Wednesday, September 14, 2011

Update on FDIC v. LPS (LSI Appraisal): LSI Argues that AMCs Owed No Legal Duties of Care to their Clients and Appraisal Users -- FDIC Argues that Appraisers Are the Legal Agents of AMCs

By Peter C

As was first predicted on this blog here, the FDIC, as receiver for failed lender Washington Mutual, sued appraisal management company LSI Appraisal and its corporate parent Lender Processing Services for breach of contract and gross negligence on May 9, 2011. The lawsuit relates to hundreds of thousands of appraisals managed by LSI for WaMU between June 2006 and May 2008. The FDIC alleges that 220 of the reports it has analyzed were faulty and seeks more than $150 million in damages based only on those appraisals. (By the way, that amount of damages alleged by the FDIC in just this one case is more than all appraisers and AMCs collectively pay for their E&O insurance each year. Appraisers and AMCs simply cannot afford to pay for, or insure, the FDIC's aggressive position that appraisals equate to guaranties of value and serve as cheap mortgage insurance.)

On July 22, LSI filed a motion to dismiss. In that motion, LSI argues that the FDIC's gross negligence claim should be dismissed based on the economic loss rule. While application of the rule varies from state to state, the economic loss rule is a judicially created doctrine holding that parties cannot sue in tort (*e.g.*, cannot sue based on negligence) for economic losses resulting from the breach of contractual duties. Based on the rule, LSI argues that the FDIC's negligence claim is really just a restatement of its breach of contract claim because the only duties that LSI owed WaMu were duties established in the parties' lengthy written appraisal outsourcing agreement.

LSI argues that, apart from what it agreed to in the contract, it owed no other legal duties to WaMu -- in other words, LSI contends that appraisal management companies (AMCs) owe no legal duties of care to their clients or appraisal users. LSI does acknowledge in a footnote that the Dodd-Frank legislation and some state AMC laws "arguably may now create a duty on the part of AMCs," but points out that these laws did not exist and do not apply to appraisals managed by AMCs during the mortgage boom years. The argument basically is that since LSI is not an appraiser, it does not owe any of the duties that an appraiser might owe to his or her client or intended users. Here is the thrust of LSI's argument on this point from its motion to dismiss:

> As for the other "noncontractual duty" exception of a "breach [of] a duty imposed by some types of 'special' or 'confidential' relationships," that exception also does not apply. The FDIC has alleged a "common law duty to WaMu," and alleged that "Without regard to the LSI Agreement, LSI owed a duty of care to WaMu to exercise reasonable care in the course of providing appraisal services to WaMu." Compl. ¶ 26.[13] Nevertheless, the reality is that the only duties LSI owed WaMu were created in and arose solely out of the Agreement.
>
> In an effort to manufacture a duty outside the Agreement, the FDIC cites USPAP and some federal and state laws and regulations, and language from the Freddie Mac Single-Family Seller/Servicer Guide (Compl. ¶¶ 18-20), apparently suggesting that those provisions somehow create a duty of care that LSI allegedly owed to WaMu. However, the FDIC fails to make clear that those authorities and guidelines by their terms apply only to appraisers, not to appraisal management companies like LSI that did not, and does not, perform appraisals.[14]

Excerpt from LSI's Motion to Dismiss

This the most frequent defense argument made by AMCs when they are sued about faulty appraisals by lenders or, more commonly, borrowers. And, in the FDIC's opposition to the motion as well as in its original complaint, the FDIC really does a very poor job of countering LSI's predictable position -- but I will not dabble here in suggesting how the FDIC

could be more persuasive or otherwise ever assist the FDIC with appraisal liability arguments because, whether it comes to suing an AMC or suing an individual appraiser, the FDIC's course of action in its appraisal-related litigation is extremely harmful to all appraisers and their profession.

Against the FDIC's breach of contract claim -- *i.e.*, that LSI breached the various representations and warranties it made in its written appraisal outsourcing agreement with WaMu -- LSI argues the claim should be dismissed because it is subject to arbitration under the terms of the contract. The gross negligence claim, however, is likely of far greater significance to LSI. Why? The reason is that LSI's contract with WaMu contains several provisions imposing a limitation or cap on the damages that might be owed by LSI. One of those caps potentially could limit LSI's financial exposure to the FDIC to a total of $1 million. Here is that cap from LSI's contract with WaMu:

B. WM AGREES THAT IN NO EVENT SHALL COMPANY'S LIABILITY FOR WM'S DAMAGES ARISING AS A RESULT OF BREACH OF THE APPRAISAL WARRANTY EXCEED THE GREATER OF (I) THE TOTAL AMOUNT PAID BY WM TO COMPANY UNDER THE AGREEMENT DURING THE TWELVE (12) MONTHS PRECEDING THE CLAIM (LESS ANY WARRANTY CLAIMS ALREADY PAID BY COMPANY DURING SUCH PERIOD); OR (II) $1,000,000.00. THIS LIMIT IS CUMULATIVE AND ALL PAYMENTS UNDER THE AGREEMENT WILL BE AGGREGATED TO CALCULATE SATISFACTION OF THE LIMIT. THE EXISTENCE OF MULTIPLE CLAIMS WILL NOT ENLARGE THE LIMIT.

Excerpt from Ex. B (Appraisal Warranty) to LSI's Appraisal Outsourcing Agreement with WaMu

One of the legal hurdles for LSI in successfully applying that limitation of liability is that New York law applies to the contract by its terms and under New York law, a limitation of liability will not cap LSI's liability for gross negligence. If the gross negligence claim is not thrown out, LSI's potential financial exposure could be the full amount of the damages to be proven by the FDIC -- which the FDIC alleges exceed $150,000,000 for just 220 "grossly negligent" appraisals.

As far as my opinion as a lawyer, I will briefly offer that I believe LSI's arguments are sound and that I believe Judge Carter may likely give them some weight. Judge Carter has dismissed similar types of tort claims by the FDIC against other mortgage service providers based on the economic loss rule (but not specifically against AMCs).

What is most interesting in all of this and what poses a potential "nuclear" threat to AMCs is a throw-away argument made by the FDIC in a last-ditch response -- in a sur-reply filed on September 6 after completion of the regular motion briefing. In that sur-reply, the FDIC argues that when it comes to the gross negligence claim, it doesn't matter that LSI was not the appraiser and does not matter that AMCs might not have owed any legal duties of care to clients or intended users. ***According to the FDIC, the reason it does not matter is that appraisers purportedly are the legal agents of the AMC*** -- that means that LSI, again according to the FDIC, is legally liable for its fee panel appraisers' errors. This is the FDIC's argument on this point in its sur-reply:

Third, Defendants ignore the fact that the individual licensed appraisers who actually performed the appraisal services for WaMu were at all times acting as the agents of LSI. LSI was "responsible and liable" for the appraisal services performed by the appraisers both as a matter of principal/agency law[2] and pursuant to Section 4.4 of the Agreement. Agmt. at 8. As alleged in the Complaint, "LSI also promised to ensure the qualifications of its appraisers and to stand behind its appraisers. . . . Ensuring such qualifications should have been equally important to LSI because LSI stood behind those appraisers, as it stood behind any subcontractor it hired to perform Services under the LSI Agreement . . . ." Compl. ¶ 24. That LSI itself is not a licensed appraiser is irrelevant. Obviously, only individuals can obtain professional appraiser licenses, not entities like LSI. *See, e.g.*, Cal. Code Reg. tit. 10, § 3500(b)(1), (3) (defining "applicant" as "a natural person and "appraiser" as "an individual"). The services that LSI offered for sale could, of course, be provided only by licensed appraisers – either an employee of LSI or an agent of LSI acting at the direction of LSI.

Excerpt from FDIC's Opposition to LSI's Motion to Dismiss

This argument upends the normal understanding of the legal relationship between AMCs and fee panel appraisers. Under this argument, AMCs would essentially be liable for all fee panel appraiser negligence in connection with claims by all types of parties such as lenders and borrowers. If Judge Carter rules in favor of the FDIC on its agency argument in a reasoned opinion, his ruling might open a new era for liability claims against AMCs. It would also potentially open the door for holders of mortgage backed securities to name some of the large AMCs as defendants in the pending MBS litigation cases which allege billions of dollars of mortgage losses. But . . . I don't think Judge Carter will likely base his ruling on this point -- indeed, the Court does not even have to consider it because it was asserted by the FDIC in a late-filed paper.

Judge Carter has taken LSI's motion to dismiss under submission without oral argument.