

# Regulation Z, Rescission, and Real Estate

Part of the Congressional response to pleas for consumer protection legislation is the Truth-in-Lending Act,<sup>1</sup> which requires creditors to make extensive disclosures to consumers. The goal of this legislation is to provide customers with information about credit extended to them so that they can make rational decisions as to whether they should utilize credit. The Federal Reserve Board was granted authority to issue detailed rules to implement the new legislation.<sup>2</sup> As a result, the Board promulgated Regulation Z.<sup>3</sup> This article will focus on the provisions of that Regulation which are important in real estate transactions. Both the credit cost disclosure requirements and the new right of rescission will be discussed.

## I. CREDIT COST DISCLOSURE

### A. THE SCOPE OF REGULATION Z

Creditors must make disclosures only when dealing with consumers. When credit is extended to organizations<sup>4</sup> or for business or

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<sup>1</sup>Title I of the Consumer Credit Protection Act, 15 U.S.C.A. §§ 1601-65 (Supp. 1971) is the Truth-in-Lending Act.

<sup>2</sup>15 U.S.C.A. § 1604 (Supp. 1971). The Federal Reserve Board is hereinafter referred to as the Board.

<sup>3</sup>Regulation Z is found at 12 C.F.R. § 226.1-.9 (1970). All citations referring to Regulation Z are to C.F.R. Regulation Z is hereinafter referred to as the Regulation.

<sup>4</sup>Corporations, trusts, estates, partnerships, cooperatives, associations, and all governmental subdivisions and agencies are organizations. 12 C.F.R. § 226.2(s) (1970).

commercial purposes, other than agricultural purposes, no disclosures are required.<sup>5</sup> The exclusion for business related extensions of credit is difficult to deal with. At some point, a consumer who invests in real estate as a part-time activity begins to look very much like a businessman, and credit extended to him for use in investment activity should fall within the exception. The Board has offered some guidance in this area by indicating that:

(b) credit extended to an owner of a dwelling containing more than four family housing units for the purpose of acquiring, financing, refinancing, or maintaining that dwelling is an extension of credit for business or commercial purposes.<sup>6</sup>

Not all real estate investment, however, is in apartments, but the Board has not said the above rule applies in the case of four or more individual units. Also unanswered is the question of whether an extension of credit enabling a consumer to buy a small motel or other business for investment purposes is a business related extension of credit.

A literal reading of Regulation Z leads to the conclusion that credit can be extended only by creditors. Creditors are persons who in the ordinary course of business regularly extend or arrange for the extension of consumer credit.<sup>7</sup> Thus when the right to defer payment of an obligation is granted by someone who does not regularly grant the right, there is no extension of credit. An informal opinion of the Board suggests that this is a correct reading. When a homeowner sells his home and takes back a second mortgage, the Board says he does not have to make any disclosure of credit cost.<sup>8</sup> This could only be because he is not a creditor, and only creditors are required to make these costs known.<sup>9</sup>

An individual who extends credit to consumers in the course of his business is not a creditor in all situations. For example, a plumber who extends credit to his customers is not a creditor when he sells his home and takes a second mortgage, because he is not in the busi-

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<sup>5</sup>12 C.F.R. § 226.3(a) (1970). Other transactions, not relevant here, are also excluded. 12 C.F.R. § 226.3(b)-(d) (1970).

<sup>6</sup>35 Fed. Reg. 2865 (1970).

<sup>7</sup>12 C.F.R. § 226.2(m) (1970). Consumer credit is credit extended to a natural person when the money, property or service which is the subject of the transaction is to be used primarily for personal, family, household, or agricultural purposes. Additional requirements are that it be repayable in four or more installments or be subject to a finance charge. 12 C.F.R. § 226.2(k) (1970). If a seller allows customers to defer payment only in isolated instances, he does not regularly extend credit, and is therefore not a creditor. 3 CCH CONSUMER CREDIT GUIDE, CORRESPONDENCE ¶¶ 30,086, 30,190, [hereinafter cited as CCH CORRESPONDENCE].

<sup>8</sup>CCH CORRESPONDENCE ¶ 30, 155.

<sup>9</sup>CCH CORRESPONDENCE ¶ 30, 190.

ness of selling or financing homes.<sup>10</sup> He is a creditor only when he allows the deferral of payments in the ordinary course of *his business*.

### 1. REAL ESTATE AGENTS AS CREDITORS

The usual lender in a real estate sale is a lending institution, such as a bank. Because of the expansive definition of creditor in the Regulation, real estate agents who assist buyers in obtaining credit will sometimes find themselves classified as creditors and will be under an obligation to make disclosures. A person who provides or offers to provide credit to be extended by another person or firm that is a creditor, is an arranger of credit, and thus a creditor.<sup>11</sup> The arranger must receive a fee or other compensation for his services, or alternatively, he must be a person "who has knowledge of the credit terms and participates in the preparation of the contract documents required in connection with the extension of credit"<sup>12</sup> before he has a duty to disclose. For an agent to come within the knowledge and participation prong of the definition, he must do more than help a potential customer fill out a loan application and refer him to a bank. Only if he goes further and assists with the preparation of the other necessary documents, such as the note and mortgage or deed of trust, does he fulfill the definitional requirements.<sup>13</sup> As for the other prong of the definition, a broker who receives any compensation for services in arranging credit is an arranger. He receives compensation if there is some addition to his standard fee for credit related work. A general practice of charging a little more in credit transactions than in those involving only a cash payment is sufficient compensation.<sup>14</sup> Brokers who have an arrangement with a lending institution whereby they receive a fee for guiding buyers to that institution would be arrangers. An agent who has only a casual nexus with a lender does not fall within the definition.<sup>15</sup> If he assists a buyer in gaining the right to defer payments to a non-creditor, he is not an arranger of credit.<sup>16</sup>

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<sup>10</sup>CCH CORRESPONDENCE ¶ 30, 190.

<sup>11</sup>12 C.F.R. § 226.2(m) (1970).

<sup>12</sup>12 C.F.R. § 226.2(f) (1970).

<sup>13</sup>CCH CORRESPONDENCE ¶ 30,187.

<sup>14</sup>CCH CORRESPONDENCE ¶ 30,197.

<sup>15</sup>CCH CORRESPONDENCE ¶ 30,095.

<sup>16</sup>CCH CORRESPONDENCE ¶ 30,170.

## B. SPECIFIC COST DISCLOSURES

All charges in a credit transaction are included in either the finance charge, which is the cost of the extension of credit, or the amount financed, which is the amount of the extension of credit. Including charges in the amount financed serves to decrease the finance charge and the annual percentage rate, and thus to make the deal more to the customer's liking. Some of the variety of charges imposed on purchasers of real estate fall in each category. Following is an examination of which fees belong in the finance charge.

*1. THE FINANCE CHARGE*

The finance charge is more than a mere statement of interest as it is designed to inform the consumer of the real cost of credit. Generally, it includes all charges payable directly or indirectly by the customer and imposed directly or indirectly by the creditor as part of the credit transaction.<sup>17</sup> If the charge is one which would have to be paid even if the transaction were in cash rather than credit, it is probably not a finance charge. Whether the charge is paid by the customer, creditor, or any other person on behalf of the customer makes no difference<sup>18</sup> in the disclosure requirement.

Any finance charge paid separately in cash to the creditor, or withheld by the creditor from the credit proceeds, is a prepaid finance charge.<sup>19</sup> As will be seen later, prepaid finance charges are deducted from the unpaid balance in credit sales and from the amount of credit in non-sale credit. Despite this, they are included in the total finance charge when that figure is calculated.<sup>20</sup>

Regulation Z specifically includes a number of fees in the finance charge. These are:

1. Interest, time-price differential, and any amount payable under a discount or other system of additional charges.
2. Service, activity, or carrying charges.
3. Loan fees, points, finders fees and similar charges.
4. Appraisal, investigation and credit report fees.
5. Any charge imposed by a creditor upon another creditor for accepting an obligation of a customer, if the customer pays any part of that charge in cash, or as a deduction from the proceeds of the obligation.
6. If credit life insurance is required by the creditor, that cost is

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<sup>17</sup>12 C.F.R. § 226.4(a) (1970).

<sup>18</sup>12 C.F.R. § 226.4(a) (1970).

<sup>19</sup>12 C.F.R. § 226.8(e) (1) (1970).

<sup>20</sup>12 C.F.R. § 226.8(e) (1) (1970).

part of the finance charge. Charges for insurance covering loss or damage to property, or liability arising from ownership are to be included unless the creditor (1) discloses the cost of the insurance if purchased from the creditor, and (2) informs the debtor that he may obtain the insurance coverage elsewhere. Creditors may reserve the right to approve an insurer offered by a customer and still not include the insurance premiums in the finance charge. Costs for other insurance or guarantees protecting the creditor against a consumer's default are part of the finance charge. When insurance fees are so included, the full premium for the entire period of time is the correct amount to use.<sup>21</sup>

There is a group of charges which need not be included in the finance charge if they are itemized and disclosed. Among these are:

1. Fees prescribed by law to be paid to a public official for discovering, perfecting, releasing, or satisfying a security interest.
2. Premiums for insurance in lieu of perfecting a security interest.
3. Taxes, license, certificate of title and registration fees imposed by law.<sup>22</sup>

Other charges, found only in real estate transactions, are excludable if bona fide, reasonable in amount, and not imposed to circumvent or evade the law.<sup>23</sup> These are closing costs, and include:

1. Title examination, abstract of title, or required related property survey fees.
2. Cost of preparation of deeds, settlement statements, or other documents.
3. Amounts placed in escrow for future payment of taxes, insurance, water, sewer, and land rents.
4. Notarization, appraisal, or credit report fees.<sup>24</sup>

The above list is clearly not all inclusive, but it is as far as Regulation Z ventures. The proper classification of other charges can be determined by perusing the informal publications of the Board, and by applying the general principles of the Regulation. For example, neither the Act nor Regulation Z mentions attorney's fees. Where does that leave the mortgage lender who regularly incurs such fees in preparing credit transactions? Because the fees are imposed by a creditor in connection with a credit transaction, it is likely that they

<sup>21</sup>12 C.F.R. §§ 226.4(a) (1)-(8) (1970).

<sup>22</sup>12 C.F.R. §§ 226.4(b) (1)-(4) (1970).

<sup>23</sup>The standard of reasonableness is determined by the general practice in the customer's locality. CCH CORRESPONDENCE ¶ 30,009.

<sup>24</sup>12 C.F.R. §§ 226.4(e) (1)-(6) (1970).

are part of the finance charge.<sup>25</sup>

Some of the common charges present in real estate transactions are considered to be prepaid finance charges. Stand-by fees paid to a lender and built into the cash price of homes are prepaid finance charges when the customer utilizes the stand-by creditor. If the customer goes to another lender for financing, it is not a prepaid finance charge as it is not a fee imposed in connection with an extension of credit. FHA<sup>26</sup> mortgage insurance premiums are part of the finance charge, and the first month's payment for such insurance is a prepaid finance charge when deducted at closing.<sup>27</sup>

Any sales escrow charge, if the same in credit and non credit transactions, is not part of the finance charge. If there is an extra charge in credit transactions, it is a prepaid finance charge. Only that part of the fee in a credit sale which exceeds the charges in a non credit sale is a finance charge.<sup>28</sup> The same analysis is true of the usual fee paid a real estate broker; only the extra compensation paid the broker for services in arranging or extending credit is a finance charge.<sup>29</sup>

Reconveyance fees required by a prior mortgagee when the new creditor requires a first lien and thus requires that the prior mortgage be paid is not a prepaid finance charge. The new creditor does not impose the fee, even if he requires the prior lien to be extinguished.<sup>30</sup> Extension fees charged by the FHA to extend its commitment to insure a loan are not finance charges unless contemplated at the time of consummation.<sup>31</sup> Costs of termite inspections can be excluded from the finance charge,<sup>32</sup> as can the costs of structural repairs required as a condition of FHA or VA guaranty.<sup>33</sup> Tax investigation fees for a report to the creditor of the real property taxes levied and paid on the property may be part of the excludable title examination fee. If they are fees charged in addition to the normal title examination cost, they are likely part of the finance charge. Local practice will determine their status.<sup>34</sup>

Regulation Z clearly puts lender's points in the finance charge.

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<sup>25</sup>CCH CORRESPONDENCE ¶ 30,282. Attorney's fees for services which are not related to the extension of credit can be excluded from the finance charge. This would include fees for such services as preparing a deed.

<sup>26</sup>CCH CORRESPONDENCE ¶¶ 30,197, 30,227.

<sup>27</sup>CCH CORRESPONDENCE ¶ 30,197.

<sup>28</sup>CCH CORRESPONDENCE ¶¶ 30,197, 30,120, 30,246.

<sup>29</sup>CCH CORRESPONDENCE ¶ 30,197.

<sup>30</sup>CCH CORRESPONDENCE ¶ 30,246.

<sup>31</sup>CCH CORRESPONDENCE ¶ 30,246.

<sup>32</sup>CCH CORRESPONDENCE ¶ 30,243.

<sup>33</sup>CCH CORRESPONDENCE ¶ 30,243.

<sup>34</sup>CCH CORRESPONDENCE ¶ 30,246.

One difficulty this raises is whether points charged a builder when he finances construction of a home should be included in the finance charge of the ultimate purchaser if he buys on credit. The points paid by the builder will be included in his selling price whether his customer pays cash, assumes the builder's loan, or obtains outside financing. The points are thus not credit related and not part of the finance charge.<sup>35</sup>

A special problem occurs when the seller of single family homes provides financing for consumers and takes mortgages in his own name as mortgagee. The seller then discounts the mortgages with a lending institution. Informal opinions by Board members indicated that the discount was a finance charge in the seller-consumer transaction,<sup>36</sup> since the seller would be able to sell for a lower price were it not for the discount. Also, the discount is present only in credit transactions, thus making it credit related. A later official interpretation repeated this position saying, "any such discount, to the extent it is passed on to the buyer through an increase in the selling price must be included in the finance charge."<sup>37</sup> In the same ruling, the Board refused to create a presumption that the charges are passed on.

## 2. THE ANNUAL PERCENTAGE RATE

The relationship between the finance charge and the amount financed is expressed as the annual percentage rate. This figure represents in percentage terms the true effective rate of the finance charge. Instead of treating the debt and interest rate as though the debt were to be paid back in one installment, the annual percentage rate reflects the fact that the consumer does not have all the proceeds of the extension of credit for the full length of time that he is a debtor. Thus the add-on method of determining interest rates in which the finance charge is expressed as a percentage of the amount financed is not a proper method of computation. In closed end transactions,<sup>38</sup> the figure may be computed by the actuarial method, or by use of the United States Rule.<sup>39</sup> Supplement I to Regulation Z contains the technical data needed for computations. Fortunately for creditors, two volumes of tables and instructions have been compiled by the Board. Using the tables in these volumes is a much easier way of

<sup>35</sup>CCH CORRESPONDENCE ¶¶ 30,616, 30,585.

<sup>36</sup>CCH CORRESPONDENCE ¶ 30,372.

<sup>37</sup>35 Fed. Reg. 17029 (1970).

<sup>38</sup>See text at note 42. The annual percentage rate is given only a brief treatment here because of the detailed discussion it has received elsewhere. *See generally* R. JOHNSON, R. JORDAN, W. WARREN, ATTORNEY'S GUIDE TO TRUTH IN LENDING 35-64 (1969).

<sup>39</sup>12 C.F.R. §§ 226.5(b)(1)-(2) (1970).

computing the annual percentage rate than fumbling with the complicated equations of Supplement I. Regardless of the method used, the rate stated to consumers must be accurate to within one quarter of one percent.<sup>40</sup>

### C. GENERAL DISCLOSURE REQUIREMENTS

As defined by Regulation Z, there are two general types of consumer credit, open end and closed end. Open end credit is the revolving charge plan where the consumer can make purchases or obtain loans from time to time by use of a card, check, or other device.<sup>41</sup> The other classification is a catchall, and is defined as "credit other than open end."<sup>42</sup> The term closed end is used to indicate that the extension of credit is for a specific amount. Within this classification are two sub-categories, the credit sale and non-sale credit. A credit sale is any sale with respect to which consumer credit is extended or arranged by the seller.<sup>43</sup> When someone other than the seller is the creditor, the transaction with the creditor is a non-sale extension of credit. This discussion deals only with closed end credit as that is the type used in real estate sales.

A number of disclosure requirements are common to the credit sale and non-sale credit, but each has some special requirements. All creditors must disclose the date on which the finance charge begins to accrue,<sup>44</sup> the finance charge expressed as an annual percentage rate,<sup>45</sup> the number, amount and due dates or periods that payments are due, and, with an exception for some real estate transactions, the total of the payments.<sup>46</sup> Balloon payments,<sup>47</sup> the amount or method of determining late charges<sup>48</sup> and a description of any security interest held by the creditor in connection with the credit transaction, including a clear identification of the property to which the interest relates must be revealed to the consumer.<sup>49</sup> Prepayment penalties, and the method of determining unearned finance charges in the event of prepayment, must also be disclosed.<sup>50</sup>

<sup>40</sup>12 C.F.R. § 226.5(b) (1) (1970).

<sup>41</sup>12 C.F.R. § 226.2(r) (1970).

<sup>42</sup>12 C.F.R. § 226.8(a) (1970).

<sup>43</sup>12 C.F.R. § 226.2(n) (1970).

<sup>44</sup>12 C.F.R. § 226.8(b) (1) (1970).

<sup>45</sup>12 C.F.R. § 226.8(b) (2) (1970).

<sup>46</sup>12 C.F.R. § 226.8(b) (3) (1970).

<sup>47</sup>12 C.F.R. § 226.8(b) (3) (1970).

<sup>48</sup>12 C.F.R. § 226.8(b) (4) (1970).

<sup>49</sup>12 C.F.R. § 226.8(b) (5) (1970).

<sup>50</sup>12 C.F.R. §§ 226.8(b) (6)-(7) (1970).



When the seller is the creditor, he must provide his customer with a document that clearly shows the cash price of the goods sold, the amount of any down payment, and the difference between the two. This figure is labeled *unpaid balance of cash price*.<sup>51</sup> All charges which are not included in the finance charge are added to this sum, but each of such charges must be disclosed. The result is the *unpaid balance*.<sup>52</sup> From this total, prepaid finance charges and required deposit balances are deducted, and the result is labeled *amount financed*.<sup>53</sup> Prepaid finance charges and required deposit balances are to be itemized and the combined total of all such charges disclosed.<sup>54</sup> With an exception for some real estate transactions, the statement must list each finance charge, their total, and the total of all payments to be made.<sup>55</sup>

When credit takes the form of a loan rather than a sale, there are slightly different requirements. Prepaid finance charges and required deposit balances are excluded from the amount loaned to, or on behalf of, the consumer. Those charges included in the amount financed are added to the loan amount, and the total is labeled *amount financed*. The charges included in the amount financed must be itemized and disclosed.<sup>56</sup> Prepaid finance charges, required deposit balances, the finance charges, and the total of payments then receive the same treatment as in the case of a credit sale.<sup>57</sup>

When disclosure is required in closed end arrangements, the customer must be given a copy of the instrument or statement which contains the information, but this does not mean that he must receive a

<sup>51</sup> 12 C.F.R. §§ 226.8(c) (1)-(3) (1970).

<sup>52</sup> 12 C.F.R. §§ 226.8(c) (4)-(5) (1970).

<sup>53</sup> 12 C.F.R. §§ 226.8(c) (6)-(7) (1970). A required deposit balance is defined by 12 C.F.R. § 226.8(e) (2) (1970) as:

(2) Any deposit balance or any investment which the creditor requires the customer to make, maintain, or increase in a specified amount or proportion as a condition to the extension of credit except:

(i) An escrow account under paragraph (e) (3) of § 226.4, (see text at note 33),

(ii) A deposit balance which will be wholly applied toward satisfaction of the customer's obligation in the transaction,

(iii) A deposit balance or investment which was in existence prior to the extension of credit and which is offered by the customer as security for that extension of credit, and

(iv) A deposit balance or investment which was acquired or established from the proceeds of an extension of credit made for that purpose upon written request of the customer.

<sup>54</sup> 12 C.F.R. §§ 226.8(c) (6), (e) (1)-(2) (1970).

<sup>55</sup> 12 C.F.R. § 226.8(c) (7) (1970).

<sup>56</sup> 12 C.F.R. § 226.8(d) (1) (1970).

<sup>57</sup> 12 C.F.R. §§ 226.8(d) (2)-(3), (e) (1)-(2) (1970).

copy of the note or contract.<sup>58</sup> All disclosures may be put on a separate statement and the creditor can give his customer a copy of that statement. Except in cases where the customer has the right to rescind, only one customer need be provided with the statement if there is more than one customer, provided the one given the statement is someone other than an endorser, comaker, guarantor, or similar party.<sup>59</sup>

When there are two or more creditors in any transaction, a situation that pertains when one person arranges for the extension of credit by another, each creditor must be clearly identified and each is responsible for disclosing the information within his knowledge and the purview of his relationship with the customer. Several creditors may present the customer with a joint statement, but every creditor must be identified.<sup>60</sup>

There are a number of general requirements which disclosure statements must meet. To insure that consumers are able to understand them, all disclosures must be made clearly, conspicuously, and in meaningful sequence.<sup>61</sup> When they must be used, the terms finance charge and annual percentage rate must be more conspicuous than other required terminology.<sup>62</sup> Except for the requirements as to advertising, numerical amounts and percentages must be stated in figures, and may be printed in no less than the equivalent of 10 point type, .075 inch computer type, or elite size typewritten numerals. Legible handwriting is permitted.<sup>63</sup> In cases where the consumer has the right to rescind, he must receive two notices of his right to do so.<sup>64</sup> The exact wording of the notice is prescribed by Regulation Z. As is clearly apparent by now, the Federal Reserve Board has left very little to chance, or to the imagination of creditors.

If an eager creditor should so desire, he may include in his statement to a consumer any additional information he wishes, provided attention is not detracted from the federally required disclosures.<sup>65</sup> Inconsistent disclosures made to comply with state law can be put on a separate statement, or included with the truth-in-lending information if put below and clearly identified as not part of, the federally required disclosures.<sup>66</sup>

<sup>58</sup>CCH CORRESPONDENCE ¶¶ 30,072, 30,085.

<sup>59</sup>12 C.F.R. § 226.6(e) (1970).

<sup>60</sup>12 C.F.R. § 226.6(d) (1970).

<sup>61</sup>12 C.F.R. § 226.6(a) (1970).

<sup>62</sup>12 C.F.R. § 226.6(a) (1970).

<sup>63</sup>12 C.F.R. § 226.6(a) (1970).

<sup>64</sup>12 C.F.R. § 226.9(b) (1970).

<sup>65</sup>12 C.F.R. § 226.6(c) (1970).

<sup>66</sup>12 C.F.R. § 226.6(b) (1970).

## 1. TOTAL COSTS

The general rule of Regulation Z is that consumer debtors must be told the total amount of the payments they agree to make, the amount of each fee in the finance charge, and the total finance charge they agree to pay.<sup>67</sup> However, when the extension of credit is secured by a first lien on a *dwelling* and is made to finance the purchase of that dwelling, these totals can be deleted from the disclosure statement. The interest of a vendor in a contract for the sale of a dwelling is equivalent to a security interest in the property for purposes of this special rule. The interests of a mortgagee or the holder of a deed of trust, if they have first lien status, are also sufficient security interests for this purpose.<sup>68</sup>

When a loan is made to finance the initial construction of a dwelling and a security interest is acquired in real property, the security interest is considered to be a first lien against the dwelling to finance the purchase of the dwelling.<sup>69</sup> However, if the advance is made to finance remodeling or making an addition to the home, it is not for initial construction, and the above mentioned exception does not apply. One authority has suggested that this is true where the loan is made to finance both the purchase of a home and some remodeling of the same dwelling.<sup>70</sup>

## 2. REFINANCING

The modern consumer frequently finds that he has over extended himself in his utilization of credit, so to gain more time to pay he refinances his obligations. Refinancing of an old obligation is a new transaction subject to Regulation Z disclosure requirements.<sup>71</sup> It is the position of the Board that if the above exceptions applied in the original transaction, they apply at the time of refinancing, provided the amount of the new transaction does not exceed the amount of the unpaid balance plus any accrued and unpaid finance charge, and the lien still has first lien status.<sup>72</sup>

When the finance charge for the new transaction is computed, the Regulation directs that “. . . any unearned portion of the finance charge which is not credited to the existing obligation shall be added

<sup>67</sup>12 C.F.R. §§ 226.8(b) (3), (c) (3), (d) (3) (1970).

<sup>68</sup>12 C.F.R. §§ 226.8(b) (3), (c) (3), (d) (3) (1970). This exception extends to the disclosure of prepaid finance charges as well. CCH CORRESPONDENCE ¶ 30,246.

<sup>69</sup>12 C.F.R. § 226.8(f) (1970).

<sup>70</sup>Kratovil, *Truth-in-Lending and Mortgage Lenders*, 48 TITLE NEWS, May, 1969, at 18,22.

<sup>71</sup>12 C.F.R. § 226.8(j) (1970).

<sup>72</sup>CCH CORRESPONDENCE ¶ 30,563.

to the new finance charge, and shall not be included in the new amount financed.”<sup>73</sup> There are also special rules for refinancing when the land is farm land, but that is outside the scope of this article.<sup>74</sup>

Regulation Z disclosures are required when a creditor agrees to a change of obligors, a situation common in real estate transaction.<sup>75</sup> If the obligation assumed is secured by a first lien on a dwelling, and the assumption is to enable the subsequent obligor to finance his purchase of that dwelling, the exceptions as to the total of payments and the total amount of the finance charge are applicable.<sup>76</sup> An informal opinion of the Board indicates that disclosures must be made only when by written agreement a creditor agrees to a change of obligors. If an obligor sells his mortgaged property and simply notifies his creditor of the change, and the creditor starts to bill the new obligor, there is no formal assumption and Regulation Z is inapplicable.<sup>77</sup>

### 3. TIME OF DISCLOSURE

When disclosures are required, they must be made before consummation of the credit transaction.<sup>78</sup> Transactions are consummated when a contractual relation first exists between the parties.<sup>79</sup> Some commentators have argued that the drafters of the statute did not intend to force disclosure before formation of a contract. They argue that such early disclosure puts too heavy a burden on creditors, as they usually do not have complete information as to the data they must reveal until closing the deal.<sup>80</sup>

Disclosure after a contract is formed would be meaningless from the consumer's point of view. Behind the idea of disclosure is the thought that they will give consumers enough information about credit terms to enable them to shop around; something they can't do if they learn the cost of credit only after obligating themselves. Regulation Z recognizes that its requirements may cause problems for creditors and allows them to use estimates of unknown charges if they are clearly identified as estimates, are reasonable, and are based on the best information available. Creditors are under an obligation to make a reasonable effort to determine the unknown charges.<sup>81</sup>

<sup>73</sup>12 C.F.R. § 226.8(j) (1970).

<sup>74</sup>See 12 C.F.R. § 226.8(j) (1970).

<sup>75</sup>12 C.F.R. § 226.8(k) (1970).

<sup>76</sup>12 C.F.R. § 226.8(k) (1970).

<sup>77</sup>CCH CORRESPONDENCE ¶¶ 30,134, 30,260.

<sup>78</sup>12 C.F.R. § 226.8(a) (1970).

<sup>79</sup>12 C.F.R. § 226.2(cc) (1970).

<sup>80</sup>Kratovil, *Truth in Lending and Mortgage Lenders*, 48 TITLE NEWS, May, 1969 at 18.

<sup>81</sup>12 C.F.R. § 226.6(f) (1970).

The precise meaning of the terms consummation in the real estate context is unclear. There is confusion over whether a unilateral contractual relation is sufficient for consummation, as opposed to a bilateral relation. The Board has indicated in informal opinions that a purely unilateral credit contract between a buyer and seller is not sufficient for consummation. If a seller in a contract of sale agrees to provide his purchaser with a mortgage for financing the home, but includes a contract provision allowing the buyer to go elsewhere for financing, a Board member has said that, as to the mortgage, the contract of sale is no more than an offer. Consummation of the credit transaction he said, would occur at the time of a *bilateral* commitment, or execution of the mortgage document.<sup>82</sup> This analysis cannot be correct. The contract terms relating to the mortgage are more than an offer; they are in fact an option, bargained for and received by the purchaser. He has given good consideration for the promise to finance, as he has promised to buy the property. There is a contractual relation between the parties at the time the credit option contract is signed, but the Board views this as insufficient for consummation.

When a land sales contract is used, consummation occurs at the time the contract is signed. Signing results in both a sale and an extension of credit, and is the first hint of a contractual relation in this relatively simple sale. For a number of reasons, this means of transfer has fallen into disfavor, especially in California. The other more popular means of financing home purchases raise difficult questions as to when the required contractual relation is formed.

Often an independent lender enters the picture. He makes a loan to the customer, and takes a mortgage on the property, or holds a deed of trust until the loan is repaid. Standard procedure in third-party financing is for customers to submit a loan application and a request for credit which is submitted to the lending institution. This application is an offer to utilize credit which may be accepted by the lender, or the lender may respond by issuing a formal commitment, containing all the terms of the credit agreement, for the customer's acceptance. Some suggestion has been made that the time of the lender's issuance of a commitment is the time of consummation. The Board has said informally that if the creditor agrees to extend certain described credit and the customer becomes obligated to use that credit upon issuance of the commitment, the commitment consummates their deal. If the commitment does not create this bilateral relationship, it does not consummate the credit transaction.<sup>83</sup>

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<sup>82</sup>CCH CORRESPONDENCE ¶ 30,245.

<sup>83</sup>One letter from the Board reads: "That is, it is our position that consummation occurs when a creditor agrees to extend credit and a customer agrees to utilize that

When commitments are issued for a consumer's acceptance, truth-in-lending disclosures should be sent along with the commitment, as the consumer has the power to consummate the transaction by his unilateral action of accepting the lender's offer. If this procedure is used, there is no need for disclosures at the time the loan application is completed, as the lender does not unilaterally complete the transaction by accepting the application. The practice of issuing commitments thus offers a good opportunity for making disclosures.

The Board's interpretation of 'consummation' is helpful to consumers in another part of Regulation Z. In order for the new right of rescission to be truly effective, consummation should not be deemed to have occurred until the consumer is contractually bound to utilize credit. If the receipt of a commitment consummated the transaction, the consumer's three day period within which to rescind would begin to run at that time. His right to rescind would be disappearing as he took time to consider whether he should accept the lender's offer. The new right is meaningful only if he can rescind after he is contractually bound to utilize credit. The Board appears to agree with this position. When the buyer in a real estate sale has this right, early disclosure is advantageous to sellers and lenders, as the rescission period then begins to run immediately upon the buyer's acceptance of the credit offer.

## II. THE RIGHT TO RESCIND

The most interesting section of the Truth-in-Lending law, and the one most likely to cause fear in creditors, allows consumers to rescind certain credit transactions. Generally, by § 125 of the Consumer Credit Protection Act and § 226.9 of Regulation Z, consumers can cancel any credit transaction that may result in a security interest being taken in their home, provided the action is taken by midnight of the third business day after the credit transaction is consummated. Consumers are thus given a second chance to quietly consider the wisdom of their actions.

Creditors are directed by the Regulation to inform consumers of the right to rescind whenever it is applicable. If the information is credit. Accordingly, in the factual context which you presented in your letter, consummation would occur at the time the lender issued its permanent loan commitment to the purchasing customer and the purchasing customer accepted such commitment." CCH CORRESPONDENCE ¶ 30,147. The letter further states that when a contract of sale binds the customer to enter a certain mortgage agreement, consummation occurs at the signing of the contract. *See also* CCH CORRESPONDENCE ¶¶ 30,281, 30,399, 30,447.

given before the time of consummation, the three day period begins to run at consummation. If such early disclosure is not made, the three day period begins to run not at consummation, but whenever the required disclosure is made. There is no statute of limitations on the right, so if a creditor first informs a debtor that he has the right to rescind a year after their credit agreement was closed, the debtor can rescind at that late date. Early disclosure is strongly encouraged.

Problems raised by the broad scope Regulation Z gives the right to rescind will be explored here. When the effect on statutory lienholders is discussed, special attention is given to implications in California. The discussion includes an examination of what happens when the credit arrangement is not between buyer and seller but is made a tri-partite transaction by the consumer's use of a bank credit card.

## A. RESCINDIBLE TRANSACTIONS

Before the right of rescission applies to a transaction, there are two fundamental criteria which must be fulfilled. First, there must be a credit transaction.<sup>84</sup> While a glossary is included in Regulation Z, this term is not defined. An interpretation by the Board indicates that a transaction must include an extension of consumer credit before the right of rescission applies.<sup>85</sup> As mentioned above, credit can be extended only by creditors, so a credit transaction must be one in which consumer credit is extended by a creditor. This means that when the homeowner sells and takes back a second mortgage, not only is he relieved of all disclosure obligations, but the buyer does not have the right to rescind.<sup>86</sup>

### 1. THE SECURITY INTEREST REQUIREMENT

Secondly, the transaction must be one in which a security interest is or "will be retained or acquired in any real property which is used or is expected to be used as the principal residence of the customer."<sup>87</sup> This includes a vacant house which the customer expects to move into, or a vacant lot on which he expects to build his principal residence.<sup>88</sup> If the security interest is taken in a second home, such as a

<sup>84</sup>12 C.F.R. § 226.9(a) (1970).

<sup>85</sup>12 C.F.R. § 226.901 (1970); CCH CORRESPONDENCE ¶ 30,155.

<sup>86</sup>See CCH CORRESPONDENCE ¶¶ 30,206, 30,245 which clarify ¶ 30,155.

<sup>87</sup>12 C.F.R. § 226.9(a) (1970). If a security interest is taken in property which is not classified as real property by the applicable state law, the right of rescission does not arise even if the property is used as the consumer's principal residence. See 12 C.F.R. § 226.2(w) (1970). This would be significant to consumers in states that classify mobile homes as personal rather than real property.

<sup>88</sup>CCH CORRESPONDENCE ¶ 30,606.

vacation residence, the right to rescind does not arise. Creditors who do or may take a security interest in real property have reason to inquire as to the property's intended use.

An exception to the general rule has been granted to the real estate industry. When a *first lien* or other equivalent security device is created, retained or assumed, to finance the acquisition of a *dwelling* in which the customer resides or expects to reside, the customer cannot rescind.<sup>89</sup> The same is true when a first lien is acquired or retained

by a creditor in connection with the financing of the initial construction of the residence of the customer, or in connection with a loan committed prior to completion of the construction of that residence to satisfy that construction loan and provide permanent financing of the residence, whether or not the customer previously owned the land on which that residence is to be constructed.<sup>90</sup>

Note that this exception does not apply when a first lien is taken in a vacant lot on which the customer expects to build his residence, but only to security interests taken in dwellings. Nor does it extend to first liens on a home in connection with financing an addition to the home; it applies only to cases of initial construction.

Regulation Z defines the term security interest, and by so doing extends the applicability of the right to rescind beyond transactions in which the parties agree to a security interest being taken in the consumer's home. Citing the legislative history of the Act as evidence of Congress' intent to include a broad range of security arrangements,<sup>91</sup> the Board defined security interests as "any interest in property which secures payment or performance of an obligation."<sup>92</sup> Security interests under Article 9 of the Uniform Commercial Code are included, as are real property mortgages, deeds of trust, other consensual or confessed liens, mechanic's liens, materialman's liens or any other lien arising by operation of law, and any interest in a lease when used to secure payment or performance of an obligation. The lien of a vendor of real property and the interest of the seller in a contract for the sale of real property are also security interests.<sup>93</sup>

The broad definition of security interest reaches many confession of

<sup>89</sup>12 C.F.R. § 226.9(g) (1) (1970). If at the time of its creation a lien is a first lien made to finance the purchase of a dwelling, it does not lose its first lien status because of later subordination. Thus an extension of credit which cannot be rescinded when first extended because of the first lien status of the security interest does not become rescindible because of the subordination of that security interest. 12 C.F.R. § 226.9(g) (3) (1970).

<sup>90</sup>12 C.F.R. § 226.9(g) (2) (1970).

<sup>91</sup>CCH CORRESPONDENCE ¶ 30,001.

<sup>92</sup>12 C.F.R. § 226.2(z) (1970).

<sup>93</sup>12 C.F.R. § 226.2(z) (1970).



judgment clauses found in retail installment contracts and occasionally in closed end credit agreements. This is because these clauses could be used to create a lien on the debtor's residence. Under the confession of judgment clauses allowed by some states, the creditor can simply register a judgment against his debtor, then obtain a lien, all before the debtor has any opportunity to raise his defenses to the claim.<sup>94</sup> The distinction between those situations where the consumer has an opportunity to defend before a judgment is entered against him and those where he cannot defend, is important to the Board. In states where debtors who have signed confession of judgment clauses are entitled to notice of the pending proceedings and are afforded a chance to enter defenses before a lien can be recorded, the Board has indicated that the clauses do not rise to the level of a security interest.<sup>95</sup> In states where the debtor does not have this opportunity, the parties can take a confession of judgment clause out of the security interest definition by excluding a lien on the debtor's residence from the operation of the clause.<sup>96</sup>

The operation of this security device in a real estate context affords an opportunity to explore the method of Regulation Z. There are situations where a consumer may have two principal residences. If the consumer lives in a home which he owns or is purchasing and buys another which he expects to make his principal residence, he has two principal residences. If in this situation there is a first mortgage or equivalent security interest in his first home, and he then executes a purchase money security interest in the second home and in addition executes a cognovit note, the cognovit note is a junior security interest in the first home. Since that home is still a principal residence, the second transaction is rescindible. Without the cognovit provision, there would be only a security interest with first lien status in each home, and the credit transaction would be exempt from the right to rescind.<sup>97</sup> Further, if the consumer does not own any real property which he uses as his principal residence when he executes the security interest and cognovit note, the cognovit note does not serve to take the transaction out of the exemption for transactions involving security interests in a dwelling with first lien status for the purpose of financing that dwelling.<sup>98</sup>

Closely related to confession of judgment clauses is the right under the law of some states to attach a debtor's property before judgment.

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<sup>94</sup>CCH CORRESPONDENCE ¶ 30,148.

<sup>95</sup>CCH CORRESPONDENCE ¶¶ 30,064, 30,150.

<sup>96</sup>CCH CORRESPONDENCE ¶ 30,132.

<sup>97</sup>CCH CORRESPONDENCE ¶ 30,168.

<sup>98</sup>CCH CORRESPONDENCE ¶ 30,168.

The Board has said that this practice does not fall within its definition of a security interest, as the consumer is able to present his defenses before a judgment is entered against him.<sup>99</sup>

## 2. *REFINANCING*

Frequently someone buying a home will arrange with his creditor to refinance the purchase. An important question is whether this refinancing results in the debtor having the right to rescind. The Board has said that the transaction is not rescindible if the amount of the new transaction does not exceed the amount of the unpaid balance plus any accrued and unpaid finance charge on the original obligation.<sup>100</sup> When these conditions are met, the loan is viewed as one to finance the purchase of the home, and if the lien still has first lien status, the transaction fits within the exception for credit extended to finance the purchase of a home and is therefore not rescindible.<sup>101</sup> If the new extension of credit is for an increased amount, the customer can rescind. In this case, however, only the additional amount of credit extended is affected. The existing obligation for the unpaid balance plus accrued, unpaid finance charges is left untouched.<sup>102</sup> If a creditor other than the original creditor does the refinancing, the entire transaction is subject to rescission.<sup>103</sup>

## 3. *NOTIFICATION*

If the customer in any transaction has the right to rescind, the creditor has a duty to so inform him. The customer must receive two copies of a notice, the wording of which is prescribed by the Regulation. Every person entitled to rescind the transaction is entitled to receive two copies of the notice.<sup>104</sup> Where there are joint owners of the property subject to a security interest, only those owners who are parties to the transaction are able to rescind and they are the only owners who must be notified.<sup>105</sup> The notice must include the name and address of the creditor, the date of consummation, and the day by which the customer must rescind, but that date may not be less than three business days after consummation.<sup>106</sup>

<sup>99</sup>CCH CORRESPONDENCE ¶ 30,249.

<sup>100</sup>12 C.F.R. § 226.903 (1970).

<sup>101</sup>12 C.F.R. § 226.903 (1970).

<sup>102</sup>12 C.F.R. § 226.903 (1970).

<sup>103</sup>12 C.F.R. § 226.903 (1970).

<sup>104</sup>12 C.F.R. § 226.9(b) (1970).

<sup>105</sup>12 C.F.R. §§ 226.9(f) (1)-(2), 226.902 (1970); CCH CORRESPONDENCE ¶ 30,592.

<sup>106</sup>12 C.F.R. § 226.9(b) (1970); "[A] business day is any calendar day except Sunday, or the following business holidays: New Year's Day, Washington's Birthday, Memo-

The customer exercises his right of rescission by notifying the creditor in writing of his decision to do so. Use of a letter or telegram is acceptable.<sup>107</sup> In the case of mail, notice is considered given at the time of mailing. If a telegram is used, the time that it is filed for transmission is the time that notice is given. In any other case, notice is considered given when delivery is made to the creditor's designated place of business.<sup>108</sup> One of the copies of the notice of the right to rescind received by the customer can be used to rescind. All the consumer need do is sign the form and mail it in. Whatever method is used, it must be in writing; a telephone call is ineffective.<sup>109</sup>

#### 4. THE EFFECT OF RESCISSION

When the customer exercises his right, he is not liable for any finance or other charge. Within ten days after rescission, the creditor must return any property or money held as a down payment or earnest money. After the creditor has performed this obligation, the customer must return any property delivered by the creditor, or if return of the property in kind would be impractical or inequitable, the customer is to tender its reasonable value. The creditor must take the property within ten days of tender by the customer, or title to it vests in the customer without obligation to pay for it. The Regulation requires tender to be made at the sight of the property, *or* at the residence of the customer, at the customer's option.<sup>110</sup> To minimize the difficulties caused by a customer's rescission, the creditor in a rescindible transaction is required, with one exception, to delay his performance. He must delay performance for the three day rescission period and until he has reasonably satisfied himself that the customer has not rescinded. The exception is for materialmen making deliveries to construction sites. They must delay performance only when they acquire a lien against the customer's principal residence other than by operation of law; there must be a consensual security interest in favor of the materialman before he need delay.<sup>111</sup>

A distinction was made above between sale and nonsale credit. That distinction is very important in the area of the right to rescind. When the credit transaction is a credit sale and the rescission right is applicable, rescission voids the entire transaction; both the sale and

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rial Day, Independence Day, Labor Day, Veterans' Day, Thanksgiving, and Christmas." 12 C.F.R. § 226.9(a) n.14 (1970).

<sup>107</sup>12 C.F.R. § 226.9(a) (1970).

<sup>108</sup>12 C.F.R. § 226.9(a) (1970).

<sup>109</sup>12 C.F.R. § 226.9(a) (1970).

<sup>110</sup>12 C.F.R. § 226.9(d) (1970).

<sup>111</sup>12 C.F.R. § 226.9(c) (1970).

the extension of credit are voided.<sup>112</sup> If the credit transaction is not with the seller but with an independent lender, only the credit transaction is affected.<sup>113</sup>

Problems arise, of course, when the creditor does not delay his performance and the customer then rescinds. Suppose the case of a plumber who performs work for a customer, and then discusses payment. If he agrees to extend credit at this point, the customer can rescind even though the work is completed. Since rescission voids the statutory lien, the plumber is now without security. The customer is liable only for the reasonable price of the service, not necessarily the asking price, and can make the plumber come to his house for payment.<sup>114</sup> Because of the broad definition of credit in Regulation Z, statutory lienholders may often find themselves extending credit. The artisan who offers to let his customers pay in 30 days, with a two percent discount for payment in ten days, is extending credit. He is allowing a deferral of payment, and the additional charge for payment after ten days is a finance charge.<sup>115</sup> The method of payment should clearly be settled before performance is started.

The type of real estate lending most likely to result in an extension of credit by the seller is the land sales contract. When a consumer purchases an unimproved lot upon which he expects to build his principal residence, and signs a land sales contract to finance his purchase, the vendor's interest in the contract is a security interest which gives rise to the rescission right. If the buyer elects to rescind, the deal is cancelled in its entirety since seller and creditor are the same person. If a land sales contract is used to sell a dwelling already subject to a mortgage, the vendor's right under the sales contract is not a first lien, providing the other liens are more than tax and assessment liens. The contract of sale may thus be rescinded, and the entire deal voided.<sup>116</sup> In these situations, the vendor need not delay his performance, since delivery of possession is not one of the performances prohibited by the Regulation.<sup>117</sup>

Failure to delay performance can also raise serious problems in non-sale extensions of credit. If a financial institution extends credit to a consumer and takes a second mortgage on his home, the transaction is rescindible. If the loan proceeds are dispersed before the three day period expires, and the debtor uses the money for a pur-

<sup>112</sup>CCH CORRESPONDENCE ¶¶ 30,245, 30,356.

<sup>113</sup>CCH CORRESPONDENCE ¶ 30,245.

<sup>114</sup>12 C.F.R. § 226.9(d) (1970); CCH CORRESPONDENCE ¶¶ 30,169, 30,181.

<sup>115</sup>12 C.F.R. § 226.8(o) (1970); CCH CORRESPONDENCE ¶ 30,172.

<sup>116</sup>CCH CORRESPONDENCE ¶ 30,172.

<sup>117</sup>CCH CORRESPONDENCE ¶ 30,580.

chase and then rescinds, he is in no position to return the money. The seller of the goods is not affected unless his transaction with the consumer is also a credit transaction and is rescinded. The net effect is to make the creditor unsecured, and the debtor is relieved of the duty to pay any finance or other charge.

Exercise of the right to rescind may have indirect effects on a creditor holding a purchase money security interest in a principal residence. If in the sale of a home a second mortgage is taken back by a seller who is also a creditor, the sale is a credit transaction. Rescission voids the second mortgage and the sale. The first mortgage financing can not be rescinded, but if the sale is canceled, the loan advanced by the holder of the first lien is unsecured.<sup>118</sup>

## B. STATUTORY LIENS

One of the more controversial aspects of the right to rescind is its application to holders of liens that arise by operation of law. Statutory or common law in nearly every jurisdiction gives laborers and artisans who work on other people's property an interest in that property to secure payment. When the law entitles a mechanic to a lien on a customer's principal residence and that mechanic extends consumer credit to his customer, the transaction is rescindible. The impact of Regulation Z in this area depends on state law because state law determines when liens arise. For purposes of example, this section examines the effect in California.

### 1. THE EFFECT IN CALIFORNIA

The California legislature has recently reorganized and reenacted California statutory lien law, moving it from the Code of Civil Procedure to the Civil Code. The broad scope of the statutory language creates liens in many consumer transactions.<sup>119</sup> Anyone who makes

<sup>118</sup>CCH CORRESPONDENCE ¶ 30,210.

<sup>119</sup>The new statute became effective Jan. 1, 1971. A work of improvement, which is basic to the statutory scheme, is defined to include: "[T]he construction, alteration, addition to, or repair, in whole or in part, of any building, wharf, bridge, ditch, flume . . . the seeding, sodding or planting of any lot or tract of land for landscaping purposes, the filling, leveling, or grading of any lot or tract of land . . . ." CAL. CIV. CODE § 3106 (West Supp. 1971). Statutory liens are granted to: "Mechanics, materialmen, contractors, subcontractors, lessors of equipment, artisans, architects, registered engineers, licensed land surveyors, machinists, builders, teamsters and draymen, and all persons and laborers of every class performing labor upon or bestowing skill or other necessary services on, or furnishing materials or leasing equipment to be used in . . . a work of improvement . . . ." CAL. CIV. CODE § 3110 (West Supp. 1971). The liens provided for: "[A]ttach to the work of improvement and the land on which it is situated together with a convenient space about the same . . . ." CAL. CIV. CODE § 3128 (West Supp. 1971).

an addition to a home, does some remodeling, or landscaping work acquires a lien on that residence. Plumbers and other craftsmen, suppliers of cement for backyard patios, sellers and installers of built-in home appliances,<sup>120</sup> and wall to wall carpeting<sup>121</sup> are typical examples of persons entitled to statutory liens on consumer residences.

Statutory lienholders do not always deal directly with the owner of the property to be improved but work through a general contractor. When the transaction between the contractor and the consumer is a consumer credit transaction, the contractor must deliver notices of the right of rescission to the customer if he or any of his subcontractors will obtain a lien on the customer's residence.<sup>122</sup> If the subcontractor deals directly with the contractor, the consumer cannot void their agreement, but exercise of the right of rescission will void any lien acquired by the subcontractor on the consumer's home. If the subcontractor delays performance until the rescission period has passed, the right of rescission does not constitute a danger to him.<sup>123</sup> To make sure that this period has passed, he will want to check with the contractor to make sure that he has delivered the required notices, and that the customer has not rescinded.

Under California law, every contractor, subcontractor, architect, builder, or other person having charge of a work of improvement is an agent of the owner.<sup>124</sup> If such an agent extends credit to a lienholder on behalf of the consumer, it would seem that that transaction is rescindible by the consumer, even if the contractor-consumer agreement is not subject to rescission. If the lienholder agrees to look to the contractor for payment, and not the consumer, then the rules in the preceding paragraph are applicable.

Statutory lienholders can avoid the right of rescission by not extending credit, or by not taking a lien on their customer's principal residence. Credit can be avoided by insisting on cash, or by allowing customers to pay in installments but forgoing the finance charge and allowing only four installments. When customers are allowed to defer payment, there should be no discount for early payment. If such a discount is given, the transaction is an extension of credit.<sup>125</sup>

An alternative to not extending credit is to avoid taking a lien on the customer's principal residence. In California, lienholders can

<sup>120</sup>CAL. CIV. CODE §§ 3106, 3110 (West Supp. 1971).

<sup>121</sup>CCH CORRESPONDENCE ¶ 30,171; CAL. CIV. CODE § 3110 (West Supp. 1971).

<sup>122</sup>CCH CORRESPONDENCE ¶¶ 30,181, 30,225. The contractor may be a creditor because of his role in arranging for an extension of credit by a bank to the consumer, as well as by extending credit himself.

<sup>123</sup>CCH CORRESPONDENCE ¶¶ 30,181, 30,317, 30,225.

<sup>124</sup>CAL. CIV. CODE § 3110 (West Supp. 1971).

<sup>125</sup>12 C.F.R. § 226.8(o) (1970); see text at note 111.

waive their lien rights.<sup>126</sup> If there is only one lienholder working on a consumer's home, waiver is easily accomplished. When a group of lienholders work on a single home, difficulties multiply. The general contractor has a lien on the home, as do all the people he contracts with to work on the project. If the contractor wants to avoid the right of rescission, every possible lien must be waived.<sup>127</sup> General contractors in California cannot waive or in any way impair the lien rights of other persons without their written consent, and any contractual provision allowing them to do so is void.<sup>128</sup>

Alternatively, the homeowner may waive his right to rescind. To keep this from becoming a general practice, Regulation Z limits the situations in which the right can be waived. A consumer can waive only when:

(1) The extension of credit is needed in order to meet a bona fide immediate personal financial emergency of the customer;

and:

(2) The customer has determined that a delay of 3 business days in performance of the creditor's obligation under the transaction will jeopardize the welfare, health, or safety of natural persons or endanger property which the customer owns or for which he is responsible.<sup>129</sup>

If these conditions are met, the customer may waive his right of rescission even if the security interests arises by agreement, rather than by operation of law. A third alternative is for the statutory lienholder to honor a bank credit card. The next section explores this possibility in detail.

## 2. CREDIT CARD TRANSACTIONS

As the typical billfold amply demonstrates, credit cards are very popular. The credit card transaction is a credit transaction as defined by Regulation Z.<sup>130</sup> The issuer of the card is the creditor, since he makes advances and collects the finance charge, if one is paid.<sup>131</sup> There are currently two general types of credit cards in popular use. One is the two party card issued by a store for use in charging purchases from that establishment only. The other is the newer and more

<sup>126</sup>Reinhart Lumber & Planing Mill Co. v. Hladik, 259 P. 363 (Cal. D.C. App. 1927).

<sup>127</sup>CCH CORRESPONDENCE ¶ 30,169.

<sup>128</sup>CAL. CIV. CODE § 3262 (West Supp. 1971).

<sup>129</sup>12 C.F.R. § 226.9(e) (1)-(2) (1970). All customers entitled to rescind the transaction must sign the waiver agreement. CCH CORRESPONDENCE ¶ 30,592.

<sup>130</sup>Credit card transactions result in the extension of one type of open end credit. 12 C.F.R. § 226.2(r) (1970).

<sup>131</sup>12 C.F.R. § 226.2(f) (1970).

challenging bank credit card, where a card is issued by a bank or group of banks to members of the public who can use the card at any of numerous stores authorized by the bank to honor the cards. These cards introduce much additional confusion to consumer credit by changing the standard bipartite agreement into a tripartite arrangement. The following discussion is restricted to the effects of three party cards in the area of rescission, since no special consequences flow from a consumer's use of a two party card.

The parties in three party credit card transactions are the bank which issues the credit cards, often called the issuer, the holder of the card, or the holder, and the merchant who honors the cards. There are two contracts in this arrangement. One is between the issuer and the holder, by which holder agrees to make payments in a certain manner, to pay a specified finance charge if he chooses to delay payment, and possibly to additional terms. The other contract is found between issuer and merchant. By this contract, merchant agrees not to bill the holder for purchases but to sell the sales slip to issuer. In return, issuer agrees to purchase the sales invoices without recourse to the merchant. After making a sale, merchant is relieved of any further problems. All he need do is send the sales invoice to issuer and wait for his payment, a payment which may arrive very quickly.<sup>132</sup> The issuing bank is central to these transactions, as it controls the entire affair. It investigates potential holders and decides on their reliability. It extends the credit and takes the risks. The issuer not only decides who may buy on credit, but decides also where the holder can use his card. Merchants allowed to honor the card are passive. They rely on the issuer's reputation and need know nothing about their customers.

It is suggested that before any credit card transaction is rescindible, the creditor must have the right to a lien on the consumer's home.<sup>133</sup> In the bank card situation, it is not enough that the honoring merchant have a lien on the consumer's residence because he is neither a creditor nor an arranger of credit.<sup>134</sup> When the merchant is the creditor and the customer has the right to rescind, rescission voids the sale and the extension of credit. In the bank card situation, if the honoring

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<sup>132</sup>See HOUSE SELECT COMM. ON SMALL BUSINESS, THE IMPACT OF CREDIT CARDS ON SMALL BUSINESS, H.R. REP. NO. 91-1500, 91st Cong., 2d Sess. for a general discussion of problems raised by bank credit cards.

<sup>133</sup>This follows from the fact that the right of rescission arises only in consumer credit transactions, that only the creditor is required to give notice of the right of rescission and to delay performance and only the credit transaction can be rescinded. 12 C.F.R. § 226.9(a),(c) (1970).

<sup>134</sup>A seller who merely honors a credit card issued by another firm does not thereby become a creditor. 12 C.F.R. § 226.2(f) (1970); CCH CORRESPONDENCE ¶ 30,038.



merchant has a lien and the bank does not, nothing is rescindible. If the bank does obtain a lien, only the extension of credit by the bank is subject to rescission. This is good news for holders of statutory liens. If they honor a bank credit card, their deal with the customer cannot be affected by any right of rescission the customer may have against the bank. The lienholder is assured of payment under his contractual arrangement with the bank, as that cannot be reached by any exercise of the consumer's rescission right.<sup>135</sup>

If the creditor in a three party credit card arrangement obtains a lien on real property used or expected to be used as the holder's principal residence, the right to rescind does arise. An informal opinion of the Board considered the effect of a clause in the agreement between issuer and holder of a bank credit card giving the bank the right to "assert a security interest in property of the cardholder in which it otherwise has or may acquire a security interest" should the holder fail to pay debts incurred through use of the card. The Board said if the bank held an otherwise unrelated mortgage in the cardholder's home, the holder could rescind credit transactions resulting from use of the card. If the bank waived its possible security interest in his principal residence, the customer could not rescind.<sup>136</sup> Presumably the same analysis would apply if the holder-issuer agreement contained a confession of judgment clause considered by the Board to be a security interest.

Customers should also be able to rescind bank credit card transactions if the creditor bank obtains a nonconsensual lien against the customer's principal residence. This situation would result from the bank succeeding to the rights of a statutory lienholder when that lienholder honors a bank credit card. To determine if a lien arises when a potential statutory lienholder honors a bank credit card and, if one does arise, whether the creditor can enforce the lien, the legal relations of the parties must be determined. Many commentators have recently analyzed the transaction in terms of familiar legal doctrines. The two favorites are the letter of credit transaction, and the factoring of accounts. The effect of adopting either theory in California is the subject of the remainder of this section.

In the letter of credit situation, the debtor's obligation is directly to the creditor. He has in effect been granted a loan, but instead of handing him cash, the creditor agrees to pay certain obligations in-

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<sup>135</sup>When a bank credit card is honored, there are really two transactions, an extension of credit by the issuer, and a sale by the merchant. Only the credit transaction is rescindible. 12 C.F.R. § 226.9(a) (1970).

<sup>136</sup>CCH CORRESPONDENCE ¶ 30,157.

curred by the debtor on the strength of the creditor's backing.<sup>137</sup> In a situation very similar to this, a California court held that the bank did not obtain a mechanic's lien against the debtor when the credit advanced was used to pay artisans and materialmen. In *Godeffroy v. Caldwell*,<sup>138</sup> a banker agreed to extend a loan to Caldwell for construction of a building on unimproved realty. Bills for labor and material were handed to Rodgers, the banker, who paid them with loan proceeds. When the mortgagor of the property defaulted and foreclosure proceedings were started, Rodgers claimed a prior lien by way of a mechanic's lien. His argument was rejected as the court said the right to a lien was personal to the materialmen and artisans, and the statute did not give the right to a lien to bankers who paid their claims. The court further stated that lending money is not one of the services for which the statute creates a lien right. Since the wording of the statute<sup>139</sup> today refers to labor or materials, this analysis is still valid and banks do not obtain a statutory lien by providing money to pay laborers and materialmen.

Should the letter of credit analogy be applied to the three party credit card in California, the rule in *Godeffroy* precludes formation of a lien on a debtor's home in favor of the bank when a person entitled to a statutory lien honors a bank card. If the bank is not entitled to a lien in its own right, it can obtain a lien against a holder's residence only by succeeding to the rights of a statutory lienholder who has such a lien. If the credit card transaction is analogized to the factoring of accounts situation, this result is possible.

The factor purchases accounts receivable. He is an assignee of a debt that was originally owed to a merchant, and has the right to collect payments.<sup>140</sup> Application of this theory to the three party credit card makes the issuer an assignee, the merchant an assignor, and holder remains a debtor. By this theory, the consumer is first indebted to the merchant, and this debt is then assigned to the card issuer. The issuer-holder arrangement becomes an agreement giving notice to the holder that his debt will be assigned to the issuer, and further, it binds him to make payments to the issuer following the assignment. Because the merchant is contractually obligated to assign the accounts and not to bill the consumer, finding a creditor-debtor relation be-

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<sup>137</sup>For a more detailed explanation see Comment, *The Applicability of the Law of Letters of Credit to Modern Bank Card Systems*, 18 KAN. L. REV. 871 (1970), Comment, *The Tripartite Credit Card Transaction, a Legal Infant*, 48 CAL. L. REV. 459 (1960).

<sup>138</sup>2 Cal. 489, 56 Am. Dec. 360 (1852).

<sup>139</sup>CAL. CIV. CODE § 3110 (West Supp. 1971).

<sup>140</sup>Moore, *Factoring, A Unique and Important Form of Financing and Service*, 14 BUS. LAW. 703, 704-06 (1959).

tween holder and merchant is an exercise in legal fiction, but its theoretical presence may provide the indebtedness necessary to creation of a merchant's statutory lien rights, if he is so entitled. The question of primary concern is whether the bank can exercise the lien rights of such a merchant in this situation. In California, the rule has been that the right to a statutory lien cannot be assigned.<sup>141</sup> The inchoate right is a personal one, and must be exercised by the original lien holder. After perfection of the right by recordation of the claim, the lien can be assigned.<sup>142</sup> A formal assignment of the lien is not required; assignment of the debt carries with it, in California, the power to enforce a properly recorded lien.<sup>143</sup> Despite the rule against assignment of the inchoate right to a mechanic's lien, which is all the statutory lienholder has at the time he honors a bank credit card, the bank may still be able to obtain a lien on the customer's principal residence. In *Heberling v. Day*,<sup>144</sup> one Murphy supplied materials for a building, and extended credit to the owner. He assigned his right to a lien to the First National Bank. After the assignment, Murphy properly filed his claim, and the First National Bank sought to enforce the lien. When the defendant challenged the bank's right to foreclose because all it had been assigned was the right to a lien, the court answered, ". . . even if Murphy assigned the claim to the bank prior to the date of the filing of his claim of lien, he still had sufficient interest in the claim to entitle him to file a lien."<sup>145</sup> Because the assignor had filed, the bank was permitted to foreclose on the lien.

Theoretically then, the law appears to provide a means by which banks can succeed to the rights of statutory lienholders who honor their cards. Practical difficulties, however, may prevent this from happening. In most cases, California statutory law requires potential lienholders to file a preliminary notice with the owner and several of his agents as a precondition to enforcing a lien.<sup>146</sup> This preliminary notice must be given not later than 20 days after the claimant has first furnished labor or materials, or all rights under the lien law are waived.<sup>147</sup> The only persons exempt from this requirement are a contractor dealing directly with the owner and persons performing actual

<sup>141</sup>Mills v. LaVerne Land Co., 97 Cal. 254, 32 P. 169 (1893).

<sup>142</sup>Mitchell v. Shoreridge Oil Co., 24 Cal. App.2d 382, 75 P.2d 110 (1938).

<sup>143</sup>Union Supply Co. v. Morriss, 220 Cal. 331, 30 P.2d 394 (1934); Mitchell v. Shoreridge Oil Co., 24 Cal. App. 2d 382, 75 P.2d 110 (1938).

<sup>144</sup>59 Cal. App. 13, 209 P. 908 (1922).

<sup>145</sup>Heberling v. Day, 59 Cal. App. 13, 209 P. 908 (1922).

<sup>146</sup>CAL. CIV. CODE §3097 (West Supp. 1971).

<sup>147</sup>CAL. CIV. CODE §3097(c) (West Supp. 1971).

labor for wages.<sup>148</sup> In addition to the preliminary notice requirement, the claim must be recorded. Recordation is required before any claimant can enforce his lien. To be effective, the claimant must record:

his claim of lien after he has ceased furnishing labor services, equipment, or materials, and before the expiration of (a) 90 days after completion of the work of improvement if no notice of completion or cessation has been recorded, or (b) 30 days after recordation of a notice of completion or notice of cessation.<sup>149</sup>

In the case of a contractor who deals directly with the owner, a period of 90 days is allowed from the time he completes his contract or 60 days after recordation of a notice of completion or cessation.<sup>150</sup>

In the case of the bank credit card, the bank could ask statutory lienholders who honor their cards to give the required preliminary notice and then to file for a lien when one of their customers who used the bank's credit card fails to pay. This involves a lot of paper work and time, but if restricted to cases of large extensions of credit it is not impractical. When more than a certain amount is charged with a bank card, usually \$50, the merchant must check with the bank before honoring the card.<sup>151</sup> If a large purchase of building materials is charged, the bank might request that the merchant give the preliminary notice required by the statute when he calls for approval to honor the card. Recordation of the claim can then take place during the 90 day period provided for. It is to be noted, however, that at the time the card is honored, there is always the possibility under the factoring of accounts theory, however remote, that the bank will obtain a lien against the holder's home if the honoring merchant is so entitled. This possibility may be enough to give the customer the right to rescind.

In states where the inchoate right to a mechanic's lien is freely assignable,<sup>152</sup> there is clearly a possibility that a bank in these transactions may acquire a lien on the debtor's principal residence. If the right to the lien is assigned with mere assignment of the debt, as is the case in California when the claim has been recorded, the bank is in the same position as the artisan who extends credit. In either case, the customer would seem to have the right to rescind the credit transaction with the bank.

If indeed the banks are subject to the right of rescission in these

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<sup>148</sup>CAL. CIV. CODE § 3097(a), (b) (West Supp. 1971).

<sup>149</sup>CAL. CIV. CODE § 3116 (West Supp. 1971).

<sup>150</sup>CAL. CIV. CODE § 3115 (West Supp. 1971).

<sup>151</sup>Davenport, *Bank Credit Cards and the Uniform Commercial Code*, 85 BANK. L. J. 941, 955 (1968).

<sup>152</sup>WASH. REV. CODE § 60.04.080 (1961).

transactions because of an agreed security interest, a confession of judgment clause, or a statutory lien, they must notify the customer of his right to rescind, and they must delay performance for three business days. The Board has offered no guidance as to the mechanics of carrying out these requirements in the bank card situation.

The most practical way of giving notice is to inform new holders of the right, and to send out the required notices with each billing. In the case of an agreed upon security interest or a confession of judgment clause every extension of credit to a home-owner consumer would be rescindible, so the alternative to sending a notice out every month is to have the honoring merchant hand out the required notice every time a consumer uses the card. This is obviously very impractical, and would be more so if the merchant were required to determine which customers had the right to rescind.<sup>153</sup> If the only transactions subject to rescission are those involving statutory lienholders, then the monthly notice would have to clearly identify those few transactions which the customer can rescind. Alternatively, the honoring merchants who acquire statutory liens and who honor the bank's card could be required to give notice of the right to customers who use the bank's cards.

The delay of performance requirement is more difficult to deal with. The performance to be delayed is the extension of credit but as soon as the merchant honors the bank's card, the bank is contractually obligated to purchase the sales slip from him. If incurring and fulfilling this obligation is the bank's performance under its agreement with the holder, then the bank cannot delay for the required three day period. Because a customer who rescinds must return to the bank the reasonable value of its performance, and returning a product or service purchased with the card to the bank is clearly impractical and inequitable, the alternative of payment in money is the only course open to the holder. In short, the right of rescission cancels only the security interest, not the obligation. For the right to be effective in this analysis, performance by the honoring merchant would have to be postponed so the bank's extension of credit can be delayed and the customer can avoid the extension of credit. But, as the Regulation now reads, only the creditor need delay. On the other hand, if payment to the merchant is conceptually separated from entering a debit in the holder's account, then performance can be delayed. Taking this view of the situation, rescission prevents the bank from

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<sup>153</sup>Some holders may not have the right of rescission because they do not own any real property which they use as their principal residence, or because their contract with the issuing bank does not contain a valid security agreement or confession of judgment clause.

entering such a debit. The bank is put in the position of having paid an honoring merchant, with no right to reimbursement from the cardholder. This result is as unsatisfactory as the first one.

There is clearly a need for special rules to deal with this problem. Three party credit cards should either be exempt from the right of rescission, or better, the means of effectuating that right should be more clearly delineated. One possibility is to require a delay of performance by the honoring merchant in transactions in which the creditor may take a security interest in the consumer's residence. Then the bank would be under no obligation to the merchant until after the rescission period, and the consumer could direct the bank to not advance him money. A further step would be to make the sale by the honoring merchant subject to rescission, as well as the bank's extension of credit. This may appear harsh to the merchant, but from the consumer's point of view a mere cancellation of the advance by the bank does not cancel his obligation to purchase goods or services from the merchant. That purchase is the reason for the credit transaction, and an effective right of rescission would allow the consumer to cancel both segments of the credit card purchase.

### **III. PENALTIES FOR NONCOMPLIANCE**

To encourage strict observance of Regulation Z, Congress provided for stiff criminal and civil penalties in cases of violations. For those who wilfully and knowingly make false disclosures, or fail to make required disclosures, or use any chart to consistently understate the annual percentage rate, there is a fine of up to \$5,000 and/or imprisonment of up to one year. Any other failure to comply with any requirements of Truth-in-Lending law subjects the offender to the same liabilities.<sup>154</sup>

Errant creditors are subject to civil liability up to twice the finance charge of the relevant transaction, providing that figure is at least \$100 and not more than \$1,000, plus reasonable attorney's fees for the debtor. A creditor can defend by showing that he used methods reasonably calculated to avoid errors. He can completely avoid suit by correcting the error within 15 days after discovering it, if suit has not already been brought.<sup>155</sup>

In cases which involve a security interest in real property, the debtor may sue an assignee of the original creditor where the assignee or

<sup>154</sup>15 U.S.C.A. § 1611 (Supp. 1971).

<sup>155</sup>15 U.S.C.A. § 1640 (Supp. 1971).

his affiliates are in a continuing business relation with the original creditor. The assignee can defend by showing that it "did not have reasonable grounds to believe that the original creditor was engaged in violations of [the] chapter and that it maintained procedures reasonably adapted to apprise it of the existence of any such violations."<sup>156</sup>

#### IV. CONCLUSION

Regulation Z has added a new element to nearly every sale of real property to consumers. Brokers must be careful to ascertain their responsibility for making disclosures if they assist buyers in obtaining loans or other credit, and lenders must be careful to comply with the detailed requirements of the Regulation. As experience is gained in working with Truth-in-Lending, the task of creditors will become easier. The difficulty of determining which charges properly belong in the finance charge and which properly belong in the amount financed is being cleared up by the numerous informal opinions given by the Board. Several authorities have developed or compiled forms for use by lenders that will reduce the risk of forgetting to make an important disclosure, or of making a disclosure in an incorrect manner.<sup>157</sup> Hopefully the required efforts of creditors will be worthwhile, and the goal of informed use of consumer credit will be achieved. The new right of rescission is another hopeful means of promoting the informed use of credit. A three day cooling-off period may alleviate some of the personal hardship inflicted on consumers by fast talking, high pressure salesmen.

Responsibility for enforcement of the Act and Regulation Z is divided among nine government agencies, none of which has sufficient staff to closely supervise the millions of consumer credit transactions that occur each year. Enforcement will depend in large measure on court action by individual consumers who are not well versed in the law. Important too, is the willingness of the nation's creditors to comply with the new requirements.

*Burton R. Loehr*

<sup>156</sup>15 U.S.C.A. §1640(d)(Supp. 1971).

<sup>157</sup>A number of forms may be found in R. CLONTZ, TRUTH IN LENDING MANUAL (rev. ed. 1970). See also, Frank, *Preparation of Bank Forms for Regulation Z*, 87 BANK. L. J. 307 (1970).

