Servicer May Owe Borrower Duty of Care as to Loan Mod Efforts, Loan Owner May Be Liable for Servicer's Misconduct

The Court of Appeal of the State of California, Sixth Appellate District, recently held that a loan owner may be liable for misrepresentations made by the loan servicer.

The Court also held that a loan servicer may owe a duty of care to a borrower through application of the "Biakanja" factors, even though its involvement in the loan does not exceed its conventional role.

A copy of the opinion is available at: **Link to Opinion**.

In May 2005, the borrowers obtained an adjustable rate mortgage. In early 2008, the borrowers asked their servicer to refinance or modify the loan. They were told that neither were possible because another was in the process of acquiring the right to service the loan.

The borrowers eventually contacted the new servicer about refinancing the loan. They alleged they contacted the new servicer on a weekly basis until they finally received a loan modification application in mid-2009. The employees of the new servicer allegedly told the borrowers they would be granted a modification if they complied with all of the servicer's requirements.

Months later, the borrowers' modification application was denied because the borrowers did not provide the appropriate documents. The borrowers again applied for a loan modification. The servicer allegedly told the borrowers they had provided the proper documentation, but then denied the application for failure to provide documentation.

In mid-2010, the borrowers again contacted the servicer and were supposedly told they were ineligible for a loan modification because they were not at least three months' delinquent in their payments. The servicer's employees allegedly led the borrowers to believe they would be granted a loan modification if they became at least three months' delinquent in their mortgage payments.

The borrowers, who were current on the loan, allegedly purposefully became three months' delinquent in their payments. The borrowers were then allowed to reduce their payments. The borrowers eventually attempted to resume making their regular higher monthly payments but the servicer allegedly refused to accept those payments. At the end of 2011, the servicer refused to accept any payment from the borrowers.

The borrowers continued to attempt to obtain a loan modification but were continually denied. The servicer's employees allegedly told the borrowers multiple times that the proper paperwork was not submitted, even though the servicer allegedly had independently confirmed receipt of the documents. In 2012, the borrowers again attempted to modify the loan but the servicer denied them because their home was underwater.

In August 2011, the trustee on the deed of trust was substituted. Another servicer began to service of the loan on Dec. 1, 2012. In August 2012, a notice of default was recorded against the property. The notice was recorded on Nov. 28, 2012.

The borrowers were plaintiffs in a mass joinder action against multiple servicers in 2011, *Maxam et al v. Bank of America* (Super. Ct. Orange County, 2011). The complaint alleged multiple causes of action based upon borrowing loans and loan modification.

The *Maxam* defendants moved to dismiss the allegations, and the trial court sustained the demurrer with 60 days' leave to amend. The borrowers failed to file an amended complaint. The trial court entered a judgment of dismissal with prejudice against the plaintiffs. Four months later, the borrowers moved to set aside the judgment due to its preclusive effect on their legitimate and meritorious claims.

The borrowers filed the current action against the servicers on March 19, 2013. The servicers filed motions to dismiss on the ground that the borrowers' claims were barred by res judicata. The trial court sustained the demurrers. The borrowers appealed.

The Appellate Court first looked to if the borrowers' claims were precluded on the grounds of res judicata, based on the *Maxam* judgment.

As you may recall, claim preclusion bars re-litigation of a claim altogether where a second suit involves the same cause of action between the same parties after a final judgment on the merits by a court of competent jurisdiction.

Here, the Court of Appeal found that there were additional servicers in the instant suit that were not parties in the *Maxam* action. Thus, the Appellate Court held that the same parties' element was not satisfied as to those servicers and claim preclusion did not apply as to those parties.

The Court of Appeal then addressed the final factor. The Court recited that, under California law, a former judgment entered after a general demurrer is sustained with leave to amend is a judgment on the merits. However, the former judgment will not bar a subsequent action alleging new or additional facts that cure the defects in the original pleading.

The Appellate Court held that the current action alleges facts about the origination and attempted modification of borrowers' loan that were not alleged in*Maxam*. The Court found the issue of whether the final judgment on the merits was satisfied was insufficiently developed, and thus it concluded that the borrowers were entitled to amend their complaint.

The Court of Appeal then looked at the borrowers' intentional and negligent misrepresentation claims.

As you may recall, the elements of a cause of action for intentional misrepresentation are (1) a misrepresentation, (2) with knowledge of its falsity, (3) with the intent to induce another's reliance on the misrepresentation, (4) actual and justifiable reliance, and (5) resulting damage.

The elements of a claim for negligent misrepresentation are nearly identical. Only the second element is different, requiring the absence of reasonable grounds for believing the misrepresentation to be true instead of knowledge of its falsity. Each element must be plead with specificity. However, this requirement is relaxed when the allegations indicate the defendant must necessarily possess full information concerning the facts of the controversy.

Here, the Court of Appeal looked to whether borrowers stated a claim for intentional or negligent misrepresentation based on any alleged misrepresentation by the servicers.

The Court noted that the borrowers alleged that one of the servicers had not received financial documents submitted in support of their loan modification application, and that the borrowers identified the employee in their complaint. The Appellate Court held this was sufficient to apprise the defendant servicer of the specific grounds of the charge.

In addition, the Court of Appeal held it could reasonably infer from the allegations that the borrowers were alleging that they believed the representation, and that they relied upon information exclusively within the servicer's knowledge. The Court held that the borrowers also sufficiently pleaded the remaining factors for negligent and intentional misrepresentation. Accordingly, the trial court's order granting motion for judgment on the pleadings as to the intentional and negligent misrepresentation claims against the servicer were reversed.

However, the Court of Appeal found that the borrowers failed to state a claim for negligent and intentional misrepresentation against the subsequent servicer.

The borrowers alleged that the subsequent servicer was liable for the prior servicer's misrepresentations because the subsequent servicer benefited from the prior servicer's fraudulent conduct, and under agency and successor-in-liability theories. The Court noted that the subsequent servicer did not address any deficiencies with these arguments, but it nevertheless found the borrowers' allegations against the subsequent servicer to be insufficient. The Court of Appeal granted the borrowers another opportunity to amend their claims for intentional and negligent misrepresentation against the subsequent servicer.

Importantly, the Court of Appeal found that the borrowers stated misrepresentation claims against the owner of the loan based on agency.

As you may recall, an agent is anyone who undertakes to transact some business, or manage some affair, for another, by authority of and on account of the latter, and to render an account of such transactions. The chief characteristic of the agency is that of representation, the authority to act for and in the place of the principal for the purpose of bringing him or her into legal relations with third parties. The significant test of an agency relationship is the principal's right to control the activities of the agent. A principal is liable to third parties for the frauds or other wrongful acts committed by its agent in and as a part of the transaction of the business of the agency.

Here, the Court noted that the alleged business of the agency was the servicing and modification of the borrowers' loan. The Court found that the borrowers alleged the misrepresentations were made in the course of servicing their loan, and as such the representations were alleged to have been made within the scope of the alleged agency relationship. Accordingly, the Court of Appeal found that the borrowers stated claims for negligent and intentional misrepresentation against the owner of the loan.

However, the Court of Appeal held that the borrowers failed to state a negligent or intentional misrepresentation claim against two servicers and the owner of the loan under a civil conspiracy theory. The borrowers alleged the defendants conspired to deceive and defraud the borrowers into participating in the loan modification process.

The Court recited that conspiracy is not an independent cause of action, but rather a doctrine imposing liability for a tort upon those involved in its commission. Thus, liability for a conspiracy must be activated by the commission of an actual tort. To allege a conspiracy, a plaintiff must plead: (1) formation and operation of the conspiracy and (2) damage resulting to plaintiff (3) from a wrongful act done in furtherance of the common design.

The Court of Appeal found the borrowers' allegations too conclusory as there were no factual allegations about the nature of the agreement or the timing of the alleged conspiracy. Accordingly, the Court of Appeal found the trial court did not err in dismissing the civil conspiracy cause of action without leave to amend.

The Appellate Court then looked to the borrowers' causes of action based on breach of contract.

As you may recall, a cause of action for damages for breach of contract is composed of the following elements: (1) the contract, (2) plaintiff's performance or excuse for nonperformance, (3) defendant's breach, and (4) the resulting damages to plaintiff.

The borrowers alleged one of the servicers breached an oral agreement promising a loan modification. The Court of Appeal found the terms of the alleged agreement to be not sufficiently definite to render the agreement enforceable.

The Court recited that the terms of a contract are reasonably certain if they provide a basis for determining the existence of a breach and for giving an appropriate remedy. Where a contract is so uncertain and indefinite that the intention of the parties in material particulars cannot be ascertained, the contract is void and unenforceable. Typically, a contract involving a loan must include the identity of the lender and borrower, the amount of the loan, and the terms for repayment in order to be sufficiently definite. Agreements to agree are not enforceable contracts.

The Court of Appeal looked to the Home Affordable Modification Program and the U.S. Court of Appeals for the Seventh Circuit's ruling in *Wigod v. Wells Fargo.* The HAMP loan modification process consisted of two stages. After determining a borrower was eligible, the servicer implemented a Trial Period Plan (TPP) under the new loan repayment terms it formulated using the method prescribed by HAMP program directives. The trial period under the TPP lasted three or more months. After the trial period, if the borrower complied with all terms of the TPP Agreement—including making all required payments and providing all required documentation—and if the borrower's representations remained true and correct, the servicer had to offer a permanent modification.

In *Wigod*, the Seventh Circuit reasoned that the TPP was enforceable despite open terms because the HAMP guidelines provided an existing standard by which the ultimate terms of the permanent modification were to be set.

In the instant case, the Appellate Court found that the borrowers did not allege or argue on appeal that HAMP applied thus there was no standard to determine the essential terms of the loan modification they were allegedly promised. Thus, the Court held that the borrowers did not allege the existence of an enforceable contract.

The defendants also argued that the alleged oral contract fell within the statute of frauds and thus is not enforceable as it was not in writing. The Court noted that full performance takes a contract out of the statute of frauds. Here, the Court of Appeal found the borrower alleged full performance of their obligations under the contract and therefore the statute of frauds did not bar enforcement of the alleged oral contract.

The Court of Appeal held that the borrowers should be given another opportunity to amend their complaint to include the specific pleading deficiencies.

The borrowers also alleged that the servicer twice promised them a loan modification and they relied on those promises by (1) applying for the promised loan modifications, (2) becoming delinquent in their monthly mortgage payments, (3) making the lower monthly payments, (4) providing the servicer with personal financial information, (5) spending time and resources applying for loan modifications, and (6) foregoing other remedies to cure the default.

As you may recall, the elements of a promissory estoppel claim are (1) a promise clear and unambiguous in its terms, (2) reliance by the party to whom the promise is made, (3) [the] reliance must be both reasonable and foreseeable, and (4) the party asserting the estoppel must be injured by his reliance.

The Court of Appeal found that the borrowers adequately alleged detrimental reliance to sustain a promissory estoppel cause of action by alleging they repeatedly contacted the servicer, prepared documents at the servicer's request, and by foregoing other means of avoiding foreclosure.

However, the Court found that the absence of essential loan modification terms rendered the alleged promise insufficiently clear and unambiguous to support promissory estoppel. In addition, the Court found that no borrower could reasonably rely on a promise to make a unilateral loan modification offer because the offered modification might not lower their monthly payments sufficiently to allow them to avoid default.

Nevertheless, the Court of Appeal held that the borrowers should be given another opportunity to amend their promissory estoppel claim.

The borrowers also alleged the servicer breached its duty to act reasonably with respect to their loan modification application by (1) allegedly failing to accurately account for the documents the borrowers supposedly submitted, (2) allegedly failing to give them a fair loan modification evaluation, and (3) allegedly accepting trial payments from the borrowers but by not accurately accounting for this or by not granting them or denying a modification in a reasonable time period.

As you may recall, to state a cause of action for negligence, a plaintiff must allege (1) the defendant owed the plaintiff a duty of care, (2) the defendant breached that duty, and (3) the breach proximately caused the plaintiff's damages or injuries.

As a general rule in California, a financial institution owes no duty of care to a borrower where the institution's involvement is simply to lend money.

However, this general rule has exceptions. In *Biakanja v. Irving*, 49 Cal.2d 647 (1958), the Supreme Court of California held that whether the defendant in a specific case will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, including: (1) the extent to which the transaction or conduct was intended to affect the plaintiff, (2) the foreseeability of harm to the plaintiff, (3) the degree of certainty that the plaintiff suffered injury, (4) the closeness of the connection between the defendant's conduct and the injury suffered, (5) the moral blame attached to the defendant's conduct, and (6) the policy of preventing future harm.

The Court of Appeal looked to the *Biakanja* factors to determine if the servicer had a duty to the borrowers.

As to the first factor — the extent to which the transaction was intended to affect the plaintiff – the Appellate Court found that the alleged conduct was intended to affect the borrowers as it was directed toward determining whether or not the borrowers could keep their home and at what cost. The Court concluded the first factor weighed slightly in favor of finding a duty of care.

As to the second factor — the foreseeability of harm to the plaintiff — the Appellate Court noted that the alleged mishandling of the borrowers' documents and the alleged failure to grant or deny a modification in a timely fashion in the Court's view kept the borrowers in a lending limbo where they paid less than they owed on the servicer's instruction, and fell further into arrears. The Court concluded the second factor weighed in favor of finding a duty of care.

As to the third factor — the degree of certainty that the plaintiff suffered injury – the Appellate Court noted that the borrowers alleged they were injured due to damage to their credit, foregone remedies, and increased arrears, interest, penalties, and fees due to the servicer's alleged conduct. The Court concluded the third factor weighed in favor of finding a duty of care.

As to the fourth factor — the closeness of the connection between the defendant's conduct and the injury suffered – the Appellate Court noted that the borrowers were current on their loan payments until the servicer allegedly advised them to become delinquent to obtain a loan modification, which in the Court's view suggested a close connection between the servicer's conduct and the default-related remedies. The Court concluded the fourth factor weighed in favor of finding a duty of care.

As to the fifth factor — the moral blame attached to the defendant's conduct – the Appellate Court held that the servicer's blameworthiness was impossible for the Court to assess at this stage thus it considered the factor neutral.

As to the sixth and last factor — the policy of preventing future harm — the Court of Appeal found the policy of preventing future harm cut both ways. The Court looked to *Alvarez v. BAC Home Loans Servicing, L.P.*, 228 Cal.App.4th 941 (2014) for guidance. In *Alvarez*, the appellate court concluded that the sixth*Biakanja* factor weighed in favor of finding a duty because recent statutory enactments demonstrate the existence of a public policy of preventing future harm to loan borrowers. Here, the Court of Appeal could not say whether or not the imposition of a duty would prevent future harm to borrowers.

In sum, in the Appellate Court's view, four of the six factors weighed in favor of finding a duty, and therefore the Court of Appeal concluded that the servicer owed the borrowers a duty of care with respect to the loan modification process.

The Court of Appeal also found the borrowers properly alleged a breach of duty and damages, thus concluding the borrowers stated a claim for negligence against the third servicer.

However, the Court of Appeal found the borrowers' secondary liability allegations against the subsequent servicer and the loan owner were insufficient. The Court found the borrowers should be permitted to amend their negligence claims against these parties.

The borrowers also alleged wrongful foreclosure. As you may recall, in California, the basic elements of a tort cause of action for wrongful foreclosure track the elements of an equitable cause of action to set aside a foreclosure sale. These are: (1) the trustee or mortgagee caused an illegal, fraudulent, or willfully oppressive sale of real property pursuant to a power of sale in a mortgage or deed of trust, (2) the party attacking the sale (usually but not always the trustor or mortgagor) was prejudiced or harmed, and (3) in cases where the trustor or mortgagor challenges the sale, the trustor or mortgagor tendered the amount of the secured indebtedness or was excused from tendering.

Here, the borrowers alleged the assignment of the deed of trust to the trustee was invalid because the securitized trust closed prior to the assignment. The borrowers conceded during oral argument that, as pleaded, their wrongful foreclosure claim was insufficient and they would be unable to amend it to create a viable cause of action. The Court of Appeal therefore held that the trial court did not abuse its discretion in dismissing the claim for wrongful foreclosure.

The borrowers also sued under California's Unfair Competition Law (UCL). The UCL prohibits, and provides civil remedies for, unfair competition, which it defines as any unlawful, unfair or fraudulent business act or practice. A plaintiff may pursue a UCL action in order to obtain either (1) injunctive relief, the primary form of relief available under the UCL, or (2) restitution as may be necessary to restore to any person in interest any money or property, real or personal, which may have been acquired by means of such unfair competition.

The Appellate Court held that to the extent the borrowers' UCL claim was predicated on an alleged violation based on transfer of property, the allegations fail because the borrowers' failed to state a claim for wrongful foreclosure. Otherwise, the Court of Appeal held that the trial court erred by denying the borrowers leave to amend their UCL claim.

In sum, the Court of Appeal reversed the judgment of the trial court with specific remand instructions for each respondent and claim.