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Commentary on the economy & regulatory policies affecting financial companies

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Trade-off Between Flexibility and Liability*

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Regulations and legislation often present an inexorable conflict — how much flexibility should be provided so that companies may engage in their operations with innovation and enthusiasm but still create an environment in which those same companies can avoid unreasonable supervisory, reputation and litigation risk.

The conflict is not easily resolved, even within industries. Some companies feel they will not be the targets of litigation or supervisory penalties and some managers simply have greater risk tolerance than others. In other industries, it has become practice to follow in great detail the guidelines laid out by the regulators (see the savings and loan industry over the years).[1] Regardless of the industry, however, the debate between certainty and flexibility surfaces in a host of statutes and regulations.

Litigation

Under the rules of most courts, there is an opportunity for a defendant to prevail in its lawsuit by a verdict of the jury. In addition, in most courts a defendant may prevail through a motion made before the trial itself actually begins and during the trial after the plaintiff has submitted its entire case. Both parties may prevail in an appropriate motion after the defendant has presented its material in response and before the matter goes to the jury. Think of those in the short hand of a motion to dismiss or a summary judgment motion. The key is that the judge can decide the case on the law before it gets to the jury.

Many defendants prefer prevailing in the case at that stage, if possible, for a variety of reasons. First, it terminates the expenses of defending the case; in large civil cases that can be a significant amount of money saved.

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[1] Some say that led to its demise.

Similarly, in many such cases, it is very difficult to explain the facts and how they apply to the law, and how such matters will be interpreted in the jury room cannot be rationally predicted. There is also a feeling that a large corporate defendant will be seen as easily capable of paying the damages sought by the individual plaintiff, or that the corporation is supported by an insurance company whose business takes into account paying such claims. There is fear that facing those possibilities, a jury may well award significant damages out of proportion to the actual damages suffered by the plaintiff should it decide for the plaintiff.[2]

Faced with that situation, many companies will seriously consider settling the case rather than let it go to a jury, and settlements, just like jury decisions, can be very costly.

Cases generally go to a jury only if there are no facts to be decided by the jury and the question to be decided is simply what is the law and how does it apply to the uncontested statement of facts. Therefore, if there are no significant facts in dispute, the judge can decide the case and a motion to dismiss or summary judgment motion will be decided.

That is the ideal outcome for most litigation from a defendant's perspective, assuming, of course, that it has prevailed on the facts.

<u>Implication for regulation drafting</u>

If that is the background, then what is most desired by litigators is a firm, predictable, objective set of rules and regulations. Proving that the actions of the defendant have complied with rules of that type will be easier for an attorney than proving that defendant has complied with rules in which a great deal of latitude for flexibility and interpretation exists. For example, by way of general background, take two approaches to credit history:

> *Case one*: Assume that the rule is that a party must have a FICO score of 690 or more to show it has the ability to repay a loan. What the litigator representing the lender must show in that case is that the borrower had a FICO score of 690 or better. That can be done by introducing the FICO score into the record. Once done, that fact is established, is not reasonably in dispute and normally the judge would

[2]There is, of course, a chance that the judge will decide the case for a plaintiff in a summary judgment motion filed by the defendant, or vice versa.

> instruct the jury that it should not question whether or not the party had a FICO score of 690 or better. If that is the only fact that is in dispute in the case, the lender should be able to prevail without the case going to the jury.
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> *Case two*: The rule is that a FICO score of 690 or better is needed to show a party has the ability to repay a loan, but compensating factors may be considered by the lender to overcome a FICO score lower than 690. The lender can show that the borrower had a 670 FICO, and can introduce evidence that the compensating factors provided by the borrower were sufficient to compensate for the difference between 670 and 690. Faced with that, the borrower is free to introduce evidence that supports its position that the factors were not sufficient to compensate for the lower score, and whether the lender had compensating factors sufficient to overcome the 670 FICO score generally would become an issue for the jury to decide.

A general rule for lenders, therefore, considering just the potential litigation risk, is that clearly identifiable rules for which compliance can be easily shown objectively without leaving an avenue for the plaintiffs to challenge that conclusion are the ideal rules — they make proof on a motion to dismiss easier to produce.

<u>Underwriting and loan approval</u>

On the other hand, underwriting a loan is an art, and while there are parameters in which underwriters are directed to operate, they generally are given some discretion that permits them to consider varying elements that may outweigh other elements and, when considered appropriately, may permit a lender to conclude, for example, that a borrower has the ability to repay a loan. Underwriters are generally expected to exercise judgment on subjective questions, and the success or failure of the loans they approve is the best measure of judging their ability. Over time, the judgment evidenced by the underwriting rules of the lender and of the abilities of individual underwriters can be tested, and the company will gain enhanced revenue and profits from decisions by the better underwriters. Some of those decisions will have been made by applying compensating factors in reaching the decisions; strict adherence to a fixed guideline that eliminates that discretion (no approval if the DTI is below 690, for example) may reduce profitability of the company and deny loans to some lenders that the underwriters might feel could repay the loan.

Underwriting, therefore, encourages the use of skilled business judgment in cases in which the correct answer cannot be objectively determined from the facts that are available to the person making the decision. Successful underwriting creates profits for the firm, and so the ideal rule in which they operate should provide ample flexibility for the underwriters to utilize their ability at making these subjective decisions.

The dilemma

The dilemma is how to resolve the conflict between the two points of view — in other words, should one draft the regulation that says no loan may be approved if the borrower does not have a FICO score of 690 or better, or should one draft one that says a loan may be approved if the borrower has a FICO score of 690 or better or there are compensating factors that lead the lender to conclude that the borrower has the ability to repay the loan.

In part, the answer to the dilemma depends upon the penalties that exist for violating the rule. If the penalties are severe, such as class action lawsuits, statutory as well as actual damages, no statute of limitations for utilizing the violation as a defense to foreclosure or collection of the debt, etc., then a lender would be faced with hard choices — it wants to lend but doesn't want to be exposed to out of proportion damage claims in situations in which the jury will decide the issue. One would have a difficult time succeeding on a motion to dismiss when the elements of the claim are subject to interpretation or argument, and the juries could reach a different interpretation than the one the lender had acted upon. Certainly the chances are excellent that if damages are awarded, they would be greater than the damages the lender's actions had caused.

If the penalties were more reasonable such as actual damages for a violation of the rule, then you might be willing to permit your underwriters to try to exercise their judgment and make more loans than they otherwise would be able to under a non-discretionary rule. You still would be subject to the possibility of losing the case before the jury, but the loss that you might suffer would be not out of proportion to the damages the jury would have found that you had caused.

When potential losses can be significantly out of proportion to the damages that the lender's actions have, and lenders have not been provided a true safe harbor[3] lenders will necessarily be very cautious in making lending decisions. If the rule says that lenders will not make loans without a reasonable belief that the borrower has the ability to repay the loan, and if the potential damages are significantly out of proportion to the actual damages the lender's violation of that rule have caused, lenders will most likely be very conservative. Not only will they refrain from making loans that the borrower cannot repay, but they will not make loans if there is significant doubt that the borrower can repay.

The resolution of the dilemma is not in the hands of the lenders or borrowers, the parties most affected. It is in the hands of the Congress, in the first instance, and when regulations are promulgated to implement the rule, the regulators. If Congress provides for potential damages significantly out of proportion to the damages actually caused, and fails to provide objective standards that, if met, protect the lender from liability, then Congress has made a decision that the scope of lending should be limited to less than would be available if the penalties were less and a true safe harbor was provided.

Congress often makes declaratory statements such as this, however, and then at the same time provides regulators with broad exemption authority in the statute, perhaps on the assumption that regulators have more experience and can see those situations in which deviations from some parts of the Act are in the public interest. In those cases, it seems incumbent upon the regulators to take a very close look at the results of regulations that promote certainty and those that promote flexibility, particularly in those cases in which the potential penalties are severe and out of proportion to damages actually suffered.

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[3] A rebuttable presumption can be easily rebutted and provides almost no protection from liability in most cases.