Pepper Hamilton LLP
Attorneys at Law

Federal Court Clarifies Banks' Obligations Under Appendix Q

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John V. Levonick | levonickj@pepperlaw.com
Scott D. Samlin | samlins@pepperlaw.com
Avinoam D. Erdfarb | erdfarba@pepperlaw.com

The U.S. District Court for the Southern District of Ohio recently issued a landmark decision regarding the reasonableness of a bank's reliance on Appendix Q regarding nonemployment-related consumer income validation for a qualified mortgage (QM). On March 26, in *Elliott v. First Federal Community Bank of Bucyrus*, the court found that it was appropriate for a bank to rely on its customer's legal marriage separation agreement, which provided for a signification portion of the customer's expected nonemployment-related income, as part of the bank's debt-to-income (DTI) calculation. This is the first time a federal court has ruled on the veracity of the Appendix Q standards for purposes of relying on the reasonableness of specific documentation — a legal separation agreement as sufficient documentation of income in a DTI calculation — providing greater certainty to lenders in developing their own calculations.

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Background

The Truth in Lending Act (TILA), 15 U.S.C. § 1639c, along with its implementing Regulation Z, 12 C.F.R. § 1026.43, requires banks to conduct an ATR calculation before making a residential mortgage loan. When making a QM loan, there is a presumption that the individual has the ability to repay, but the bank still needs to document the individual's income and asset sources. The ATR calculation must be a "reasonable and good faith determination based on verified and documented information" that the consumer will be able to repay the loan. Appendix Q to Regulation Z outlines what is considered sufficient documentation for evidencing income and assets in a QM loan.

In the *Elliott* case, the plaintiff provided his bank with a draft of the marriage separation agreement he negotiated with his wife. Under the terms of the agreement, the plaintiff would receive $2,200 per month in spousal support and keep his job at his ex-wife's office, in addition to a number of other income sources. Using this information, the bank determined that the plaintiff's DTI ratio was within the acceptable range for a QM loan and refinanced the mortgage on his primary residence. Note that the plaintiff's loan application represented $2,300 per month in spousal support, despite the separation agreement only providing for $2,200, which the court did not take exception to.

Following the subject loan consummation, the legal separation agreement broke down, and the couple's property and debts were redivided in formal divorce proceedings. The plaintiff was awarded $250 per month in spousal support, instead of $2,200, and he was fired from his job at his ex-wife's office. This reduced income, combined with the cost of the divorce proceedings, led the plaintiff to fall behind on his mortgage payments.

Court's Opinion

The plaintiff brought suit against the bank, claiming that it "failed to make a 'reasonable and good faith determination based on verified and documented information' that [the plaintiff] had a 'reasonable ability to repay the loan.'"

The court disagreed and found that the breaking down of the plaintiff's separation agreement "was not an event that was reasonably foreseeable to the Bank." The court also stated that the bank conducted appropriate due diligence to confirm the plaintiff's ability to repay his mortgage at the time of the transaction and that all proper steps were taken to meet the TILA and Appendix Q requirements. As a result, summary judgment was granted in favor of the bank.

Pepper Points

- A bank's compliance with Appendix Q to Regulation Z allows it reasonably rely on documentation to support a borrower's income, including marriage separation agreements supported by verbal assurances from the parties as to their intentions to comply with the separation agreement.

- A breakdown of a legal marriage separation agreement and ultimate redividing of assets and liabilities in a divorce proceeding is not a reasonably foreseeable event, and therefore a lender does not need to take it into consideration when conducting an ATR calculation.

- Lenders have been uncertain as to what standard Appendix Q held them to with legal separation agreements, and with this finding by the Eastern District of Ohio, they finally have some answers. This decision is promising for all lenders in other jurisdictions.