

Legal analysis to guide the mortgage industry and protect its interests.

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Post-Petition Rescission Risk

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In *In re Jaaskelainen*, 391 B.R. 627 (Bankr. D. Mass. 2008), the United States Bankruptcy Court for the District of Massachusetts was presented with several important questions concerning the Notice of Right to Rescind (“NOR”) under the Massachusetts Consumer Credit Cost Disclosure Act (“CCCD”), which is the Massachusetts equivalent of the Truth-in-Lending Act (“TILA”). The case points out, among other things, that in a debtor Chapter 13 bankruptcy, a mortgage that has been rescinded becomes a regular unsecured debt like a credit card that gets discharged in bankruptcy. The result — cancellation of a mortgage without requiring a full return of the entire unpaid principal — creates a substantial risk, at least in the District of Massachusetts. The specific facts and analysis from the opinion follow.

Adequacy of Notice of Right to Rescind

In *In re Jaaskelainen*, the debtor-borrowers (“debtors”), who filed for Chapter 13 protection, brought an adversary proceeding against the mortgage company through whom they had refinanced their home and the mortgage company that eventually purchased their loan before the debtors defaulted on their payments. The debtors first argued that their mortgage loan should be subject to the CCCD’s three-year rescission period because they had not received their NORs at closing even though they conceded that they signed an acknowledgment that they received four copies of the NOR at closing. Instead, the debtors argued that they had received their NORs in the mail three days after closing; however, the NORs still had the expiration of the three-day rescission period listed as the date three days after closing. The debtors argued that the NORs were legally insufficient, and therefore, allowed the debtors to exercise their three-year right to rescind.

The court rejected the debtors’ argument as a matter of law, holding that their NORs had contained the legally sufficient language that the debtor could rescind “within three (3) business days from whichever of [three enumerated] events occur[ed] last.” One of the enumerated events was receipt of the NOR. The court held that even though the incorrect rescission date was specifically listed on the NOR, they were not legally defective.

Proper delivery of the Notice of Right to Rescind

The court was then faced with the question of what constituted sufficient evidence to rebut the presumption of delivery created when the debtors signed an acknowledgment stating that they had received the statutorily required number of NORs. While the debtors had conceded that they signed the acknowledgment, they submitted their closing booklet into evidence that contained only two NORs, two short of the number required under the CCCD.

The defendants argued that such evidence was insufficient, because the debtors could not establish a “reliable chain of custody” to prove that the closing booklet was short of the required NORs when it was delivered to the debtors. The court disagreed, holding that “[a] closing booklet is not a murder weapon or controlled substance which requires a perfect chain of custody to prove guilt.” The court stated that the debtors had presented sufficient evidence through the introduction of the closing booklet and supporting testimony to show the booklet’s chain of custody.

Thus, upon a reasonable showing of a reliable chain of custody, the burden shifts to the defendants to prove that the debtors did receive adequate numbers of the NORs. Because the defendants had no evidence in addition to the signed acknowledgment, the court held that the debtors had not received the appropriate number of NORs. It is unclear what exactly would be sufficient evidence to this court that the debtors did receive the NORs.

Bona fide error defense

The court then considered whether the defendants were entitled to the bona fide error defense, a statutorily created safe harbor under the CCCD. The court first acknowledged that in order to qualify under the bona fide error defense, a defendant must show: (1) that the error committed was purely clerical in nature, and (2) that the defendant had implemented procedures reasonably adopted to avoid such errors. After noting that the defendants had failed to present any evidence that the errors were unintentional, the court found that the defendants’ procedures were inadequate to prevent such clerical errors. The defendants argued that they had a procedure whereby the closing agent would forward the loan papers to the lender after he checked their sufficiency. The court held that such procedures were insufficient because the defendants never verified that the borrowers received a sufficient number of copies of the NOR. The court stated that having a closing attorney attest to the delivery of the NORs would not allow the defendants to escape liability through the bona fide error defense.

Obligation to tender loan proceeds

The general rule is that once the borrower properly exercises his or her right of rescission, the lender must return all money or property given in consideration for the loan, and the borrower must return the money or property loaned back to the creditor. However, the court held that when a borrower rescinds a transaction and the security interest is terminated as a matter of law, the creditor is left only with an unsecured debt. Therefore, in a bankruptcy proceeding, unsecured debts are paid pro rata and may be discharged without payment. The court found that because the debtors had filed for Chapter 13 before they filed their notice of rescission, the debtors were only liable for the principal of the loan minus any finance charges paid upon closing. The court concluded by noting that having a Chapter 13 debtor tender the full amount of the loan on a creditor’s unsecured claim would unfairly discriminate against unsecured claims in violation of the bankruptcy code.

Statutory damages

Finally, the court noted that only the assignor defendant mortgage company would be liable for statutory damages under the CCCD. The court held only violations of the CCCD that were “apparent on the face of the disclosure statement” would be subject to statutory damages. Furthermore, the court reasoned, only the assignor mortgage company would have known of the violation because they had failed to provide the debtor with the proper number of NORs. The court stated that the assignee mortgage company would have been unable to tell of a violation on the face of the credit documents.

Conclusion

This case is essential to understanding the risk of failing to provide two copies, per person, of the required NOR at closing and failing to have an independent party perform verification. These two steps are essential to securing the interest in the collateral. The risk is that in a post-petition rescission, the debtor can have the mortgage discharged and the mortgage company, as an unsecured creditor, no longer holds a security interest in the property to liquidate their interest. As an unsecured creditor, what remains is divided pro rata amongst all creditors seeking payment, which can be small.