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A New Duty of Care for Holders of Distressed Commercial Mortgage Debt?

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Recently, a California Court of Appeal issued an opinion likely to gain the attention of holders of distressed commercial mortgage debt. In *Scott Call Jolley v. Chase Home Finance, LLC*, (February 11, 2013), 2013 Cal. App. Lexis 107, the court reversed the trial court's summary judgment order in favor of lender. In doing so, the court rejected lender's proffer of its purchase and assumption agreement governing its acquisition of assets from the Federal Deposit Insurance Company, and concluded that under certain circumstances a lender may have a duty of care to its borrower, giving rise to potential liability for negligence.

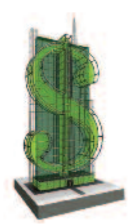
Responding to the financial crisis, federal and state regulations have been enacted to protect homeowners at risk of losing their homes. However, *Jolley* did not involve a residential mortgage loan implicating those federal and state protections. The plaintiff obtained a construction loan from Washington Mutual ("WaMu") to renovate a house to be used as a rental property. Despite the FDIC receivership, the acquisition of the loan by Chase, and the trial court grant of summary judgment in favor of Chase, the *Jolley* court determined that there were sufficient triable issues of fact relating to the loan administration continuing from the time of WaMu's ownership, and the conduct of Chase's own representatives.

The loan was entered into with WaMu in January 2006, however the initial funding was delayed for eight months as the lender lost the loan documents. Nevertheless, borrower proceeded with construction, and even after loan funding began, there were irregularities in disbursements increasing construction costs. In September 2008, the Office of Thrift Supervision closed WaMu and appointed the FDIC as receiver, and the same day Chase acquired certain assets of WaMu from the FDIC, including loans and loan commitments. Approximately two months after Chase acquired the loan, the borrower defaulted, ostensibly as a result of breaches and negligence of WaMu in funding the loan. Borrower sought a loan modification from Chase, while providing substantial information to representatives of Chase about the loan problems caused by WaMu, the effects of which continued. On several occasions a representative of Chase assured borrower that there was a "high probability" that Chase would agree to a loan modification, and that the "likelihood was good" that Chase would agree to permit the loan to be rolled over to an amortizing conventional loan upon completion of construction. In reliance upon those representations, borrower secured additional funds from third parties and completed construction. Upon completion, Chase refused to modify the loan and proceeded with foreclosure. Borrower filed the lawsuit and enjoined the scheduled foreclosure sale.

Chase's summary judgment motion relied heavily upon its assertion that the purchase and assumption agreement with the FDIC expressly provided that it acquired the assets of WaMu without the liabilities. The motion included a request for the court to take judicial notice of the 39-page purchase and assumption agreement with the FDIC, attached as an exhibit with a note that it could be found on the FDIC website. Borrower's opposition included a declaration from its consultant, a former FDIC staffer who borrower had hired to help negotiate loan modifications with WaMu and later with Chase. The declaration included a statement that he had seen and read a 118-page purchase and assumption agreement for Chase's purchase of WaMu assets, and that the agreement "obligated Chase 'to work directly with the customers to do as much as possible to modify any loans…so that no foreclosures are made and borrowers are kept in their homes.'" The Court further noted that despite borrower's requests for copies of the more extensive agreement, the FDIC refused to provide a copy unless all parties signed a confidentiality agreement.

The court observed that the request for judicial notice of the purchase agreement attached to the declaration of counsel included the representation that it was a copy of the agreement found on the website. However, the Court observed that such declaration did not identify declarant as the custodian of records, as a party to the agreement, as having been involved in negotiating or drafting the agreement, and indeed provided no information how counsel acquired knowledge of the document. The court noted that California Evidence Code Section 452(c) permits judicial notice of "[o]fficial acts of the legislative, executive, and judicial departments of the United States and of any state of the United States," and Section 452(d) permits such notice of records of courts within the state of California and of federal and other state courts. It also acknowledged that under Federal Rules of Evidence, judicial notice can be taken of matters deemed to be "public records" or because the contents of such items can be "accurately and readily determined from public sources whose accuracy cannot reasonably be questioned." However, the court determined that there is no "official Web site" provision for judicial notice in California, and the trial court had no authority to accept the proffered purchase agreement by judicial notice. As a result, the consultant's declaration, and the evidence of the FDIC's reluctance to provide the longer agreement, raised a triable issue of fact as to the substance of the agreement, including the purported purchase of the assets without liabilities.

The court noted borrower's testimony as to the assurances ("highly probable," "likely," "look[ed] good") of Chase's representative regarding the prospects for the modification. Rejecting the trial court's characterization of those statements as "at most an overoptimistic opinion upon which [Borrower] could not reasonably rely," the court cited established authority that an opinion may be actionable if made by a party who possesses, or is assumed to possess, superior knowledge or special information. In addition, an opinion may be actionable when "expressed in a manner implying a factual basis which does not exist." The court concluded that whether the statements made by the Chase representatives rose to a level of fraudulent misrepresentation was a matter for the trier of fact, not summary judgment: "we conclude that prolonged communication—perhaps more accurately, miscommunication—about a possible loan modification raises a triable issue of fact of intent by Chase to profit by misleading [Borrower] about his loan modification prospects, a showing sufficient to withstand summary adjudication."



Based upon plaintiff's assertion that Chase made the decision not to fund WaMu's loans and then acted unreasonably by failing to review borrower's request for a loan modification in good faith, the court held that if such decisions were "made without due care to avoid further injury to [Borrower], then Chase is potentially liable for its own negligence."

Perhaps the most disturbing provisions for lenders is the court's analysis of borrower's negligence cause of action. The trial court granted summary adjudication on the negligence cause of action citing the California rule that "a lender does not owe a borrower or third party any duties beyond those expressed in the loan agreement, except those imposed due to special circumstances." The *Jolly* court concluded that where there have been ongoing disputes between borrower and lender, and where lender's representatives have made specific representations as to the likelihood of a loan modification, "a cause of action for negligence cannot be properly resolved based upon a lack of duty alone." Based upon plaintiff's assertion that Chase made the decision not to fund WaMu's loans and then acted unreasonably by failing to review borrower's request for a loan modification in good faith, the court held that if such decisions were "made without due care to avoid further injury to [Borrower], then Chase is potentially liable for its own negligence."

The court observed that the recent financial crisis was precipitated in substantial part "by lending practices perhaps too much colored by short-sighted self-interest." Recognizing the initiatives announced by the federal government and the California legislature to protect homeowners from losing their homes, and acknowledging that such initiatives are not directly applicable to the dispute before it, the court asks itself whether that legislation establishes policy considerations that affect the duty of care owed by Chase to borrower, and answers that question affirmatively, creating a potential new duty of care owed by lenders to borrowers in distress.

In light of *Jolley*, lenders must govern their administration of distressed debt with the realization that courts will be carefully scrutinizing actions taken by lenders in connection with loans in default, actions that, in retrospect, can be construed as breaching a duty of care to avoid further injury to borrowers.

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About the Author

Alfred M. Clark is Partner in the Los Angeles office and a member of the national Board of Directors of Locke Lord LLP. His principal practice area involves representing institutional lenders and private investors in mortgage financing transactions, including the exercise of creditor's rights in troubled projects. In addition, Mr. Clark represents investors, landowners and commercial users in a wide variety of real estate transactions.

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