HUNTON& WILLIAMS

Client Alert

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The Return of Lender Liability – Only This Time it Includes Buyers of Distressed Debt

Recently, a California appellate court issued an opinion in a wrongful foreclosure lawsuit that has significant ramifications for lenders, especially those that acquire troubled loans from failed banks. In *Jolley v. Chase Home Finance, LLC*, the court reversed a trial court's order disposing of a commercial borrower's claims of fraud, negligence and breach of contract arising from the handling of a loan that Chase Home Finance ("Chase") acquired from a failed financial institution, Washington Mutual ("WaMu").[1] The borrower sought damages against Chase arising from WaMu's alleged mishandling of the loan as well as for specific misrepresentations and negligence by Chase after it acquired the loan. In an opinion that many will view as flawed and result-oriented, the *Jolley* court rejected the protections that Chase had under the purchase and assumption agreement ("P&A Agreement") with the FDIC, which purported to shield it from liability arising from actions by WaMu. The court also held that "encouraging" statements and "upbeat predictions" by Chase about a potential loan modification could be the basis for a fraud claim, and declared that the no-duty rule[2] that has generally been used by banks to dispose of negligence claims may not be a "general rule" after all.

Jolley involved a commercial borrower who took out a $2.1 million construction loan from WaMu in January 2006 in order to renovate a rental house and to pay off a preexisting mortgage on the property. Trouble with the loan quickly arose. WaMu initially misplaced the loan documents resulting in a 8-month funding delay. Thereafter, WaMu failed to make timely disbursements of the loan proceeds. WaMu then allegedly promised to reimburse Jolley for prepaid construction costs of $328,000 but never did.

WaMu and Jolley executed a loan modification in October 2006. The modification agreement did not specify a loan amount, and Jolley subsequently argued that WaMu had agreed to supply "any additional" funding needed to complete the renovation. In September 2008, the Office of Thrift Supervision closed WaMu and the FDIC was appointed as receiver. Simultaneously, all of WaMu's loans and loan commitments, including the loan to Jolley, were transferred to Chase pursuant to the P&A Agreement. The P&A Agreement excluded from the transfer WaMu's liabilities, including those "arising in connection with WaMu's lending and loan purchase activities."[3]

Jolley stopped making payments shortly after his loan moved to Chase, and he asked for a loan modification. In the course of these discussions, a Chase employee told Jolley there was a "high probability" that Chase would modify the loan, that the "likelihood was good," and that it was "likely" that he would be able to roll the construction loan into a fully amortizing conventional loan. Relying on these statements, Jolley invested personal and family funds into the project. Ultimately, Chase chose to foreclose on the property rather than modify the loan, and Jolley sued for damages relating to the handling of the loan from its inception.

[1] 213 Cal. App. 4th 872 (Cal. Ct. App. 2013).

[2] The "no duty" rule is set forth on page 3.

[3] Under a typical loss sharing arrangement with the FDIC, asset-related litigation is assumed by the purchaser.

Chase filed a Motion for Summary Judgment on grounds that the P&A Agreement shielded it from liability for acts by WaMu, the fraud claim failed because the "encouraging" statements about the loan modification were not actionable, and the negligence claim could not succeed because Chase did not owe a duty of care on which to base such a claim. The trial court agreed with Chase and granted its motion, but the court of appeals reversed in a lengthy opinion that many lenders may find alarming. Three aspects of the *Jolley* decision stand out.

First, the court ruled that the trial court erred when it relied on the P&A Agreement to dismiss the claims against Chase arising from WaMu's prior handling of the loan. Chase offered the P&A Agreement into evidence as an "official act" of a government agency (FDIC) and as a fact that was "not reasonably subject to dispute," just as Chase had done in prior cases. Jolley objected to the admissibility of the P&A Agreement and submitted an affidavit from a prior FDIC employee challenging its authenticity and suggesting that the actual agreement was much longer. The court held that a contract between "a private bank" and the FDIC does not constitute an "official act" and declared that "simply because information is on the Internet [FDIC's website] does not mean that it is not reasonably subject to dispute." The affidavit challenging the authenticity of the agreement was critical in the court's ruling. The court held that the trial judge had improperly "resolved a disputed issue of fact by resting its decision on the terms of the shorter agreement."

The court then addressed the fraud claim arising out of the Chase employee's statements that the loan modification was "highly probable," "likely" and that the "likelihood was good." The trial court had concluded that the statements were merely "opinions…which do not create a binding commitment to modify a loan…." Bucking prior decisions holding that opinions and predictions were not actionable, the court of appeals held that these "upbeat predictions" and "encouraging" statements could be actionable when the party possesses superior knowledge or when the opinion implies a factual basis that does not exist. The court held that a jury should decide whether the statements were expressions of opinion or affirmations of fact. Interestingly, even if the encouraging statements were actionable, Jolley still had to show that Chase knew the statements were false but no analysis was devoted to this element of the fraud claim. In fact, the court stated in a footnote that it "agree[d] with Chase that no admissible evidence was submitted to support the assertion that Chase had decided in advance not to further fund any WaMu loans."

Lastly, and possibly most disturbing for lenders, the court appeared to ignore the general rule that a lender in a traditional lender/borrower relationship does not owe a duty of care on which the borrower could base a negligence claim. Stating that the "no-duty rule is only a general rule," the appeals court held that a duty may arise and a viable negligence claim may exist where the dispute arose with a failed bank over the loan, the ongoing dispute is "bridged" by an FDIC receivership, and when the acquiring lender makes encouraging statements to the borrower about a loan modification.

While the *Jolley* opinion is troubling, lenders and their lawyers can take action to avoid the result faced by Chase. For example, the affidavit disputing the completeness of the P&A Agreement was a clear difference-maker in the case. The importance of producing full copies of relevant agreements (indisputable in their authenticity) goes without saying. Frankly, the court's holding that the P&A Agreement was not admissible is at odds with other state and federal court decisions admitting such agreements.[4] The real importance of the case, however, relates to Jolley's fraud and negligence claims.

[4] In fact, in a decision that was issued weeks after *Jolley*, a sister court of appeals upheld the dismissal of a borrower's claims against Chase based upon the very same P&A Agreement because the authenticity of the agreement had not been questioned. *See Scott v. JPMorgan Chase Bank, N.A.*, 2013 WL 1098436, ___ Cal. Rptr. 3d. ___ (Cal. Ct. App. March 18, 2013) ("In this case, the fact of the P&A Agreement and the fact of the transfer to JPMorgan of WaMu assets, but not liabilities for borrower's claims, are not reasonably subject to dispute and are capable of ready determination, ***particularly since Scott did not question with specificity the authenticity, completeness, or legal effect of the P & A Agreement posted on the official FDIC Web site***.") (emphasis added).

Lenders need to be especially careful in connection with workouts and modifications. Lenders should require borrowers seeking modifications to execute an acknowledgment disclaiming any reliance on statements by the lender's employees during loan modification discussions and agreeing that the lender is not liable for the prior lender's handling of the loan. Lenders should also review the entire history of the loan, including the course of dealing between the failed bank and the borrower, so that their actions with respect to the loan are fully informed. Additionally, lenders should caution their employees regarding the significance of statements during loan modification discussions and instruct employees to follow-up any such discussions in writing confirming that there has been no agreement or promise. It is human nature to want to be encouraging; but when, as in *Jolley*, the statements can be characterized as representations of fact, the door is opened to a claim for redress under state fair trade statutes and common law theories.

In addition to the prudent practices that come to mind in the aftermath of *Jolley* referenced above, lenders should generally consider adopting the following practices to help avoid lender liability claims, including:

- obtain releases in connection with renewals, modifications and workouts of problem credits;
- salesmanship should be avoided and the need for details, final approval, and legal documentation should always be emphasized in communications to the borrower;
- if the lender meets or communicates with the borrower, a memo that accurately reflects the discussions should be made and filed;
- document any contingencies upon which commitments are made;
- assume that any communications with the borrower, or notes relating to those communications, will be key exhibits in any future litigation;
- all external communications must remain highly professional;
- ensure that the bank employee tasked with communicating with the borrower has actual knowledge of the status of any loan modification request so as to avoid any speculative statements on his or her part;
- negotiate honestly and fairly and make decisions based upon available facts and give timely notice of the lender's true intentions;
- give reasonable notice and an opportunity to cure, or at least an opportunity to find an alternative source of funds;
- avoid sudden shifts in policies or practices that a borrower may argue show bad faith;
- where possible, avoid calling loans based upon arguably immaterial grounds, such as an interest payment being a few days late;
- treat the guarantor the same as the maker and provide the same notices to the maker and guarantor, including foreclosure notices;
- avoid "calling the shots" or making day-to-day operating decisions for borrowers, always let them make the final decision;
- protect loan and collateral without interfering with management of the borrower;
- avoid approving checks to some trade creditors but not to others, or saying when they should be paid;

- think twice before putting a representative of the bank on the board of the borrower or paying an employee of the borrower directly; and

- recognize that the more onerous the limitations and requirements imposed by the loan documentation are, the more likely an unfriendly court will find a basis to rule against the lender.

In summary, *Jolley* represents a resurgence of lender liability claims with respect to purchasers of distressed debt. The decision also serves as a reminder that courts are sympathetic to borrowers undergoing financial hardship. Lenders should take heed of the holdings in this case by adopting new internal policies and practices, or by fine-tuning existing ones, with the goal of avoiding the fate of Chase and the jury trial that it now faces.

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