Banking
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When duty doesn't call: Sheen v Wells Fargo Bank

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For years, California courts followed the holding of *Nymark v. Heart Fed. Savings & Loan Assn.*, 231 Cal. App. 3d 1089 (1991), that, ordinarily, a lender acting within the scope of its traditional role did not owe a duty of care to its customer. In the past several years, however, some decisions started chipping away at that bulwark.

The first notable challenge was *Jolley v. Chase Home Finance, LLC*, 213 Cal. App. 4th 872 (2013), where it was noted that: "*Nymark* does not support the sweeping conclusion that a lender never owes a duty of care to a borrower. Rather, ... the question of whether a lender owes such a duty requires 'the balancing of the "*Biakanja* factors."'"

This was followed by *Alvarez v. BAC Home Loans Servicing L.P.*, 228 Cal. App. 4th 941 (2014), which held that a lender/servicer who chose to engage in a loan modification *did* owe a duty of care to its customer in connection with that modification, rejecting a blanket defense under *Nymark*.

Similarly, in *Daniels v. Select Portfolio Servicing, Inc.*, 246 Cal. App. 4th 1150 (2016), the court agreed that *Nymark* only established a "general rule" and that courts still needed to apply the *Biakanja* factors to determine whether a tort duty was owed and breached by the lender/servicer.

Biakanja v. Irving, 49 Cal. 2d 647 (1958), was a non-banking case in which the California Supreme Court established 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" (emphasis added), including (1) "the extent to which the transaction 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."

Some courts took the view that the *Biakanja* factors are irrelevant where the parties *are* in contractual privity, as would be the case with lenders and borrowers. However, the California Supreme Court depublished the leading appellate decision so holding.

Other cases, such as *Lueras v. BAC Home Loans Servicing, L.P.*, 221 Cal. App. 4th 49 (2013), have simply disagreed that a duty generally exists, leading to a split of authority as to whether loan modifications are subject to a negligence duty. Federal courts in California have also split on the issue, though a majority have adopted the *Lueras* view.

Sheen v. Wells Fargo Bank, N.A., 38 Cal. App. 5th 346 (2019), intensified the split. Sheen complained that Wells Fargo had negligently mishandled his application for modification of his junior lien loans. The 2nd District Court of Appeal affirmed Wells Fargo's demurrer to the complaint, seizing upon a seemingly unrelated California Supreme Court decision to double-down on the argument that the *Biakanja* factors should not be used to circumvent the rule that a lender, acting in the normal course and scope of its business, should not be held liable under a negligence duty. The court relied on *Southern California Gas Leak Cases*, 7 Cal. 5th 391 (2019), noting that: "economic losses flowing from 'a financial transaction gone awry' are 'primarily the domain of contract and warranty law or the law of fraud, rather than of negligence.' ... Here we have a financial transaction gone awry and nothing more: Sheen suffered neither personal injury nor property damage." The court also pointed out that, "at least 23 states have refused to impose tort duties on lenders about loan modifications."

The 2nd District's decision threatened to be a game-changer, with implications well beyond loan modifications.

Sheen was not pleased and successfully petitioned the state high court for review on the following question: "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?"

The Supreme Court, in an opinion authored by Chief Justice Tani Cantil-Sakauye, concluded that there was *no* "special relationship" between a borrower and a lender/servicer in the loan modification context, nor could such a duty properly be imposed by invocation of the *Biakanja* factors.

As to the statutory bases, although Sheen had not invoked the general statutory duty of care under Civil Code Section 1714, the court reaffirmed its holding in the *Gas Leak Cases* that, notwithstanding the broad language in Section 1714, "liability in negligence for purely economic losses ... is 'the exception, not the rule,' under our precedents." The court did *not* address whether, under other circumstances, a duty might exist based on other statutory claims under federal or state law (e.g., the Homeowner Bill of Rights), as none of those statutes applied in Sheen's case. The court did point out, though, that: "neither HBOR nor any other state or federal statute or regulation applies here to impose a duty along the lines sketched by plaintiff."

The court found that the common law provided no greater support for Sheen's position. Despite its earlier depublication of an appellate decision which had been based on that very point, the court held that the *Biakanja* factors, "are commonly employed to ascertain whether a court should recognize a duty, *but are useful and appropriate for that purpose only in situations involving parties that are not in privity with one another*." (Emphasis added.) Instead, the economic loss rule applied to preclude recovery in negligence for purely economic losses. While the court acknowledged that the economic loss rule did not apply to claims based on intentional misrepresentations, as those are independent of any contract between the parties, any tort claims that arose from the underlying contract itself would be barred. Sheen's negligence claims indisputably arose from the loan contract as he was seeking to modify its terms. There was never any agreement that "Wells Fargo would 'process, review and respond carefully and completely to the ... applications Plaintiff submitted,' and could foreclose only after discharging such obligations." Nor did the court agree that the mere acceptance of a loss mitigation application could give rise to such a duty. The terms in the parties' contract controlled and would be given deference. Indeed, the court commented that the duty asserted by Sheen ran *counter to* those terms as it sought to impose conditions on when a default could be declared and foreclosure occur.

The Supreme Court made clear that the general rule stated in *Nymark* -- that, "a financial institution owes no duty of care to a borrower when the institution's involvement in the loan transaction does not exceed the scope of its conventional role as a mere lender of money" -- was not only still the law in California, but did not admit of an exception for loss mitigation as that process was within the scope of that conventional role. While conceding that there might be circumstances where a lender *did* owe a duty to a borrower, loss mitigation was not one of them.

The Supreme Court acknowledged there were exceptions to the economic loss rule -- for example, in the context of insurance cases and the rendition of professional services -- but found that mortgage loans did not share the special characteristics warranting the rare departures from the rule. Rather, they were more akin to typical commercial contracts. In addition, the court rejected the argument that the rule only applied where plaintiff was claiming defendant had breached a contract, since the assertion of a tort claim under those circumstances would interfere with the terms of the parties' contract (here, as to the right to foreclose).

The Supreme Court also rejected Sheen's argument that the rule should not apply because, at the loss mitigation stage, a borrower is at the mercy of the lender or loan servicer, who might have incentives contrary to the interests of the borrower. The court pointed out that the reason the borrower is in that position is *because of the existing contract terms* which gave the lender those rights, so no exception was appropriate and one would constitute "a potentially enormous expansion of tort law."

However, the Supreme Court cautioned that it was not ruling on whether claims for misrepresentation or promissory estoppel could still be asserted in the loan modification context since Sheen had not asserted those claims, though it suggested that such claims might be viable where facts existed to support them.

Sheen's argument that a duty should be imposed because "no other source of law addresses the harm that [he] identifies" proved unpersuasive as well. The Supreme Court declined the opportunity to impose such a sweeping new remedy by judicial fiat, stating that it was up to the lawmakers to create such a duty if they wanted one and noting that they had not been shy in doing so in recent years where they believed the situation warranted relief. The determination of the appropriateness of such changes to existing law involves tradeoffs and policy determinations which were more appropriate for lawmakers to decide as they were better equipped to gather the necessary information and make the determination as to whether to impose a duty of care on loss mitigation efforts.

So what does this all mean? In practical terms, unless the legislators or regulators choose to impose a statutory duty of care on lenders/servicers (beyond that already provided by existing laws), borrowers can no longer hope to obtain damages from their lenders/servicers based on negligence, at least where the handling of loss mitigation requests is concerned. To the extent that they are inconsistent with its opinion, the Supreme Court disapproved of *Alvarez* and its progeny. More broadly, application of the *Biakanja* factors to impose liability cannot be invoked where the parties are in privity of contract. Borrowers might follow the court's hint and try to assert claims of misrepresentation and/or promissory estoppel, among others, but the proof required for these theories is a steeper hill to climb than ordinary negligence. Borrowers might also attempt to find solace in Justice Goodwin Liu's concurring opinion, especially his speculation that a duty might still be found based on a lender/servicer's affirmative conduct. Whether lower courts will agree with that speculation, and whether this Supreme Court would affirm such a decision, remains to be seen.

Jonathan was one of the attorneys who drafted an amicus brief in support of Wells Fargo Bank's position in Sheen.