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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TABLE OF CONTENTS

TABLE OF CONTENTS (cont.)

TABLE OF AUTHORITIES

Cases **Pages**

TABLE OF AUTHORITIES (cont.)

TABLE OF AUTHORITIES (cont.)

TABLE OF AUTHORITIES (cont.)

TABLE OF AUTHORITIES (cont.)

Statutes

Treatises

Secondary Sources

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

the controlling hand be required to exercise reasonable care in their dealings with borrowers seeking a loan modification." (Pet. App. 8 [quoting *Alvarez*, 228 Cal.App.4th at 949].)

Despite these observations as to why a tort duty on the part of loan servicers is not just warranted, but "moral[ly] imperative," the Court of Appeal ultimately rejected *Alvarez* and *Daniels*, holding instead that there is *no* duty of care that extends to borrowers like Sheen, who are lulled into a false sense of security by their loan servicer that their application to modify their loan has been accepted and that the servicer will *not* foreclose on their home—only to then lose their home to foreclosure. (Pet. App. 8.)

The Court gave two distinct reasons for its decision. First, the Court expressed its mistaken belief that "the issue of whether a tort duty exists for mortgage modification has divided California courts for years." (Pet. App. 2); *see also* Pet. App. 8 [discussing (*inter alia*) *Lueras v. BAC Home Servicing, LP* (2013) 221 Cal.App.4th 49, 67].)

Even though *Lueras* involved a different question than this case—whether a lender owes a common law duty "to offer, consider, or approve" a loan modification, *not* whether a lender has a duty of ordinary care to process and respond carefully and completely to a loan modification application that it has

accepted—the Court concluded that *Lueras* (and other cases like it) conflict with *Daniels* and *Alvarez*. (Pet. App. 2, 8.)[4]

Based on this alleged conflict among California appellate courts, the Court of Appeal concluded that the *Biakanja* factors do not yield a clear result on the duty question. (*See* Pet. App. 9 [stating that "how one views [the *Biakanja*] test apparently depends on the beholder."].)

In order to break the tie on what it saw as a "deeply divi[sive] issue," the Court looked to this Court's recent decision in *SoCalGas*, which held that there is no tort duty of care for negligently inflicted economic losses caused by a massive methane gas leak that ruined the local economy surrounding the gas facility.

Even though *SoCalGas* involved tort claims between strangers, where there was no "special relationship" linking the parties under the *Biakanja* factors, the Court of Appeal concluded that *SoCalGas* weighed heavily against recognizing a duty of care in *this* case, where there *is* such a relationship. (Pet. App. 10.)

The Court of Appeal was further persuaded by the fact that, in *SoCalGas*, this Court "also considered the views of other jurisdictions and of the Restatement of Torts." (Pet. App. 10.)

With regard to other jurisdictions, the Court was impressed by the fact that "[c]ourts in at least 23 states have refused to

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[4] As explained below at Part I(A), that conclusion was error; prior to the lower court's decision in this case, there was no conflict among the lower courts as to the issue in *this* case.

impose tort duties on lenders about loan modifications." (Pet. App. 10 [citing cases].) Yet the Court made no attempt to analyze the specific facts of those cases, much less determine whether the cases in those jurisdictions applied a version of the economic loss rule that comports with California's treatment of that doctrine. Instead, it simply concluded that those decisions "cut sharply against recognizing a duty of care" here. (Pet. App. 10 [citing *SoCalGas,* 7 Cal.5th at 403].)[5]

With regard to the *Restatement*, the Court looked to a provision suggesting that the economic loss rule should bar tort claims for purely economic losses incurred in the conduct of contract negotiations, without noting (much less analyzing) the Restatement's rationale for that provision, or determining whether that rationale applies in the context of this case—as explained below, it does not. (Pet. App. 13-14.)

* * *

In short, the Court of Appeal misread consistent California cases, which addressed different legal questions, and announced that, faced with a (nonexistent) split of authority, it had to pick a side. The Court concluded that "we should follow *Lueras*, not *Alvarez*." (Pet. App. 16.) This false choice led to an unjustifiable and unjust result that left Sheen without any remedy at all.

This appeal followed.

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[5] As explained below, that was error. In reality, the cases cited by the lower court are either distinguishable or wrongly decided—or both. (*See infra* at Part II(C).)

STANDARD OF REVIEW

"Duty is a question of law for the court, to be reviewed de novo on appeal." (*Kesner v. Super. Ct.* (2016) 1 Cal.5th 1132, 1142 [quoting *Cabral v. Ralphs Grocery Co.* (2011) 51 Cal.4th 764, 770].) A court must "independently review a ruling on a demurrer to determine whether the pleading alleges facts sufficient to state a cause of action." (*Lueras*, 221 Cal.App.4th at 61.) In so doing, "[t]he complaint must be liberally construed and survives a general demurrer insofar as it states, however inartfully, facts disclosing some right to relief." (*Id.* [quoting *Longshore v. County of Ventura* (1979) 25 Cal.3d 14, 22].)

SUMMARY OF ARGUMENT

The lower court committed two distinct errors warranting reversal.

First, it wrongly concluded that the California Courts of Appeal are "deeply" split on whether there is a tort duty of care in the context of this case. In fact, as explained below in Part I(A), before the Court of Appeal issued its decision in this case, the appellate courts of this state all *agreed* that there should be a duty of care in the processing of a loan modification request that has been accepted for review.

And those decisions were correct: every one of the *Biakanja* factors points toward a duty of care here. If the Court of Appeal had properly applied those factors in this case, it likely would have concluded the same. (*See* Part I(B), *supra.*)

But the Court of Appeal never got that far, because—based on its mistaken notion of a preexisting split of appellate authority

on the question presented—the Court looked to *SoCalGas* to break the tie, finding that *SoCalGas*' analysis of the economic loss rule, and its reliance on the *Restatement of Torts* and case law from other jurisdictions, trumps whatever conclusion the Court might have reached under the *Biakanja* factors (had it applied them—it didn't).

That was error for three distinct reasons.

First, *SoCalGas* actually reaffirms that *Biakanja* supplies the appropriate test in this case. And there's nothing in *SoCalGas* to suggest that the economic loss rule (ELR) should bar tort claims between contracting parties where there has been no underlying breach of contract and the tort claim is predicated on a duty entirely independent of the underlying contract.

Second, the Court of Appeal's reliance on the *Restatement* was error because the *Restatement* reaffirms that the principal goal of the ELR is to prevent erosion of the boundary line between tort and contract. That goal is not implicated here because Sheen's claims do not arise out of any contractual breach. Instead, he alleges negligence in Wells' performance of its *non-contractual* duty to exercise due care when processing and responding to a loan modification application that it has accepted.

Nothing about that claim disrupts any underlying contract between Mr. Sheen and Wells. And nothing about this lawsuit interferes with these parties' ability to reach a private bargain about who should bear the risk of Mr. Sheen's original loan,

because that issue is entirely distinct from a possible loan modification.

Finally, the Court of Appeal erred in relying on case law from other jurisdictions to reject a duty of care here. If the Court of Appeal had analyzed those cases, it would have discovered that the majority involve economic loss claims arising from a contract breach—not this case.

A second category of cases it cited goes further, barring *any* tort claims for economic losses simply because the tort claim would never had existed "but for" the underlying contractual relationship between the parties. Those cases are contrary to this Court's prior recognition that the mere existing of a contractual relationship between parties does *not* bar tort claims based on independent duties. (*See Robinson Helicopter Co, Inc. v. Dana Corp.* (2004) 34 Cal.4th 979, 988.)

A third category of cases cited from other jurisdictions actually *support* finding a duty here. They recognize that a purely economic loss does not bar a tort claim, and they apply the binding tests in their respective jurisdictions to determine whether there is a special relationship between a loan servicer and a borrower. That framework is precisely the one California law uses, and under California's *Biakanja* test, the result is clear: loan servicers are in a special relationship with borrowers and they do owe them a tort duty of care.

ARGUMENT

I. The Court of Appeals Erred in Not Recognizing a Duty of Care in the Loan Modification Context.

A. Prior Courts of Appeal Were Not in Conflict on the Issue Presented.

The lower court's first error was in concluding that the California appellate courts are "deeply" split on whether there is a tort duty of care in the loan modification context. Not so.

1. Aside from the decision below, California appellate courts agree that loan servicers are subject to a duty of care in loan modification processing.

Before the Court of Appeal issued its decision in this case, California appellate courts agreed that, although lenders do *not* owe a borrower a duty to offer, consider, or approve a loan modification at all, lenders *do* owe borrowers a duty of care in their handling of a borrower's loan modification application, even if they ultimately decline to modify the loan.[6]

A careful reading of *Lueras, supra,* 221 Cal.App.4th 49, and *Alvarez, supra,* 228 Cal.App.4th 941, the two primary negligence cases involving applications for residential loan modification, bears this out.

In *Lueras*, the plaintiff claimed that the mortgage servicer had a duty *to offer and approve* a loan modification. (221 Cal.App.4th at 62.) On those facts, *Lueras* correctly found, based

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[6] The basis for that distinction is addressed below at Part I(A)(2).

on an application of the *Biakanja* factors, that there is no duty to "offer, consider, or approve a loan modification." (*Id.* at 67.)[7]

In contrast, *Alvarez* held that the mortgage servicer only had a duty *after* the mortgage servicer agreed to review the plaintiff's loan modification application. (*Alvarez*, 228 Cal.App.4th at 944.) *Alvarez* emphasized that *Lueras* involved a negligence claim based on a servicer's failure to offer, consider, and approve a loan modification, which *Alvarez* agreed would not support negligence liability under *Biakanja*. (*Id.* at 946.) However, *Alvarez* ultimately found that a servicer *does* owe a duty to exercise reasonable care in the *processing* of a loan modification once a servicer agrees to consider a modification of an applicant's loan. (*Id.* at 948.)

Importantly, *Alvarez* also highlighted the holding in *Lueras* itself that "a lender *does* owe a duty to a borrower to not make material misrepresentations about the status of an application for a loan modification or about the date, time, or status of a foreclosure sale." (*Id.* at 946-947 [emphasis added]; *see also Beatty v. PHH Mortg. Corp.* (N.D. Cal. Dec. 10, 2019) No. 19-CV-05145-DMR, 2019 WL 6716295, at *10 [critiquing the Court of Appeal decision in this case and noting, "[a]lthough it putatively

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[7] *Lacken v. Select Portfolio Servicing, Inc.* (4th Dist. 2018) 2018 WL 948198, an unpublished/noncitable decision referenced by the lower court (Pet. App. 9), is in the same camp as *Lueras*, because it involved *denial* of a loan modification. (*See* 2018 WL 948198 at *7.)

adopted *Lueras*, it did not address or even mention *Lueras*'s holding that '[t]he law imposes a duty not to make negligent misrepresentations of fact'"].)

Alvarez further noted that *Lueras* cited a number of decisions "recognizing that a lender *does* owe a borrower a duty of care in negotiating or processing an application for a loan modification." (*Id.* at 848 [emphasis added and citing *Lueras,* 221 Cal.App.4th at 64-65].) Based on these observations, *Alvarez* ultimately found that "because defendants allegedly agreed to consider modification of the plaintiffs' loans, the *Biakanja* factors clearly weigh in favor of a duty." (*Id.* at 948.)

Daniels, *supra*, 246 Cal.App.4th 1150, applied *Alvarez*'s reasoning and reached the same result. There, the plaintiffs argued that the lender breached its duty to act reasonably with respect to their loan modification application by, among other things, "failing to give [plaintiffs a fair loan modification evaluation [and] 'accepting trial payments from [plaintiffs]" that were not accurately accounted for. (*Id.* at 1180.) The Court held, based on an application of the *Biakanja* factors, that a mortgage loan servicer has a duty to process a loan modification application with ordinary care. (*Id.*)

Just as in *Alvarez*, *Daniels* emphasized the distinction between cases involving an alleged breach of duty to offer, consider, or approve a loan modification (where there is no duty) and cases involving negligence during the loan modification process, *after* a lender has accepted the application from the borrower. (*See id.* at 1180-1182.) In the latter context, the Court

held that the question of whether there is a duty should be determined by application of the *Biakanja* factors. (*Id.* at 1182.)

Even *Nymark v. Heart Federal Savings & Loan Association*, the case on which mortgage servicers often rely to argue that they owe no common law duty of care regarding mortgage modification, does not establish the absence of a duty in all circumstances. ((1991) 231 Cal.App.3d 1089.) Instead, *Nymark*'s holding is limited to the loan origination context, "when the institution's involvement in the loan transaction does not exceed the scope of its conventional role as a mere lender of money." (*Id.* at 1096; *see also Jolley v. Chase Home Finance, LLC* (2013) 213 Cal.App.4th 872, 901 [recognizing that "*Nymark* does not support the sweeping conclusion that a lender never owes a duty of care to a borrower. Rather, the *Nymark* court explained that the question of whether a lender owes such a duty requires 'the balancing of [the "*Biakanja* factors"].'")[8]

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[8] Notably, in 2014, this Court de-published *Aspiras v. Wells Fargo Bank, N.A.*, which declined to apply *Jolley* to impose a duty on loan servicers to consider mortgage loan modification applications by conventional borrowers in good faith. (*See Aspiras v. Wells Fargo Bank, N.A.* (2013) 162 Cal.Rptr.3d 230, 243 [review den. and opn. ordered nonpub. Jan. 15, 2014, S214277].) *Jolley* had previously held, in the construction loan context, that once a servicer undertakes to consider a borrower's loan modification application, the *Biakanja* factors weigh in favor of imposing a duty on the servicer to process the application with ordinary care. (*Jolley*, 213 Cal.App.4th at 899.) Like the Court of Appeal in this case, *Aspiras* rejected an invitation to apply the *Biakanja* factors to determine the existence of a duty, relying

* * *

In short, the lower court erred in looking to *Lueras*, on the one hand, and *Alvarez* and *Daniels*, on the other, as evidence of a preexisting split of authority among California appellate courts on the issue presented in this case. There is none.[9]

2. The distinction between loan origination and loan servicing is rooted in powerful policy concerns about abuses in the loan servicing industry.

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instead on a supposed "general rule" against the imposition of negligence liability on loan servicers in the handling of a mortgage loan. (*Aspiras*, 162 Cal.Rptr.3d at 242.) Per this Court's 2014 order denying review and ordering depublication, *Aspiras* is no longer good law.

[9] Unlike the California cases applying California law, no consensus emerges from the federal cases cited by the lower court. (Pet. App. 9.) Some, like *Lueras*, merely refuse to recognize a duty to *approve* a loan modification, which is consistent with the distinction drawn by the California appellate courts. (*See, e.g., Anderson v. Deutsche Bank Nat. Trust Co. Americas* (9th Cir. 2016) 649 Fed.Appx 550, 552.) Others go further than California courts by refusing to recognize any duty with regard to a lender's duty during loan modification processing. (*E.g., Hackett v. Wells Fargo Bank, N.A.* (C.D. Cal. 2018), Case No. 2:17-cv-7354, 2018 WL 1224410 at *2.) The latter category of cases are wrongly decided and, in any event, "are neither binding nor controlling on matters of state law." (*T.H. v. Novartis Pharmaceuticals Corp.* (2017) 4 Cal.5th 145, 175. *See also id.* at 178 [noting that "[f]ederal courts sitting in diversity are 'extremely cautious' about recognizing innovative theories under state law..."] [citation omitted].)

Alvarez is especially helpful in understanding why the distinction between loan origination (no duty) and loan servicing (duty) makes sense. *Alvarez* concerns loan origination, not loan servicing. *Alvarez* recognized that loan servicing, particularly in its modern form, differs significantly from money lending, involving different actors, different rules, different incentives and different problems. (*See Alvarez*, 228 Cal.App.4th at 949.) These differences weigh heavily in favor of imposing tort duties on servicers. (*Id.*)

As discussed above (at pp. 6-10), the disconnect between loan origination and loan servicing in the modern mortgage servicing industry has left borrowers particularly vulnerable. Unlike in the loan origination context, where borrowers can choose their own lender, borrowers *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.

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 their home, or give up their home through foreclosure or deed in lieu of foreclosure. But servicers often fail to provide such necessary information.

This is why it makes good sense for California appellate courts to distinguish between loan origination and loan servicing when it comes to recognizing a tort duty of care. It is that distinction that the Court of Appeal in this case failed to grasp—which is one of the errors that led it to conclude that there should be no duty in this case.

B. The *Biakanja* Factors Squarely Counsel in Favor of Recognizing a Duty of Care in this Context.

If the lower court had considered the *Biakanja* factors, it would have seen that they squarely point toward a duty of care in the mortgage servicing context. Those factors include: (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." (*Biakanja*, 49 Cal.2d at 650.)

As this Court has explained regarding the analogous "*Rowland*" factors, a Court conducts the duty analysis "at a relatively broad level of factual generality." (*Kesner v. Superior*

Court (2015) 1 Cal.5th 1132, 1144 [quoting *Cabral v. Ralphs Grocery Co.* (2011) 51 Cal.4th 764, 770].)[10]

Thus, the question for this Court is whether the *Biakanja* factors generally counsel in favor of recognizing a duty of care on the part of servicers in the processing of loan modification applications. The answer to that question should be yes.

1. The extent to which the transaction was intended to benefit the plaintiff.

The first *Biakanja* factor is "the extent to which the transaction—the loan modification—was intended to benefit the Plaintiff." (*Alvarez*, 228 Cal.App.4th at 948.) This is an easy call: the entire reason Sheen (and similarly situated borrowers who fall behind on their mortgage payments) seek loan modifications is to stave off foreclosure. If granted here, modification would have conferred an obvious benefit on Sheen.

Garcia v. Ocwen Loan Servicing, LLC (N.D. Cal. 2010) No. C 10–0290 PVT, 2010 WL 1881098, supports this conclusion. There, the Court found that a loan servicer's agreement to review a loan modification application "was unquestionably intended to affect" the homeowner plaintiff, because "[t]he decision on Plaintiff's loan modification application would determine whether or not he could keep his home." (*Id.* at *3. *See also Alvarez,* 228 Cal.App.4th at 948 [holding that " 'unquestionably' " the

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[10] The "*Rowland* factors" stem from *Rowland v. Christian* (1968) 69 Cal.2d 108, 113, which enunciated the factors for evaluating a duty of care under Cal. Civ. Code § 1714(a).

transaction was intended to affect plaintiffs, as " '[t]he decision on [plaintiffs'] loan modification application would determine whether or not [they] could keep [their] home' " and at what cost."].)[11]

These Courts' conclusions make sense, given that the central goal of loan modification is to allow the homeowner to remain in their home with an affordable mortgage payment. The servicer's modification analysis will likely determine whether foreclosure will take place, since the homeowner is almost universally required to attest that they have defaulted on the loan (or will do so soon) and have insufficient funds to continue making payments and prove financial hardship. (*See Jolley*, 213 Cal.App.4th at 900 [noting that, to the extent the servicer undertook a re-assessment, it did so for the benefit of the borrower].)

It is important to recognize that loan modifications are primarily directed at saving the homes of borrowers in default, not making more money for servicers. In fact, the flagship federal loan modification program, HAMP, was created to help homeowners facing a foreclosure crisis; the Treasury Department's press release announcing the program, for example, stated that "Making Home Affordable will offer assistance to as many as 7 to 9 million homeowners, making their

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[11] The fact that the transaction may have also benefitted Wells "does not mean that it was not also intended to affect [Sheen]." (*Daniels*, 246 Cal.App.4th at 1182.)

mortgages more affordable and helping to prevent the destructive impact of foreclosures on families, communities and the national economy."[12]

And, as noted above, California's procedural protections during modification, contained in the Homeowner Bill of Rights, are clearly directed at protecting the rights of those with the most to gain and to lose in modification: the homeowner. (*See, e.g.,* Cal. Civ. Code § 2923.4 [defining HBOR's purpose as "ensur[ing] that, as part of the nonjudicial foreclosure process, borrowers are considered for, and have a meaningful opportunity to obtain, available loss mitigation options, if any, offered by or through the borrower's mortgage servicer, *such as loan modifications or other alternatives to foreclosure.*"] [emphasis added].)

These statutes underscore that loan modifications are principally for the benefit of homeowners. The first *Biakanja* factor is therefore met.

2. Foreseeability of harm to the homeowner.

The second *Biakanja* factor—foreseeability of harm to the homeowner—is also readily met in this context, because the harm that can come to a borrower from mishandling a loan modification is utterly predictable.

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[12] (*See* U.S. Department of the Treasury, Press Center, *Relief for Responsible Homeowners: Treasury Announces Requirements for the Making Home Affordable Program* (March 4, 2009) [*available at* https://www.treasury.gov/press-center/press-releases/Pages/200934145912322.aspx [press release and link to summary of guidelines].)

As *Alvarez* noted, "[a]lthough there was no guarantee the modification would be granted had the loan been properly processed, the mishandling of the documents deprived Plaintiff of the possibility of obtaining the requested relief." (*Alvarez*, 228 Cal.App.4th at 949 [quoting *Garcia*, 2010 WL 1881098, at *3].)

Mishandling of a loan modification application can result in unnecessary foreclosure, as it did here: Sheen clearly alleged that Wells failed repeatedly misled him about the status of the foreclosure sale of his home, and about the status of his loan, after he submitted his application.

Even extended delay causes predictable harm: added interest from falling further behind and unnecessary default-related fees can eat up any remaining equity in the home, or make other means of avoiding foreclosure (such as short sale or repayment through Chapter 13 bankruptcy) more difficult. Because servicers continue negative credit reporting even while they process modification applications, damage to credit during months of delay can make it harder for borrowers to recover financially, even if their mortgages are ultimately modified.

On this point, it is notable that even *Lueras* recognized that "[i]t is foreseeable that a borrower might be harmed by an inaccurate or untimely communication about a foreclosure sale or about the status of a loan modification application, and the connection between the misrepresentation and the injury suffered could be very close." (*Alvarez*, 228 Cal.App.4th at 947 [quoting *Lueras*, 221 Cal.App.4th at 68-69].)

In short, there is no question that negligent conduct during the course of loan modification can result in serious harm—even homelessness. The foreseeability factor is therefore also met.

3. The degree of certainty that the plaintiff suffered injury.

The third *Biakanja* factor—the degree of certainty that the plaintiff suffered an injury—is also satisfied in this context. (*See Garcia*, 2010 WL 1881098, at *3 ["The injury to Plaintiff is certain, in that he lost the opportunity of obtaining a loan modification and [] his home was sold"].) More amorphous harms, such as the loss of opportunity to save the home by other means, are susceptible to proof, as they all involve a practical, factual (and often financial) calculation of what would have happened had the modification application been processed according to the appropriate standard of care.

Here, it is once again notable that even *Lueras* held that it is predictable that a borrower like Sheen would suffer harm as a result of misrepresentations about the status of a foreclosure sale and failure to communicate accurately about the status of a modification application. (*See Lueras*, 221 Cal.App.4th at 68-69.)

There was no doubt that Sheen was injured as a result of Wells' acts: he refrained from taking action to prevent the foreclosure sale of his home after Wells stated that the home would not be sold. This was after Wells had already agreed to review Sheen's application to modify the Second Loan, and Wells' subsequent failure to provide Sheen with an accurate status update regarding the application, which led Sheen to believe that

the loan had been modified. (*See also Jolley*, 213 Cal.App.4th at 899 [noting the certainty that the borrower had been injured by the servicer's failure to review his loan modification application with ordinary care].)

Taking the allegations in the Second Amended Complaint as true (which the Court must at the demurrer stage, *see T.H. v. Novartis*, 1 Cal.5th at 162), the harm from these actions was certain.

4. The closeness of the connection between Wells' conduct and the injury suffered.

The connection between servicer's conduct and the borrower's injury in the modification context is close—and thus this factor is met as well.

A homeowner's injury is tightly connected to a servicer's conduct "because, to the extent Plaintiff otherwise qualified and would have been granted a modification, Defendant's conduct . . . precluded the loan modification application from being timely processed." (*Alvarez*, 228 Cal.App.4th at 948 [quoting *Garcia*, 2010 WL 1881098, at *3].) Even a homeowner who would not have qualified for modification may be able to show he or she missed a different opportunity to save the home (for instance, through bankruptcy protection), as Sheen has pled in this case.

Lueras is not to the contrary. *Lueras* acknowledged that the connection between a servicer's failure to process a loan modification application with ordinary care and a borrower's injury, like losing their home, would be close. *Lueras* simply found no close connection between a servicer's failure to *grant* a

loan modification and the borrower's preexisting obligation to make payments on their original loan. (*Lueras*, 221 Cal.App.4th at 67.)

Here, as in *Alvarez* and *Daniels*, the negligent conduct alleged is not a denial of a loan modification application, but rather (1) a failure to handle an application with ordinary care and (2) misrepresentations about the status of a foreclosure sale after Wells accepted Sheen's loan modification application for review, which led to reliance by a borrower and resulting damages beyond a mere continuing obligation to pay an existing debt. In this context the connection between the misconduct and the injury *is* close—and thus this factor is met as well.

5. The moral blame attached to the servicer's conduct.

Under *Biakanja* and the analogous *Rowland* factors, moral blame attaches to a defendant's conduct and supports a duty "in instances where the plaintiffs are particularly powerless or unsophisticated compared to the defendants or where the defendants exercised greater control over the risks at issue." (*Kesner v. Superior Court* (2016) 1 Cal. 5th 1132, 1151.)

Wells is far more powerful and sophisticated than Sheen, and it controlled all information regarding the mortgage on Sheen's home. As a result, Sheen's "ability to protect his own interests in the loan modification process [was] practically nil," and the bank held "all the cards." (*Alvarez*, 228 Cal.App.4th at 949 [quoting *Jolley*, 213 Cal.App.4th at 900].)

As described above, and as noted by *Alvarez*, "borrowers are captive, with no choice of servicer, little information, and

virtually no bargaining power." (228 Cal.App.4th at 949.) This stark power disparity led *Alvarez* to its emphatic conclusion that the bank was morally blameworthy and subject to a duty of care. The court explained:

> The borrower's lack of bargaining power, coupled with conflicts of interest that exist in the modern loan servicing industry, provide a *moral imperative* that those with the controlling hand be required to exercise reasonable care in their dealings with borrowers seeking a loan modification.

(*Id.* [emphasis added].)

As with the other factors, *Lueras* is inapposite because it concerned whether a lender has a duty to *grant* a loan modification. All California appellate courts agree that a servicer is free to decline a modification. But here, the question is whether a lender has a duty to exercise ordinary care as it *considers* a loan modification.

Lueras was not wrong when it stated, "[i]f the lender did not place the borrower in a position creating a need for a loan modification, then no moral blame would be attached to the lender's conduct," i.e., its failure to modify the loan. (221 Cal.App.4th at 67.) But that is not the situation here.

The question is *not* whether Wells was responsible for the circumstances that led Sheen to seek a loan modification, and therefore whether moral blame attached to Wells' refusal to approve Sheen's application to modify his loan. Instead, the question is whether, having accepted Sheen's application, Wells was morally responsible when it indicated to Sheen and his wife

thereafter that their loan was unsecured (when it was still secured by the home) and then said the home would never be sold (when it was still subject to foreclosure). To that question, the answer is clearly yes. Wells was blameworthy.

This Court's precedent supports this conclusion. In case after case, both under *Rowland* and under *Biakanja*, this Court has found conduct morally blameworthy where a defendant not only has superior information, but knows the plaintiff is likely to rely on the defendant's expertise. (*See, e.g.*, *Kesner*, 1 Cal.5th at 1151 [assigning moral blame to asbestos facility because it "had greater information and control over the hazard than employees' households"]; *Beacon Residential Cmty. Assn. v. Skidmore, Owings & Merrill LLP* (2014) 59 Cal.4th 568, 586 [assigning "significant" moral blame to architects for defective design because of "their awareness that future homeowners would rely on their specialized expertise in designing safe and habitable homes"].)

Here, Wells had all of the information about Sheen's loans and the status of Sheen's loan modification application. Moreover, like the architect in *Beacon*, Wells was aware that Sheen and his wife would rely on Wells' expertise and on the representations Wells made about Sheen's mortgage. This made for a gross asymmetry in expertise and information. Wells was thus morally blameworthy—not for refusing to modify Sheen's loan, but for negligently processing his application to modify it, and leading him to believe his home would not be foreclosed on.

6. The policy of preventing future harm.

This factor asks whether "public policy supports finding a duty of care." (*J'Aire Corp. v. Gregory* (1979) 24 Cal.3d 799, 805). It does. Recognizing a duty here would advance "the admonitory policy of the law of torts" and prevent future harm by a dangerous industry. (*Connor v. Great W. Sav. & Loan Ass'n* (1968), 69 Cal.2d 850, 618); *see T.H. v. Novartis Pharm. Corp.* (Cal. 2017) 1 Cal.5th 145, 168 ["[T]he overall policy of preventing future harm is ordinarily served, in tort law, by imposing the costs of negligent conduct upon those responsible."].)

In *Connor*, this Court observed, "[r]ules that tend to discourage misconduct are particularly appropriate when applied to an established industry." (69 Cal.2d at 618.) There, as here, this Court applied the *Biakanja* test to the financial industry and the lenders that operate within it. (*Id.*) As discussed at length above, the loan-servicing industry is well-established and has a history of causing great harm to consumers. Imposing liability on Wells here would "give lenders an incentive to handle loan modification applications in a timely and responsible manner." (*Daniels*, 246 Cal.App.4th at 1183 [citation omitted].)

Despite finding an overall duty of care under *Biakanja*, *Daniels* cautioned that this factor "appears to cut both ways," because, absent a duty to undertake modification negotiations in the first place, "imposing negligence liability for the mishandling of loan modification applications could be a disincentive to lenders from ever offering modification." (*Id.*).

But this concern is misplaced. In any given mortgage, there will be at least one actor who *is* incentivized to offer a loan

modification: the owner of the loan. That actor, whether the loan originator or a subsequent buyer, is incentivized to modify the loan rather than foreclose so that it can continue to receive regular payments and interest. Recognizing a tort duty in this case would simply ensure that the actor who undertakes modification negotiations does so with ordinary care.

Recognizing a duty here would also bolster existing public policy protecting homeowners. The current legislative landscape governing mortgage-servicing is highly relevant to this inquiry and reveals a strong public policy favoring liability here. (*See Alvarez*, 228 Cal.App.4th at 950; *Garcia*, 2010 WL 1881098, at *3.)

Recent federal legislation—including HAMP—demonstrates a public policy of "preventing future harm to home loan borrowers" that favors allowing tort claims to proceed. (*Id.*) "[T]he California Legislature," too, "has expressed a strong preference for fostering more cooperative relations between lenders and borrowers who are at risk of foreclosure, so that homes will not be lost." (*Jolley*, 213 Cal.App.4th at 903.)

In particular, HBOR, which became effective January 1, 2013, demonstrates "a rising trend to require lenders to deal reasonably with borrowers in default to try to effectuate a workable loan modification." (*Alvarez*, 228 Cal.App.4th at 950; *Jolley*, 213 Cal.App.4th at 903). On the federal side, the Consumer Financial Protection Bureau has also promulgated regulations that provide procedural protections to homeowners and impose servicing standards. (*See Mortgage Servicing Rules*

under the Real Estate Settlement Procedures Act (Regulation X) (Feb. 14, 2013) 78 Fed. Reg. 10,696.)

Thus, there is a strong federal and state policy of avoiding future unnecessary harm to homeowners seeking to avoid foreclosure, and of protecting them in the course of loan modification. This policy weighs heavily in favor of imposing a duty on servicers to process mortgage modification applications with ordinary care.

* * *

In sum, all the *Biakanja* factors are met in this case. The Court should have applied those factors here—but it did not. Instead, based on its mistaken view that the California appellate courts are "deeply split" as to application of those factors, the Court leapfrogged over *Biakanja* straight into the arms of the economic loss rule, as enunciated by this Court in *SoCalGas*, 7 Cal.5th 391. That was error, as we now explain.

II. The Lower Court Erred in Finding that *SoCalGas* Militates Against Recognizing a Duty of Care in this Case.

A. *SoCalGas* Confirms that *Biakanja* Supplies the Governing Test for Determining Whether Economic-Loss Claims are Cognizable in Tort.

First, it is important to recognize that *SoCalGas* actually *confirmed* that *Biakanja* supplies the proper test for evaluating whether there is a duty of care in this context.

There, this Court held that California law allows for recovery of negligently inflicted economic losses where the

plaintiff and the defendant have a "special relationship." (*Id.* at 400 [citing *J'Aire Corp. v. Gregory* (1979) 24 Cal.3d 799, 804].) Whether such a relationship exists is determined by applying the various factors set forth in *Biakanja*. (*Id.*) And, as explained above, this case passes the *Biakanja* test with flying colors. Since the ELR has no application where there *is* a special relationship between the parties, and there is such a relationship here, the ELR is simply not relevant to this case.

SoCalGas's analysis of the rationale for the ELR underscores this point. There, this Court stated that the ELR bars tort recovery of "purely economic losses [that] flow *not* from a financial transaction meant to benefit the plaintiff (and which is later botched by the defendant), but instead from an industrial accident caused by the defendant (and which happens to occur near the plaintiff)." (7 Cal.5th at 889 [emphasis added].) As the italicized language shows, *SoCalGas* reaffirmed that where, as here, "purely economic losses" *do* flow "from a financial transaction meant to benefit the plaintiff..." (*id.*), the ELR does *not* pose any kind of categorical barrier to recovery of such losses.

B. The Lower Court Misread *SoCalGas* As Militating Against a Tort Duty of Care in the Loan Modification Context.

The lower court's contrary conclusion was based on an oversimplified reading of this Court's statement, in *SoCalGas*, that "purely 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.'" (Pet. App. 10 [quoting *SoCalGas*, 7 Cal.5th at 402] [emphasis added].)

It is true that the ELR generally bars extra-contractual recovery of economic losses where there is privity of contract between the parties *and* the plaintiffs' losses arise solely out of a contractual breach. (*See, e.g., Seely v. White Motor Corp.* (1965) 63 Cal.2d 9, 19.) In such cases, the ELR steps in to prevent the law of contract and the law of tort from "dissolving one into the other." (*Robinson Helicopter Co, Inc.*, 34 Cal.4th at 988.)

But here, although Sheen does have a financial relationship with Wells, Sheen's damages do not arise out of a contractual breach. To the contrary, he seeks damages for Wells' negligent conduct in processing his application for loan modification—conduct he does *not* claim violated any contractual duty on Wells' part. (*See* Second Amended Complaint ¶¶ 52-63.)

Under these circumstances, there is no "boundary line" between tort and contract for the ELR to protect. (*See* Vincent R. Johnson, *The Boundary-Line Function of the Economic Loss Rule* (2009) 33 Wash. & Lee L. Rev. 523, 571 [explaining how California law permits tort recovery of purely economic losses where defendant's conduct violates tort duty independent of underlying contract].)

And the main policy rationale for the ELR—to preserve parties' ability "to control and adjust the relevant risks through 'private ordering" (*Bily v. Arthur Young & Co.* (1992) 3 Cal.4th 370, 398)—has no application where, as here, the plaintiff's damages were caused by actions outside the scope of any

contractual agreement between the plaintiff and the defendant. (*See Robinson Helicopter, supra*, 24 Cal.4th at 988 [holding that "economic loss rule requires a purchaser to recover in contract for purely economic loss due to disappointed expectations, *unless he can demonstrate harm above and beyond a broken contractual promise.*"] [emphasis added].)[13]

C. The *Restatement of Torts* Should Not Bar Plaintiff's Claim.

The lower court nonetheless relied on the draft *Restatement (Third) of Torts* to find that the ELR bars Sheen's tort claim against Wells. That was error, because this lawsuit is entirely consistent with the purposes of the ELR as described in the *Restatement*.

Again and again, the *Restatement* emphasizes that the main purpose of the ELR is to prevent blurring the boundary line between tort and contract. (*See* Rest.3d Torts, *Liability for Economic Harm* (Tent. Draft No. 1, Apr. 4, 2012) § 3, cmt. (a) [explaining that, in the contractual setting, the ELR stems from a

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[13] As *SoCalGas* makes clear, the *other* principal policy justification for the ELR is to avoid the serious "line drawing problems and potentially overwhelming liability..." that can result from allowing tort recovery of stand-alone economic losses in a tort action between strangers, particularly in the context of an environmental catastrophe. (*SoCalGas*, 5 Cal.5th at 889.) That rationale has no application where, as here, the parties are tethered by some kind of special relationship.

"need to separate matters best left to contract from those properly resolved by the law of tort."].)

As the *Restatement* puts it, the ELR is designed to "protect[] the bargain the parties have made against disruption by a tort suit." (*Id.* cmt. (b).) By barring extra-contractual recovery of economic losses arising from a contractual breach, the ELR "allows parties to make dependable allocations of financial risk without fear that tort law will be used to undo them later." (*Id.*) In the long run, the ELR "prevents the erosion of contract doctrines by the use of tort law to work around them." (*Id.*)

These are all laudable and important goals. But none of them is implicated this case because Sheen's claims do *not* arise out of a negligent breach of contract on Wells' part.

Again, Sheen here is not suing for breach of contract. That is because Wells did not breach its underlying loan agreements with Sheen. Nor does Sheen argue that Wells had an obligation, under those loan agreements, to grant—or even consider—his applications for a loan modification. Sheen's theory, rather, is that once Wells accepted Sheen's applications to modify his loans, it had an *independent duty* to process his application in a non-negligent way and to not mislead him into believing that his home would not be sold.

As a result, Sheen's tort claim does not "disrupt" the bargain Wells and Sheen made when they entered into the original loan agreements. That bargain had nothing to do with Wells' independent duty to process loan modification applications with adequate care, and to refrain from making misleading

statements regarding the status of the applications and of a foreclosure sale while those applications were pending. Allowing Sheen to sue in tort is thus entirely consistent with the *Restatement*'s policy rationale for applying an ELR in the contractual setting.[14]

To be sure, the *Restatement* suggests that the ELR should also bar tort claims for economic loss caused by negligence "in the *negotiation of a contract between the parties.*" (*Restatement* § 3 [emphasis added].) The lower court relied on this aspect of the ELR in rejecting a tort duty of care in this case. (*See* 38 Cal.App.5th at 684.)

But the lower court ignored the fact that Sheen's tort claim *does not arise from contractual negotiations*. Sheen never entered into any negotiations with Wells about whether to modify his loan. Instead, Sheen's claim is based on Wells' misleading conduct in suggesting that the application had been granted and that his home would not be sold at foreclosure when in fact the

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[14] Even if this case did involve a contractual breach (it does not), the *Restatement* recognizes that the ELR *does not foreclose tort claims based on conduct outside the contract's scope.*" (*Id.* cmt. (c) [emphasis added].) The *Restatement* acknowledges that "[c]lose cases can arise when an act of negligence occurs at the fringe of a contract's coverage. The important question is whether allowing the tort claim creates a risk of interference with an allocation of risk made by the parties." *Id.* Here, allowing Sheen to sue in tort would not interfere with any allocation of risk made between him and Wells, because their underlying contract did not address possible future modifications.

opposite was true. That part of the *Restatement* therefore has no bearing on this case.

But even if it did, the *Restatement*'s **rationale** for extending the ELR to contract negotiations—that the law of promissory estoppel or other doctrines of contract law could "provide relief in such cases where necessary" (*Restatement* § 3 at cmt. (e))—does not apply under the facts of this case, which does not include a claim for promissory estoppel.

There's a good reason for that. Under California law, promissory estoppel requires: (1) a promise clear and unambiguous in its terms; (2) foreseeable and reasonable reliance by the party to whom the promise is made; and (3) injury suffered by the party asserting the estoppel as a result of his reliance. (*Jones v. Wachovia Bank* (2014) 230 Cal.App.4th 935, 945.)

These elements are difficult to establish in the mortgage modification context. Thus, for example, in *Daniels,* 246 Cal.App.4th at 1150, a case whose facts closely resemble this case, the Court of Appeal rejected a claim for promissory estoppel because the lender had never made any promises as to the "essential terms of a loan agreement, such as the new lower interest rate." (*Id.* at 1178.) *Daniels* held that "[t]he absence of those essential loan modification terms renders the alleged

promises insufficiently clear and unambiguous to support a promissory estoppel." (*Id.*)[15]

So here, too, the "absence of essential loan modification terms" would likely have defeated any promissory estoppel claim against Wells. Wells' suggestions to Sheen that his loan had been modified and that his house was safe from foreclosure are not sufficiently definite promises to support a promissory estoppel claim, even though they inflicted serious harm on Sheen and his wife. That means that Sheen's *only* avenue of relief lies in tort, rendering the *Restatement*'s suggestion that his remedy could be supplied by "other doctrines of contract law" (§ 3 cmt. (d)) unrealistic at best.[16]

The *Restatement* acknowledges that estoppel might not work as a remedy in the contract negotiation context, but at this point it simply throws up its hands. It states, if other "bodies of law fall short, the appropriate response again is to reform them, not to use the law of tort to supply their deficiencies." (*Id.* § 3 cmt. (d).) Why should that be so? The *Restatement* does not adequately explain why "the appropriate response" to this unjust

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[15] Of course, *Daniels* then went on to hold that the plaintiff could sue in tort over the lender's breach of a duty to act reasonable with respect to loan modifications—exactly what Sheen is asking to do in this case. (*See id.* at 1180.)

[16] As noted above, Sheen could not have brought a claim under HBOR because that statute only applies to first-lien mortgages, and Sheen's loan here was a second-lien mortgage. (Cal. Civ. Code § 2924.18.)

outcome is to "reform" the law of estoppel, rather than "reform" the ELR so the plaintiff has a rightful remedy in tort.

* * *

In short, the lower court's reliance on the *Restatement* to support its conclusion that the ELR bars Sheen's claims was misplaced. The *Restatement* reaffirms that the ELR's dominant purpose is to protect the sanctity of contract and encourage private risk allocation. That rationale has no application where, as here, the plaintiff's injuries do not arise out of any contractual breach.

D. The Lower Court Erred in Relying on Case Law from Other Jurisdictions.

The lower court compounded its errors by relying on a number of cases from other jurisdictions that declined to recognize a tort duty of care in the mortgage context. These cases are readily distinguishable or wrongly decided—or both.

1. Many of the cases cited below involve the negligent performance of a *contractual* duty. (*See Henderson v. Wells Fargo Bank,* N.A. (N.D.Tex. 2013) 974 F.Supp.2d 993 ["[Plaintiff's] negligence claim fails because his only alleged injury is the economic loss to the subject matter of the contract at issue."]; *Wigod v. Wells Fargo Bank, N.A.* (7th Cir. 2012) 673 F.3d 547, 567–568 [applying Illinois law]; *Chung v. JPMorgan Chase Bank, N.A.* (N.D. Ga. 2013) 975 F.Supp.2d 1333, 1344–1346 [applying Georgia law]; *Legore v. OneWest Bank, FSB* (D. Md. 2012) 898 F.Supp.2d 912, 918–919 [applying Maryland law]; *Dooley v. Wells Fargo Bank, Nat. Ass'n* (S.D. Ohio 2013) 941 F.Supp.2d 862, 866–

867 [applying Ohio law]; *Wivell v. Wells Fargo Bank, N.A.* (8th Cir. 2014) 773 F.3d 887, 900 [applying Missouri law]; *Henderson v. Wells Fargo Bank, N.A.* (N.D. Tex. 2013) 974 F.Supp.2d 993, 1010–1012 [applying Texas law]; *Needham v. Fannie Mae* (D. Utah 2012) 854 F.Supp.2d 1145, 1153 [applying Utah law]; *Srok v. Bank of Am.* (E.D.Wis. Nov. 6, 2015) 15-CV-239, 2015 WL 6828078, pp. *7–*8 [applying Wisconsin law]; *Powell v. Ocwen Loan Servicing, LLC* (D.Wyo. Aug. 7, 2014) 14-CV-113, 2014 WL 11498232, pp. *5–*6 [applying Wyoming law].)[17]

Those cases have no bearing here because, as explained above, Sheen is not alleging (and could not allege) that Wells violated any contractual duty in refusing to modify his loan. Instead, he is alleging that Wells violated an entirely distinct, non-contractual duty to exercise due care in the processing of an application to modify a mortgage loan. Because that duty is distinct from any obligations imposed by the underlying loan agreements, it is not barred by the ELR.

2. Other cases go further and hold that the mere existence of a contractual relationship between a lending institution and a borrower bars *any* tort duty relating to negligent loan modification, even where—as here—the lender did not breach any of its underlying loan obligations. (*See, e.g., Prickett v. BAC*

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[17] *Burdick v. Bank of America, N.A.* (S.D.Fla. 2015) 99 F.Supp.3d 1372, 1377–1378, falls in this category, although it involved force-placed insurance, not lending.

Home Loans (N.D.Ala. 2013) 946 F.Supp.2d 1236, 1244–1245 [applying Alabama law]; *Polidori v. Bank of America, N.A.* (E.D. Mich. 2013) 977 F.Supp.2d 754, 763–764 [applying Michigan law]; *Jaffri v. JPMorgan Chase Bank, N.A.* (Ind. Ct. App. 2015) 26 N.E.3d 635, 638; *Schaefer v. Indymac Mortgage Services* (1st Cir. 2013) 731 F.3d 98, 103–107 [applying New Hampshire law].)

These courts reasoned that, because the tort claim would not have arisen "but for" the underlying contract, the plaintiff can *only* sue for contractual breach—even if there was no such breach, in which case the plaintiff simply has no remedy at all. (*E.g., Prickett*, 946 F.Supp.2d at 1244-1245.)

All these cases reflect a rigid approach to the ELR that is fundamentally incompatible with California law. As noted above, this Court has held that the mere existence of a contractual relationship between the parties does *not* automatically bar tort claims for purely economic losses, even where the tort claim would never have arisen "but for" the underlying contractual relationship, so long as the tort claim arises out of a duty independent of the underlying contract. (*E.g., Robinson Helicopter,* 34 Cal.4th at 988.)

California's approach makes good sense. As one learned commenter has noted, a rule that reflexively bars tort claims for economic losses whenever the losses relate to the subject matter of a contract "is obviously much too broad." (Vincent R. Johnson, *The Boundary-Line Function of the Economic Loss Rule*, 66 Wash. & Lee L. Rev. at 575.) Among other things, such a rule "could easily be improperly manipulated" by—for example—

allowing a contracting party like Wells to commit tortious acts against its customers without fear of liability so long those acts relate to the subject matter of an underlying contract. (*Id.* at 575-576; *cf. SoCalGas*, 7 Cal.5th at 409 [considering how "Justice Oliver Wendell Holmes's infamous 'bad man'—that is, a company that, 'cares nothing for an ethical rule' and thus cares 'only for the material consequences' its actions"—might manipulate the ELR].) Just because this type of activity might be protected from tort liability in other jurisdictions does not mean that California should tolerate such an unfair result.

3. A third category involves cases that *admit* the ELR does not bar a tort claim by a borrower against a loan servicer where there is a special relationship between the parties. For example, *Miller v. Bank of New York Mellon* (Colo. Ct. App. 2016) 379 P.3d 342, stated that "[a] special relationship automatically triggers an independent duty of care that supports a tort action even when the parties have entered into a contractual relationship." (*Id.* at 346. *See also Anderson v. ReconTrust Company, N.A.* (Mont. 2017) 407 P.3d 692, 699 [holding that "extraordinary circumstances or interaction between a lender and borrower or applicant may . . . independently give rise to a general or fiduciary duty of care to the borrower or applicant."].)

Some of these courts found no special relationship based on factors more restrictive than *Biakanja*. (*E.g.*, *McNeely v. Wells Fargo Bank, N.A.* (S.D. W.Va. Dec. 10, 2014) 2014 WL 7005598, at *6 ["In the lender-borrower context, a special relationship exists if the loan servicer has 'perform[ed] services not normally

provided' to a borrower."]; *Miller, supra,* 379 P.3d at 346 ("[F]ew special relationships [are] recognized in Colorado."].)

Others applied no test at all, instead stating there was no special relationship without engaging in any analysis. *E.g.*, *Afridi v. Residential Credit Solutions, Inc.* (D. Mass. 2016) 189 F.Supp.3d 193, 199 (invoking Massachusetts law); *Medici v. JP Morgan Chase Bank, N.A.* (D. Or. Jan. 15, 2014, 3:11–CV–00959) 2014 WL 199232, at *3–*4 (invoking Oregon law).

Others still chastised the plaintiffs for pleading insufficient facts to even assess whether there was a special relationship. (*E.g.*, *McGee v. CitiMortgage* (D.Nev. May 31, 2013) 2:12-CV-2025, 2013 WL 2405301, p. *6 [applying Nevada law] ["[P]laintiff argues that [the loan servicer] and/or [the loan trustee] should be held to a higher standard a care, a fiduciary relationship. Plaintiff cites no cases in support of this argument."]; *Patetta v. Wells Fargo Bank, N.A.* (D.N.J. Sep. 10, 2009) 3:09–CV–2848, 2009 WL 2905450, at *8 ["[B]ald assertions that a duty was owed will not carry the day. Plaintiffs do not identify any exceptional facts, or case law for that matter, that would support . . . impos[ing] a fiduciary duty upon a lender."].)

Under the *Biakanja* test in California, there *is* a special relationship that gives rise to a duty between a loan servicer and a borrower. (*See supra* Part I(B).) By recognizing that the ELR does not bar a tort claim where there is a special relationship, and then looking to the relevant state law test to determine whether there is a special relationship, this third category of cases actually reaffirms that the ELR is no bar here.

CONCLUSION

For the foregoing reasons, the lower court's decision should be reversed.

Respectfully submitted,

PUBLIC JUSTICE, P.C.

DATED: January 27, 2020 By: _____

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DATED: January 27, 2020 By: /s/ Noah Grynberg

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CERTIFICATE OF WORD COUNT

Pursuant to Rule 8.204(c) of the California Rules of Court, I hereby certify that this brief contains 12,743 words, including footnotes and excluding the caption page, table of contents, table of authorities, signature blocks, and certificates. In making this certification, I have relied on the word count of the computer program used to prepare the brief.

Dated this 27th day of January, 2020.

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CERTIFICATE OF INTERESTED ENTITIES OR PERSONS

Counsel for Plaintiff and Appellant lists the following entities that may qualify as interested entities or persons pursuant to California Rules of Court, Rule 8.208(e)(2):

1. FCI Lender Services, Inc.
2. Mirabella Investments Group, LLC

I certify and declare under the laws of the State of California that the foregoing is true and correct.

Dated this 27th day of January, 2020.

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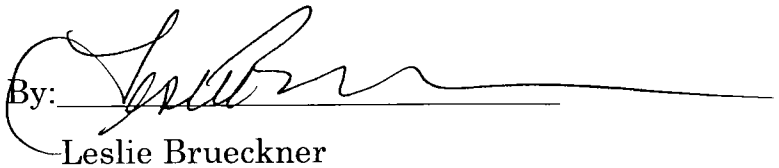
By: 

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PROOF OF SERVICE

I, the undersigned, declare that I am over the age of 18 and am not a party to this action. I am employed in the City Oakland, California; my business address is 475 14th St., Suite 610, Oakland, CA 94612.

On the date below, I served a copy of the foregoing document entitled:

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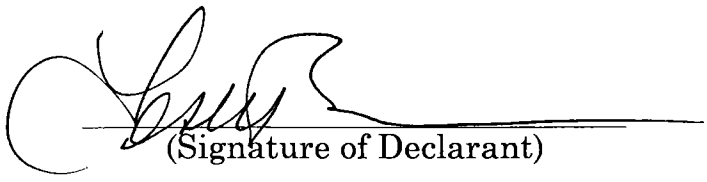

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