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Case No. S258019

In the Supreme Court

of the

State of California

KWANG K. SHEEN,

Plaintiff and Appellant

v.

WELLS FARGO BANK, N.A., et al.

Defendant and Respondent

AFTER A DECISION BY THE COURT OF APPEAL
SECOND APPELLATE DISTRICT, DIVISION EIGHT, CASE NO. B289003
SUPERIOR COURT OF CALIFORNIA, COUNTY OF LOS ANGELES
CASE NO. BC631510
THE HONORABLE JUDGE ROBERT L. HESS

Petitioner's Opening Brief on the Merits

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ISSUE PRESENTED FOR REVIEW

Does a mortgage servicer owe a borrower a duty of care to refrain from making material misrepresentations about the status of a foreclosure sale following the borrower's submission of, and the servicer's agreement to review, an application to modify a mortgage loan?

INTRODUCTION

Plaintiff-Petitioner Kwang K. Sheen purchased his home with a loan from Wells Fargo ("Wells") in 1998. At the height of the 2008-09 financial crisis, Sheen fell into serious financial difficulties. Behind in his loan payments, he asked Wells if he could modify his loan in order to prevent foreclosure of his home.

Wells accepted Sheen's loan modification application and promised him that he and his wife would *never* lose their house following Sheen's submission of the application. Based on various representations made by Wells, Sheen assumed that the application had been granted and that his home was permanently saved from foreclosure.

Wells then sold Sheen's loan to a third party knowing that the third party might one day sell Sheen's house at foreclosure. The loan was sold several more times, all unbeknownst to Sheen. Eventually, the newest owner of the loan did indeed foreclose, evicting Sheen and his wife, and leaving them homeless.

Loan servicers have become notorious for this type of deception and obfuscation. Particularly troubling is a practice known as "dual tracking," which has now been prohibited in the

State of California. (*See* California Homeowner Bill of Rights, Cal. Civ. Code §§ 2923.6, 2924.18 [HBOR].)

Dual tracking is when a mortgage servicer proceeds with the foreclosure process while simultaneously considering the borrower's application for a loan modification or other foreclosure avoidance option. (*See Alvarez v. BAC Home Loans Servicing, L.P.* (2014) 228 Cal.App.4th 941, 950.) This practice lulls borrowers who are behind on their mortgage payments into a false sense of security: the loan servicer accepts a loan modification application and often, as here, makes explicit assurances that the borrower can keep their home, only to turn around and foreclose on the home after all. (*See id.*)

That is akin to what happened to Sheen and his wife. Suddenly homeless, they sued Wells for negligence and other claims. The trial court sustained Wells' demurrer, reasoning (in part) that Wells did not owe Sheen a duty in *tort* for acts that occurred during *contract* negotiations, even though Sheen did not have any contractual remedy against Wells.

This decision left Sheen without any remedy at all. Wells never breached any underlying contractual obligation to Sheen, so Sheen had no contract claim. Instead, because Wells "merely" engaged in negligent and misleading actions with regard to

Sheen's application to modify his loan, the trial court held that Sheen could not sue Wells at all.[1]

The Court of Appeal affirmed the demurrer in a decision that, if upheld, would have far-reaching and devastating consequences for borrowers like Sheen who are preyed upon by negligent loan servicers—and for victims of negligence in California more broadly.

The Court of Appeal recognized, correctly, that the governing test for evaluating a duty of care in the mortgage modification context stems from *Biakanja v. Irving* (1958) 49 Cal.2d 647. And the Court acknowledged that several California Courts of Appeal have found that the *Biakanja* factors squarely counsel in favor of recognizing a duty of care in the context of loan modification negotiations. (*See, e.g., Alvarez,* 228 Cal.App.4th at 948; *Daniels v. Select Portfolio Servicing* (2016) 246 Cal.App.4th 1150, 1180-1183.)

But the Court held, incorrectly, that the *Biakanja* factors are trumped by the economic loss rule, based on this Court's recent decision in *Southern California Gas Cases* (2019) 7 Cal.5th 391 ("*SoCalGas*"), which disallowed tort claims filed by businesses that suffer purely economic losses from an environmental catastrophe caused by a defendant's negligence.

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[1] Sheen does not have a remedy under HBOR because that law only grants a private right of action with regard to first-lien mortgages, and Sheen's mortgage from Wells was a second-lien mortgage. (*See* Cal. Civ. Code § 2924.18.)

That was error. What the Court of Appeal failed to recognize is that *SoCalGas* reaffirmed that the *Biakanja* factors supply the appropriate test for determining whether to recognize a tort duty of care for purely economic losses. Nothing in that decision suggests that the economic loss rule should bar tort claims in a lawsuit between contracting parties, where—as here—there is a "special relationship" between them that meets all the *Biakanja* factors.

The Court of Appeal's reliance on *SoCalGas* transforms the economic loss rule—a rule that is supposed to be about protecting the sanctity of *contract*—into a shield for tortfeasors like Wells, who hurt borrowers with their negligence and then seek immunity by hiding behind underlying loan contracts.

This Court should reject this unlawful and unfair result.

STATEMENT OF FACTS

A. The Mortgage Servicing Landscape.

Traditional mortgage lending involved a bank evaluating a borrower and her security, and issuing a loan with terms reflecting the perceived risk that the borrower would default. The same bank would then: (i) retain the loan, making its profit on interest the borrower paid; and (ii) service the loan by maintaining direct contact with the borrower, collecting her payments and negotiating any changes to the loan. (*See* Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis* (2009), 13 N.C. Banking Inst. 5, 32 (2009) ["Traditionally, banks managed loans 'from cradle to grave' as they made mortgage loans and retained the risk of default, called

credit risk, and profited as they were paid back."] [citation omitted].)

In the modern mortgage servicing context, however, these tasks have been dispersed among different actors, changing the relationships between the borrower, the loan originator, the ultimate holder of the loan, and the servicer of the loan.

First, borrowers are captive. They cannot choose who will service their loan, and they often are not even informed when the loan originator has contracted out for the servicing of the loan, or has sold the loan itself to a different investor. Moreover, each individual borrower has virtually no bargaining power against institutional lenders and servicers.

In the absence of any constraint, servicers may actually have incentives to misinform and under-inform borrowers. Providing limited and low-quality information not only allows servicers to save money but increases the chances they will collect late fees and other penalties from confused borrowers.[2]

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[2] (*See* Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers* (2004) 15 Hous. Pol'y Debate 753, 769-770]; *see also* Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 Yale J. on Reg. 1, 25-29 (2011) [discussing why servicers prefer highly automated default management]; *cf. Burch v. Sup. Ct.* (2014) 223 Cal. App. 4th 1411, 1421 [fact that the injured plaintiff has no ability to "control and adjust the risks by contract" weighs in favor of duty].)

Servicers' dramatic failure to invest in personnel, infrastructure, and technology has led to a focus on problems of "dual-tracking" and "single point of contact." (*See, e.g., 2012 Real Estate Settlement Procedures Act [Regulation X] Mortgage Servicing Proposal* (Sept. 17, 2012), 77 Fed. Reg. 57,200, 57,200 (Sept. 17, 2012) [("As millions of borrowers fell behind on their loans . . . [m]any servicers simply had not made the investments in resources and infrastructure necessary to service large numbers of delinquent loans."]); Cal. Civ. Code § 2923.6 [prohibiting "dual-tracking"].)

Borrowers experience this failure to invest as an inability to talk to anyone at their (unchosen) servicer, constant, repeated requests for the same documents "lost" by servicers, improper denial of loan modifications, and foreclosures despite pending loan modification applications. (*See* Paul Kiel, *Homeowners Say Banks Not Following Rules for Loan Modifications, ProPublica,* Jan. 14, 2010, 9:00am ["Like many borrowers in the program, [Reynolds] says he was asked over and over to send the same documents and later, updated versions of those documents. Finally, in late November, he received an answer: He was denied a permanent loan modification."].)

At best, borrowers are discouraged by these time and energy-wasting problems. At worst, borrowers are denied help or misled about the status of a foreclosure sale, and can unnecessarily lose their homes.

For homeowners, the stakes of servicer failures are extremely high. Homeowners facing foreclosure and applying for

modification are absolutely dependent upon their mortgage servicers to process their requests in a timely, accurate fashion.

During the modification process, the homeowner has to rely entirely on information from the servicer both about whether the loan is likely to be modified, and on the status of the modification, to make life-changing decisions such as whether to file for bankruptcy, sell the home, or give up the home through foreclosure or deed in lieu of foreclosure. But servicers often fail to provide such necessary information.[3]

The potential harm to the homeowner flowing from this disparity in bargaining power is greatest in the loan modification process, where a servicer's improper or erroneous denial of loan modification can end in unnecessary foreclosure. Even delay can be harmful; over the course of the modification process, which can take months or even years, the homeowner may be falling further and further behind on the mortgage (or, alternately, using up savings on a home that is no longer affordable).

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[3] *See* Lydia Nussbaum, *ADR's Place in Foreclosure: Remedying the Flaws of a Securitized Housing Market*, 34 Cardozo L. Rev. 1889, 1901 (2013) (stating that the servicing industry is "notorious for its lack of customer service"); Christopher L. Peterson, *Predatory Structured Finance* (2007) 28 Cardozo L. Rev. 2185, 2265 ["Phone calls to the loan's servicer are frequently ignored, subject to excruciating delays, and typically can only reach unknowledgeable staff who themselves lack information on the larger business relationships."].)

Because modern mortgage servicing has become divorced from loan ownership, servicers have incentives to charge borrowers unnecessary fees and to extend default. These incentives shifted in part as a result of mortgage loan securitization, which increasingly unmoored banks from the fate of the mortgages they created, invested in, and serviced. (Susan E. Hauser, *Predatory Lending, Passive Judicial Activism, and the Duty to Decide*, 86 N.C. L. Rev. 1501, 1517 (2008) ["Today, there is no longer one 'lender' who faces the full panoply of risks associated with the making of a mortgage loan."].)

After origination, the servicer only has a financial incentive to collect its servicing fee. This servicing fee does not depend on loan performance, nor on maximizing net present value through a modification. (*See* Steven L. Schwarcz, *The Future of Securitization* (2009) 41 Conn. L. Rev 1313, 1322-1323; Diane Thompson, *Foreclosing Modifications: How Servicer Incentives Discourage Loan Modifications* (2011) 86 Wash. L. Rev. 755, 767-768 [explaining servicer fee structure].) Thus, loan servicing looks even less like traditional lending activity than originating-to-securitize loans.

B. Statutory Responses to the Mortgage Crisis.

In an attempt to address the modern mortgage servicing industry's failures, legislators and other regulators have responded with increasingly specific rules governing loan servicing and loss mitigation. These responses have sought to identify and prohibit the most harmful servicer conduct, and to create procedures that correct for the gross power disparity

between borrower and lender, in keeping with the strong public policy of avoiding foreclosure where possible.

At the federal level, the government created the Home Affordable Modification Program (HAMP) to help borrowers avoid foreclosure. Rather than create a private right of action, Congress intended that HAMP rules (promulgated by the Treasury Department) be enforced under state common law and general consumer protection statutes as an industry-wide standard of care: 15 U.S.C. § 1639a(c) provides that "[t]he qualified loss mitigation plan guidelines issued by the Secretary of the Treasury . . . shall constitute standard industry practice for purposes of all Federal and State laws."

In California, HBOR sets out stringent procedural protections for borrowers seeking modifications or other loss mitigation options. Civil Code section 2923.6 prohibits "dual tracking"—the servicer practice of proceeding to foreclosure even while the borrower is still being considered for loss mitigation options. Civil Code section 2924.12 provides a private right of action and damages for dual tracking violations. Crucially, however, Section 2924.12 only creates a private right of action for first-lien mortgages, not second-lien mortgages like Sheen's. (*See* Cal. Civ. Code § 2924.18.)

Moreover, HBOR expressly states that it does not preclude any other common law causes of action. (*See* Cal. Civ. Code § 2924.12(g) ["The rights, remedies, and procedures provided by this section are in addition to and independent of any other rights, remedies, or procedures under any other law. Nothing in

this section shall be construed to alter, limit, or negate any other rights, remedies, or procedures provided by law."].)

C. Underlying Facts.

Kwang Sheen is a Korean American who speaks almost no English. (3 Clerk's Transcript (CT) 488 ¶ 17). He and his wife lost their home to foreclosure in October 2014. (3 CT 496 ¶ 49.)

In November 2005, Sheen obtained second- and third-lien residential mortgage loans (the "Second Loan" and "Third Loan", respectively) from Wells (3 CT 487 ¶¶ 7–8.) These loans were secured by his property. (3 CT 487-488 ¶¶ 7–8.)

Sheen experienced tremendous financial difficulty in late 2008 and, in 2009, missed a number of payments due on the Second and Third Loans. (3 CT 488 ¶ 9.) Wells recorded a Notice of Default and Election to Sell Under Deed of Trust (the "Notice of Default") in September 2009, ostensibly in connection with the Second Loan. (3 CT 488 ¶ 9.)

On December 14, 2009, Wells recorded a Notice of Trustee's Sale, again ostensibly in connection with the Second Loan. (3 CT 488 ¶ 10.) The Notice of Trustee's Sale stated that the Property would be sold at auction on January 4, 2010. (3 CT 488 ¶ 10.) In or about the last week of December 2009, Wells caused the January 4 foreclosure sale of the Property to be postponed to February 3, 2010. (3 CT 488 ¶ 10.)

In late January 2010, Sheen and his legal representatives contacted Wells by email regarding the possibility of cancelling the foreclosure sale scheduled for February 3, 2010 so that Sheen

could apply and be considered for modifications of the Second and Third Loans. (3 CT 488 ¶ 11.)

A Wells representative replied that Wells' Loss Mitigation department "is currently working on this matter." (3 CT 488 ¶ 11.) At the same time, Sheen submitted applications for modification of the Second and Third Loans. (3 CT 488 ¶ 12.) Then, in or about the first week of February 2010, Wells cancelled all foreclosure proceedings that had previously been initiated in connection with the Second Loan, which Wells and Sheen's representatives had previously discussed so that Sheen's loan modification application could be considered and which therefore caused Sheen to believe that Wells had agreed to review his application. (3 CT 488 ¶ 13.) On the date the sale was cancelled, Wells had already accepted Sheen's applications for review. (3 CT 488 ¶ 13 [stating that the applications were "pending"].)

On or about March 17, 2010, Wells sent Sheen two separate letters in connection with the Second and Third Loans, respectively. (3 CT 488 ¶ 15.) The first letter addressed Sheen as follows, in part:

> Due to the severe delinquency of your account, it has been charged off and the entire balance has been accelerated. Accordingly, your entire balance is now due and owing. In addition, we have reported your account as charged off to the credit reporting agencies to which we report. As a result of your account's charged off status, we will proceed with whatever action is deemed necessary to protect our interests. This may include, if applicable, placing your account with an outside collection agency or referring your account to an Attorney with instructions to take whatever action is

> necessary to collect this account. Please be advised that if Wells Fargo elects to pursue a legal judgment against you and is successful, the amount of the judgment may be further increased by court costs and attorney fees.

(3 CT 488 ¶ 15.)

The letter stated that the date of the "charge-off" was February 25, 2010. (3 CT 488 ¶ 15.) The second letter was almost identical to the first. (3 CT 488 ¶ 16.)

Sheen received these letters less than two months after he had submitted applications for modification of the Second and Third Loans, and while he was still waiting for a response to those applications. (3 CT 488 ¶ 18.) He therefore believed that Wells sent the March 17, 2010 letters in response to his pending applications for mortgage modification. (3 CT 488 ¶ 19.) He believed that the letters meant that the Second and Third Loans had been modified such that they were unsecured loans, that Wells had cancelled the February 3, 2010 foreclosure sale as a result of its plan to modify the Second and Third Loans, and that the Property would never be sold at a foreclosure auction as a result of these modifications. (3 CT 488 ¶ 19.)

In or about March 2010, Wells also contacted Sheen by phone. (3 CT 488 ¶ 22.) Sheen's wife Jong-Sin Sheen answered the call. During the call, a Wells representative told her that there would be no more foreclosure sale of their home. (3 CT 488 ¶ 22.)

About a month later, Sheen received a letter from Wells dated April 23, 2010. (3 CT 488 ¶ 23.) The letter referred to the

Second Loan and to a "Date of Charge-Off" of February 24, 2010 in the subject line above the body of the letter. (3 CT 488 ¶ 23.) The letter then stated:

> In an effort to resolve your charged-off account, Wells Fargo recently attempted to contact you to discuss the repayment of your debt with one of our multiple payment options. Unfortunately, we have been either unable to reach you or unable to obtain an acceptable payment arrangement on your account.
>
> . . .
>
> Unless we receive a phone call from you within 15 days of this offer, we may take advantage of all remedies available to us to recover our balance in full, which may include outsourcing your account to a collection agency or referring your account to an attorney with instructions to take whatever action deemed necessary to collect this account.

(3 CT 488 ¶ 23.)

The April 23, 2010 letter further confirmed Sheen's understanding that the Second Loan had been modified such that it was now unsecured. (3 CT 488 ¶ 24.) Sheen interpreted the letter as a standard collections letter a consumer would receive in connection with an unsecured, unpaid debt, in particular because the letter made no direct mention of a possible foreclosure sale and instead referred directly to the intervention of a collection agency in connection with the Second Loan. (3 CT 488 ¶ 24.)

On November 22, 2010, Wells assigned the servicing rights to the Second Loan to Dove Creek. (3 CT 488 ¶ 28.) On November 24, 2010, Wells also assigned its beneficial interest under the

deed of trust securing the Second Loan to Dove Creek. (3 CT 488 ¶ 28.)

After a series of subsequent assignments, the beneficial interest in the Second Loan was assigned to Mirabella Investments Group, LLC ("Mirabella"). (3 CT 488 ¶¶ 29-31.) In April 2014, Mirabella recorded a Notice of Default stating that the Second Loan was in default. (3 CT 488 ¶ 31.) Next, in July 2014, Mirabella recorded a Notice of Trustee's Sale stating that the Property would be sold at a public auction on August 22, 2014. (3 CT 488 ¶ 32.) Also in or about July 2014, Sheen received a letter from Mirabella stating that the Second Loan was in default. (3 CT 488 ¶ 33.)

On October 29, 2014, Sheen's home was sold at a trustee's sale. (3 CT 488 ¶ 49.)

D. This Lawsuit.

Sheen sued Wells and others in 2016. His first claim was for negligence: he alleged that Wells owned him a duty of care to process and respond carefully and completely to the loan modification applications he submitted to Wells. (Pet. App. 5.)

Additionally, Sheen alleged that Wells owed him a duty to refrain from engaging in unfair and offensive business practices that confused Plaintiff and prevented him from pursuing all options to avoid foreclosure. (*Id.*) Sheen alleged Wells breached its duty by initially failing to respond to his applications, by then sending two letters suggesting his loans had been modified and his house would not be sold, by phoning his wife to say there would be no foreclosure sale of his home, by confirming Sheen's

interpretation of these letters with a further letter that read like it was sent in connection with an unsecured debt rather than a secured mortgage loan, and by assigning a loan without notifying the assignor that Sheen's modification application was pending. (*Id.* 5-6.)

The trial court sustained Wells' demurrer to the Second Amended Complaint (SAC), holding both that Wells did not owe Plaintiff a duty of care and that Wells had not breached any duty of care. (4 CT 893-894; RT 20:15-26.)

E. The Decision Below.

In an opinion certified for publication, the Court of Appeal affirmed the trial court's ruling, finding that mortgage servicers do not have a tort duty to handle mortgage modification applications with reasonable care. (*See* Pet. App. 1-17.)

In so ruling, the Court recognized that the "governing test" for determining whether there is such tort duty under California law is set forth in *Biakanja v. Irving* (1958), 49 Cal.2d 447. (*See* Pet. App. 8-9.) The Court further recognized that two California appellate courts, *Alvarez,* 228 Cal.App.4th 948, and *Daniels*, 246 Cal.App.4th 1150, have held that the *Biakanja* factors counsel in favor of finding that loan servicers owe borrowers a tort duty to exercise reasonable care when responding to modification applications. (Pet. App. 8-9.)

The Court quoted extensively from *Alvarez,* which noted that because "the bank holds all the cards" in the mortgage modification context and borrowers "are captive, with virtually no bargaining power," there is a "moral imperative that those with