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Truth-in-Lending--Disclosure of Security Interests (N. C. Freed Co. v. Board of Governors)

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court judgment was the lifting of the nationwide injunction against Corning.[37] The court found that such a large scale injunction was unjustified since Corning had made some sincere efforts to comply with the Equal Pay Act, and because there was no evidence that Corning maintained a company-wide policy of sex discrimination.

The court's holding that time of day is not a working condition which might make jobs unequal gives added impetus to the Act's effectiveness. It appears that the beneficial purpose of the Act will not be frustrated by applying the words of the statute in an overly technical manner. The Second Circuit squarely faced the time of day question and answered it in a way that will help other courts apply the Act's provisions to more subtle types of wage discrimination based on sex. Therefore, it is hoped that the Supreme Court will affirm the Second Circuit.

However, at least one problem remains unsolved. Corning's pay scheme was the result of agreements with a union, and not a unilateral act. The district court denied Corning's motion to join the union as a party defendant and the Second Circuit did not address this point. In order to fully implement the spirit of the Equal Pay Act, the courts should extend liability to unions as the Act would allow[38] since pay scales found in violation of the Act may often be the product of collective bargaining.

TRUTH-IN-LENDING — DISCLOSURE OF SECURITY INTERESTS

N. C. Freed Co. v. Board of Governors

Section 125(a) of the Truth-in-Lending Act[1] gives the consumer the unqualified right to rescind a credit transaction within three business days if "a security interest *is* retained or acquired in any real property which is used or is expected to be used as the [consumer's] residence . . . ."[2] Having been authorized to prescribe rules for implementing the act,[3] the Federal Reserve Board expanded the statutory

violate the equal-pay requirements; the temporary nature of the reassignment becomes questionable under government enforcement policy after one month.

37 474 F.2d at 236.

38 *See* note 13 *supra*.

1 15 U.S.C. § 1601 *et seq.* (Supp. 1972). The Truth-in-Lending Act constitutes Title I of the Consumer Credit Protection Act of 1968.

2 *Id.* § 1635(a) (emphasis added):

[T]he 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 disclosures required under this section [including disclosure of the right to rescind without liability], whichever is later . . . .

3 *Id.* § 1604.

language to include a credit transaction in which a security interest "is *or will be* retained or acquired."[4] By virtue of this extension, the disclosure requirements of the Act apply not only to consensual second mortgages given by the consumer[5] but also to security interests which may arise in favor of the creditor or third parties by operation of law.[6] Thus, if credit is extended, the regulation requires the contractor-creditor to disclose to his customer the possibility of potential liens and the resultant three-day rescission right.[7]

Since the typical home improvement contract[8] generates a variety of such liens, two home improvement corporations challenged the Board's implementation of the regulation. The district court ruled that the regulation was "null and void, . . . and not within the scope of Section 125(a) . . . insofar as it relates to liens which may come into existence by operation of law . . . ."[9] Moreover, the Federal Trade Commission was enjoined from enforcing the regulation. Relying upon fragmentary statements of legislative purpose[10] and the rule that

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4 12 C.F.R. § 226.9(a) (1973) (emphasis added).

5 Purchase money first mortgages to finance the initial construction on a home are excluded from the right of rescission. 12 C.F.R. § 226.9(g)(1) (1973).

6 Under the Board's application of the Act,

> "[s]ecurity interest" and "security" mean any interest in property which secures payment or performance of an obligation. The terms include, but are not limited to, security interests under the Uniform Commercial Code, real property mortgages, deeds of trust, and other consensual or confessed liens whether or not recorded, mechanic's, materialmen's, artisan's, and other similar liens, vendor's liens in both real and personal property, the interest of a seller in a contract for the sale of real property, any lien on property arising by operation of law, and any interest in a lease when used to secure payment or performance of an obligation.

12 C.F.R. § 226.2(z) (1973).

7 12 C.F.R. § 226.9(b) (1973). Other disclosures required by the Act include finance charges and annual percentage rates. 15 U.S.C. §§ 1605-06 (Supp. 1972). *See* Bowmar, *Truth-in-Lending: A Look at Some Real Estate Ramifications*, 34 ALBANY L. REV. 231, 233-39 (1970).

8 In the typical home improvement transaction, a contractor agrees to renovate the customer's residence on credit terms. Although the homeowner executes no mortgage or other security interest, both the contractor and his subcontractors may be entitled to statutory liens. *See, e.g.*, N.Y. LIEN LAW § 3 (McKinney 1966). The homeowner's failure to pay the contractor could result in foreclosure on the premises. If the contractor, on the other hand, does not pay his workers and suppliers, the consumer may be forced to pay twice for the same work in order to avoid foreclosure by the subcontractors. *See generally* Note, *Mechanics' Liens and Surety Bonds in the Building Trades*, 68 YALE L.J. 138 (1958) [hereinafter cited as *Mechanics' Liens*]. For an analysis of various types of home improvement credit transactions see Comment, *The Right of Rescission and the Home Improvement Industry*, 37 ALBANY L. REV. 247, 262-66 (1973) [hereinafter cited as *The Right of Rescission*].

9 N.C. Freed Co. v. Board of Governors, Civil No. 1970-43 (W.D.N.Y. Sept. 29, 1971). According to the provisions of the Truth-in-Lending Act, the Federal Reserve Board is empowered to "prescribe regulations to carry out the purposes of this subchapter." 15 U.S.C. § 1604 (1970). The Federal Trade Commission (FTC) is charged with the enforcement of most of the requirements of the Act. 15 U.S.C. § 1607(c) (1970). Because of this distinction in roles, the injunction was directed at the FTC, the enforcing agency.

10 *See* note 15 *infra*.

remedial statutes should be broadly construed,[11] the Second Circuit Court of Appeals in *N. C. Freed Co. v. Board of Governors*[12] reversed the district court's decision. For the sake of "uniformity among the states" and to effectuate the Act's purpose of assuring "meaningful disclosure of credit terms," the Second Circuit held that potential statutory lines are security interests within the meaning of the Act.[13] In upholding the Board's construction of section 125(a), the court reasoned that, "Congress intended to establish a national policy of protecting consumers whose residences are jeopardized by operation of all types of security interests acquired by creditors in the home improvement industry . . . ."[14]

Clearly, the disclosure requirements and right of rescission expressed in section 125(a) manifest a congressional concern with the mortgage and potential foreclosure features of credit transactions.[15] If the consumer is to be fully informed of the consequences of contracts in which security interests are given voluntarily, it follows a fortiori that the same information should be disclosed when liens may arise non-voluntarily. Unfortunately, Congress did not word the statute to meet the latter contingency. The statute speaks only of the security interest which "is retained or acquired" in the credit transaction.[16] While in a few states[17] a mechanic's lien arises by operation

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11 *See* Peyton v. Rowe, 391 U.S. 54, 65 (1968) ("remedial statutes should be liberally construed"); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) ("remedial legislation should be construed broadly to effectuate its purposes"). *See also* Udall v. Tallman, 380 U.S. 1, 16 (1964).

12 473 F.2d 1210 (2d Cir. 1973), *cert. denied*, 42 U.S.L.W. 3195 (U.S. Oct. 9, 1973) (No. 72-1601).

13 *Id.* at 1216.

14 *Id.*

15 [T]he homeowner is hurried and rushed through the [credit] transaction by glib and reassuring talk and in many cases he is never informed nor aware that his home is being made subject to a mortgage . . . .

. . . .

One amendment [to the Act] would require that there be disclosure that a mortgage is being placed on the borrower's home and that the consequences of such a mortgage can be explained.

114 CONG. REC. 1611 (1968) (remarks of Representative Cahill, author of the mortgage disclosure requirements of section 125(a)) [hereinafter cited as Remarks of Representative Cahill].

Representative Sullivan commented:

[T]he Cahill amendment, or rather a series of amendments in the House . . . strike[s] at home improvement racketeers who trick homeowners, particularly the poor, into signing contracts at exorbitant rates, which turn out to be liens on the family residences. Any credit transaction which involves a security interest in property must be clearly explained to the consumer as involving a mortgage or lien . . . .

114 CONG. REC. 14,388 (1968). *See* H.R. Rep. No. 1397, 90th Cong., 2d Sess. 26 (1968).

16 15 U.S.C. § 1635(a) (Supp. 1972).

17 *See, e.g.*, ILL. ANN. STAT. ch. 82, § 1 (Supp. 1973) (mechanic's lien attaches as of the date of contract); ME. REV. STAT. ANN. tit. 10, § 3251 (Supp. 1973).

of law at the time a construction agreement is made in the majority of states,[18] such a lien does not become effective until either materials and supplies are delivered, actual work is begun, or the lien is filed in a recording office. The Second Circuit, nevertheless, seized upon this lack of uniformity as a basis for confirming the regulation. Judge Moore refused to accept appellees' argument that Congress thought of providing the right of rescission only in those instances in which liens arise at the moment of contracting:

> . . . [T]he goal [of the Act] was to provide uniform protection throughout the nation, irrespective of the vagaries among the states' lien laws . . . . [C]onsumers can be effectively protected only if *all* statutory liens are included within the regulatory ambit of that Section.[19]

A literal reading of section 125(a), the court ruled, would be "too technical and narrow" and would "eviscerate" the statute.[20]

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18 *See* 3 R. POWELL, THE LAW OF REAL PROPERTY ¶ 484, at 724-28 (1970). Those states embracing the majority view fall into one of three categories:

(1) *Lien attaches when work commences on building.* Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Florida, Kansas, Maryland, Michigan, Minnesota, Montana, New Mexico, Ohio, Oklahoma, South Dakota, Tennessee, and Wyoming.

(2) *Lien attaches when notice is filed.* Arizona, Mississippi, Missouri, New Jersey, New York, North Dakota, Rhode Island, South Carolina, Texas, Vermont, Washington, and Wisconsin.

(3) *Lien attaches when labor or supplies are actually furnished.* Connecticut, Delaware, Georgia, Indiana, Iowa, Kentucky, Nebraska, Nevada, New Hampshire, Utah, and West Virginia. *Mechanics' Lien, supra* note 8, at 152 n.69. *See, e.g.*, N.Y. LIEN LAW § 13 (McKinney 1966); VA. CODE ANN. § 43-3 (1970).

Relying upon Von Hoffman v. City of Quincy, 71 U.S. (4 Wall.) 535 (1866), the *Freed* panel concluded that statutory liens may arise at the time a credit transaction is consummated. 473 F.2d at 1215. The principle that a contract is deemed to include all statutory rights in existence at its inception is well supported. *See* Northern Pacific Ry. v. Wall, 241 U.S. 87, 91 (1916); United States v. Essley, 284 F.2d 518, 520 (10th Cir. 1960); Battaglia v. General Motors Corp., 169 F.2d 254, 261 (2d Cir.), *cert. denied*, 335 U.S. 887 (1948). In addition, the Supreme Court, in Federal Crop Ins. Corp. v. Merrill, 332 U.S. 380 (1947), held that statutory regulations are incorporated into contracts between private and public parties. *See also* Federal Housing Admin. v. Morris Plan Co., 211 F.2d 756 (9th Cir. 1954); A. CORBIN, CONTRACTS § 551, at 197-98 (1960).

19 473 F.2d at 1216.

20 *Id.* at 1217. The court, citing Tcherepnin v. Knight, 389 U.S. 332 (1967), adopted the position that the Truth-in-Lending Act, being a remedial statute, should be construed liberally in order that its remedial purpose be achieved. 473 F.2d at 1214.

In so construing the statute, the court suggested the application of an "economic reality" approach to the definition of the term "security interest" in the statute. This test was derived from cases interpreting certain terms undefined by the Securities Exchange Act of 1934, 15 U.S.C. § 78(a) *et seq.* (1970), or the legislative history of that act. The Supreme Court, in SEC v. W.J. Howey Co., 328 U.S. 293 (1946), indicated that the term "investment contract" had been construed by courts along broad lines to effectuate the protective mandate of the state "blue sky" statutes. In so doing, the Court stated, "Form was disregarded for substance and emphasis was placed upon economic reality." *Id.* at 298. *Cf.* SEC v. Universal Service Ass'n, 106 F.2d 232, 237 (7th Cir.), *cert. denied*, 308 U.S. 622

Freed is not the first decision sanctioning the Federal Reserve Board's alteration of verb tense in section 125(a). In *Gardner & North Roofing & Siding Corp. v. Board of Governors*,[21] the Court of Appeals for the District of Columbia Circuit held that Congress intended to protect consumers from all the "inherent consequences" and "hidden traps" of a home improvement contract.[22] The Board's regulation, therefore, "is entirely consistent with the legislative purpose and is a proper device for carrying it out."[23] By sustaining the regulation promulgated by the Federal Reserve Board, the *Gardner* and *Freed* courts have stretched the language of section 125(a) to conform to the putative purpose of Congress.

In summary, the Second Circuit's ruling requires full compliance by home improvement contractors with the Federal Reserve Board's directive. After being warned of potential liens, the consumer has a three-day "cooling-off" period in which to consider the ramifications of the transaction.[24] If the consumer chooses to rescind, all security interests inherent in the transaction are nullified, and any consideration exchanged between the parties must be returned.[25] From the contractor's point of view, the practical effect of compliance is a delay of three days before the job can be safely begun. Although he can waive his own right to a mechanic's lien[26] in an attempt to avoid the three-day rescission threat,[27] the contractor usually cannot speak for

(1940). More recently, the District of Columbia Circuit, in Gardner & North Roofing & Siding Corp. v. Board of Governors, 464 F.2d 838, 841-42 (D.C. Cir. 1972), took a similar approach in liberally interpreting the same Federal Reserve System regulation challenged in *Freed*. *See* notes 21-23 *infra* and accompanying text.

This "economic reality" approach has found widespread applicability in the area of the interpretation of securities acts. *See, e.g.*, Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir. 1972); Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir. 1972); Kemmerer v. Werner, 445 F.2d 76 (7th Cir. 1971); Continental Marketing Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967).

21 464 F.2d 838 (D.C. Cir. 1972).

22 *Id.* at 842.

23 *Id.*

24 Congressman Cahill observed that "most fraudulent mortgage schemes are consummated in an atmosphere of hurry, rush, and fast talking." Remarks of Representative Cahill, *supra* note 15, at 1611. As a result of the three-day rescission period, "homeowners will be able to study and investigate the contemplated seriousness of the obligations which they are able to undertake in the privacy and unhurried atmosphere of their own home." *Id. See The Right of Rescission, supra* note 8, at 250.

25 15 U.S.C. § 1635(b) (Supp. 1972).

26 *See, e.g.*, Cummings v. Broadway—94th St. Realty Corp., 233 N.Y. 407, 135 N.E. 832 (1922).

27 The Federal Reserve Board has announced that a waiver of all lien rights will eliminate security interests from the transaction, making it nonrescindable. *See* Federal Reserve Board Public Position Letter No. 135 (Oct. 9, 1969), *reprinted in* R. CLONTZ, TRUTH-IN-LENDING MANUAL A47 (Cum. Supp. 1972).

his subcontractors and materialmen. They must expressly waive their lien rights before all security interests will be extinguished.[28]

Future controversy over congressional intent and the legitimacy of the Board's implementing regulation will be purely academic if pending legislation is adopted. Following the district court's adverse ruling in *Freed*, the Federal Reserve Board requested an amendment to section 125(a) which would broaden the language to encompass statutory liens.[29] The amending bill,[30] unanimously approved by the Senate,[31] will clarify the Board's authority by including in the statute present and future security interests "arising by operation of law."[32] If the bill becomes law, courts such as the Second Circuit will be relieved of the task of compensating for the under-inclusive language of the original statute. The Board's regulation will more clearly constitute "a clarification, and not an improper extension of the statute."[33]

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28 A subcontractor may, by express agreement with a general contractor, waive his right to a lien. *See* Mintzes Contracting Co. v. Country Wood Homes Corp., 202 N.Y.S.2d 359 (Sup. Ct. Westchester County 1960). However, the general contractor, although he may waive his own rights, may not unilaterally waive the lien rights of subcontractors. *See* C.M. Heist Ohio Corp. v. Bethlehem Steel Co., 20 App. Div. 2d 201, 246 N.Y.S.2d 15 (4th Dep't 1964). This approach is similar to the requirements contained in the New York Lien Law, which include the existence of an express waiver agreement, in writing, and signed either by the waiving party or his agent. N.Y. LIEN LAW § 34 (McKinney 1966).

29 *See* Letter from J.L. Robertson, Vice-Chairman of the Federal Reserve Board, to Senator Proxmire, Feb. 28, 1972, in 4 CCH CONSUMER CREDIT GUIDE ¶ 30,811, at 66,354-56 (1973).

30 S. 2101, 93d Cong., 1st Sess. § 204 (1973).

31 119 CONG. REC. 14,428 (daily ed. July 23, 1973). The bill has been referred to the House Committee on Banking and Currency. 119 CONG. REC. 6588 (daily ed. July 24, 1973).

32 S. 2101, 93d Cong., 1st Sess. § 204 (1973). *See* SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, TRUTH IN LENDING AMENDMENTS, S. REP. No. 93-278, 93d Cong., 1st Sess. 24 (1973).

33 N.C. Freed Co. v. Board of Governors, 473 F.2d 1210, 1217 (2d Cir. 1973).