CAN A FORECLOSURE BE "WRONGFUL" IF THE DEBTOR IS UNDERWATER?

In most successful "wrongful foreclosure" cases (challenging an already-completed trustee's sale), the debtor's most obvious source of damages is the lost equity in the wrongfully sold security property.

In fact, one California Court of Appeal decision from 1970,*Munger v. Moore* (1970) 11 Cal.App.3d 1 (First District, in San Francisco), made it sound like "lost equity" might be the ONLY permissible recovery in a wrongful foreclosure case.

But in a recent decision by the Fourth District (Santa Ana) — *Miles v. Deutsche Bank Nat'l Trust Co.* — **the Court of Appeal held that even an *underwater* wrongful foreclosure plaintiff (with no equity in the security property) was still entitled to the normal tort recovery of all damages "proximately caused" by the wrongful conduct — in that case, moving expenses, lost rental income, damage to credit, and emotional distress.**

The facts

There is an old saying in the law that "bad facts make bad law." That's probably true, but it might be more accurate to say "judges are human, and bad facts carry a stench that can ruin your case." As in many other debtor-friendly decisions, this case featured disturbingly bad behavior by the lender and loan servicer….

The plaintiff owned property in Riverside, and refinanced the loan on that property in July 2005 with a total loan amount of $815,000 at an adjustable rate. Plaintiff stayed current on the loan for almost two years.

Between June 2007 and September 2007, the monthly payment on the loan increased substantially and plaintiff applied for a modification. In March 2008, plaintiff and the loan servicer *signed a modification agreement*, which increased the loan balance to $834,051 and fixed the rate at 5.99%.

Less than a month later, the loan servicer stated it would no longer honor the terms of the modification agreement, and sent plaintiff a default lender demanding that he pay almost $40,000 or face immediate foreclosure. One week later, without explanation, the loan servicer sent the plaintiff a *new* modification agreement that increased the loan balance to $870,767, and told plaintiff he must sign the new agreement or face foreclosure. Plaintiff refused to sign the new agreement, instead relying on the original agreement.

Plaintiff made several more payments. In June 2008, the loan servicer sent plaintiff yet *another* modification agreement, which raised the balance to $895,117, again without explanation.

The loan servicer then began refusing Plaintiff's payments under the original (and the only signed) loan modification agreement, and demanded that Plaintiff pay a lump sum of more than $35,000 to "process" a new loan modification. Plaintiff refused.

The loan servicer recorded a notice of default and election to sell the property, and then recorded a notice of trustee's sale. The notice of default listed the amount in default as $52,558 — a different amount than had been listed on a statement to plaintiff one day earlier.

The loan servicer then demanded that plaintiff pay $14,050 for a "new" modification and, facing an imminent sale, the plaintiff complied. However, instead of sending plaintiff a new modification agreement, it sent only a forbearance agreement that would have required substantial payments that plaintiff could not afford. Plaintiff refused to sign the forbearance agreement.

Over the next several weeks, the loan servicer sent plaintiff other modification agreements and offers, each conditioned on plaintiff's upfront payment of substantial amounts — all the while ignoring the terms of the parties' signed March 2008 modification agreement. Plaintiff refused to sign.

The servicer also sent plaintiff payoff statements on two consecutive days, each showing a different amount owing. Plaintiff refused to pay.

The lender and loan servicer completed a trustee's sale of the property.

Plaintiff sued for wrongful foreclosure, among other claims.

The trial court's ruling

The trial court granted the lender's and loan servicer's motion for summary judgment on the wrongful foreclosure claim, holding plaintiff could not prove damages. The court ruled that the only permissible damages in a wrongful foreclosure suit is the lost equity in the property, and without equity, the claim could not survive.

The trial court based its ruling on the 1970 *Munger* opinion, which, the trial court held, limited a wrongful foreclosure plaintiff's recovery to only the lost equity in the property.

The Court of Appeal's opinion

In the Court of Appeal's *Miles* opinion, the court ruled in favor of the plaintiff, and reversed the trial court's order granting summary judgment. The court disagreed with the trial court's "narrow" reading of *Munger*.

In the 1970 *Munger* decision, the plaintiff had defaulted on a secured loan, but timely tendered the entire amount due before any foreclosure sale. The lenders refused the tender, foreclosed, and later re-sold the property for $30,000 more than any of the prior encumbrances. The court of appeal in *Munger* affirmed the trial court's award of $30,000 to plaintiff. The *Munger* decision first highlighted that wrongful foreclosure is fundamentally a tort, and therefore governed by the broad tort measure of damages in Civil Code section 3333 (all "proximately caused" damages, whether foreseeable or not). The *Munger* decision then applied that measure of damages to the case before it, in which the "only damages at issue" were the lost equity in the property.

The *Miles* opinion held that *Munger* should be interpreted broadly, and that the general measure of tort damage recovery should govern in wrongful foreclosure cases. Lost equity might be one type of "proximately caused" damages, but it is not the *only* type. The court held that other types of recoverable damages can include moving expenses, lost rental income, damage to credit, and emotional distress.

The court signaled that its conclusion was driven, at least in part, by public policy concerns. It noted that the trial court's ruling in favor of the lender and loan servicer would "create a significant moral hazard" because:

> **“lenders could foreclose on underwater homes with impunity, even if the debtor was current on all debt obligations and there was no legal justification for the foreclosure whatsoever. So long as there was no equity, there would be no remedy for wrongful foreclosure. And since lenders can avoid the court system entirely through nonjudicial foreclosures, there would be no court oversight whatsoever. Surely that cannot be the law.”**

Lesson

Under the *Miles* opinion, a debtor’s lack of equity in the security property does not amount to a license to conduct a wrongful foreclosure.

It will be interesting to see whether other Courts of Appeal follow in line with *Miles* or, instead, give *Munger* a more narrow reading along the lines of: “no equity–>no damages–>no case” rule (as the trial court did in the *Miles* case, and as I have personally seen at least one trial court do in my practice).

Assuming the *Miles* opinion’s reasoning and public policy concerns prevail, wrongful foreclosure cases will gain more traction, as even an underwater plaintiff might be able to recover other forms of damages.