Advisory

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SETTING A HIGHER BAR

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Avoiding Class Actions Under The Truth in Lending Act

As the sub-prime market implodes, many homes are in foreclosure or at the brink of it. As a result, an increasing number of homeowners are searching for ways to avoid foreclosure. One fruitful ground for them is the Truth in Lending Act ("TILA").

The Homeowner's Right To Rescind Under TILA

TILA gives a homeowner the right to rescind his or her transaction with a lender. Enacted in 1968, the purpose of this law is "to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him, avoid the uninformed use of credit, and be protected against inaccurate and unfair credit billing card practices." In short, TILA requires lenders to clearly and accurately disclose credit transaction terms.

The general rule under TILA is that the homeowner has three business days after the closing to exercise his or her right to rescind the transaction. However, if the lender does not give proper notice of the right to rescind, the homeowner has three years to exercise this right. And, the lender is subject to damages for failing to give proper notice to the homeowner.

To comply with the notice requirements under TILA, the lender must deliver two copies of the notice of the right to rescind to the homeowner. The notice must clearly and conspicuously disclose the following:

(a) the retention of a security interest in the homeowner's principal dwelling;
(b) the homeowner's right to rescind;
(c) instructions on how to exercise the right to rescind;
(d) the effects of rescission; and
(e) the date the rescission period expires.

Class Actions

TILA expressly authorizes class actions against lenders. If a class is successful in their claim, a lender faces damages of up to $500,000 or 1% of the lender's net worth, whichever is less, and must pay attorneys' fees, which can be significant. It is prudent for lenders to take a close look at their TILA notices and to review their protocols for providing homeowners' notice of their right to rescind under TILA.

Reducing Risk of Class Actions

A growing defense against TILA class actions is to **include an arbitration clause** in the credit agreement. An arbitration clause may protect some lenders from these actions.

Some courts have rejected the argument that banning class actions is against the legislative intent of TILA and thus should be prohibited. In so holding, these courts have stated that TILA does not preclude parties from engaging in arbitration and that arbitration does not irreconcilably conflict with the purposes of the Act. Lenders should consult the Federal Arbitration Act when drafting arbitration clauses to ensure they are drafted properly.

Lenders should be aware that arbitration clauses in credit agreements are not always upheld by the courts. Some courts have taken the position that the arbitration clause is unconscionable and against public policy. These courts have reasoned that if the costs of arbitrating a claim are "prohibitively high," the parties should be required to litigate the claim instead of arbitrating it. The homeowner making the claim of unconscionable expenses, however, must prove with particularized evidence that (s)he will likely face prohibitive costs and that (s)he is financially incapable of meeting those costs. If the parties agree that any arbitration will be governed by the National Arbitration Forum ("NAF"), lenders can add a clause stating that **arbitration fees may be waived** by the NAF if the homeowner proves his or her financial inability to cover the arbitration costs. In some cases, creditors have agreed to pay or advance to the consumer the fees of arbitration in an attempt to alleviate his or her concern regarding high arbitration costs.

In conjunction with the arbitration clause, lenders should include an explicit provision stating that **borrowers waive their right to class actions** as a result of the clause. Homeowners should be adequately notified of the legal ramifications of consenting to arbitration, including their lost ability to commence class actions. An example of an adequate provision is: "Arbitration replaces the right to go to court, including the right to a jury and the right to participate in class actions." While the waiver of class actions is inherent in agreements to arbitrate, lenders could further insulate themselves from allegations of unconscionable business tactics by plainly and unequivocally spelling out the consequences of the arbitration clause.

Conclusion

As a result of the crisis in the housing market, lenders are exposed to increased litigation under TILA. Lenders must, therefore, take precautions to reduce their risk to TILA claims and class actions. In that regard, lenders should take a close look at their TILA notices to ensure compliance with the law and review their protocols for providing homeowners' with notice of their right to rescind under TILA.

This advisory was written by David A. Scheffel, Esq., counsel to the firm and a member of the commercial litigation practice group. If you have questions regarding this advisory, please contact Mr. Scheffel at 516.227.0627 or dscheffel@farrellfritz.com.