

Legal analysis to guide the mortgage industry and protect its interests.

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Suitability Might Not Fly in Alabama by Shaun Ramey

Suitability is a concept that has recently pervaded the residential mortgage industry even though support for the claim has traditionally been lacking with the one notable exception of the Massachusetts Attorney General action against Freemont (discussed at length in another article in this publication entitled "Suitability is Alive and Well"). While the Freemont decision appears to be detrimental to the mortgage industry as a whole, at least one opinion entitled Flying J. Fish Farm v. Peoples Bank of Greensboro has surfaced in Alabama and might assist mortgage lenders. In this opinion, the Alabama Supreme Court appears to have no sympathy for a borrower so long as the borrower appreciated, through disclosures or otherwise, the risk of the loan they were receiving. While this opinion involved a commercial loan, the logic might extend to traditional residential borrowers and be used to defeat future suitability claims in Alabama.

Suitability's origins

In order to understand the potential significance of Flying J. Fish, it is important to briefly retrace the roots of suitability. The concept of suitability can be traced back to the securities industry and appears in various disciplinary rules of the stock exchanges, the rulings of the Securities and Exchange Commission (SEC), and in court decisions in private security-fraud claims under the Securities and Exchange Act. For example, Rule 2310 of the Rules of Fair Trade and Practice promulgated by the National Association of Securities Dealers provides that:

In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situations and needs. (emphasis added)

A dealer is required by the same rule to make "reasonable efforts to obtain information concerning (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives and (4) such other information used or considered to be reasonable by such [broker-dealer] in making recommendations to the customer." Likewise, Rule 405 of the New York Stock Exchange imposes a suitability requirement by requiring every managing partner or agent to "[u]se due diligence to learn the essential facts relative to every customer." The American Stock Exchange and the regional stock exchanges have similar rules, generally called "know your customer" rules.

The SEC has found suitability requirements to arise from the antifraud provisions of the federal securities laws. The commission has relied on two theories to find a duty: the "shingle" theory and the "trust and confidence" theory. Under the shingle theory, the SEC has argued that simply by making their services available to the public — "hanging out their shingle" — broker dealers implicitly represent to customers that they will deal fairly and abide by the standards of the industry. Under the "trust and confidence" theory, broker-dealers who cultivate trust in their customers thereby become fiduciaries and owe a duty to act in their customers' best interests.

Under both of these theories, the SEC has taken action against brokers who recommend a security without "an adequate and reasonable basis for such recommendation." A reasonable basis is established by reasonable investigation and recommendations must be in accord with the results of the investigation. Brokers must also take their customers' risk thresholds into account when making decisions.

Suitability standard

These same concepts have filtered over to the residential mortgage industry. Proponents of a suitability standard in this industry claim that disclosure requirements have proven ineffective, and thus, a standard of suitability is needed. These proponents further argue that the public relies, and has been trained to rely, on the expertise of mortgage brokers rather than develop their own financial literacy. Such reliance, they claim, is justified based on the brokers being in a better position than borrowers to predict the amount of debt the borrowers can manage, the risk involved and the financial consequences of the credit extended. Consequently, a suitability standard creates some form of a fiduciary relationship between lenders and borrowers.

Flying J. Fish Farm, however, might indicate that a suitability standard will not be so easily recognized in Alabama. The borrower, Charles Jay, attempted to secure financing for the Flying J Fish Farm with the Peoples Bank. Initially, Peoples Bank refused his loan request because he could not offer collateral to guarantee the loan. Jay returned to the bank with his mother, and, based on her personal guarantee, the bank agreed to finance the Jays' loan. The loan was renewed and modified each year in order to finance the continuing operations and expansion of the Flying J Fish Farm. The two loan officers who advised the Jays' on the catfish farming business were also shareholders in Alabama Catfish, a company with which the Flying J Fish Farm did business. The loan officers did not disclose their relationship with Alabama Catfish to the Jays. Upon discovery of that relationship and the fact that Alabama Catfish was going to raise more of its own catfish for its processing plant, the Jays filed a complaint against the bank and the loan officers alleging negligence, among other claims. The Court, in reaching its decision not to hold Peoples Bank liable for negligence or wantonness, noted that the Jays made the decision to start a catfish-farming business. The Jays applied for and received the loan knowing that they stood to profit if the business succeeded and that they could be exposed to economic loss if the business failed. Although the loan may have been risky, the Court noted that it was not certain that the Jays would default on it. The Court stated that a bank's loan approval policies are intended solely for the benefit of the bank, not the customer. Moreover, the Court refused to make Peoples Bank the insurer of the Jay's business decision.

Suitability of home loans

Flying J. Fish Farm's logic could be extended to the residential mortgage context. For example, borrowers take out loans for a myriad of reasons. While many borrowers prefer a fixed rate loan, others prefer a lower, yet temporary rate, so that they can purchase a house (otherwise, they might not have the means). After all, home ownership is purportedly the American Dream. These same borrowers may have reason (and perhaps good reason) to believe that their income will materially increase when the rate changes or that their present income will be sufficient when (and if) the payments increase. Also, the TILA states that when making disclosures, a lender is not to assume that the interest rate for an adjustable product will increase or to what rate it might increase. Nevertheless, the risk is one that borrowers are presumably willing to take. Per Flying J. Fish Farm, it is not for the lender to insure the borrowers from their assumed risk when the borrowers knowingly enter these types of transactions — indeed, per TILA, they should receive adequate disclosures concerning the transaction they are entering at loan origination.

Perhaps more encouraging, the Alabama Supreme Court in Flying J. Fish Farm appears to have placed some importance on the fact that it was not certain that the borrower would default. If that truly is an important factor to the Alabama Supreme Court, then suitability will have a long road to climb. Also encouraging was the Court's statements that the lender's underwriting policies were solely for the benefit of the bank. Finally, and perhaps most importantly, the Alabama Supreme Court in Flying J. Fish Farm did not view the relationship between the lender and the borrower as a fiduciary one, which is at the heart of any suitability claim. While the borrower may have sought the proceeds for a commercial purpose, the facts indicate that he was a small business and more akin to a traditional consumer rather than a traditional business. Consequently, if the Alabama Supreme Court views residential borrowers like the borrower at issue in Flying J. Fish Farm, then it is unlikely that the Court will impose any new duties like suitability on mortgage lenders. At least it will give future mortgagees a new argument to defeat future suitability claims in Alabama.