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Truth in Lending: The Right to Rescind and the Statute of Limitations

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Comment

Truth in Lending: The Right to Rescind and the Statute of Limitations

I. Introduction

By enacting section 125[1] of the Truth in Lending Act,[2] Congress sought to protect consumers in transactions creating a security interest in a consumer's principal dwelling.[3] Under this section, a cooling-off period of three business days is provided in which a consumer may rescind or cancel the transaction, presumably after more deliberate consideration.[4] If statutory requirements are not met, however, the right to rescind extends for three years after consummation of the transaction.[5] A problem of statutory interpretation has arisen regarding the effect of

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1. 15 U.S.C. § 1635(a)-(g) (1988).

2. 15 U.S.C. §§ 1601-1665b (1988).

3. N.C. Freed Co. v. Board of Governors of the Federal Reserve System, 473 F.2d 1210, 1214 (2d Cir. 1973).

4. 15 U.S.C. § 1635(a) (1988). The statute provides:

> Except as otherwise provided . . . in the case of any consumer credit transaction . . . in which a security interest . . . is or will be retained or acquired in any property which is used as the principal dwelling of the person to whom credit is extended, the obligor shall have the right to rescind the transaction until midnight of the third business day following the consummation of the transaction or the delivery of the information and rescission forms required under this section together with a statement containing the material disclosures required under this subchapter, whichever is later . . . .

Id.

5. 15 U.S.C. § 1635(f) (1988). The section provides:

> An obligor's right of rescission shall expire three years after the date of consummation of the transaction, or upon sale of the property, whichever occurs first, notwithstanding the fact that the information and forms required under this section or any other disclosures required under this part have not been delivered to the obligor . . . .

Id.

the three-year limitation period on the right to rescind when the consumer asserts the right as a defense to a creditor's cause of action, rather than as a claim for affirmative relief.[6] Although only two cases have been decided on the issue, the courts that have considered the question have held that the consumer's right to rescind may be asserted as a defense by recoupment[7] after the statutory limitation period has ended.[8]

This Comment begins its analysis by setting forth the history and purpose of the Truth in Lending Act in Part II and delineating the statutory right of rescission. Part III proceeds to analyze common law recoupment and its relationship to statutes of limitation. The precedential value of litigation concerning civil liability brought under section 130 of the Truth in Lending Act,[9] upon which courts deciding the rescission issue have relied, is discussed in Part IV. Part V then examines the primary cases that have directly considered the defensive claim of rescission beyond the limitation period, both of which held that the claim remains effective to defeat or reduce creditors' affirmative actions. These courts interpreted the provisions of the Truth in Lending Act broadly to achieve its purpose of consumer protection. The Comment then analyzes the economic effect of affording a rescission remedy after the three-year limitation period has expired, finding that the penalty increases over time. In light of this increasing penalty, analogy to section 130 penalties, which are capped at $1,000, is deemed inappropriate. The policy rationale underlying recoupment doctrine, the Comment concludes, is not called into play absent detrimental reliance by a consumer or other inequitable conduct by the creditor. Therefore, rescission should not be allowed on a theory of recoupment without clear congressional intent in the Act.

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6. *Id.*

7. Recoupment is defined as "a right of the defendant to have a deduction from the amount of the plaintiff's damages, for the reason that the plaintiff has not complied with the cross-obligations or independent covenants arising under the same contract." BLACK'S LAW DICTIONARY 1275 (6th ed. 1990).

8. Dawe v. Merchants Mortgage & Trust, 683 P.2d 796 (Colo. 1984); FDIC v. Ablin, 532 N.E.2d 379 (Ill. App. Ct. 1988).

9. 15 U.S.C. § 1640(a)-(h) (1988).

II. The Truth in Lending Act and the Right to Rescind

A. *The Truth in Lending Act*

Enacted in 1968, the Truth in Lending Act was the first federal consumer protection law and is considered a leading consumer protection statute.[10] The Act regulates primarily by mandating standard terminology and uniform disclosure requirements;[11] it is an information protection device aimed at allowing informed credit shopping.[12] In this way, not only does the individual consumer benefit by the ability to make an informed choice, but the market efficiency so achieved provides benefits to consumers and society generally.[13]

The Act provides, however, for certain behavioral or market protection goals.[14] These provisions "involve direct governmental interventions to affect market behavior of participants (especially businesses) . . . ."[15] Among these is the requirement of a cooling-off period for credit secured by the consumer's home—the right to rescind.[16]

The right to rescind arises when a consumer enters into a non-purchase-money transaction that grants a security interest in the consumer's principal dwelling.[17] If the creditor complies

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10. S. REP. No. 73, 96th Cong., 1st Sess. 2 (1979), *reprinted in* 1980 U.S.C.C.A.N. 280, 280 [hereinafter SENATE REPORT]. The Truth in Lending Act § 102 provides:

> The Congress finds that economic stabilization would be enhanced and the competition among the various financial institutions . . . would be strengthened by the informed use of credit. The informed use of credit results from an awareness of the cost thereof by consumers. It is the purpose of this subchapter 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 and avoid the uninformed use of credit, and to protect the consumer against inaccurate and unfair credit billing and credit card practices.

15 U.S.C. § 1601(a) (1990).

11. Joseph A. Dworetzky, Comment, *Truth in Lending and the Statute of Limitations*, 21 VILL. L. REV. 904, 909-10 (1975-76). *See also* FEDERAL RESERVE BOARD, REGULATORY ANALYSIS OF REVISED REGULATION Z, 46 Fed. Reg. 20,941 (1981) [hereinafter ANALYSIS].

12. SENATE REPORT, *supra* note 10, at 280.

13. *Id.*

14. ANALYSIS, *supra* note 11, at 20,946.

15. *Id.* at 20,944.

16. *Id.* at 20,946.

17. 15 U.S.C. § 1635(a) (1988).

with the requirements of the Act, then the consumer's right to rescind expires three business days after the last of three events: the date of the transaction, the furnishing of material disclosures, or the furnishing of two properly completed copies of a notice of right to cancel.[18] If the creditor fails to comply, then the consumer's right to rescind continues for three years or until sale of the property, whichever occurs earlier.[19]

The Truth in Lending Act and the implementing regulations[20] provide specific procedures the creditor must follow if the consumer rescinds.[21] The exercise of the right itself cancels the security interest, and the creditor must take the necessary steps to so indicate.[22] The creditor must also return all amounts paid by the consumer in connection with the transaction, even if paid to third parties.[23] Only then must the consumer return the money or property given by the creditor in connection with the transaction.[24] Courts are specifically authorized to modify the procedure in equity.[25] Thus, in a normal loan transaction, it is likely a creditor will be allowed to net any amount it owes the consumer from the amount the consumer must return to the creditor. This is particularly so if the rescis-

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18. *Id.*

19. *Id.* § 1635(f).

20. Regulation Z of the Federal Reserve Board, 12 C.F.R. §§ 226.1-.30 (1993).

21. 15 U.S.C. § 1635(b) (1988). The statute provides:

> Within 20 days after receipt of a notice of rescission, the creditor shall return to the obligor any money or property given as earnest money, down payment, or otherwise, and shall take any action necessary or appropriate to reflect the termination of any security interest created under the transaction. If the creditor has delivered any property to the obligor, the obligor may retain possession of it. Upon the performance of the creditor's obligations under this section, the obligor shall tender the property to the creditor . . . . The procedures prescribed by this subsection shall apply except when otherwise ordered by a court.

Id.

22. 15 U.S.C. § 1635(b) (1988). Regulations further provide that "[w]hen a consumer rescinds a transaction, the security interest giving rise to the right of rescission becomes void and the consumer shall not be liable for any amount, including any finance charge." 12 C.F.R. § 226.23(d)(1) (1993).

23. 12 C.F.R. § 226.23(d)(2) (1993).

24. *Id.* § 226.23(d)(3).

25. *Id.* § 226.23(d)(4).

sion is raised solely in defense to the creditor's claim as a reduction of the amount due the creditor on the note.[26]

In some cases, the consumer first attempts to exercise the right to rescind when the creditor brings an action in foreclosure after the consumer's default. If this occurs more than three years after the date of the transaction that gave rise to the right to rescind, the creditor did not meet the statutory disclosure or notice requirements, and the consumer raises the right in defense of the foreclosure action, the issue at hand arises.

B. *The Truth in Lending Simplification and Reform Act*

The original Truth in Lending Act was considered effective in fostering increasing consumer awareness of credit costs and, indirectly, greater market efficiencies.[27] Despite its success, experience during the first decade under its provisions indicated improvements were called for.[28]

The Act is complex and technical. Even more complex is Regulation Z, promulgated by the Federal Reserve Board to effectuate the Act. "By early 1980 the Act filled 20 printed pages in 52 numbered sections, many with lengthy subdivisions. The regulation measured 53 printed pages in 153 highly technical sections . . . ."[29] Between 1968 and 1980 the Federal Reserve Board had issued more than 1500 interpretations and more than 1300 lawsuits had been filed in federal courts, "representing 2 per cent of the [f]ederal civil caseload."[30] Compliance with the Act was difficult. "Federal bank regulatory agencies reported that more than 80 per cent of banks were not wholly in compliance, although most violations were judged 'nonsubstantive' or 'technical'."[31]

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26. The Simplification Act specifically authorizes courts to adjust the rescission procedure to apply equitable principles. *See infra* note 44 and accompanying text. *See also infra* text accompanying note 214 for an example of the effect of rescission on a hypothetical transaction.

27. SENATE REPORT, *supra* note 10, at 280.

28. *Id.* at 281.

29. ANALYSIS, *supra* note 11, at 20,941-42.

30. *Id.* at 20,942.

31. *Id.* (citing BOARD OF GOVERNORS OF THE FED. RESERVE SYS., ANNUAL REPORT TO CONGRESS ON TRUTH IN LENDING FOR THE YEAR 1978, at 10-11 (1979)).

In response, Congress passed the Truth in Lending Simplification and Reform Act.[32] The Simplification Act focused on four major areas: providing simpler, more understandable information to the consumer, making creditor compliance easier, limiting civil liability for creditors to significant violations only, and strengthening provisions for administrative enforcement.[33]

Creditor's civil liability for statutory penalties was limited to disclosure violations of central importance only.[34] In closed-end transactions,[35] the Simplification Act provided that liability attached only to violations regarding "disclosure of the amount financed, the finance charge, the total of payments, the annual percentage rate, the number, amount and due dates of payments, any security interest taken, and, where applicable, the consumer's right of rescission."[36] In open-end transactions, liability continued to attach to most of the specific disclosure requirements.[37] Under this provision, a consumer may recover twice the amount of the finance charge, but not less than $100 nor more than $1000.[38] These penalties are available without any showing of damage by the consumer, who may also recover actual damages sustained.[39]

In considering the Simplification Act, Congress gave specific attention to the defensive use of section 130 truth in lending claims. The Simplification Act explicitly provided that a

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32. Truth in Lending Simplification and Reform Act, Pub. L. No. 96-221, 94 Stat. 168 (1980) [hereinafter Simplification Act].

33. SENATE REPORT, *supra* note 10, at 281.

34. *Id.*

35. For purposes of the Truth in Lending Act, closed-end credit is defined as consumer credit other than open-end credit. 12 C.F.R. § 226.2(a)(10) (1993). The regulation defines open-end credit as follows:

> "Open-end credit" means consumer credit extended by a creditor under a plan in which:
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> (i) The creditor reasonably contemplates repeated transactions;
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> (ii) The creditor may impose a finance charge from time to time on an outstanding unpaid balance; and
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> (iii) The amount of credit that may be extended to the consumer during the term of the plan . . . is generally made available to the extent that any outstanding balance is repaid.

12 C.F.R. § 226.2(a)(20) (1993).

36. SENATE REPORT, *supra* note 10, at 285.

37. *Id. See supra* note 35 for a definition of open-end credit.

38. 15 U.S.C. § 1640(a)(2)(A)(i) (1988) [hereinafter § 130 penalties].

39. *Id.* § 1640(a)(1).

consumer may assert a defensive truth in lending claim in recoupment or offset beyond the one-year limitation period applicable to these claims, unless otherwise prohibited by state law.[40] In so doing, Congress settled an issue that had divided the courts that had considered the question.[41]

Congress amended provisions dealing with the right of rescission as well. Material disclosures were limited by definition to the ones of central importance.[42] Thus, misdisclosure of other, non-material terms did not prevent the three day cooling-off period from running.[43] When a consumer exercised the right to rescind, the Simplification Act provided that courts were authorized to impose equitable conditions on the precise procedural requirements mandated by the Act to afford adequate protection to the creditor.[44] Furthermore, the time for creditors to respond was lengthened to twenty days.[45]

Congress further provided amendments expanding the right to rescind. Key among these was:

> an important provision designed to preserve the consumer's right of rescission where an enforcement agency is investigating whether a creditor has failed to inform the consumer of his right. . . . This will assure that the maximum 3 year period for rescinding . . . does not expire before a consumer's rights are adjudicated by an enforcing agency.[46]

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40. Simplification Act § 615(d)(4) (amending Truth in Lending Act § 130, codified at 15 U.S.C. § 1640(e) (1988)).

41. *See infra* part IV.

42. Section 612(a)(2) of the Simplification Act defines material disclosure as disclosure of:

> the annual percentage rate, the method of determining the finance charge and the balance upon which a finance charge will be imposed, the amount of the finance charge, the amount to be financed, the total of payments, the number and amount of payments, and the due dates or periods of payments scheduled to repay the indebtedness.

15 U.S.C. § 1602(u) (1988).

43. Simplification Act § 612(a)(1) (amending Truth in Lending Act § 125, codified at 15 U.S.C. § 1635(a) (1988)).

44. Simplification Act § 612(a)(4) (amending Truth in Lending Act § 125, codified at 15 U.S.C. § 1635(b) (1988)); *see also* S. REP. No. 368, 96th Cong., 2d Sess. 29 (1980), *reprinted in* 1980 U.S.C.C.A.N. 236, 265.

45. Simplification Act § 612(a)(3) (amending Truth in Lending Act § 125, codified at 15 U.S.C. § 1635(b) (1988)).

46. SENATE REPORT, *supra* note 10, at 292. The Simplification Act § 608(a) (amending the Truth in Lending Act § 125, codified at 15 U.S.C. § 1697 (1988)), generally strengthened the power of enforcement agencies to force restitution to

III. Limitations and Recoupment

A statute of limitation serves both private and public purposes.[47] The direct effect is to insure repose for potential defendants after lapse of time.[48] It encourages prompt assertion of claims to allow full and fair litigation of the issues while witnesses are available, memories are fresher, documents can be produced and final judgments can be rendered.[49] Thus, the private interests of potential defendants are served, while the public interests are served as well by keeping stale litigation out of the courts, barring inefficient use of limited public resources.[50]

Recoupment, on the other hand, is a common law doctrine which allows the defensive use of a claim to reduce or defeat plaintiff's claim if both claims arise from the same transaction.[51] Recoupment is generally considered timely as a defense, although barred by limitation as an affirmative claim.[52] It is grounded in equity to prevent the defeat of otherwise valid defenses, which in fairness will be considered despite the expiration of the applicable limitation period, so long as plaintiff's claim is before the court.[53] Recoupment promotes efficient use of judicial resources as well by avoiding circuity of action and multiplicity of lawsuits, allowing simultaneous adjudication of claims arising from the same transaction.[54]

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consumers for truth in lending violations. Enforcement responsibility is assigned to any of a number of agencies, depending upon the regulated entity. Enforcement agencies include the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the National Credit Union Administration. 15 U.S.C. § 1607(a) (1988). If enforcement is not otherwise delegated, the Federal Trade Commission bears enforcement responsibility. 15 U.S.C. § 1607(c) (1988). The Simplification Act further provided that the right to rescind shall extend to one year after the conclusion of an enforcement proceeding despite the expiration of the three-year limitation period, unless the property had been sold. 15 U.S.C. § 1635(f) (1988).

47. 51 AM. JUR. 2D *Limitation of Actions* § 18 (1970 & Supp. 1992).

48. *Id.* § 17.

49. *Id.* §§ 18, 19.

50. *Id.* § 19.

51. *Id.* § 77; *see also* Dworetzky, *supra* note 11, at 905, 907.

52. 51 AM. JUR. 2D *Limitation of Actions* § 77 (1970 & Supp. 1992).

53. Bull v. United States, 295 U.S. 247, 262 (1935). For a discussion of *Bull*, see *infra* notes 65-70 and accompanying text. *See also* 20 AM. JUR. 2D *Counterclaim, Recoupment, and Setoff* § 6 (1965).

54. 20 AM. JUR. 2D *Counterclaim, Recoupment, and Setoff* § 6 (1965).

Courts have drawn a distinction between a true limitation statute and a statute that specifically creates a right and simultaneously limits the time in which it may be asserted.[55] A true limitation statute is thought to extinguish only the right to enforce a remedy;[56] a statute creating a time-limited right is thought to extinguish the existence of the right itself upon the passage of the applicable time period.[57] Courts have used the short-hand term "procedural" for the first type and "substantive" for the second.[58]

Courts have almost uniformly allowed true recoupment claims to survive general (procedural) statutes of limitation.[59] These decisions conform with the underlying fairness of allowing valid defenses to be raised to reduce or defeat a claim, while not conflicting with the purpose of keeping stale litigation out of court.[60] Courts have split, however, when defendant's claim is asserted under a statute creating the right and containing its (substantive) limitation as well.[61]

Whether a limitation is procedural or substantive is a matter of statutory construction.[62] It is persuasive, but not conclusive, that the limitation is contained in the same statute creating the right.[63] Thus, a statute that on its face is substantive may still be given effect as if procedural, allowing for assertion of the right under appropriate circumstances.[64]

Federal common law has adopted this view. An often cited and leading case is *Bull v. United States*.[65] The case arose when the Internal Revenue Service adopted the position that a decedent's partnership interest had been undervalued and was therefore subject to estate tax, which the executor paid.[66] After

55. 51 AM. JUR. 2D *Limitation of Actions* § 21 (1970 & Supp. 1992).
56. *Id.* § 15.
57. *Id.*
58. *Id.* § 21.
59. *See* 51 AM. JUR. 2D *Limitation of Actions*, *supra* note 52, § 77 and accompanying text.
60. *See* 51 AM. JUR. 2D *Limitation of Actions*, *supra* note 52, § 77.
61. *Id.* § 15.
62. *Id.*
63. *Id.*
64. *See* Lincoln First Bank v. Rupert, 60 A.D.2d 193, 196-97, 400 N.Y.S.2d 618, 619 (4th Dep't 1977) (construing the Truth in Lending Act).
65. 295 U.S. 247 (1935).
66. *Id.* at 252.

the time to claim a refund had passed, the I.R.S. then characterized the same amount as income and claimed a deficiency, despite the fact that the amount could not be both income and corpus.[67] The *Bull* court held that the income characterization was correct, but the executor could nonetheless assert the refund claim for estate taxes by recoupment:[68] "This is because recoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded. Such a defense is never barred by the statute of limitations so long as the main action itself is timely."[69]

In reaching its conclusion, the Court relied on the unjust enrichment that would otherwise accrue to the United States, the executor's reliance on the initial I.R.S. position, the subsequent reversal of that position, and the power of the I.R.S. to issue assessments with the force of judgments.[70]

Following the decision of the *Bull* Court, additional federal litigation has reached similar results. In *Pennsylvania Railroad v. Miller*,[71] the Fifth Circuit Court of Appeals was confronted with a suit to collect unpaid freight charges.[72] The bill of lading covering the shipment provided that the carrier was not liable for damage to the consigned goods if suit was not brought within two years and one day after notice of a disallowed claim for the loss.[73] Claims of loss were disallowed prior to May 31, 1936, and the carrier filed suit for the unpaid portion of the freight charges on June 10, 1938;[74] the defendant asserted the negligence of the carrier as a defense to the carrier's claim.[75] The court viewed this as a defense by way of recoupment, holding that the provision in the bill of lading did not bar the claim.[76] The defendant sought no affirmative damages "rather, he challenged the right of the carrier in equity and good conscience to recover . . . on the cause of action alleged."[77] The

67. *Id.* at 252, 255.
68. *Id.* at 254, 262.
69. *Id.* at 262.
70. *Id.* at 258-60.
71. 124 F.2d 160 (5th Cir. 1941).
72. *Id.* at 161.
73. *Id.*
74. *Id.*
75. *Id.*
76. *Id.* at 161, 162.
77. *Id.* at 161-62.

court explained that recoupment is not a set-off or counterclaim, because it is not an affirmative demand, "but rather it lessens or defeats any recovery by the plaintiff."[78] The court summarized its view of recoupment as follows:

> Recoupment goes to the foundation of plaintiff's claim; it is available as a defense, although as an affirmative cause of action it may be barred by limitation. The defense of recoupment, which arises out of the same transaction as plaintiff's claim, survives as long as the cause of action upon the claim exists. It is a doctrine of an intrinsically defensive nature founded upon an equitable reason, inhering in the same transaction, why the plaintiff's claim in equity and good conscience should be reduced.[79]

Thus, the *Miller* court upheld the recoupment defense in this dispute revolving around the contractual limitation period.[80]

In *United States v. Western Pacific Railroad*,[81] the Supreme Court was confronted with construing a two-year statutory limitation period in the Interstate Commerce Act,[82] which on its face barred the government from asserting a claim in recoupment against the railroad's affirmative action. This was a suit by common carriers initiated in the Court of Claims to recover from the United States, as shipper, the difference between the amounts actually paid and the amounts allegedly due.[83] The Court of Claims determined that the carrier's actions were subject to a six-year limitation period under the Tucker Act,[84] while the government's defense of unreasonableness was subject to a two-year limitation period under the Interstate Commerce Act.[85]

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78. *Id.* at 162.

79. *Id.* (footnotes omitted).

80. *Id.*

81. 352 U.S. 59 (1956).

82. *Id.* at 70 (construing § 16(3)(a) of the Interstate Commerce Act, codified at 49 U.S.C. § 16(3) (1988)).

83. *Id.* at 60.

84. *Id.* at 70 (citing the Tucker Act, 28 U.S.C. § 2501 (1988) (providing that every claim under the jurisdiction of the Court of Claims is barred unless brought within six years)).

85. *Id.* at 70-71. "Relying on the broad language of the . . . [Tucker] [A]ct, the Court of Claims has, since 1926, consistently held that § 16(3) [of the Interstate Commerce Act] does not apply to suits by carriers to recover alleged undercharges from the United States as shipper." *Id.* at 70.

The Court reasoned that the purpose of statutes of limitation "is to keep stale litigation out of the courts."[86] That purpose was not implicated once the dispute was before the court:

> To use the statute of limitations to cut off the consideration of a particular defense . . . is quite foreign to the policy of preventing the commencement of stale litigation. We think it would be incongruous to hold that once a lawsuit is properly before the court, decision must be made without consideration of all the issues in the case . . . . If this litigation is not stale, then no issue in it can be deemed stale.[87]

The Court further stated that "[o]nly the clearest congressional language could force us to a result which would allow a carrier to recover unreasonable charges with impunity merely by waiting two years before filing suit."[88]

In *Burnett v. New York Central Railroad*,[89] the Supreme Court was confronted with the assertion of an offensive claim by the plaintiff beyond the statutory limitation period.[90] An employee of the defendant railroad instituted an action in state court under the Federal Employers' Liability Act (FELA), which was dismissed for improper venue.[91] Eight days later suit was filed in federal district court.[92] Although the state action was timely, during the eight days the applicable three-year limitation period expired, and the district court dismissed the action as untimely.[93] The court of appeals affirmed, holding that the limitation was "substantive" rather than "procedural," and therefore was extinguished after three years.[94]

In holding that the statute of limitations had been tolled by the state action, the Court began by stating that "whether, under a given set of facts, a statute of limitations is to be tolled, is one 'of legislative intent whether the right shall be enforcea-

86. *Id.* at 72.
87. *Id.*
88. *Id.* at 71.
89. 380 U.S. 424 (1965).
90. *Id.* at 425.
91. *Id.* at 424.
92. *Id.* at 425.
93. *Id.*
94. *Id.*

ble . . . after the prescribed time'[95]. . . . Classification . . . as 'substantive' rather than 'procedural' does not determine whether or under what circumstances the limitation period may be extended."[96]

To determine congressional intent, the Court continued, "the purposes and policies underlying the limitation provision, the Act itself, and the remedial scheme developed for the enforcement of the rights given by the Act" must be examined.[97] Statutes of limitation, the Court reasoned, are designed to protect defendants from unfair surprise.[98] "The theory is that even if one has a just claim it is unjust not to put the adversary on notice to defend within the period of limitation . . . ."[99]

The policy to protect defendants, however, "is frequently outweighed . . . where the interests of justice require vindication of plaintiff's rights."[100] The Court then considered that the action had been timely filed, that most states had statutes that would permit transfer of the action or relation back to the initial date of filing, and that the defendant had been properly served under state law.[101] Thus, the Court concluded that congressional intent was to toll the statute under these circumstances.[102]

IV. Defensive Section 130 Claims and the One-year Limitation

Because of the limited litigation on the defensive use of rescission, both courts in the rescission cases found precedential value in decisions of courts considering defensive claims for section 130 penalties under the Act after the applicable one-year limitation period.[103] Congress, of course, settled the issue in

95. *Id.* at 426 (quoting Midstate Horticultural Co. v. Pennsylvania R.R., 320 U.S. 356, 360 (1943)).

96. *Id.* at 426-27.

97. *Id.* at 427.

98. *Id.* at 428.

99. *Id.* (quoting Order of R.R. Tels. v. Railway Express Agency, Inc., 321 U.S. 342, 348-49 (1944)).

100. *Id.* at 428.

101. *Id.* at 431, 434, 435.

102. *Id.* at 432-35.

103. Dawe v. Merchants Mortgage & Trust, 683 P.2d 796 (Colo. 1984); FDIC v. Ablin, 532 N.E.2d 379 (Ill. App. Ct. 1988).

favor of the survival of the defensive civil penalty claim by amendment in the Simplification Act.[104] A review of the cases however, will add to the consideration of the survival of the right to rescind by recoupment.

A. *The Argument for Recoupment*

A line of cases allowing recoupment based their holdings on the underlying purposes of the Truth in Lending Act and a sufficiently broad interpretation of federal common law recoupment to allow, if not mandate, defensive claims after the one-year limitation. An early and often-cited case is *Wood Acceptance Co. v. King.*[105]

In *Wood*, the plaintiff sued on a deficiency judgment and the defendant counterclaimed, asserting truth in lending violations and seeking civil penalties.[106] The court applied state law to interpret the one-year limitation in the Act.[107] Under state law, substantive limitations were to be interpreted in light of the purposes of the law creating the limitation;[108] rote reliance on substantive or procedural classifications was specifically rejected.[109] The court reasoned that the Truth in Lending Act was meant to safeguard the consumer in the use of credit, and enforcement was placed largely in the hands of individual consumers.[110] Thus, the *Wood* court found that the "one year

104. *See supra* notes 40-41 and accompanying text.

105. 309 N.E.2d 403 (Ill. App. Ct. 1974).

106. *Id.* at 404.

107. *Id.* at 405. The court relied on § 17 of the Illinois Limitations Act, ILL. REV. STAT. ch. 83, para. 18 (1971), which provides: "A defendant may plead a set-off or counter claim barred by the statute of limitation, while held and owned by him, to any action, the cause of which was owned by the plaintiff . . . before such set-off or counter claim was so barred . . . ." *Wood*, 309 N.E.2d at 404.

108. *Wood*, 309 N.E.2d at 405. The *Wood* court relied on Helle v. Brush, 292 N.E.2d 372 (Ill. 1973). The issue in *Helle* was whether defendant's counterclaim arising out of the same occurrence, could be filed against a public entity despite failure to give timely notice to the entity under applicable law. *Id.* at 373. The *Helle* court found that the purposes of § 17 of the Limitations Act, ILL. REV. STAT. ch. 83, para. 18 (1967), were a concern for fundamental fairness and a desire to grant defendant a full hearing. These purposes outweighed the notice requirements under the applicable Illinois law, Local Government and Governmental Employees Tort Immunity Act, ILL. REV. STAT. ch. 85, para. 8-102, 8-103 (1967). *Helle*, 292 N.E.2d at 374-75.

109. *Wood*, 309 N.E.2d at 405.

110. *Id.*

limitation . . . is not such an integral part of the Federal Truth in Lending Act as to outweigh the combined purposes of that Act and the . . . [Illinois] Limitations Act."[111]

In *Shannon v. Carter*,[112] the Supreme Court of Oregon sitting *en banc* upheld the defensive assertion of a truth in lending claim. Shannon was sued to recover the balance owing on a retail installment contract to Associates Financial Services Co., the plaintiff below.[113] The *Shannon* court looked to federal law in concluding that limitation periods could be extended by recoupment or otherwise, depending upon congressional intent.[114] The court further reviewed common law recoupment, deciding that the rationale underlying recoupment is to avoid inequity.[115] In upholding the defensive claim, the court reasoned that the primary purpose of the civil liability section was one of enforcement.[116]

In *Household Consumer Discount Co. v. Vespaziani*,[117] the Supreme Court of Pennsylvania explicitly considered the issue of whether federal or state common law governs, and whether a defensive claim under section 130 of the Act is one in recoupment or set-off. Defendant Vespaziani was sued on two notes dated in 1972 that were in default; plaintiff's action was begun in 1976.[118] The defendant asserted violation of the Truth in Lending Act defensively as a common law recoupment.[119]

The court first concluded that federal common law governs, because of concerns for uniformity and certainty in enforcing federally created rights.[120] In confronting the second issue, the

111. *Id.*
112. 579 P.2d 1288 (Or. 1978).
113. *Id.* at 1288-89.
114. *Id.* at 1289.
115. *Id.* at 1290.
116. *Id.*
117. 415 A.2d 689 (Pa. 1980); *see infra* text accompanying note 148 for the distinction between recoupment and set-off.
118. *Vespaziani*, 415 A.2d at 690.
119. *Id.*
120. *Id.* at 691-93. The court reasoned that a state court must enforce federal law or violate the Supremacy Clause of the United States Constitution. U.S. CONST. art. VI, cl. 2. The court relied on the following cases. In Dice v. Akron, Canton & Youngstown R.R., 342 U.S. 359 (1952), at issue was the validity of a written release from liability signed by the employee under the Federal Employer's Liability Act (FELA). *Vespaziani*, 415 A.2d at 691. In reversing the decision below, the Supreme Court reasoned that a federally created standard could be evis-

court reasoned that both the action on the debt and the penalties for the truth in lending violation arose from the same transaction.[121] Furthermore, the requirement to accurately disclose the cost of the credit was at the very heart of the contract, and was therefore an integral part of the transaction.[122] The court concluded that the defensive claim was one in recoupment.[123] It went on to hold that recoupment should be allowed beyond the one-year limitation.[124] Its holding was based on the superior position of the lender in the market, the consumer's inability to determine proper compliance without legal assistance, which normally is first obtained when the creditor forces legal action, and the fear that a creditor could avoid penalties by delaying suit until the limitation period had expired.[125]

The court in *Vespaziani* found support for its holding in *Plant v. Blazer Financial Services, Inc.*,[126] which held that a creditor's counterclaim for amounts due on the underlying note was mandatory when the consumer sued, seeking section 130 penalties for disclosure violations.[127] The facts are straightforward. Plant executed a note in July, 1975.[128] Making no payments thereon, Plant brought an action in federal district court in July, 1976, asserting failure of the creditor to make the required disclosures.[129] The district court allowed defendant's counterclaim under state law on the note, despite no independent basis for federal court jurisdiction, ruling the counterclaim

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cerated if interpretation was left to state law. Moreover, uniform application of federal law was essential to achieve its purpose. In Clearfield Trust Co. v. United States, 318 U.S. 363 (1943), the United States was denied recovery on a forged check due to failure to comply with a notice requirement under Pennsylvania law. The Supreme Court reversed, holding that the rights and duties of the United States on commercial paper are governed by federal law, essential to uniform application of the law. *Vespaziani*, 415 A.2d at 691-92. For an excellent discussion of this issue, see Dworetzky, *supra* note 11, at 915 n.58 (concluding that federal common law governs claims under the Truth in Lending Act).

121. *Vespaziani*, 415 A.2d at 696.

122. *Id.*

123. *Id.* at 697.

124. *Id.*

125. *Id.* at 696.

126. 598 F.2d 1357 (5th Cir. 1979).

127. *Id.* at 1363.

128. *Id.* at 1359.

129. *Id.*

was mandatory.[130] On appeal, Plant claimed the district court erred, characterizing the counterclaim as permissive, and asserting dismissal for lack of subject matter jurisdiction.[131]

The *Plant* court adopted the "logical relationship" test promulgated in *Revere Copper & Brass, Inc. v. Aetna Casualty & Surety Co.*,[132] in which a counterclaim is considered compulsory if it arises from the same "aggregate of operative facts" as the opponent's claim.[133] Applying this test, the court found the conditions were met.[134] The obvious factual overlap, a desire for judicial economy, and a willingness to grant the defendant a convenient forum for vindication of the defendant's claim mandated classification of the counterclaim as compulsory.[135]

A decision that provides a well-reasoned summary of the pro-recoupment line of cases is *Beneficial Finance Co. v. Swaggerty*.[136] The defendant executed a promissory note in October, 1974.[137] In July, 1976, after default on the note, the plaintiff sued for the balance due.[138] Defendant counterclaimed, alleging violations of the Truth in Lending Act and praying for section 130 penalties.[139] On motion for summary judgment, the trial court dismissed the counterclaim as time-barred, reasoning that the one-year limitation period was "substantive."[140] The appellate division affirmed, holding that recoupment was un-

130. *Id.* Rule 13(a) of the Federal Rules of Civil Procedure provides: "Compulsory Counterclaims. A pleading shall state as a counterclaim any claim which at the time of serving the pleading the pleader has against the opposing party, if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim . . . ." FED. R. CIV. P. 13(a).

131. *Plant*, 598 F.2d at 1359-60.

132. 426 F.2d 709, 714 (5th Cir. 1970).

133. *Plant*, 598 F.2d at 1361 (quoting Revere Copper & Brass, Inc. v. Aetna Casualty & Surety Co., 426 F.2d 709, 715 (5th Cir. 1970)).

134. *Id.*

135. *Id.* at 1363, 1364. In so holding, the *Plant* court rejected cases and commentary to the contrary. These contrary holdings rest upon concern for affording an efficient forum for vindication of the consumer-plaintiff's federally created rights, recognizing the consumer's role as essential to proper enforcement of the Truth in Lending Act. *Id.* at 1361-62.

136. 432 A.2d 512 (N.J. 1981). The case was consolidated with Consumers Fin. Servs. v. Taylor. It is the facts of this second case that are discussed.

137. *Id.* at 514.

138. *Id.*

139. *Id.*

140. *Id.*

available because the counterclaim did not arise from the same transaction as the plaintiff's claim for default on the note.[141]

In reversing, the New Jersey Supreme Court applied federal common law to decide that the counterclaim was a claim in recoupment and was not barred by the one-year limitation period.[142] Echoing previous decisions, the court began its analysis of which law governs with the Supremacy Clause of the United States Constitution.[143] The court proceeded in its analysis to Supreme Court doctrine enunciated in *Burnett v. New York Central Railroad*[144] and *Dice v. Akron, Canton & Youngstown Railroad.*[145] Consistent with a policy of uniform interpretation of federally created rights, the court concluded federal law governs.[146]

The court next considered whether the counterclaim was one in recoupment, or conversely, a set-off.[147] Recoupment, the court recognized, is a counterclaim arising from the same transaction that is the basis of the plaintiff's claim and is used only to reduce or defeat plaintiff's claim, whereas a set-off arises from an independent transaction and may be awarded in any amount.[148] The court concluded that the counterclaim was one in recoupment.[149] "The underlying loan transaction . . . serves as the common source for the correlative rights and liabilities of lender and consumer."[150] Furthermore, the court reasoned that under both federal and New Jersey law, parties are deemed to contract in light of existing law.[151] The requirement for adherence with the disclosure requirements of the Truth in Lending Act is an implied term in the contract.[152] Therefore, the coun-

141. *Id.*at 514.

142. *Id.*

143. *Id.* at 515. U.S. CONST. art VI, cl. 2.

144. *Beneficial Fin. Co.*, 432 A.2d at 515; *see supra* notes 89-102 and accompanying text for a discussion of *Burnett.*

145. *Beneficial Fin. Co.*, 432 A.2d at 515. For a synopsis of *Dice*, see *supra* note 120.

146. *Beneficial Fin. Co.*, 432 A.2d at 515.

147. *Id.* at 516.

148. *Id.*

149. *Id.* at 517.

150. *Id.*

151. *Id.* at 516.

152. *Id.* at 517.

terclaim arises from the same transaction as plaintiff's claim, and is one in recoupment.[153]

Having determined that the counterclaim was a claim in recoupment, the court considered next whether the one-year limitation period barred such a claim.[154] The court rejected a formalistic distinction between "substantive" and "procedural" statutes of limitation.[155] "Origin of the right is not *per se* conclusive whether the limitation of time 'extinguishes' . . . or 'merely bars the remedy'. . . . Source is merely evidentiary, with other factors of legislative intent whether the right shall be enforceable . . . after the prescribed time . . . ."[156] The operative question therefore "is whether congressional policy will be thwarted by allowing the defense of recoupment."[157]

In analyzing congressional intent, the court recognized that the purpose of the Truth in Lending Act is to promote the informed use of credit.[158] It is remedial and is to be interpreted liberally to effectuate legislative intent.[159] While the purpose of the one-year limitation period is not clear, the court concluded that allowing a claim in recoupment after one year was consistent with legislative intent.[160] Furthermore, the court was concerned that to hold otherwise would allow the creditor to avoid the penalties in the Act by delaying its suit beyond the one-year limitation period.[161] Therefore, the court concluded that the claim in recoupment is permissible beyond the one-year limit.[162]

B. *The Argument Against Recoupment*

Courts holding against recoupment claims have expressed their reasoning in a variety of ways. The common thread in all

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153. *Id.*
154. *Id.*
155. *Id.*
156. *Id.* (quoting Midstate Horticultural Co. v. Pennsylvania R.R., 320 U.S. 356, 360 (1943) (interpreting the Interstate Commerce Act)).
157. *Id.* at 518.
158. *Id.* at 519. "By requiring disclosure of credit terms and hidden costs, the [Truth in Lending Act] cut a path to guide the consumer to an informed use of credit." *Id.*
159. *Id.*
160. *Id.*
161. *Id.*
162. *Id.* For an earlier decision following the same line of reasoning, see Lincoln First Bank v. Rupert, 60 A.D.2d 193, 400 N.Y.S.2d 618 (4th Dep't 1977).

these cases is the view that the truth in lending claim is extrinsic to the underlying transaction, and is therefore barred as an impermissible set-off if not asserted within the one-year limitation period.

In *Hodges v. Community Loan & Investment Corp.*,[163] a loan was granted to Hodges in June, 1972, the creditor initiated suit on the note in September, 1973, and the borrower asserted truth in lending violations, seeking section 130 penalties.[164] The court began its analysis with the proposition that the truth in lending violation for failure to properly disclose the terms of credit occurs at the consummation of the loan transaction, and is not a continuing violation.[165] Therefore, the one-year period starts to run at consummation of the loan.[166] The court rejected the debtor's contention that the one-year limitation was inapplicable because the debtor was unaware of a possible truth in lending violation until counsel was consulted after the creditor brought suit.[167] It did not feel bound by the holding in *United States v. Western Pacific Railroad,*[168] because the court concluded the truth in lending claim was "not an integral part of the action for money had and received; it is merely ancillary to that action."[169]

On motion for rehearing, Hodges directly contended that the counterclaim was in the nature of recoupment, and was therefore not barred.[170] In rejecting the motion, the court reiterated its view that the truth in lending claim was not an integral part of the loan transaction: "The . . . counterclaim . . . did not arise out of the mutual obligations or covenants of the loan

163. 210 S.E.2d 826 (Ga. Ct. App.), *reh'g denied*, 210 S.E.2d 826 (1974).

164. *Id.* at 828.

165. *Id.* at 830 (relying on Wachtel v. West, 476 F.2d 1062 (6th Cir.), *cert. denied*, 414 U.S. 874 (1973) (concerning an offensive claim for disclosure violations)).

166. *Hodges*, 210 S.E.2d at 830.

167. *Id.* at 831.

168. 352 U.S. 59 (1956) (construing the combined effect of the Tucker Act and the Interstate Commerce Act to allow the United States to assert a claim on which the two-year limitation period had run defensively in recoupment against a claim by the railroad which was subject to a six-year limitation period; both claims arose out of the same transaction). For a discussion of this case, see *supra* notes 81-88 and accompanying text.

169. *Hodges*, 210 S.E.2d at 831.

170. *Id.* at 831.

transaction . . . but is independent thereof. Although the claim arose contemporaneously with the execution of the contract, it is not a product of a breach of any obligation or covenant therein . . . ."[171] The court therefore concluded the counterclaim was a set-off, not a recoupment, and denied the motion for rehearing.[172]

A case relying on *Hodges* is *Aetna Finance Co. v. Pasquali*.[173] In this case, the creditor brought suit on a note executed in April, 1976; the answer and truth in lending counterclaim seeking section 130 penalties were filed June 28, 1977.[174] It was conceded that the one-year limitation operated to cut off an affirmative action, but the debtor advanced the claim as one in recoupment.[175]

The court began its analysis by acknowledging that the purpose of the Truth in Lending Act is to require meaningful disclosure by creditors, intended to promote informed credit shopping by consumers.[176] Enforcement of the Act is carried out through administrative action, criminal enforcement for willful and knowing violation, and through the imposition of section 130 penalties in actions brought by aggrieved consumers.[177] Furthermore, both federal and state law allow an "affirmative defense of equitable recoupment" to be advanced beyond the limitation period.[178] "Therefore, if [the debtor's] defense and counterclaim is in the nature of recoupment, it may be asserted as long as [the creditor's] claim on the note survives."[179]

In denying the debtor's claim, however, the court concluded that the claim was not in the nature of recoupment.[180] To be in the nature of recoupment, the court reasoned, the claim must arise "out of some feature of the transaction upon which the

171. *Id.* at 832.

172. *Id.*; *accord* Hewlett v. John Blue Employees Fed. Credit Union, 344 So. 2d 505, 508 (Ala. Civ. App. 1976) (rejecting characterization of the counterclaim as one in recoupment, citing *Hodges* for support that the truth in lending claim did not arise from the mutual covenants of the parties).

173. 626 P.2d 1103 (Ariz. Ct. App. 1981).

174. *Id.* at 1104.

175. *Id.* at 1105.

176. *Id.* at 1104.

177. *Id.* at 1104-05.

178. *Id.* at 1105.

179. *Id.*

180. *Id.*

plaintiff's action is grounded,"[181] and "[go] to the very existence and foundation of plaintiff's claim."[182] The court viewed the truth in lending claim as not sufficiently enmeshed with the mutual rights and duties contained in the contract between debtor and creditor to satisfy these requirements.[183] "[Debtor's] claim is predicated upon a specifically imposed statutory penalty which is an extrinsic by-product of the loan transaction and it is not dependent upon . . . [the mutual] contractual obligations. . . . [It] does not go to the justness . . . but is an affirmative action . . . for an independent wrong."[184] Thus, at least when the debtor claims no actual damages, the claim may not be asserted beyond the one-year limitation period.[185]

V. The Rescission Cases

A. Dawe v. Merchants Mortgage & Trust

The primary case to consider survival of the right to rescind beyond the limitation period is *Dawe v. Merchants Mortgage & Trust*.[186] The case involved a dispute that arose when the Dawes purchased a lot in a subdivision under development, executing a note and deed of trust on September 30, 1973.[187] The actual sales agreement was signed sometime between September 30 and October 4, 1973.[188] It was undisputed that the notice of right to rescind misidentified the expiration date of the

181. *Id.* (quoting Bull v. United States, 295 U.S. 247, 262 (1935)).

182. *Id.* at 1105 (citing Rothensies v. Electric Storage Battery Co., 329 U.S. 296 (1946)).

183. *Id.*

184. *Id.*

185. *See* Basham v. Finance Am. Corp., 583 F.2d 918 (7th Cir. 1978), *cert. denied*, 439 U.S. 1128 (1979). *Basham* raised the issue whether a debtor, having filed a petition under Chapter XIII of the Bankruptcy Act, may respond to a claim filed by a creditor by alleging a claim in recoupment for truth in lending violations beyond the one-year limitation period. *Id.* at 927. The *Basham* court reasoned that the Truth in Lending Act was designed "to provide protection to consumers by affording them meaningful disclosure . . . . It was not designed, nor should it be used to thwart, the valid claims of creditors." *Id.* at 928. In denying relief for the debtors, it specifically limited its holding to the case when the debtor has suffered no actual damage as a result of the truth in lending violation. *Id.* at 927-28 n.16. "Certainly, however, such a claim [to the extent of actual damages] is much closer to the concept of 'recouping' something unlawfully taken by the creditor." *Id.*

186. 683 P.2d 796 (Colo. 1984).

187. *Id.* at 798.

188. *Id.*

right.[189] When it became apparent to the Dawes that the subdivision improvements would not be completed, they suspended regular payments as of August, 1974.[190] Merchants, as assignee of the seller, initiated action on the note in November, 1978.[191] In June, 1980, over six years after the date of the transaction, the Dawes notified Merchants that they were exercising their right to rescind.[192] The trial court granted Merchants' motion for summary judgment, which was affirmed by the Colorado Court of Appeals.[193] The Supreme Court of Colorado, sitting *en banc*, reversed.[194]

The Supreme Court of Colorado reasoned that "[t]here is a well recognized distinction between the maintenance of an original action and the assertion of a defense by recoupment."[195] It is the defense of "[r]ecoupment, which arises out of and is connected with the transaction upon which the original action is brought, [which] survives for as long as the cause of action upon the note exists."[196]

The *Dawe* court found no direct precedent on point regarding application of recoupment theory to rescission claims.[197] It reasoned by analogy without articulation to survival of claims in recoupment for section 130 penalties under the Truth in Lending Act.[198] The court aligned itself with the series of cases holding that section 130 penalties may be asserted in recoupment to reduce creditors' claims, even though the recoupment claims are asserted after the one-year limitation period.[199] The court reasoned that the purpose of the Truth in Lending Act is to assure meaningful disclosure to promote informed use of

189. *Id.*
190. *Id.*
191. *Id.*
192. *Id.* at 798.
193. *Id.* The Court of Appeals rejected the Dawes' argument that rescission could be raised defensively, holding that the right to recoup is predicated on the existence of a contract, whereas rescission disaffirms the contract and is therefore inconsistent with a recoupment theory. Merchants Mortgage & Trust v. Dawe, 660 P.2d 1299, 1301 (Colo. Ct. App. 1982).
194. *Dawe*, 683 P.2d at 801.
195. *Id.* at 799.
196. *Id.* (citing Wyatt v. Burnett, 36 P.2d 768, 769 (Colo. 1934)).
197. *Id.* at 800.
198. *Id.*
199. *Id.*

credit.[200] Furthermore, "[i]f recoupment claims were barred . . . lenders could avoid the penalties of the [Truth in Lending] Act by waiting, as here, three years or more to sue . . . ."[201] Thus, the *Dawe* court concluded that to bar rescission as untimely would frustrate the purposes of the Truth in Lending Act.[202]

B. FDIC v. Ablin

The second case to consider the rescission remedy is *FDIC v. Ablin*.[203] In this case, the Ablins executed a note to a bank in May, 1983, pledging their home as collateral.[204] In February, 1986 the FDIC, as receiver, instituted a foreclosure action; in February, 1987, the Ablins rescinded the loan on the basis that they never received the required notice of right to rescind.[205] Rescission was pled as a counterclaim and affirmative defense, seeking return of all interest and other fees paid.[206]

The *Ablin* court, like the *Dawe* court, found no direct precedent and again reasoned by analogy to civil penalties under the Truth in Lending Act section 130.[207] The *Ablin* court adopted the rationale in *Wood Acceptance Co. v. King*,[208] relying on the combined effect of an Illinois statute of limitations[209] and the purpose of the Truth in Lending Act "to safeguard the consumer in . . . the utilization of credit and [because] enforcement is accomplished largely through . . . [private] civil actions."[210] The court made its decision expressly in light of the Simplification Act amendment to the Truth in Lending Act section 130, specifically authorizing claims in recoupment or set-off beyond the

200. *Id.* at 800-01.

201. *Id.* at 801.

202. *Id.*

203. 532 N.E.2d 379 (Ill. App. Ct. 1988).

204. *Id.* at 379.

205. *Id.* at 379-80.

206. *Id.* The trial court granted summary judgment for the FDIC on the rescission claim, holding that the three-year limit barred both the counterclaim and the defense. *Id.* at 380.

207. *Id.* at 381-82. For a discussion of the Truth in Lending Act § 130, see *supra* notes 38-39 and accompanying text.

208. *Ablin*, 532 N.E.2d at 381. For a discussion of *Wood Acceptance Co.*, see *supra* notes 105-11 and accompanying text.

209. *Ablin*, 532 N.E.2d at 381; *see supra* note 107.

210. *Ablin*, 532 N.E.2d at 381.

one-year limitation, except as otherwise provided by state law.[211]

The *Ablin* court rejected the argument that Congress did not intend survival of rescission claims in recoupment beyond three years, because it had specifically authorized recoupment or set-off for section 130 monetary penalties in the Simplification Act, but had failed to provide a similar provision regarding section 125 rescission rights.[212] The *Ablin* court, relying on *Dawe,* concluded that the right to rescind could be raised defensively after the three-year limitation period had run.[213]

VI. Analysis

A. *The Functioning of the Rescission Remedy*

To illustrate the functioning of the remedy after an extended period of time, a simple example is offered:

> A creditor grants a $100,000 loan with payment of interest-only for fifteen years at the annual rate of 10%. After ten years of payments totalling $100,000 ($10,000 per year for ten years) the consumer defaults and the creditor brings suit. No other fees were paid by the consumer to the creditor. The consumer raises a claim of rescission defensively to reduce the creditor's claim. If rescission is allowed, the creditor's lien is automatically void and the creditor must return all money paid by the consumer ($100,000). The consumer would then be required to return the amount received from the creditor ($100,000). This would be netted to zero and the consumer would be released from further obligation.[214]

The essential effect of the remedy is to afford the consumer an interest-free loan from the date of the transaction to the exchange of money after rescission. Therefore, the longer one allows the right of rescission to be exercised, the greater the benefit to the consumer, and the greater the penalty to the creditor.

The writer estimates the following economic losses to the creditor and corresponding economic gains to the consumer, as-

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211. *Id.* For a brief discussion of the Simplification Act, see *supra* text accompanying note 40.

212. *Ablin*, 532 N.E.2d at 381-82.

213. *Id.* at 382.

214. 12 C.F.R. § 226.15(d) (1993).

suming rescission is exercised immediately after each year, and the consumer makes all required payments:[215]

YEAR	LOSS ($)
1	9,090
3	24,869
5	37,908
10	61,446

Compare this to the fixed penalty amount under section 130 of twice the finance charge not to exceed $1,000.[216]

The use of the rescission remedy after an extended period of time effectively allows the knowledgeable consumer to bypass the three-year limitation period. In the example, after ten years the consumer can simply stop paying. In the normal case, the creditor will sue, the debtor will rescind defensively, and the debt will effectively have been canceled, with a real economic loss to the creditor and gain to the debtor of $61,446.[217]

B. *Analogy to Section 130 Penalties*

1. *Both courts in the principal cases reasoned by analogy to the decisions considering recoupment claims for section 130 penalties.*[218]

The pro-recoupment line of cases generally followed a line of reasoning that began with recognition that federal law, as opposed to state law, governs the question of whether to allow

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215. The amounts computed represent the present value of the amounts received by the creditor subtracted from the total payments called for in the loan contract. This analysis assumes level interest rates, annual payments on the loan at the end of each year, and ignores the effect of income taxes.

216. In theory, the $1,000 penalty, if assessed a significant amount of time after consummation of the transaction, should be reduced to a lesser amount by a present value calculation as well. If the $1,000 penalty were reduced to present value at the loan contract rate of 10% per annum and income taxes are ignored, the penalty is reduced to $909 after one year, $751 after three years, $621 after five years, and $385 after ten years.

217. The intelligent creditor, of course, will consider not suing. The creditor might wait until the consumer attempts to transfer title to the property, which is likely to be held as extinguishing the right to rescind both offensively and defensively. 15 U.S.C. § 1635(f). Alternatively, the transfer may take place, and the creditor could attempt to proceed *in rem* on its mortgage. Certainly, the Truth in Lending Act did not envision this kind of cat-and-mouse game.

218. Dawe v. Merchants Mortgage & Trust, 683 P.2d 796 (Colo. 1984); FDIC v. Ablin, 532 N.E.2d 379 (Ill. App. Ct. 1988).

recoupment beyond the one-year statutory limit.[219] This is based on a concern for vindication of federally created rights and for their uniform application.[220]

Having decided that federal law governs, the courts then surveyed the federal common law of recoupment.[221] The first issue the courts had to consider was whether the section 130 counterclaim arose from the subject matter of plaintiff's claim.[222] The pro-recoupment courts found that the counterclaim was an integral part of the loan transaction.[223] The courts reasoned that both the creditor's and debtor's claims arose simultaneously from consummation of the loan transaction, and adjudication of both claims required inquiry into the same operative facts.[224] This contrasts with the anti-recoupment cases, which viewed the counterclaim as unrelated to the mutual rights and obligations contained in the loan contract, arising instead from a separate statutory right.[225]

Either point of view regarding the common basis of the claims can be supported in logic.[226] It cannot be denied, however, that there is a factual overlap and a clear nexus regarding the foundations for both claims. It seems overly formalistic to deny a debtor the ability to advance a claim because it arose from a statutory obligation of the creditor, when the creditor is suing on the very contract that gave rise to the statutory obligation.

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219. Beneficial Fin. Co. v. Swaggerty, 432 A.2d 512, 515 (N.J. 1981); Household Consumer Discount Co. v. Vespaziani, 415 A.2d 689, 693 (Pa. 1980). For a discussion of these and related cases, see *supra* part IV.A.

220. *Vespaziani*, 415 A.2d at 691-93; Plant v. Blazer Fin. Servs., Inc., 598 F.2d 1357 (5th Cir. 1979); *see supra* notes 117-31 and accompanying text. *See generally*, *supra* part IV.A.

221. *Beneficial Fin. Co.*, 432 A.2d at 515-16; *Vespaziani*, 415 A.2d at 693-96; Shannon v. Carter, 579 P.2d 1288, 1290 (Or. 1978).

222. *See, e.g., Vespaziani*, 415 A.2d at 694; *see supra* notes 117-25 and accompanying text.

223. *See, e.g., Vespaziani*, 415 A.2d at 696; *see supra* part IV.A.

224. *Plant*, 598 F.2d at 1363, 1364; *see supra* notes 126-35 and accompanying text for a discussion of *Plant*.

225. Aetna Fin. Co. v. Pasquali, 626 P.2d 1103, 1105 (Ariz. Ct. App. 1981). For a discussion of this case, see *supra* notes 173-85 and accompanying text. Hodges v. Community Loan & Inv. Corp., 210 S.E.2d 826, 832 (Ga. Ct. App.), *reh'g denied*, 210 S.E.2d 826 (1974). For a discussion of *Hodges*, see *supra* notes 163-72 and accompanying text.

226. *See supra* text accompanying notes 121-25, 147-53, 167-72.

Neither can the issue be considered apart from the purpose of the Truth in Lending Act. The statute is remedial, aimed at promoting consistent, accurate information about the cost of credit, to allow the consumer to make informed credit decisions.[227] The distinction between the precise terms of the loan and the method of disclosure of those terms mandated by the Act is, at least partially, artificial. The statutory penalties payable to the consumer for violation of the Act arise from the very wording and terms of the contract. Given the remedial purpose of the Truth in Lending Act, artificial distinctions should not be drawn to allow a creditor to exact compliance with its contract when it has not disclosed its terms in accordance with the law.

The purpose of the law of recoupment is to do justice to the parties in light of the transaction as a whole.[228] The pro-recoupment courts, having found that the section 130 counterclaim arises from the same transaction as plaintiff's claim, also found that granting the section 130 penalties was at least consonant with doing justice to the parties in light of the entire transaction.[229] These courts reflected on the remedial purpose of the Truth in Lending Act, interpreting its provisions strictly to foster accurate disclosure of credit terms.[230] Furthermore, private legal action by the consumer was considered the primary enforcement mechanism; to frustrate consumer action is to frustrate enforcement of the Act.[231]

The pro-recoupment courts recognized that a consumer is often unaware of the requirements of the Act, and of the consumer's rights thereunder.[232] As a practical matter, then, the courts reasoned that violations will not become evident until the consumer consults an attorney, often after the creditor has instituted suit in the event of default.[233] Under these condi-

227. *See supra* note 4 and accompanying text; *see also* Beneficial Fin. Co. v. Swaggerty, 432 A.2d 517, 519 (N.J. 1981). For a discussion of *Beneficial Fin. Co.*, see *supra* notes 136-41 and accompanying text.

228. Rothensies v. Electric Storage Battery Co., 329 U.S. 297, 299 (1946); *see generally supra* notes 53, 65-70 and accompanying text.

229. *Rothensies*, 329 U.S. at 299; *see generally supra* part IV.A.

230. *Rothensies*, 329 U.S. at 299; *see generally supra* part IV.A.

231. Shannon v. Carter, 579 P.2d 1288, 1290 (Or. 1978); *see supra* notes 112-16 and accompanying text for a discussion of *Shannon*.

232. *See, e.g.*, Household Consumer Discount Co. v. Vespaziani, 415 A.2d 689, 696 (Pa. 1980); *see supra* notes 117-25 and accompanying text.

233. *See, e.g., Vespaziani*, 415 A.2d at 696.

tions, the courts were concerned that a creditor could avoid the section 130 penalties by simply delaying action on the debt until at least one year after consummation of the transaction.[234] In addition, at least one court took judicial notice of the superior bargaining power of the creditor in a market dominated by institutional lenders.[235]

2. *Anti-Recoupment Analysis*

The courts finding against recoupment viewed the situation differently. These anti-recoupment courts saw no injustice in disallowing the section 130 claims.[236] There was no contention that the truth in lending violation invalidated the debt,[237] nor did the debtor allege any actual harm resulting from the violation.[238] According to these courts, the debtor simply was seeking statutory penalties, without in any way diminishing the justice of the creditor's claim for amounts properly due.[239] The time having expired for the debtor to seek the statutory penalties, there was no reason to reduce the creditor's judgment on the note.[240]

In contrast, the pro-recoupment courts did not explicitly consider the application of recoupment doctrine when no actual harm to the defendant was alleged. The law of recoupment is based on an equitable doctrine of fairness to do justice to the parties as a whole.[241] Without any harm, the purposes underlying recoupment doctrine are not fully implicated. Instead, the pro-recoupment courts analyzed the policies underlying the Truth in Lending Act. It was in furtherance of these policies, rather than a desire to do justice to the consumer in the transaction as a whole, that dominated their reasoning.[242] It is to

234. *See, e.g.*, Beneficial Fin. Co. v. Swaggerty, 432 A.2d 512, 519 (N.J. 1981).

235. *Vespaziani*, 415 A.2d at 696.

236. *See supra* part IV.B.

237. Basham v. Finance America Corp., 583 F.2d 918, 927-28 (7th Cir. 1978); *see supra* note 185 for a discussion of *Basham*.

238. *Basham*, 583 F.2d at 927.

239. *See supra* note 184 and accompanying text.

240. *See supra* note 183 and accompanying text.

241. Rothensies v. Electric Storage Battery Co., 329 U.S. 297, 299 (1946).

242. *See supra* notes 111, 116, 125, 155-62 and accompanying text. In none of these cases did the consumer allege actual harm or detrimental reliance as a result of the truth in lending violation.

these policies, as modified by the Simplification Act, that the analysis now turns.

C. *The Truth in Lending Simplification and Reform Act*

The Truth in Lending Act is an important consumer protection statute meant to be interpreted broadly on behalf of the consumer.[243] The Truth in Lending Simplification and Reform Act, a package of comprehensive amendments, was enacted to enhance the effectiveness of the Truth in Lending Act.[244]

In the Simplification Act, Congress turned its attention to many of the factors the courts considered in dealing with section 130 recoupment. Most directly, Congress authorized section 130 recoupment claims beyond the one-year limitation.[245] It did not do likewise in regard to rescission claims, however, despite consideration and modification of the rescission remedy.[246] Furthermore, enforcement action was strengthened, putting less emphasis on private action to achieve the purposes of the Act.[247] In connection with enforcement actions, the right to rescind was extended to one year after the conclusion of action by an enforcement agency if the three-year limitation period had not expired prior to institution of the agency action.[248] In allowing increased time to rescind in the case of agency enforcement action, it is evident Congress at least considered the time limitation on the right to rescind. Congress did not, however, authorize defensive rescission claims, as it did for section 130 penalties.

The provisions of the Simplification Act mitigate the suitability of analogy to the cases concluding that Congress intended to allow claims for section 130 penalties in recoupment beyond the one-year limitation period. Congress considered claims in recoupment, but did not specifically authorize them for use in rescission claims.[249] Strengthened enforcement provisions and

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243. *See supra* notes 10, 159 and accompanying text.
244. *See supra* notes 32-33 and accompanying text.
245. *See supra* note 40 and accompanying text.
246. *See supra* notes 43-46 and accompanying text.
247. *See supra* note 46 and accompanying text.
248. *See supra* note 46 and accompanying text.
249. Given the sparsity of litigation of rescission claims asserted by recoupment, it is of course possible that the issue was not on Congress' collective mind. *See supra* notes 197, 207 and accompanying text regarding the limited litigation.

an extension of the right to rescind in connection with enforcement proceedings further diminish the force of the policy rationale expressed by the section 130 pro-recoupment cases, and therefore weaken the effectiveness of analogy to them.[250]

D. *The Rescission Remedy and Recoupment*

The rescission remedy is different in kind than the section 130 monetary penalties. It is a benign sounding remedy, intended to put the parties in *status quo ante*; and so it does, if it is exercised within a reasonable time after consummation of the loan. The exchange of property mandated by the rescission procedure ignores the time-value of money. As reflected in the example and related analysis above, the economic loss to the creditor, and corresponding gain to the debtor grows over time, to a significant amount of the principal value of the loan.[251]

This is in stark comparison to the section 130 penalties, which are limited to twice the finance charge, not to exceed $1,000.[252] As a typical loan transaction often has a finance charge in excess of $500, the maximum penalty is capped, often at a very modest amount in relation to the loan proceeds. Furthermore, in the case of the section 130 penalties, the adverse economic impact on the creditor decreases over time, because of the same time-value of money that causes the impact of the re-

250. If the foregoing attenuates the policy rationale for allowing defensive recoupment claims, other considerations by Congress add vitality to the rationale. Congress was aware that many claims for truth in lending violations were being advanced on highly technical grounds. *See supra* notes 33, 34 and accompanying text. In an attempt to give meaning to the term "simplification" in the Simplification and Reform Act, Congress limited creditor liability to errors of central importance only. *See supra* note 34 and accompanying text. Disclosure violations that extend the right to rescind beyond the statutory three-day period were limited to errors in material disclosures only, while Congress left intact extension of the right to rescind for any error in the required notice of the right itself. *See supra* note 36 and accompanying text. In regard to errors in material disclosure that extend the right to rescind, there is, therefore, a stronger argument to construe the right more strictly against the creditor after consideration of the effect of the Simplification Act. Although research has revealed no affirmative consideration of errors in the notice itself that extend the right to rescind, there is at least an inference that Congress considered strict compliance to be of central importance as well. Violations in the notice procedure should therefore be strictly interpreted against the creditor.

251. *See supra* notes 214-15 and accompanying text.

252. *See supra* note 38 and accompanying text.

scission remedy to increase over time. This effect makes analogy to section 130 penalties inapposite.

The Truth in Lending Act is not intended to undermine the otherwise valid claims of creditors.[253] Extension of the rescission remedy beyond the three-year limit does that to a significant degree, however. Without clear indication of Congressional intent to allow recoupment, courts should not categorically permit it. The requisite intent is not evident. When Congress could have directly settled the issue by legislation in the Simplification Act, it did not, despite its consideration of recoupment and of rescission.[254]

It is not necessary to categorically allow or disallow rescission claims in recoupment. One reason courts have allowed recoupment for section 130 penalties is a belief that the creditor could otherwise avoid the Act by delaying its action on the note until after one year had passed.[255] In such a case, the courts could allow recoupment on a theory of equitable tolling,[256] consonant with the underlying purposes of the Truth in Lending Act. The same is true if there had been actual damages or detrimental reliance on either disclosure violations, improper notice of the right to cancel, or, perhaps most significantly, no notice at all.[257] Without actual harm, the policies of fairness and justice underlying recoupment doctrine are not fully called into play. Absent one of these factors, claims for rescission in recoupment beyond the three-year limitation period should be disallowed as not in accordance with congressional intent.

VII. Conclusion

The issue of recoupment and the right to rescind is one of statutory interpretation. Congress provided a three year limit in which to exercise the right and, despite specifically authorizing recoupment for section 130 penalties, it has not done so for rescission. The rescission remedy is different in kind than section 130 penalties, as the economic impact of the remedy in-

253. *See supra* note 185.

254. *See supra* part VI.C.

255. *See supra* note 125 and accompanying text.

256. *See, e.g.*, Burnett v. New York Central R.R., 380 U.S. 424 (1965). For a discussion of *Burnett*, see *supra* notes 89-102 and accompanying text.

257. *Burnett*, 380 U.S. at 424.

creases over time. Without evidence of clear congressional intent, the courts should not categorically allow rescission claims in recoupment. Under appropriate circumstances, such as intentional delay, actual harm, or detrimental reliance, claims for rescission in recoupment may be allowed.

Daniel Rothstein

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