.

119. *Id.* at 646. 11 U.S.C. § 1322(a)(3) (2009) states that "[i]f the plan classifies claims, [the plan shall] provide the same treatment for each claim within a particular class." *Id.* (relating to a debtor's bankruptcy plan).

in-Lending claim.”¹²⁰ In *In re Jaaskelainen*, the court found the creditors inequity arguments unpersuasive and found that “[r]equiring a Chapter 13 Debtor to tender the full amount of the loan on a creditor’s now unsecured claim would unfairly discriminate among unsecured claims in violation of 11 U.S.C. § 1322(a)(3).”¹²¹

The apparent victory for the minority view in *In re Jaaskelainen* was short-lived. On appeal, the United States District Court for the District of Massachusetts vacated the “determination that rescission may not be conditioned upon tender by Debtors.”¹²² Relying on the majority view among the circuit courts, Judge Zobel concluded that “rescission does not flow automatically from the [debtor’s] mailing of a notice of rescission.”¹²³ In addition to the traditional equity arguments that rely upon section 1635(b) for courts to procedurally modify the rescission sequence, Judge Zobel focused with equal force on congressional intent. Arguing that one of the objectives in the enactment of section 1635(b) was to restore the status quo ante, Judge Zobel reasoned that this objective could not be met if rescission was found to be automatic upon the mere assertion of the debtor.¹²⁴ The District Court’s reasoning and holding on appeal is consistent with the modern approach to rescission in bankruptcy. With the historical precedent of equity on their side, it would be a monumental task for the minority position to jettison the equity argument in favor of a literal reading of the sequence of events set forth in the statute. In this regard, *In re Jaaskelainen* is likely an illustration of the future—courts will almost unilaterally condition rescission on tender by the debtor.

Following the District Court’s ruling in *In re Jaaskelainen*, the United States Bankruptcy Court for the District of Massachusetts, Western Division, issued a holding similar in effect to that provided by the Bankruptcy Court in *In re Jaaskelainen*. Judge Boroff, in *In re Giza*,¹²⁵ “respectfully [took] a different view”¹²⁶ from Judge Zobel’s opinion and reasoned that the procedures that may be modified “occur[] after the security interest has been voided.”¹²⁷ The debtors in *In re Giza* refinanced their property in Palmer, Massachusetts and later discovered that their refinancing documents were missing the requisite number of NOR’s and Truth-in-Lending disclosures.¹²⁸ The debtors filed for Chapter 13 bankruptcy approximately one year later and listed their refinance lender’s debt as unsecured on their bankruptcy schedules.¹²⁹ Per the debtors’ Chapter 13 plan, their lender

120. *In re Piercy*, 18 B.R. at 1008 (internal quotation marks omitted).

121. *In re Jaaskelainen*, 391 B.R. at 627.

122. *Wells Fargo*, 407 B.R. at 463.

123. *Id.* at 458-59.

124. *Id.* at 460. Judge Zobel relied heavily on *Ray v. Citifinancial, Inc.* for his explanation of Congress’s intent which, in relevant part, stated:

Within the meaning of the law, “rescission” does not mean an annulment that is definitively accomplished by unilateral pronouncement. Rather, it contemplates a remedy that restores the status quo ante. If a party has a legal or equitable right to annul a transaction, he may do so, but only upon returning any benefit he has received.

Ray v. Citifinancial, Inc., 228 F.Supp.2d 664, 667 (D. Md. 2002).

125. *Giza v. Amcap Mortg. Inc. (In re Giza)*, 428 B.R. 266 (Bankr. D. Mass. 2010).

126. *Id.* at 273.

127. *Id.* at 275.

128. *Id.* at 268-69.

129. *Id.* at 269.

would receive a pro rata share of the dividends that would be paid out to the unsecured creditors.¹³⁰ The lender objected to the plan, relying largely in part on the decision of Judge Zobel in *In re Jaaskelainen*.¹³¹

Judge Boroff's approach makes a crucial distinction between the process of rescission and the voiding of the security interest—they are separate according to Massachusetts General Laws. The provision in the Massachusetts's version of TILA, supplemented through the Massachusetts Code of Regulations, is structured in a manner that allows for the rescission procedures to be modified, but explicitly does not address the process of modifying the underlying security interest.¹³² Judge Boroff, like Judge Hillman in *In re Jaaskelainen*, reasoned that requiring the debtor to tender the proceeds to their lender “would violate the requirements of § 1322(a)(3) by giving [the lender] unsecured preferential treatment.”¹³³ Because of the amount of the lender's claim, the debtor's unsecured creditors would receive little, possibly nothing, in dividends.¹³⁴ Furthermore, Judge Boroff reasoned that even if tender is required for rescission, the court needs to examine the debtor's ability to pay the principal amount.¹³⁵ The court ultimately decided that, if the conditions for rescission were met, it would “determine the amount of tender and order the [debtors] to classify that claim and treat it consistently with those of other

130. *Id.*

131. *In re Giza*, 428 B.R. at 273.

132. The Massachusetts law states, in relevant part:

(4) Effects of Rescission

(a) When a consumer rescinds a transaction, the security interest giving rise to the right of rescission becomes void and the consumer shall not be liable for any amount, including any finance charge.

(b) Within 20 calendar days after receipt of a notice of rescission, the creditor shall return any money or property that has been given to anyone in connection with the transaction and shall take any action necessary to reflect the termination of the security interest.

(c) If the creditor has delivered any money or property, the consumer may retain possession until the creditor has met its obligation under 209 CMR 32.23(4)(b). When the creditor has complied with 209 CMR 32.23(4)(b), the consumer shall tender the money or property to the creditor or, where the latter would be impracticable or inequitable, tender its reasonable value. At the consumer's option, tender of property may be made at the location of the property or at the consumer's residence. Tender of money must be made at the creditor's designated place of business. If the creditor does not take possession of the money or property within 20 calendar days after the consumer's tender, the consumer may keep it without further obligation.

(d) The procedures outlined in 209 CMR 32.23(4)(b) and (c) may be modified by court order.

209 MASS. CODE REGS. 32.23 (2010). Accordingly, under Judge Boroff's reasoning, the procedures that may be modified occur after the security interest has already been extinguished and the procedures that may be modified occur in an environment where there is no longer a remaining security interest.

133. *In re Giza*, 428 B.R. at 275. Section 1322(a)(3) of the Bankruptcy Code states that “if the plan classifies claims, [the plan shall] provide the same treatment for each claim within a particular class” 11 U.S.C. § 1322(a)(3) (2009).

134. *In re Giza*, 428 B.R. at 275.

135. *Id.* at 275 (quoting *Wells Fargo*, 407 B.R. at 462 (urging the bankruptcy court on remand to consider “the appropriate conditions to impose on Debtor's exercise of rescission. In understanding this evaluation the bankruptcy court should consider traditional equitable notions, including such factors as the severity of Appellants' MCCCDA violation and the degree to which Debtors are able to pay the principal amount”).

unsecured creditors.”¹³⁶ Although the holding of the *Giza* court disagreed with that of the District Court, the reasoning and outcome harmonized the Massachusetts version of the TILA laws with the United States Bankruptcy Code. Rescission may be allowed, but it does not follow that the debtor will walk away from the obligation—the court may establish the appropriate tender amount leaving the onus on the debtor to then determine the classification of the now unsecured claim.

E. The Maine Approach

Although there is very little case law in Maine regarding conditional rescission of a loan in the bankruptcy setting, the limited law that does exist does not bode well for debtors. One of the few cases in the First Circuit, and the only one from Maine, that has addressed this issue has found that rescission can be conditioned upon tender by the borrower. In *New Maine National Bank v. Gendron*,¹³⁷ the District Court held that when “[debtors] have the right to rescind the loan transaction with [a creditor], such rescission is subject, in the exercise of the Court’s discretion, to being conditioned upon the return of the loan proceeds.”¹³⁸ Adopting the majority approach of courts, Judge Carter stated that “equity demands such condition[al] rescission.”¹³⁹ In *Gendron*, the debtors were seeking rescission of a loan acquired to satisfy tax liabilities and later discovered a disclosure violation in their loan documents.¹⁴⁰ Shortly thereafter, the debtors filed a Chapter 7 petition for bankruptcy.¹⁴¹ Although the court recognized the debtors’ right to rescission, principle of equity governed the court’s statutory grant of rescission.

Nearly one hundred and seventy years prior to *Gendron*, the Supreme Judicial Court of Maine, sitting as the Law Court, set forth the proposition that has been embraced by the modern majority of circuits. In *Norton v. Young*,¹⁴² the Law Court held that, in exchanging goods, where “one person defrauds the other, who elects to rescind the contract, it is not enough for the injured person to give notice to the other and call on him to receive his goods, but he must return them to the person defrauding him before any right of action accrues.”¹⁴³ Because *Young* dealt with fraud being exercised upon the debtor seeking to rescind, the conditional rescission declaration may be more forceful. In many instances of asserted rescission, the debtor is relying upon a minor or technical omission within the closing documents. The importance of restoring the status quo ante in situations where the debtor is a victim of fraud is indicative of the courts reluctance to impute an inequity on even the wrongdoers. Additionally, this case was not argued in the bankruptcy context, but it is apparent that traditional notions of contract law have continued to influence rescission disputes.

The Maine equivalent of TILA, codified as part of the Maine Consumer Credit

136. *In re Giza*, 428 B.R. at 276.

137. 780 F. Supp. 52 (D. Me. 1991).

138. *Id.* at 60.

139. *Id.* at 57.

140. *Id.* at 55.

141. *Id.* at 56.

142. 3 Me. 30 (1824).

143. *Id.*

Code (MCCC Truth-in-Lending),¹⁴⁴ allows for the sequence of procedures to be modified by the court in the same manner provided by TILA. The only significant departure of the MCCC Truth-in-Lending from TILA is the inclusion of the language “[i]f the creditor has delivered any property to the [debtor], the [debtor] may retain possession of it.”¹⁴⁵ Apart from the varied language between the MCCC Truth-in-Lending and TILA, Judge Carter relied on the almost identical amended language of both statutes, particularly the omnipresent phrase: “The procedures prescribed by this subsection shall apply except when otherwise ordered by a court.”¹⁴⁶ Maine echoes the approach taken by most courts by providing that rescission can be conditioned upon tender by the borrower.

V. SUGGESTIONS FOR THE FIRST CIRCUIT

As Judge Zobel stated in *Wells Fargo*, “[a]lthough the First Circuit has not spoken, the majority of circuit courts to consider the issue agree that courts have the equitable power to condition rescission on tender by the borrower.”¹⁴⁷ Even in the absence of a direct ruling by the First Circuit, it appears likely that the majority view will be adopted. One of the principal motives behind TILA was to provide consumers with an accurate portrayal of the financial transaction they were entering. Creditors could still charge exorbitant interest rates over questionable durations—they simply had to disclose that fact according to the provisions set forth in TILA. The dominant position has been to allow consumers to rescind the transaction upon a later discovered omission, conditioned on their return of the principal loan amount. The subordinate position has been to apply a literal reading of the statute and allow the consumer to rescind the transaction and have their security interest terminated, with the final step of the process being the tender back of the principal loan amount. Arguably, each position visits some inequity on the party whose view is not advanced by the court. This Comment asserts that there

144. 9-A M.R.S.A. § 8-101 *et seq.* (2009) (Maine Consumer Credit Code—Truth-in-Lending). The Maine Consumer Credit Code—Truth-in-Lending is almost identical to that of TILA and states in relevant part:

When an obligor exercises his right to rescind under subsection 1, he is not liable for any finance or other charge, and any security interest given by the obligor, including any such interest arising by operation of law, becomes void upon such a rescission. Within 20 days after receipt of a notice of rescission, the creditor shall return to the obligor any money or property given as earnest money, down payment or otherwise, and shall take any action necessary or appropriate to reflect the termination of any security interest created under the transaction. If the creditor has delivered any property to the obligor, the obligor may retain possession of it. Upon the performance of the creditor’s obligations under this section, the obligor shall tender the property to the creditor, except that if return of the property in kind would be impracticable or inequitable, the obligor shall tender its reasonable value. Tender shall be made at the location of the property or at the residence of the obligor, at the option of the obligor. If the creditor does not take possession of the property within 20 days after tender by the obligor, ownership of the property vests in the obligor without obligation on his part to pay for it. The procedures of this section shall apply except when otherwise ordered by a court.

9-A M.R.S.A. § 8-204(2).

145. *Id.*

146. *Gendron*, 780 F. Supp. at 60.

147. *Wells Fargo*, 407 B.R. at 460.

are alternative positions supported by case law that may depart from the majority and minority views but still fall under the umbrella of equity.

At first glance, it appears that the court's power to condition rescission is limited to one of two scenarios: first, that rescission is automatic and the creditor terminates the security interest and will then be tendered back their loan principal; and second, the consumer must tender back the principal, at which point the security interest is terminated and the loan is rescinded. Under the language of section 1635(b), however, "[t]he procedures prescribed by this subsection shall apply except when otherwise ordered by a court."¹⁴⁸ Although this provision has been applied almost exclusively to the aforementioned scenarios, the courts have the statutory authority to condition rescission on factors that may exercise more equity in favor of the debtors than the majority approach. This flexible approach may be labeled the "balancing rescission model."

The balancing rescission model may be seen as a fusion of the existing approaches found across the spectrum of courts. The model may be applied by weighing the depth or seriousness of the TILA violation against the debtor's proposed rescission and underlying financial position. The scale for this test has three positions: the first position is weighted in favor of the debtor; the second is a point of equilibrium, where the parties are returned to the positions they were in before the transaction; and the third position is weighted in favor of the creditor.

For the test to weigh in favor of the debtor, the court would need to find particularly egregious or predatory behavior on the part of the lender. In this scenario, the court should be less inclined to condition rescission upon tender by the borrower if they are a victim of fraud or unscrupulous behavior. Additionally, this approach requires the court to tailor its reasoning to the facts specific to the case at hand, but also liberates the courts from being tethered to a bright-line rule that introduces uncertainty and inequity in certain loan transactions. Cases that fall under this line of reasoning are compelling and re-enforce the public policy rationale that is invariably embedded in the TILA.

For example, in *Cole v. Lovett*,¹⁴⁹ the debtors were solicited by vinyl siding salesmen at their home and eventually agreed to have the siding installed. Prior to installation, the debtors requested that the company delay the installation because they were not sure if they still wanted the siding.¹⁵⁰ Despite the debtor's request to delay installation, the workers began work immediately and prior to the statutory three-day expiration for the right to rescind.¹⁵¹ Additionally, the sellers failed to notify the debtors that they were securing the siding by taking a security interest in their home, and failed to properly provide the debtors with all the necessary disclosure documents.¹⁵² The court stated:

[The sellers] attempted to deprive plaintiffs of their right to rescind, first, by failing to inform them of the right and, secondly, by subtly forcing them to accept the siding . . . although rescission is an equitable remedy and conditions may be

148. 15 U.S.C. § 1635(b) (2010).

149. 672 F. Supp 947 (S.D. Miss. 1987).

150. *Id.* at 948.

151. *Id.* at 956.

152. *Id.*

placed on the exercise of that right, the equity in this case does not lie with the defendants.¹⁵³

Although this holding seems to parallel that of the minority position, the deceitful conduct of the sellers factored heavily into the court's reasoning. The sellers' behavior was precisely the type of conduct that TILA sought to deter and, accordingly, the seller was forced to bear the brunt of the losses. *Lovett* illustrates one end of the spectrum of the "balancing rescission model" proposed in this Comment. This end of the spectrum exacts a certain amount of inequity upon the creditors, but is justified in doing so because of the nature of the lender's actions. This outcome should be applied in only the most egregious of circumstances or where a creditor persistently makes TILA violations.¹⁵⁴

In order for equilibrium to be achieved under the "balancing rescission model," the parties must be returned to the positions they were in prior to the transaction. This is accomplished by implementing section 1635(b) as it was intended under the purest of circumstances. In this scenario, a debtor may choose to rescind the transaction because of a minor technical violation or inadvertent omission. The creditor releases the security interest and returns all fees to the debtor, who then returns the principal amount of the loan. However, within this zone of equilibrium, there may be room for an additional approach. This approach would allow the creditor and debtor to modify the terms of repayment in the rescission process. It may be viewed as a settlement-like process, allowing for the debtor and creditor to achieve a resolution that satisfies both parties.

To illustrate, in *In re Sterten*,¹⁵⁵ the United States Bankruptcy Court for the Eastern District of Pennsylvania found the "concept of permitting a consumer a reasonable time frame to repay the creditor while the creditor retains the security interest it acquired in the rescinded transaction to be a balanced, equitable approach."¹⁵⁶ The *In re Sterten* court found that the creditor had made material violations in the loan transaction with the debtor, but allowed the parties to structure a repayment plan over an extended duration, at a reasonable interest rate.¹⁵⁷ Judge Frank found the material violation "was not a transaction that involved any pervasive overreaching or irregularities . . . [and the] nature of the statutory violation in this case would support a repayment period and an interest

153. *Id.*

154. *See, e.g., Perkins v. Mid-Penn Consumer Disc. Co. (In re Perkins)*, 106 B.R. 863 (Bankr. E.D. Pa. 1989). In *In re Perkins*, the court reprimanded the creditor for persistent TILA violations in multiple cases within the Eastern District of Pennsylvania. Because of the ongoing illegal behavior of the creditors, the court relegated the creditor's security interest to an unsecured status and awarded statutory damages and attorney's fees to the debtor. The court held that its "decision is one more in the consistent line of cases which declines to excuse Mid-Penn for liability for the failure to correct practices which have been consistently declared illegal since [an earlier] decision." *Id.* at 865.

155. *Sterten v. Option One Mortg. Corp. (In re Sterten)*, 352 B.R. 380 (Bankr. E.D. Pa. 2006).

156. *Id.* at 387. *See also* *Murken, supra* note 7, at 473-74 (citing *Shepard v. Quality Siding & Window Factory, Inc.*, 730 F. Supp. 1295 (D. Del. 1990) (allowing debtor to repay \$11,361.58 in monthly installments of \$199); *Mayfield v. Vanguard Savs. & Loan Ass'n*, 710 F. Supp. 143 (E.D. Pa. 1989) (allowing debtor to repay \$16,113.62 in monthly installments of \$171); *Bookhart v. Mid-Penn Consumer Disc. Co.*, 559 F. Supp. 208 (E.D. Pa. 1983) (allowing debtor to repay \$3,412.20 in monthly installments of \$15)).

157. *In re Sterten*, 352 B.R. at 390.

rate more favorable to Option One.”¹⁵⁸ The balancing approach employed by the court allowed the transaction to be rescinded by stretching the boundaries of equity to its outermost limits. By allowing the creditor to receive payment over an extended period of time, and reducing the payments to a level that was affordable by the debtor, the court found the intensive fact-finding mission to be an equitable mechanism for complying with TILA.¹⁵⁹ Although this “repayment” approach arguably strikes a balance between the debtor and the creditor, the scale has the potential to tip slightly in favor of one side. The creditor may be getting a less favorable interest rate than they originally contracted for, over a longer period of time—tipping in favor of the debtor. Conversely, a debtor may be obligated to future payments that are affordable, but slightly suffocating under the weight of other bankruptcy creditors. Thus, the repayment method has the advantage of allowing the parties to leave the bankruptcy table with a little something in hand, but arguably less than they would have hoped. This approach may require more legwork on the part of the court, but it offers an equitable solution where none is otherwise provided.

For the “balanced rescission” test to weigh in favor of creditors, a court would need to find an unwarranted windfall in favor of the debtor. In this scenario, the court should be more inclined to condition rescission on tender by the borrower where the debtor would reap an unreasonable windfall because of a minor technical violation. This situation may arise when a debtor attempts to rescind a loan, but the debtor has already consumed the principal loan amount or has no ability to tender their loan proceeds.

For example, in *In re Requilman*, the United States Bankruptcy Court for the Northern District of California found that a court may condition the rescission of a loan on tender by the borrower when “the TILA violation giving rise to the right to rescind is not egregious, and where the lender would otherwise be left with an unsecured claim in the borrower’s bankruptcy.”¹⁶⁰ In *In re Requilman*, the borrowers executed two refinancing loans, each secured by their principal residence.¹⁶¹ Less than three years later, the borrowers filed a petition for Chapter 7 bankruptcy, at which point the Chapter 7 trustee handled the estate.¹⁶² The trustee found a minor TILA violation within one of the loans and sought rescission

158. *Id.*

159. *Id.*

160. U.S. Bank Nat’l Ass’n v. Requilan (*In re Requilman*), No. 08-32240 TEC, 2009 WL 4929397, at *3 (Bankr. N.D. Cal. Dec. 11, 2009) (citing *Yamamoto*, 329 F.3d at 1171). Judge Carlson further explained:

[W]hether a decree of rescission should be conditional depends upon the equities present in a particular case, as well as consideration of the legislative policy of full disclosure that underlies the Truth in Lending Act . . . in *LaGrone* we held that rescission should be conditioned on repayment of the amounts advanced by the lender. We noted that the TILA violations there were not egregious . . . and that the equities favored the creditor who would otherwise have been left in an unsecured position in the borrower’s intervening bankruptcy.

Yamamoto, 329 F.3d at 1171.

161. *In re Requilman*, 2009 WL 4929397, at *1.

162. *Id.*

under TILA.¹⁶³ Because the trustee was unable to tender back the principal on the loan, Judge Carlson held that the court “can deny rescission at any time it determines that the borrower cannot make the required tender.”¹⁶⁴ In *In re Requilman*, the court was faced with the possible inequities that would be visited upon the creditor in the absence of conditional rescission. Judge Carlson explained that the conditioning of rescission upon tender by the trustee was appropriate by stating:

[T]here is no reason why a court that may alter the sequence of procedures *after* deciding that rescission is warranted, may not do so *before* deciding that rescission is warranted when it finds that, assuming grounds for rescission exist, rescission still could not be enforced because the borrower cannot comply with the borrower’s rescission obligations no matter what. Such a decision lies within the court’s equitable discretion, taking into consideration all the circumstances including the nature of the violations and the borrower’s ability to repay the proceeds. In the present case, Trustee is unable to make the required tender immediately. Trustee should not be afforded additional time to make the tender, because the Bank will be entitled to take all the proceeds from a sale of the Residence, whether or not the [] Loan is rescinded. In this situation, it would be inequitable to continue to restrain the Bank from exercising its right to foreclose upon the Residence, when such restraint would provide no meaningful benefit to the bankruptcy estate or Debtor.¹⁶⁵

Cases like *In re Requilman* align with a court’s equitable power to condition rescission on tender by the borrower.¹⁶⁶ The approach that weighs in favor of the creditors is closely related to the majority view because courts are cautious when large consumer loans have the potential to be discharged in bankruptcy.

Thus, although the First Circuit has not expressly declared that it has the equitable power to condition rescission on tender by the borrower, the overwhelming case law and section 1635(b) of TILA imply that it does indeed possess that power. The more important question is how should that power be exercised? A bright-line application that holds all assertions of rescission are conditioned upon a borrower tender is arguably too restrictive and weighted too heavily in favor of creditors. Conversely, a strict adherence to the literal language of section 1635(b) exposes creditors to potentially devastating losses in the bankruptcy setting based upon minor technical violations.

Additionally, due to the current state of the housing market, many debtors in

163. *Id.*

164. *Id.* at *6.

165. *Id.*

166. See, e.g., *Wepsic v. Josephson (In re Wepsic)*, 231 B.R. 768, 775 (Bankr. S.D. Cal. 1998). The *In re Wepsic* court explained:

The TILA rescission remedy provides that once the transaction in question is rescinded, [debtor] must return any monies advanced to her by [creditor] and [creditor] must take steps to release her security interest and return finance and other charges. Some courts have struggled with the possibility of a creditor’s forfeiture when an indigent borrower seeks to rescind a loan under TILA.

Id. (citing *Trimmel v. General Elec. Credit Corp.*, 555 F. Supp. 264, 267-68 (D. Conn. 1983)). “To avoid such results courts have exercised their equitable discretion to condition the rescission on the obligor’s tender of the monies advanced by the lender.” *In re Wepsic*, 231 B.R. at 775.

bankruptcy are able to “strip off” second mortgages and residence-related loans via the lien avoidance provisions of the Bankruptcy Code. Consequently, the eligible debtor in Chapter 13 may find the “strip off” provisions of the Code more useful and more affordable than the process of rescission. Also, many refinanced or consolidated loans will not be eligible for rescission pursuant to the language of Regulation Z.¹⁶⁷ As long as the debtor’s home has no equity to support the underlying obligations, they can treat that obligation as a general unsecured claim subject to similar treatment as their credit card debt. Currently, this is achieved quite easily because of the declining value of homes coupled with many debtors’ burdensome second mortgage loans. The “strip off” provisions are not helpful for those debtors looking to rescind their primary mortgage because these mortgages will always be supported by equity and would be disqualified from lien avoidance.

Although the “balancing rescission model” is more labor and fact intensive, it allows a court to merge the concepts of equity with a statutory scheme. By examining the behavior and financial climate of the parties involved, courts are better able to avoid inequities. This avoidance stems from a court’s freedom to not be bound by inconsistent case law or statutes that are silent on the issue.

VI. CONCLUSION

As this Comment has illustrated, how rescission is treated in bankruptcy is uncertain and unsettled. The competing rationales among the circuits have created a philosophical divide on the issue: the majority, arguing that rescission under TILA intends to return creditors and debtors to their positions prior to the transaction and, the minority, arguing that rescission is a punitive remedy for TILA violations. The role of equity within a statutory framework has allowed the bankruptcy courts to speak where the Code is silent, but the voices are saying different things. In order to harmonize these competing rationales, the First Circuit will need to strike a balance between the Bankruptcy Code, the language of TILA or applicable state equivalents, and the principles of equity. The careful weighing of the competing interests may actualize this balance by focusing on the facts and behavior of the parties involved. This balancing act may demand judges and courts to expend more time and energy on the details and nuances within their cases, but that is the unintended consequence when the law is painted in shades of gray.

167. 12 C.F.R. § 226.23(f)(2) (2010). Regulation Z states in relevant part:

(f) Exempt transactions. The right to rescind does not apply to the following:

...

(2) A refinancing or consolidation by the same creditor of an extension of credit already secured by the consumer’s principal dwelling. The right of rescission shall apply, however, to the extent the new amount financed exceeds the unpaid principal balance, any earned unpaid finance charge on the existing debt, and amounts attributed solely to the costs of the refinancing or consolidation.

Id.