Saved by Default

A recent case from the Fourth Circuit highlights the continued difficulty that the Equal Credit Opportunity Act ("ECOA") and Regulation B poses for loan officers and compliance departments despite its enactment in 1974. In *Ballard v. Bank of America, N.A.*, ___ F.2d ___, (4th Cir. 2013), Mrs. Ballard alleges violations of ECOA based on Bank of America's requirement that she execute a full guaranty of payment for a loan taken out by her husband. What makes *Ballard* an interesting read, and an important decision in today's economic environment, was Bank of America's ability to "remedy" its putative ECOA violation during several rounds of debt restructurings. This article will detail the events and findings of *Ballard*, offer a compliance roadmap for ECOA, and then provide some comments and best practice suggestions for ECOA compliance.

The Ballard Case

In 2008, Kevin Ballard, Mrs. Ballard's husband, obtained a $4,100,000 loan from Bank of America for Foodswing, Mr. Ballard's closely held corporation. Although, Mrs. Ballard owned no interest in Foodswing, Bank of America required her to enter into a full guaranty of the loan. In 2009, 2010, and 2011 Foodswing defaulted on the loan. In each instance, Bank of America and Mr. Ballard entered into various restructuring agreements. In each case, Mrs. Ballard continued to guaranty the loan as restructured. These restructuring agreements required Mr. and Mrs. Ballard to waive "any and all" claims—past, present, or future—either of them had against Bank of America.

After the 2011 default, Bank of America recorded a lien on a home in Maryland and a winery in California as additional collateral to secure the loan. Mrs. Ballard co-owned these properties with her husband.

In 2012, Mrs. Ballard filed a lawsuit against Bank of America alleging violation of ECOA based on her required guaranty of her husband's loan. Bank of America contended that, since Mrs. Ballard co-owned some of the property pledged as collateral for the loan, she became a de-facto joint applicant and ECOA's prohibitions on spousal signatures did not apply.

ECOA and Regulation B

ECOA prohibits "any creditor [from] discriminat[ing] against any applicant, with respect to any aspect of a credit transaction on the basis of . . . marital status." 15 U.S.C. § 1691(a)(1) (2006). ECOA and Regulation B, which implements ECOA, bars lenders from requiring a spouse to execute loan documents if the individual applicant qualifies for the requested credit. Accordingly, not every credit application is treated the same under ECOA; the regulations provide for a number of exemptions to the general rule prohibiting spousal signatures. First, and most obviously, a spouse's signature can be required when the applicant independently cannot qualify "under the creditor's standards of creditworthiness for the amount and terms of the credit requested." 12 C.F.R. § 202.7(d)(1) (2013). Implicit in this exception is an independent determination that an applicant cannot satisfy the lender's credit standards before seeking an additional signer. Only after this independent determination can a lender seek an additional

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obligor for the credit sought, but cannot "require that the spouse be the additional party." 12 C.F.R. § 202.7(e) (2013). The creditor may only request a "cosigner, guarantor, endorser, or similar party." *Id.*

Second, when the applicant relies on property that the applicant owns jointly with a spouse to "satisfy the creditor's standard of creditworthiness," the lender may require the spouse's signature. 12 C.F.R. § 202.7(d)(2) (2013). This exception, however, does not create an unfettered authorization to force the spouse to guaranty or co-sign for the credit. The regulations only permit the lender to obtain the spouse's signature on instruments "necessary, or reasonably believed by the creditor to be necessary … to enable the creditor to reach the property … relied upon" in the event the applicant defaults. *Id*. For example, a lender may require a spouse to sign a pledge agreement for co-owned securities on which an applicant relied to meet the lender's net worth thresholds.

Similarly, ECOA permits a lender to require a spouse's signature when the spouse co-owns the collateral pledged as security for the loan. This exception too is limited to instruments necessary to "create a valid lien, pass clear title, waive inchoate rights, or assign earnings" so that the property pledged is eligible to satisfy the debt in the event of a default. 12 C.F.R. § 202.7(d)(4) (2013). The most common example involves a non-applicant spouse signing a deed of trust or mortgage for real property pledged as collateral.

Fourth, ECOA and its regulations permit lenders to obtain the signature of a spouse when the spouse is a joint applicant for the loan. On its face, this exception is not particularly noteworthy; however, the courts have enlarged this exception by judicial gloss. That is, when an individual seeks credit for the benefit of an entity co-owned with the spouse, lenders may require the signature of the spouse even though the spouse did not initially apply for the requested credit. *See, e.g., Midlantic Nat'l Bank v. Hansen*, 48 F.3d 693, 700 (3d Cir. 1995). In this scenario, the courts have held that the spouse, due to her co-ownership in the entity, is a de-facto joint applicant; thus permitting lenders to require spouses' signatures when these facts are present.

Ballard Analysis

Turning back to *Ballard*, Mrs. Ballard claimed that Bank of America violated ECOA by requiring her to guaranty her husband's loan without first establishing that he could not independently qualify for the loan. Conversely, Bank of America argues that Mrs. Ballard—through her co-ownership of the Maryland house and the California winery pledged as collateral for the loan—became a de-facto joint applicant and that requiring her guaranty of the loan did not violate ECOA.

After analyzing ECOA and Regulation B, the court held that Mrs. Ballard's unlimited guaranty may have violated ECOA because the exception for co-ownership of property pledged as collateral only allows the lender to seek spousal signatures on documents necessary to create security interests in such property. Bank of America's argument attempted to stretch this exception beyond security documents to allow the bank to require a full guaranty of the loan. The court rejected Bank of America's position, reasoning that allowing a lender to pursue a full spousal obligation based simply on co-ownership of collateral securing the loan would "contravene the plain language and purpose of ECOA."

Despite indicating that Bank of America's conduct may have violated ECOA, the court upheld the lower court's dismissal of Mrs. Ballard's claim for another reason; she waived it through a number of restructuring agreements that she executed after each of the defaults.

Waiver and Restructuring

Mrs. Ballard's original guaranty of the Foodswing loan contained a waiver provision, but it was limited to punitive and non-compensatory damages. After each default of the Foodswing loan, Mrs. Ballard executed certain loan restructuring agreements. Each of these agreements contained express waiver provisions, waiving "any and all" claims that Mrs. Ballard may have had against Bank of America in exchange for the bank's waiver of Foodswing's default.

Federal claims can be waived by agreement and courts will enforce such a waiver unless it was obtained by some type of misconduct, was involuntary, or would undermine the policy pursuant to which the statute was enacted. Mrs. Ballard contended that broad waivers such as the ones Bank of America obtained in the restructuring agreements would allow lenders to violate ECOA and simultaneously coerce waivers of their rights. The court in *Ballard* suggests this argument has merit if the waiver is a precondition for obtaining the credit. However, Mrs. Ballard's initial guaranty did not waive her ECOA rights, but only waived claims that she may have had for punitive damages and equitable relief (ECOA allows for actual damages and attorneys' fees, *see* 15 U.S.C. § 1691(e), (d)). The waivers contained in the restructuring agreements that Bank of America required Mrs. Ballard to sign after Foodswing defaulted were given in exchange for the bank's own waiver of Foodswing's default and the parties' agreement to restructure the debt. As a result, the court held that ECOA claims can be waived so long as the waiver is not a prerequisite to obtaining the credit applied for, and that Mrs. Ballard waived her ECOA claims pursuant to the restructuring agreements.

Postscript and Best Practices

Based on the holding in *Ballard*, ECOA and Regulation B violations occurring in the origination process can be dealt with during renegotiations, restructurings, workouts and renewals. Notwithstanding the ability to obtain a waiver by a borrower or guarantor of his or her ECOA claims in a restructuring context, compliance in the application and origination process should be the primary objective. Accordingly, lenders should carefully consider when and under what circumstances to seek additional signatories on loan documents. Unless one of the exceptions listed above is present, ECOA and its regulations prohibit lenders from seeking spousal signatures for extensions of credit. What's more, two of the exceptions listed above are limited to security documents and do not allow a lender to seek a spousal guaranty or a spousal co-maker for the loan. Moreover, lenders should, as a matter of course, evaluate the applicant independently to determine whether or not the applicant alone satisfies the bank's creditworthiness standards. Credit officers who routinely require spousal guaranties without undertaking this analysis run the risk of repeatedly violating ECOA. Finally, in the event the applicant does not independently qualify for the credit, the lender cannot demand that the spouse co-sign for the loan; rather the lender can only request that an additional party co-sign or guaranty the loan. In this instance, lenders should create processes and forms designed to seek additional signers for the loan without automatically suggesting that the spouse co-sign or guaranty the loan.

In cases where confusion arises, compliance officers who are well-versed in banking regulations can and should be consulted. Likewise, loan documents and applications should be crafted with an eye toward compliance with ECOA. Simply because an application contains a joint financial statement, lenders cannot automatically assume that it is a joint application for credit. 12 C.F.R. 202.7 (d)(1) (2013). Lenders should have documented systems in place to determine when and what conditions create a joint application for credit. At the other end of the spectrum, when restructuring documents are drafted, they should ensure not only that the debt is properly restructured, but also that any remaining regulatory loose ends from the origination process are properly waived or remedied—including ECOA violations. Following these guidelines will help ensure compliance with ECOA and, in the event a loan needs to be restructured, provide for some additional peace of mind through properly drafted waivers and releases. ₰

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