The Banking Law Journal

Established 1889

An A.S. Pratt® PUBLICATION JULY/AUGUST 2015

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ISBN: 978-0-7698-7878-2 (print)
ISBN: 978-0-7698-8020-4 (eBook)

Cite this publication as:

The Banking Law Journal (LexisNexis A.S. Pratt)

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An A.S. Pratt® Publication

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(2015–Pub.4815)

Editor-in-Chief & Board of Editors

The Banking Law Journal (ISBN 978-0-76987-878-2) (USPS 003-160) is published ten times a year by Matthew Bender & Company, Inc. Periodicals Postage Paid at Washington, D.C., and at additional mailing offices. For customer support, please contact LexisNexis Matthew Bender, 1275 Broadway, Albany, NY 12204 or e-mail Customer. Support@lexisnexis.com. Direct any editorial inquires and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 26910 Grand Central Parkway, #18R, Floral Park, NY 11005, smeyerowitz@meyerowitzcommunications.com, 718.224.2258 (phone). Material for publication is welcomed— articles, decisions, or other items of interest to bankers, officers of financial institutions, and their attorneys.

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POSTMASTER: Send address changes to THE BANKING LAW JOURNAL LexisNexis Matthew Bender, 630 Central Ave, New Providence, NJ 07974.

POSTMASTER: Send address changes to THE BANKING LAW JOURNAL, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207.

Is *Jesinoski* a Dangerous Precedent for the Student Loan Industry?

Eric Epstein*

This article discusses the potential importance to the student loan industry of the U.S. Supreme Court's recent decision in Jesinoski v. Countrywide. *In* Jesinoski, *the Court held that, in the residential mortgage lending industry, a borrower may be able to rescind a loan years after origination by serving a notice of rescission on the lender. The author explores the question of whether the reasoning of Jesinoski will spill over to the student loan industry, which now represents the second-largest category of household debt in the United States and has delinquency rates that rival those in the residential mortgage industry.*

In *Jesinoski v. Countrywide*,[1] the Supreme Court clarified the procedure, under the Federal Truth in Lending Act ("TILA"), for rescinding a residential mortgage refinance loan secured by the borrower's principal residence. A borrower may rescind such a loan within three days of closing (the borrower's remorse rule), or within three years of closing if the lender materially violated the disclosure obligations of TILA (the extended right of rescission). A borrower can invoke the borrower's remorse rule by serving a notice of rescission on the lender. The question in *Jesinoski* was whether the borrower similarly can invoke the extended right of rescission by serving a notice of rescission on the lender, or whether the borrower must commence and prevail in a lawsuit against the lender to invoke that right. Resolving a Circuit split, the Court held that both categories of rescission may be exercised by serving a notice of rescission on the lender.

Considered a victory for consumers in the mortgage lending arena, *Jesinoski* has made rescission significantly easier for borrowers. At the same time, the decision puts lenders in the difficult position of effectively acting as a court of first instance and determining whether a rescission notice is substantively valid—that is, whether the lender materially violated an applicable disclosure obligation, whether the notice is timely, and whether the transaction indeed was

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[1] 135 S.Ct. 790 (2015).

a residential mortgage refinance secured by the borrower's principal residence. If the lender is wrong and rejects the rescission notice, the borrower may argue that the lender committed another violation of TILA by failing to rescind.

Even before *Jesinoski*, the extended right of rescission was a major risk factor for lenders in the mortgage industry. The successful exercise of the extended right of rescission voids the lender's lien on the secured property and requires the lender to return any money that has been paid by the borrower, effectively reversing any previously-paid interest, late charges, or other penalties. The borrower's liability for any future interest, late charges, or other penalties also is cancelled. While the borrower also must repay (or, in the words of the statute, "tender") to the lender the outstanding principal balance of the loan, the statute contemplates that the lender must fulfill its part of the rescission process first, unless a court alters that sequence. As a result, in the event the borrower ultimately is unable or unwilling to tender, the lender may find itself with an unsecured and uncollectable judgment.

Furthermore, even if the borrower's assertion of an extended right to rescind is eventually deemed invalid by a court, the litigation of that issue may delay for years the disposition of a foreclosure action, during which time the borrower may continue occupying the property. Thus, the extended right to rescind can be an important component of the borrower's leverage in negotiating a loan modification with a lender.

The *Jesinoski* decision has made the extended right of rescission an even more attractive prospect for delinquent obligors and an even more problematic issue for lenders. From the perspective of an obligor facing foreclosure, invoking an extended right of rescission is, at first, now as easy as mailing a letter stating, in substance, "I want to rescind." The worst-case scenario for the borrower is that the notice will be deemed invalid. This tactic is now virtually a given for any borrower who is facing foreclosure.

From a lender's perspective, the *Jesinoski* decision has raised concerns that lenders will be overwhelmed by a tidal wave of rescission notices from homeowners who have misunderstood their rescission rights or are seeking to manufacture a defense to a foreclosure action. Upon receiving a purported rescission notice, the lender must promptly investigate and determine whether the borrower is entitled to rescind. If the rescission notice is proper, the lender may opt to effectuate the rescission. If the lender finds that the notice is invalid, the lender can ignore the notice, seek to resolve the issue with the borrower, or sue the borrower to seek a declaration that the notice is void.

The question at hand is whether *Jesinoski* will have similar implications for the student loan industry. It is only a matter of time before borrowers begin putting that question to the test. After mortgage debt, student loan debt is the largest category of consumer debt in the United States. According to the Federal Reserve, between 2004 and 2014 the volume of student loan debt tripled from $364 billion to $1.16 trillion. During that same period, the rate of delinquency on student loans rose from 10 percent to 17 percent. The Federal Reserve has predicted that "a significant portion of the outstanding federal student loans in income-based repayment-type programs will ultimately be charged off after 20 or 25 years."[2] What if a borrower who is unable or unwilling to repay a student loan purports to "rescind" the loan by serving a rescission notice on the lender, and then, citing *Jesinoski*, objects to the lender's attempt to collect the arrears?

With respect to federal student loans, this question is easily answered. Federal student loans are not governed by TILA. Therefore, *Jesinoski* will not carry any weight with respect to standards or procedures for rescinding such loans.

However, unlike federal student loans, and like residential mortgage refinance loans, private education loans are governed by TILA. Compared to federal student loans, private education loans—which often are used to fill the gap between a federal student loan and the actual cost of post-secondary education—represent a relatively small segment of the student loan industry. According to the Consumer Financial Protection Bureau ("CFPB"), there are approximately $150 billion in outstanding private student loans. However, in that pool, there are approximately 850,000 loans that, cumulatively, are in default.[3] As the foreclosure crisis in the residential mortgage industry demonstrated, a proportionally small number of defaults can have an outsized impact on industry health.

In the private education loan area, borrowers inevitably will contend that the extended right of rescission is meant to operate uniformly throughout TILA—therefore, if, as held in *Jesinoski*, a borrower can exercise an extended right to rescind a mortgage refinance loan by serving a notice on the lender, then the same rule should apply to private education loans. Does that argument have merit? In the private education loan area, what should a lender do if a delinquent obligor serves the lender with a rescission notice?

THE *JESINOSKI* DECISION

Under traditional common law, the rescission of any contract "required either that the rescinding party return what he received before a rescission could be effected (rescission at law), or else that a court affirmatively decree rescission

[2] *See* Federal Reserve Bank of New York, *Student Debt and Higher Education Financing: A Public Finance Perspective*, Feb. 5, 2015.

[3] *See* Consumer Financial Protection Bureau, *Private Student Loans*, August 29, 2012.

(rescission in equity)."[4] But TILA displaces those common law rules, and prescribes a different protocol, codified at 15 U.S.C. § 1635, with respect to the rescission of a residential mortgage refinancing loan secured by a borrower's primary residence.

Pursuant to Section 1635, the right to rescind does not apply to the funding of the purchase of a home. However, the refinancing of an existing mortgage on a borrower's primary residence comes with two distinct rescission rights. One, the borrower's remorse rule, is absolute. The other, the extended right to rescind, is conditional on demonstrating that the lender's TILA disclosures were materially deficient.

Notably, early drafts of the legislation that ultimately became TILA would not have provided for any of the above rescission rights. During debate over that draft legislation in 1968, Congressman William T. Cahill of New Jersey proposed a three-day waiting period rule under which, for all mortgage loans, the lender would have been required to furnish the requisite loan disclosures to the borrower at least three days before closing. Congressman Cahill's concern was that "most fraudulent mortgage schemes are consummated in an atmosphere of hurry, rush, and fast talking," and that a mandatory waiting period would allow borrowers "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."[5]

For reasons that the legislative history does not make entirely clear, the Senate rejected the proposed waiting-period rule, and, over the objection of Congressman Cahill, the waiting period rule instead was converted, as a compromise, into the rescission regime that is codified today at 15 U.S.C. § 1635(a). As part of that compromise, home purchases were excluded from the ambit of the rule. The exclusion of home purchases was based, at least in part, on the view of some Senators and Representatives that the relevant problem was "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."[6]

As noted, two separate rescission rights emerged from this legislative compromise. First, under the borrower's remorse rule, within three days of the consummation of a refinancing secured by the borrower's principal residence, the borrower may rescind for any reason (or no reason). During this three-day

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[4] *Jesinoski*, 135 S.Ct. at 793.

[5] *See* Remarks of Representative Cahill, January 31, 1968, 114 C.R. 1611.

[6] *See* Remarks of Representative Leonor Sullivan, May 22, 1968, 114 C.R. 14388.

cooling-off period, the lender is prohibited from funding the loan. Therefore, in this context, rescission, for all practical purposes, amounts to the cancellation before the lender has incurred any significant risk of loss.

Even before *Jesinoski*, there was never any doubt that, under Section 1635, this right of rescission—rescission before the funding of the loan—could be exercised by serving a notice on the lender, and did not require the borrower to commence or prevail in a lawsuit and obtain an order of rescission. Indeed, Section 1635(a) explicitly states that this category of rescission may be exercised by notice, and requires lenders to provide borrowers with a form that they may use for that purpose. And common sense dictates that rescission by notice is the appropriate procedure for rescinding such a loan on a pre-funding basis because, given the absolute nature of this right of rescission, and the relative simplicity of cancelling the loan before it is funded, there rarely would be any need for litigation.

Second, if the lender fails to properly advise the borrower of the three-day borrower's remorse rule, or fails to provide the borrower with other material disclosures required under TILA with respect to the terms and conditions of a loan, a borrower may have an extended right to rescind after the initial three-day period has expired and the loan has been funded. As approved in 1968, this extended right of rescission was not bounded by any ultimate deadline, meaning that a borrower potentially could rescind a loan decades after funding if the lender's disclosures were materially defective. In 1974, however, Congress amended TILA so to circumscribe this extended right of rescission by a three-year deadline, recognizing that a lender should not have to face possible uncertainty as to the enforceability of its lien for the entire life of a loan. This three-year limit is codified at 15 U.S.C. § 1635(f).

Over time, a Circuit split emerged over the question of whether a borrower can exercise this extended right of rescission without judicial oversight by means of serving a notice of rescission on the lender. Many courts reasoned that, given the high probability of disputes between the parties as to whether an underlying material disclosure violation occurred and whether the borrower was willing and able to tender, it is likely that Congress intended to channel this process through the courts by requiring a borrower to file a lawsuit to seek rescission. Also, while Section 1635(a) plainly states that an unfunded residential refinance loan secured by the borrower's principal residence may be rescinded by notice within three days of closing, the statute arguably is not entirely clear as to whether the same procedure is meant to apply to the extended right to rescind.

The question at issue in *Jesinoski* was whether, in fact, the service of a notice of rescission is sufficient for purposes of exercising the extended right to rescind, and in particular whether service of a notice can operate to satisfy the three-year deadline for exercising that right. The Court answered that question in the affirmative, finding that this result was the more persuasive plain-language reading of the statute, because there was no specific indication in the language or structure of Section 1635 that Congress meant for the rescission process to work differently depending on the timing of rescission.

The Court recognized the possibility of abuse of this rule by delinquent obligors who, notwithstanding the absence of any underlying disclosure violation by the lender, may purport to exercise an extended right of rescission for tactical reasons, to obstruct a foreclosure action. However, the Court found that, under the statute, it falls to the lender to seek judicial relief if a rescission notice appears to be substantively improper.

JESINOSKI AND THE RESCISSION OF STUDENT LOANS

Based on the reasoning of *Jesinoski*, will courts find that borrowers can exercise an extended right to rescind a student loan—to the extent such a right applies at all—by serving a notice of rescission? At the outset, it is important to distinguish between federal student loans and private education loans in this regard.

Federal student loans—such as Stafford or Perkins Loans—are categorically exempted from TILA.[7] As *Jesinoski* dealt with the provisions of TILA that govern residential mortgage refinance loans, it has no bearing on the rules that govern the origination and servicing of federal student loans, which exist outside of TILA. As a result, *Jesinoski* will not destabilize any existing rules regarding the rescission of federal student loans (which may vary among different federal loan programs, and are beyond the scope of this article).

The more relevant question is whether *Jesinoski* applies to the rescission of private education loans, which are governed by TILA and therefore at least potentially must follow *Jesinoski*. This question is complex and may generate inconsistent decisions until it is ultimately resolved at the Circuit level or Supreme Court level.

The question is complex for two reasons. First, the statutory provisions of TILA that govern the rescission of private education loans are not worded identically to the provisions of TILA that govern the rescission of mortgage refinance loans. In the area of private education loans, the relevant statutory language leaves greater latitude for the argument that borrowers do not have an

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[7] *See* 15 U.S.C. § 1603(7); *Armstrong v. Accrediting Council for Continuing Educ. and Training, Inc.*, 168 F.3d 1362, 1364 (D.C. Ct. App. 1999), reh'g den. 177 F.3d 1036, cert. den. 528 U.S. 1073 (2000).

extended right of rescission, and would not be able to exercise such an extended right of rescission by serving a notice of rescission. Second, the CFPB regulations concerning the rescission of private education loans are difficult to interpret, and do not explicitly take a position on whether an extended right of rescission exists in this area, or, if it does, when or how a borrower is entitled to exercise that right.

TILA and the Rescission of Private Education Loans

Private education loans were not explicitly placed under the purview of TILA when the statute was promulgated in 1968. However, in 2008, Congress amended TILA to bring private education loans explicitly under the purview of the statute.[8] Together with that amendment, Congress built into TILA a new, separate regime to govern the terms and conditions of private education loans, the provision of disclosures with respect to private education loans, and the circumstances under which a private education loan can be rescinded. That regime is codified today at 15 U.S.C. § 1638(e).

In designing a statutory provision to govern the rescission of private education loans, Congress could have replicated, in its entirety, the language of Section 1635, which, when the drafting process took place in 2008, had been in existence for 40 years. But Congress opted not to do so. Instead, Section 1638(e), while bearing some similarities to Section 1635, also departs from Section 1635 in significant respects.

In particular, Section 1635 states that the right to rescind is measured as three business days "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."[9] The phrase "following the consummation of the transaction" is the borrower's remorse rule. The phrase "or the delivery of . . ." is the extended right of rescission.

By contrast, Section 1638(e) only provides for rescission "within 3 business days of the date on which the loan is consummated."[10] Section 1638(e) does not contain the phrase "or the delivery of . . ." or any equivalent to that language. Thus, while Section 1638(e) provides for a borrower's remorse rule similar to that found in Section 1635, it does not expressly provide for an extended right of rescission. Given that Section 1638(e) was promulgated long after Section 1635, it would be well within reason to interpret the omission of

[8] *See* 15 U.S.C. § 1603(3).

[9] *See* 15 U.S.C. § 1635.

[10] *See* 15 U.S.C. § 1638(e)(7).

that phrase from Section 1638(e) as a rejection, by Congress, of the extended right of rescission in the area of private education loans.

Thus, the question of whether, under *Jesinoski*, a borrower may exercise the extended right to rescind a private education loan by serving a rescission notice on the lender is arguably moot, because the extended right to rescind may not exist in this context. A variety of other factors lend further support to this view.

First, Section 1635 was a product of a concern on the part of Congress regarding the problem of con artists who were misleading poor and uneducated homeowners into signing away their homes. The extended right of rescission built into Section 1635 serves as an additional layer of protection in that regard. Section 1638(e), by contrast, has to do with college and graduate students, and does not involve the borrower's primary residence being put up as security. There is no indication in the legislative history of Section 1638(e) that an extended right of rescission was viewed by Congress as necessary in that context. To the contrary, the intent of Section 1638(e) was specifically to create "a 3-day 'cooling off' period *after the date of consummation* during which the borrower may cancel the loan without any legal or financial obligation on the part of the lender or the borrower."[11]

Second, in 1974, Congress determined that it was unreasonable for the extended right of rescission, under Section 1635, to be entirely open-ended. Thus, Congress added the final, three-year deadline that is now codified at Section 1635(f). No such deadline appears in Section 1638(e), which was promulgated 35 years after Section 1635(f). This suggests that an extended right of rescission was not contemplated for Section 1638(e).

Third, in the somewhat analogous context of bankruptcy proceedings, Congress does not treat mortgage loans and student loan debt equivalently. In particular, 11 U.S.C. § 523(a)(8) prohibits the discharge of student loans in bankruptcy unless non-discharge "would impose an undue hardship on the debtor and the debtor's dependents."[12] Given that these two categories of debt are distinguished from each other in the bankruptcy context, why would one assume that they would be treated equivalently under TILA? Is it not more likely that, just as the discharge of student loan debt is subject to a heightened standard in bankruptcy—requiring a showing of undue hardship—the rescission of a private education loan would be subject to a more rigorous standard under TILA—requiring rescission to take place within three days of the consummation?

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[11] *See* Committee on Banking, Housing and Urban Affairs Report No. 110-327 on Private Student Loan Transparency and Improvement Act of 2008, at 4 (emphasis added).

[12] *See* 11 U.S.C. § 523(a)(8).

Assuming, however, that a borrower does have an extended right to rescind a private education loan under certain circumstances, can the borrower exercise that right by serving a notice of rescission on the lender? Again, certain distinctions between Section 1638(e) and Section 1635 present themselves in this regard and suggest that, notwithstanding the result in *Jesinoski*, the answer to this question may be "No."

First, in *Jesinoski*, the Court found that the best plain-language reading of Section 1635 was that a borrower may exercise the extended right to rescind by serving a notice of rescission. That argument is untenable with respect to Section 1638(e), because that provision, as noted, does not contain any language regarding an extended right of rescission, let alone speaking to how such a right would be exercised.

Second, unlike Section 1635, no explicit guidance is to be found in Section 1638(e) as to what would trigger an extended right of rescission, or what concrete steps the lender and borrower are expected to take in order to rescind a private education loan that has already been funded. Presumably, if Congress imagined borrowers and lenders handling this process out of court—rather than requiring the borrower to sue—it would have provided at least as much guidance as is contained in Section 1635, not less.

Regulation Z and the Rescission of Student Loans

The Supreme Court has held that official agency interpretations of TILA are entitled to particular deference.[13] Therefore, in addition to directly construing the statutory language, it is necessary to look to Regulation Z, which sets forth the CFPB's interpretation of TILA.

Regarding the standards and procedures for rescinding a private education loan, Regulation Z is worded differently than Section 1638(e). Section 1638(e) provides for a right to rescind within three days of consummation. Regulation Z states that the right to cancel a private education loan expires three business days "following the date on which the consumer receives the disclosures" that the lender is required to provide under TILA.[14] In the next sentence, the Regulation states: "No funds may be disbursed for a private education loan until the three-business day period has expired."[15]

Regarding how the right of rescission can be exercised, the CFPB states that "[t]he creditor must specify a method or methods by which the consumer may

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[13] *See Ford Motor Credit Co. v. Milhollin*, 444 U.S. 555, 567 (1980).

[14] *See* 12 C.F.R. § 1026.48.

[15] *Id.*

cancel."[16] The CFPB goes on to list, as examples, that the creditor may require cancellation "orally or in writing," including "electronically" or "by mail."[17] The CFPB does not explicitly state that the exercise of an extended right to rescind a private education loan can be achieved by notice.

Regulation Z also does not explain what steps the parties would take to rescind a private education loan if that right is successfully exercised. That is, the Regulation does not contain any description, analogous to that which is found in Section 1635, of the sequence of steps the parties must take to accomplish rescission. The Regulation also does not discuss whether the extended right of rescission—to the extent it exists it in this context—is bounded by a three-year deadline similar to that which is found in Section 1635.

Courts likely will have difficulty construing the intent of this regulation. Borrowers may argue that the phrase "following the date on which the consumer receives the disclosures"[18] should be interpreted as an attempt to mirror the extended right to rescind that is built in Section 1635, which is concerned with, and triggered by, disclosure violations on the part of the lender. Therefore, borrowers may contend, the reasoning of *Jesinoski* should be deemed applicable to private education loans.

That argument is probably incorrect. Instead, the phrase "following the date on which the consumer receives the disclosures"[19] more likely is related to another difference in semantics between the statute and the Regulation. Specifically, under the statute, the lender must provide the final round of disclosures to the borrower "contemporaneously with the consummation."[20] Thus, the three-day borrower's remorse period begins upon consummation of the transaction.

But under the Regulation, the word "consummation" is not used to describe the timing of the final round of disclosures. Instead, the lender is to provide the final round of disclosures "[a]fter the consumer has accepted the loan."[21] The consumer is deemed to have received those disclosures three business days after they are mailed.[22] Accordingly, the Regulation describes the three-day borrow-

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16 *See* 12 C.F.R. Pt. 1026, Supp. I, Part 3, § 48(d)(1).

17 *Id.*

18 *See* 12 C.F.R. § 1026.48.

19 *See* 12 C.F.R. § 1026.48.

20 *See* 15 U.S.C. § 1638(e)(4).

21 *See* 12 C.F.R. § 1026.47(c).

22 *See* 12 C.F.R. § 1026.46(d)(4).

er's remorse period as beginning upon receipt, not consummation.

Other aspects of the Regulation support this reading. First, the sentence "No funds may be disbursed for a private education loan until the three-business day period has expired"[23] suggests that this aspect of Regulation Z was concerned with the short window of time following the borrower's acceptance of the loan, and not with a default by the borrower months or years later. Second, if the CFPB intended to create an extended right of rescission in this area, the CFPB arguably would have done so much more explicitly given the concern that such a rule could be perceived as a significant departure from the plain text of the statute. Third, it seems unlikely that the CFPB would have created an extended right of rescission in this context while leaving so many questions unaddressed in regard to how the right can be exercised or how rescission is to be accomplished.

WHAT PRIVATE EDUCATION LENDERS SHOULD DO UPON RECEIVING A RESCISSION NOTICE

For the reasons discussed above, a notice purporting to rescind a private education loan is probably invalid on its face if it comes after the three-day borrower's remorse window has closed, because the better reading of the applicable law is that such a loan cannot be rescinded by notice, or at all, at that point. What should a lender do upon receiving such a notice? First, the lender should investigate other factors that also may impact the perceived validity of the notice, particularly whether the borrower can reasonably argue that the lender materially violated a disclosure obligation during the origination of the loan.

Second, assuming the lender determines that the borrower does not have a right to rescind, the lender should consider whether to simply ignore the notice, contact the borrower to negotiate a resolution, or sue the borrower to seek a declaration that the notice is void. Outright ignoring such a notice will carry risk unless and until courts confirm that the extended right of rescission indeed does not apply to private education loans or that the service of a notice is not a proper means of exercising that rescission right.

In light of the *Jesinoski* decision, it also is more important than ever for private education lenders to meticulously document during the loan origination process that a borrower has received all requisite TILA disclosures, and to maintain those records throughout the life of the loan. If the lender can eliminate any doubt that the borrower in fact received such disclosures, the

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[23] 12 C.F.R. § 1026.48.

lender should be able to defeat, even under the reasoning of *Jesinoski*, any purported exercise by a borrower of an extended right to rescind a private education loan.