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Focus

BACKING OUT

By Sherwin Root

Three recent decisions — one by the 1st U.S. Circuit Court of Appeals, one by a California state appeals court and one by the U.S. District Court for the Eastern District of Wisconsin — concern whether plaintiffs may assert class claims for rescission under the Truth in Lending Act. The 1st Circuit and California cases held that class claims for rescission are not available under the act. The District Court in Wisconsin reached the opposite conclusion.

In the California case, *LaLiberte v. Pacific Mercantile Bank,* 147 Cal.App.4th 1 (Cal. App. 4th Dist. Jan. 25, 2007) (in which my law firm, Sheppard Mullin, represented the bank), which was the first California state-court case to rule on this issue, the court first stated that Section 1635 of the act, which gives borrowers the right to rescind mortgage loans under certain circumstances, provides a personal remedy requiring parties to provide the lender with a notice of rescission. Because plaintiffs did not (and indeed could not) assert that any of the class members served such a notice, it was doubtful that most of the class members would even desire this remedy. The court held that it was not clear that a justiciable controversy would exist between the class and the bank.

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The court went on to point out that Congress had provided expressly for class actions under Section 1640 of the Truth in Lending Act, governing statutory damages, and had never amended Section 1635, governing rescission, to include class actions. In addition, Section 1640 had been amended to cap money damages recoverable in a class action at the lesser of $500,000 or 1 percent of the creditor's net worth. According to a House conference report, this was done "to protect small business firms from catastrophic judgments." The court added that it would be "difficult to believe that Congress would carefully balance the deterrent effect of class actions under TILA against the potential harm to businesses in the context of statutory damages, and yet allow class action rescission to proceed without any safeguard for the affected business."

Finally, the court stated that, if 100 class members with loan amounts similar to those of the plaintiffs were to seek rescission through a class action, the bank could face the loss of security exceeding $37 million, a result that likely would be "catastrophic" (that is, exactly the type of result Congress apparently sought to avoid through its enactment of a cap on class-action monetary damages).

In the 1st Circuit case, *McKenna v. First Horizon Home Loan Corp.,* 475 F.3d 418 (1st Cir. Jan. 29, 2007), the court reversed a trial-court decision certifying a class for a rescission claim and held that based on a review of legislative intent (that is, that Congress had placed a limitation on statutory damages in class actions under the act), Congress had not intended that class actions be available for rescission claims. The court stated that "[t]he notion that Congress would limit liability to $500,000 with respect to one remedy while allowing the sky to be the limit with respect to another remedy for the same violation strains credulity."

The California and 1st Circuit cases had been watched closely in the mortgage lending industry, and a number of lenders' groups combined to file an amicus brief in the *McKenna* case.

In the U.S. District Court case, *Andrews v. Chevy Chase Bank F.S.B.,* 05C0454 (E.D. Wis. Jan. 16, 2007), the court did not review legislative intent but stated that it was just as likely that Congress did not intend to limit class rescission claims. The court stated that public policy strongly favors allowing class actions in cases such as this and that denial of class status would reward defendants who may have committed wrongs and leave victims who may have been wrongly uncompensated (which makes no sense, since those "victims" would have the right to individually rescind their loans if they chose to do so).

The court reviewed the requirements for class certification under Federal Rule of Civil Procedure 23. The rule requires the plaintiff to establish numerosity, commonality, typicality and adequacy of representation — all of which were easy to establish in this case. The plaintiffs established numerosity by presenting evidence that the defendant extended 7,000 loans with incorrect Truth in Lending Act disclosures. The court also held that, because all the claims would arise out of the same documents and be based on the same legal theory, typicality was established.

Adequacy of representation required the class representative to establish that his interests were not in conflict with those of the class, and class counsel to establish that it is qualified.

Proof of commonality could have introduced an element of controversy, because the defendant argued that rescission is a personal and equitable remedy that is available based only on the particular facts of a case. The court rejected this argument, however, stating that the plaintiffs do not seek rescission of an entire class of transactions but only a declaration that each class member may rescind if he or she wishes to do so.

The *Andrews* court's determination that the defendant had been deficient with respect to three material disclosures in the Truth in Lending Disclosure Statement provided to the plaintiffs (which served as the basis for the rescission claim) will be controversial. The court first held that the defendant had improperly disclosed the loan's payment schedule, because the court found confusing a fairly innocuous sentence that defendant added to the payment schedule (which otherwise met the act's requirements).

Next, the court held that an ordinary consumer reading the defendant's disclosures would be confused about the cost of the loan, expressed as an annual percentage rate. This stemmed from the fact that the plaintiffs' loan featured a one-month initial rate of 1.95 percent. The monthly payment would be fixed for five years, but the interest rate would adjust monthly starting after one month. A disclosure with respect to the terms of the initial rate is not required to appear in the Truth in Lending Act disclosure statement, but the court faulted the defendant's other disclosures, which the court stated made the defendant's disclosure of the annual percentage rate in the statement unclear. Among the language the court said could confuse a borrower was language that exactly follows suggestions appearing in the Commentary to Regulation Z, the regulation promulgated by the Federal Reserve Board to assist in the interpretation of the act.

Third, the court disapproved the defendant's disclosure that the loan contained a variable rate feature. The main focus of criticism was again something the defendant added to the disclosure statement, that is, an identifier at the top of the form that the type of loan was a "5-year fixed" and that the note interest rate was 1.95 percent. The court held that this language could cause the plaintiff to believe that the variable rate did not take effect until after the first five years of the loan, even though this is totally irrelevant in connection with whether the disclosure was correct, because the only requirement is that the Disclosure Statement state whether the loan contains a variable-rate feature.

Finally, the court found that the defendant violated the act by adding information to the disclosure statement that is not related directly to required information. The court again focused on the inclusion by the defendant of the initial interest rate.

The lessons to be learned from this case are threefold: (1) never include extraneous information in the Truth in Lending Act disclosure statement; (2) make sure that all of your disclosures are clear, concise and correct; and (3) regardless of how careful you are, you may end up in front of a judge with an agenda who renders a decision that is questionable at best.

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