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John G. Aldridge

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# TRUTH-IN-LENDING IN REAL ESTATE TRANSACTIONS

JOHN G. ALDRIDGE\*

## INTRODUCTION

The Federal Truth-in-Lending Act,<sup>1</sup> which is embodied in Title I of the comprehensive Consumer Credit Protection Act,<sup>2</sup> became effective with its administrative counterpart, Regulation Z,<sup>3</sup> on July 1, 1969. Founded on the premise that "economic stabilization would be enhanced and the competition among the various financial institutions . . . would be strengthened by the informed use of credit,"<sup>4</sup> the Act requires meaningful disclosure of credit terms in consumer credit transactions "so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit."<sup>5</sup> Since the effective date, attorneys nationwide have been struggling to inform their creditor clients, with varying degrees of success, of the varied and complex requirements imposed by this innovative legislation.

Although the dust has not settled completely, it is becoming increasingly apparent, from the standpoint of the creditor, that the major impact of the Act is being felt in the area of real estate credit transactions.<sup>6</sup> The varied and often complex nature of such transactions has made adequate disclosure of credit terms more difficult than in credit transactions involving consumer goods. The presence of intermediaries, such as mortgage brokers, loan correspondents and real estate brokers, in real estate transactions often necessitates the determination of whether the intermediary is required to join the lender in disclosing the terms of the transaction. Many real estate developers and builders have not yet fully

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\* Member, District of Columbia and Georgia Bars. Associate in the firm of Sutherland, Asbill & Brennan, Atlanta, Georgia.

<sup>1</sup> 15 U.S.C.A. §§ 1601-65 (Supp. 1970) [hereinafter referred to as the Act and cited to the appropriate section of the Truth-in-Lending Act as well as to 15 U.S.C.A. (Supp. 1970)].

<sup>2</sup> 15 U.S.C.A. §§ 1601-77 (Supp. 1970).

<sup>3</sup> 12 C.F.R. 226 (1969) [hereinafter referred to as the Regulation and cited as Reg. Z].

<sup>4</sup> Act § 102, 15 U.S.C.A. § 1601 (Supp. 1970).

<sup>5</sup> *Id.*

<sup>6</sup> To confirm this statement, one need only review the inquiries directed to and the Interpretations issued by the Federal Reserve Board since the effective date of the Act.

realized the extent to which their businesses are affected by the Act. In many instances, practicing attorneys, including those involved primarily in commercial real estate, who initially concluded that the Act would not affect their practices, are finding that the Act is broader than it first appeared.<sup>7</sup>

It is with these facts in mind that this article is limited to Truth-in-Lending in real estate transactions<sup>8</sup> and is intended to review the Act and to comment upon the problem areas that have emerged in the first eight months of its existence. It is not the purpose of this article to question the wisdom of those who designed the Act or to speculate upon its effectiveness, but only to assist those who are finding it necessary to develop at least a basic familiarity with the requirements of the Act as they pertain to real estate transactions.

### I. REAL ESTATE TRANSACTIONS REQUIRING DISCLOSURE

For the purposes of the Act, a *real property transaction* is a transaction in which there is an "extension of credit in connection with which a security interest in real property is or will be retained or acquired."<sup>9</sup> The Act does not, however, purport to cover all real property transactions. There are two basic limitations on coverage.<sup>10</sup>

First, disclosure of credit terms is required only in connection with an extension of *consumer credit* or, as stated in the Regulation, only in connection with credit

offered or extended to a natural person, in which the money, property, or service which is the subject of the transaction is primarily for personal, family, household, or agricultural purposes and for which either a finance charge is or may be imposed or which, pursuant to an agreement, is or may be payable in more than four instalments. 'Consumer loan' is one type of 'consumer credit.'<sup>11</sup>

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<sup>7</sup> Many transactions that are typically viewed as being of a commercial nature, such as the acquisition of income-producing real estate by an investor, may be covered by the Act if the investment is not related to the normal business activities of the investor. See p. 429 & note 14 *infra*.

<sup>8</sup> Although in this article the Act will be discussed only in the context of the conventional real estate credit transaction involving a promissory note and mortgage, the principles set forth will generally be applicable to transactions in which the security interest is created by operation of law.

<sup>9</sup> Reg. Z § 226.2(x).

<sup>10</sup> Note also that in non-real property credit transactions there is an additional exemption for credit transactions exceeding 25,000 dollars in amount. Reg. Z § 226.3(c).

<sup>11</sup> Reg. Z § 226.2(k).

Disclosure is not required, therefore, in connection with loans or other extensions of credit to an organization<sup>12</sup> or to a natural person for business purposes. Although generally a loan may be readily identified as being for a business or personal purpose, lenders are discovering that the distinction is occasionally elusive when considered in the context of loans made for investment purposes. For example, if a loan is sought by an individual who plans to invest the proceeds in the stock market or to finance the acquisition of income-producing real estate, coverage by the Act will depend largely upon factors such as (i) the percentage of the total income of the individual attributable to such investments, (ii) the amount of the individual's time consumed by such investments, and (iii) the relation of the investment to the stated profession of the individual.<sup>13</sup> When these factors indicate that the individual is a professional investor, the loan would appear to be for business purposes and thus exempt from the disclosure requirements of the Act. On the other hand, if the investment activities of the individual are insignificant in terms of time spent and income earned, and bear little or no relation to the individual's customary business activities, the loan will be considered personal, and the terms of the credit extended must be disclosed. However, between these extremes lies an area of uncertainty, and until such time as definitive guidelines are issued by the Federal Reserve Board,<sup>14</sup> lenders will be well advised to err on the side of disclosure.

Second, the obligation to make full disclosure of credit terms in connection with a consumer credit transaction is imposed only upon *creditors*, a term limited to those

who regularly extend, or arrange for the extension of, credit for which the payment of a finance charge is required, whether in connection

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<sup>12</sup> The Regulation defines an *organization* as "a corporation, trust, estate, partnership, cooperative, association, government, or governmental subdivision, agency, or instrumentality." *Id.* § 226.2(s). A proprietorship does not come within this definition. 3 CCH CONSUMER CREDIT GUIDE, CORRESPONDENCE ¶ 30,002 (1969) [hereinafter cited as CCH CORRESPONDENCE].

<sup>13</sup> See CCH CORRESPONDENCE ¶¶ 30,026; 30,207.

<sup>14</sup> The Board presently has this problem under advisement and, hopefully, an Interpretation will be issued in the near future. See CCH CORRESPONDENCE ¶ 30,210.

Immediately prior to the publication of this article, the Board issued an Interpretation to the effect that a loan made for the purpose of enabling an individual to acquire, finance, refinance, improve, or maintain a dwelling containing more than four family housing units shall be deemed a loan for business or commercial purposes and thus is not subject to the disclosure requirements of the Act. Reg. Z Interpretations § 226.302, note 28 *infra*. In this narrow context, therefore, the uncertainty discussed in the text has been alleviated.

with loans, sales of property or services, or otherwise. The provisions of this Title apply to any such creditor, irrespective of his or its status as a natural person or any type of organization.<sup>15</sup>

Included within the terms of this definition are not only the professional lender, developer and builder, who regularly extend credit in the ordinary course of their businesses, but also those who regularly *arrange* for extensions of credit or, as stated in the Regulation, those who regularly

provide or offer to provide consumer credit which is or will be extended by another person under a business or other relationship pursuant to which the person arranging such credit receives or will receive a fee, compensation, or other consideration for such service or has knowledge of the credit terms and participates in the preparation of the contract documents required in connection with the extension of credit.<sup>16</sup>

Thus, before the arranger of a consumer loan will be classified as a creditor, and therefore required to disclose credit terms, he must either (i) receive a fee for the services rendered in obtaining the loan or (ii) have knowledge of the terms of the loan and participate in the preparation of the closing documents. These alternative prerequisites to creditor status for a loan-arranger obviate the possibility that a party only indirectly involved with the financing aspect of a transaction will be required to disclose credit terms.

To illustrate the application of these alternative tests, consider the real estate broker. A common intermediary in real estate transactions, the broker regularly arranges for extensions of credit in the ordinary course of his business, generally has knowledge of the terms of the credit so arranged, and receives a commission for his services. However, the broker arranging a loan for a home-purchaser, for example, generally will not be required to join the lender in disclosing credit terms. Although he will probably have knowledge of the terms of the loan, he rarely, if ever, will prepare or assist in preparing the note, mortgage or other loan closing documents.<sup>17</sup> Furthermore, in many areas of the country, the standard broker's commission in no manner relates to the nature or extent of the services rendered by the broker. Instead, it is keyed to the pur-

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<sup>15</sup> Act § 103(f), 15 U.S.C.A. § 1602(f) (Supp. 1970).

<sup>16</sup> Reg. Z § 226.2(f).

<sup>17</sup> Although there has been no official Interpretation, it seems clear that the phrase "contract documents" in Reg. Z § 226.2(f) refers to the actual loan closing documents. See CCH CORRESPONDENCE ¶ 30,187.

chase price of the property and is the same whether or not the broker arranges financing for the purchaser. If such is the case, the broker's commission cannot reasonably be considered compensation for loan-arranging services.<sup>18</sup> To bring a broker arranging a loan within the definition of *creditor*, a fee directly attributable to the arranging services must be received by the broker.<sup>19</sup> Accordingly, when a broker's compensation and participation in a transaction are of a nature similar to that outlined above, his relation to the financing aspect of the transaction will not be considered sufficient to require disclosure on his part.

Whether a person or entity arranging a loan will be considered a creditor for disclosure purposes depends also upon the status of the actual lender. The Federal Reserve Board has unofficially taken the position that, within the confines of the Act, *credit* can be extended only by a *creditor*.<sup>20</sup> From this proposition it follows that an extension of credit may be arranged only with a person or entity within the Act's definition of *creditor*. Thus, for example, one who arranges a second mortgage with a non-creditor, such as a private home owner, will not be required to disclose credit terms even though he regularly arranges extensions of credit in the ordinary course of his business and receives a fee from the purchaser for such services or has knowledge of the credit terms and participates in the preparation of the documents required to close the second mortgage transaction. Although the inclusion of loan arrangers within the definition of *creditors* would seem to be superfluous unless the draftsmen of the Act intended to require disclosure in transactions in which the sole creditor is an arranger,<sup>21</sup> it appears at present that the Board will not alter its opinion that a *non-arranger-creditor* is the sine qua non of an *arranger-creditor*.

In summary, it may be stated as a general proposition that the Act applies to, and thus disclosure of credit terms is required in connection with, any extension of credit (i) that is made by a person or entity that in the ordinary course of business regularly extends or arranges for the

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<sup>18</sup> Conversation with Truth-in-Lending official.

<sup>19</sup> It would appear that such a fee will be included in the *finance charge*, as that term is defined below. See p. 432 *infra*; CCH CORRESPONDENCE ¶ 30,197 (5).

<sup>20</sup> CCH CORRESPONDENCE ¶¶ 30,097; 30,170. The basis for this proposition is found in the Regulation's definition of *credit* as "the right granted by a *creditor*." Reg. Z § 226.2(1) (emphasis added).

<sup>21</sup> In transactions in which there are two creditors, one of which is an arranger, the consumer generally receives the same disclosures he would have received absent the presence of the arranger. In most instances the arranger merely makes a joint disclosure with the primary creditor. See Reg. Z § 226.6(d).

extension of credit (ii) to a natural person (iii) in connection with which a finance charge will be imposed or that will be repaid in more than four installments and (iv) that is sought and obtained by the borrower for personal, family, household or agricultural uses.

## II. DISCLOSURE

To insure that the consumer receives meaningful and understandable information with respect to the cost of credit, the draftsmen of the Act developed two new measures—the *finance charge*<sup>22</sup> and the *annual percentage rate*<sup>23</sup>—by which the consumer may readily compare terms available from different lenders. The effectiveness of the Act depends to a great extent upon these terms becoming synonymous with *credit cost* in the mind of the consuming public. To this end the draftsmen of the Act required that each be set forth in bold face type on disclosure statements.<sup>24</sup> Since these new concepts form the core of the Act, a thorough understanding of each is necessary before a discussion of the details and mechanics of disclosure will be meaningful.

### A. Finance Charge

Simply stated, the *finance charge* represents the total cost of credit to the consumer. It may be broadly defined as the total of all mandatory charges imposed, directly or indirectly, by a creditor as conditions to the extension of credit. Interest, which is traditionally viewed as the cost of credit, constitutes only a portion of the *finance charge*, which is

the sum of all charges, payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by the creditor as an incident to the extension of credit, including any of the following types of charges which are applicable:

- (1) Interest, time-price differential, and any amount payable under a point, discount, or other system of additional charges.
- (2) Service or carrying charge.
- (3) Loan fee, finder's fee, or similar charge.
- (4) Fee for an investigation or credit report.
- (5) Premium or other charge for any guarantee or insurance protecting the creditor against the obligor's default or other credit loss.<sup>25</sup>

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<sup>22</sup> Act § 106, 15 U.S.C.A. § 1605 (Supp. 1970).

<sup>23</sup> *Id.* § 107, 15 U.S.C.A. § 1606 (Supp. 1970).

<sup>24</sup> Reg. Z § 226.6(a).

<sup>25</sup> Act § 106(a), 15 U.S.C.A. § 1605(a) (Supp. 1970). Examples of other fees required to be included in the finance charge are: loan escrow fees, CCH CORRE-

In addition, if a creditor requires credit life, accident, health or loss-of-income insurance in connection with a loan, the cost of such insurance for the full period of coverage required by the creditor<sup>26</sup> is considered to be part of the cost of credit and must be included in the finance charge.<sup>27</sup> If a creditor does not require such insurance, and this fact is clearly and conspicuously stated in the disclosure statement, the premiums need not be included in the finance charge if the borrower desiring such insurance gives to the creditor a dated and separately signed written indication of such desire after receiving from the creditor a written disclosure of the cost of such insurance for the initial policy period.<sup>28</sup>

Similarly, the cost of hazard and extended-coverage insurance for the full period required by the creditor must be included in the finance charge unless the creditor shows on the disclosure statement the cost for the initial policy period, if such insurance is obtained from or through the creditor, and states that the borrower is free to choose the person through whom such insurance will be obtained.<sup>29</sup> The former disclosure relating to cost cannot be made, of course, when such insurance is not obtainable from or through the creditor. In such circumstances, however, the creditor is still required to advise the borrower that he is free to choose the person through whom the insurance will be obtained.<sup>30</sup> Only if hazard insurance is not required in connection with the transaction is the creditor relieved of that obligation. This freedom of choice by the borrower is subject, however, to the right of the creditor to reject for reasonable cause an insurer offered by the borrower.<sup>31</sup> Finally, if hazard insurance is not required by the creditor, a simple statement to this effect, though not required by the Act, should be inserted in the disclosure statement for the creditor's protection.

As opposed to mandatory charges imposed by the creditor, there are a number of fees and charges over which the creditor has no control and which, if itemized and disclosed to the borrower, may be excluded

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SPONDERANCE ¶¶ 30,197(4); 30,210; standby fees, *Id.* ¶ 30,197(1); arrangers fees, *Id.* ¶ 30,197(5); assumption fees, *Id.* ¶ 30,008.

<sup>26</sup> Reg. Z § 226.4(h).

<sup>27</sup> Act § 106(b), 15 U.S.C.A. § 1605(b) (Supp. 1970).

<sup>28</sup> Reg. Z § 226.4(a)(5); *Truth In Lending Interpretations of Regulation Z* § 226.402 (1969), compiled in 1 CCH CONSUMER CREDIT GUIDE, TRUTH IN LENDING, *Miscellaneous Interpretations—Regulation Z* [hereinafter cited as Reg. Z Interpretations].

<sup>29</sup> Act § 106(c), 15 U.S.C.A. § 1605(c) (Supp. 1970); Reg. Z § 226.4(a)(6).

<sup>30</sup> Reg. Z Interpretations § 226.403.

<sup>31</sup> Reg. Z § 226.4(a)(6)n.5.



from the finance charge.<sup>32</sup> These charges are set forth in the Regulation as follows:

(1) Fees and charges prescribed by law which actually are or will be paid to public officials for determining the existence of or for perfecting or releasing or satisfying any security related to the credit transaction.

(2) The premium payable for any insurance in lieu of perfecting any security interest otherwise required by the creditor in connection with the transaction, if the premium does not exceed the fees and charges described in subparagraph (1) of this paragraph which would otherwise be payable.

(3) Taxes not included in the cash price.

(4) License, certificate of title, and registration fees imposed by law.<sup>33</sup>

Thus, although it is necessary to itemize and disclose the dollar amount of recording fees, cancellation fees, document taxes, etc. incurred in connection with a real estate transaction, such fees are not considered costs of credit.

Typical real estate closing costs are also excludable from the finance charge<sup>34</sup> "provided they are bona fide, reasonable in amount, and not for the purpose of circumvention or evasion of . . . [the Act]."<sup>35</sup> This latter proviso is intended to serve as a warning to those creditors who might otherwise entertain thoughts of padding such costs. The closing costs excludable under the Act include:

- (1) Fees or premiums for title examination, abstract of title, title insurance, or similar purposes and for related property surveys.
- (2) Fees for preparation deeds, settlement statements, or other documents.
- (3) Amounts required to be placed or paid into escrow or trustee accounts for future payments of taxes, insurance, and water, sewer, and land rents.
- (4) Fees for notarizing deeds and other documents.
- (5) Appraisal fees.
- (6) Credit reports.<sup>36</sup>

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<sup>32</sup> Act § 106(d), 15 U.S.C.A. § 1605(d) (Supp. 1970).

<sup>33</sup> Reg. Z § 226.4(b).

<sup>34</sup> Act § 106(e), 15 U.S.C.A. § 1605(e) (Supp. 1970).

<sup>35</sup> Reg. Z § 226.4(e).

<sup>36</sup> *Id.*; Act § 106(e), 15 U.S.C.A. § 1605(e) (Supp. 1970). Note that credit-investigation costs are excludable from the finance charge only in real estate credit transactions. See p. 432 & note 25 *supra*.

It is interesting to note that neither the Act nor the Regulation requires that closing costs be itemized and disclosed to the borrower. However, since questions of reasonableness, as well as evasiveness on the part of the creditor, are more likely to arise absent disclosure, the creditor will be well advised to itemize and disclose the dollar amount of all closing costs on the disclosure statement.

### B. Annual Percentage Rate

The *annual percentage rate* is merely the expression of the finance charge in terms of a percentage figure. The annual percentage rate applicable to any closed-end credit transaction<sup>37</sup> may be determined either by the *actuarial method* of computation or by application of the *United States Rule*.<sup>38</sup> Both of these methods of computation take into account that a borrower does not have the use of the full amount of the credit for the life of the loan. Each reveals, therefore, the true annual percentage cost of credit, rather than a misleading percentage rate such as that produced by the *add-on* or *discount* methods. The actual calculation that must be made in a given transaction depends, of course, on the nature of the transaction and the repayment schedule involved.<sup>39</sup> Fortunately for the creditor, the Federal Reserve Board has issued tables that greatly simplify the determination of the annual percentage rate for equal monthly payment plans and also for transactions involving irregular payments or multiple advances.<sup>40</sup> A creditor seeking to determine the annual percentage rate in a transaction involving equal monthly payments needs only to determine the *finance charge per \$100 of amount financed* by dividing the total finance charge for the life of the loan by the amount financed and multiplying the quotient by 100.<sup>41</sup> Having

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<sup>37</sup> A transaction in which a fixed amount of credit is available to the consumer for a fixed period of time. Compare Reg. Z § 226.2(r).

<sup>38</sup> Reg. Z § 226.5(b).

<sup>39</sup> Supplement I to the Regulation provides actuarial method formulas for (i) installment transactions; (ii) transactions involving a single advance with (a) payments at equal periods in equal amounts, (b) payments at equal periods in unequal amounts, (c) payments at unequal periods in equal amounts, and (d) payments at unequal periods in unequal amounts; (iii) transactions involving multiple advances by a creditor; and (iv) single advance, single payment transactions, among others.

<sup>40</sup> Available annual percentage rate tables are described in Reg. Z § 226.5(c) and may be obtained from Federal Reserve Banks or by writing to the Federal Reserve Board.

<sup>41</sup> See instructions contained in Federal Reserve Board, Table FRB-100-m (1969).

determined this figure, it is then a simple matter to ascertain the annual percentage rate from the tables.

Due to the varied nature of transactions involving periodic advances and irregular payment schedules, it is impossible even to generalize with respect to the method of computing the annual percentage rate in such transactions. However, brief mention should be made of the real estate transaction most commonly involving such irregularities—the construction loan. At the time a construction loan is closed, it is often contemplated that the loan proceeds will be drawn down periodically with interest on each advance to accrue from the date of the draw. The date and amount of the draws are generally unknown at the time of closing since they depend primarily upon the progress of the construction and the operating procedure of the builder. The only known factors are the total amount of credit available to the borrower and the maturity date. In this situation, creditors have no alternative other than to estimate, on the basis of prior experience, the period of time over which the principal amount of the loan, less any amount disbursed at closing, will remain outstanding.<sup>42</sup> For example, a number of construction lenders have found that, on the average, the full amount of a construction loan remains outstanding for one-half of the projected construction period. Thus, if construction is to be completed in five months, interest is computed on the assumption that it will accrue on the full amount of the loan, less any initial disbursements, for a period of two and one-half months. This amount is then added to the other finance charges and the total is used in computing the annual percentage rate. This method is, however, only one of a countless variety used in computing the finance charge and annual percentage rate in irregular payment transactions. Although any reasonable method may be employed, creditors frequently encountering such transactions will be well advised to have their methods approved by the Federal Reserve Board due to the estimated factors involved.

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<sup>42</sup> Creditors are allowed to use an estimate or approximation when necessary, provided that it "is clearly identified as . . . [an estimate or approximation] . . . , is reasonable, is based on the best information available to the creditor, and is not used for the purpose of circumventing or evading the disclosure requirements . . ." Reg. Z § 226.6(f).

Immediately prior to the publication of this article, the Board issued an Interpretation setting forth approved formulas for estimating the *annual percentage rate* and the *finance charge* on construction loans with respect to which the dates and amounts of advances are not determinable at the time of closing. Reg. Z Interpretations § 226.813.

### C. Required Disclosures

To insure that credit-cost disclosure will be meaningful and uniform and to negate the possibility of evasion, the Regulation sets forth in detail the items that must be included in the disclosure statement.

Separate treatment is accorded *loans*<sup>43</sup> secured by real estate and real estate *credit sales*,<sup>44</sup> the latter being defined as "any sale with respect to which consumer credit is extended or arranged by the *seller*."<sup>45</sup> When a seller of real property, such as a builder or developer who comes within the Act's definition of *creditor*, extends credit to a purchaser of a lot and takes back a purchase money mortgage, the transaction is deemed a credit sale, and the seller must make credit-sale disclosures, as opposed to loan disclosures. Similarly, if a seller acts as an *arranger*, it appears from the above-quoted provision of the Regulation that he will be required to make credit-sale disclosures despite the fact that the lender will make loan disclosures. Since there is only one extension of credit in this situation—a loan—it seems unnecessary to require the seller to give disclosures different from those of the lender. Furthermore, credit-sale disclosures would not even appear to be relevant in such a transaction since, as to the seller, the sale is for cash. In the opinion of the writer, the purposes of the Act would be served more adequately by allowing the arranger-seller to join the lender in making loan disclosures. There is no justifiable reason that an arranger should be treated differently for purposes of disclosure merely because he happens to be the seller of the property that is the subject of the transaction. Although the Federal Reserve Board has not officially addressed itself to this problem, joint loan disclosures have been unofficially sanctioned in transactions involving an arranger-seller and a lender.<sup>46</sup>

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<sup>43</sup> Loan disclosures are set forth in Reg. Z §§ 226.8(b) & (d).

<sup>44</sup> Credit sale disclosures are set forth in Reg. Z §§ 226.8(b) & (c).

<sup>45</sup> Reg. Z § 226.2(n).

<sup>46</sup> This method of disclosure was sanctioned by a Truth-in-Lending official in the following context. A developer-owner of a large vacation home project arranged for a particular lender to provide financing for the individual vacation home lots if requested by the purchasers. Each purchaser was free to arrange his own financing or to accept that arranged by the developer. In transactions in which the purchaser chose the latter alternative, the developer became a *creditor* for disclosure purposes since it arranged the financing, had knowledge of the credit terms, and prepared the loan closing documents on behalf of the lender. Despite the fact that the developer was also the *seller* in such transactions, it was permitted to join the actual lender in making loan disclosures rather than being required to make separate credit-sale disclosures. According to the Truth-in-Lending official,

## 1. Loans

With respect to consumer loans secured by real estate, the following specific items of information must be disclosed by the creditor :

(a) The date on which the finance charge begins to accrue, if other than the date of closing.<sup>47</sup>

(b) The *annual percentage rate*.<sup>48</sup>

(c) The number, amount, and due dates or periods of payments scheduled to repay the loan. In the event the amount of any payment is more than twice the amount of regularly scheduled equal payments, the creditor is required to identify the amount of such payment by use of the term *balloon payment* and state the conditions, if any, under which the balloon payment may be refinanced if not paid when due.<sup>49</sup>

(d) The amount, or method of computing the amount, of any delinquency or similar charges payable in the event of late payments.<sup>50</sup>

(e) A description or identification of the type of security interest to be retained by the creditor in connection with the extension of credit, together with a clear description of the property to which the security interest will relate. This requirement may be met by furnishing the borrower with a copy of the mortgage if it is impractical or impossible to insert a legally sufficient description of the property in the disclosure statement itself. In addition, if the mortgage is to contain a *dragnet* or *open-end* provision or to cover after-acquired property, such must be clearly set forth in conjunction with the description of the security interest.<sup>51</sup>

(f) A description of the prepayment penalty, if any, with an explanation of the method of computation and the conditions under which it may be imposed.<sup>52</sup>

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joint loan disclosures will be permitted in this situation only if the purchaser is free to obtain financing elsewhere. In other words, if the purchaser is required to accept the financing arranged by the seller, the seller must make separate credit-sale disclosures. This distinction appears irrelevant to the writer, who is of the opinion that a seller-arranger should *always* be allowed to join the lender in making loan disclosures.

<sup>47</sup> Reg. Z § 226.8(b) (1).

<sup>48</sup> *Id.* § 226.8(b) (2).

<sup>49</sup> *Id.* § 226.8(b) (3).

<sup>50</sup> *Id.* § 226.8(b) (4).

<sup>51</sup> *Id.* § 226.8(b) (5).

<sup>52</sup> *Id.* § 226.8(b) (6).

(g) The description of the rebate formula, if any, which will be used to compute the unearned portion of the finance charge in the event of prepayment.<sup>53</sup>

(h) All *prepaid finance charges*, which differ from other finance charges in that they are withheld from the amount of credit extended or are separately paid at or prior to the loan closing, must be disclosed as such in addition to being disclosed as ordinary *finance charges*.<sup>54</sup> Loan discount fees, loan origination fees, loan assumption fees, arranger's fees, and prepaid interest are examples of charges falling within this category, as is

[a]ny finance charge paid separately, in cash or otherwise, directly or indirectly to the creditor or with the creditor's knowledge to another person, or withheld by the creditor from the proceeds of the credit extended . . . [and] 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 [required escrow accounts, deposit balances which will be wholly applied toward the satisfaction of the obligation, deposit balances or investments in existence prior to the extension of credit and offered by the customer as security and deposit balances and investments acquired or established from the proceeds of the extension of credit].<sup>55</sup>

(i) The *amount financed*, which equals:

- (1) The amount of credit that will be paid to the borrower, or for his account, or to another person on his behalf, *including*
- (2) All charges, individually itemized, *that are included in the amount of credit extended*, but that are not part of the finance charge, *less*
- (3) The total prepaid finance charge.<sup>56</sup>

<sup>53</sup> *Id.* § 226.8(b)(7).

<sup>54</sup> *Id.* § 226.8(d)(2). Immediately prior to the publication of this article an unofficial interpretation was issued to the effect that *prepaid finance charges* need be itemized and disclosed only in transactions in which the ordinary *finance charges* are required to be itemized and disclosed. CCH CORRESPONDENCE ¶ 30,246. This interpretation appears to be somewhat questionable in that the Regulation treats *prepaid finance charges* and *finance charges* as separate items of disclosure. See Reg. Z § 226.8(d)(2); *Id.* § 226.8(d)(3).

<sup>55</sup> Reg. Z § 226.8(e).

<sup>56</sup> *Id.* § 226.8(d)(1).

The charges referred to in subparagraph (ii) above are those charges, such as closing costs, that are excluded from the finance charge but that are financed by the lender. Thus, it is quite clear that the *amount financed* will always equal the *gross* loan proceeds less the total pre-paid finance charge, whether or not such excludable charges are deducted from the principal amount of the loan as a matter of convenience.

(j) *Unless the loan will be secured by a first lien on a dwelling and will be made to finance either the purchase of the dwelling, the initial construction of the dwelling, or to satisfy a construction loan and provide permanent financing for the dwelling, the following must be disclosed:*

- (1) The *total of payments*, which is the sum of all scheduled payments required to repay the loan,<sup>57</sup> and
- (2) The total amount of the *finance charge* with a description of each amount included within that charge.<sup>58</sup> Note, however, that even though the finance charge need not be disclosed in certain transactions, it will be necessary in all transactions to determine the total finance charge in order to compute the annual percentage rate.

## 2. Credit Sales

The disclosures required for a credit sale differ in the following respects from those required in connection with a loan transaction.

The major difference is attributable to a number of interim disclosures required before arriving at the *amount financed*. These disclosures, which should be made in lieu of those set forth in paragraph (1)(i) of the loan disclosures above, are as follows:

(a) The *cash price* of the property that is the subject of the transaction.<sup>59</sup>

(b) The down-payment, itemized as *cash down-payment* and *property down-payment*, using the term *trade-in*, with the aggregate down-payment designated as *total down-payment*.<sup>60</sup>

<sup>57</sup> *Id.* § 226.8(b)(3).

<sup>58</sup> *Id.* § 226.8(d)(3).

<sup>59</sup> *Id.* § 226.8(c)(1).

<sup>60</sup> *Id.* § 226.8(c)(2).

(c) The *unpaid balance of cash price*, which equals the *cash price* less the *total down-payment*.<sup>61</sup>

(d) All charges, individually itemized, included in the amount financed, but not included in the finance charge.<sup>62</sup>

(e) The *unpaid balance*, which equals the sum of the *unpaid balance of cash price* and the total amount of the charges described in subparagraph (d) above.<sup>63</sup>

(f) The *amount financed*, which equals the *unpaid balance* less the total *prepaid finance charge*.<sup>64</sup>

Finally, *unless the credit sale transaction involves the sale of a dwelling*, the total amount of the *finance charge*,<sup>65</sup> the *total of payments* required to repay the loan,<sup>66</sup> and the *deferred payment price*, which equals the sum of (i) the *cash price*, (ii) the total amount of the charges described in subparagraph (d) above, and (iii) the *finance charge*, must be disclosed.<sup>67</sup> These disclosures are the credit-sale counterparts of the loan disclosures set forth in paragraph (1) (j) above, except for the *deferred payment price* disclosure, which is unique to credit sales.

In addition to the disclosures required in connection with loans and credit sales, a creditor may, at his option, give the borrower such additional information or explanations as the creditor deems necessary in the context of a particular transaction.<sup>68</sup> In construction loan transactions, for example, the creditor often exercises this option in order to explain to the borrower that the annual percentage rate may, in fact, be higher or lower depending on the date and amount of the periodic draws made by the borrower. This right on the part of the creditor is, however, subject to the proviso that such additional information may not "be stated, utilized, or placed so as to mislead or confuse the customer, or contradict, obscure, or detract attention from the information required by the [Act] to be disclosed."<sup>69</sup> In other words, such information must be offered by a creditor in a good-faith attempt to amplify, rather than to restrict, the effectiveness of the required disclosures.

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<sup>61</sup> *Id.* § 226.8(c) (3).

<sup>62</sup> *Id.* § 226.8(c) (4).

<sup>63</sup> *Id.* § 226.8(c) (5).

<sup>64</sup> *Id.* § 226.8(c) (7).

<sup>65</sup> *Id.* § 226.8(c) (8).

<sup>66</sup> *Id.* § 226.8(b) (3).

<sup>67</sup> *Id.* § 226.8(c) (8).

<sup>68</sup> Act § 122(b), 15 U.S.C.A. § 1632(b) (Supp. 1970); Reg. Z § 226.6(c).

<sup>69</sup> Reg. Z § 226.6(c).



#### D. Form of Disclosure

In addition to prescribing the basic terminology that must be used in making credit-cost disclosures, the Regulation imposes certain requirements with respect to the form of disclosures. If a creditor elects to combine Truth-in-Lending disclosures and the evidence of indebtedness in a single document, the disclosures may be shown on the face of the document, on the reverse side of the document, or on both sides.<sup>70</sup> However, the finance charge and annual percentage rate *must* appear on the face of the combined document<sup>71</sup> and, as mentioned above, in print more conspicuous than that used for other terminology.<sup>72</sup> On the other hand, if a separate disclosure statement is used by the creditor, as is usually the case in real estate transactions, all disclosures must appear on the face of the document.<sup>73</sup> In addition, wherever the disclosures appear, they must be clear, conspicuous<sup>74</sup> and in meaningful sequence.<sup>75</sup>

#### E. Time of Disclosure

The determination of the time for disclosure has received much attention and comment since the Act became effective. The Act provides simply that the required disclosures "shall be made before the credit is extended, and may be made by disclosing the information in the note or other evidence of indebtedness to be signed by the obligor."<sup>76</sup> This statement is, however, greatly expanded by the Regulation, which provides that disclosures must be made before a transaction is *consummated*<sup>77</sup> and that a transaction "shall be considered consummated at the time a contractual relationship is created between a creditor and a customer irrespective of the time of performance of either party."<sup>78</sup> *Literally interpreted, these provisions allow disclosure at any time prior to the actual*

<sup>70</sup> Reg. Z § 226.8(a); Reg. Z Interpretations § 226.801.

<sup>71</sup> Reg. Z Interpretations § 226.801.

<sup>72</sup> See p. 432 & note 24 *supra*.

<sup>73</sup> Reg. Z § 226.8(a)(2).

<sup>74</sup> For assistance in determining whether disclosures are sufficiently *conspicuous*, the reader is referred to the *Uniform Commercial Code*, which provides that [a] term or clause is conspicuous when it is so written that a reasonable person against whom it is to operate ought to have noticed it. . . . Language in the body of a form is "conspicuous" if it is in larger or other contrasting type or color.

UNIFORM COMMERCIAL CODE § 1-201(10).

<sup>75</sup> Reg. Z § 226.6(a).

<sup>76</sup> Act § 129(b), 15 U.S.C.A. § 1639(b) (Supp. 1970).

<sup>77</sup> Reg. Z § 226.8(a).

<sup>78</sup> *Id.* § 226.2(cc).

*closing of a loan unless a firm commitment has been issued, in which event disclosure must be made prior to the issuance of the commitment. With respect to credit sales, disclosure may be made at any time prior to the execution of the sales contract.*

This interpretation recently received the sanction of the Federal Reserve Board<sup>79</sup> despite some comment, primarily by title insurance companies with visions of escrow fees,<sup>80</sup> to the effect that the draftsmen of the Act did not intend to require disclosure prior to the time that a contractual relationship is created between a creditor and borrower. Proponents of this argument find support in the provisions of the Act and Regulation that permit disclosure "in the note or other evidence of indebtedness to be signed by the obligor."<sup>81</sup> It can be argued that these provisions obviously contemplate disclosure subsequent to the contract stage and that to require disclosure prior to the issuance of a commitment places an unreasonable burden on the lender since it is impossible at that time to determine the amount of many charges required to be disclosed. However, there can be no question that a disclosure of credit terms is meaningless after the consumer is contractually obligated to accept them. In addition, in transactions in which the consumer will have the right to rescind, it is to the lender's advantage to issue a firm commitment for the purpose of consummating the transaction. Although the lender may be unable to determine the exact amount of some of the items required to be disclosed, he will be allowed to make good faith estimates.<sup>82</sup> Upon acceptance of the commitment, the lender is then in a position to wait the three-day rescission period<sup>83</sup> before incurring attorney's fees and rendering costly services on behalf of the borrower. On the other hand, if no commitment is issued and disclosure is made at the closing, not only must the loan be closed in escrow,<sup>84</sup> but also the services rendered by the lender and the lender's attorney will go unrewarded if the borrower elects to rescind.<sup>85</sup> Accordingly, disclosure at the closing proper would place a tremendous burden on the lender, or the seller in a credit-sale transaction, in addition to denying the borrower the opportunity to

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<sup>79</sup> CCH CORRESPONDENCE ¶¶ 30,147; 30,211.

<sup>80</sup> See, e.g., Lagorio, *Truth-in-Lending Act and Its Impact on the Mortgage Lender*, in Chi. Title Ins. Co., Lawyer's Supplement (July 1969).

<sup>81</sup> Act § 129(b), 15 U.S.C.A. § 1639(b) (Supp. 1970); Reg. Z § 226.8(a)(1).

<sup>82</sup> Reg. Z § 226.6(f).

<sup>83</sup> See p. 448 & note 107 *infra*.

<sup>84</sup> See p. 448 & note 109 *infra*.

<sup>85</sup> See p. 448 & note 111 *infra*.

"credit shop" after receiving the disclosure. As a practical matter, the borrower is much more likely to rescind at the commitment stage than at the closing stage. Thus, whether intended by the draftsmen or not, the pre-contract disclosure requirement often enables lenders and sellers to avoid the burdens incident to escrow closings and affords a more meaningful opportunity for the borrower to compare credit terms. As such is the case, it is extremely unlikely that the Board will alter the Regulation.

#### *F. Disclosure upon Assumption or Refinancing*

Upon the assumption of an existing consumer obligation, a creditor is required to deliver to the assuming party the loan disclosures required in an ordinary loan transaction,<sup>86</sup> with the exception that any *prepaid finance charges* paid by the original borrower need not be disclosed.<sup>87</sup> The creditor is, however, required to include and individually itemize any *prepaid finance charge*, such as an assumption fee, imposed in connection with the assumption.<sup>88</sup> If the existing obligation is secured by a first mortgage on a dwelling and is assumed by the subsequent borrower to acquire that dwelling, the transaction will be considered a loan to finance the acquisition of a dwelling and disclosure of the *finance charge* and *total of payments* will not be required.<sup>89</sup> It is important to note that, for the purposes of disclosure, an assumption "occurs only when, by *written agreement* entered into between a subsequent customer and the creditor, that subsequent customer is or will be accepted by that creditor as an obligor on an existing evidence of debt."<sup>90</sup> Accordingly, in the absence of such an agreement, disclosure of credit terms will not be required by the creditor. Disclosure also need not be made when a consumer merely takes *subject to* an existing obligation and does not become personally obligated thereon.<sup>91</sup>

The refinancing by a creditor of an existing consumer obligation is considered a new transaction under the Regulation, and full disclosure of credit terms is required.<sup>92</sup> In such disclosure, "any unearned portion of the finance charge which is not credited to the existing obligation shall

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<sup>86</sup> Reg. Z § 226.8(k); Reg. Z Interpretations § 226.807(2).

<sup>87</sup> Reg. Z Interpretations § 226.807(2).

<sup>88</sup> *Id.*

<sup>89</sup> Reg. Z § 226.8(k).

<sup>90</sup> Reg. Z Interpretations § 226.807(b) (emphasis added).

<sup>91</sup> CCH CORRESPONDENCE ¶ 30,008.

<sup>92</sup> Reg. Z § 226.8(j).

be added to the new finance charge and shall not be included in the new amount financed."<sup>93</sup> It would appear that whether a portion of the original prepaid finance charges will be considered unearned upon a refinancing will depend solely upon the creditor's policy. If the creditor has traditionally considered such charges to be earned upon the processing of the loan application and the closing of the loan, no portion of these charges need be taken into consideration in making disclosures upon a refinancing.<sup>94</sup> If such is not the case, however, the creditor must either credit the unearned charges against the existing obligation or add them to the finance charge imposed in connection with the refinancing. Finally, it should be noted that the right of rescission, which is fully discussed below, can apply only to the amount, if any, by which the amount of the refinanced transaction exceeds the sum of the unpaid balance and accrued but unpaid finance charges on the existing obligation.<sup>95</sup> In other words, the right of rescission may arise in connection with a refinancing only if the amount of the existing obligation is increased, and then only with respect to the amount of such increase.

### III. RIGHT OF RESCISSION

The right of the consumer to rescind certain real estate transactions is without question the most disturbing provision of the Act as far as creditors are concerned. This provision is unusual and often misunderstood in that it is a *right* and not a *penalty* for nondisclosure. In other words, even though a creditor makes all required disclosures, the consumer may have the right to rescind the transaction. Broadly speaking, the right to rescind extends to all transactions in which a security interest is acquired in real property used or expected to be used as the *principal residence* of the consumer,<sup>96</sup> unless the transaction falls within one of the following categories:

- (1) The creation, retention or assumption of a first lien or equivalent security interest to finance the acquisition of a dwelling in which the customer resides or expects to reside.
- (2) A security interest which is a first lien retained or acquired by a creditor in connection with the financing of the initial construction of the residence of the customer, or in connection with a loan

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<sup>93</sup> *Id.*

<sup>94</sup> CCH CORRESPONDENCE ¶ 30,233.

<sup>95</sup> Reg. Z, Interpretations § 226.903.

<sup>96</sup> Reg. Z § 226.9(a).

committed prior to completion of the construction of that residence to satisfy that construction loan and provide permanent financing of that residence, whether or not the customer previously owned the land on which the residence is to be constructed.

- (3) Any lien by reason of its subordination at any time subsequent to its creation, if that lien was exempt from the provisions of this section when it was originally created.<sup>97</sup>

From these provisions, it appears that only the following real estate transactions are *not rescindable* by the consumer :

1. A transaction in which the real property securing the consumer loan is not used or expected to be used as the *principal residence* of the consumer. The term *residence* is defined to include unimproved lots on which the consumer resides or expects to reside.<sup>98</sup> Accordingly, no right to rescind will arise in connection with the credit sale or financing of vacation homes or unimproved vacation home lots since the consumer will not use the property as his principal residence.

2. A transaction in which the real property is used or expected to be used as the principal residence of the consumer, and in connection with which a *first* security interest is retained in the property to secure a loan made either :

- (a) To finance the acquisition of a dwelling located on the property, or if no dwelling is located on the property;
- (b) To finance the construction of a dwelling thereon; or
- (c) To satisfy a construction loan on a dwelling and provide permanent financing.

On the other hand, the following are examples of frequently encountered rescindable transactions :

1. A consumer loan made to finance the acquisition of an unimproved lot that the consumer expects to use for his principal residence, irrespective of the priority of the security interest retained in the lot. Similarly, a credit sale of such a lot will be rescindable even though the seller retains a first security interest. These transactions are rescindable because the

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<sup>97</sup> *Id.* § 226.9(g). Note that the first two exceptions are related to those involving disclosure of the *finance charge* and *total of payments*. See p. 440 & notes 57 & 58 *supra*. Accordingly, when a security interest is retained in a principal residence and the creditor is required to disclose the *finance charge* and *total of payments* (and the *deferred payment price* in connection with credit sales), the transaction will be rescindable.

<sup>98</sup> *Id.* § 226.2(y).

important exception for a first purchase-money security interest relates only to dwellings, a term that does not include unimproved residential lots.<sup>99</sup> It should be noted, however, that if a consumer loan is made both to finance the acquisition of an unimproved lot expected to be used for the consumer's principal residence *and* to finance the construction of a dwelling thereon, and the lender retains a first security interest in the lot, the loan will come within the construction-loan exception and will not be rescindable.<sup>100</sup>

2. A consumer loan secured by a secondary security interest in a consumer's principal residence or in an unimproved lot expected to be used by a consumer for his principal residence. The Regulation provides, however, that the right of rescission does not apply to a secondary security interest that was reduced to that status by subordination at a time subsequent to its creation.<sup>101</sup> In other words, if a security interest was not rescindable upon its creation, no right of rescission will arise upon the subsequent subordination of that security interest. Furthermore, though the Regulation does not address itself to the subordination of a security interest that *was* rescindable upon creation, it is clear that a right of rescission does not again arise upon the subordination of such an interest.<sup>102</sup> Thus, subordination per se can neither create nor revive the right to rescind a credit transaction.

Whenever a consumer has the right to rescind a transaction, the creditor is required to give notice of that fact by furnishing the consumer with two copies of a *notice of right to rescind*, one of which may be used by the consumer to effect rescission.<sup>103</sup> Once again leaving nothing to chance, the Regulation expressly sets forth the required text of this notice.<sup>104</sup> Through this notice the consumer is advised that he has entered into a transaction that may result in a mortgage on his *home*<sup>105</sup> and that

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<sup>99</sup> *Dwelling* is defined as "a residential-type structure which is real property and contains one or more family housing units, or a residential condominium unit wherever situated." Reg. Z § 226.2(p).

<sup>100</sup> *Id.* §§ 226.8(f), 226.9(g)(2).

<sup>101</sup> *Id.* § 226.9(g)(3).

<sup>102</sup> CCH CORRESPONDENCE ¶ 30,198.

<sup>103</sup> Reg. Z § 226.9(b).

<sup>104</sup> *Id.*

<sup>105</sup> The use of the word *home* in the notice of right to rescind has been the subject of much criticism. When a loan finances the acquisition of an unimproved lot expected to be used as a principal residence, lenders often find it necessary to explain to the consumer that the security interest is created only in the lot and any improvements that may subsequently be constructed thereon, and not in the consumer's *present* home. The Federal Reserve Board is presently considering

he has the right, under federal law, to rescind the transaction without penalty. The notice must also set forth, in its entirety, the provision of the Regulation that describes the effect of rescission.<sup>106</sup> The right to rescind remains in effect until midnight of the third business day following the date that the transaction is consummated or the date that the disclosure of credit terms and the notice of rescission are delivered, whichever occurs later.<sup>107</sup> Since the later of these events triggers the rescission period, a right to rescind may exist throughout the term of a loan if the lender fails to deliver either the disclosures or the notice of rescission. As long as the right of rescission exists, the consumer may rescind the transaction merely by notifying the creditor by mail, telegram or other written instrument that he intends to do so.<sup>108</sup> Until the rescission period has expired, the creditor is expressly prohibited from disbursing any money other than in escrow.<sup>109</sup>

Upon rescission, the consumer is immediately relieved of all liability for finance or other charges, and the security interest retained by the creditor is automatically void.<sup>110</sup> The burden is then placed upon the creditor to return all money, charges, and fees, including attorney's fees,<sup>111</sup> collected in connection with the transaction and, if necessary, to cancel the security interest on the public records.<sup>112</sup> It is only after the creditor has fulfilled these obligations that the consumer is required to tender the property, or its reasonable value if a return in kind is impracticable, to the creditor.<sup>113</sup> This tender may, at the consumer's option, be made at the site of the property or at the consumer's residence.<sup>114</sup> *If the creditor fails to take possession of the property within ten days after tender, "ownership of the property vests in the [consumer] without obligation on his part to pay for it."*<sup>115</sup>

In the context of a credit-sale transaction, the post-rescission procedure set forth in the Regulation appears to be adequate. Only a seller and

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a change in this required terminology and has suggested that, for the present, creditors footnote the term *home* with a proper explanation when necessary. CCH CORRESPONDENCE ¶ 30,179.

<sup>106</sup> Reg. Z § 226.9(d).

<sup>107</sup> *Id.* § 226.9(a).

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* § 226.9(c)(1).

<sup>110</sup> *Id.* § 226.9(d).

<sup>111</sup> See CCH CORRESPONDENCE ¶ 30,032.

<sup>112</sup> Reg. Z § 226.9(d).

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> *Id.*

purchaser are involved in such a transaction, and the return of money and charges by the seller and the tender by the purchaser may be easily accomplished. However, in the unfortunate event that a loan transaction involving a seller, purchaser, and lender is closed and the loan proceeds disbursed, a difficult situation may be presented upon rescission by the purchaser-borrower. Although the lender can return the fees and charges collected, the borrower is in no position to tender the loan proceeds to the creditor since they are in the hands of the seller. If the seller received a good price for his property, he may refuse to cooperate in effecting the rescission on the grounds that he was not a party to the loan transaction and that a subsequent occurrence affecting the validity of that transaction should not affect his cash sale to the borrower. In view of the fact that the Act governs only the relationship between creditors and borrowers, the resolution of this problem will undoubtedly be left to the courts. In the event that the innocent seller in this situation is required by judicial decision to return the purchase price of the property so that rescission may be effected, he should clearly be allowed to recover from the lender the amount, if any, by which the sales price of the property in the rescinded transaction exceeds the price obtained upon resale of the property. Furthermore, since the blame lies solely upon the lender, it would appear only just that he be required to bear the burden of attorney's fees incurred by the seller and borrower in connection with the litigation.

In order to protect adequately creditor clients in real estate credit transactions, an attorney must be aware that his client may, in certain circumstances, be affected by a right of rescission created in an ancillary transaction. Suppose, for example, that a seller-builder takes back a second mortgage on a consumer's principal dwelling while a bank takes a first purchase-money mortgage. Although the bank's mortgage is not rescindable, the consumer can rescind the credit sale transaction with the builder since the security retained by the builder is a secondary security interest in a principal residence.<sup>116</sup> If the bank disburses the proceeds of the first mortgage and the consumer subsequently elects to rescind the escrowed credit-sale transaction, the deed from the builder to the consumer will probably be returned to the builder and cancelled

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<sup>116</sup> It is assumed for purposes of illustration that disclosure of the credit terms of the second mortgage is made immediately prior to closing so that the right of rescission arising in connection with the second mortgage will exist for three days subsequent to the closing.



of record,<sup>117</sup> and the bank will be left holding a worthless mortgage from the consumer and the proverbial bag.<sup>118</sup> To protect himself, therefore, the creditor must be aware of all aspects of a real estate credit transaction. If a rescindable secondary security interest is involved, the creditor's loan, even though not rescindable, should be closed and held in escrow until the rescission period for the second mortgage has expired. Otherwise, the creditor may find his loan unsecured.

By way of summary, a creditor can adequately protect himself against the harsh effects of rescission merely by taking a number of simple precautions. Real estate loan procedures should be formalized to guard against the possibility that a busy loan officer will fail to recognize that a transaction is rescindable. In all transactions subject to the Act, the creditor should require the borrower to acknowledge, in writing, receipt of credit cost disclosures. If it appears that a transaction will not be rescindable, the creditor should obtain a written statement from the consumer to the effect that the property that is the subject of the transaction is not used, nor is expected to be used, as the principal residence of the consumer. If taken in good faith, this statement should adequately protect the creditor in the event that the consumer asserts otherwise upon a change in circumstances subsequent to the loan closing. Also, whenever possible, transactions should be consummated at the contract or commitment stage so that the rescission period will expire prior to the time costly services are rendered by the creditor and his attorney. If early consummation is not possible, the loan should, of course, be closed and held in escrow pending expiration of the rescission period. When the rescission period expires, the creditor should attempt to obtain a written assurance from the borrower that the right of rescission was not exercised and, in any event, should wait a reasonable time after the

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<sup>117</sup> Only the security interest is voided upon rescission. Reg. Z § 226.9(d). However, the right to rescind relates to the *entire credit sale transaction* and not merely to the security interest retained by the creditor. CCH CORRESPONDENCE ¶ 30,245.

<sup>118</sup> Since the rescinded credit-sale transaction was closed in escrow, the consumer never held title to the property and, accordingly, the consumer's mortgage to the bank created no security interest. On the other hand, if the credit-sale transaction had not been closed in escrow and title had passed to the consumer prior to rescission, it would appear that, upon rescission, the property would be tendered back to the seller-creditor encumbered by the first mortgage. However, since rescission is an equitable remedy under which parties must be restored to their positions prior to the rescission, the consumer in this situation would probably be required under state law to return the proceeds of the first mortgage to the bank, thereby releasing the tendered property from the encumbrance.

period for rescission has expired before disbursing the loan proceeds to insure that rescission was not effected by the borrower's *mailing* a notice of rescission within the three-day period. Finally, a creditor should be fully informed of all aspects of real estate transactions subject to the Act in order to assure that his rights will not be affected by an ancillary credit transaction. When these precautions become standard operating procedure, a creditor will encounter few problems with respect to rescindable transactions.

#### V. CONCLUSION

At this point in the development of Truth-in-Lending law, the role of the attorney is particularly crucial. Without the aid of judicially-tested compliance procedures and comprehensive administrative interpretations, the creditor must look primarily to his attorney for Truth-in-Lending advice. As the consumer becomes more familiar with the Act, the attorney will increasingly be called upon to protect and assert the rights and remedies accorded under the Act. Although it has been the purpose of the writer to assist the attorney in meeting these challenges in the area of real estate transactions, new interpretations and rulings have undoubtedly been issued between the writing and publication of this article. It is necessary, therefore, that this article be used only to develop a basic familiarity with the requirements of the Act and that all concerned with Truth-in-Lending remain constantly alert for new developments.<sup>119</sup>

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<sup>119</sup> Those frequently encountering Truth-in-Lending in real estate transactions are referred to a treatise by Joseph L. Abraham, which will be published in the near future by Commerce Clearing House.